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About this article:

This column is intended to provide guidance for individuals as they navigate the path of personal wealth management.

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TAX MATTERS

Tax lot accounting is not a game.

Imagine that you are the owner of an NFL football team. In your plans to build a team that will win the Super Bowl, you choose to pay all of your players the average NFL player salary of \$770,000 per year. Your thinking is that you are paying a lot more than the minimum NFL salary of \$295,000, so you will provide a great incentive to some players that might not otherwise earn \$770,000. By the same token, you would save money since you don't have to pay any players at the top of the pay scale, for instance Peyton Manning who earns \$18.7 million per year. Your costs would be contained — but what would be your chances of having a championship team?

What if you instead elected to pick and choose each player and pay him according to his skill? Being selective in choosing players and having flexibility in how you pay them, you would likely have many players above the average salary as well as players below the average salary. However, with this flexibility, you could construct a team that would have a much higher chance of winning a championship.

Don't assume — call the winning play

Being selective rather than average in your tax accounting methods can make the difference between a losing and a winning portfolio. Within the mutual fund investment realm, many individuals suffer negative tax consequences by reporting investment gains and losses using the "average cost method" or the "first-in first-out (FIFO) method" rather than the "specific identification method."

This problem is often created by investment custodians who either assume, by default, an average cost basis or FIFO method of accounting, or custodians who fail to provide tax lot accounting. Tax lot accounting is a record-keeping technique that traces the dates of purchase and sale, cost basis and transaction size for each security in your portfolio, even if you make more than one trade in the same security.

Keep the goal in mind

The goal of tax lot accounting is to minimize the net present value of your current taxes by deferring the realization of capital gains and recognizing losses sooner. Many times, professional investment advisors fail to recognize the importance of tax lot accounting and accept the custodian's default. Let's walk through some examples of the different accounting methods and their financial impact.

For the purpose of our discussion, let's assume that over time five purchases of 1,000 shares each of XYZ mutual fund has occurred. The investor owns a total of 5,000 shares. These purchases have occurred at prices of \$8 per share, \$9 per share, \$5 per share, \$15 per share, and \$13 per share. By taking the average price per share, the average cost basis for the purchases is \$10 per share. For simplicity, we will assume that all shares have been held long enough to receive long-term capital gain treatment. In our example, we have chosen to sell 1,000 shares at a current market price of \$13 per share.

Average cost basis method

If my custodian defaults to an "average cost basis method" to report this transaction to the IRS, they will show that 1,000 shares were sold for \$13 per share and the average cost basis was \$10 per share. As a result, I have a \$3 per share gain, or \$3,000 in long-term taxable gains. You may think, "One gain is as good as any other." However, let's compare this to the other methods of tax accounting.

IRS method of first-in first-out

If my custodian reports the transaction based on the IRS default method for tax lot accounting, the gain will be reported on a first-in first-out basis. In other words, the first shares purchased in the fund will be the first shares sold. In this case, since my first shares were purchased at \$8 per share and my sale price was \$13 per share, I have a gain of \$5 per share. The custodian will report a taxable gain of \$5,000. This is almost double the taxable gain that would be reported under the average cost basis method.

Specific identification method — the best tactic

The best method to control your taxable situation is the specific identification method. This method requires you to specifically identify which shares are to be sold and must be elected at the time that the sale takes place.

In our scenario, I may be in a situation where I would prefer to recognize a loss on the transaction in order to offset gains in other investments. By using the specific identification method, I would identify the shares that I purchased for \$15 per share to be sold. Since my sale price is \$13 per share and my cost basis is \$15 per share, I have a \$2 per share loss or a \$2,000 loss on the transaction. If I don't have other gains to offset the loss, I have created a tax write-off rather than a tax liability.

I could be in a situation where I want to have a tax neutral transaction. My objective is to recognize no gain on the sale. By using the specific identification method, I would identify the shares to be sold as those that I purchased for \$13 per share. Since my sale price is \$13 per share and my cost basis is \$13 per share, I have no gain on the transaction and I will have no taxable gain. As a result, no tax will be due on the sale.

Take advantage of the current rules

Something to consider is that we are at historically low capital gains tax levels, so now may be the time to recognize as much taxable gain on the sale as possible. By using the specific identification method, I would identify the shares that I purchased for \$5 per share to be sold. Since my sale price is \$13 per share and my cost basis is \$5 per share, I have an \$8 per share gain or an \$8,000 long-term gain on the transaction.

One thoughtful move can make the difference

As you can see from these scenarios, depending on your tax accounting method, you may have a taxable event ranging from a \$2,000 loss to an \$8,000 gain. These are dramatic differences.

Consider the following action items:

- **Check with your current custodian** to verify that they keep tax lot accounting records and that they allow you to use the specific identification method for transactions.
- **When selling shares in a mutual fund**, decide whether you want to recognize gains or losses on the transaction. Identify which shares are to be sold to have the intended tax consequence.
- **Make sure that your confirmations** for these transactions reflect the specific identification of shares method. Otherwise the transaction will be reported incorrectly to the IRS.

Touchdown

We admire professional football teams that avoid average talent and that can be selective in choosing the best talent to build championship teams. Likewise, by being selective in your method for reporting transactions using the specific identification of shares method of tax lot accounting, your wise tax management can build a tax-efficient, championship-level portfolio. ■



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The Insight Group is a team of financial planning professionals that enable affluent families across the Wasatch Front (and the backside, too) to navigate the impact of wealth-transforming events. Planning for these events, whether driven by retirement, a business sale, death, inheritance or market conditions, will maximize the positive impact of wealth for your family and community.

The Insight Group ... achieving financial wellness for yourself, your family and your community.



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