

Now You Can Avoid Taxes Like the Rich and Famous

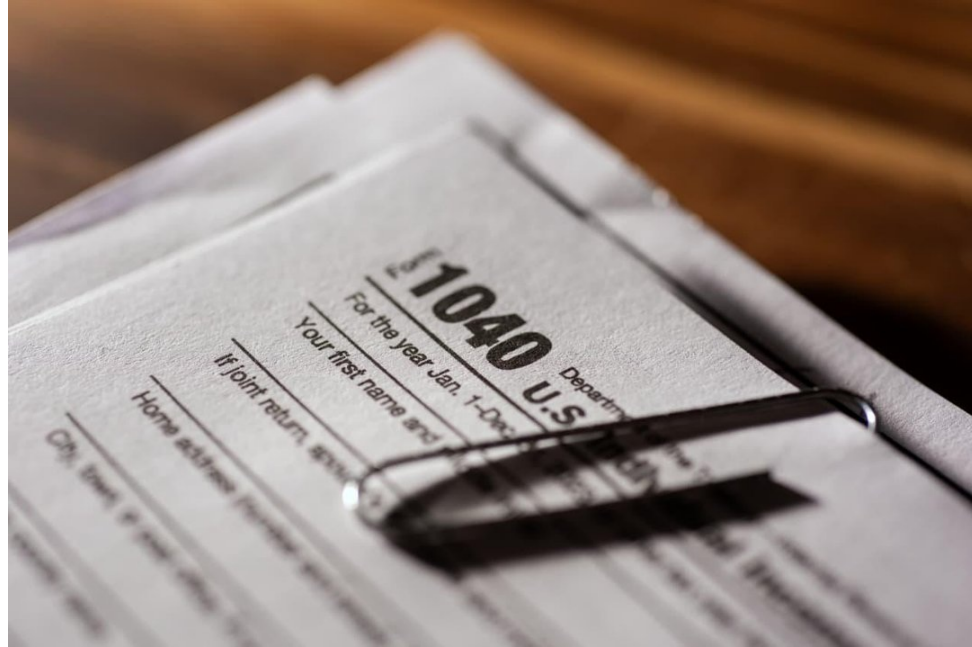
THE WALL STREET
JOURNAL

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Dec. 10, 2024

The buzzword on Wall Street is to "democratize" everything that was once exclusively for sophisticated investors, be it hedge-fund strategies, options trading or private markets. It was only a matter of time until the list included tax avoidance.

This is the time of year when legal ways to avoid paying income tax are top of mind. Income taxes are levied on interest from bonds and bank deposits, as well as on preferred dividends and the sale of investments for a gain. Qualified dividends and long-term capital gains get a lower rate. Even if you receive cash from your fund and invest it right back, you owe the taxman.

This creates funkiness in markets. The famous Santa Claus rally is likely the rebound from what is known as tax-loss harvesting in early December, when investors sell their unprofitable securities to offset broader gains in their portfolios.



Tax-busting products are booming. Photo: Michael Bocchieri/Getty Images

If it seems like a lot of work for scant gain, think again: A 2020 paper estimated an extra annual return of 1.1% from tax-loss harvesting with U.S. blue-chip stocks. For someone investing \$10,000 in a taxable brokerage account now, it could mean having \$235,000 in 30 years' time instead of \$175,000.

The second approach is to defer tax payments as much as possible, allowing money to compound for longer. It is a crucial reason why the highest-income households often pay less tax than middle-class ones, according to the Tax Policy Center.

To invest in the S&P 500, for example, the rich might eschew mutual funds and use direct indexing—that is, owning the stocks in the index individually so the underperforming ones can be disposed of even if the market does well. Parametric Portfolio Associates pioneered this strategy in the 1990s.

Still, stocks tend to go up, so eventually there are no losers to sell. For a few years now, quantitative-investment shops such as AQR Capital Management and Quantinno Capital Management have offered better, more complex products that combine long and short bets on stocks.

Traditionally, it only made sense to dabble in such products if you had savings in the many millions of dollars. But tax-optimizing solutions are booming as a wave of innovations reduce barriers to entry.

Take Vanguard, which in 2021 bought direct-indexing specialist Just Invest, and is deploying this capability for accounts with as little as \$250,000. Two decades ago, replicating an index while assessing the tax situation daily in order to sell and reinvest—all while not violating the wash-sale rule that prevents tax-loss harvesting if a similar security is purchased shortly after—required an unworkable number of staff hours. Now it can be done by a computer algorithm.

Schwab's direct-indexing strategies have an even lower minimum: \$100,000.

Similarly, today's mass-affluent wealth platforms such as Betterment and Wealthfront offer automated tax optimization. These can involve direct indexing, daily tax-loss harvesting using advanced mathematical models, or timing fund purchases around cash distributions. And they do the simple things that humans lose track of, such as placing bonds and high-dividend stocks in tax-sheltered 401(k)s and individual retirement accounts, while using taxable accounts for exchange-traded funds.

Indeed, the rise to dominance of ETFs over the past 30 years has already given the masses a tax-friendly product. Unlike mutual funds, they don't need to sell assets whenever shareholders want their money back. They are underpinned by banks that swap ETF shares for a basket of the underlying securities. And if you just dumped a stock for tax-harvesting purposes, an ETF is a great, diversified way to reinvest that cash.

Asset-management firms are increasingly converting their funds, including actively managed ones, into ETFs. BlackRock, the world leader, did so for the first time last month with its International Dividend Fund.

Smaller competitors are unveiling explicitly tax-busting products: In 2022, Pennsylvania-based Alpha Architect launched an ETF under the ticker BOXX. The fund uses option strategies to build an alternative to short-term Treasury bills without paying out interest income, though it has still been occasionally compelled to distribute cash. High rates have made it a popular product: In 2024, it has increased its assets more than the largest similar Treasury-bill ETF, which is run by State Street Global Advisors.

Alpha is also taking part in the coming launch of the Cambria Tax Aware ETF, or TAX, announced in October. A more complicated proposition, it allows investors who seed the fund with their own in-kind contributions to benefit from a loophole similar to one used by the wealthy to defer capital-gains tax on real estate. The benefit is a more diversified portfolio, but they initially own the hodgepodge of stocks they and others use to seed the fund. Taxes are still due eventually.

Another hitch is that such ETFs need to keep to a clear investment mandate filed with the Securities and Exchange Commission. That will get easier with scale, so it seems inevitable that the top investment platforms will soon start marketing similar products to their direct-indexing clients.

"We are exploring some of these solutions," said Brent Beardsley, Vanguard's head of advisor solutions. He is also looking into making long/short loss harvesting more accessible.

Generative artificial intelligence is set to lower costs further, both for launching products and for building AI agents that customize savers' tax needs.

Technology could eventually allow the average Joe to optimize his tax bill with nearly the finesse of the yacht and private-jet crowd. The big unknown is what Uncle Sam might do about it when the numbers get uncomfortably big.

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