

## Tax Strategies for Alternatives: Sharpening After-Tax Performance

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### Key takeaways

- Investors can improve after-tax returns by reducing marginal tax rates, deferring tax liabilities and by generating investment losses to offset taxable gains.
- Tax liabilities can vary by the location of assets, including tax-free distributions from Roth IRAs, distributions from traditional IRAs and 401(k)s taxable at ordinary rates, and distributions from taxable accounts, which can take advantage of lower qualified dividend and long-term capital gains tax rates.
- Certain strategies, such as exchange funds, tax-loss harvesting, life insurance and variable annuities, can also be used to reduce or defer tax liabilities.

### Introduction

Taxes are a controllable factor that can significantly impact wealth preservation and growth. With tax rates ranging from zero to the highest marginal brackets, strategic planning is essential for protecting and compounding capital over time. Sophisticated solutions such as exchange funds, tax-loss harvesting, and insurance-based structures can be powerful levers for reducing current tax liabilities, deferring future taxes, and optimizing estate transfers. By integrating these strategies into the management of portfolios, investors can potentially increase after-tax returns and enable greater wealth accumulation for current and future generations.

### Tax Rates Vary by Asset Type, Asset Location, & Holding Period

Investors and their advisors need to be aware of tax implications across an investment portfolio. As noted in Table 1, tax rates can range from zero to the investor's marginal rate, depending on the investor's overall taxable income, the type of asset, the holding period of the asset, and the type of account in which the asset is held.

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**TABLE 1**  
**Typical Tax Treatment of Income Received by US Investors**

INVESTMENT TYPE	TAX TYPE	FEDERAL TAX RATE
Qualified Dividends on Common and Preferred Stocks	Preferentially Taxed	0%, 15%, or 20% based on the investor's tax bracket (plus 3.8% net investment income tax, if applicable)
Long-Term Capital Gains on Assets Held Longer than 12 Months	Preferentially Taxed	0%, 15%, or 20% based on the investor's tax bracket (plus 3.8% net investment income tax, if applicable)
Short-Term Capital Gains on Assets Held Less than 12 Months	Ordinary Income	Taxed at the investor's marginal rate (plus 3.8% net investment income tax, if applicable)
Qualified Distributions from 401(k) Plans and Traditional IRAs	Ordinary Income	Taxed at the investor's marginal rate
Non-Qualified Income Distributed by Bonds, Private Credit, REITs, BDCs, MLPs, etc	Ordinary Income	Taxed at the investor's marginal rate (plus 3.8% net investment income tax, if applicable)
Qualified Distributions from Roth IRAs. Interest on Municipal Bonds	Tax-Exempt	Tax-Exempt

## Tax Considerations for Alternative Investments

Alternative investments may complicate or simplify taxes, depending on the strategy and how they are implemented in a portfolio. Investors usually prefer to have taxable income reported on a Form 1099, which is a simple form that is issued to investors as early as January of the year after a taxable event.

Transactions reported on a Schedule K-1 can significantly complicate taxes, as the information may not be available before the regular tax filing deadline of April 15<sup>th</sup>. Many alternative investments, such as private equity funds and hedge funds, which are organized as partnerships and report transactions on a Schedule K-1.

When building holistic tax-management strategies, investors need to be mindful of the unique tax implications of adding private assets to their portfolios. Some investments, such as hedge funds, deploy high-turnover strategies that may generate substantial short-term gains. Other strategies, such as Real Estate Investment Trusts (REITs), Master

Limited Partnerships (MLPs), and energy investments, may generate tax-advantaged income by classifying portions of distributed income as depreciation, depletion, or as a return of capital.

## Investment Strategies to Reduce or Defer Tax Liability

Investors can improve after-tax returns by reducing the marginal tax rate they pay on income and asset sales, by deferring tax liability to later years, or by generating investment losses to offset taxable gains. Capital losses are eligible to offset capital gains in the current year with no limit. If losses exceed gains, you can then deduct up to \$3,000 of the excess against other ordinary income. Any remaining unused losses in excess of the \$3,000 can carry forward indefinitely to offset future capital gains in subsequent years. Holding investments that generate ordinary income in a tax-deferred account, such as a traditional IRA, can defer taxes on income that would be taxed at the higher non-qualified rate in the current year.

**TABLE 2**  
**Strategies to Defer or Reduce Tax Liabilities**

<b>INVESTMENT STRATEGY</b>	<b>STRATEGY OR VEHICLE</b>	<b>TAX BENEFIT</b>
<b>Estate and Gift Tax Planning Strategies</b>	Trusts to help manage the transfer of alternative investments to future generations, such as Grantor Retained Annuity Trusts (GRAT)	Reduce or minimize tax liability
<b>Concentrated Wealth Strategies</b>	Exchange funds offer diversification without triggering immediate tax liabilities	Valuable for reducing concentrated stock risks and benefiting from diversification without paying tax.
<b>Long-Short Tax Strategies</b>	Tax Loss Harvesting	Generate losses to offset taxable gains and income now or in the future. One common use of long/short is building-up losses (using loss carry forwards) for future taxable events such as the sale of a business
<b>Tax-Advantaged Income Strategies</b>	REITs, MLPs, and Energy Investments	Income may be treated as a return of capital.
<b>Insurance-Related Tax-Advantaged Growth Strategies</b>	Private Placement Life Insurance (PPLI) Private Placement Variable Annuities (PPVA)	Private assets can be held in an insurance wrapper, which defers taxable income until the income is withdrawn.

In addition, as noted in Table 2, certain investment types can be used to defer or reduce tax liabilities. Estate and gift tax planning strategies seek to transfer assets with the greatest potential appreciation out of the investor's taxable estate. One such strategy is a Grantor Retained Annuity Trust (GRAT), where the grantor transfers assets expected to appreciate in value into the trust for a fixed term while retaining the right to receive annual annuity payments, plus an interest charge. Because the GRAT is typically a grantor trust, the grantor continues to pay income taxes on the trust's earnings as if they still owned the assets personally. At the end of the trust's term (assuming the grantor survives), the assets remaining in the trust are transferred to the beneficiaries, free of estate or gift tax liabilities. GRATs are attractive to investors whose estates may exceed the Federal Gift and Estate Tax Exemption, especially if they hold concentrated positions in private company stock expected to appreciate substantially over the life of the trust.

Concentrated wealth is a key concern for many investors. While the outsized position(s) may increase portfolio volatility, investors may be reluctant to sell due to emotional attachment, overconfidence, or employee trading restrictions. However, the most common hurdle to a sale is the reluctance to pay taxes on the embedded capital gains.

Investors can pair a concentrated position with direct indexing, or they can use a long-short strategy to harvest tax losses. As tax losses are generated to offset the taxable gains embedded in a concentrated position, the stock is sold off incrementally to match the realized gains to the losses generated.

Investors may also choose to contribute a highly appreciated position to an exchange fund, which diversifies the portfolio, reduces volatility, and defers taxes until the exchange fund is sold. No tax liability is triggered when the concentrated asset is contributed to an exchange fund, which allows for the compounding of returns on deferred taxes. Investors

frequently hold exchange funds until death, allowing their heirs to potentially inherit the exchange fund with a step up in cost basis.

Tax-advantaged income strategies are used to shield investment income from taxes. Such strategies may offer favorable tax treatment, such as pass-through taxation or reduced tax rates on certain types of income. For example, investments in REITs, MLPs, or energy projects may pass-through tax benefits to investors in the form of depreciation or depletion deductions that are generated by the investments (subject to the basis, at-risk, passive activity, and excess business loss-limitation rules). Some distributed income may be treated as a return of capital, deferring taxes on the income until the investment is sold.

Insurance-related solutions can be used to achieve tax-advantaged investment growth. Private Placement Variable Annuities (PPVAs) allow investors to allocate to an actively managed portfolio of traditional and alternative investments while deferring tax liability until assets are withdrawn

from the policy. Similar to annuities or traditional IRAs, withdrawals are taxed as ordinary income. PPVAs do not receive a step-up in basis at death and do not provide a tax-free death benefit.

Private Placement Life Insurance (PPLI) can also allocate to alternative investments, with gains growing tax-free inside the policy. Similar to a life insurance policy, proceeds at death are distributed to heirs free of income tax liability. The death benefit may be free of estate tax liability if the PPLI is held in an Irrevocable Life Insurance Trust (ILIT).

## Conclusion

Incorporating tax considerations into portfolios that include alternative assets is crucial for optimizing wealth preservation and growth. By employing tax strategies such as exchange funds, tax-loss harvesting, and insurance-based structures, investors can enhance their after-tax returns while ensuring greater wealth accumulation for current and future generations.

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