NAVIGATING CAPITAL GAINS: A TAX-SMART APPROACH WITH ETFS

Vanya Sharma — Senior Associate, Capital Markets
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The woes of taxes mean everyone worries about the bottom line—not gross gains but net gains after taxes. After all, the saying goes, "It's not how much you make, but how much you get to keep that matters."

What Is a Capital Gain?

A capital gain occurs when an investor accrues profit from the sale of an asset such as a stock or ETF.

Simply, *(sale price – purchase price) * shares = profit > 0*. However, this profit is taxable.

Capital Gains in a Mutual Fund vs. an ETF

- **Mutual fund:** With a mutual fund, capital gains can be generated in three ways: active management, rebalancing or redemption. All three require a profitable sale of mutual fund shares. When mutual fund shares are sold, the fund also sells the underlying securities. By law, the possible capital gains generated from these sales have to be distributed immediately and are taxable.
- **ETF:** In contrast, when someone sells shares of an ETF, the fund does not have to sell the underlying securities. Capital gains with an ETF occur only if there's been an appreciation of the ETF's price. If there has been no positive price gain, then an investor can exit out of an ETF without any tax consequences. This is true as long the sale does not impact other shareholders, which is less likely to happen because of how liquid most ETFs are and because the sale trade would have to be significantly block-size.

Tax Loss Harvesting

Taxes are no fun, but a fun perk of owning an ETF is how easy it is to enter and exit out of ETFs. This may help an investor avoid wash sales and make the most of tax loss harvesting. A wash sale is when an investor exists an investment only to reenter the product or a "substantially identical" one within 30 days. Tax loss harvesting is taking the losses in one investment to offset the gains in another to minimize the taxable capital gains. With ETFs, it is easier to stay true to an investment objective and exposure while also capturing losses for tax purposes.

Here are the three main ways:

1. **Mutual Fund-to-ETF Transfer:** Mutual fund investors can sell a mutual fund at a loss and buy an ETF with similar, or even exactly the same, holdings, and the wash-sale rule would not apply.
2. **Stock-to-ETF Transfer:** Similarly, investors looking to take advantage of tax losses on a stock or a number of stocks can look for an ETF that holds the same security or has exposure to the same market sector. After 30 days, the ETF could be sold and the stock repurchased.
3. **ETF-to-ETF Transfer:** Investors can also avoid the wash-sale rule by making a transfer from one ETF to another holding similar, but not identical, securities—as long as it tracks a different index.

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Wash-Sale Rule : An Internal Revenue Service rule that prohibits a taxpayer from claiming a loss on the sale or trade of a security in a wash sale. The rule defines a wash sale as one that occurs when an individual sells or trades a security at a loss, and within 30 days before or after this sale, buys a “substantially identical” stock or security, or acquires a contract or option to do so.