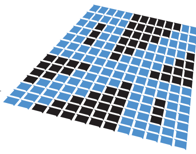
TAXES



Seeking tax-efficient income and equity

EATON VANCE

MARCH 2015 CORNERSTONES OF TAX-SMART INVESTING

Investing in a rising tax environment – 2015

Andrew H. Friedman
Principal
The Washington Update

SUMMARY

Many investors had sticker shock last April when they filed their 2013 tax returns. The combination of a tax increase in legislation to avoid the "fiscal cliff" and new taxes imposed to fund the Affordable Care Act ("Obamacare") caused the top tax rates on investment income to jump by *ten percentage points* in 2013. According to the non-partisan Congressional Budget Office, tax rates imposed on high-income taxpayers are now the highest they have been in the past 35 years. *Congressional Budget Office Report (November 2014).*

Congress is about to embark on an effort to implement tax reform, which, if successful, would reduce the top tax rates. On the other hand, Congress and the Administration are looking for ways to pay for increased overseas military operations, new social programs to help the middle class, and the quotidian annual measures to fund the federal government, pay for summer road repairs, and raise the nation's borrowing limit.

This white paper discusses the likely future direction of taxes, and what investors can do to minimize the tax impact on their investment returns.

Not FDIC Insured | Not Bank Guaranteed | May Lose Value

Whither tax reform?

Both the Administration and the Republican Congressional leadership have expressed a desire to pursue tax reform in an effort to simplify the tax code. Generally speaking, the tax reform process involves lowering tax rates and recouping the lost revenue by eliminating or curtailing tax deductions and exemptions. All deductions and exemptions become candidates for change, including popular ones such as the mortgage interest deduction and the tax exemption for interest on municipal bonds. The challenge is that most of these "tax expenditure" items have strong support from particular industries or groups, making it difficult for Congress to agree on curtailing them.

It is early for definitive predictions, but my guess is that agreeing on a plan to reform taxes on individuals is too heavy a lift for this Congress and this Administration. It is hard to imagine Congress agreeing on such controversial proposals as taxing municipal bond interest or limiting charitable contribution deductions. It, thus, appears that the high current individual tax rates are here to stay. (I am more hopeful about business tax reform, which would lower the nation's corporate tax rate – the highest among industrialized countries – in an effort to stem the movement of jobs overseas.)

Whither taxes in the absence of reform?

Assuming the effort to lower tax rates fails, the question becomes whether taxes will stay constant or will increase in the coming years. This analysis in turn is driven by the extent to which Washington will need additional revenue. Both parties have said that more money is needed to fund the nation's escalating military initiatives in the Middle East, eastern Europe, and Africa.

At the same time, President Obama has asked Congress to approve new social programs to help middle- and lower-income families. To pay for these initiatives, the President has proposed sweeping tax increases – eliminating stepped-up basis at death, increasing the capital gains tax rate, and capping accumulations in qualified retirement accounts – that would raise $320 billion in new revenue, almost exclusively from high-income taxpayers. The Republican Congress will almost certainly reject these proposals as unnecessary "tax-and-spend" policy.

But even aside from these broad initiatives, Congress must address more immediate spending deadlines. Within the next several months, Congress must agree on (i) an increase in the debt ceiling so the country can continue to borrow money; (ii) an appropriations bill to keep the government running past September; (iii) and a source of funding to replenish the highway fund and pay for road and bridge repairs this summer. These items require additional spending, which Congress will seek to try to recoup by raising additional revenue or cutting spending elsewhere.

A tax rate hike is unlikely given the strong opposition of the Republican-controlled Congress. But, raising tax rates is not the only way to increase taxes. Nor is it necessary to make sweeping changes to popular deductions and exemptions to pay for these smaller items. Instead, the necessary tax revenue can be garnered by eliminating the tax-favored treatment of smaller income items. These changes often are denominated as "loophole closers" because they curtail tax treatment that many in Washington believe is inappropriately generous.

Examples of loophole closures that have been under discussion include:

- Tax the sale of "carried interests" as ordinary income.
- Repeal oil and gas tax preferences.
- Eliminate pass-through treatment for oil and gas MLPs.
- Curtail "stretching" of inherited IRAs and 401(k)s.

Not FDIC Insured | Not Bank Guaranteed | May Lose Value

- Apply required minimum distribution rules to Roth accounts beginning age 70-1/2.
- Limit Roth conversions to pre-tax dollars.
- Treat all distributions from S corps and partnerships to owner-employees as subject to employment taxes.
- Curtail sophisticated wealth transfer techniques.

In short, although tax rates might not increase further, *taxes paid* by high-income investors are likely to rise as Congress over time eliminates favorable tax treatment of more and more items to pay for annual spending. Because any change in tax treatment is likely to apply only prospectively, investors should make sure to take advantage in 2015 of the current tax treatment of endangered items while it remains available. For instance, an investor who maintains a Roth IRA should consider this year making a nondeductible contribution to an IRA and rolling that contribution over to the Roth account without tax, in case Congress eliminates that option in 2016.

What can investors do to minimize taxes?

1. Give increased consideration to investments that shield earnings from tax.

Municipal bonds, master limited partnerships, and real estate investment trusts shield some or all of their distributed investment income from federal income tax. This tax savings enhances the after-tax returns these investments provide.

The higher the tax rate, the higher the effective return on tax-efficient investments. For instance, a municipal bond paying 3% interest pays a tax-equivalent yield of 4.6% in a 35% tax rate environment. But, if the tax rate rises to 43.8%, the tax-equivalent yield on the same bond rises to 5.3%.

Although the favorable tax treatment of municipal bonds, MLPs, and REITs could be questioned during the tax reform or loophole closing processes, in my view the current treatment is unlikely to change. Even if Congress does change the tax-favored treatment, I would expect that current rules will continue to apply for investments existing before the date of change (although there can be no guarantee when predicting the whims of Congress).

Similarly, investment strategies that defer capital gains taxes, such as certain types of private placements, provide significantly greater benefits as taxes rise.

2. Take advantage of the lower tax rates on long-term capital gains and qualifying dividend income.

The tax rate on capital gains and qualifying dividends is about 45% lower than the tax rate on ordinary income. Thus, from a tax planning perspective, it may make sense to hold investments that produce qualified dividend income, and to hold them long enough to produce long-term capital gains on sale.

3. Give increased attention to harvesting losses and buy-and-hold investment strategies.

As taxes on capital gains increase, the tax deferral afforded by buy-and-hold strategies becomes more valuable. It becomes more important to defer recognition of gains and to harvest tax losses throughout the year to shelter gains that are recognized.

4. Pay attention to tax lot selling.

When selling a portion of one's holdings, it pays to identify the particular lot that is being sold. The goal is to sell first the assets with the highest basis. For instance, suppose an investor buys 100 shares of stock X at $10 and (at some later point) 100 shares of X at $20. A year after the second purchase, the investor sells 100 shares of X at $30. If the investor simply uses the average basis of $15, he will recognize a gain of $1,500. But, if he identifies the second lot as the one being sold, his taxable gain will be only $1,000.

Not FDIC Insured | Not Bank Guaranteed | May Lose Value

5. Consider tax-efficient mutual funds and other professionally managed tax-advantaged investment strategies.

A mutual fund or other professional manager can use the above strategies to minimize taxes to investors. A professional management strategy that seeks to enhance after-tax returns by balancing investment and tax considerations – buy and hold, harvesting losses, tax lot selling – becomes increasingly important in a rising tax environment.

Tax management techniques include purchasing stocks with a long-term perspective to delay recognition of taxable gains, reducing turnover to minimize short-term gains, investing in stocks that pay qualifying dividends, harvesting tax losses (and being mindful of the "wash sale" rules on repurchase), and selectively using tax-advantaged hedging techniques as an alternative to taxable sales.

A management strategy that seeks to reduce taxes while also maximizing returns can provide greater after-tax returns.

6. Take advantage of tax deferral.

Some mutual fund managers seek high returns regardless of tax consequences. Such a strategy can result in frequent trading, short-term gains distributions taxed at the full ordinary income rates, and "December surprises" where large dividends are declared late in the year when it is too late to take action to offset the adverse tax consequences.

If a manager does not take taxes into account, an investor can lose almost *half* of the annual returns to taxes. To avoid this result, investors should consider holding tax-inefficient investments in tax-deferral vehicles. As a starting point, investors should make sure to maximize contributions to tax-qualified IRA and 401(k) accounts. At some point, Congress might see fit to impose a cap on the total assets an individual can hold in retirement accounts, as the President has proposed. Amounts in the account before such action likely would be grandfathered. Taking advantage of annual contributions is a must.

After maxing out on retirement plan contributions, high-income taxpayers can obtain additional tax-deferred compounding on retirement savings by holding a portion of their non-qualified assets (assets held outside an IRA, 401(k), or other retirement account) in a deferred annuity. Annuities function much like an IRA, except that the initial investment itself is not tax-deductible. The owner of an annuity invests assets in a choice of investment options. Earnings on those assets accumulate tax-deferred. When withdrawn from the annuity, earnings are taxed at ordinary rates (and if taken prior to age 59-1/2 may incur a tax penalty). Investors also might consider an immediate annuity, which begins providing retirement income upon purchase. In a rising tax environment, the tax deferral feature of annuities becomes increasingly valuable.

Life insurance also can provide tax deferral, and even complete tax avoidance. If held until death, life insurance benefits are generally exempt from capital gains and income taxes. If the policy is held in an irrevocable life insurance trust, it is considered outside the insured's taxable estate and, therefore, exempt from estate and gift taxes as well.

Indeed, life insurance does not provide income only in the case of untimely death. Certain kinds of insurance have an underlying investment account that can build up the policy's "cash value." Depending on the policy terms, this account can be accessed tax-free during the insured's lifetime, thereby providing a ready source of tax-efficient income. The insured accesses the account through principal withdrawals and loans, which can be repaid out of the death benefit when the policyholder dies.

Maintaining tax-inefficient assets in a tax-deferral vehicle renders tax-inefficient investing styles far less important, eliminates year-end surprises such as short-term gains distributions, and permits portfolio rebalancing without current imposition of tax.

Not FDIC Insured | Not Bank Guaranteed | May Lose Value

7. Donate appreciated investments to charity.

By donating appreciated assets to charity, an investor can get a dual tax benefit: a deduction equal to the full value of the asset contributed (subject to the phase out and limitations imposed generally on charitable contribution deductions) without recognition of gain on the asset appreciation.

For instance, suppose an investor holds 100 shares of X stock purchased for $10 a share and now worth $20 a share. By donating the shares to charity, the investor gets a $2,000 charitable contribution deduction (subject to any applicable phaseout or income limitation). Compare this to the case where the investor sold the stock and donated the proceeds to charity. In that case, the investor would recognize a gain of $1,000 before claiming the $2,000 deduction.

Many investors use this method to save taxes on large, irregular contributions, such as the establishment of an endowment fund. But, the approach can be used equally with smaller, regular contributions. For instance, instead of making weekly or monthly payments to a church or other religious institution, an investor can pay a year's worth of contributions with appreciated assets.

8. Take advantage of the IRA/charitable contribution rollover.

Under the tax law in effect through 2014, an individual over the age of 70-1/2 was permitted to transfer up to $100,000 from an IRA to a charity and avoid all tax on the IRA distribution. Moreover, the distribution to the charity would count toward satisfying the individual's required minimum distribution obligation. Amounts transferred from the IRA to the charity were not subject to the phase outs and limitations that apply to charitable contributions claimed as deductions on Schedule A. Thus, investors over age 70-1/2 were well-advised to use IRA funds to make their first charitable contributions, before using non-qualified money.

I believe that, later this year, Congress will reinstate this IRA/charitable contribution rule for 2015 and perhaps for later years as well. Thus, investors over 70-1/2 who are charitably minded should hold off taking required distributions from their IRAs or making large charitable contributions until later this year when Congress acts. Once Congress extends this provision for 2015, these investors can use up to $100,000 of IRA funds to make their donations.

Not FDIC Insured | Not Bank Guaranteed | May Lose Value

Partner with a pioneer in tax-efficient investing.

Eaton Vance has a decades-long history of offering mutual funds and wealth management strategies designed to maximize after-tax returns:

- We have one of the broadest selections of tax-efficient investment solutions in the industry, including a lineup of tax-advantaged and municipal income products and separately managed accounts.
- We have the most actively managed tax-managed equity funds (open- and closed-end) as of 12/31/2014.
- We are the only manager with more than $10 billion in both actively managed tax-managed equities and municipal bonds assets (open- and closed-end) as of 12/31/2014.

Visit **eatonvance.com/taxes** to explore our Investment Tax Center and to access our strategies, tools and resources.

Take the first step toward tax-efficiency.

Use our interactive tax calculator to determine your actual tax rate in seconds. Our calculator also shows the impact of taxes on fixed income, dividends, capital gains and withdrawals from retirement accounts.

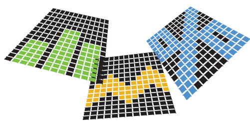
In addition to our tax calculator, we've developed a suite of tools to help you illustrate various tax impacts on your portfolio:

- The after-tax yield potential of municipal bonds.
- After-tax growth potential for "tax-oblivious" portfolios.
- The laddered bond potential in an environment of higher taxes and rising rates.

Visit **eatonvance.com/tools** to help find the tax answers you're looking for.

At Eaton Vance, we value independent thinking. In our experience, clients benefit from a range of distinctive, strongly argued perspectives. That's why we encourage our independent investment teams and strategists to share their views on pressing issues—even when they run counter to conventional wisdom or the opinions of other investment managers**. Timely Thinking. Timeless Values.**

Not FDIC Insured | Not Bank Guaranteed | May Lose Value



Income | Volatility | Taxes
Strategies. For times like these.

Eaton Vance offers strategies to help meet three of today's most important investment challenges—Income, Volatility and Taxes. Explore our broad range of strategies to address these issues at **eatonvance.com/IVT.**

Andrew H. Friedman is the principal of The Washington Update LLC and a former senior partner in a Washington, D.C. law firm. He speaks regularly on legislative and regulatory developments and trends affecting investment, insurance and retirement products. He may be reached at www.TheWashingtonUpdate.com.

Neither the author of this paper, nor any law firm with which the author may be associated, is providing legal or tax advice as to the matters discussed herein. The discussion herein is general in nature and is provided for informational purposes only. There is no guarantee as to its accuracy or completeness. It is not intended as legal or tax advice and individuals may not rely upon it (including for purposes of avoiding tax penalties imposed by the IRS or state and local tax authorities). Individuals should consult their own legal and tax counsel as to matters discussed herein and before entering into any estate planning, trust, investment, retirement or insurance arrangement.

Copyright Andrew H. Friedman 2015. Reprinted by permission. All rights reserved.

About Eaton Vance

Eaton Vance Corp. is one of the oldest investment management firms in the United States, with a history dating to 1924. Eaton Vance and its affiliates offer individuals and institutions a broad array of investment strategies and wealth management solutions. The Company's long record of exemplary service, timely innovation and attractive returns through a variety of market conditions has made Eaton Vance the investment manager of choice for many of today's most discerning investors. For more information, visit eatonvance.com.

The views expressed in this white paper are those of Andrew Friedman and are current only through the date stated at the top of this page. These views are subject to change at any time based upon market or other conditions, and Eaton Vance disclaims any responsibility to update such views. These views may not be relied upon as investment advice and, because investment decisions for Eaton Vance are based on many factors, may not be relied upon as an indication of trading intent on behalf of any Eaton Vance fund.

Eaton Vance does not provide legal or tax advice. The discussion herein is general in nature and is provided for informational purposes only. There is no guarantee as to its accuracy or completeness. Individuals should consult their own legal and tax counsel as to matters discussed.

Before investing, investors should consider carefully the investment objectives, risks, charges and expenses of a mutual fund. This and other important information is contained in the prospectus and summary prospectus, which can be obtained from a financial advisor. Prospective investors should read the prospectus carefully before investing.

©2015 Eaton Vance Distributors, Inc. | Member FINRA/SIPC | Two International Place, Boston, MA 02110 | 800.836.2414 | eatonvance.com