The Power of Automated Tax-Aware Investing

By George Michaels – CEO and Founder, G2 FinTech

What do retail investors have that institutional investors want? Ready access to sophisticated software designed to help them increase their investment earnings. Thanks to the rise of the so-called "robo-advisors," 35+ firms with $19+ billion in AUM, more and more mass affluent investors (with less than $1 million in capital) now have the power of tax-aware investing (TAI) technology and the promise of improved after-tax returns – all at their fingertips.

To stay competitive (and to cash in on the projections that robo-advisors will run $2 trillion by 2020, according to A.T. Kearney consulting firm) a growing number of robo-advisor firms are offering clients more than low-cost, digital-based investment services. They also offer automated, continuous tax loss harvesting (TLH), a tactic for improved tax efficiency. TLH involves selling securities at a loss to offset a capital gains tax liability. A popular way to reduce an investor's tax liabilities, TLH typically limits the recognition of higher short-term capital gains.

Taxes can erode returns for any investor — not just trend-setting Millennials who make up the lion's share of robo-advisor clients — but institutional investors as well. Given this reality, institutional investors who have been saddled with a huge tax bill due to unexpected disallowed losses, or worse yet subject to tax liabilities on non-existent gains, may wonder how they can benefit from automated, continuous TLH and TAI technology. Like their retail brethren, they too want to optimize their investment returns.

TAI technology at work

An investor's tax bill is determined by the sections of the tax code that govern taxable gains and losses. The IRS recognizes certain investment losses based on whether portfolio holdings meet criteria such as risk exposure (hedging) and holding period requirements, and taxpayers must pay either short-term (higher, 39.6%) or long-term (lower, 20%) capital gains rates. Using this and other criteria, TAI technology continuously scans and analyzes trading activity throughout the year and reports on the tax implications (which losses will be disallowed and which tax rate will apply) of that trading activity.

Automated TLH is getting more attention these days no doubt because established, notable firms like Charles Schwab and BlackRock have joined the robo ranks. However, the technology (tax analyses of securities transactions, or "TAST") behind TAI software is not new. Historically, firms have performed TAST, which identifies and treats taxable events and adjustments — e.g. sales, covering short positions, wash sales and qualified dividends — as an end-of-year, April 15th tax compliance task to generate IRS-required forms.

The same technology that automates TAST can be applied to investment portfolios throughout the year and generate proactive TAI reports (tax analyses of potential trades on current holdings) and predictive TAI reports (tax analyses on possible new acquisitions). To boost a client's after-tax wealth, investment managers can use these reports to adjust trading activity during the year before the tax impact is indelible.

Proactive TAI Reports

A seasoned TAI tactic, TLH has traditionally been available to the very wealthy, done by hand and deployed once a year. Now automated, continuous TLH is available. To help lower her clients' taxes, an investment manager can gain insight from the TLH analysis that produces several reports of clients' holdings. A TLH analysis identifies short-term losses that will become long-term within a defined period of time, and provides a list of positions to sell in order to recognize these short-term losses and offset short-term gains at the higher rate.

When harvesting tax losses, it is important to use tax-adjusted data. If investment managers just looked at the unadjusted book data, certain shares will have an unrecognized gain, and fall short of qualifying as long-term. Since TLH deals with losses, it is also important to minimize the negative impact of the wash sale rule, which disallows losses when you sell a security at a loss and buy a replacement security within 30 days before or after the sale. Certain shares may be the replacement security for a wash sale. As a result, both the basis and the holding period of these shares are adjusted. Without taking this into account, the opportunity to lock in a short-term loss might be lost.

What if? Predictive TAI Reports

Predictive TAI reports indicate how recognized gains will be impacted if certain securities transactions are executed. For instance, a predictive tax alert can warn of possible disallowed losses and a higher tax bill because, a series of trades, if executed, will trigger the wash sale rule.

Here's an example of how predictive tax alerts can help investment managers maximize after-tax returns. On June 1, 2015, a manager buys some Apple stock for $110 per share. Two months later, she buys more Apple stock at $100 per share. The price of Apple drops to $80 per share on August 2nd.

In the absence of an automated tax-sensitive investing strategy, a typical plan of action would be to cut the position size and sell some of the Apple shares. Normally it would make sense to sell the highest cost shares to harvest the largest loss possible. However, with the help of a predictive TAI report, the investment manager can learn that if she sells the shares bought for $110/share on August 3rd, those losses would not be recognized because of the wash sale rule. To avoid these disallowed losses and instead recognize a full $20/share loss, she should sell the $100 shares, which have no replacement trade within the wash sale window.

Conclusion

Thanks to the robo-advisor phenomenon and associated disruptive technology sweeping the wealth management space, the power of automated TAI is now, more than ever before, front and center. Automated TAI can help retail and institutional investors alike lower their tax liabilities. Without a tax-sensitive investment strategy and the rules-based software to implement it, ugly and unwelcome surprises can frequently occur at year-end. Investors can be saddled with tax liabilities on gains that never occurred. Worse yet, investors can be subject to the doomsday scenario of economic losses but taxable gains. These scenarios are preventable with continuous tax analysis, and the amount of tax alpha that can be harvested increases with continuous analyses throughout the tax year.

About the author

George Michaels is the CEO and Founder of G2 FinTech. An authority on tax analysis of securities transactions, Mr. Michaels shares his subject matter expertise at industry conferences, and his commentary regularly appears in financial trade and major media publications.