The Road to Tax Alpha

"Danger, Will Robinson! Danger!" To alert him of impending peril, this is what the Robot tells young Will in the 1960s TV show *Lost in Space*. Similar to Will's protector, today automated alerts warn of potential mistakes or point out something overlooked . . . sans Robot's oscillating arms of course. We embrace and rely on alerts of all types. Google calendar alerts remind us of meetings lest we miss them. To stay healthy, Fitbit devices remind us when our activity level wanes. Daily alerts on positions and portfolios help investment managers to monitor the economic health of their investments.

Tax-related alerts are increasingly helping investment managers harvest tax alpha and deliver optimized after-tax returns. These alerts, whether **proactive** or **predictive**, warn investment managers about tax implications of their trading activity and help keep them out of the danger zone: revealing unexpected disallowed losses or even tax liabilities on non-existent gains.

Historically, tax analysis of securities transactions (TAST) has been performed as an end-of-year, April 15th tax compliance task to generate IRS-required forms. TAST identifies and treats taxable events and adjustments, e.g. sales, covering short positions, wash sales and qualified dividends; these sections of the tax code determine taxable gain and loss – which losses can be recognized and whether short-term (higher) or long-term (lower) capital gains rates must be paid. The very same technology that automates TAST can also alert investment managers to the tax health of their portfolios all year long and give them the choice – monthly, weekly or daily to adjust trading activity and optimize after-tax results.

Investment managers of every ilk stand to benefit from tax alerts. Alternative investment managers in particular have the most to gain from this practice. Their use of some of the most complex securities, including options and other derivatives and their high trading volumes, requires complex tax analyses. Regardless of investment style, let's see how tax alerts can help managers deliver improved results. First let's explore proactive tax alerts.

For additional insight and a deeper dive into tax-aware investing, visit the "Tax Alpha and the When Factor" blog series.

Proactive Tax Alerts

Imagine the following scenario. Investment manager Jane Dough's client, John Liftoffer plans to retire soon and as a result has a low risk profile. Normally Ms. Dough would switch Mr. Liftoffer's investments to mostly more stable securities like bonds vs. more volatile stocks. However, given low yields, Jane Dough eschews bonds and instead buys high-quality dividend-producing stocks to produce sufficient after-tax cash flow for her client.

Jane Dough's trading activity:

- She buys shares of XOM.
- Since she's concerned that the value of XOM might decline, she buys a put option to hedge her position.
- XOM announces a dividend with an ex-date of December 15th.

Trading Activity / No Tax Analysis: Client John Liftoffer			
Investment	Ex-Date	Shares	Dividend Amount
XOM	12/15/2014	100	50

Proactive tax alert report: A tax analysis (run date: November 30th) of Mr. Liftoffer's portfolio warns Jane Dough that, because of the hedge, the XOM dividend will not be a qualified dividend, with preferential tax treatment.

Proactive Tax Analysis (run date: November 30th) / Client John Liftoffer						
Investment	Ex-Date	Shares	Eligible Shares	Dividend Amount	Eligible Amount	Ineligibility Reason
XOM	12/15/2014	100	0	50	0	Hedged position

The lower tax rate is more important to John Liftoffer; as a result Ms. Dough wants this dividend to qualify for preferential tax treatment. To accomplish this, before the ex-date of the dividend Ms. Dough closes out the put option and stays unhedged for the necessary 61 days.

But what about alerts on trades that managers are thinking about executing?

Predictive Tax Alerts

To comply with investor's wishes or manage risk, investment managers regularly rely on predictive alerts. These alerts indicate what will happen if certain trades are executed. Predictive tax alerts can also help managers meet investor needs and generate tax alpha. These alerts 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 harvest tax alpha. Imagine the following scenario for Sarah Smith, Investment Manager.

Sarah Smith's existing trades:

- On June 1st she bought some AAPL for $110 per share.
- On August 1st she bought more APPL shares for $100 per share.

Trading Activity / No Tax Analysis					
Lot Date	Investment	Quantity	Event Type	Total Cost	UGL
6/1/2014	AAPL	100	Buy	11000	-3000
8/1/2014	AAPL	100	Buy	10000	-2000

Market activity:
On August 2nd AAPL declines to $80 per share.

Sarah Smith's desired plan of action:
Ms. Smith wants to cut the position size and sell some of the AAPL shares. She would normally sell the highest cost shares to harvest the largest loss possible.

Predictive tax alert report: If Ms. Smith were to sell the shares bought for $110/share on August 3rd, those losses would not be recognized because of the *wash sale* rule.

Predictive Tax Analysis Report (run date: August 2nd)						
Lot Date	Investment	Quantity	Event Type	Total Cost	UGL	WS Eligible
6/1/2014	AAPL	100	Buy	11000	-3000	YES*
8/1/2014	AAPL	100	Buy	10000	-2000	

* *Loss will be disallowed if position is closed*

To avoid these disallowed losses and instead recognize a full $20/share loss, Ms. Smith should sell the $100 shares, which have no replacement trade within the wash sale window.

Conclusion

The heightened tax-awareness afforded by tax alerts enriches the investment decision making process, and elevates tax processing from solely an accounting function, to one that can also contribute alpha. Ugly and unwelcome surprises frequently occur at year-end, saddling investors with tax liabilities on gains that never occurred. Worse yet is the doomsday scenario of a manager reporting economic losses but taxable gains. These scenarios are preventable with frequent tax analysis, and the amount of tax alpha that can be harvested increases with more frequent analyses throughout the tax year.

For additional insight and a deeper dive into tax-aware investing, visit the "Tax Alpha and the When Factor" blog series from G2 FinTech.

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