# Tax Intelligence

## The Evolution of Tax-Smart Financial Planning

Avantax
by Cetera

## Tax Intelligence: The Evolution of Tax-Smart Financial Planning

Over the passing decades, tax laws have undergone continuous changes, markets have maintained volatility and the financial landscapes have grown increasingly intricate. We recognized that relying solely on tax-loss harvesting wasn't sufficient to adequately serve clients. Instead, it became clear that all facets of a client's financial plan needed to be carefully considered in relation to taxes. This realization 40 years ago, prompted a shift towards a new approach – **one that recognizes the inherent tax implications in every financial decision.** Consequently, our services evolved into a more comprehensive and strategically aligned framework and thus, tax-intelligent planning was born.

Tax-intelligent planning signifies an elevated and all-encompassing financial strategy that transcends the foundational tax-smart approaches and ensures that clients retain a greater portion of their hard-earned income. Tax-intelligent planning embraces the understanding that every financial decision has tax implications, yet the majority of financial planners have not yet incorporated this perspective into their existing practices.

## Different Tax Perspectives

When it comes to how financial professionals view the role of taxes in a client's comprehensive plan, we find there to be three primary perspectives:

**Tax-ignorant** behavior involves a complete disregard for taxes and their far-reaching implications in a client's financial plan.

**Tax-smart**, while beneficial, adopts a myopic view of the role of taxes and the manifold levers to influence tax savings.

In the realm of **tax-intelligent** planning, taxes serve as a lens through which every tax-related decision is assessed, and a multitude of levers are available and actively used by a financial professional to the benefit of the client and the success of their financial plan.

While the world is gradually embracing tax-smart strategies, Avantax's commitment to this approach spans over four decades, placing us well ahead of the curve.

Ignore Taxes | Tax-Smart | **Tax-Intelligent**

## Comprehensive Financial Planning

Avantax defines comprehensive planning as using tax information to identify substantial opportunities and vulnerabilities to help maximize financial potential by reducing tax liability. It all begins (and ends) with understanding how taxes integrate into a client's wealth.


## Integrating Taxes into Comprehensive Financial Planning

When creating a financial plan, financial professionals often start with a fact-finding exercise — listing assets, liabilities and expenses. Once this is complete, they create a balance sheet and an income statement. Quite often, this discovery indicates that the client has two exceptionally large expenses every year: a mortgage and taxes. This discovery makes it clear: to offer comprehensive financial planning, financial professionals must consider taxes when building a client's financial plan.

**The AVANTAX INTELLIGENT PLANNING Client Experience offers Avantax financial professionals the following benefits:**

- Strategies to continually identify prospective wealth management clients and tax-intelligent planning opportunities to help them with their financial goals.
- A cohesive set of resources that defines the people, process and practice management efforts to work with clients.
- The ability to efficiently onboard clients.
- The ability to deliver an easily repeatable comprehensive planning experience.
- An organized system of tax-intelligent collateral, technology and expertise.

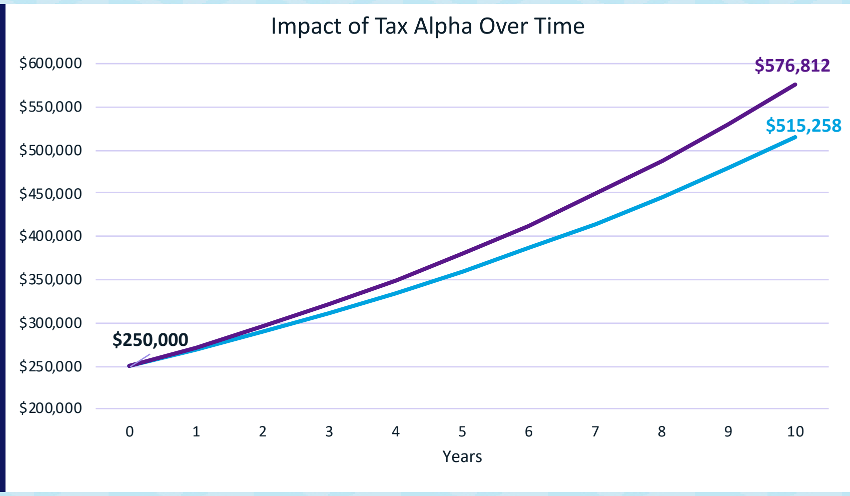
## Tax Alpha and a Client's Financial Picture

Taxes can erode the net result of a client's hard work. That is why comprehensive financial advice focuses on after-tax results — not just portfolio performance.

**Tax alpha** refers to the potentially higher value of after-tax returns generated when combining multiple tax-intelligent strategies relating to asset transfers, asset management, pre- and post-retirement, distribution and wealth transfer. By combining various tax-intelligent strategies — asset transfers, asset management, pre-retirement, distribution and wealth transfers — you can help generate a potentially higher value of after-tax returns, otherwise known as tax alpha.

According to a study from Russell Investments[1], the potential amount of tax alpha available to an investor whose assets are managed in a tax-intelligent manner is 1.2% annually. Here is what applying 1.2% every year over a 10-year period could look like.

**Hypothetical Growth of 7.5% Annual Return and 1.22% Average Tax Alpha Added**




Annual Return + Tax Alpha

Annual Return

| | |
|---|---|
| Initial Investment | $250,000 |
| 10-Year Ending Value Without Tax Alpha | $515,258 |
| Cumulative Tax Alpha | $61,554 |
| 10-Year Ending Value With Tax Alpha | $576,812 |

Source: Russell Investments' 2022 Value of an Advisor Study. To get the full study, go to ttps://russellinvestments.com/Publications/US/Document/Value_of_Advisor_EI.pdf

## Our Tax-Intelligent Approach

For tax-intelligent planning to work properly, the tax-focused lens must be applied to all aspects of a client's financial life. Avantax has defined a systematic planning process to consider all of these aspects. **The Avantax-intelligent Planning Concepts**, shown below, are the seven core components of a comprehensive financial plan.

EVERY client will need to confront these topics at some point in their financial lives, and a financial professional with a deep understanding of an investor's situation can provide significant value. However, it takes more than implementing one of these concepts to increase a client's tax alpha.

## Why settle for average results when you could be the financial professional who transforms a client's financial future with a complete, tax-intelligent plan?

### Tax-focused Investment Strategies

Wise investing requires that a portfolio reflect a client's risk tolerance, time horizon and liquidity needs However, successfully navigating the markets' ups and downs requires further steps to maximize net results. By considering tax implications, you can help ensure the returns clients earn are not eroded by taxes.

### Retirement Planning & Withdrawal Strategies

While retirement may start in the later stages of life, the dreams of a comfortable and secure retirement start much earlier. The sooner retirement needs are identified and addressed, the more likely clients will realize those dreams. Guiding clients through the accumulation and withdrawal stages of retirement requires consistency and discipline — as well as an intimate understanding of the tax implications of saving and spending in retirement.

### Family Risk Management

Every financial plan has potential risks associated with it — risks that can become very real when life does not go as planned. It is important to mitigate these risks so the client's family and their financial plan, does not suffer because of catastrophic life events.

## Business Planning

Most businesses in the U.S. are not run by corporations, but rather by families. Planning for contingencies is important especially when the focus of the business is on the day-to-day operations instead of the overall company vision. Preparing for growth, business continuity, employee retention and tax savings is of utmost importance. Planning for these areas can help both the employer and employee to succeed financially.

## Legacy Planning

Legacy planning comes down to ensuring wishes, values and priorities are upheld throughout — and beyond — a client's life. Whether through education, charitable giving or trust planning, building a legacy can ensure the next generation of family are supported and a client's hard work leaves the intended impact.

## Education Planning

Despite increasing tuition costs and uncertainty surrounding the value of attending college, education planning can be one of the easiest financial hurdles to overcome. With recent tax-law changes, education planning is not limited to college tuition alone. It is important to discuss the educational options available for children and grandchildren, and see how these options can affect cash flow, debt management, and estate tax planning.

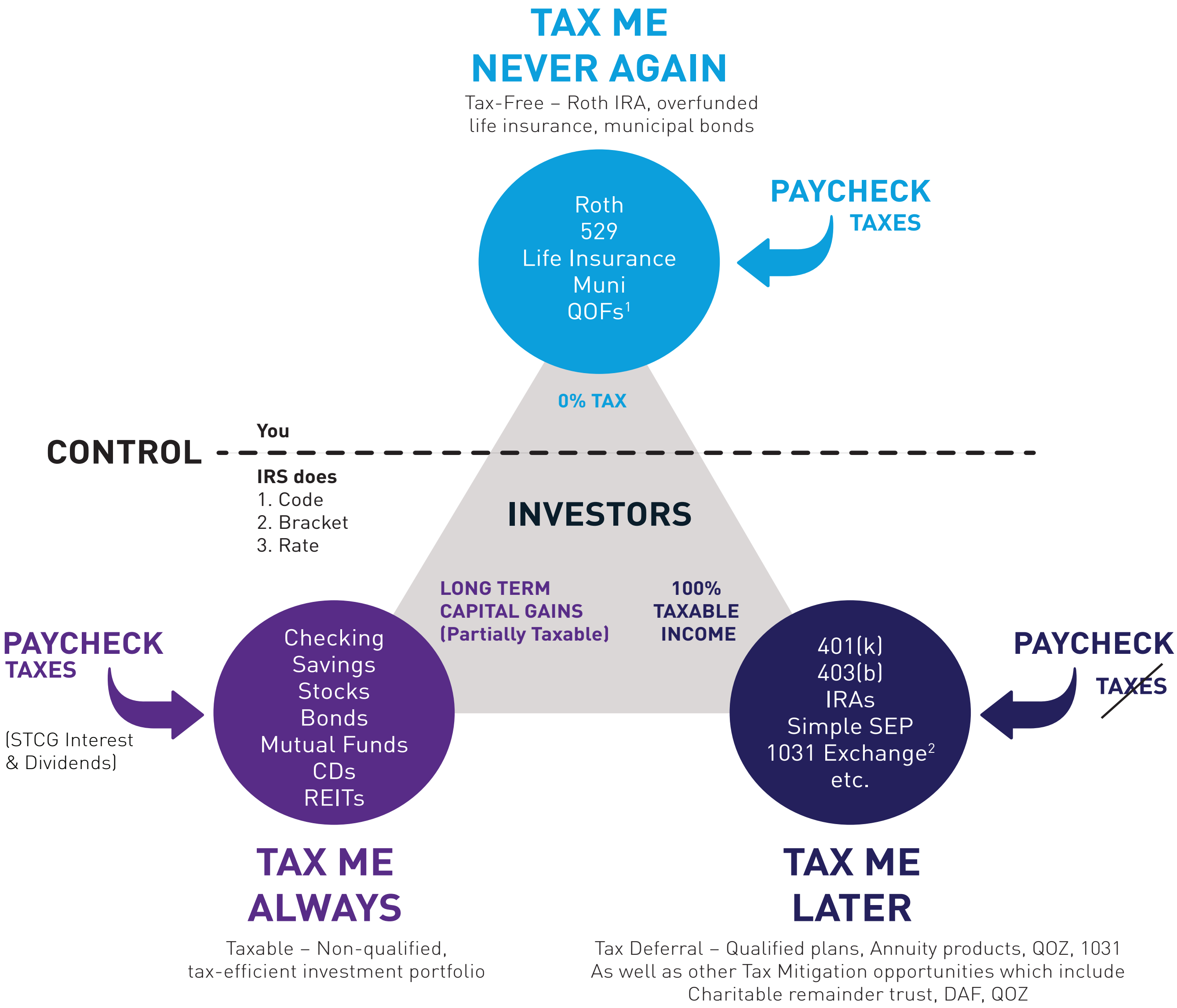
## Cash Flow Management

The concept of cash-flow management boils down to one thing – how much is being saved versus how much is being spent. A client's savings and spending choices should reflect their values and priorities and illustrating those priorities in a cash flow plan can positively impact their financial situation. A clear picture of monthly inflows and outflows can lead to informed decisions on other aspects of financial planning.

## Where To Invest

Now that we have laid the groundwork for how to think about investing, where should a client's assets be invested? Being tax-intelligent entails more than just contemplating the tax rate; it also involves considering the tax accumulation strategy so that we can have the most tax-efficient decumulation strategy as well.

The foundation for asset location strategies across taxable and tax-deferred account types is account registration. 401(k)s, 403Bs, 457s, traditional IRAs, IRAs, Roth 401(k)s, multiple accounts and trusts, each have their own unique nuances. These are captured in different buckets:




The key takeaway is simple: clients are not well-served by simply concentrating the bulk of their assets exclusively into one of these buckets. From the perspective of accumulation and decumulations, clients are better served with diversification across these buckets.

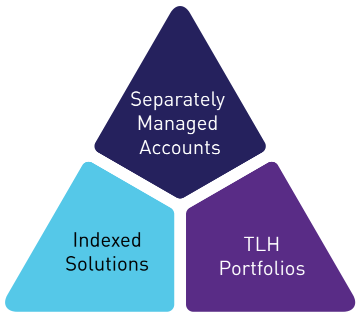
[1]Held for 10 years.
[2]Continuous exchange until heirs receive a stepped up basis.

## Why Is Diversification the Key?

Financial plans need to account for the dynamic and fluid situation of a client's tax situation, as well as the tax environment and the dynamic nature of tax law changes. A client's plan needs to have some diversification across these three buckets to take advantage of the benefits of each.

## What Products to Invest In

Our analysis will consider the seven Tax-Intelligent Planning Concepts along with investment allocation solutions that provide tax deferral, such as qualified opportunity zones and 1031s exchanges. This assessment will also encompass a range of tax mitigation techniques integral to a robust estate plan, as well as investment strategies like separate accounts, ETFs, and index solutions, such as fixed annuities or tax loss harvesting endeavors.




## The Tax-Intelligent Approach

A client's primary concern is **investment sufficiency** prompting questions like, "Will I be able to retire on time? Will I be able to live the same standard of living that I've grown accustomed to in retirement? Or am I going to have to downsize or take a step back? What happens if a loved one goes into long-term care?" Once this pivotal concern is addressed, their attention shifts to **investment efficiency** and making sure their investments are made in the most effective way. Interestingly, a tax-intelligent approach provides answers to both investment sufficiency and efficiency and provides a client with additional tax alpha generated, increasing their account balance due to reduced tax payments.

In the table below, we compare the Tax-Smart Industry Perspective which includes specific tactics to the larger, comprehensive strategy behind the Tax-Intelligent Approach.

### TAX-SMART INDUSTRY PERSPECTIVE

- Diversified and rebalanced investment portfolios
- Higher yielding or distributing investments located in qualified accounts.
- Low turnover, low distribution investments in non-qualified accounts
- Tax deferral vehicles included, for example annuity planning
- Municipal bonds in taxable accounts for clients above tax rate threshold
- ETF investing for low cost and low turnover in taxable accounts.
- Tax-loss harvesting at year-end.

### THE TAX-INTELLIGENT APPROACH

- Eventual distribution strategy taken into consideration
- Optimizing asset location and investment strategies
- Maximizing contributions to tax deferred vehicles including 401(k), IRA, Annuities, Max-funded Life Insurance (LIRP)
- Roth conversions where appropriate
- Selection of charitable investments and alternative investments for tax deferral and tax deductions
- Accumulation location strategy
- Selection of managers who seek to minimize capital gains and other fund distribution to mitigate tax drag
- Systematic tax-loss/gain harvesting throughout the year
- Tax alpha reporting
- Location-aware rebalancing
- Tax lot accounting
- Mutual Fund distribution management
- Distribution location optimization

1. **First, diversification of investment registrations**, i.e., tax me now, tax me later, tax me never, begins with accumulation. A client needs to have accumulation diversification. This builds a firm foundation for when they do get to retirement and the withdrawal stage, they ultimately can have some diversification from where they can withdraw.

2. **Second, it is crucial to be selective when choosing investment partners.** This could include opting for ETFs or exploring the potential of separate account managers. Leveraging these managers provides the ability to customize investment vehicles and potentially isolate specific exposure. This can be particularly valuable when dealing with historical positions from a legacy 401(k) that a client may still hold.

3. **Third, tax loss harvesting should be systematically performed throughout the year.** Volatility drives real value in tax loss harvesting — by waiting until the end of the year, the client's portfolio does not benefit from market volatility and the dips in the market.

4. **Next, tax-aware rebalancing is critical and touches on the accumulation location strategy.** However, a client's investments should not be thought of as one allocation, or as one pie, so the pie is not being replicated in all different registrations. Instead, carve up pieces of that pie to sit in certain registrations. A client's assets might have some allocation of the higher turnover positions that would generate ordinary income tax in a tax-deferred or tax-free account while others have positions that are lower turnover. This might include municipal bonds or investments that are more tax-efficient in taxable registrations. It is crucial to comprehend the holistic view of all these components as a unified pie.

5. **Lastly, tax lot accounting is most relevant when considering tax loss harvesting and tax gain harvesting.** This means rebalancing is not done on an average share basis but paying attention to the respective lots. Every lot has its own time horizon, and its own tax consequence and some lots may have short-term capital gain consequences while others may have long-term capital gain consequences.

## Tax-Intelligent Investments and Portfolio Management Risks and Considerations

- Targeted loss harvesting taking into consideration the selection of tax lots
- Holding period considerations
- Elimination of wash sales
- Reduction of high turnover strategies that can erode the after-tax return
- Managing portfolio yield
- Overlay portfolio management to coordinate trading across all managers

With the specifics of a tax-intelligent approach defined, it's time to look at its practical application.

# CASE STUDY:

## Tailored Investment Solutions Aligned with Individual's Unique Tax Scenario and Life Stage

Clients John and Mary Smith, both aged 48, are a married couple with two children. The Smiths fall into the highest tax bracket and prioritize minimizing taxes whenever possible. It's important to analyze the various asset accumulation avenues currently held by these clients while emphasizing the principle that each investment choice carries tax implications. Let's explore how the accumulation facets of these accounts will shape up as the Smiths eventually transition into retirement.

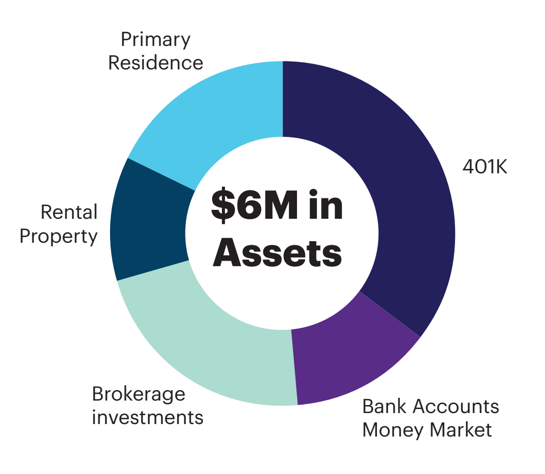
Do these clients have an estate tax problem? Presently, the limits for the estate and gift tax exemptions are close to $13 million per person, per couple, so the inclination is to say they do not have an estate tax problem. However, it is essential to note that these tax exemptions are scheduled to revert at the end of 2025. Speculation suggests the exemption may decrease to around $5 to $6 million per individual and such a reduction would bring the Smiths closer to the exemption threshold.

The Smiths are 48 years old with potentially 10 - 20 years of working life left and they're good savers. If the estate tax exemption does revert to the previous level at the rate that these clients are growing, they will have a need for tax-intelligent planning in the future.

The Smiths have approximately $6 million in assets spread across the following asset vehicles:

### Current Assets

a. 401(k) $2,000,000 combined
b. Bank accounts and money market $750,000
c. Brokerage, non-qualified investments $1,250,000
d. Rental property from which they derive income $650,000
e. Primary residence $1,000,00000




### Tax-Intelligent Solutions

Determine liquidity needs, invest excess cash in money market (which is currently earning over 4%).

Invest the remainder of cash into money market, bank CDs and short-term treasuries.

Invest the non-qualified funds in tax-efficient asset allocation strategies (for example ETF portfolios, low expense, low turnover and municipal bonds for tax-free income). Max out contributions to 401(k) accounts, additional contributions allowed at age 50.

Qualified accounts can include investments that are less tax-efficient (mutual funds, high dividend, high yield).

Education funding utilizing 529 accounts.

Eventual conversion of the rental property by utilizing 1031 exchange. Achieve tax deferral and create a stream of income while giving up the duties of being a landlord.

Consideration of charitable giving strategies to mitigate current tax burden (CRT, Donor Advised Funds, direct charitable giving).

The focus of the solutions is to find the right location for the non-qualified dollars, the liquidity needs that the client requires, and allocate money to money markets and other vehicles. Currently, the Smiths are earning over 4% on their money market account while earning nothing on cash — something that needs to be continuously monitored and why the financial planning process is so dynamic.

The tax-intelligent approach involves meeting with clients every year to make sure that everything remains in line with their objectives.

**Municipal bonds** are a frequent solution for high-net-worth clients. Federally tax-free income and high quality is typically recommended. The Smiths should consider maxing out their 401(k) accounts with additional contributions that are allowed once they are over 50 years old.

**Education funding** is underutilized and can tie in with the gift and estate tax exemption that can be front-loaded into 529 plans for children. In this case study, the Smith's children are presumably adult age so it's possible that they do not have a need for 529 plans, but they can be established for grandchildren and other family members, if applicable. Each gift giver can provide an annual gift of $17,000, which falls under the tax-exempt category. For the Smiths, this could potentially amount to as much as $34,000 per year. This could be a great benefit for the Smiths if they are looking to get assets out of the estate and into the hands of their family. An effective way to do this is to start early and establish a gifting schedule to align with the annual exemption.

The Smiths possess a **rental property** that could eventually transfer into a 1031 exchange, considering the property's appreciating value. There is no need to transfer or sell the property and incur a large capital gain. By utilizing a 1031 exchange, the Smiths have the opportunity to secure an indefinite tax deferral by consistently rolling funds from one 1031 exchange property to another.

**Charitable giving strategies** can be used to mitigate current tax burdens. A trust, donor-advised funds or direct charitable giving could provide an immediate tax reduction and be an option the Smiths may consider in the future.

## CONCLUSION

Avantax has maintained a tax-intelligent mindset since its inception over 40 years ago. The tax-smart approach that Avantax pioneered back then has evolved into the industry standard for financial planning. Today, Avantax continues to lead the way by redefining financial planning with a tax-intelligent approach which broadens our financial professionals' focus to initiate earlier, adopt a more strategic perspective and encompass all facets of their clients' financial lives.

Contact Avantax to discover how to offer your clients a truly comprehensive approach with a tax-intelligent financial plan.

Avantax
by Cetera

Visit [avantax.com](https://avantax.com)

Call a Business Development Consultant at 800.742.7950

Diversification does not assure or guarantee better performance and cannot eliminate the risk of investment losses.

Not all products and services are offered by all Avantax Professionals. Products and services listed may only be offered by properly licensed individuals.