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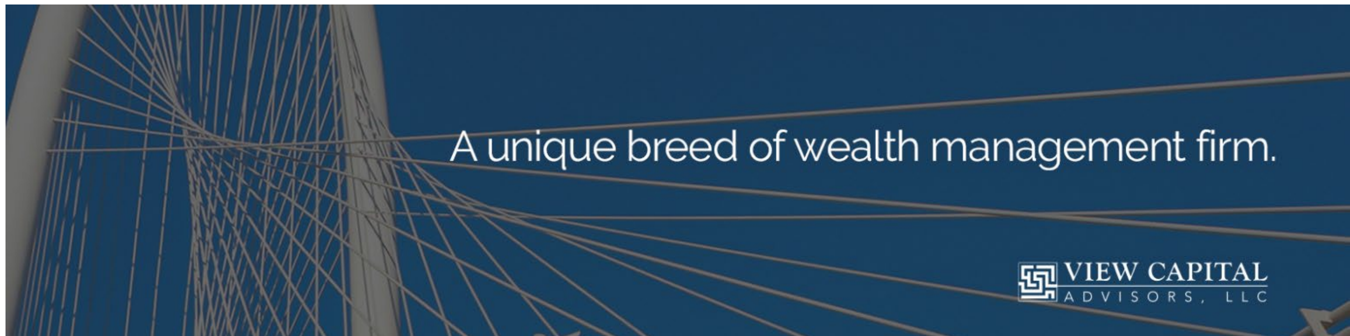

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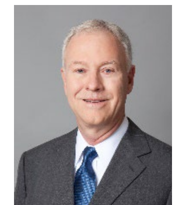

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PORFOLIO TAX DRAG, PART II

In our last quarterly Issue of Panorama, we described how investment related income tax costs can significantly drag down net portfolio returns in taxable portfolios. Continuing the discussion, we will present some concepts and strategies you can take to reduce the tax cost of your portfolio returns without necessarily having to sacrifice the gross returns of your portfolio.

1. *Location*. Tax deferred retirement accounts provide great shelter and tax deferral on what otherwise would be currently taxable income. So for those investments and funds in your portfolio that you wish to hold as a major component of your portfolio allocation, consider owning some of those that produce the most taxable income in your retirement accounts.
2. *Tax efficient investments*. Consider three common investment vehicles used by investors – mutual funds, exchange-traded funds (ETFs) and separately managed accounts (SMAs). ETF and SMA investors will only experience taxable gains when they wish to liquidate their holdings, either in ETF shares or in shares owned in the SMA. Mutual funds redeem exiting shareholders

by selling appreciated fund assets for cash to redeem shares. So a mutual fund investor will be allocated a portion of the gains from the fund's sale of portfolio stocks for redemptions by all investors, even if you did not redeem. You have greater control of the timing and amount of taxable gain with ETF and SMA investments.

3. *Long term capital gains and qualified dividends*. U.S. tax rules provide a beneficial tax rate on the taxable sale of capital assets. So long as a capital asset has been held more than one year when it is sold (the trade date is the measure), then any gain will be labelled long term capital gain with tax rates of 0%, 15%, 20% or 23.8% depending on the taxpayer's taxable income. The most common scenario where this might apply is the sale of securities in a taxable portfolio. Likewise, certain dividends known as qualified dividends are subject to the same tax rates as long-term capital gains, whereas other ordinary dividends are taxable as ordinary income at marginal rates up to 37%. Qualified dividends are generally dividends from unhedged shares in domestic corporations and certain qualified foreign corporations which you have held for at least a specified minimum period of time, known as a holding period.
4. *Tax loss harvesting*. Throughout the year, take the time to selectively "harvest" (sell) some of your unrealized loss positions and then sell a corresponding amount of your gain positions. You have to wait 30 days to buy the loss positions back, but you can buy the gain positions back immediately. This effectively gives those gain positions a new higher cost basis without the tax cost.

SECURE ACT PROPOSED REGS CREATE CONFUSION

When the SECURE Act was signed into law in December 2019, it introduced some of the most significant changes to the rules for retirement accounts in well over a decade. At the same time however, the statutory language included a number of provisions that were left open to substantial IRS interpretation. Therefore, the IRS issued Proposed Regulations on February 23, 2022, to provide guidance on the "to be defined" changes to the Internal Revenue Code made by the SECURE Act. The Proposed Regulations are likely to be amended at least somewhat before they are finalized, but they do provide a view into the IRS's current thinking on a variety of issues. And as currently proposed, the regulations provide some interpretation that advisors were not expecting.

For many individuals, the most significant change made by the SECURE Act was the introduction of the "10-Year Rule" which became effective for IRA participants who die after December 31, 2019. Under this rule, most non-spouse beneficiaries are required to distribute the entirety of their inherited retirement account by the end of the tenth year following the decedent's death. After the enactment of the SECURE Act, the general consensus among financial advisors was that the 10-Year Rule would be implemented in such a manner that would simply require the inherited account to be fully distributed by the end of the 10 year after death. During those 10 years however, it was thought that beneficiaries would have ultimate flexibility, and the ability to take out as much, or as little, as desired in each of the

first nine years after the owner's death as long as anything still left in the 10 year after death was distributed by the end of that year.

In an unexpected turn of events, the new Proposed Regulations seek to implement a remarkably complex system, whereby Non-Eligible Designated Beneficiaries would be split into two distinct groups, each with their own set of post-death distribution rules. One group would be comprised of Non-Eligible Designated Beneficiaries who inherited from retirement account owners who died prior to their Required Beginning Date (meaning the person who owned the IRA that was inherited died before age 72). This group of beneficiaries would be subject to only the 10-Year Rule.

Non-Eligible Designated Beneficiaries who inherited from retirement account owners who died on or after their Required Beginning Date (age 72 or older) would comprise the second group. And this group of beneficiaries would be subject to both the 10-Year Rule and regular stretch distributions. In other words, beneficiaries who inherit retirement accounts whose owners die on or after the Required Beginning Date would continue to have to comply not only with the stretch distribution rules in place before the SECURE Act was passed, but on top of those annual minimum requirements in each of the first nine years after death, they would also be required to empty the account by the end of the 10th year after death.

The sum and substance of the IRS regulation position on non-spouse inherited IRA accounts is that too much deferral is bad, and paying taxes sooner is good (for IRS). Leave it to government bureaucracy to find the most complicated ways to force this result from taxpayers. So if this situation applies to you, what should you do? The proposed regulations will likely become final in 2022, and could require affected beneficiaries to start taking taxable distributions in 2022. But for now, the message is "heads up", the rules are not officially effective yet and could change, so put this on the 2022 discussion agenda (don't wait until 2023) with your tax adviser so that you can take any appropriate actions when the final regulations unfold.

CORPORATE TRANSPARENCY ACT

The Corporate Transparency Act (CTA) was enacted on January 1, 2021 as part of the National Defense Authorization Act. It effectively will create a national beneficial ownership registry in the United States. This is an anticipated development of the efforts of the international community through the Financial Action Task Force (FATF), to combat the use of anonymous entities for money laundering, tax evasion, and the financing of terrorism.

Customer due diligence regulations in the U.S., adopted in 2016 and 2018 (the "CDD Regulations"), require financial institutions to obtain identifying information when opening bank accounts for entities. In addition, title insurance companies must provide beneficial ownership information for legal entities

used to make high-end cash and wire purchases of real estate in various metropolitan areas. Even with the CDD Regulations, the U.S. has been viewed internationally as still being weak on money laundering and tax evasion because of a perceived lack of corporate transparency and reporting of beneficial ownership.

The CTA requires that certain entities must disclose to the Financial Crimes Enforcement Network ("FinCEN") identifying information about individual owners and those who control the entity ("Beneficial Owners") and "Applicants" applying to form an entity. A national registry of entities and their applicants and owners in the United States will be created. Charitable organizations, including private foundations, and a number of entities that are already subject to a high level of U.S. regulation are specifically exempt from the reporting requirements.

Reporting Companies

The proposed rule identifies two types of reporting companies: domestic and foreign. A domestic reporting company would include a corporation, limited liability company, or any other entity created by the filing of a document with a secretary of state or similar office under the law of a state or Indian tribe. A foreign reporting company would include a corporation, limited liability company, or other entity formed under the law of a foreign country and that is registered to do business in any state or tribal jurisdiction.

Certain types of legal entities including certain private trusts, would appear to be excluded from the definitions to the extent that they are not created by the filing of a document with a secretary of state or similar office. FinCEN recognizes that the creation of many trusts does not involve the filing of such a formation document. The Notice of Proposed Rulemaking (NPRM) however, seeks public comment on state and Indian Tribe law practices regarding trust formation to better understand and define the scope of the rule.

Beneficial Owners

Under the proposed rule, a beneficial owner would include any individual who (1) exercises substantial control over a reporting company, or (2) owns or controls at least 25 percent of the ownership interests of a reporting company. The proposed regulation defines the terms "substantial control" and "ownership interest" and sets forth standards for determining whether an individual owns or controls 25 percent of the ownership interests of a reporting company. The proposed rule exempts five types of individuals from the definition of "beneficial owner."

Company Applicants

In the case of a domestic reporting company, the proposed rule defines a company applicant

as the individual who files the document that forms the entity, typically a lawyer. In the case of a foreign reporting company, a company applicant would be the individual who files the document that first registers the entity to do business in the United States.

In both cases, the proposed regulation specifies that anyone who directs or controls the filing of the relevant document by another would also be a company applicant and this person would likewise be required to disclose his/her identity information.

Beneficial Ownership Information (BOI) Reports

When filing BOI reports with FinCEN, the proposed rule would require a reporting company to identify itself and report four pieces of information about each of its beneficial owners and company applicants: name, birthdate, address, and a unique identifying number from an acceptable identification document (and the image of such document). If an individual provides his or her BOI to FinCEN, the individual can obtain a "FinCEN identifier," which can then be provided to FinCEN in lieu of other required information about the individual. Perhaps this will be similar to the TSA Security Pre-Check process?

Timing

Under the proposed rule, BOI report timing would depend on (1) when a reporting company was created or registered, and (2) whether the report at issue is an initial report, an updated report providing new information, or a report correcting erroneous information in a previous report.
Domestic reporting companies created before the effective date of the final regulation would have a year to file their initial reports; reporting companies created or registered after the effective date would have 14 days after their formation to file. The same deadlines would apply to existing and newly registered foreign reporting companies.

Reporting companies would have 30 days to file updates to their previously filed reports, and 14 days to correct inaccurate reports after they discover or should have discovered the reported information is inaccurate. So unless you have the prohibited intentions for creating your affected entities, this will just be another reporting requirement that you have to pay attention to. Don't take the obligation lightly however, as there are expensive civil and potentially criminal sanctions for noncompliance. We expect these rules to become effective in 2022, with applicable reporting for new entities following the guidelines, and reporting for existing entities beginning in 2023.

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