



# Tax Overlay Implementation Guide



## OVERVIEW

Tax overlay is a holistic service that enables advisors and investors to address needs around tax management while minimizing the affect these client specific customization requirements have on their investment portfolios. Tax overlay makes the customization possibilities of equity SMA sleeves practical, scalable, and broadly applied.

Most tax overlay strategies use a “rules-based” optimization process that uses cut-and-dry parameters that do not always take into consideration other factors.

**Our patented Risk-Based Optimization is an innovative process that enables balancing the investment decisions of individual managers with specific client customization requests, all while maintaining the overall risk profile model portfolio.**

## HOW IT WORKS

### Risk-Based Optimization Process

This patented process incorporates strict adherence to each investment manager’s strategy within the UMA (including overall risk profile) and centralizes the discretionary authority, providing a single investment solution.

### Deferring short-term gains

Envestnet | PMC can delay the sale of a security to allow the security to mature from short term gains to long term gains.

### Tax loss harvesting

Looking back at what gains were realized year to date and then harvesting losses in the portfolio to reduce the tax burden.

### Versus Purchase (VSP) Trading

Identifies which tax lot to sell at the custodian, and if there are multiple tax lots for the same security, tax overlay will identify which tax lot should be sold resulting in the lowest capital gains.

### Client specific tax budgets

Investors can express to Envestnet | PMC their desire to limit the amount of capital gains realized on a yearly basis while maintaining reasonable tracking error.

### Short-term gain/loss matching

Immediately harvest a short-term loss in the account to offset a short-term gain.



## BENEFITS

- ✓ Allows investors to realize the full potential of the customization an equity SMA offers due to the client owning the securities within the SMA, therefore decisions can be made at the account level and not at the model level as taxes are unique to the client
- ✓ Automates tax management of an equity SMA by minimizing the short-term capital gains that result from client customizations and trading
- ✓ Diversifies concentrated portfolios in a tax-efficient manner
- ✓ Delivers goals and parameters defined through consultation with Envestnet | PMC
- ✓ Addresses ongoing model changes in a tax-efficient manner
- ✓ Seeks to limit the amount of tracking error (TE) while also balancing the tax implications of each transaction within a client's account
- ✓ Provides the tools to assist in growing your taxable account business
- ✓ Adds a solution for large tax liabilities to differentiate your practice with high net worth clients
- ✓ Provides a scalable way for advisors to manage accounts with client specific tax budgets

Tax overlay provides a year-round, comprehensive solution to tax management that **allows you to no longer worry about year-end tax loss harvesting.**

## REQUIREMENTS FOR USE

- > Available only for UMA accounts
- > The UMA account must contain at least 1 equity SMA sleeve (fund strategist portfolios (FSPs) do not qualify)
- > At least 50% of the UMA account should be allocated to equity SMA sleeves OR 35% to Quantitative Portfolio sleeves
- > Mutual fund, ETF, and bond SMA sleeve(s) must be fully funded at the inception of the account
- > Cost basis information must be complete for all holdings
- > Proposed Asset Transition Summary (PATS) analysis must be done for all accounts being funded by legacy securities
- > Tax form must be completed



## TURNING ON TAX OVERLAY

If your overlay account is being funded by legacy securities, contact an Overlay Services Specialist to conduct a PATS analysis prior to turning on.

### DURING THE PROPOSAL PROCESS

1. Once you get to the “**Implement**” tab you will go through the “**Account Setup**” tab
2. In the next screen you will select your “**Overlay Features**”
3. Select the “**Tax Overlay Service**” option
4. Select “**Save + Next**”
5. When you generate the paperwork for the proposal an additional Tax overlay services form will also generate and need to be filled out

### ACCOUNTS ALREADY ON THE PLATFORM

1. On the client profile page, go to the **Service** tab
2. Click on the “+” and select “**Modify Goal**”
3. In the left sidebar go to the “**Overlay Features**” tab
4. Select the “**Tax Overlay Service**” option
5. Select “**Save + Next**”
6. When you generate the paperwork for the proposal an additional Tax overlay services form will also generate and need to be filled out

## CASE STUDY

### Example 1: Portfolio transition with or without tax management

Tax overlay allows you to significantly reduce short-term capital gains for a low tax management fee, with the trade-off being an increase in the tracking error.

Account Value: \$11,649,130.00

Year 1 Tax Budget	Net Realized Short Term Gains	Net Realized Long Term Gains	Weighted Account Tracking Error	First Year Tax Bill Due To Transition	Tax Management Fee	Potential First Year Tax Savings
<b>No Tax Management</b>	\$376,234	\$1,625,776	.02%	\$550,220	\$0	N/A
<b>\$0ST/\$0LT</b>	\$0	\$0	2.81%	\$0	\$11,649	\$538,571
<b>\$0ST/\$500K LT</b>	\$0	\$500,000	1.80%	\$119,000	\$11,649	\$419,571
<b>\$0ST/\$1MM LT</b>	\$0	\$1,000,000	1.22%	\$238,000	\$11,649	\$300,571
<b>\$0ST/Unlimited LT</b>	\$0	\$1,625,000	.80%	\$386,750	\$11,649	\$151,821

*\*This is a hypothetical example for illustrative purposes only and not based on actual account information. This scenario is assuming an income tax rate of 43.4% and a capital gains rate of 23.8%.*

### Example 2: Risk optimization at the account level

A simple instruction from the manager to trim a position might result in different trading results at the account level

Client	Security Holding Status	Short Term Capital Gains Budget	Long Term Capital Gains Budget	Account Level Results
<b>A</b>	Long-term gains	\$0	None or Below	Position is sold. Client has a LT capital gain.
<b>B</b>	Long-term gains	\$0	At Budget	Position maybe sold if losses are available to offset gains. If tracking error allows, position may continued to be held.
<b>C</b>	Short-term gains	\$0	None or Below	Position is held for additional two weeks allowing the tax lot to mature from short term gains to long term gains.
<b>D</b>	Short-term gains	\$0	None or Below	Position is sold and the risk optimizer identifies losses in the UMA to immediately harvest.
<b>E</b>	Short-term gains	\$0	None or Below	Position is sold and the risk optimizer will try to identify losses throughout the remainder of the year to offset gains.

## BEST PRACTICES

The ideal accounts for tax overlay services are taxable accounts of \$500,000 or more and a significant equity allocation.

Overlay is intended to help an advisor by:

- “Proactively” managing tax exposure while staying true to investment model
- Accommodating portfolio changes while managing taxes to client specific mandates
- Limiting or eliminating short term capital gains to improve client outcomes
- Harvesting losses to offset gains elsewhere in a client’s asset base
- Checking in with your client annually to review and make any necessary changes to the tax form
- Scheduling a call with the overlay specialist team as needed to check in on your client’s progress throughout the year



For any questions or assistance regarding Overlay Services contact an Overlay Services Specialist at

**(972) 996-5404**



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