# TAX COST RATIO



The Morningstar Tax Cost Ratio measures how much a fund's annualized return is reduced by the taxes investors pay on distributions. Mutual funds regularly distribute stock dividends, bond dividends and capital gains to their shareholders. Investors then must pay taxes on those distributions during the year they were received. Like an expense ratio, the tax cost ratio is a measure of how one factor can negatively impact performance. Also like an expense ratio, it is usually concentrated in the range of 0-5%. 0% indicates that the fund had no taxable distributions and 5% indicates that the fund was less tax efficient. **For example**, if a fund had a 2% tax cost ratio for the three-year time period, it means that on average each year, investors in that fund lost 2% of their assets to taxes. If the fund had a three-year annualized pre-tax return of 10%, an investor in the fund took home about 8% on an after-tax basis. (Because the returns are compounded, the after-tax return is actually 7.8%.)

For the Pros This methodology allows us to calculate the tax efficiency for all funds.

# Formula

The Tax-Cost Ratio for time period t (TCRt) can be calculated as follows:

$$\text{TCR}_{t} = (1 - \frac{1 + \text{TR}_{\text{ATPL}, t}}{1 + \text{TR}_{t}}) \times 100$$

Where

TR<sub>t</sub> = the annualized load-adjusted total (pretax) return for time period t

TR<sub>ATPL,t</sub> = the annualized total net SEC after-tax return (pre-liquidation) for time period t

### Example 1

Suppose the annualized total return and SEC-after-tax (pre-liquidation) return from November 2000 to October 2001 are 10% and 8%, respectively.

**Then:** TCR = 1 - [(1 + 0.08)/(1 + 0.10)] = 1.8%

# Example 2

Suppose the total return and SEC-after-tax (pre-liquidation) return from November 1998 to October 2001 are 5% and 2%, respectively.

**Then:** TCR = 1 - [(1 + 0.02)/(1 + 0.05)] = 2.9%



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