Advisory Blog

Timely insights on the issues that matter most to investors and their clients

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Taxes

Tax day: How investors can have their cake and eat it too

By: Andrew Subkoviak, CFA | April 5, 2021

Seattle - Cake and taxes are definitely not the two certainties in life that Benjamin Franklin quipped about during American revolutionary times. The tax-managed equity investor may have reason to celebrate a "twofer" as they file their 2020 tax returns, however.

In mid-February, just as Congress began debating the $1.9 trillion American Rescue Plan Act that was ultimately pushed through the budget reconciliation process, IRS tax season officially began.

The IRS extended the filing deadline to July last year as both tax filers and the IRS adjusted to pandemic life and Congress hurried out the first two rounds of relief payments. This year we have a new administration that has prioritized economic relief and vaccinations but also has an ambitious long-term tax agenda. The IRS has extended the tax filing deadline again this year, highlighting how the lingering irregularity of life continues to complicate matters for most taxpayers.

What about taxes on investments?

Although the market finished 2020 in strong positive territory, it was a tale of two time periods. The first quarter saw the fastest bear market in history, with the remaining quarters showing a remarkably swift recovery and advancement. The recovery period was notable for the disparate outcomes among segments of the broader market, with growth vastly outperforming value and large-cap dominating early in the recovery, only for small-cap to catch up later in the year.

Investment income for its part was moderately lower than it historically has been. Many companies and industries acutely impacted by the pandemic that have reliably paid a dividend either canceled, postponed, or cut dividend payments. The dividend yield on the S&P 500® Index was about 1.5% in 2020, down from the typical 2%. The tax hit from income will likely be smaller in this regard than in years past, reducing the tax burden from investment income by less than 20 basis points for most indexers.

Capital gains distributions typically have a larger tax impact. For the buy-and-hold investor, these gains depend on the type of investment. Through the creation and redemption process, exchange-traded funds rarely distribute any capital gains in the modern age; only if the individual sells a position do they realize a capital gain or loss.

Mutual funds

The story gets a bit more complicated for mutual fund investors. Mutual fund investors' capital gains distributions may come from sources other than an individual taxpayer's buy-and-sell decisions. A mutual fund is subject to the fund manager's investment decisions within the corpus of the fund, so the investor inherits not only the fund's market value at the time of purchase but also its cost basis. For individual positions held within the fund, the investor may enjoy only a portion of the gains but pay the full amount of taxes due on that investment. In other words, buying a mutual fund may come with some tax baggage in the form of distributed capital gains.

Unfortunately, there's more bad news for mutual fund investors. A sell-off like we saw last year forces mutual fund companies to redeem shares and, in the process, sell underlying holdings, which impacts the fund's end-of-year capital gains distribution. According to Morningstar, redemptions from active equity mutual funds totaled an estimated $350 billion in 2020.[1]

Depending on the fund's cost basis profile and size and timing of redemptions, the gains realized from the redemption could be quite different. If the fund realizes greater losses than gains, it can carry that capital loss forward for future use *within the fund* to offset gains, but can't distribute the loss to the end investor.

What will capital gains distributions look like in 2020?

The bear/bull market paths in 2020, coupled with disparate outcomes among different equity classes and heavy redemptions early in the year, will leave a range of capital gains distribution outcomes. That is confirmed by an early Morningstar summary of fund distribution estimates across more than 15 major mutual fund companies, with a reasonable range of capital gains distributions between 6% and 12% of net asset value.[2] Conservatively assuming a long-term holding period for all sales, this suggests that most funds will incur an estimated tax drag on their performance of 1.4% to 2.8% for the year after capital gains distributions.

In a year when most funds and equity classes finished in positive territory, perhaps this is a pill the taxpayer may be willing to swallow, given the positive pretax performance delivered by the investment manager. After all, positive returns and, ultimately, gains are the goal of investing, and tax drag is a part of that equation.

Separately managed accounts may be able to do the taxable investor one better. The beauty of maintaining a portfolio under the individual investor's own tax ID is that the investor has full ownership of capital gains and losses, with the potential to take advantage of tax-loss harvesting.[3] Using a tax-managed passive core portfolio maintains equity exposure but passes through capital losses, effectively offsetting any capital gains distributions from mutual funds or other investments, thereby reclaiming, in part or in whole, the tax drag incurred.

In fact, 2020 was a successful year for tax-managed passive investing. By accelerating capital losses, deferring capital gains and managing relative exposure to the benchmark of choice, some investors could take advantage of both substantial pretax returns in 2020 and significant tax benefits from losses taken early in the year. In years with very few capital gains to offset, investors may also be able to bank capital losses and carry them forward for future years.

Not every year is as fortuitous as 2020 was, from either a pre- or post-tax perspective, but tax management tends to deliver consistently in most years. The outcome varies with market environment, but the odds are predominantly in the taxable investor's favor, delivering 1% to 2% annually, on average.

Bottom line: The harsh reality is that the economy is still aimlessly lurching from the impacts of the pandemic, and those fits may spill over into tax-filing season. It's likely that a disproportionate number of filers will have some income and capital gains they weren't expecting as the result of mutual fund distributions last year. Through an effective tax-managed investment strategy that structures realized losses to manage the tax burden, even a tumultuous year like 2020 can produce benefits that may help investors meet their goals.

1. Morningstar, "U.S. Fund Flow Records Fell in 2020" by Tony Thomas, Ph.D., and Supreet Grewal, January 20, 2021.
2. Morningstar, "Capital Gains Roundup: 2020 Edition" by Christine Benz, November 9, 2020.
3. Tax loss harvesting is a strategy for managing taxes in an investment portfolio. Selling a security that's trading at a loss creates a realized tax loss, which can be used to offset a capital gain realized in the same year.

S&P 500® Index is an unmanaged index of large-cap stocks commonly used as a measure of U.S. stock market performance.

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It is not possible to invest directly in an index. ***Past performance is no guarantee of future results.***

Tax-loss harvesting involves certain risks including, among others, the risk that the new investment could perform worse than the original investment and that transaction cost could offset the tax benefit. There may also be unintended tax implications. Eaton Vance does not provide tax or legal advice. Prospective investors should consult with a tax or legal advisor before making any investment decision.

Elements of this commentary include comparisons of different investment vehicles, each of which has distinct risk and return characteristics. Unlike mutual funds, ETF shares trade on an exchange and are not individually redeemable from the fund. ETF shares are bought and sold at market-determined prices, which may vary throughout the trading day and may be higher or lower than net asset value (NAV). Lower minimums may apply to ETF trades than mutual fund purchases. Index ETFs typically have lower fees than actively managed mutual funds. ETFs utilizing in-kind redemptions may pay out lower capital gains distributions than similar mutual funds, reducing or deferring shareholder taxes. Eaton Vance does not provide tax or legal advice. Prospective investors should consult with a tax or legal advisor before making any investment decision.

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Picture of Andrew Subkoviak, CFA

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"Through an effectively structured tax-managed investment strategy, investors can meet goals even in a challenging year like 2020. The savvy investor could use losses now to offset gains later, thus helping to manage their tax burden."