Valuing Portfolios on an After-Tax Basis: The Pros and Cons

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Estimating taxes is so difficult that we usually just work with the pretax value of investments in constructing portfolios or building retirement plans. But it's a disservice to clients not to consider the tax bill when setting the allocation. The question becomes how?

Uncle Sam is a silent partner in nearly every investment. His cut depends on a number of factors unique to each situation:

- The type of account the investment is held in (taxable or tax-deferred)
- The type of income earned (interest, dividends, capital gains, or IRA distribution)
- The investor's tax bracket at the time the income or gain is reported

The timing of Uncle Sam's cut is also unique to each situation. Taxes could be owed this year if a client decides to liquidate a profitable position in a taxable account. They could be deferred for many years if a young IRA holder plans not to take distributions for 40 or 50 years. They could even be escaped entirely, if a client donates the asset to charity or dies holding a profitable position that receives a step-up in basis.

Because of all these variables—not the least of which is the unknowable future of the U.S. income tax system—most clients and advisors tend not to account for potential tax liabilities when valuing assets. We intuitively know that the assets in a traditional IRA, 401(k), or other tax-deferred retirement plan are worth less than an equivalent amount held in a Roth, but because we can't predict when the taxes will be paid or at what rate, we tend to work with these accounts at face value.

Assets in taxable accounts are the most difficult to value on an after-tax basis. Do you reduce them by:

- 20%—assuming they'll all be taxed as dividends or long-term capital gains?
- 39.6%—assuming they'll all be taxed as ordinary income or short-term capital gains (and that the client is in the top federal tax bracket)? Or
- 0%—assuming they'll all receive a step-up in basis or be donated to charity?

And what about losses? Do you increase their value to account for the taxes saved when losses are offset against other gains or income? If so, how do

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you do this when there is no way of knowing how much other gains the client will have at the time the losses are taken? And what if the losses turn into profits between now and then? Fluctuating asset values can make tax adjustments seem minor in comparison.

Then, assuming you can arrive at some sort of estimate of future tax liability, you really need to determine the present value of the liability in order to arrive at a true after-tax asset valuation. A $100,000 asset whose taxes are due in 30 years is worth more than a $100,000 asset whose taxes are due next year. And because the taxes may not be due all at once—especially true for retirement accounts that continue to grow tax-deferred as small amounts are siphoned off each year—you can't just calculate the present value of the taxes paid on a lump sum received in one year. Instead, you must do lots of present-value calculations for each year's taxable withdrawal.

With so many unknowns, it seems almost dangerous to estimate after-tax asset values because your guess could be so far off the mark. Still, some estimate of taxes is probably better than zero.

Why after-tax asset valuations matter

Here are some reasons why you might want to consider the after-tax values of your clients' assets.

Retirement planning

One of the most important reasons to factor future tax liabilities into a client's balance sheet is to help clients know how much spendable income they will have in retirement. Some retirement budgets have an entry for taxes, but because retirement income often comes from different sources including pensions, Social Security, annuities, traditional IRA distributions, Roth IRA distributions, part-time employment, and dividends and interest earned in taxable accounts—each with its own manner and rate of taxation—it is very difficult to estimate taxes in a retirement budget. An easier way might be to take the taxes off the top and work with the budget using after-tax income.

For example, if you have a $500,000 IRA as part of the retirement portfolio, and if the client's tax rate in retirement is expected to be around 25%, you can value the IRA at 75% of the total, or $375,000, and assume it's all available for spending.

A $500,000 Roth, on the other hand, can be counted at full value. A taxable account is trickier for the aforementioned reasons, but you can take a stab at estimating its after-tax value based on the investments it holds and your plans for managing the account (buy and hold vs. active trading).

Clients who are not used to valuing assets on an after-tax basis may gulp when you slice an immediate 25% or 30% off their tax-deferred account values in their financial plan, but it's better that they get used to the fact now that Uncle Sam will eventually claim his partnership distribution.

Asset location

When you consider that a client's share of ownership in a taxable asset is not 100% but rather 75% or 65%, with Uncle Sam's share making up the difference, it skews the asset allocation. For example, if a client has $500,000 in a nontaxable Roth IRA with $250,000 in stocks and $250,000 in bonds, the allocation is 50-50. But if the same allocation were done in a taxable account where the stocks were projected to be taxed at 15% and the bonds at 35%, the after-tax allocation would be $212,500 in stocks and $162,500 in bonds, or 57-43.

The math for after-tax asset allocation can get pretty complicated, and since asset allocation is not an exact science anyway (is there enough difference between 50-50 and 57-43?), you may or may not wish to go to the trouble of incorporating potential tax liabilities into your asset allocation

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strategy. However, you can be mindful of one of the key takeaways noted by those who have done the research: Put bonds in tax-deferred accounts and stocks in taxable accounts.

Divorce settlements and other special circumstances

Let's face it, in most cases a precise asset valuation on any given day is not necessary. Because the values keep changing anyway, estimates are usually sufficient for planning purposes. But in circumstances where a portfolio needs to be precisely valued as of a specific date, such as for a divorce settlement, taxes are an essential element in the valuation.

Tax-deferred accounts are usually a significant asset in most divorcing couples' property settlements. To compare them to other assets that do not have embedded tax liabilities, it is necessary to estimate future taxes as accurately as possible, calculate the present value of the taxes, and subtract the amount from the total asset value. This is a job for an expert—and even then it's not an exact science.

Estimating future tax liabilities for the purpose of determining current after-tax asset valuations involves lots of assumptions and many calculations. The extent to which you decide to integrate this feature into your financial planning activities will depend on the purpose of the valuation. While it is probably safe to reduce taxable and tax-deferred account values by some percentage amount to account for taxes, clients will need to understand that these are estimates only and subject to revision based on potential changes in their own circumstances and the tax rates in effect at the time Uncle Sam takes his share.

Elaine Floyd, CFP®, is the Director of Retirement and Life Planning, Horsesmouth, LLC., where she focuses on helping people understand the practical and technical aspects of retirement income planning. Horsesmouth is an independent organization providing unique, unbiased insight into the most critical issues facing financial advisors and their clients. Horsesmouth was founded in 1996 and is located in New York City.

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