Watch out for hidden tax traps

A quick guide to investment tax liabilities

A key component of an investment strategy is asset allocation. Most clients in or near retirement should consider maintaining some equity exposure to help minimize the effects of inflation, while also maintaining diversification to help reduce the impact of potential market downturns.

Part of a diversified investment strategy requires yearly rebalancing. When financial professionals rebalance investment portfolios in nonqualified accounts, however, they may create taxable events for their clients, who get caught in what I call "hidden tax traps." Potential capital gains exposure (PCGE) and a mutual fund's turnover ratio are two metrics that give investors an idea of potential taxes on their investments.

Financial professionals selling mutual funds should be aware of potential tax liabilities in nonqualified accounts. Portfolio managers invest for performance and returns, often buying and selling assets, which creates taxable gains that are distributed to clients. Unfortunately, the duration or the amount of these distributions could potentially result in unwanted and unnecessary tax liabilities.

Keep an eye on potential capital gains exposure

When money managers sell long-term holdings, they may also unleash a hidden tax trap—embedded gains. Embedded capital gains are unrealized gains in a mutual fund that are eventually passed to investors when the securities are sold. The net effect to clients is they may receive these taxable distributions on gains they did not participate in or realize.

Morningstar calculates PCGE on a yearly basis to help determine the potential tax consequences of owning mutual funds. A positive PCGE means a fund's investments have increased in value. For example, if a fund had $1,000 and its holdings gained $250 (end value of $1,250), the PCGE would be 20% ($250/$1,250). A fund must distribute any realized gains to shareholders, and investors must pay the corresponding taxes. A high PCGE can indicate the potential for capital gains distributions.

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Check a mutual fund's turnover ratio

Turnover ratio is an indicator of the potential for taxable short-term gains. It is the percentage of a mutual fund's investments that have been sold and replaced within a year. For example, a mutual fund holding 100 stocks that sold 70 stocks during the year has a turnover ratio of 70%.

Actively managed funds typically have higher turnover ratios and potentially larger tax liability in nonqualified accounts. The higher the turnover ratio, the higher the potential for taxable short-term gains, which are taxed at a person's ordinary income tax rate. Turnover ratio within a qualified account or a tax-deferred annuity does not directly impact a client's tax liability, as it is "sheltered" within the account.

Be mindful of the net investment income tax

Investors with large capital gains and dividend distributions may also be exposed to the net investment income tax (NIIT). This is a 3.8% tax on the lesser of net investment income or the amount by which modified adjusted gross income is above $200,000 for individuals and heads of households, and $250,000 for couples filing jointly.

Conclusion

In retirement, investors must minimize taxes to maximize assets. Financial professionals creating a thorough income distribution plan should consider potential tax liabilities associated with their client's underlying investment portfolio. Creating a proper balance of tax-efficient assets could help clients generate the necessary income for life.

About Jeng Chiu, JD, CFP®

Jeng Chiu is a vice president for Delaware Life National Sales Consulting (NSC). He has worked with financial professionals, CPAs, and legal advisors for more than 20 years, leading hundreds of client seminars, continuing education courses, and breakout sessions at regional and national conferences.

About National Sales Consulting

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