PARAMETRIC

Pending FIFO tax legislation - FAQs

November 21st, 2017

Background

- The U.S. Senate and the House of Representative have proposed separate tax bills targeting aggressive timelines—proponents are aiming for a January 1, 2018 implementation. The House version passed late last week.
- One of the tax law changes proposed in the Senate bill, but not the House bill, would require investors to use a first in, first out (FIFO) accounting methodology for tax lots when calculating capital gains tax.
- If this remains in an adopted bill, it will impact the way portfolios are tax managed, and it increases the importance of using tax management in combination with portfolio management expertise.

Q&A

Q: What does this FIFO amendment really mean?

The FIFO provision is essentially a new tax on investors. As a result, tax management should command a premium going forward because it will become more complicated to help investors reach their objectives. Advisors and clients will need customized tax-managed solutions more than ever before, and Parametric is prepared to help position client's portfolios as soon as any new rules are enacted.

If the Senate's version of tax legislation is passed, we believe that requiring the use of FIFO would reduce some of the benefit of aggressive tax-loss harvesting. This is due to a loss of flexibility in choosing tax lots for loss harvesting.

The good news is that tax management is still very valuable. Under the current specific-lot accounting rules, our simulations show that systematic tax-loss harvesting in a broad market separate account can provide excess after-tax returns ranging from 0.7% to 2.5%, depending on market conditions and the specific client situation. Under FIFO, we estimate the benefit will be lower, between 0.5% and 2.0%.

We have been following and researching the specific potential for FIFO legislation for much of 2017. As part of our disciplined approach, our Research and Investment Strategy teams have been testing systems and processes across various scenarios to ensure we can comply quickly on behalf of investors.

Q: What investment vehicles would be impacted?

The tax bill is in flux, but as of earlier this week, the FIFO requirement seems to apply to all vehicles except for trading within Registered Investment Companies (mutual funds).

Q: Would this give mutual funds a huge advantage?

No. They are still 'commingled' vehicles. As such, they are still subject to embedded gains earned by earlier investors. They cannot be customized to a particular investor's situation and, in the case of tax-loss harvesting, they cannot distribute losses in excess of realized gains. Commingled funds can also experience tax distribution increases during periods of high redemptions.

Q: How will this impact Separately Managed Accounts (SMAs)?
Most separate-account managers could face increased taxation costs because they don't manage their portfolios for 'after-tax' performance like Parametric does, with active and continuous tax management.

Q: What about the impact on Custom Core™, where tax management is a critical part of the offering?
There are three reasons why we believe any reduction in tax alpha across Custom Core accounts will be modest:

1) When there is only one tax lot for a security, there is no difference between HIFO (highest in, first out) and FIFO, so there would be no change to our approach.

2) Many of the benefits of tax loss harvesting come from large price moves. If the corresponding loss is significant, there will usually be tax-loss harvesting benefits regardless of the accounting method.

3) Realizing a long-term capital gain (from an old tax lot) to get a short-term capital loss (from a newer tax lot) creates a tax rate arbitrage that can actually boost tax alpha. These gain realizations also refresh the cost basis, making tax-loss harvesting opportunities more likely in the future.

Q: This seems to apply to cash-funded Custom Core accounts, but what about a transition where the prior manager had multiple tax lots?

This situation can be more challenging, but the actual difference is very dependent on each case and on specific client circumstances. In several transitions we looked at (where we keep the tracking error and benchmark risks constant) we observed a range of 10% to 20% increase in gain realization under FIFO. Of course, the client may choose to accept a wider tracking error to reduce gain realization.

Our Approach

There are three key questions we are actively working to address:

Q: What code changes do we need to make to our proprietary systems?

Our Technology team, in collaboration with our Research group, has produced a new formulation of our optimization software. Initial tests show that it meets all our requirements and compares favorably with other testing we have done.

Q: Can we quantify the impact on tax alpha?

We have produced an initial research brief that finds only a modest impact on tax alpha. We are in the process of extending our testing looking at bull and bear market periods.

Q: If FIFO starts January 1, 2018, what trades would we do in December?

We have sorted through all taxable Custom Core accounts (totaling $56 billion assets under management (AUM)). On average, there is only about 10 basis points worth of harvestable losses, excluding the first lot (only 60 basis points including the first lot). This is not surprising because we continually look for harvestable losses.

When we looked at accounts with greater than 25 basis points of harvestable losses, not including the first lot, it was a small fraction of our total accounts. We will review these accounts and proactively reach out to advisors to plan year-end trades. Additionally, we plan to produce some reports on charitable gifting of tax lots, which could be advantageous to implement this year.

What's Next

- If this legislation is pushed through, we expect it to increase pressure on actively managed SMAs which will likely see increased taxation. Requiring FIFO is essentially a new tax on stock portfolios.
- Overall, tax management should command a premium going forward as it will become more complicated to help investor reach their objectives.
- Advisors and clients will need tax-managed solutions like Custom Core more than ever before and Parametric is prepared to help optimally position client portfolios.

Parametric is located at 1918 8th Avenue, Suite 3100, Seattle, WA 98101. For more information regarding Parametric and its investment strategies, or to request a copy of Parametric's Form ADV, please contact us at 206.694.5575 or visit our website, www.parametricportfolio.com.