Generating Cash Flow More Tax Efficiently

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A taxable investor needing to withdraw cash from an account may wish to consider a tax-efficient sell-and-withdraw program rather than a high-dividend-yield-and-withdraw strategy.

INVESTMENT PROBLEM

Many investors who require consistent cash flow from their accounts may initially gravitate toward higher-yielding portfolios from which they can sweep out the cash that comes from the dividend payments.

However, by using a separately managed account without a dividend-yield tilt, a selling program can achieve the same cash-withdrawal target while leading to fewer taxes now.[1]

For illustrative purposes only.

EXAMPLE

Consider the following example of two securities (such as a stock or an exchange-traded fund), each of which has a 7% total return in a calendar year, and a client who wants to withdraw 4% of the initial value.

The first security's total return comes from 4% dividends and 3% capital appreciation. The second security's total return derives entirely from capital appreciation.

As shown in the table to the right,* the first security's approach would involve paying substantially more in taxes for this period.

	Security A	Security B
Initial Value	$1,000,000	$1,000,000
Dividend Income	$40,000	$0
Unrealized Gain	$30,000	$70,000
Current Value	$1,070,000	$1,070,000
Gain/Current Value	2.80%	6.54%
Cash Withdrawal		
Dividends Withdrawn	$40,000	$0
Security Sold & Withdrawn	$0	$40,000
Total Cash Withdrawn	$40,000	$40,000
Taxes		
Realized Gain	$0	$2,617
Taxes on Dividends	$9,520	$0
Taxes on Realized Gains	$0	$623
Total Taxes	**$9,520**	**$623**

HIGH-DIVIDEND-YIELD STRATEGIES: HIGHER TAXES & HIGHER TRACKING ERROR

Aperio can offer a high-dividend-yield tilt on client accounts, and we typically target a dividend yield of 1.5 times the benchmark yield. This yield tilt seeks to provide greater *income*—but greater income comes with greater *income tax*. Moreover, the yield tilt adds to the active risk of the portfolio.[2] Clients who are restricted (by contract) from spending anything other than income will have more spending available from portfolios that deliver higher income.

Taxes and Qualified Dividends

Dividends paid by most companies can qualify for a lower tax rate than non-qualified dividends. While non-qualified dividends are taxed as ordinary income (top federal marginal tax rate of 40.8%), qualified dividends are taxed at the long-term capital gains rate (top federal marginal tax rate of 23.8%).[3] Thus, most dividends and long-term capital gains are currently (October 2019) taxed at the same rate. Going forward, any changes in tax rates may impact these calculations, and given the long-term nature of these strategies, investors may wish to consider this risk.

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PAY TAXES NOW, OR PAY TAXES LATER

Under the current tax code, for dividends, taxes are paid now. With capital gains, taxes are paid only when the gains are realized. However, over the lifetime of a liquidated account, taxes will be the same on total dividends and total realized capital gains—unless the account is not liquidated due to a step-up in basis or a donation.

SUMMARY

A simple selling program in an Aperio account may be more tax-efficient and less risky than a high-dividend-yield strategy.

Unless a client is restricted from spending anything other than income, the client may prefer to skip a dividend-yield tilt and instead utilize a selling program due to better tax efficiency, lower taxes, and the option of forgoing taxes though a future step-up in basis or charitable donation.*

ADDITIONAL RESOURCE

Webcast: Case Study—Dividends vs. Withdrawals (6:56)

Dividends, Capital Gains, and Total Returns

The efficient-markets hypothesis[4] informs us that dividend-paying stocks and non-dividend-paying stocks have the same expected total return (capital gains plus dividends before taxes), all other things being equal, because any dividend payment is offset by a reduction in stock price.

However, differences occur on an after-tax basis, since the dividends are taxed in the year they are received, while capital appreciation isn't taxed until securities are sold. Thus, until an account is fully liquidated, the lower-dividend-yield security will have a higher after-tax return.

Timing of Cash Withdrawals*

The sweeping of dividends out of an account leads to inconsistent cash flow due to the variability of companies' schedules for paying dividends. Instead of sweeping out dividends, an investor who reinvests dividends while using a consistent selling program may realize marginally higher returns by being more fully invested during periods of rising markets.

Notes

*This example is hypothetical and is provided for illustrative purposes only. It does not reflect the experience of any actual investor and should not be relied upon to make investment decisions. Actual results may vary. This is not a recommendation to buy or sell any security. All investments are subject to the risk of loss.

[1]Prior to any future liquidation, the high-yield strategy will always be less tax efficient than the sell-and-withdrawal program unless the portfolio has a cost basis of exactly zero. At liquidation, if we assume that a high-yield strategy and a nontilted strategy have produced the same pre-tax total return since inception, then the income plus gains in one will equal the income plus gains of the other. If all dividends are qualified, then the taxes on the two portfolios over their lifetimes are the same—but the high-yield strategy pays the taxes faster.

[2]Aperio analysis of a global model portfolio, benchmarked to the MSCI ACWI as of September 30, 2019, showed a high-dividend-yield tilt increased tracking error by 0.34%.

[3]20.0% for the dividends plus 3.8% Medicare tax. www.irs.gov/publications/p17/ch08.html.

[4]Developed by Eugene Fama.

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