

# The Math of After-Tax Returns

Calculating the after-tax return on your investments may help you better assess whether you are on track with your goals—and determine where various tax strategies may be able to help.

# Different Tax Strategies Create Different Tax Outcomes

In our example, two hypothetical couples have the same stock/bond investment mix and the same portfolio value of \$1,000,000. But because they use different tax strategies, they end up with starkly different tax costs for the year.

#### WHICH TAX BILL WOULD YOU PREFER?

Terry and Pam must pay \$17,781 in taxes, reducing their \$1,000,000 portfolio to \$982,218. As for Clark and Maria, their tax bill will only be \$183, leaving them with an after-tax portfolio of \$999,817.



How did Clark and Maria create a tax-aware portfolio that reduced their tax burden?



#### DOING THE MATH

Your after-tax return is the profit on your investment after deducting your taxes for the year.

[(Ending market value – tax paid) – (beginning market value)] / (beginning market value) = after-tax return

#### A LOOK AT A TYPICAL PORTFOLIO

First, let's look at the after-tax returns for Terry and Pam, who have a combined income of \$375,000 a year and invest in an equity mutual fund. The fund's dividend yield was 1.8% and had 10% in capital gains distributions before the end of the year.

The pre-tax market return of 8% fell to an after-tax return of 5.63% for Terry and Pam—given their tax rates and that they held this mutual fund in a taxable brokerage account. Taxes decreased the market return by 2.37%.

Terry and Pam's Mutual Fund Returns	
Mutual fund beginning value	\$694,444
Mutual fund ending market value	\$750,000
Pretax market return	8%
Taxable distributions:	
10% mutual fund capital gains distributions for the year	\$75,000
1.8% dividend yield	\$12,500
Total taxable distributions (capital gains distributions + dividends)	\$87,500
Tax rate:	
Long-term capital gains federal tax rate	15%
Net investment income tax applies	3.8%
	18.8%
Federal tax due (18.8% x \$87,500)	\$16,450
Ending market value (net of tax paid)	\$733,550

Knowing the after-tax return, Terry and Pam may now question whether this is the most tax-efficient way to hit their financial goals.

#### After-tax return = (\$733,550 - \$694,444) / \$694,444

Source: American Century Investments. Assumes capital gains distributions are reinvested and dividends are qualified. This hypothetical situation contains assumptions that are intended for illustrative purposes only and are not representative of the performance of any security. There is no assurance similar results can be achieved, and this information should not be relied upon as a specific recommendation to buy or sell securities.

### THE BENEFITS OF A TAX-AWARE PORTFOLIO

Now let's review Terry and Pam's portfolio versus one invested by tax-aware Clark and Maria. Both families earn a household income of \$375,000 and have 75% equity/ 25% bond investment portfolios totaling \$1,000,000.

According to the current income tax rates, this income places Terry and Pam in the 32% marginal tax bracket.

<b>Terry and Pam – Typical Portfolio</b>	C					
	\$1,000,000 Portfolio					
Investments:	Income	Tax Rate*	Taxes			
Equity Mutual Fund						
\$750,000 year-end balance						
1.8% dividend yield of \$694,444 beginning balance (all qualified dividends)	\$12,500	18.8%	\$2,350			
10% capital gains distributions (all long-term and reinvested in fund)	\$75,000	18.8%	\$14,100			
Bond Mutual Fund						
\$250,000 year-end balance						
1.5% yield of \$250,000 beginning balance	\$3,750	35.5%	\$1,331.25			
Total Taxes	\$17,781.25					
% lost to taxes			-1.78%			
Clark and Maria – Tax-Aware Po	rtfolio					
	\$1,000,000 Portfolio					
Investments:	Income	Tax Rate*	Taxes			
Tax-Managed Equity Mutual Fund						

\$750,000 year-end balance

0.13% vield	\$975	18.8%	\$183.30	
No capital gains distribution		18.8%	\$0	
Municipal Bond Mutual Fund				
\$250,000 year-end balance				
0.9% yield not taxed at the federal level	\$2,250	0%	\$O	
Total Taxes	\$183.30			
% lost to taxes			-0.02%	
*Marginal income tax rate + net investment income tax (NII <sup>-</sup> NIIT 3.8%. NIIT applies because combined income is greater t	T) 3.8%. Long-term capital gain than \$250.000.	is and qualified divid	dend tax rate +	

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## The Outcome

Terry and Pam's tax bill was \$17,781, leaving them with an after-tax return of -1.78%. Clark and Maria paid just \$183 in taxes, with an after-tax return of -0.02%. While these scenarios are for hypothetical investors, you can still see the impact of a tax-aware strategy.

When you know the impact of taxes on your investments, you can explore various tax strategies to see if you can keep more of your returns.

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