Smartleaf's Estimated Taxes Saved or Deferred Report FAQ

What is the Estimated Taxes Saved or Deferred Report?

The Estimated Taxes Saved or Deferred Report ("ETSoD Report") is an estimate of how much you save or defer in taxes through active tax management.

How are Estimated Taxes Saved or Deferred calculated?

The ETSoD Report compares the taxes on realized capital gains of your portfolio relative to the hypothetical alternative where your account was traded exactly to your target model every day. The ETSoD Report has three components:

- Tax savings from gains not realized
- Tax savings from short-to-long events
- Tax savings from net loss harvesting

What are "Tax savings from gains not realized"?

These are taxes saved by not selling an overweighted position with unrealized gains down to its target weight.

Example:

- Assumptions:
  - The target weight of IBM is 2%.
  - Your portfolio is currently 3% IBM, with $150 of long-term unrealized gains.
  - Your long-term marginal tax rate is 20%.
- Selling IBM down to its target weight would result in $50 in realized capital gains (it would require selling ⅓ of your holdings and so realizing ⅓ of the $150 in gains) and $10 in capital gains taxes ($50 x 20%).
- *Not* selling IBM down to its target weight would therefore save (or defer) $10 in taxes. This would generate $10 in "tax savings from gains not realized".

What are "Tax savings from short-to-long events"?

These are taxes saved by holding an overweighted position with *short-term* unrealized gains until the position is long term.

Example:

- Day 1: You buy $100 of IBM, which is IBM's target weight
- Day 300:
    - The "target" weight of IBM is reduced to 0%.
    - The value of your IBM has risen to $150 ($50 of gain)
    - Your tax rates are: 45% on short-term gains, 20% on long-term gains
    - If you sold your IBM, you'd pay tax at short-term rates on your gains: 45% * $50 = $22.50
- Day 366:
    - Your IBM is now long term
    - The value of your IBM remains at $150
    - If you sold your IBM, you'd pay tax at long-term rates on your gains: 20% * $50 = $10.00

By waiting until your IBM position becomes long term, you have cut the applicable tax rates from 45% to 20%, from $22.50 to $10.00. The savings of $12.50 represents "Tax Savings from short-to-long events"

What are "Tax savings from net loss harvesting"?

These are taxes saved from selling a position at a loss below its target weight.

Example:

- Assumptions:
    - The target weight of IBM in your portfolio is 2%
    - Your portfolio is 3% IBM, with $150 of long-term unrealized losses
    - Your long-term marginal capital gains rate is 20%.

- Selling IBM down to 1% would result in $100 in realized capital losses (it would require selling 2/3 of your holdings and so realizing 2/3 of the $150 in losses) and $20 in tax credits ($100 x 20%), assuming the loss can be used to offset realized gains from other portfolio activity.
- However, only $10 would count as "tax savings from net loss harvesting". The reason is that we only count the amount of losses that result from selling a position *below its target weight.* In this case, the first $50 of loss (and $10 of tax savings) comes from selling the IBM position down *to* its target weight and so does not count (Why doesn't it count? Because we are calculating the taxes saved or deferred from *active* tax management. In the scenario we're considering, the $50 realized loss from selling IBM from 3% down to its target weight would have happened even without tax management.)

{Technical note: should the situation ever arise, selling a position with a gain below its target weight would reduce reported "tax savings from net loss harvesting". This is where the "net" in "net tax loss harvesting" comes from.}

What's the difference between "taxes saved" and "taxes deferred"?

Taxes saved are taxes that you do not pay. Taxes deferred are taxes you do not pay *today*, but you may (or may not) pay in the future. The ETSoD report includes both.

Components of the ETSoD report that represent taxes saved:

- "Tax savings from short-to-long events": when we hold an overweighted position with short-term gains until the gains were long-term, the difference between the amount you would have paid at short-term vs. long-term capital gains rates represents taxes saved.

- Some of "Tax savings from net loss harvesting": when we loss harvest a position with short-term losses, the difference between the amount of taxes you offset with short losses vs long losses represents taxes saved. Loss harvesting always lowers your basis (the purchase price used to determine the amount of taxable capital gains), but if you loss harvest short term gains now, and sell the replacement security only when it becomes long term, you will have realized short-term losses but paid long-term gain.

Components of the ETSoD that represent taxes deferred:

- "Tax savings from gains not realized": these are overweighted positions with unrealized gains. By not selling these positions today, we defer taxes. However, it is possible that these overweighted positions will be sold in the future. (On the other hand, if these oveweighted positions are donated to charity or held until death, there will be no future capital gains tax burden and "deferred" taxes will become "saved" taxes.)

- Most of "Tax savings from savings from net loss harvesting": we noted above that with realized short term losses, the difference between the short and long-term tax rates may represent tax savings, but the tax savings from the loss harvesting of long term losses represents taxes deferred, not saved (unless the substitute security you buy either 1) does not rise in value, 2) is donated to charity, or 3) is held until death, in which case "deferred" taxes will become "saved" taxes).

Why is deferring taxes valuable? Will I eventually have to pay taxes that are deferred?

Deferring taxes is valuable for two reasons:

1. You can continue to earn money on the taxes you defer, until the taxes are paid. For example, if you defer paying $100 in taxes for 10 years and earn 6%/year during that time, you will end up with an extra $79 (though you may owe tax on this extra income).
2. You may never have to pay taxes – that is, "deferred" taxes may become "saved" taxes. In the case of "gains not realized", this will happen if you donate shares with unrealized

gains to charity or hold them until death. In the case of loss harvesting, this will happen if the substitute security you buy either 1) does not rise in value, 2) is donated to charity, or 3) is held until death, in which case "deferred" taxes will become "saved" taxes.

Do the savings from "taxes saved or deferred" add or compound?

No. Taxes saved or deferred do not compound. That is, if, in year one your reported taxes saved or deferred is 1% and in year two, it's 2%, the cumulative taxes saved or deferred is neither additive, like simple interest (1% + 2% = 3%) nor compounding, like compound interest (1.01 × 1.02 - 1 = 3.02%).

The reason is that some or all of "taxes saved from unrealized gains" can roll over from one year to the next, which would result in double-counting if you tried to add or compound the savings from multiple years. For example, holdings of IBM with $100 of unrealized gains on December 31 that still had $100 of unrealized gains on January 1st would count towards taxes saved from unrealized gains in both years. To avoid this double counting over multiple years, we provide a "since inception" Taxes Saved or Deferred report in addition to the "year to date" number.

In addition, taxes saved or deferred would only compound if you assume that the taxes that you don't pay would otherwise have been withdrawn from the investment portfolio (as opposed, say, to a separate savings account). This isn't an unreasonable assumption, but it isn't necessarily representative of what most investors do. In calculating the ETSoDR, we do not assume the taxes saved or deferred are reinvested.

What is the difference between "Taxes saved or deferred year-to-date" and "Taxes saved or deferred since inception"?

The methodology of the calculator is the same (see the response to the "How are Estimated Taxes Saved or Deferred calculated?" FAQ above). The only difference is the time period. The "year-to-date" calculation starts at the beginning of the current year. The "since inception" calculation starts on whatever date the portfolio was first traded on the Smartleaf system.

Is "taxes saved or deferred" the same thing as "tax alpha"?

No. Tax alpha is defined as the difference in after-tax returns minus the difference in pre-tax returns of a portfolio vs benchmark. While the TSoDR compares your portfolio to the hypothetical alternative of simply trading to the target portfolio everyday, it is not based on pre or after-tax returns as it might be measured by a performance-reporting system – it just adds up the three elements described in the response to the "How are Estimated Taxes Saved or Deferred calculated?" FAQ above.

In particular, the TSoDR report does not consider the:

- difference in the pre-tax performance of substitutes. Specifically, in the case of loss harvesting, we don't compare the performance of the original security with its substitute. And in the case of gains deferral, we don't compare the performance of the overweighted security to the security (or securities) that, of necessity, must be underweighted.
- potential follow-on tax consequences of tax-driven trades. Specifically, in the case of loss harvesting, we don't consider the tax costs or savings that arise from the sale of the substitute security.

See also the response below to the "Why is it called an "estimate"?" FAQ.

Why is it called an "estimate"?

The ETSoDR is calculated daily based on your specific target and holdings, but it is still only an estimate. Here are some of the reasons why:

- The calculations are based on the security prices at the time the Smartleaf system does its analysis, which may be different from the actual execution prices of the recommended trades
- We assume that all long-term losses will be used to offset long-term gains and all short-term losses will be used to offset short-term gains. In practice, long-term losses may be used to offset short-term gains or ordinary income (in which case the ETSoDR estimate is low), short-term losses may be used to offset long-term losses (in which case the ETSoDR estimate is high), or realized losses may be unused and carried over to the next tax year (which would likely lower the actual value of taxes saved or deferred).
- We do not account for potential follow-on tax consequences of tax decisions. For example, in the case of loss harvesting, we don't consider the tax costs or savings that arise from the sale of the substitute security.
- We do not adjust for loss harvesting that would have subsequently occurred even without tax management. For example, suppose a position is loss harvested and, coincidentally, the security is removed from the target the next day. In this case, the position would have been sold at a loss anyway, even without tax management. The methodology for calculating the ETSoDR does not retroactively uncredit the previous loss harvesting event, and this results in an overestimate of the value of loss harvesting.
- We do not include the value of reinvesting saved taxes. This results in an underestimate of the value of both gains deferral and loss harvesting.
- We do not include the effect of:
    - trades exported from the system that were not executed or trades that did not come through the Smartleaf system.
    - the holdings or trades of Bin assets