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From Cap Gains to Dividend Income: Exploring Potential ETF Tax Management

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INVESTMENTS & WEALTH INSTITUTE®

From Cap Gains to Dividend Income

EXPLORING POTENTIAL ETF TAX MANAGEMENT

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Exchange-traded funds (ETFs) have gained traction during the past 20-plus years and generally are accepted as being more tax efficient than their mutual fund counterparts. However, the tax efficiency of an ETF primarily refers to its ability to allow an investor to defer paying capital gains taxes until the fund is sold at the end of the investment horizon. Despite being able to defer capital gains, ETFs usually still make dividend distributions, which typically are taxable events for the ETF investor in taxable accounts throughout the investment horizon. Investors who are income-agnostic and choose to reinvest dividend distributions must still pay income taxes on the dividends, resulting in a tax drag to long-term total returns.

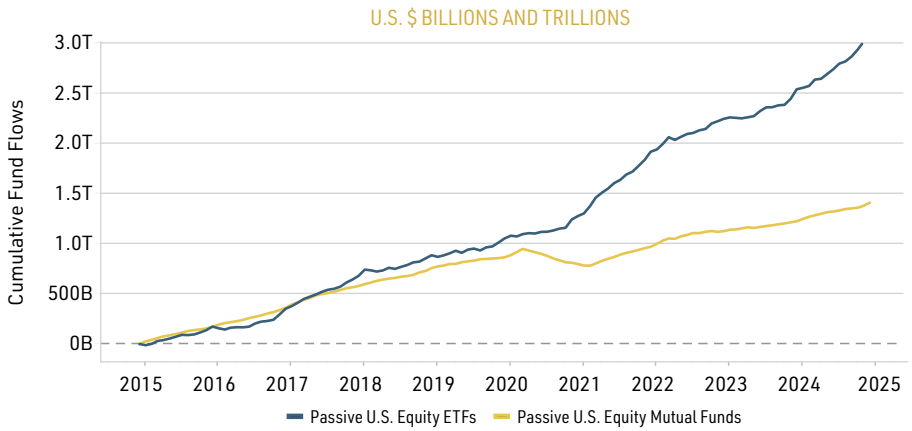
Financial advisors deploy numerous creative tax strategies at the portfolio level; still, no one can dispute that the development of a tax-advantaged version of income-dominant assets would be a welcome addition to the U.S. ETF landscape. Is it possible for ETFs to circumvent this remaining tax burden to become fully tax efficient? In this article we explore a potential solution that could harness the custom creation and redemption mechanism already present in ETFs to compound the tax efficiency of the investor's experience.[1]

ETF Break Out: Outpacing Mutual Funds Since 2020

ETFs have grown in popularity over index mutual funds due to the ability to trade various markets and asset classes (especially equities) easily in a liquid, transparent, and tax-efficient manner.[2]

For example, data show that passively managed domestic equity ETFs have attracted more net inflows than index domestic mutual funds since 2014 (see figure 1).

FIGURE 1 **Cumulative ETF vs. Mutual Fund Inflows**
January 2015–December 2024



Sources: Morningstar, Nasdaq Index Product Development.

What Makes ETFs Tax Efficient?

The tax efficiency of ETFs relative to mutual funds is well known and appears to be a dominant factor driving investor allocation preferences. The in-kind creation and redemption mechanism that relies upon exchanging securities means, in most cases, that ETF investors do not incur capital gains taxes until the end of their investment horizon, when they choose to liquidate their shares.

A recent paper shows that, despite realizing capital gains, ETFs distribute close to no capital gains compared to more than 200 basis points (bps) in capital gains distribution yields per year for index mutual funds.[3]

Despite the ETF wrapper's success in deferring capital gains, there remains a residual tax burden: nonqualified dividend income from equities and coupon yield from bonds.

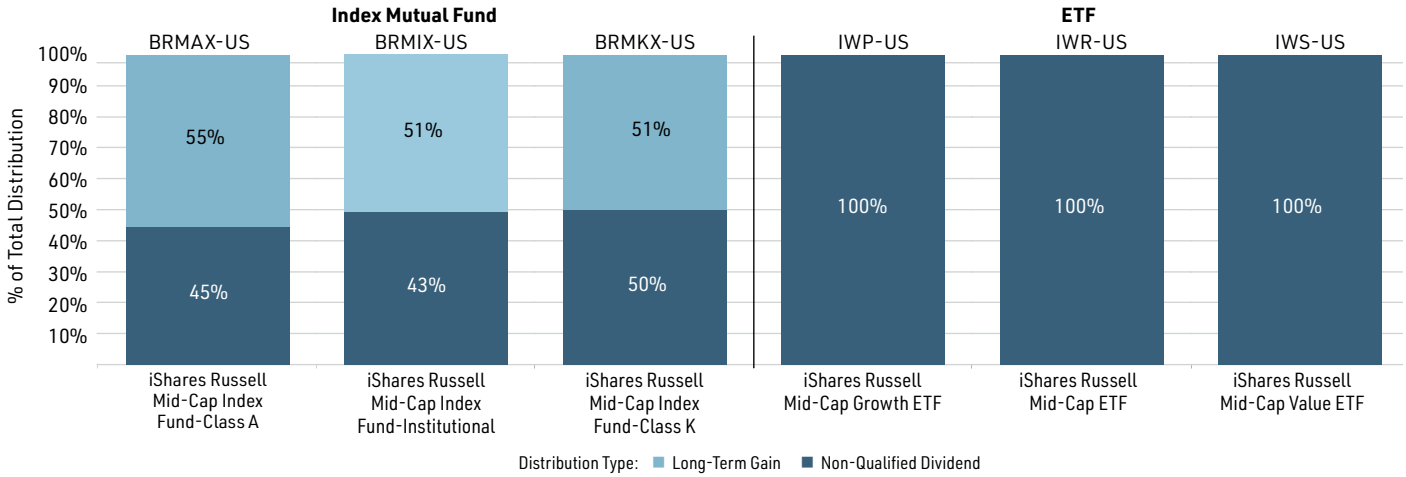
Taxes Still Are Due on Income Received

According to the Internal Revenue Code, to be considered a regulated investment company, an ETF must distribute at least 90 percent of its investment company taxable income each year.[4]

Figure 2 compares the distributions of three ETFs tracking Russell mid-cap strategies with three share classes of a similar index-tracking mutual fund. Note that in 2023, the total distribution of the mutual fund was split between long-term capital gains and nonqualified dividends, whereas the ETFs distributed only nonqualified dividends.

Unlike capital gains, which can be deferred through ETFs even in a taxable brokerage account, there is currently no way

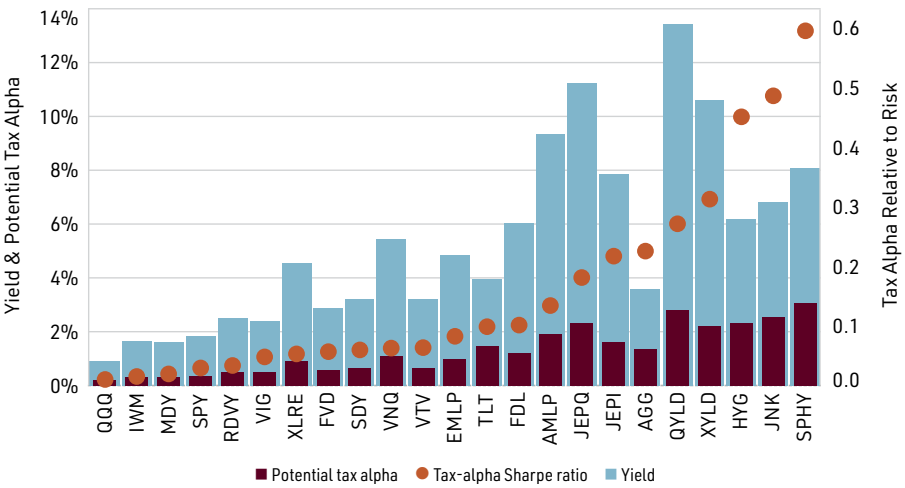
FIGURE 2 **Russell Mid-Cap Distributions–Mutual Funds vs. ETFs**
Based on total fund distributions through 2023



▲ *Figure 2 shows the breakdown of distributions across long-term capital gains, short-term capital gains, qualified dividends, and nonqualified dividends.*

Sources: FactSet, Nasdaq Index Product Development.

FIGURE 3 **Potential Tax Alpha Across Various ETFs**
Based on daily returns of respective ETFs from November 1, 2023–October 31, 2024



▶ *Yield estimated as the difference between annualized total return and annualized price return. Potential alpha measured as the annualized difference in post-tax total return and pre-tax total return. Tax-alpha Sharpe ratio measured as the ratio of estimated potential tax alpha to annualized volatility of price returns. Distributions taxed at 20 percent for equity ETFs and 37 percent for fixed income ETFs.*

Sources: FactSet, Nasdaq Index Product Development.

for a U.S. investor to defer taxes on dividend distributions.

Reinvesting Is Important but Not Tax-Free

Investors who are focused on achieving long-term total return, and who have little or no need for interim income, may elect to reinvest their distributed dividends. The compounding effect of putting dividend income back to work by reinvesting it into the original holding can be powerful.

For example, had an investor invested $1,000 into SPDR S&P 500 ETF Trust (SPY) in January 1993, the value of the investment would be worth nearly $14,000 today due to price return, i.e., market appreciation, alone. But if the investor chose to reinvest dividends, the theoretical value would be more than $21,000.

In a taxable brokerage account, however, an investor still must pay annual income taxes on the dividend received even if the dividend is reinvested. Thus, dividends are reinvested on a post-tax basis. This can cause a meaningful tax drag on long-term performance, reducing the compounding effect.

Tax Burden Varies Across Assets

It is worth noting that the estimated tax drag discussed above varies across asset classes. Some assets naturally yield more than others. For example, one could expect a fixed-income ETF to distribute more in nonqualified income return than a generic U.S. large-cap equity fund. Additionally, the specific tax rate on higher yielding instruments may be higher depending on the type of distribution.

In figure 3, we estimate that higher yielding ETFs (especially dividend-oriented equities or higher yielding bond ETFs) contain

OVERALL, THE TAX DRAG ALONE MAY BE SUFFICIENT REASON FOR INVESTORS TO AVOID INCLUDING THESE TYPES OF DIVERSIFYING ASSETS FROM TAXABLE PORTFOLIOS.

higher potential tax alpha on both an absolute and risk-adjusted basis.[5]

Like the SPY example discussed above, each time an investor in any of the funds above receives a dividend distribution, even if the investor chooses to reinvest, taxes must be paid on the distribution. This suggests that funds with higher yields are susceptible to higher tax drag. For example, we estimate that funds such as JPMorgan Nasdaq Equity Premium Income ETF (JEPQ), State Street SPDR Bloomberg High Yield Bond ETF (JNK), or Global X NASDAQ 100 Covered Call ETF (QYLD) might incur around 2-percent annualized tax drag compared to SPY's approximate 30 bps of drag. Overall, the tax drag alone may be sufficient reason for investors to avoid including these types of diversifying assets from taxable portfolios.

Earn Total Return (Without Dividends)

The question we wish to explore is whether there is a way to reduce this tax headwind. In the same way that ETFs have been successful for their ability to defer capital gains taxes, is it possible for ETFs to expand the boundaries of their tax efficiency to include dividend income in the case of equities and coupon yield in the case of bonds?

TABLE 1 **Quarterly Distributions Across S&P 500-Tracking ETFs**

FUND	FUND NAME	ISSUER	BENCHMARK	RETURN	RISK
SPY	SPDR S&P 500 ETF Trust	State Street	S&P 500	13.6%	17.6%
IVV	iShares Core S&P 500 ETF	BlackRock, Inc.		13.6%	17.6%
VOO	Vanguard S&P 500 ETF	Vanguard		13.6%	17.6%
SPLG	SPDR Portfolio S&P 500 ETF	State Street		13.6%	17.6%

Note: Based on select funds. Return and risk measured as compound annual return and annualized standard deviation of daily total returns. Data from November 1, 2014–November 29, 2024.
Sources: FactSet, Nasdaq Index Product Development.

TABLE 2 **2023 Distribution Dates Across S&P 500-Tracking ETFs**

QUARTER	EX-DATE	SPY	IVV	VOO	SPLG
Q1	3/17/2023	0.38%	0.00%	0.00%	0.00%
	3/20/2023	0.00%	0.00%	0.00%	0.40%
	3/23/2023	0.00%	0.42%	0.00%	0.00%
	3/24/2023	0.00%	0.00%	0.41%	0.00%
Q2	6/7/2023	0.00%	0.31%	0.00%	0.00%
	6/16/2023	0.37%	0.00%	0.00%	0.00%
	6/20/2023	0.00%	0.00%	0.00%	0.39%
	6/29/2023	0.00%	0.00%	0.39%	0.00%
Q3	9/15/2023	0.35%	0.00%	0.00%	0.00%
	9/18/2023	0.00%	0.00%	0.00%	0.38%
	9/26/2023	0.00%	0.46%	0.00%	0.00%
	9/28/2023	0.00%	0.00%	0.38%	0.00%
Q4	12/15/2023	0.40%	0.00%	0.00%	0.00%
	12/18/2023	0.00%	0.00%	0.00%	0.40%
	12/20/2023	0.00%	0.40%	0.41%	0.00%

Note: Based on select funds. Yield based on the difference between total return and price return on each ex-date. Daily data from 2023.
Sources: FactSet, Nasdaq Index Product Development.

Proliferation of ETFs Provides One Key Ingredient

As noted, the growth of ETFs has led to a landscape that contains funds for a plethora of investment strategies. In some cases, there are even "duplicate" funds—funds that track the same benchmark, or follow the same investment strategy, but are managed by different ETF issuers.

Funds such as SPY, iShares Core S&P 500 ETF (IVV), Vanguard S&P 500 ETF (VOO), and SPDR Portfolio S&P 500 ETF (SPLG) are nearly identical from a risk and return perspective (see table 1). During the past 10 years each fund has earned around 13.6-percent return per year while taking on around 18-percent annualized volatility.

This is unsurprising given each fund tracks the same underlying index (S&P 500). The key difference between each of these funds (aside from the fund manager and potential fees) is the distribution date. Although each fund makes a quarterly distribution (again, a taxable event), the distribution dates, i.e., the ex-dates, are on slightly different days (see table 2).

A Strategy for Deferring Dividend Distributions

On the ex-dividend date, the dividend-paying security's net asset value is reduced precisely by the amount of the distribution, and the market price should adjust accordingly. Otherwise, the security is expected to trade in line with any other similar ETF with a different ticker that did not just go ex-dividend (note the difference in SPY, IVV, and VOO on different ex-dates in figure 4).

To avoid the distribution, one would need to dispose of the dividend-paying security before the ex-dividend date. However, an individual would be unable to accomplish this alone in a personal taxable brokerage account without incurring capital gains taxes and potentially violating wash sale rules, because such a switch can be executed only through a trade transaction. Using the existing creation/redemption mechanism of the ETF structure, a fund might be able to temporarily rotate into

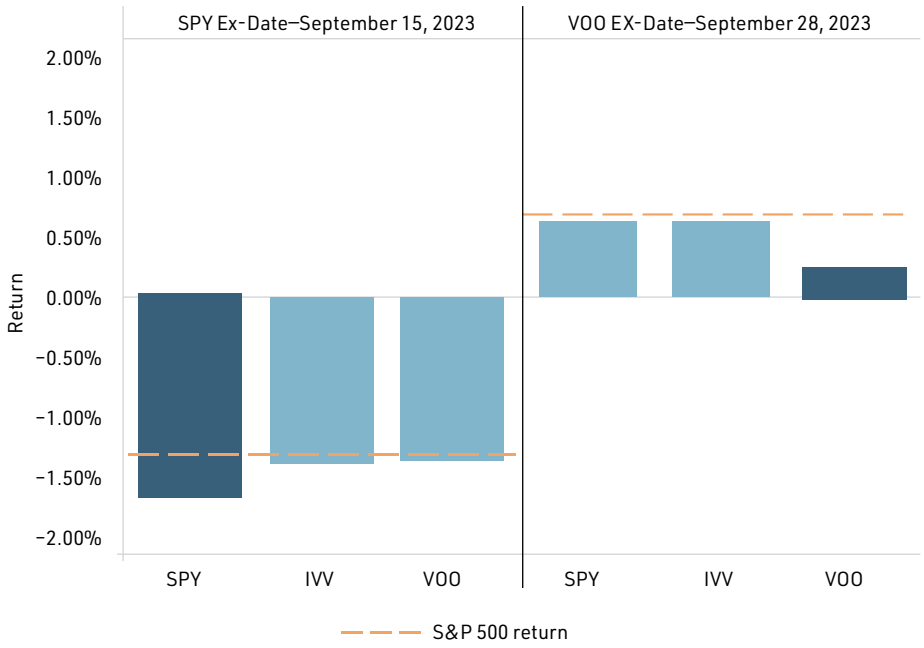
an identical, non-dividend paying security to maintain a similar risk and return exposure, and avoid the distribution.

Assume there was an ETF (referred to as the Fund) that indirectly tracked the S&P 500 by holding SPY, i.e., the ETF in this example would be a "fund-of-funds-of-one." On SPY ex-dividend dates, the holder of SPY would be entitled to the dividend distribution of SPY. Thus, the price of SPY should decrease relative to VOO or IVV (holding all else constant). If the Fund were to avoid this downward adjustment and rotate into a similar fund (such as VOO or IVV) to avoid the ex-dividend date, the Fund potentially could earn a price return that is similar to total return. No dividend would be received by the Fund, and therefore no income would need to be paid to the end investor.

Figure 5 demonstrates that the price return of the rotation strategy would mirror the total return of the targeted benchmark. In fact, over the sample period the rotational strategy achieves very similar returns and

FIGURE 4 Example of Ex-Date Return

Based on daily price returns of SPY, IVV, and VOO around September Ex-Dates

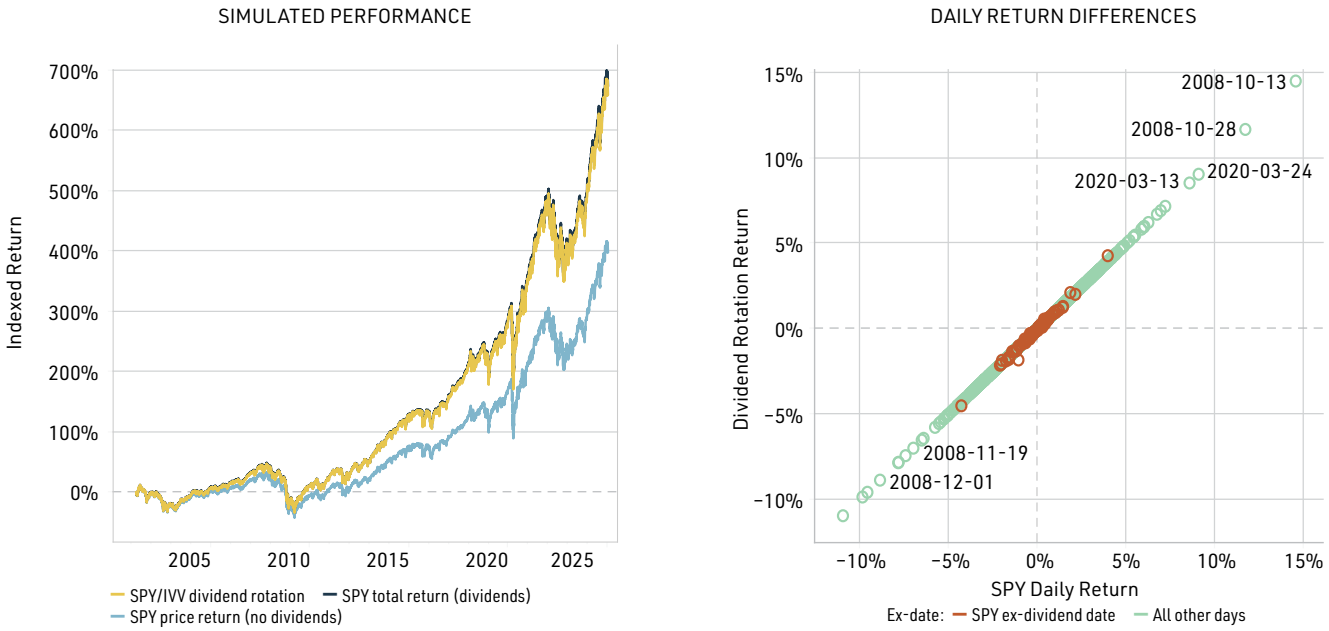


Sources: FactSet, Nasdaq Index Product Development.

FIGURE 5 Example Rotation Strategy for SPY

Based on backtested returns from March 2001–December 2024

Dividend rotation strategy rotates between SPY and IVV on SPY ex-dividend dates



Sources: FactSet, Nasdaq Index Product Development.

risk as the total return benchmark, without dividends (see table 3).

It is possible that over the long term a strategy that implements the dividend rotation might exhibit some potential tracking errors to the theoretical total return of the targeted asset. This is due to the temporary allocation to the "substitute" fund which may exhibit similar, but not identical, performance to the target asset on ex-dividend dates (note the yellow dots on the right panel of figure 5). Thus, when considering a strategy such as this, in addition to the "substitute" asset not paying a dividend on the same date, it is paramount that the substitute exhibits similar risk and return characteristics, i.e., low tracking error, to the core asset.

Overall, this suggests that an investor of the rotational strategy would not receive dividend payments, yet still would achieve a risk and return profile that is similar to one that requires reinvesting dividends to capture total return. Because no dividends are earned in the strategy, an investor does not recognize income.

Application to Other Assets

The elegant feature of this approach is that it could be applied to any ETF security. As we saw above, some asset classes exhibit higher tax drag. Thus, applying this strategy to funds that pay higher incomes could have a greater impact.

The key requirements of this type of strategy would be:

- Substitute must not be going ex-div on the same date as the core allocation
- Substitute must exhibit a similar risk and return profile as the core allocation

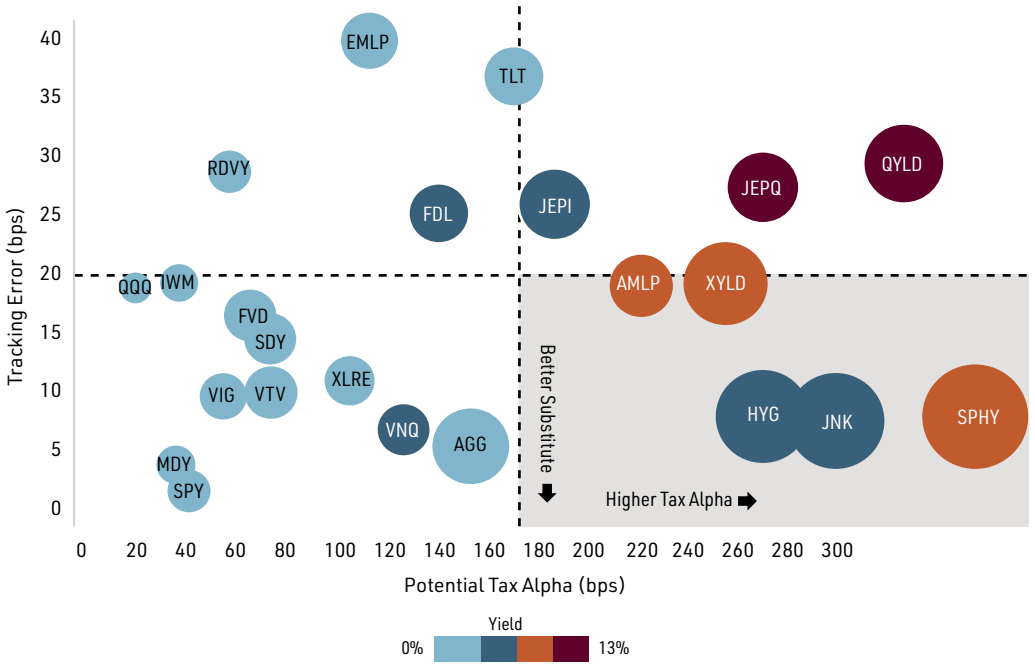
When looking at other core holdings, we see a trade-off emerge between the potential tax alpha and replicability (see figure 6). Very liquid U.S. equity strategies tend to have close substitutes, but the potential tax alpha may be insufficient to implement such a strategy. On the other hand, higher income-oriented strategies, such as master limited partnerships, covered calls, etc., may offer higher potential tax alpha, but their replicability could be lower.

Based on the opportunity set in figure 6, we see that high-yield bond funds generally offer higher potential tax alpha (on an absolute and risk-adjusted basis) along with reasonable substitutes.

TABLE 3 **SPY Ex-Dividend Rotation Summary Stats**
Based on daily return data from March 2001–December 2024

MEASURE	SPY (PRICE RETURN)	SPY (TOTAL RETURN)	SPY ROTATION (PRICE RETURN)
Return	7.53%	9.00%	8.91%
Risk	19.17%	19.13%	19.14%
Dividend Yield		1.47%	0.00%
Tracking Error			0.23%
Correlation			99.99%
Beta			100.04%

FIGURE 6 **Potential Alpha vs. Replicability**
Based on a sample of U.S. listed ETFs from November 1, 2023–October 31, 2024



Error is measured as the standard deviation of daily return differences. Tracking error displayed is the tracking error of the closest fund to the core holding. Potential alpha measured as the difference between total return and estimated post-tax reinvested total return. Reinvested distributions taxed at 20 percent (equity ETFs) and 37 percent (fixed-income ETFs). Size of dot reflects potential tax alpha relative to price return volatility.

Sources: FactSet, Nasdaq Index Product Development.

How Is This Different Than Other Products?

As the U.S. ETF market has evolved, there have been new products that attempt to offer investors an improved tax experience in the ETF wrapper.

Perhaps the most recent is BOXX (Alpha Architect's 1-3 Month Box ETF), which seeks to earn similar (total) returns to one-to-three-month Treasury bills (see figure 7).

The BOXX strategy uses a multi-leg options strategy to isolate the risk-free rate (T-bills).[6] Despite BOXX's success, the strategy is constrained to the return profile of T-bills.

Another recent launch is the Cambria Tax-Aware ETF, which seeks to invest in low-to-no dividend paying securities with strong value metrics.[7] Although the strategy attempts to reduce the tax burden associated with dividend distributions, the return profile of the strategy may tilt toward large-cap value stocks.

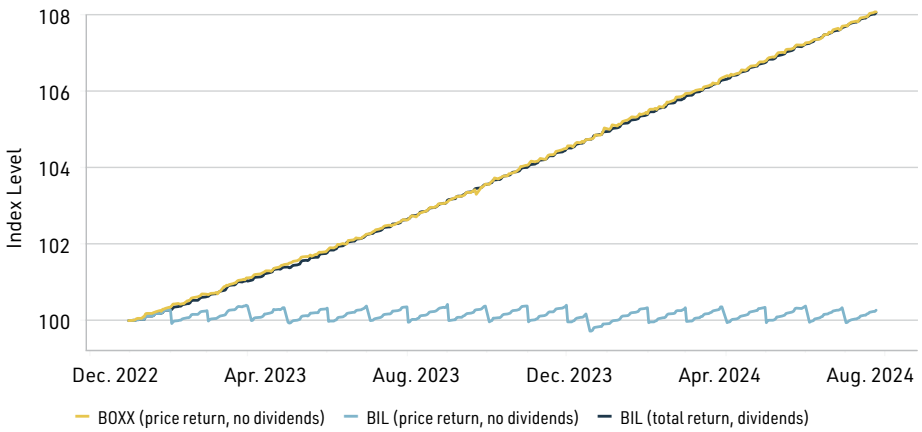
The key benefit of the dividend rotation strategy proposed above is that it could be applied to any ETF security that has substitute funds with no ex-date overlap. This flexibility allows investors to maintain their desired investment exposure through any core holdings (such as U.S. equity and high-yield bonds) while mitigating tax drag, unlike strategies that are constrained to a specific return profile such as T-bills. The strategy is a straightforward approach for investors to achieve the compounded total return of any benchmark fund or security over time in taxable accounts.

Conclusion

Overall, ETFs have become a preferred wrapper for launching investment strategies. Despite an ETF's ability to defer capital gains, there remains a residual tax burden associated with dividend distributions. In the strategy proposed above, we explored how the existing mechanisms that have led to the broad success of the ETF wrapper potentially could be extended to alleviate the residual tax burden associated with dividend distributions. Ultimately, we showed how this strategy potentially could achieve price returns that are equivalent to a total return strategy without reinvesting dividends. This could allow an investor to meet long-term financial goals without incurring a tax burden along the investment horizon.

FIGURE 7 **Performance of BOXX ETF Strategy**

Based on daily returns from December 30, 2022–July 24, 2024



Note: 1-3 Month T-Bills approximated by SPDR Bloomberg 1-3 Month T-Bill ETF.
Sources: FactSet, Nasdaq Index Product Development.

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ENDNOTES

1. The strategy is the foundation of the Nasdaq Compoundr Index Series. For more information on the Nasdaq Compoundr Indexes, including index methodology and other educational resources, see https://indexes.nasdaqomx.com/docs/Methodology_CompoundrFamily.pdf and https://compoundretfs.com/.
2. "Understanding Exchange-Traded Funds: How ETFs Work," ICI Research Perspective (September 2014), https://www.ici.org/system/files/attachments/per20-05.pdf.
3. See R. Moussawi, K. Shen, and R. Velthuis, "The Role of Taxes in the Rise of ETFs" (2025), https://ssrn.com/abstract=3744519.
4. See "Distribution Requirements" under "General Requirements to Qualify as a RIC," https://www.irs.gov/pub/irs-pdf/i1120ric.pdf.
5. We define "potential tax alpha" as the difference in theoretical annual total return (without taxes) and the estimated annual total return (with taxes applied to reinvested dividends). For the purposes of the analysis, a 20-percent (37 percent) tax rate was applied to reinvested distributions for equity (fixed income) ETFs.
6. See https://funds.alphaarchitect.com/boxetf/.
7. See prospectus here: https://www.cambriafunds.com/assets/docs/Cambria_TAX_Prospectus.pdf.

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