ADVISOR'S QUARTERLY

Tax-Efficient Investing of Planned Gifts

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Kaspick & Company manages trust portfolios with the goal of optimizing the after-tax payments received by income beneficiaries. Before we hire a manager or trade a portfolio, we consider the potential tax consequences. This tax-aware investment approach has been part of our investment strategy since the inception of the firm.

In 2004–2006, the tax profile of payments from a 6% standard unitrust was such that 75% of the payments were taxed at the lower 15% federal tax rate and 25% of the payments were taxed at the higher 35% rate, an excellent after-tax outcome for beneficiaries. We have produced these solid after-tax results without compromising portfolio returns.

The IRS Four-Tier System

While charitable remainder trusts are generally exempt from income tax, payments to income beneficiaries are taxable under a four-tier accounting system defined by the IRS, summarized in Table I. Amounts are added to the tiers each year based on the investment activity in the trust portfolio (including the gain on the sale of the donated assets, calculated using the donor's cost basis). Payments empty the tiers in the order listed in Table I.

Table I

Tax Tier	Source	2006 Maximum Federal Rate
Tier 1, first	Interest, non-qualified dividends, short-term capital gains distributions from mutual funds	35%
Tier 1, second	Qualified dividends	15%
Tier 2, first	Short-term capital gains from trading activity	35%
Tier 2, second	Long-term capital gains from trading activity and mutual fund distributions	15%
Tier 3	Exempt income	Exempt
Tier 4	Return of corpus	Exempt

The four-tier system is designed to prevent donors from contributing appreciated assets to a trust, selling them and side-stepping the capital gain, then buying tax-exempt bonds and receiving tax-exempt income. Under the four-tier system, all of the capital gain from the sale of the donated assets (plus any other gains incurred) would have to be distributed before the donor's income distribution could be treated as tax-exempt. In most cases, the sale of the highly appreciated donated asset adds a large amount to the long-term capital gain tier. As a result, over its life, a standard unitrust will rarely distribute exempt income.

Standard unitrusts rarely distribute exempt income.

The top marginal rate for federal income taxes in 2006 was 35% (applied to interest, non-qualified dividends, and short-term capital gains), whereas qualified dividends and long-term capital gains were taxed at 15%. Interest income from bonds and bond funds (and most preferred stocks) was taxed at the 35% rate.

Common stock dividends can be either qualified (taxed at 15%) or non-qualified (taxed at 35%). Qualified dividends generally include those paid by domestic companies (and certain foreign companies) that also meet the following holding period rule: the investor must hold the security for at least 61 days during the 121-day period beginning 60 days before the ex-dividend date. The rule applies to stocks held in our managers' portfolios as well as to our holdings of equity mutual fund shares.

Under the four-tier system, standard unitrusts and annuity trusts generally distribute some combination of income taxed at 15% and income taxed at 35%. The proportion depends on the investment strategy and the execution of that strategy. Distributions from net income trusts and pooled income funds invested wholly in bonds are generally taxed entirely as non-qualified income at 35%.

Kaspick & Company Results

In 2006, 4.5% of a typical 6% payout was taxed at the lower rate of 15%, with the remaining 1.5% taxed at 35%.

The 6% standard trusts that we analyzed are invested in our Growth allocation and have investment advisory and gift administration fees of 0.87% charged to the portfolios each year. On a trust tax return, fees are applied to Tier 1. If no fees had been charged to the trusts, the outcome in 2006 would have been: 3.9% taxed at 15% and 2.1% taxed at 35%. Table II shows the results for the last three years.

Table II

Source	2006 Maximum Federal Rate	2004	2005	2006
Interest and non-qualified dividends	35%	1.6%	1.5%	1.5%
Qualified dividends	15%	0.6	0.5	0.7
Short-term capital gains	35%	0.0	0.0	0.0
Long-term capital gains	15%	3.8	4.0	3.8
Annual payment		6.0%	6.0%	6.0%

Based on trusts invested in our Growth allocation; investment advisory and gift administration fees are charged to the portfolios.

While an all-equity portfolio would have produced less non-qualified income and more capital gain income than the Growth allocation, it would have resulted in more volatile trust values and payments. The asset allocation decision is determined after considering many factors including the trust's objective, the expected horizon, the beneficiary's tolerance for payment volatility, and the likely tax impact on the beneficiary. We make these trade-offs in consultation with the trustee.

How We Do It

We influence the tax character of beneficiary payments through our selection of managers and our trading of portfolios. At a high level, the two primary objectives are to minimize short-term gains (both trading gains and mutual fund distributions) and to avoid "converting" qualified income into non-qualified income by failing to meet the IRS's holding period rule.

Selecting Managers: We select investment managers using detailed selection criteria, including low portfolio turnover. Lower turnover usually results in lower trading costs and fewer short-term capital gain distributions. Our small cap managers, for example, have an average annual turnover of 31% versus 82% for the typical small cap mutual fund. Our results demonstrate that a portfolio of carefully selected mutual funds not only offers important diversification benefits but also can be tax-efficient. Although short-term gains are distributed from the funds, for the most part the amounts are small. They are likely to be similar to the short-term gains generated in individually managed stock portfolios, even those managed with taxes in mind. Also, as noted above, charitable remainder trusts that are funded with highly appreciated assets can receive long-term gain distributions with no negative tax consequences.

Trading Portfolios: When we trade portfolios, we consider the trust type and any tax implications so as to minimize negative tax outcomes. For example, we might postpone a rebalancing for a short period if it will reduce the portfolio's short-term capital gains. We avoid generating capital gains in portfolios invested in all tax-exempt bonds. We have a dedicated team of traders who understand the intricacies of four-tier trust accounting; they are not trading planned gifts as an add-on to other duties.

A portfolio of carefully selected mutual funds can be tax-efficient.

Our proprietary trading systems can analyze large groups of trades and determine the short-term gain implications. We also review taxable portfolios for tax-advantaged trades at least twice a year. And lastly, at the end of every tax season, we review the K-1s in order to assess the results of our efforts.

Summary

We continually analyze the impact of our investment decisions and our trade execution on the tax character of beneficiary payments. This work has resulted in more tax-efficient portfolios for our clients' income beneficiaries. Tax-efficient portfolio management represents good stewardship, meets the requirements of the Prudent Investor Rule, and creates immediate value for income beneficiaries.

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