iShares®

How are ETFs tax efficient?

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KEY TAKEAWAYS

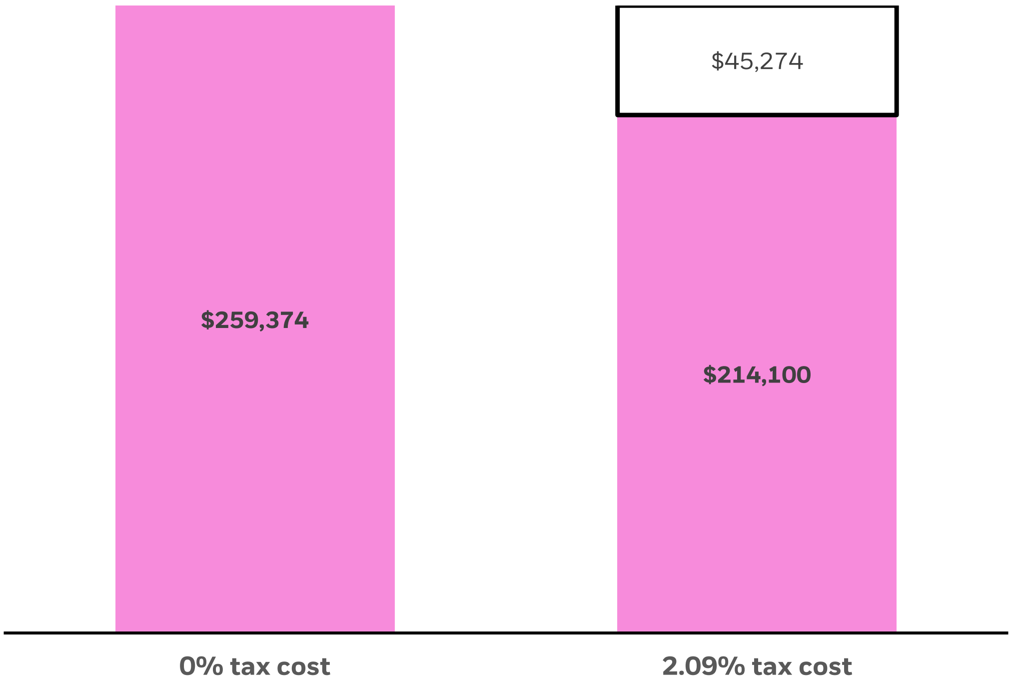
- When investing for retirement, it's critical to stay focused on after-tax returns. ETFs are generally tax efficient, which can help investors keep more of what they earn.
- Low turnover and insulation from the actions of other shareholders are keys to the tax efficiency of ETFs.
- ETFs held 24% of U.S. managed fund assets but accounted for less than 1% of capital gains distributions in 2021.[1]

You've probably learned that keeping fees low can be a big driver of successful investing. And while keeping fees low is important, taxes may actually be more harmful to long-term returns than fund management fees.

For example, the average annual tax cost for active U.S. large-cap mutual funds was 2.09% for the 10 years ending in 2021, more than double their average annual expense ratio of 0.85%.[2] And while 2% may not seem like a big tax burden, a hypothetical $100,000 portfolio would have suffered a tax drag of over $45,000 after a decade of 10% average annual returns. [3]

Taxes can cost more than you think

Hypothetical growth of $100,000 over 10 years at 10% return



Source: BlackRock. As of 12/31/21.
The chart is for illustrative purposes only and is not indicative of the performance of any actual fund or investment portfolio. Does not include commissions or sales charges or fees. 10% represents the average pre-tax return over the same 10 year period for large cap equity mutual funds. The hypothetical growth of $100,000 over ten years at an 10% return is $259,374. The hypothetical growth over ten years at a 10% return with a 2.09% tax cost is $214,100, resulting in a tax drag of $45,274. Past performance is not indicative of future results.
Chart description: Bar chart showing the long-term impact of taxes on a hypothetical $100,000 portfolio.

ETFs can help shield investors from capital gain distributions, or the periodic distributions funds make to shareholders on realized profits from the sale of underlying assets. ETFs held 24% of U.S. managed fund assets at the end of 2021 but accounted for less than 1% of capital gains distributions.[4]

HOW ARE ETFs TAX EFFICIENT?

Two key reasons explain why ETFs can be so tax efficient: Low turnover and ETF shareholders are insulated from the actions of other investors.

The vast majority of ETFs are index funds, which typically trade less frequently than actively managed funds. Low turnover means fewer sales of stocks that have risen in price, resulting in the generation of fewer realized capital gains. Thus, ETF owners are likely to incur capital gains taxes only when they sell the investment.

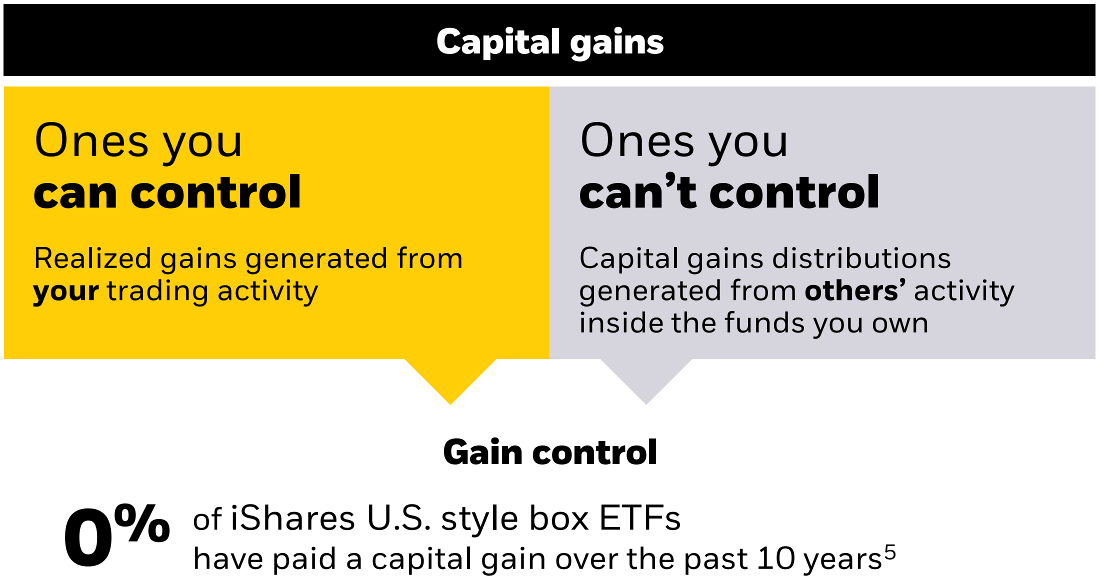
In addition, investors buy and sell ETF shares with other investors on an exchange. As a result, the ETF manager doesn't have to sell holdings — potentially creating realized capital gains — to meet investor redemptions. If you're invested in an ETF, you get to decide when to sell, making it easier to avoid those higher short-term capital gains tax rates. For the ten years ending 2021, no iShares U.S. style box ETFs paid a capital gain.[5]

Certain traditional mutual funds can be tax efficient and, of course, ETF shareholders can incur tax consequences when they sell shares, but that tax consequence is not passed on to other ETF shareholders.

For investments in so-called qualified accounts like a 401(k) or IRA, you're insulated from the impact of taxation. But for investors with taxable (non-qualified) accounts, owning cost and tax-efficient iShares ETFs can help improve your long-term investment returns, allowing you to keep more of what you earn.

Combining a low turnover strategy with a tax-efficient structure gives you more control over when to pay taxes on your ETF's gains. And for long-term investors, this can mean more money in your account working for you rather than the IRS.

Where does “tax cost” come from?



Past distributions not indicative of future distributions. Transactions in shares of ETFs may result in brokerage commissions and will generate tax consequences. All regulated investment companies are obliged to distribute portfolio gains to shareholders. Chart description: Illustration showing how ETF investors are protected from the actions of other shareholders when it comes to capital gains.

When creating great portfolios for your clients, tax efficiency should be top of mind. Incorporating tax-efficient ETFs into your portfolio is a great place to start, but it is imperative to have an understanding of the whole portfolio to better manage its tax implications.