How ETFs Keep the Taxman at Bay

ETFs are often touted for their tax efficiency, and for good reason. They can be significantly more tax-efficient than conventional mutual funds, making them good candidates for taxable accounts. But what's the secret behind their tax-efficient ways?

First of all, ETFs are tax-efficient because the majority of them are index funds. Most index funds keep trading to a minimum, which means fewer taxable gains are realized, and the few gains that are realized often qualify for the lower long-term capital gains tax rate.

ETFs are shielded from unpredictable and frequent shareholder cash flows that can also trigger tax consequences. With a regular mutual fund, investor selling can force managers to sell stocks in order to meet redemptions, which can result in taxable capital-gains distributions being paid to shareholders. In contrast, most trading in ETFs takes place between shareholders, shielding the fund from any need to sell stocks to meet redemptions. Furthermore, redemptions made by large investors are paid in kind with shares of stock, again protecting shareholders from taxable events. All of this should make ETFs more tax-efficient than most mutual funds, and they may therefore hold a special attraction for investors in taxable accounts.

Keep in mind, however, that ETFs can and do make capital-gains distributions, as they must still buy and sell stocks to adjust for changes to their underlying benchmarks.

When it comes to tax efficiency, not all ETFs are created equal. Some track indexes that trade more often, and some even sport turnover rates that exceed 90%. Such funds that trade more often are more likely to generate taxable gains.

Furthermore, some ETFs lack tax efficiency because of their underlying investments. ETFs that invest directly in precious metals, such as silver or gold, are taxed as "collectibles" rather than securities. That means gains are taxed at a maximum rate of 28% rather than the current 15% for long-term capital gains on securities that most investors pay.

The tax-efficient structure of ETFs is also not as relevant for bond ETFs, because the bulk of their returns come from interest rather than capital gains, and any interest distribution is taxed at the shareholder's ordinary income tax rate.

Sometimes it's not what an ETF owns but how it's structured that gives rise to tax inefficiency. The vast majority of ETFs are organized as registered investment companies, but a handful of specialized ETFs have adopted other structures, such as grantor trusts or limited partnerships. Under each of those structures, shareholders must pay taxes on their share of the fund's income and earnings each year even if those dividends and earnings are not distributed. In other words, shareholders of these funds could wind up owing taxes on income they've never received.

So clearly, not all ETFs are suited for taxable accounts. And it's important to do your homework before you invest so you'll know exactly how an ETF's returns will be taxed.
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