WHITE OAKS
WEALTH ADVISORS, INC.

White Paper

Written by

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Tax Efficiency: The White Oaks Perspective

In 2004, prior to the last Presidential election, I wrote a paper entitled *"Pay Me Later or Pay Me Now"* that dealt with whether or not it was prudent to defer taxes. The political climate has changed since then and much is being made now of "tax efficiency." Here is an updated re-examination of the hypothesis that tax deferral is always desirable for investors

In 2004 we analyzed whether or not it made sense to defer income with lower income and capital gains tax rates. We determined that deferral DID NOT make sense when the favorable rates expired, as the tax rate would be higher when the funds were withdrawn than during the deferral period.

Three years ago the most favorable rates were to expire at the end of 2008 with capital gains rising from 15% to 20% (33% increase) and the top ordinary income rate from 35% to 39.6% (13.1% increase). Interim legislation has delayed the sunset of the current rates until December 31, 2010.

The popular financial press has published many articles touting the value of tax efficiency with regards to investing non-retirement plan assets. The notion is put forth that "tax efficiency" is good because you pay less taxes and therefore "may" have a better after tax return. In this paper we will

- reexamine the hypothesis that tax deferral is desirable for investors;
- calculate the extra return required if an investment alternative recognizes gains more frequently; and
- determine to what extent investors should be concerned about tax efficiency in this environment.

There are often several assumptions to go along with the tax deferral hypothesis. The first is that investors don't like to pay taxes! It is a drain on their investment capital and reduces their ability to affect specific outcomes due to this extraction of capital. Second, investors have been taught over the years that deferring taxes is beneficial. They are emotionally conditioned to avoid taxes and believe that avoiding taxes should always be done. Third is the assumption that the tax climate has been in flux constantly and it will continue to be so.

It is easy to confuse your total tax bill with the portion the investment portfolio generated. Often we have clients who relay the message from their tax preparer that their taxes are too high because of their investment portfolio. Total taxes can be skewed by a number of events including bonuses, stock option exercises, deduction phase outs and withholding numbers.

We also recognize that as investors become more and more successful, the dollar amount of gains can wildly exceed the amount of income or portfolio size that they had hoped to achieve someday. It's also easy to assume your gains will be stable from year to year. This will likely be true if your portfolio value is stable as well. (Most clients don't like that idea however!) Ideally, if your portfolio goes up every year, your tax bill will also go higher, as your investment account is worth more.

Tax rates in fact have been very volatile since the income tax was first instituted in 1913.

The following hyperlink goes to a table that table shows some very interesting data. http://www.ctj.org/pdf/regcg.pdf

Tax rates have indeed been all over the universe. We believe it is important to note that the last time the Capital Gains tax has been this low is 1933! Other information on the history of the income tax can be found at http://www.infoplease.com/ipa/A0005921.html

Let's see how the numbers work out. We can assume that the common example for tax efficient investment vehicles often are index funds and Exchange Traded Funds (ETFs). In our first example the tax rates are stable (see previous hyperlink), the investment vehicle is actively managed and distributes half of its gains as realized long-term capital gains, and the competing vehicle is a passive index fund. Let's also assume that the investment vehicle is not changed during the holding period and that the investor does not use the funds until the end. In the actively managed fund, assume a 9% return of which half is recognized as gain each year, taxes are subtracted from the portfolio, and the basis increases due to taxes being paid. The passive index fund will have no realized distributions. Index funds do in fact recognize gains when stocks in the index are dropped from the index, but for simplicity's sake we will assume no distributions. Further, assume a $1,000,000 investment in a taxable account for an investor in the maximum tax bracket and that the tax rates in effect will proceed as anticipated with an increase in LTCG from 15% to 20% in 2011.

Table I

Year	Tax	Aft Tax Bal	New Basis	Active Spendable	Inv at 9%	Unrealized Gains	Passive Spendable
2007	$9,000	$1,081,000.00	$1,045,000	$1,073,800.00	$1,090,000	$90,000	$1,072,000
2008	$9,729	$1,168,561.00	$1,093,645	$1,153,577.80	$1,188,100	$188,100	$1,150,480
2009	$10,517	$1,263,214.44	$1,146,230	$1,239,817.60	$1,295,029	$295,029	$1,236,023
2010	$11,369	$1,365,534.81	$1,203,075	$1,333,042.83	$1,411,582	$411,582	$1,329,265
2011	$15,977	$1,472,456.19	$1,264,524	$1,418,393.81	$1,538,624	$538,624	$1,398,582
2012	$17,228	$1,587,749.51	$1,330,784	$1,520,938.60	$1,677,100	$677,100	$1,501,054
2013	$18,577	$1,712,070.29	$1,402,233	$1,631,512.65	$1,828,039	$828,039	$1,612,749
2014	$20,031	$1,846,125.40	$1,479,276	$1,750,744.65	$1,992,563	$992,563	$1,734,496
2015	$21,600	$1,990,677.01	$1,562,352	$1,879,312.52	$2,171,893	$1,171,893	$1,867,201
2016	$23,291	$2,146,547.02	$1,651,932	$2,017,947.25	$2,367,364	$1,367,364	$2,011,849
2017	$25,115	$2,314,621.66	$1,748,527	$2,167,437.07	$2,580,426	$1,580,426	$2,169,516
2018	$27,081	$2,495,856.53	$1,852,685	$2,328,631.95	$2,812,665	$1,812,665	$2,341,372
2019	$29,202	$2,691,282.10	$1,964,999	$2,502,448.40	$3,065,805	$2,065,805	$2,528,695
2020	$31,488	$2,902,009.49	$2,086,106	$2,689,874.66	$3,341,727	$2,341,727	$2,732,878
2021	$33,954	$3,129,236.83	$2,216,697	$2,891,976.41	$3,642,482	$2,642,482	$2,955,437
2022	$36,612	$3,374,256.07	$2,357,512	$3,109,902.72	$3,970,306	$2,970,306	$3,198,026
2023	$39,479	$3,638,460.32	$2,509,354	$3,344,892.66	$4,327,633	$3,327,633	$3,462,449

Table II

			Return Diff of .5%								
											Net Withdrawal Val
	Inv Bal	Value @ 9%	Taxable Gai	Tax	Aft Tax Bal	New Basis	Liquid		Inv at 9%	Unrealized Gai	Liquidation
2007	$1,000,000	$1,095,000.00	$47,500	$9,500	$1,085,500.00	$1,047,500	$1,077,900.00	$1,000,000	$1,090,000	$90,000	$1,072,000
2008	$1,085,500.00	$1,188,622.50	$51,561	$10,312	$1,178,310.25	$1,099,061	$1,162,460.45	$1,090,000	$1,188,100	$188,100	$1,150,480
2009	$1,178,310.25	$1,290,249.72	$55,970	$11,194	$1,279,055.78	$1,155,031	$1,254,250.82	$1,188,100	$1,295,029	$295,029	$1,236,023
2010	$1,279,055.78	$1,400,566.08	$60,755	$12,151	$1,388,415.05	$1,215,786	$1,353,889.26	$1,295,029	$1,411,582	$411,582	$1,329,265
2011	$1,388,415.05	$1,520,314.47	$65,950	$17,147	$1,503,167.55	$1,281,736	$1,458,881.21	$1,411,582	$1,538,624	$538,624	$1,430,899
2012	$1,503,167.55	$1,645,968.47	$71,400	$18,564	$1,627,404.35	$1,353,136	$1,572,550.74	$1,538,624	$1,677,100	$677,100	$1,541,680
2013	$1,627,404.35	$1,782,007.76	$77,302	$20,098	$1,761,909.32	$1,430,438	$1,695,615.06	$1,677,100	$1,828,039	$828,039	$1,662,431
2014	$1,761,909.32	$1,929,290.70	$83,691	$21,760	$1,907,531.12	$1,514,129	$1,828,850.64	$1,828,039	$1,992,563	$992,563	$1,794,050
2015	$1,907,531.12	$2,088,746.58	$90,608	$23,558	$2,065,188.57	$1,604,736	$1,973,098.14	$1,992,563	$2,171,893	$1,171,893	$1,937,515
2016	$2,065,188.57	$2,261,381.48	$98,096	$25,505	$2,235,876.40	$1,702,833	$2,129,267.70	$2,171,893	$2,367,364	$1,367,364	$2,093,891
2017	$2,235,876.40	$2,448,284.66	$106,204	$27,613	$2,420,671.59	$1,809,037	$2,298,344.67	$2,367,364	$2,580,426	$1,580,426	$2,264,341
2018	$2,420,671.59	$2,650,635.39	$114,982	$29,895	$2,620,740.09	$1,924,019	$2,481,395.86	$2,580,426	$2,812,665	$1,812,665	$2,450,132
2019	$2,620,740.09	$2,869,710.40	$124,485	$32,366	$2,837,344.26	$2,048,504	$2,679,576.23	$2,812,665	$3,065,805	$2,065,805	$2,652,644
2020	$2,837,344.26	$3,106,891.97	$134,774	$35,041	$3,071,850.77	$2,183,278	$2,894,136.20	$3,065,805	$3,341,727	$2,341,727	$2,873,382
2021	$3,071,850.77	$3,363,676.59	$145,913	$37,937	$3,325,739.23	$2,329,191	$3,126,429.55	$3,341,727	$3,642,482	$2,642,482	$3,113,986
2022	$3,325,739.23	$3,641,684.46	$157,973	$41,073	$3,600,611.58	$2,487,163	$3,377,921.96	$3,642,482	$3,970,306	$2,970,306	$3,376,245
2023	$3,600,611.58	$3,942,669.68	$171,029	$44,468	$3,898,202.13	$2,658,193	$3,650,200.20	$3,970,306	$4,327,633	$3,327,633	$3,662,107

In the illustration on the previous page there was $117,557 of difference between the total tax avoidance strategy and the one that recognized some gains along the way. This, of course, does not take into account the difference if the actively managed account did in fact earn more. What is the amount that is necessary to make the difference worthwhile? Let's take a look and see. Using a 0.5 percent difference, the results are in the table above.

As you can see, the difference of only one-half of one percent a year in returns achieves the same net spendable dollars in the long term and actually achieves better results in the short term due to the scheduled increase in 2011 to a 20% long term capital gains rate.

Conclusions:

Investment returns should take precedent over tax planning if the objective is to have higher after tax spendable dollars. Most tax deferral methodologies worked well when the tax rates were much higher, but the rules have changed. Recognizing gains while rates are low can actually increase spendable dollars in the future.

If you would like to learn more about the financial services provided by White Oaks Wealth Advisors, Inc., call us at 800-596-3579, or visit [www.whiteoakswealth.com.](http://www.whiteoakswealth.com)

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