Tax aware investing technology

By **George Michaels**, founder, **G2 FinTech**

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Taxes can erode investment returns. That's why as the 2015 calendar year comes to a close, many investors have been busy with year-end tax planning, which often means harvesting losses – selling securities at a loss to offset taxes owed on investment gains. This traditional, annual approach to tax-loss harvesting (TLH) and tax management is being upended by technology. Investors can now use computer algorithms to avoid the year-end crunch and perform TLH as well as other tax-aware investing (TAI) techniques all year long to optimize after-tax returns.

TAI is a perfect example of how technology revolutionizes business processes. TAI technology has its roots in the tax accounting of securities transactions (TAST) or compliance software used to generate K-1s and other yearly IRS-required forms. Similar to TAST, TAI was performed by hand using spreadsheets and once a year because this labor-intensive approach precluded doing it more often.

Now TAI rules-based technology analyzes trading activity throughout the year based on the sections of the US tax code that govern taxable gains and losses. To determine if short-term (39.6%) or long-term (20%) capital gains rates apply, TAI software scans portfolios for criteria such as risk exposure and holding period requirements.

TAI software informs investors of the tax implications (dividends will not qualify for preferential tax treatment, losses will be disallowed due to the wash sale rule) of their trading activity. It generates proactive TAI reports (tax analyses of potential trades on current holdings) and predictive TAI reports (tax analyses on possible new acquisitions) daily, weekly, monthly, or quarterly. To boost 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

To help lower 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 do two things. First, tax-adjusted data must be used. 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. Second, 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 report can warn of possible disallowed losses and a higher tax bill because, a series of trades, if executed, will trigger the wash sale rule.

> TAI IS A PERFECT EXAMPLE OF HOW TECHNOLOGY REVOLUTIONIZES BUSINESS PROCESSES

Here's an example: On June 1, 2015, a manager buys some Apple stock for $110/share. Two months later, she buys more Apple stock at $100/share. The price of Apple drops to $80/share on August 2.

Without TAI software, 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, a predictive TAI report can inform the investment manager that if she sells the shares bought for $110/share on August 3, 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.

The evolution of tax-aware investing technology makes year-round tax planning possible. It can help investors avoid the ugly surprises that can frequently occur at year-end: tax liabilities because of gains that never occurred or a fat tax bill due to unexpected disallowed losses. ■