

Vestmark's Tax Management Capabilities

While tax management is one of the main attractions of Separately Managed Accounts for investors and advisors alike, it isn't easy to do. Vestmark's long history of maintaining tax-lot-level detail within multiple "sleeves" for a single client means that we are uniquely positioned to optimize tax outcomes under current tax rules. Proper tax management of SMA accounts can:

- help attract client assets from other firms,
- boost recruitment of advisor teams from other firms,
- improve tax outcomes for existing clients, and
- ensure tax-optimal fulfillment of client life-cycle events.

Here are several scenarios that demonstrate the power of Vestmark's tax management capabilities.



Tax-Aware Account Transitions

Some transitions are simple. If an inbound client has been using an SMA that is also available on your platform, shares are simply transferred-in-kind with special attention paid to maintaining lot-level details (basis and purchase date). If the inbound client's SMA is not available at your firm, however, the transition is more complex.

For many years, bringing over SMA assets from other firms involved a rudimentary "overlap analysis" that compared existing stock symbols to the symbols in approved SMA portfolios of similar style. Identical names were retained (perhaps adjusting position weights in a tax-aware way) and the remaining names were sold to purchase new names, possibly resulting in a significant tax cost to the clients. In the later years of a bull market, this tax cost could present a serious barrier to attracting new clients and new advisor teams.

Vestmark's tax-aware transitions solve these challenges in several ways:

- We look to retain legacy positions with performance characteristics ("factor betas") that resemble those of the target benchmark, resulting in fewer sales of appreciated securities.
- We identify lots for sale using HIFO accounting (highest in, first out), which results in better tax outcomes than the more commonly used FIFO (first in, first out) and LIFO (last in, first out) methods.
- Lot-level analysis also allows us to identify unrealized tax losses that may be obscured by statement aggregations showing average cost basis, including identification of long-term and short-term gains and losses to ensure the most tax-optimal outcome for each client.
- Virtually any portfolio of individual securities can be mapped into one or more index-like portfolios, removing the burden of finding "best-fit" SMAs for inbound SMA assets.

While many transitions will start a longer SMA management relationship with Vestmark, we can also offer our in-kind transition services as a standalone event with transaction pricing.

Overlay Management of Existing Accounts and Households

Wealthy clients generally prefer SMAs to mutual funds or ETFs because SMAs offer unique customization and tax advantages not available with pooled investments. Yet tax inefficiencies can still exist, as when a value manager purchases a stock recently added to a value benchmark just as a growth manager is selling it. The resulting wash sale can deprive the client of a tax loss that might otherwise have reduced taxable gains elsewhere in the portfolio or been carried forward for future use.

Vestmark's Overlay Management Service preserves such tax optimization opportunities by looking for the best execution of a particular trade across a client's entire portfolio. Take a simple example:

- A client has a "sleeve" of SMA Alpha and a "sleeve" of SMA Bravo, each containing 100 shares of XYZ in several tax lots with different cost bases.
- SMA Bravo decides to reduce its XYZ exposure and recommends the client sell 25 shares.
- Vestmark's overlay service looks at all of the client's XYZ holdings, wherever they may be, to determine which shares of XYZ would provide the best tax outcome for the client.
- Vestmark finds that the best tax outcome would result from selling 25 XYZ shares owned by SMA Alpha.
- After selling 25 XYZ from SMA Alpha, Vestmark journals 25 shares from SMA Bravo to SMA Alpha to bring both SMAs in line with their managers' models.

Tax legislation considered (but ultimately tabled) in 2021 would have extended wash-sale rules to cover all accounts within a household, whether taxable or tax-deferred. In anticipation of this provision's potential future enactment, Vestmark is preparing to extend our overlay management services to cover entire client households.

Overlay management also improves outcomes when rebalancing accounts that have strayed from their target allocations. By executing tax-optimal sales, journaling across multiple accounts for the same client, and attempting to recognize offsetting tax losses when taking gains, Vestmark can improve the after-tax performance of SMA portfolios.

Ongoing Tax-Loss Harvesting

Maintaining tax-lot-level detail within a portfolio of SMAs presents opportunities to capture tax losses when they present themselves. (This is especially advantageous within direct indexing SMAs because the number of holdings and available substitutes are not as constrained as they would be in an actively managed portfolio.) Short-term losses provide a greater tax savings than long-term losses, whereas long-term gains carry a lower tax cost than short-term gains; Vestmark's use of FIFO accounting promotes the acceleration of tax-loss recognition (generally into the short-term range) and deferral of capital gain recognition (generally to long-term).

Recognized tax losses from harvesting activities can be used to offset realized capital gains elsewhere in a client's portfolio, improving the after-tax performance of a client's entire account. If no gains are available to be offset, harvested losses can reduce a client's taxable income by \$3,000 per year or carried forward for use in future years.

Tax Optimization of Life-Cycle Events

Most SMA portfolios, whether actively managed or mirroring an index, are not static over time. Clients have life events that can inject new funds into a portfolio (as when a client receives an inheritance or a cash bonus) or require a distribution of funds (as when a client purchases a vacation home, makes a tuition payment, or contemplates a charitable donation). Vestmark can tax-optimize these life events to match a specific client's needs, as in the following examples:

- **Gradual diversification of a concentrated position:** For a client with cash and a large exposure to a single stock (such as the stock of a former employer), we cash-fund an index completion portfolio around the concentration and manage tracking error by eliminating redundant exposures to the same industry. Each year, we harvest tax losses in the index completion portfolio, reduce the concentrated position (FIFO) to realize an offsetting gain, and invest the cash proceeds of that sale back into the index completion portfolio. As the index completion portfolio grows over time, the harvesting of larger tax losses allows for the tax-neutral sale of lower-basis lots of the concentrated position.
- **Termination of an active SMA manager:** Rather than liquidating the fired manager's holdings, Vestmark can allocate them to a client's direct index SMA and re-optimize the expanded portfolio so that any required position changes are made in the most tax-optimal way.

- **A large cash bonus inspires a charitable impulse:** Instead of donating cash to a charity, the client instructs Vestmark to make an in-kind donation of highly appreciated long-term shares – then contributes cash to his/her Vestmark-managed portfolio to fund replacement shares. Since wash-sale rules only apply when a loss has been realized, not when the sale results in a gain, the client effectively “refreshes” cost basis within his/her SMA while also potentially capturing a tax deduction.
- **Cash required to fund a vacation property:** Vestmark would seek to sell the highest cost-basis shares to meet the cash requirement with the lowest possible tax cost.
- **Realizing gains to absorb tax losses generated elsewhere:** If a client has sizable unused tax losses elsewhere in his/her portfolio or carried forward from previous years, Vestmark can accelerate gain-harvesting to help use up the unused losses and prolong the usefulness of the SMA portfolio.

See what Vestmark can do for you

Learn more about how Vestmark VAST can help you provide personalized investing and tax management at scale.

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