TAX AWARE

Direct Indexing and the Proposed Biden Tax Plan

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There are two basic ways to invest in a stock market index: you can buy an index fund, or you can directly buy a stock portfolio that tracks the index. If you are a taxable investor, a benefit of the direct approach is that you can harvest losses on individual positions. But how high are those benefits—and what happens to them under the proposed Biden Tax Plan?

Our new paper takes a look at this by digging into three important questions:

1) What kinds of investors are most likely to benefit from direct indexing?
2) How well do these benefits hold up over time?
3) What would the proposed Biden Tax Plan[1] mean for their efficacy?

> "Investors with regular short-term gains from their other investments are likely to derive the biggest benefit from direct indexing"

First, we show that investors with regular short-term gains from their other investments are likely to derive the biggest benefit from direct indexing. (We present evidence that such investors might be predominantly high-net-worth investors with allocations to hedge funds and derivatives). How much lower is the tax benefit for investors with only long-term gains? Let's start with the left-most chart in Figure 1,[2] which is based on historical simulations of a direct indexing strategy. For investors who don't regularly add capital to the strategy, the difference in tax benefit between having short-term gains (purple line) and having only long-term gains (green line) from other investments is 2% in the first year!

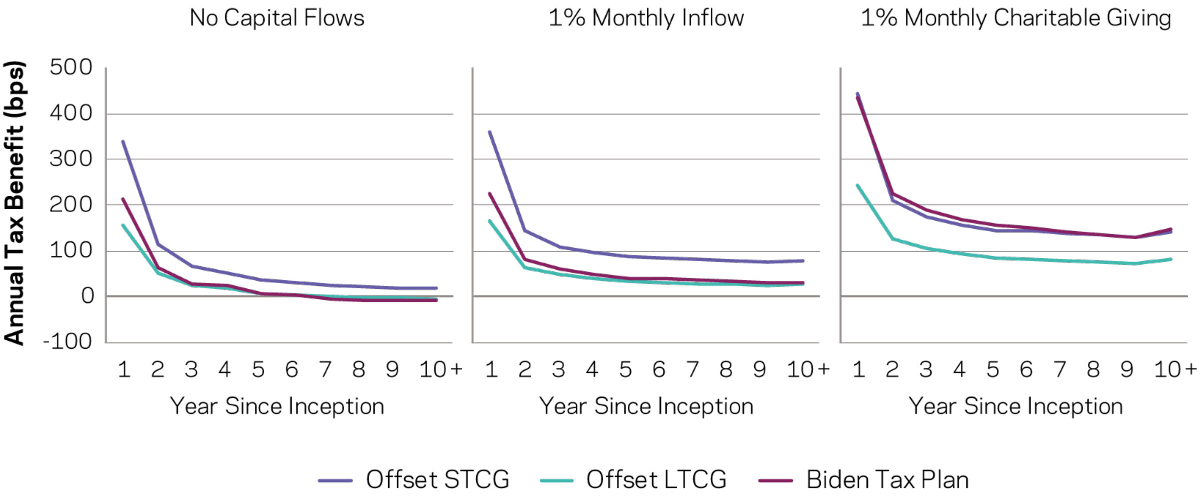
> "After approximately five to six years, the presence of regular short-term gains can make a difference between a positive tax benefit and a small tax liability"

Second, as time progresses, after approximately five to six years, the presence of regular short-term gains can make a difference between a positive tax benefit and a small tax *liability*.[3] While many investors familiar with direct indexing strategies expect their tax benefits to decay over time and to be generally lower in the absence of short-term gains from other investments, Figure 1 shows just how striking the impact is.

The last issue we tackle in the paper is the impact of the Biden Plan's proposed higher tax rates on long-term capital gains and elimination of the step-up in cost basis upon death. We use a tax rate of 43.4% (the tax rate proposed under the Biden Tax Plan for the top income bracket) for all capital gains. Sticking with the left-most chart in Figure 1, the Biden Tax Plan (red line) makes all investors look more like investors who only have long-term capital gains under the current tax regime. This makes sense: under the proposed plan, high-income investors would no longer benefit from the difference between short-term and long-term capital gains tax rates—for them the two rates will be equal.

Finally, we show how investors might be able to do better in terms of their tax benefits: 1) by contributing capital over time or, 2) by combining the strategy with a charitable giving program.[4] Regularly contributing capital to a direct indexing strategy (the middle chart) can increase the tax benefit in later years to positive territory, even for investors with only long-term capital gains from other investments. Incorporating a charitable giving program (the right-most chart) provides a meaningful bump to all investors and in all tax regimes, but especially under the Biden Tax Plan, where the build-up of unrealized gains, which results from systematic gain deferral, becomes materially less punitive because investors are able to donate appreciated positions.

Figure 1. Active Tax Benefit under Different Capital Flow and Tax Rate Assumptions



Source: XPressFeed, S&P, MSCI Barra. We run 45 separate strategy simulations starting in January of every year from 1975 to 2019 and all ending in December 2019. Each month, we minimize both tax costs and transaction costs, subject to staying within a 1% tracking error (computed using the MSCI Barra risk model) to the S&P 500. Transaction costs are computed as a function of VIX, the risk of the stock, and the amount traded relative to the stock's trading volume. For tax costs, short-term losses are rewarded more than long-term losses and short-term gains are penalized more than long-term gains. We modeled two alternative tax rate assumptions: the 2020 tax rate regime and the proposed Biden Tax Plan regime. Under the 2020 tax rate regime, the tax rate on short-term capital gains was assumed to be 40.8%, and the tax rate on both long-term capital gains and dividend income was assumed to be 23.8%. Under the Biden Tax Plan all the gains and dividends are assumed to be taxed at a uniform rate of 43.4%. When reporting tax benefits, we calculate this separately for an investor who can use short-term capital losses to offset short-term capital gains ("Offset STCG" line) and an investor who uses short-term capital losses to offset long-term capital gains ("Offset LTCG" line). Tax benefit under the proposed Biden tax Plan are shown by the line "Biden Tax Plan." We account for unrealized capital gains by computing an effective tax rate reflecting expected present value of future tax liabilities. We use the effective tax rates of 10%, 25%, 5%, and 10% for 2020 Tax Rates, Biden Tax Rate, 2020 Tax Rates with Charitable Giving, Biden Tax Rate with Charitable Giving, respectively. Finally, all tax benefits are computed relative to a benchmark, which is modeled as a direct holding in a passive ETF which distributes dividend income but does not generate any capital gains. Hypothetical performance results have many inherent limitations, some of which, but not all, are described herein. No representation is being made that any fund or account will or is likely to achieve profits or losses similar to those shown herein. Hypothetical performance results are presented for illustrative purposes only. Hypothetical performance is gross of advisory fees, net of transaction costs, and includes the reinvestment of dividends. If the expenses were reflected, the performance shown would be lower.

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[1] For high-income taxpayers, the Biden administration proposed to increase the highest bracket tax rate, tax long-term capital gains at the same rate as short-term capital gains, eliminate the step-up in cost basis upon death for assets passing through estate, and even tax all the unrealized gains upon death if the asset is not donated to charity.

[2] Figure 1 presents the same data as Figure 1 in the paper.

[3] A direct indexing strategy builds up unrealized gains due to the deferral of gains in earlier years. While this is generally beneficial for an investor, a consequence is that after a few years, rebalancing the strategy (e.g., to stay within a certain tracking error of the index) may cause the strategy to realize more gains than losses and result in a tax liability rather than a tax benefit.

[4] By combining the strategy with a charitable giving program an investor donates the most appreciated positions to charity and replaces them with new capital.

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Risks of Tax Aware Strategies (Not Exhaustive)

1. **Underperformance of pre-tax returns**: tax aware strategies are investment strategies with the associated risk of pre-tax returns meaningfully underperforming expectations.
2. **Adverse variation in tax benefits**: deductible losses and expenses allocated by the strategy may be less than expected.
3. **Lower marginal tax rates**: the value of losses and expenses depends on an individual investor’s marginal tax rate, which may be lower than expected for reasons including low Adjusted Gross Income (AGI) due to unexpected losses and the Alternative Minimum Tax (AMT).
4. **Inefficient use of allocated losses and expenses**: the tax benefit of the strategy may be lower than expected if an investor cannot use the full value of losses and expenses allocated by the strategy to offset gains and income of the same character from other sources. This may occur for a variety of reasons including variation in gains and income realized by other investments, at-risk rules, limitation on excess business losses and/or net interest expense, or insufficient outside cost basis in a partnership.
5. **Larger tax on redemption or lesser benefit of gifting**: gain deferral and net tax losses may result in large recognized gains on redemption, even in the event of pre-tax losses. Allocation of liabilities should be considered when calculating the tax benefit of gifting.
6. **Adverse changes in tax law or IRS challenge**: the potential tax benefit of the strategy may be lessened or eliminated prospectively by changes in tax law, or retrospectively by an IRS challenge under current law if conceded or upheld by a court. In the case of an IRS challenge, penalties may apply.