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What Are Tax Aware ETFs? | Twin Oak Insights

Institutional investors are utilizing tax-aware ETFs to minimize taxes while growing their portfolios.

Twin Oak Editorial Team

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When it comes to investing, the returns you keep matter more than the returns you earn. Yes, we are talking about taxes, which can quietly eat away at investment gains, especially in taxable accounts where capital gains and dividends are realized each year.

A potential solution? Tax-aware exchange-traded funds (ETFs). These funds are designed specifically to minimize investors' tax drag and maximize after-tax returns.

Tax-aware ETFs differ from regular ETFs and mutual funds in distinct ways, and specific strategies can make them more effective; high-net-worth investors and family offices can use them to build more efficient investing strategies.

What Are Tax-Aware ETFs, and How Do They Differ from Regular ETFs or Mutual Funds?

At their core, tax-aware ETFs are exchange-traded funds managed with an explicit focus on minimizing taxable distributions. While most ETFs already offer tax advantages over mutual funds (and hedge funds), tax-aware ETFs go a step further by embedding tax-aware decision-making into the investment process to reduce tax drag and increase portfolio value.

For example, traditional ETFs typically track a market index or a customized (and largely thematic) bundle of stocks that generally have little turnover, a foundational aspect of the "set it and forget it" investment strategy. ETFs are inherently tax efficient because of their in-kind redemption process, which allows them to swap securities without triggering taxable events.

This is in contrast to mutual funds, which must sell holdings for cash when investors redeem shares. Those sales can generate capital gains, which are distributed to all shareholders — even if you didn't sell. This type of investment vehicle strays the furthest from an investor who is acutely focused on tax savings.

Tax-aware ETFs, however, combine the structural benefits of ETFs with active tax management, a strategy that focuses on timing sales, managing dividends, and strategically harvesting losses to further reduce tax burden. For investors in taxable accounts, this can translate into significantly better after-tax performance, especially when holding securities for long periods of time.

What Strategies Make an ETF "Tax Aware"?

Tax-aware ETFs use several key tactics to minimize taxable distributions and enhance after-tax returns.

- **In-Kind Redemptions:** Like all ETFs, tax-aware funds rely on in-kind creations and redemptions. When large institutional investors (known as authorized participants) redeem shares, they receive a basket of the ETF's underlying securities instead of cash. This allows the fund to remove highly appreciated holdings without realizing taxable capital gains.
- **Minimizing Turnover:** Tax-aware ETFs avoid unnecessary trading. The fewer securities a fund sells, the fewer capital gains it realizes. This "buy and hold" approach makes turnover a key lever for tax efficiency. Additionally, investors may rely on companies that issue qualified dividends, which are taxed at lower long-term capital gains rates, rather than higher ordinary income rates.
- **Tax-Loss Harvesting:** In some cases, managers can strategically sell positions at a loss to offset gains elsewhere in the portfolio. This reduces taxable income while maintaining market exposure through similar (but not identical) securities. This tactic works especially well alongside a custom holding construction that requires less-frequent rebalancing.

Together, these techniques create a smoother, more tax-efficient compounding effect over time.

Pros and Cons of Tax-Aware ETFs for Different Types of Investors

Although an ETF-based, tax-aware investment strategy is beneficial for all types of investors, this approach is uniquely suited to support the goals and circumstances of high-net-worth cohorts and family offices.

Here's why: Less money is lost to capital gains and dividend taxes, which is particularly valuable for investors in higher tax brackets who hold large taxable portfolios. Moreover, this allows these investors the ability to defer taxes and maximize the long-term compounding of capital.

Beyond this, high-net-worth investors tend to leverage non-tax-advantaged accounts more than traditional investors who put more stock into their IRAs or 401(k)—where gains are already tax-deferred or tax-free—as the foundation of a long-term investment portfolio.

And although some tax-aware ETFs may lag traditional benchmarks or carry a higher expense ratio, the benefits related to tax savings or deferment can outweigh these considerations, especially for wealthier, taxable investors who rely less on sheltered accounts.

How Does a Section 351 Exchange Work, and When Might It Make Sense to Use One?

A Section 351 exchange can allow investors to transfer appreciated securities into an ETF without triggering a taxable event (subject to certain rules like diversification and control). Section 351 has been around since the Revenue Act of 1921 as a way to facilitate tax-free reorganizations, like when a company is merged in a stock-for-stock exchange or, in the case of high-net-worth investors or family offices, to transition a legacy vehicle into an ETF.

In short, a Section 351 exchange is a tool to help clients and advisors transition portfolios into a more modern investment vehicle—but it's just that, a tool, not an end in and of itself. Due to its complexity, what investments are chosen—and by whom—is crucial.

For example: Let's say an investor holds \$1 million worth of highly appreciated stock positions. If the investor were to sell these securities outright, that would generate a substantial capital gains tax burden. For example, a California resident might lose upwards of 38% of their portfolio's value if they were to sell.

But if the investor utilized a Section 351 exchange, those securities would be contributed to an ETF in return for shares of said ETF. Because it's considered a tax-free contribution of property to a corporation, no gain is recognized at the time of exchange. One thing merely becomes another thing, and nothing is bought nor sold.

This mechanism allows investors to diversify concentrated positions or rebalance occupied tax loss harvesting portfolios into a broader ETF portfolio without an immediate tax hit. It's most commonly used by institutional investors, family offices, or high-net-worth investors managing legacy stock holdings, but it demonstrates how ETFs can serve as flexible, tax-advantaged vehicles for any situation where investment restructuring and tax deferment is required.

What Is the Impact on After-Tax Returns?

With all this being said, it's crucial to understand that any ETF—but especially a tax-aware one—will have a substantial impact on after-tax returns compared to a traditional mutual fund.

Consider two funds with identical pre-tax returns of 8% per year, but one distributes annual capital gains that create a 1% "tax drag." Over 20 years, that 1% difference compounds into a gap of nearly 20% in total wealth. For a high-net-worth individual with \$10 million invested, that gap can equate to millions of dollars lost—and the average mutual fund can have a tax drag of 2.1%.

Tax-aware ETFs, by minimizing or deferring taxes, allow more of your capital to remain invested and therefore, compound over time without interruption. For long-term investors, especially in higher tax brackets, this can be the difference between average and exceptional after-tax performance.

The Holy Grail of Tax Management?

Tax-aware ETFs combine the structural advantages of ETFs with proactive tax management strategies that help investors keep more of what they earn. By leveraging in-kind redemptions, minimizing turnover, managing dividends, and employing Section 351 exchanges where appropriate, these funds deliver one of the most efficient investment vehicles available today, especially for high-income investors who want to retain more of their wealth over time.

Definitions (as used by Twin Oak):

- 1. Cost-effective ETFs:** As defined compared to hedge funds, which commonly charge a 2% management fee as well as 20% of the profits.
- 2. Institutional Grade:** Investment strategies generally only accessible in private fund formats to accredited investors.
- 3. Tax Alpha:** The amount of a gross return lost to the tax drag of an investment vehicle through realized taxable events.
- 4. Low Cost:** Defined on a case-by-case basis but generally refers to solutions that are cheaper than private funds (2% management fees and 20% carry).

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