

T.RowePrice

How to make the most of your savings using a tax-efficient approach

Make Your Plan

Key Insights

- Taxes should not drive your investment decisions, but they should be a factor you consider.
- If you have assets in a taxable account, you must focus on after-tax returns. The average U.S. equity mutual fund's annual after-tax return is about 1.8% lower than its pretax return.
- Account type and asset location are important components of a tax-efficient strategy.



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Taxes can create a drag on your investment performance, but through smart choices and a tax-wise strategy, you can reduce that impact. The goal of these efforts is not to eliminate taxes but to minimize their influence on your returns.

The importance of taxes in your investment strategy will depend on your situation, including your tax rate. The higher your marginal tax rate, the more value there is in pursuing an investment strategy that factors taxes into your decision-making process. Even so, many of the strategies described below could be options for investors in most tax brackets. That is particularly true when it comes to saving in tax-advantaged accounts and diversifying your account types.

Contribute to tax-advantaged accounts

Contributing to tax-advantaged accounts is one of the simplest and most accessible options that investors have to be more tax savvy. Retirement savings accounts provide tax advantages that offer growth potential without the annual drag of taxes on interest, dividends, or realized capital gains. Making tax-deferred contributions to some retirement accounts, including Traditional individual retirement accounts (IRAs) and 401(k) plans, reduces your taxable income. Roth contributions are not deductible, but qualified distributions are tax-free.

Since tax rates on both ordinary income and long-term capital gains have decreased in recent years, investors might wonder if a taxable account would be preferable to a

tax-advantaged account. Over a long time horizon, the short answer is no. A Roth account is almost always preferable to a taxable account, given the former's qualified tax-free withdrawals. A Roth account is also generally preferable to a tax-deferred account if your tax rate will be higher in retirement. If your tax rate will stay the same or decrease in retirement, a tax-deferred account works out better than a taxable account. (See Scenarios 1 and 2.)

Diversify your account types

Tax-advantaged accounts form an important foundation for your retirement savings, but taxable accounts can still provide flexibility for other goals and for savings above annual retirement plan contribution limits. Setting aside money in different types of accounts offers flexibility for your withdrawals in retirement, allowing you to better manage your tax liability. The different account types can include taxable accounts, tax-deferred accounts, and Roth accounts. Health Savings Accounts (HSAs) are also an investment option for those with high-deductible health plans (HDHPs) who have the ability to set that money aside over a longer time horizon to cover future medical expenses. Each account type has different tax treatments and, thus, different ways it can fit into an income plan for retirement. (See "Tax treatments of different accounts.")

Choose tax-efficient investments

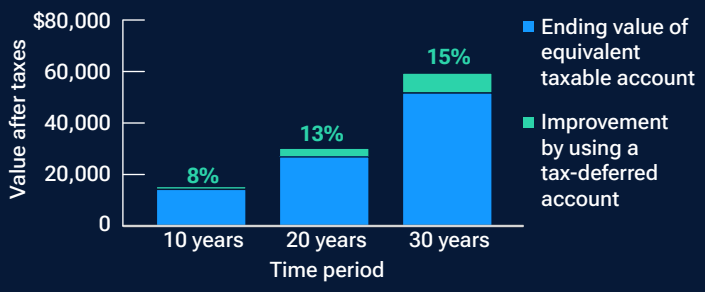
Some investments carry their own intrinsic tax benefits. For example, interest income from certain municipal bonds is tax-free at the federal level and potentially at the state and local levels as well. Similarly, investing in tax-efficient mutual funds or exchange-traded funds (ETFs) can help minimize your overall tax liability. These

The advantage of tax-deferred accounts

Tax-deferred accounts provide an important foundation for many individuals' retirement savings plans. The examples below compare the ending after-tax value of a $10,000 tax-deferred contribution and an equivalent investment in a taxable account. In both scenarios, tax-deferred is better for growing savings over time—and the longer the time horizon, the bigger the improvement.

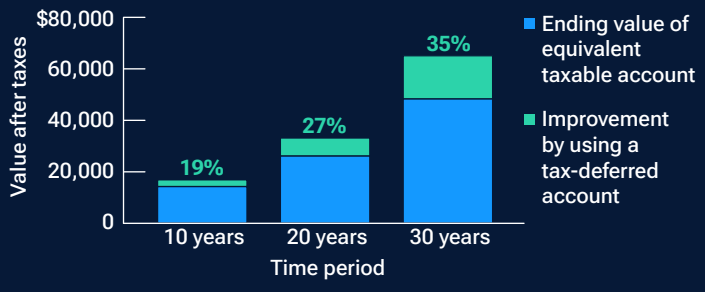
Scenario 1

(Fig. 1) This scenario reflects assumptions that are relatively favorable to the taxable account: All gains taxed are at capital gains tax rates at the end of the period (rather than each year), and the investor's tax bracket doesn't change in retirement. A tax-deferred account still comes out on top.



Scenario 2

(Fig. 2) This scenario shows a larger difference if the situation isn't quite so favorable to the taxable account: Half of that account's gains are taxed each year (though still at capital gains tax rates), and the investor drops one tax bracket lower in retirement.



Assumptions: Both scenarios assume a 7% annual rate of return and a 22% initial marginal tax rate; in Scenario 2, the marginal tax rate drops to 15% at the end. The initial tax-deferred investment in both scenarios is $10,000, while the initial investment in the taxable account is $7,800, which is the equivalent in after-tax income. All returns in the taxable account are taxed at a 15% capital gains tax rate (either each year or at the end of the period), and ending values are after all relevant taxes are deducted. Values are not adjusted for inflation.

funds may focus on keeping portfolio turnover low, having extended holding periods for their investments, or harvesting losses to offset gains, thus triggering fewer annual taxable capital gains.

When reviewing performance of tax-efficient or tax-advantaged investments and conventional securities, remember to adjust for taxes in the comparison. For example, a lower yield on a tax-free municipal bond may be preferable to the yield of a comparable taxable bond. In fact, the higher your marginal tax rate, the higher the pretax yield on a taxable bond would need to be to match the after-tax yield on a municipal bond. (See "A look at tax-equivalent yields.")

The comparison can get a little more complicated when considering other securities, such as stock funds, given the different tax treatments of dividends and capital gains, as well as the role of turnover. However, tax-efficient funds are still worth evaluating on an after-tax basis. (See "Consider tax-efficient funds.")

Pay attention to asset location

Where you hold your securities is also an important component of a tax-savvy strategy. Generally, aim to hold investments that generate significant ordinary income in tax-advantaged accounts. For instance, high-yielding taxable bonds and bond funds, as well as real estate investment trusts, should generally be held in tax-deferred accounts. Depending on your situation, even stocks or stock funds that generate qualified dividends might be better in those accounts than in taxable accounts.

Additionally, consider the benefits of using Roth accounts to hold securities that have potential for significant long-term growth. It could make sense to put very high-growth-potential securities in Roth

Tax treatments of different accounts

(Fig. 3) Consider the tax treatments of each account type and how each may fit into your retirement income plan

	Contribution type	Income tax on earnings	Income tax on distribution or liquidation	Tax treatment for heirs
Tax-advantaged accounts				
Traditional IRA or 401(k)	Tax-deferred or pretax	Deferred	Ordinary rate	Beneficiary's required minimum distributions (RMDs): ordinary rate
Roth IRA or 401(k)	After tax	Deferred	Tax-free for contributions and qualified earnings[1]	Beneficiary's RMDs: tax-free if qualified
Health savings accounts[2]	Tax-deferred or pretax	Deferred	Tax-free if for qualified medical expenses	Spousal beneficiary maintains tax advantage; full value taxable at ordinary rate for non-spousal beneficiaries
Taxable accounts				
Appreciation		None until liquidated	Return of cost basis tax-free; gains at rates applicable to short-term or long-term capital gains	Step-up in basis, so gains during life of original owner are tax-free
Ordinary income-generating (e.g., interest)		Ordinary rate		
Qualified dividend		Qualified dividend rate		

[1] Generally, a qualified owner is over age 59½ and Roth account has been open for at least 5 years.
[2] HSAs are only available for those with HDHPs; health care plans should be selected primarily based on insurance coverage needs. Some HSA tax benefits only accrue if assets are invested in the account over the longer term.

accounts if you plan to hold on to them for a long time, since that growth will be tax-free. A Roth account can be a particularly good choice for high-turnover growth strategies in your portfolio, since those could generate short-term capital gains in a taxable account.

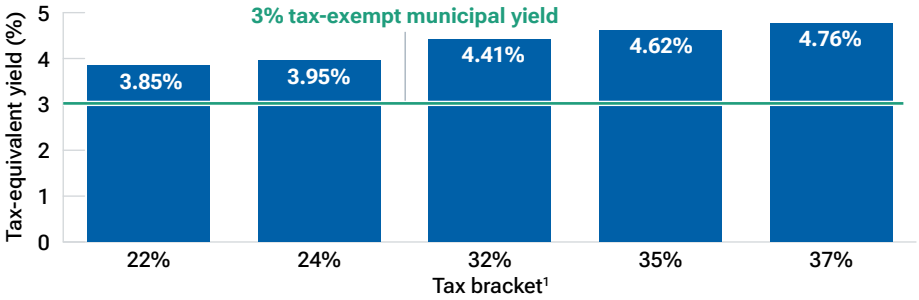
By comparison, more tax-efficient or tax-advantaged investments should be held in taxable accounts. Municipal bonds, for instance, should only go in taxable accounts, as their tax benefits are wasted when held in a tax-advantaged account. Stocks and low-turnover equity funds held longer than one year currently receive preferential capital gains tax treatment compared with short-term gains or ordinary income, so these, too, can be appropriate for taxable accounts.

In any event, keep in mind that if you have assets in a taxable account, you should focus on their after-tax returns. Most mutual funds are not managed to be tax-efficient; as a result, according to Morningstar, the average mutual fund's annual after-tax return could be as much as 1.8% lower than its pretax return.[1]

[1] Morningstar's tax cost ratio based on the January 2024 article, "Which Investments to Keep Out of Your Taxable Account." The tax cost ratio compares a fund's load-adjusted, pretax return with its tax-adjusted return. The result represents the amount of annualized return an investor loses to taxes. To find a mutual fund's tax cost ratio, go to Morningstar.com and enter the ticker symbol at the top of the page. On the resulting fund's page, click on the "Performance" link on the toolbar beneath the fund name. You'll find the tax cost ratio among trailing returns by selecting month end.

A look at tax-equivalent yields

(Fig. 4) Select your federal tax bracket below to see the pretax yield you would have to earn on a taxable bond to equal a 3% tax-free yield on a municipal bond.



[1] Does not include the 3.8% net investment income tax (NIIT); see irs.gov for more information. Chart also does not reflect any potential state or local tax benefit. Note that factoring in the NIIT and state and local income taxes, where applicable, would result in higher tax-equivalent yields.

Consider tax-efficient funds

The T. Rowe Price Tax-Efficient Equity Fund (PREFX) pursues strategies that aim to maximize after-tax returns, particularly by taking longer-term positions in equities and attempting to limit annual portfolio turnover. Ultimately, the T. Rowe Price Tax-Efficient Equity Fund has managed a 98% tax efficiency rating for the five years ended December 31, 2024, relative to an 86% tax efficiency rating for comparable U.S. large-cap growth funds. The fund's focus on growth stocks rather than high-dividend-yield stocks also helps avoid generating taxable income. The manager's process of strategically harvesting tax losses in a declining market is yet another way to improve the fund's tax efficiency. That means more of the fund's annual returns are earned after taxes, which is an important consideration when making comparisons between funds.

Implementing the specifics of a location strategy will depend on your mix of accounts and asset allocation. In addition, exceptions to these general rules are appropriate when taking your time horizon into consideration. (See "Balancing tax efficiency and time horizon.")

Stay focused on what's important

Ultimately, the most important elements of your retirement savings plan involve how much you save and how early you can start saving. Seeking tax efficiency should never get in the way of maximizing your savings, but a few relatively easy steps can go a long way toward tax efficiency. While avoiding all taxes is virtually impossible, investors can make some important portfolio decisions and adjustments to adopt a more tax-efficient investing strategy.

Tax efficiency can improve after-tax returns

(Fig. 5) A look at tax efficiency rates for various types of funds' annualized returns.[1]

	Pretax return	Five-year after-tax return pre-liquidation[2]	Five-year after-tax return post-liquidation[3]	Tax efficiency[4]
T. Rowe Price Tax-Efficient Equity Fund	15.82%	15.47%	12.72%	98%
U.S. Large-Cap Growth Funds	15.42	13.33	11.87	86
U.S. Mid-Cap Growth Funds	9.35	7.56	7.09	81
U.S. Small-Cap Growth Funds	8.47	6.58	6.33	71

Sources: T. Rowe Price and Morningstar (see Additional Disclosure).
For the most recent quarter-end returns, fees, and other important information about the T. Rowe Price Tax-Efficient Equity Fund, please visit troweprice.com/tmc.

Current performance may be higher or lower than the quoted past performance, which cannot guarantee future results. Share price, principal value, and return will vary, and you may have a gain or loss when you sell your shares. To obtain the most recent month-end performance, go to troweprice.com/tmc.

The T. Rowe Price Tax-Efficient Equity Fund's gross and net expense ratio was 0.83% as of its fiscal year ended February 29, 2024, as stated in the most recent prospectus. As of December 31, 2024, the fund's pretax annualized total returns were 32.36%, 15.82%, and 14.78% for the 1-, 5-, and 10-year periods, respectively. The fund's after-tax returns pre-liquidation were 32.11%, 15.47%, and 14.45%, respectively, and the after-tax returns post-liquidation were 19.35%, 12.72%, and 12.42%, respectively.

[1] Five years ended December 31, 2024.

[2] These returns reflect payment of taxes on annual dividend and capital gain distributions but assume that investors did not sell their shares at the end of this 5-year period.

[3] These returns reflect taxes paid on annual dividend and capital gain distributions and any capital gains tax due on the sale of all fund shares at the end of this 5-year period.

[4] Tax efficiency measures how much of a fund's annual return is earned after taxes, so the higher the number the better. These data reflect taxes paid on annual dividend and capital gain distributions but assume that investors did not sell their shares at the end of this 5-year period.

The returns presented reflect the return before taxes; the return after taxes on dividends and capital gain distributions; and the return after taxes on dividends, capital gain distributions, and gains (or losses) from the redemption of shares held for the periods shown. The after-tax returns reflect the highest long-term capital gains and qualified dividend rate (23.8%) and highest applicable rate to ordinary income (40.8%) currently in effect. State and local taxes are excluded. During periods when the fund incurs a loss, the post-liquidation after-tax return may exceed the fund's other returns because the loss generates a tax benefit that is factored into the result. An investor's actual after-tax return will likely differ from those shown and depend on his or her tax situation. Past pretax and after-tax returns do not necessarily indicate future performance. Average annual total return figures include changes in principal value, reinvested dividends, and capital gain distributions.

Balancing tax efficiency and time horizon

There are times when holding less tax-efficient securities in a taxable account makes sense. When it comes to short-term goals, such as saving for a down payment on a home, it can make sense to hold more conservative investments, such as short-term bond funds, in a taxable account. Doing so ensures that those assets are available to you, penalty-free, when it's time to withdraw them. Holding those assets in a tax-advantaged fund might lead to withdrawal penalties if your goal arrives before you reach the age of 59½. Don't let the taxes play the dominant role in your decision about where to hold various investments. To the extent that you have short-term goals, it's okay to hold conservative interest-generating investments in a taxable account to have those assets accessible when you need them.

INVEST WITH CONFIDENCE®

T. Rowe Price identifies and actively invests in opportunities to help people thrive in an evolving world, bringing our dynamic perspective and meaningful partnership to clients so they can feel more confident.

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