How ETFs can be tax advantageous

Federated Hermes

- ETFs utilize in-kind transfers to affect transactions, which may serve to reduce capital gains
- ETFs can be incorporated in different ways as part of an overall tax strategy due to their structural tax efficiency, the ease with which they can be bought and sold and the variety of products now available

Experienced investors know that seeking to maximize returns is only one part of the investment equation. Tax efficiency is another crucial component to overall performance. Investors may be able to hold onto more of their return by choosing investment options that reduce, delay or even eliminate taxes.

Tax efficiency is one reason investors may choose exchange-traded funds (ETFs) over mutual funds. Like mutual funds, ETFs are baskets of investments that can invest in various assets, such as stocks, bonds and commodities. However, ETFs generally offer specific tax advantages that mutual funds cannot.

In-kind transfers minimize capital gains distributions

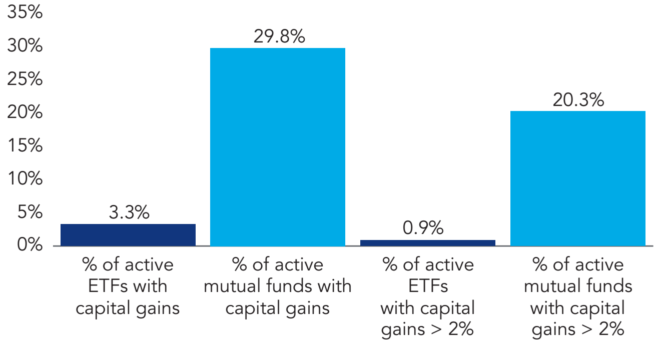
One distinction ETFs hold versus mutual funds is the ability to transfer funds between investors without constituting a sale. These "in-kind" transfers mean an ETF can swap assets without actually selling them on the open market. Without a sale, there is no capital gain or loss and, therefore, no taxable event.

Within mutual funds, in contrast, the sale of any holding can trigger a taxable event (gain or loss), which is absorbed by the existing shareholders of that mutual fund. This is true no matter how long they have owned the fund, and it can occur even if the fund has had negative returns for that year. Any capital gains on securities sold are paid out via an annual distribution of gains. These are received by investors in the form of cash or new shares, with each carrying a tax liability.

> With in-kind transfers, there is no sale of assets, and therefore there is no capital gain or loss.

97% of active ETFs paid no capital gains distributions in 2023 — those that did kept distributions lower than mutual funds, on average.

Capital gains distributions — Active ETFs vs. active mutual funds



Sources: Morningstar, Inc.; Federated Hermes, Inc. For illustrative purposes only and not representative of any specific investment. Data from 1/1/23 through 12/31/23.

Past performance is no guarantee of future results.

Control over the timing of capital gains

Because of in-kind share transfers, accumulated unrealized capital gains for which taxes are due each year have been less substantial in ETFs than with mutual funds, as seen above. Any undistributed capital gains are reflected in the fund share price, giving investors more control over when they want to realize those gains (or losses). Meaningful capital gains taxes are triggered only at the time of sale, on the profit between the purchase and sale price. In this respect, they are no different than most other investments.

This can create a more tax-efficient vehicle, letting investors keep more of their money longer, only triggering meaningful capital gains tax when they sell the ETF.

Tax-loss harvesting opportunities

The transparency and flexibility of ETFs may also allow for tactical tax planning, such as tax-loss harvesting. This involves selling securities that have experienced a loss to offset gains in other investments. While tax-loss harvesting can also be executed via mutual funds, the real-time (versus end-of-day) pricing and trading of ETFs may make the strategy more straightforward to implement.

For investors to realize a loss for tax purposes, they can't repurchase essentially the same security for 30 days. When a fund or security is sold for a loss, an ETF may be used to maintain market exposure for the subsequent 30-day period or longer, while a long-term solution to replace that asset is determined.

The potential ETF advantage

ETFs are structured so that certain tax efficiencies can be passed along to their shareholders, primarily the reduction in capital gains distributions due to in-kind transactions. Also, because they are baskets of stocks, they can be ready substitutes for other securities when implementing a tax-loss harvesting strategy. Their functionality as both a long-term and short-term solution to potentially improve after-tax return makes ETFs a attractive option to consider for any tax-aware portfolio.

Not FDIC Insured • May Lose Value • No Bank Guarantee

An investment in an exchange-traded fund ("ETF") generally presents the same primary risks as an investment in a fund that is not exchange traded and may also be subject to other risks, such as: (i) ETF shares may trade above or below their net asset value; (ii) an active trading market for an ETF's shares may not develop or be maintained and (iii) trading of an ETF's shares may be halted by the listing exchange's officials.

ETFs and mutual funds are subject to risks and fluctuate in value.

Note that ETFs are not immune to capital gains and many equity ETFs do pay dividends on which taxes are owed.

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