



Tax Aware

Separating the Wheat from the Chaff

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Investors have a range of tax-aware strategies to choose from, and we expect their choices to continue growing with time. Choosing among strategies is never easy, but, when it comes to anything tax-related, there's a simple test that can be applied to separate the wheat from the chaff: Does the strategy with beneficial tax attributes make sense before tax? In other words, would the investors have invested and paid the management fee if they were tax-agnostic?

When identifying strategies suitable for taxable investors, the most prudent approach is to focus on those that deliver pre-tax alpha—starting with strategies economically similar to those run for tax-indifferent investors—and then seek to improve the compounding of returns after tax.

It may seem counterintuitive that investors seeking tax efficiency must look for strategies motivated by a pre-tax investment rationale, otherwise known as “economic substance.” But there's a lot at stake: If a strategy fails the economic substance requirement, those tax benefits can be lost—and worse, liability penalties imposed.

However, the definition of economic substance is vague. Multiple factors may be considered when assessing a strategy's lack of economic substance, among which is how it is articulated and promoted.¹ This means investors should err on the side of conservatism when choosing a tax-aware strategy. They should also watch out for strategies that are being promoted solely (and aggressively!) for their tax benefits.

Consider an egregious example of what to avoid: a “strategy” that goes long one ETF and short another practically identical ETF. Sometime later, the strategy selectively liquidates the ETF in the losing leg of the portfolio to “harvest” a tax loss. It then replaces the liquidated ETF with another similar ETF to hedge the risk of the remaining leg of the portfolio. This helps avoid a wash sale.

In this case, it's clear that there's no pre-tax profit for the trades, and that the investment is driven exclusively by tax objectives. Moreover, the strategy is explicitly marketed as having tax benefit as its sole purpose. This “strategy” will almost certainly fail the “economic substance”² test.

Investors are unlikely (we hope!) to encounter strategies as blatantly lacking pre-tax profit motive as in this example. Real-world strategies that would be tested under the economic substance standards are likely to be more complex.

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That said, there are a few questions investors can ask to make sure they're on the right side of the economic substance divide:

1. Does the strategy deviate meaningfully from a passive benchmark?
2. Is the main objective of the strategy to deliver pre-tax risk-adjusted returns?
3. Does the strategy have an economically justifiable and evidence-supported alpha model?
4. Do tax-exempt investors—for whom pre-tax profit is the only reason to invest—invest in materially similar strategies?
5. Is the strategy promoted as solely tax-motivated and/or primarily targeting the “generation” of losses or other “tax benefits”?³

So, a word to the wise: avoid unnecessary tax risks! If a strategy doesn't seem like it's on the right side of the economic substance divide, it's best to steer clear.

[1] An IRS memorandum published in April 2022 instructs IRS examiners to consider the application of economic substance test to transactions which, among other things, have the following characteristics: 1) Transaction creates no meaningful economic change on a present value basis (pre-tax), 2) Taxpayer's potential for (pre-tax) gain or loss is artificially limited, 3) Transaction accelerates a loss or duplicates a deduction, 4) Taxpayer holds offsetting positions that largely reduce or eliminate the economic risk of the transaction, 5) Transaction has no credible business purpose apart from federal tax benefits, 6) Transaction has no meaningful potential for profit apart from tax benefits, 7) Transaction has no significant risk of loss. The memorandum also makes it easier for the IRS to challenge a transaction on economic substance grounds by removing the previously required four-step process for asserting the doctrine.

[2] It is clear from past court decisions, new language in the Code, and the guidance to IRS examiners that hedging or otherwise largely reducing or eliminating the risk of loss while seeking to achieve a tax benefit does not rise to the standard of economic substance, while economic profit as the primary motive for the transaction does.

[3] The IRS considers a variety of factors such as the perceived abusiveness and publicity/notoriety of a transaction when deciding which cases to pursue. Transactions may be deemed tax-motivated based on communications from advisors and promoters.}

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