ETF Tax Efficiency: The In-Kind Redemption

How the creation[1] and redemption[2] mechanism gives ETFs a potential structural tax advantage over mutual funds

KEY TAKEAWAYS

- ETFs are generally more tax-efficient than mutual funds because the in-kind[3] creation and redemption mechanism typically allows an ETF to meet investor redemptions without selling underlying securities, and without realizing internal capital gains, though this advantage is not guaranteed in all circumstances.
- In 2025, approximately 7% of ETFs paid a capital gains distribution, compared to 52% of mutual funds (Source: State Street Global Advisors).
- The advantage is structural, not strategy-specific, and applies to both passive and most actively managed ETFs.

Overview

For investors holding funds in taxable accounts, after-tax return[4] is what actually compounds. One of the often overlooked advantages of the ETF wrapper is its tax efficiency, and that advantage is not the result of portfolio management. It is a function of how ETF shares are created and redeemed.

The CFA Institute's Comprehensive Guide to ETFs (2nd edition, 2025) identifies tax efficiency as one of the core structural benefits of the ETF wrapper. Most ETFs distribute fewer capital gains to investors than equivalent mutual funds.

Why It Matters

Capital gains distributions may be an underappreciated drag on after-tax return. When a mutual fund manager sells appreciated securities, to meet redemptions or to rebalance, the realized gains must be distributed to shareholders. Investors who simply held the fund through the year still receive the distribution and may owe tax on it, even though they did not sell their shares.

A peer-reviewed study in the Review of Financial Studies (October 2025) estimated that ETFs' structural tax efficiency, driven by in-kind redemptions under IRC Section 852(b)(6), adds **approximately 1.05% per year in after-tax returns compared to equivalent mutual fund structures.**

How It Works

The structural difference comes down to how the two wrappers handle redemptions.

Mutual Fund

REDEMPTION IN CASH

Manager sells underlying securities to meet redemptions, potentially realizing capital gains. Those gains are distributed to all shareholders, including those who didn't sell.

ETF

REDEMPTION IN KIND

An authorized participant[5] returns ETF shares and receives a basket[6] of underlying securities. No securities are sold from the ETF's portfolio to meet redemptions, so no capital gain is typically realized, though capital gain distributions are not eliminated in all circumstances.

When a mutual fund redeems, the manager often sells appreciated securities to raise cash, realizing capital gains that must be distributed pro rata to all remaining shareholders, including investors who did not sell. When an ETF redeems, an authorized participant receives a basket of the ETF's underlying securities in-kind. No securities are sold from the ETF's portfolio to meet redemptions, and no capital gain is realized.

This in-kind treatment is codified in Section 852(b)(6) of the Internal Revenue Code. The advantage is pronounced for equity ETFs; bond and derivative-based ETFs typically forfeit some of the benefit.

Practical Implications

For advisors and investors evaluating ETFs versus mutual funds for taxable accounts, three potential takeaways follow.

1. **Compare after-tax returns, not just pre-tax.**
   Two funds with identical pre-tax performance can deliver materially different after-tax results once capital gains distributions are factored in. Check the fund's distribution history. Tax efficiency is not guaranteed in any given period.

2. **Favor ETFs in taxable accounts.**
   For the same strategy, the ETF wrapper typically delivers a tax-efficiency advantage that compounds over multi-year holding periods. This applies to most equity ETFs, including actively managed ones.

3. **Use ETFs to manage taxes across the portfolio.**
   An investor can sell one ETF to realize a loss and immediately replace it with another ETF tracking a different but similar index, preserving exposure while seeking to mitigate the impact of wash sale rules.

At Clough Capital

Clough Capital's actively managed ETFs, CBLS and CBSE, are designed to benefit from the same in-kind redemption mechanism that seeks to provide the tax efficiency advantage across the ETF wrapper. For taxable investors and the advisors who serve them, the wrapper choice itself contributes to after-tax outcomes, alongside the active strategy each fund pursues.

Definitions

1. Creation is the process by which new ETF shares come into existence. An authorized participant delivers a specified basket of securities, cash, or both to the fund and receives a large block of newly issued ETF shares in return. Creation allows an ETF's share count to grow to meet investor demand.

2. Redemption is the reverse of creation. An authorized participant returns a large block of ETF shares to the fund and receives a basket of the fund's securities, cash, or both. Redemption allows an ETF's share count to shrink when investors sell.

3. An in-kind transaction is one settled by delivering securities rather than cash. When an ETF redeems in-kind, it hands an authorized participant a basket of portfolio securities instead of selling those securities and paying out cash, which is why an in-kind redemption does not itself require the fund to realize a capital gain.

4. After-tax return is the return an investor retains once taxes on distributions and on any gain realized at sale are taken into account. It depends on the investor's own tax position and holding period, so two investors in the same fund over the same period can experience different after-tax returns.

5. Authorized Participants (APs) are large financial institutions authorized to create and redeem ETF shares directly with the fund. To create shares, an AP delivers a basket of the ETF's underlying securities to the fund and receives ETF shares in return; to redeem, the process reverses. This creation/redemption mechanism allows an ETF's share supply to expand or contract with investor demand, and ties the fund's tradable size to the liquidity of its underlying holdings.

6. The underlying basket is the portfolio of securities an ETF holds, and the basket exchanged between the fund and an authorized participant when shares are created or redeemed. Because shares can be created and redeemed against it, the tradability of the underlying basket is a principal factor in how large a trade an ETF can support.

Sources: A Comprehensive Guide to ETFs (2nd Edition), CFA Institute Research Foundation, 2025. State Street Global Advisors, "Tax Efficiency Is Structural," 2025/2026. Cai, Goldberg & Schneider, "The Role of Taxes in the Rise of ETFs," Review of Financial Studies, October 2025.