



Beyond Buy and Hold: Managing Taxes with ETFs

by Elaine Floyd, CFP®

Exchange traded funds have long been hailed for their tax efficiency. Unlike open-ended mutual funds which may be forced to pay taxable distributions as a result of capital gains realizations, ETFs enjoy a more favorable tax structure primarily due to in-kind transfers of securities which are nontaxable events for the fund and have no tax impact on shareholders. A high-bracket investor could conceivably load up on ETFs in a taxable account, sit back and relax, and have no worries about receiving unwanted taxable distributions.

But investors shouldn't get too tax-complacent when investing in ETFs. For one, some ETFs do indeed have tax consequences, some of them rather surprising. For another, ETFs lend themselves to pro-active tax-management strategies which may be used to offset some of the adverse tax events going on elsewhere in a client's portfolio. Due to the ease with which they may be bought and sold and the low cost of producing high impact transactions to reduce taxes, ETFs make excellent tax-management vehicles for spiffing up a client's Schedule D anytime throughout the year and especially before year-end.

Understanding ETF taxation

Everyone talks about the tax efficiency of ETFs, but it is actually an oversimplification to say that ETFs produce no taxable distributions. Those that pay a current yield naturally generate taxable income, and this must be taken into account when determining which type of account (taxable or IRA) these ETFs should be placed in. (More on this in a moment.)

Also, when proclaiming the tax efficiencies of ETFs, many investors assume that ETFs are subject to capital gains tax rules. You'll remember that capital gains tax rules work in investors' favor in several ways: 1) taxes are deferred until the security is sold; 2) securities held longer than one year are taxed at the long-term capital gains rate of 15% (or 5% for low-bracket investors); and 3) realized losses may be used to offset gains. Most ETFs are subject to these rules, which is why people love them. But some ETFs are subject to different tax rules which investors should be aware of.

- **Currencies.** ETFs that track currencies, such as Rydex CurrencyShares British Pound Sterling (FXB) and Rydex CurrencyShares Euro (FXE), are structured as grantor trusts, which means that tax liabilities flow through to shareholders. According to the Tax Code profits from currency transactions are taxable as ordinary income.



- **Metals.** ETFs that hold gold or silver bullion, such as streetTRACKS Gold (GLD) and iShares Silver Trust (SLV) are taxable as collectibles. Tax rates may be as high as 28%. [Editor's Note: GLD is among the [most popular funds](#) and [most popular ETFs](#) in the Advisor Perspectives universe.]
- **Futures.** ETFs that track futures contracts, such as the PowerShares DB Commodity Index Tracking Fund (DBC), are subject to mark-to-market rules that tax unrealized gains at the end of the year. Gains are considered 60% long-term and 40% short-term. Another fund, the iPath Dow Jones-AIG Commodity Index ETN (DJP), illustrates some of the subtle complexities of tax treatment issues. Barclays' position is that DJP, because it is structured as an exchange-traded note, is not subject to the tax treatment that applies to futures; others have argued that this position may be too aggressive and might not withstand IRS scrutiny. [Editor's Note: DBC and DJP are both among the [most popular ETFs](#) in the Advisor Perspectives universe.]

One of the first steps toward maximizing ETF portfolio tax efficiency is to understand the tax rules that apply to the various types of ETFs and to position them properly in client portfolios. This brings us to the next step.

Asset location

Most ETFs can be purchased in both taxable and nontaxable accounts. But you may be able to maximize your clients' after-tax returns by positioning certain ETFs in the client's taxable account and certain others in the client's IRA. The problem is that there is no definitive guidance on this matter. At one time the conventional wisdom was to put bonds in the IRA and stocks in the taxable account on the theory that a buy-and-hold strategy would automatically defer the tax on the stocks, and profits would eventually be taxed at 15% rather than as ordinary income when distributions are made from the IRA. Also, stocks are more likely to experience losses, which are more valuable in taxable accounts.

But most portfolios today hold more than stocks and bonds. With alternative investments playing a larger role in asset allocations, asset *location* becomes much more complicated. The authors of "[Asset Location: A Generic Framework for Maximizing After-Tax Wealth](#)" suggested that return or tax efficiency alone cannot be used to determine the location of an asset class. Rather, the key metric for establishing location is after-tax end wealth, which depends on some combination of return and tax efficiency. The authors state that high-return and low-tax efficiency asset classes should go into the IRA, while high-return and high-tax efficiency assets should go into the taxable account. (Low-return assets such as short-term bonds make little difference.) Based on this guidance, you



might put your clients' currency, precious metals, and futures ETFs into the IRA, while equity index and sector ETFs would go into the taxable account.

Loss harvesting

A well-diversified portfolio of ETFs is bound to have some losses. (If it doesn't, it probably is not very well diversified.) If these losses are sitting in a taxable account, they can be sold to offset gains elsewhere in the portfolio, including losses carried forward from previous years, and up to \$3,000 of ordinary income each year.

How aggressive should you be in harvesting losses? A number of researchers have run Monte Carlo simulations to find out if an active program of loss harvesting really does add value. The general consensus is yes. But when it comes to tax matters it is dangerous to generalize due to the unique character of each client's situation. The value of loss harvesting will depend on the amount of realized and unrealized gains and losses the client has (or will have) throughout the year, the amount of loss carry-forwards from previous years, and how all the transactions net out on Schedule D. Tax harvesting is one activity that must be fully customized for each client.

ETFs are ideal for loss harvesting because you can maintain the same allocations without violating the wash sale rule by switching into similar but not identical ETFs. Thanks to the burgeoning inventory of ETFs on the market, you should have an easy time finding substitutions. In other words, you need not worry about the tax tail wagging the investment dog because after taking the necessary losses your allocations can essentially remain the same. Just be careful that your substitution ETFs are different enough that they don't violate the wash sale rule. Get a ruling from the client's tax advisor to be safe.

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