

# The Tax-Busting Secret Weapon Wall Street Never Saw Coming

*As an investor exploring the markets for yield-dependent investments, you may be intrigued by Compoundr's ability to sidestep the tax burden of income distributions. You might ask: How does Compoundr earn the return of bonds without experiencing the taxable income of bonds?*

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To answer, let's delve into the conceptual framework of exchange-traded funds (ETFs), their tax dynamics under the Investment Company Act of 1940, and the time-tested strategy that allows Compoundr to avoid generating taxable income, offering a powerful approach to compounding long-term returns in high-yielding asset classes.

## The Monthly ETF Tax Bomb

Since the launch of the first ETF in 1993, these vehicles have transformed investing, growing to over 4,000 funds with \$10 trillion in assets by 2023. Their tax efficiency, rooted in the in-kind creation/redemption mechanism, defers capital gains taxes until an investor sells their shares, unlike mutual funds, which typically distribute capital gains annually. ***This structure, governed by the Investment Company Act of 1940, has made ETFs a cornerstone for tax-conscious investors.***

However, a persistent challenge remains: dividend distributions. As Regulated Investment Companies (RICs) under the 1940 Act, ETFs must distribute at least 90% of their taxable income—primarily interest from bonds or dividends from other holdings—each year to maintain RIC status. In taxable accounts, these distributions are treated as ordinary income (up to 37% for high earners) or qualified dividends (up to 20%), even if reinvested. This creates a “tax drag” that erodes long-term returns. For example, a \$1,000 investment in an S&P 500 ETF from 1993 to 2024 grows to \$21,000 with reinvested dividends, but a 20% tax on those dividends reduces it to

\$20,000—a 7% loss. In short the benefit to investors can range from a mere annoyance (as in the case of the S&P 500) to a tax drag that can exceed 2% annually for higher income portfolios.

## Why Is ETF Income Taxable?

In traditional ETFs, income is taxable because of how they process distributions from their holdings. Bonds, CLOs, or other income-generating securities produce interest or dividends, which flow through to the ETF investor. To comply with the 1940 Act's RIC requirements, the ETF must distribute this income to shareholders, triggering a taxable event in the year it's received, whether reinvested or taken as cash. This pass-through mechanism ensures the ETF avoids corporate-level taxation but unfortunately burdens investors in non-qualified accounts with immediate tax liabilities. Unlike bonds, which trade plus accrued interest, ETFs trade purely on price, with distributions explicitly passed through to shareholders through dividends. For income-agnostic investors focused on total return—price appreciation plus reinvested distributions—this tax drag reduces the capital available for compounding, creating significant opportunity costs, especially in high-yield fixed-income assets.

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**BUCKLE UP:  
HERE'S COMPOUNDR'S GAIN-CHANGER...**

**No Income...  
No Problem!**

**Compoundr addresses this challenge through a dividend avoidance strategy tailored to income-producing ETFs. The Compoundr strategy relies upon its proprietary approach to leveraging the differences between bond-ETFs which trade purely on price and bonds themselves, which trade at price plus accrued interest.**

Compoundr is deployed using a “fund-of-funds” approach, dynamically rotating among similar ETFs to bypass ex-dividend dates. Importantly, the dividends are still captured by the underlying ETFs held in the portfolio—they are just not received by the master fund.

## **Here’s how Compoundr Avoids Taxable Income:**

- **No Dividend Received, No Taxable Event:** Compoundr creates custom indexes (developed with Nasdaq) that swap out an underlying ETF for a similar substitute with a different distribution schedule before its ex-dividend date. For example, in a High Yield Bond index, Compoundr would shift from one high-yield bond ETF (e.g., SPHY) to another (e.g., USHY) with a similar risk/return profile provided it has a staggered ex-date. Since Compoundr doesn’t hold the original ETF on its ex-dividend date, it receives no interest or dividend payment from that ETF, even though the underlying ETF continues to pay its dividends to its own shareholders. ***With no income received by the ETF tracking a Compoundr benchmark, there’s no distribution to pass to investors, and thus no taxable event.***
- **Capturing Total Return Through Price:** On an ex-dividend date, an ETF’s net asset value (NAV) drops by the distribution amount and the opening

price of the ETF directly reflects the NAV drop. By rotating to a substitute ETF that isn’t ex-dividend, Compoundr avoids this NAV drop, capturing price appreciation that mirrors the total return (price plus distributions) of the target benchmark. Simulations show this approach delivers returns nearly identical to traditional ETFs (e.g., 8.91% vs. 9.00% for an S&P 500-like strategy) with minimal tracking error (0.23%). ***Wonkiness about ETF structure and fund accounting is critical to understanding here: unlike bonds, which trade with accrued interest that eventually triggers a taxable payout, ETFs of bonds allow the Compoundr strategy to trade purely on price in order to embed the would-be distribution in the substitute ETF’s price movement.***

- **Compliance with the 1940 Act:** This strategy operates within the ETF’s RIC framework. By not receiving distributions, Compoundr has no income to distribute, satisfying the 1940 Act without triggering taxable events. ***Compoundr is an innovative use of an established practice that leverages the ETF’s price-based trading and in-kind creation/redemption mechanics, which have been time-tested across every ETF since 1993.***

**Tailored for Fixed-Income Assets:** The asset classes benchmarked in the first round of Compoundr indexes—high-yield bonds, investment-grade bonds, AAA CLOs, 10-year Treasuries, and actively managed total return bonds—are particularly prone to tax drag due to their high interest payments. For example, high-yield bond ETFs can face annualized tax drags of 2% or even more depending on your state of residence. Compoundr’s rotation strategy neutralizes this, preserving capital for compounding in these critical portfolio components.

## Built on Bedrock: The Proven Playbook Behind Compoundr

The strategy deployed in Compoundr is not a novel experiment—it builds on the proven, time-tested mechanics of the ETF structure used by every ETF since their inception. **The in-kind creation/redemption process, which defers capital gains taxes, has been a cornerstone of ETFs for over three decades, underpinning their \$10 trillion growth.** Compoundr extends this principle to income, using the same portfolio management flexibility that allows ETFs to trade securities without triggering taxable events. By rotating among ETFs with staggered ex-dates, *Compoundr employs a strategy as robust and reliable as the ETF wrapper itself, which has been battle-tested in real-time across thousands of funds since 1993.*

### Setting the Record Straight

A natural concern is whether this strategy could be perceived as tax evasion. We fail to understand that argument—Compoundr is a legitimate portfolio management technique fully compliant with IRS rules and the 1940 Act. Here's why:

- **Legal Structure:** The IRS taxes income received by a fund and distributed to shareholders. Compoundr avoids receiving income by strategically rotating to substitute ETFs before ex-dividend dates, meaning there's no income to tax. This is akin to an investor choosing low-dividend stocks to minimize taxable income—a standard, legal practice. The ETF structure's price-based trading (unlike bonds which trade + accrued interest) enables this without violating tax laws.

- **Alignment with ETF Mechanics:** The rotation strategy leverages the same in-kind creation/redemption process that makes ETFs tax-efficient for capital gains. This mechanism, used by every ETF for decades, is explicitly designed to minimize taxable events. Compoundr's approach simply extends this to distributions, staying well within regulatory boundaries.

- **Transparency and Compliance:** The dividends paid by underlying ETFs (e.g., SPHY or USHY) are reported and taxed appropriately to the shareholders who receive them, ensuring no income goes untaxed at the source. Compoundr's role is to avoid holding these ETFs on ex-dividend dates, a portfolio management decision, not an attempt to conceal income. The strategy and each step of the rebalance process is fully disclosed, ensuring transparency to regulators, investors and all other market participants.

- **Precedent in Portfolio Management:** Investors and funds routinely adjust holdings to optimize after-tax returns, such as tax-harvesting or selecting tax-advantaged securities. Compoundr's rotation is a sophisticated extension of this principle, not a circumvention of tax obligations. The IRS has never challenged the in-kind exchange process, and Compoundr's approach operates under the same legal framework.

Any innovative strategy may attract attention, but Compoundr's compliance with RIC rules and reliance on established ETF mechanics minimizes this risk. The absence of received income eliminates the taxable event, not through evasion but through strategic allocation—a practice as old as portfolio management itself.

### Other Conceptual Risks

Beyond tax concerns, minor tracking error may occur if substitute ETFs diverge slightly from the core

ETF, particularly in volatile fixed-income markets. However, Compoundr's rules-based methodology, analyzing three months of daily return data for high correlation and low tracking error (e.g., 0.23% in simulations), mitigates this. Liquidity constraints are also addressed by selecting highly liquid substitutes. The trade-off—tax deferral versus slight performance deviation—is often negligible compared to the compounding benefits of avoiding a 1-2% annual tax drag that degrades long-term, compounded total returns in taxable accounts.

## The Big Picture

As you assess high-yielding investments, Compoundr's approach offers a conceptual breakthrough. These asset classes generate significant interest payments, making them tax-drag heavyweights in traditional ETFs. By avoiding distributions, Compoundr preserves capital, potentially saving 1-2% annually in tax drag, which compounds into substantial wealth over time. This aligns with the goal of optimizing after-tax returns for investors in taxable accounts.

Compoundr avoids taxable income because it doesn't receive distributions, even though the underlying ETFs continue to pay dividends to their shareholders. By dynamically rotating among similar ETFs to bypass ex-dividend dates, and exchange purely on price, **Compoundr delivers near-total returns without the annual tax burden.** This strategy, built on the time-tested mechanics of the ETF wrapper used since 1993, redefines tax efficiency for fixed-income assets.

***Compoundr is not just a tactical adjustment—it's a conceptual leap that was hidden in plain sight for 35 years. Harnessing the ETF structure to maximize compounding for investors navigating yield-dominated asset classes, now that's innovation designed with ETF strategists, advisors, and tax-conscious investors in mind!***



**[www.CompoundrETFs.com](http://www.CompoundrETFs.com)**  
**1-(877) 717-0770**