

AW Weekly: Tax Aware Investing

A significant liquidity event, such as the sale of a private business or a valuable piece of real estate, frequently highlights a vital financial reality: wealth compounds most efficiently when tax exposure is managed with the same precision as asset allocation. Without structural planning, capital gains taxes can considerably diminish realized profits.

The Real Cost of Capital Gains

When you sell an asset for a profit, federal and state governments take a cut. Depending on your income, federal long-term capital gains tax rates hover around 15% to 20%. Add to that potential state income taxes or the 3.8% Net Investment Income Tax for high earners, and a good chunk of your profit can disappear before it ever has a chance to compound and grow.

Tax-Aware Investing

When planning for an asset sale, it's essential to consider the tax implications and plan accordingly to maximize your after-tax return. Here are three fundamental ways sophisticated wealth management addresses this:

- 1. Systematic Tax-Loss Harvesting:** Market volatility is inevitable, but it also creates structural opportunities. Tax-loss harvesting involves deliberately selling specific underperforming securities to realize a capital loss. These losses are then used to directly offset capital gains realized elsewhere in your portfolio or even offset up to \$3,000 of ordinary income. By keeping the proceeds reinvested in similar (but not identical) assets, the portfolio maintains its market exposure while lowering your overall tax liability.
- 2. Direct Indexing and SMAs:** Traditional mutual funds often pass embedded capital gains distributions down to their shareholders at the end of the year, even if the investor didn't sell a single share. To bypass this inefficiency, high-net-worth portfolios often utilize Separately Managed Accounts (SMAs) or direct indexing. Because you directly own the individual underlying stocks rather than shares of a fund, managers can customize trades around your specific tax bracket, harvest losses at the individual stock level, and avoid unwanted capital gains distributions entirely.
- 3. Strategic Asset Location:** Not all investment accounts are treated equally by the IRS, and neither are all investments. Asset location is the practice of placing specific types of investments into the account structures where they are treated most favorably.

The Bottom Line

Maximizing net returns isn't just about chasing the highest-performing stock, it's about mitigating structural drag. Ensuring your portfolio architecture is fundamentally tax-aware is one of the most reliable ways to preserve long-term purchasing power.