aperio by BlackRock

Generating Cash Flow More Tax Efficiently

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]

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.

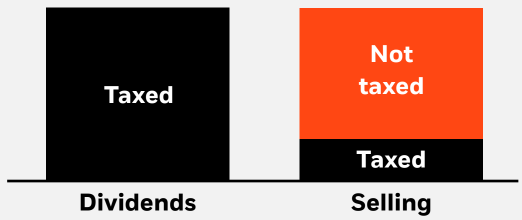
The first security's total return comes from 4% dividends and 3% capital appreciation. The second security's total return derives entirely from capital appreciation.

In the sample scenarios in the table to the right, the first two security's approach would involve paying substantially more in taxes for this period.

High-dividend-yield strategies: higher taxes and 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 generally comes with greater *income tax*. Moreover, the yield tilt is designed to increase 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.

Every dividend is taxed, but stock sales are taxed only on any gains



For illustrative purposes only.

Sample Scenarios		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Cash withdrawal	**Dividends withdrawn**	$40,000	$0
	Security sold & withdrawn	$0	$40,000
	Total cash withdrawn	$40,000	$40,000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**

For illustrative purposes only. It does not reflect the experience of any actual investor. Actual results may vary. Tax rates below apply.

Taxes and qualified dividends

Dividends paid by most companies can qualify for a lower tax rate than nonqualified dividends. While nonqualified 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 (June 2023) 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.

MKTGH0723U/S-2979748-1/2

Pay taxes now, or pay taxes later

Under the current tax code, the tax liability for dividends received is immediate. With capital gains, taxes are paid only when the gains are realized. However, over the lifetime of a liquidated account, all gains will by definition be realized, and if all realized gains and dividends are taxed at the same tax rate over this lifetime, then the mixture of dividends and realized gains would generally not impact the lifetime tax cost of the account, unless impacted by other circumstances, such as 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.

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.

[1] Prior to any future liquidation, the high-yield strategy is anticipated to 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] For example, as of March 31, 2023, a sample high dividend yield global portfolio had a forecast tracking error that was 0.44% greater than the forecast tracking error of a sample global portfolio with no tilts. Both portfolios were benchmarked to MSCI ACWI. Forecast tracking error is a point-in-time measure not intended to provide assurance as to performance/limit on losses. See Important Notes.

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

[4] Fama, Eugene (1970). "Efficient Capital Markets: A Review of Theory and Empirical Work". Journal of Finance. 25 (2): 383–417. doi:10.2307/2325486. JSTOR 2325486.

aperio
by BlackRock

Three Harbor Drive, Suite 204
Sausalito, CA 94965

415.339.4300 | aperiogroup.com

© 2023 BlackRock, Inc., or its affiliates. All rights reserved. **BLACKROCK** and **APERIO** are trademarks of BlackRock, Inc., or its affiliates. Other trademarks are the property of their respective owners.

Important notes

Aperio Group, LLC, provides this material for informational purposes only and for the sole use of the recipient. The information is provided with the understanding that we do not guarantee its accuracy, and are not engaged in rendering legal, accounting, or tax services. We recommend that all investors seek out the services of competent professionals in these areas. The strategies and/or investments referenced may not be suitable for all investors because the appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. None of the examples should be considered advice tailored to the needs of any specific investor or a recommendation to buy or sell any securities.

Investing involves risk, including possible loss of principal. Asset allocation and diversification may not protect against market risk, loss of principal, or volatility of returns. There is no guarantee that any investment strategy discussed herein will work under all market conditions. Many factors affect performance, including changes in market conditions and interest rates, as well as other economic, political, or financial developments.

You should not assume that investment decisions we make in the future will be profitable or will equal the investment performance of the past. With respect to the description of any investment strategies, simulations, or investment recommendations, we cannot provide any assurances that they will perform as expected and as described in our materials. Past performance is not indicative of future results.

Any tax information provided herein is for illustrative purposes only and does not constitute the provision of tax advice by Aperio. Due to the complexity of tax law, not every single taxpayer will face the situations described herein exactly as calculated or stated, i.e., the examples and calculations are intended to be representative of some, but not all, taxpayers. Since each investor's situation may be different in terms of income tax, estate tax, and asset allocation, there may be situations in which the calculations would not apply. Please discuss any individual situation with tax and investment advisors first before proceeding. For those clients using tax advantaged indexing, taxpayers paying lower tax rates than those assumed, or without taxable income, would earn smaller tax benefits from tax-advantaged indexing (or even none at all) compared to those described.

Forecast tracking error is a measure of how closely a portfolio is projected to track its benchmark. By definition, realized tracking error is the standard deviation of the differences between gross-of-fee portfolio returns and benchmark returns. It is not intended to provide assurance as to performance/limit on losses. This calculation is based on portfolio holdings, benchmark holdings, and a risk model (which takes into account the volatility and correlation of the risk factors in the marketplace) as of a specific date. For different dates, the portfolio and benchmark holdings, and the risk model will differ. Therefore, the measure on one date could significantly differ from a measure on another date.

MKTGH0723U/S-2979748-2/2