

WHITEPAPER

Tax-Smart Portfolio Transitions Can Drive Better Client Outcomes



Tax-Smart Portfolio Transitions can drive better client outcomes

Minimize gains. Maximize confidence.

For modern financial advisors, growth isn't just about winning new clients—it's about creating the capacity to serve them well. Advisors are increasingly turning to model portfolios to bring discipline and efficiency to their practices, creating space to focus on relationships and planning. But getting clients into the models isn't always easy. Legacy holdings and capital gains often slow transitions and delay progress (or risk eroding client trust).

Betterment's **Tax-Smart Transitions** is built to remove this friction. As an advisor-first solution, it combines automation, customization, and tax-aware logic to simplify and optimize portfolio updates.

This guide explores how you can refine model portfolio adoption, eliminate barriers like tax drag and time constraints, and turn tax optimization into a built-in advantage for your firm.



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Executive summary

Transitioning clients into model portfolios is essential for scalable portfolio management, but doing so without triggering capital gains remains a persistent challenge. Clients often bring legacy holdings that don't align with their target portfolios. Without a careful, tax-efficient transition strategy, advisors risk triggering large tax bills, eroding client trust, or stalling progress altogether.

Traditional answers to this challenge are limited. Many advisors still rely on manual rebalancing and separate account structures, which adds complexity and operational overhead. Even effective techniques like tax-loss harvesting (TLH) require constant attention when managed manually, which limits scalability—especially for growing, independent firms.

Betterment's new solution Tax-Smart Transitions unlocks tax-efficiency and scalability.

By combining automation with customizable tax controls, Tax-Smart Transitions' integrated features work together to streamline transitions while preserving after tax performance. The features include:



Tax-Aware Migration Strategies:

Allows advisors to transition portfolios while minimizing tax impact. You can select flexible transition paths, from gradual rebalancing to immediate alignment, based on your client's priorities.



Capital Gains Allowance:

Lets advisors set annual gain limits to manage tax exposure yearly, and ensure that rebalancing occurs within a client's tax budget.



Drift-Based Rebalancing:

Automatically keeps portfolios aligned within target thresholds, without triggering unnecessary gains. Advisors can set **customized drift thresholds** to further tailor rebalancing to their clients' goals.



Automated Tax-Loss Harvesting:

Actively identifies opportunities to offset capital gains to improve after-tax returns.

As advisors face increasing pressure to optimize performance, adopting a more thoughtful, tax-aware approach to portfolio transitions is essential. This guide highlights this opportunity and provides a real-world example that demonstrates the benefits of Tax-Smart Transitions, including:



Reduced concentration risk

Clients holding large single stock positions can transition into diversified portfolios over time while minimizing taxes.



Stronger alignment on inherited portfolios

Advisors can realign inherited assets to match their clients' objectives, while controlling capital gains.



Deliver clear value

Simulations reveal reduced tax drag, better diversification, and stronger after-tax performance, which can result in better long-term outcomes.

Integrated tax management tools don't just enhance portfolios—they create real momentum for advisors and clients alike. Keep reading to learn how advisors are leveraging transition technology to work *smarter*, doing more for their clients while creating the capacity to grow.



The problem of tax drag on portfolio returns

Investors who begin working with a new financial advisor typically bring a mix of qualified and non-qualified assets that may not align with the advisor's recommended strategy. These portfolios may include legacy holdings, concentrated employer stock or allocations shaped by outdated risk profiles, all of which may require significant restructuring.

Life events, such as inheritances, business liquidity events, or evolving financial goals can also prompt major portfolio transitions. However, moving non-qualified assets into the right strategy can trigger significant capital gains taxes. To minimize the tax impact, many advisors choose to manage transitions gradually, avoiding abrupt changes that could trigger large and unnecessary tax liabilities.

Taxes can substantially erode investment returns, reducing long-term wealth accumulation. **Research has shown that tax drag can reduce portfolio returns by 1% to 2% annually, and investors in the highest tax brackets can lose up to 40% of their long-term capital gains to taxes.**

But employing tax-aware portfolio management tactics that are personalized to each client isn't just about reducing tax drag on performance—it's your opportunity to drive better outcomes and more value as an advisor. By using strategies to control the total capital gain that a client's account can realize in a given year, customize your client's portfolio based on their tolerance for taxes versus drift reduction, defer capital gains, and simultaneously leveraging strategies like tax-loss harvesting and asset location, you can unlock meaningful tax alpha and deliver better long-term outcomes to your clients. **In fact, it's estimated that tax-loss harvesting alone can add between 0.47% and 1.27% in annual after-tax return.** Over time, that added return can significantly boost wealth accumulation.

For years, advisors have relied on manual strategies to manage portfolio transitions with tax efficiency in mind. In the following section, we'll explore some of these traditional methods and highlight the limitations that make them difficult to replicate effectively across a growing client base.

¹ Depending on market conditions and investor profiles. Source: Tax-loss harvesting: Why a personalized approach is important | Vanguard Research

Limitations of legacy strategies

Transitioning clients with appreciated portfolios to a new strategy is rarely straightforward. Most tools and processes available today weren't designed for this type of nuanced work, and require you to manage this process manually—adding time, complexity, and potential risk to your practice.

In many cases, advisors have two primary options when it comes to taxable assets with embedded gains:

- ✓ **Maintain legacy positions in a separate account.**

Existing holdings remain untouched, resulting in a fragmented portfolio that may not reflect the client's current risk tolerance or objectives.

- ✓ **Manually build a customized portfolio around legacy securities.**

While this approach seeks to blend existing holdings with new investments, it introduces considerable administrative complexity due to the hands-on management needed to monitor, adjust, and align the portfolio over time.



CHALLENGE

While these methods allow for some level of tax control, they come with clear trade-offs. Manual portfolio transitions introduce meaningful inefficiencies that can weigh on both your practice and your clients’ outcomes:



High administrative burden

You must continually adjust portfolios, monitor tax implications, and rebalance by hand, which consumes valuable time and resources.



Limited tax efficiency

Without a systematic, rules-based approach, transitions often result in unnecessary tax consequences, which may eat into your clients’ after tax returns.



Suboptimal portfolio alignment




Delayed or inefficient transitions can leave portfolios overexposed to certain positions, leading to higher risk and reduced diversification.

In these situations, advisors may attempt to offset tax burdens of a portfolio transition by using tax-loss harvesting (TLH), or strategically realizing gains and losses to balance costs. While this strategy can be effective, it likely requires continuous monitoring and real-time execution, which is difficult to scale across dozens, or even hundreds, of clients. As your client base grows, it becomes increasingly unmanageable unless you hire staff to manage the process, and even then it’s hard to be monitoring constantly for opportunities.

What’s needed is a more efficient, systematic approach—one that evaluates capital gains exposure, reduces appreciated positions in a tax-efficient manner, and automates tax-loss harvesting to support seamless, optimized portfolio updates for any client.

This is where **Tax-Smart Transitions** delivers a transformative solution, empowering you to manage portfolio shifts more efficiently, with tax efficiency and long-term outcomes at the core.

Add holdings to your portfolio

SPY	SPDR S&P 500	 Add
SWPPX	Schwab S&P 500 Index Fund	 Add
SPYG	SPDR S&P 500 Growth ETF	 Add

The Betterment solution for smarter transitions

Betterment's portfolio management system allows advisors to use a model-based approach for efficiency and scalability. Our rebalancing system is built around setting target model portfolios. Each model includes both a portfolio strategy—the securities and asset classes that make up the portfolio—and target allocations, which determine how those assets are weighted at different risk levels. From there, our portfolio management software automatically keeps each client aligned with their designated targets.

However, fully standardizing model portfolios is unrealistic for most advisors. Customization is important and increasingly expected by clients, particularly when it comes to navigating portfolio transitions in taxable accounts. To provide that customization in a way that's manageable, Betterment offers built-in tooling that gives you the option to layer in plenty of flexibility at the client level. You can use our technology to set up parameters that will dictate how a client is moved from an old portfolio into the target model to strike the right balance between drift reduction and tax minimization for each client's specific circumstances.

As a result, you don't have to sacrifice operational efficiency to do what's best for your clients—**it's possible to easily manage personalized portfolios at scale.**

Tax Loss Harvesting

Tax losses harvested **\$2,839.48**

Client asset location



Rebalancing



Retirement



On

Estimated tax impact

\$224

> How we got this estimate
Image is hypothetical.

Core objectives of the portfolio management system

Rebalancing logic

When you select a target model portfolio for an account, Betterment's portfolio management system is designed to keep the client's portfolio within certain bounds of its target, ensuring each client account is in line with the portfolio you've chosen. The difference between the target allocation for your client's portfolio and the actual weights in your client's current portfolio (i.e. the actual allocation) is called portfolio "drift."

Drift can also arise when you edit your client's portfolio strategy, change your client's allocation, or transfer in assets from outside Betterment that are not part of the target model portfolio.

Betterment's system employs two distinct, complementary rebalancing methods in tandem to reduce drift:

✓ Reactive rebalancing

This optimizes trading activity that needs to happen in connection with cash flows—deposits, withdrawals, or reinvesting dividends—either prioritizing underweight positions for the buys, or overweight positions for the sells. Reactive rebalancing also works in the context of instructions to migrate your client's portfolio strategy or update their allocation, with some additional customizations and guardrails described below, under **Tax-aware migration strategies**.

✓ Proactive rebalancing

When the transactional method alone cannot keep drift below the threshold, either because available cash flows are insufficient, or because the portfolio's drift is too large (or a combination of the two), this method sells overweight positions *and* buys underweight positions for the purpose of rebalancing.*

For qualified accounts, reducing drift is fairly straightforward. But for taxable accounts, there are some additional guardrails built in to make both initial transitions and ongoing portfolio management more tax efficient.

Built-in tax tools

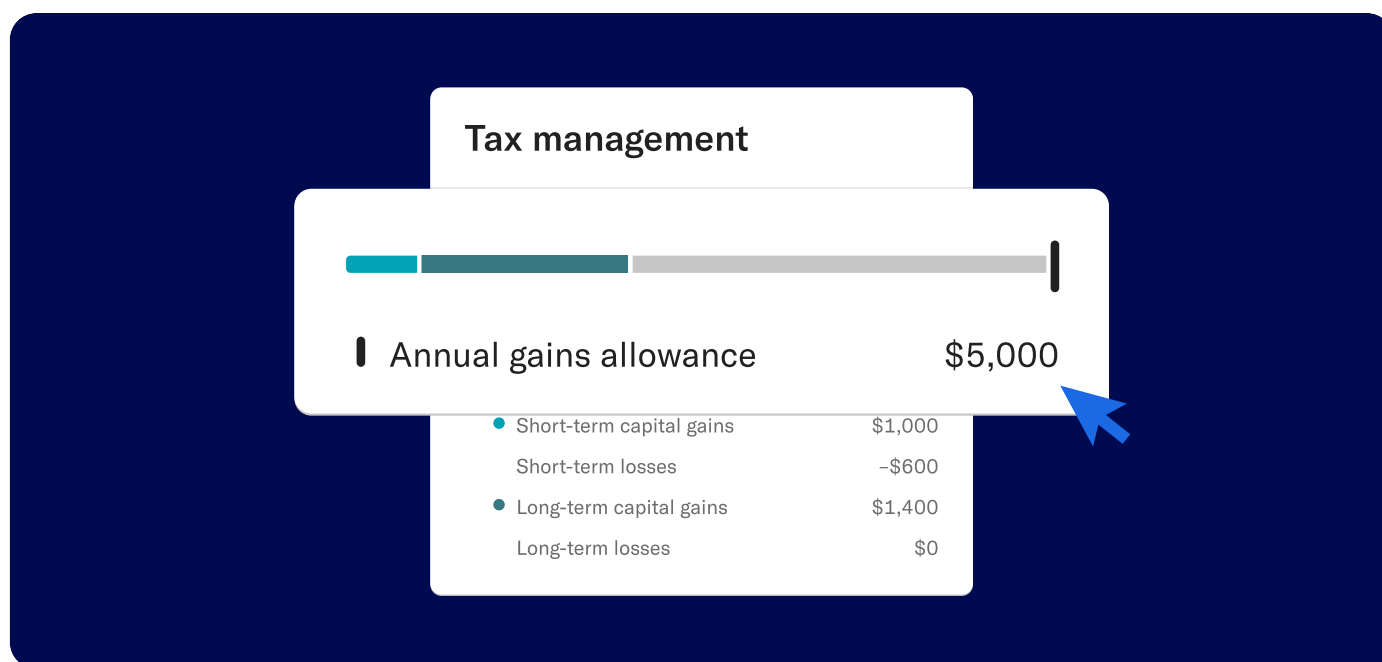
✓ Optimized Tax Lot Selection

Betterment's tax minimization algorithm selects the most tax-efficient lots to sell, prioritizing losses and then long-term gains while aiming to reduce portfolio drift. This approach reduces the tax impact of rebalancing to a target portfolio, and operates with both reactive rebalancing and proactive rebalancing. TaxMin is automatically applied by Betterment's portfolio management system to any sale, regardless of broader context.

✓ Tax Loss Harvesting

When enabled, Betterment's tax-loss harvesting feature automatically identifies opportunities to realize losses that can offset gains, enhancing after-tax returns. It also monitors for and avoids potential wash sales across the client's Betterment accounts. This continuous process ensures that portfolios remain tax-efficient without requiring manual intervention from advisors.

*There is some additional nuance that the Betterment system considers when it seeks to initiate trades to reduce drift in client portfolios. Betterment's rebalancing logic is also calibrated to avoid frequent small rebalance transactions and to seek tax efficient outcomes, such as preventing wash sales and minimizing short-term capital gains. And, when tax loss harvesting is enabled, Betterment's portfolio management system generally prioritizes identifying (and acting on) potential tax loss harvests ahead of potential rebalancing opportunities.



Additional levers for customization

Betterment's portfolio management system is designed to strike a balance between drift reduction and tax minimization on an ongoing basis, but transitioning your client's portfolio likely calls for a more personalized approach.

To handle these situations, we've built a suite of tax-smart transition tools designed to streamline portfolio transitions, enhance tax efficiency, and reduce administrative burdens for advisors.

We strongly recommend advisors take advantage of:

Capital Gains Allowance

Advisors can set an annual [capital gains allowance](#) at the household or individual taxpayer level, allowing you to set a ceiling for the amount of capital gains realized each year.

Once the allowance is reached, proactive rebalancing will only sell assets at a loss until net

realized gains are below the allowance. This feature prioritizes your client's appetite for taxes when Betterment's portfolio management system seeks to reduce drift through proactive rebalancing.*

*Certain client and advisor initiated actions are permitted to exceed the gains allowance, such as a withdrawal request that requires Betterment to generate proceeds from liquidating securities above the gains allowance. See [disclosures](#).

Customizable Drift Settings

Proactive rebalancing can be turned on and off for any client account. This allows you to disable proactive rebalancing for accounts in transition if you want to move to the new portfolio using cash flows.

If you elect to keep proactive rebalancing turned on, you can customize the threshold at which

proactive rebalancing is triggered. While Betterment's platform has a default drift threshold of 3%, advisors can set custom drift thresholds at the model level or the client account level. This allows you to take into account each client's individual preferences and tax situations.

Tax-Aware Migration Strategies

Finally, Betterment provides advisors with three distinct strategies to move clients into a new portfolio strategy and allocation while managing tax implications:



Minimize short-term gains and avoid wash sales

Client goals are gradually adjusted to the target portfolio by utilizing cash flows such as deposits and dividends, as well as client-initiated transactions, helping to minimize immediate tax impacts.



Gradual transition using cash flows

When the transactional method alone cannot keep drift below the threshold, either because available cash flows are insufficient, or because the portfolio's drift is too large (or a combination of the two), this method sells overweight positions and buys underweight positions for the purpose of rebalancing.



Immediate rebalance without tax constraints

For clients prioritizing alignment with the target portfolio over tax considerations, this strategy promptly rebalances the portfolio, regardless of potential tax implications.

Learn more about tax-aware migration strategies [here](#).

Create your portfolio

Holdings	Conservative ...	Moderate ...	Aggressive ...	+
S&P 500 VOO, IVV, SPDR ...	55 %	50 %	100 %	
iShares 0-3 Month Treasury Bond ETF SGOV ...	15 %	40 %	0 %	
Global X Robotics and Artificial Intelligence ETF (BOTZ) BOTZ, IRBO, IYW ...	30 %	10 %	0 %	

Benefits of implementing Tax-Smart Transitions

All of these features work together as part of one unified system, adding up to a whole that is greater than the sum of its parts. By leveraging the entire toolkit for each client's unique situation, you can create an automated portfolio transition plan that works for their needs, improves after-tax outcomes, and takes the

manual work of day-to-day portfolio management and tax management off of your plate.

By integrating Betterment's Tax-Smart Transitions, advisors can efficiently manage portfolio transitions, optimize tax outcomes, and enhance overall client satisfaction.

Key benefits:



Elevate tax management

By using tax-aware migration strategies, a capital gains allowance, and automated tax-loss harvesting, advisors can help clients minimize tax liabilities and maximize after-tax returns.



Increase operational efficiency

Automated features reduce the administrative workload associated with manual portfolio transitions, rebalancing, and tax management, allowing advisors to focus on strategic planning and client engagement.



Personalize client strategies

The platform's flexibility enables advisors to tailor investment strategies to individual client needs, considering both financial goals and tax situations.

Set a Gains Allowance to reduce a concentrated stock position

To illustrate the value of these tax-smart transition tools, let's look at a real-life scenario. One challenge you may face as an advisor is helping a client reduce a concentrated stock position—your goal is to improve portfolio diversification while minimizing the tax liability.

Suppose a client holds a significant portion of their portfolio in a single stock, such as Alphabet Inc. (GOOG). This exposes them to heightened volatility and company-specific risk. The goal is to help the client transition out of this position into a diversified portfolio in a tax-efficient manner.

Phased, Tax-Aware Transitions with a Gains Allowance

A full liquidation of the concentrated position at one time could lead to an outsized capital gains tax bill. Instead, a phased transition allows for gradual reallocation over several years, aligning with the client's tax preferences and risk tolerance.

Betterment's Gains Allowance feature lets you control the total capital gain that is realized in a given year. For instance, depending on your client's tax situation you might set an annual gains allowance of \$10,000.

This phased approach spreads out capital gains over time, which can preserve more capital for reinvestment and improve risk-adjusted return, as

measured by metrics like the Sharpe Ratio and sector exposures.

Gains Allowance + Tax-Loss Harvesting (TLH)

Using Betterment's gains allowance feature along with automated tax-loss harvesting can substantially reduce your client's capital gains burden. TLH enables investors to offset realized gains by strategically selling securities with embedded losses.

This process creates tax losses that can be used to neutralize gains, essentially freeing up more gains allowance and increasing the amount of stock that can be transitioned without incurring additional taxes. By incorporating TLH, investors unlock more flexibility in realizing gains while mitigating tax impact.

Additionally, an after-tax return analysis highlights the potential hypothetical alpha generated by avoiding unnecessary tax payments during the transition. Investors who leverage these strategies benefit from lower overall tax drag, reduced portfolio volatility, and enhanced long-term compounding.

By systematically transitioning out of concentrated positions while utilizing TLH and gains allowances together, investors can enhance diversification, reduce risk, and improve after-tax returns—all without triggering excessive tax liabilities in a single year.

Gains Allowance Scenarios

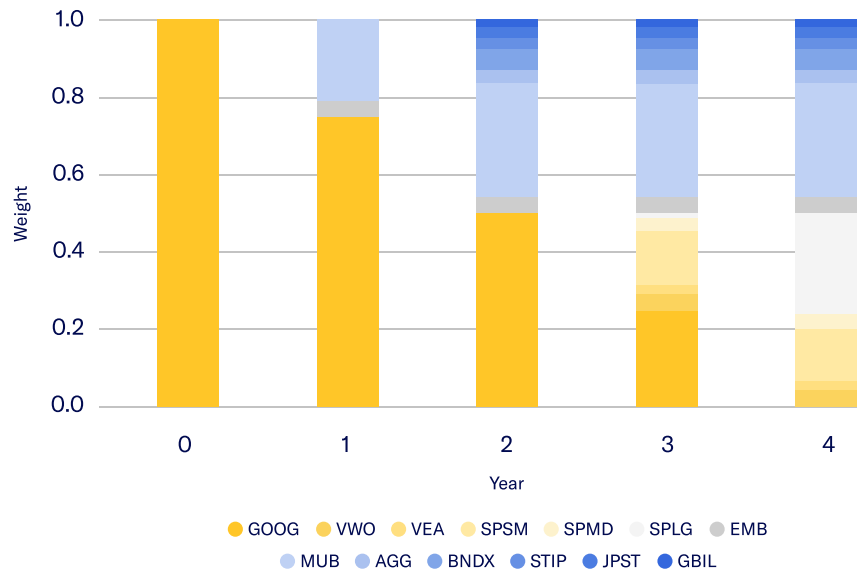
Below are two examples showing how selecting a specific annual gains allowance will impact your client's exposure, without factoring in the presence of tax-loss harvesting (TLH) and assuming prices remain constant (i.e., no market volatility).

In addition to showing exposure, these examples illustrate the time horizon for transitioning from a portfolio with a single highly concentrated single stock position to your desired diversified portfolio, using two different gains budgets.

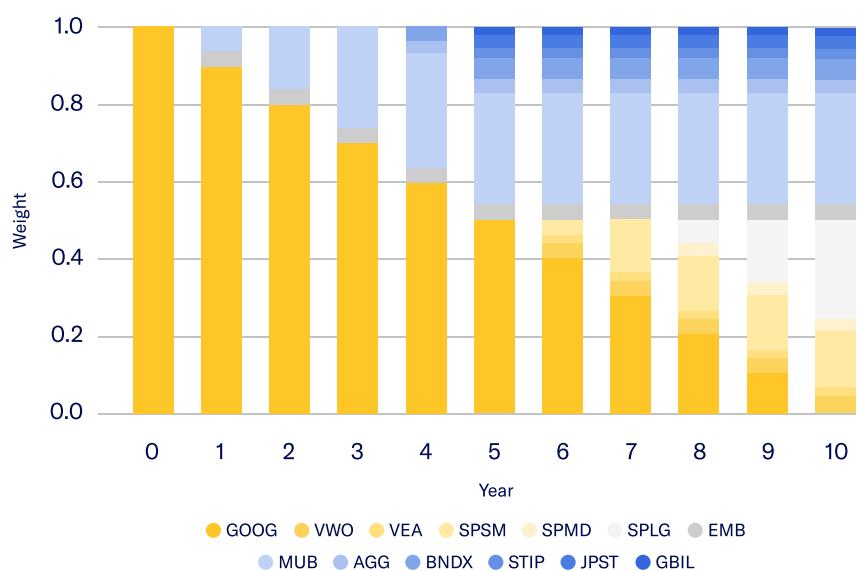
You can see that the higher the gains budget, the faster you will transition your client to the target portfolio weights. With a \$25,000 annual gains budget, it would take approximately 4 years to complete the transition, whereas with a \$10,000 gains budget, the transition would stretch out to about 10 years.

This clearly highlights how customizable and tailored the gains budget lever can be — allowing you to balance tax considerations and portfolio allocation goals to meet each client's unique situation and preferences.

Holdings by Year with a \$25k annual gains budget assuming prices stay constant:



Holdings by Year with a \$10k annual gains budget assuming prices stay constant:



Final thoughts

Managing portfolio transitions in a tax-efficient manner is a critical challenge for financial advisors. Without a structured approach, clients face unnecessary capital gains taxes, increased risk exposure, and misaligned portfolios that fail to meet their financial objectives.

Tax-Smart Transitions by Betterment provides a systematic solution that streamlines this process, ensuring optimal outcomes for both advisors and clients.

Benefits for you:

- ✓ **Scale with ease**
Manage personalized transitions across clients without increasing operational burden.
- ✓ **Add value**
Demonstrate tax alpha and strategic planning in a way that resonates with clients.
- ✓ **Free up time**
Automate time-intensive tasks like tax-loss harvesting and rebalancing.
- ✓ **Confidently handle complexity**
Easily transition legacy assets, concentrated positions, and inherited portfolios with customizable and precise tax-aware tools.

Benefits for your clients:

- ✓ **Higher after-tax returns**
Reduce tax drag with automated TLH and smart gains realization.
- ✓ **Improved diversification**
Migrate out of concentrated positions gradually and efficiently.
- ✓ **Lower tax bills**
Minimize capital gains exposure without sacrificing long-term goals.
- ✓ **Smoother onboarding and strategic updates**
Seamless transitions build trust and alignment from the start.

With the right tools, tax impact transforms from a barrier into a strategic advantage. Tax-smart technology not only reduces risk and enhances after-tax returns, but also creates space for you to nurture more meaningful client relationships. Explore how Betterment's tax management suite can help you [turn complexity into opportunity today](#).



Ready to take the next step? [Learn more.](#)

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