Capital Gain Distribution FAQs

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1. What is a capital gain?

A capital gain is the profit that results from selling a capital asset, such as a stock, for more than was paid to acquire it. All funds which elect to be treated as regulated investment companies (RICs) are required by IRS regulations to distribute their capital gains (as well as any investment income such as dividends and interest) to shareholders at least annually. All of WisdomTree's ETFs (other than the WisdomTree Continuous Commodity Index Fund (GCC)) are treated as RICs. Capital gain and income distributions are subject to tax (if not held in tax-deferred accounts such as IRAs). Due to the structure of the ETF, however, ETFs typically are more tax efficient than mutual funds with similar investment strategies, in that ETFs typically will be able to lessen or avoid incurring capital gains.

2. How do ETFs typically offer better tax efficiency than mutual funds when it comes to capital gains?

When a mutual fund sells new shares, the fund receives cash, and when a mutual fund redeems shares, it must pay out cash. The portfolio manager of a mutual fund usually will buy or sell securities to deploy or to raise cash as a consequence of sales and redemptions. The purchase and sale of securities by the fund can create taxable events inside the fund (many mutual funds also maintain an uninvested cash balance to be able to handle some redemptions without the need to sell portfolio securities, but such a balance creates what is called “cash drag”). By contrast, many ETFs use an “in-kind” mechanism when growing and shrinking in size. ETF shares are created and redeemed with certain parties known as “authorized participants” (AP) who buy and sell ETF shares in large blocks known as “creation units.” With an in-kind mechanism, the ETF receives portfolio securities from an AP in exchange for new ETF shares when the ETF grows, and delivers portfolio securities to the AP in exchange for existing ETF shares when the ETF shrinks. Typically, it is not a taxable event to the ETF to deliver portfolio securities to an AP, even if those shares have increased in value during the time they were owned by the ETF. That is the structural advantage that enables ETFs to typically be more tax efficient than mutual funds.

3. What factors can cause a fund to make a capital gain distribution?

Even when an ETF uses in-kind creation and redemption of ETF shares, it still may incur capital gains due to other factors, including:

- Selling investments to rebalance the portfolio.
- Realizing gains on certain derivative instruments, such as options or forwards that may expire or settle with a net gain to the fund.

4. Does the size of a fund have an impact on a capital gain distribution?

Yes. Gains are proportionately distributed according to the number of shares fund holders own on the capital gain distribution record date. As a fund's asset base grows, the tax impact of gains per share diminishes. Conversely, a shrinking asset base amplifies the per share tax impact of gains.

5. How can a fund’s fiscal calendar affect its capital gains?

In order to offset current or future capital gains, funds may take steps to seek to generate capital losses, such as implementing any redemptions in whole or in part in cash to sell securities that generate a loss. If gains are realized toward the end of a fund’s fiscal year (different funds have different fiscal year-ends, which you can find on a sponsor’s website), the ETF has less time to seek to take any such actions. All RICs are required by IRS regulations to distribute substantially all of their net investment income and capital gains to shareholders at least annually. Also, funds are subject to an “excise tax” unless they distribute by year-end substantially all of their capital gains incurred during the twelve-month period ending October 31 – so if gains are realized close to October 31, the ETF has less time to seek to take actions that might reduce gains.

6. How could there be a capital gain distribution if the net asset value (NAV) of the fund has decreased during the year?

Capital gain distributions reflect the sum of gains and losses from all the sales of individual securities and other investments, and other gain and loss recognition occurrences (such as the expiration or settlement of options and forwards) in a fund during the relevant tax periods. Therefore, even if the value of the securities in a fund's portfolio are currently down and consequently the ETF is as well, the sale of the securities in the fund can still result in capital gains.

7. What are the main determinants of capital gains in a WisdomTree currency-hedged fund?

WisdomTree's currency-hedged ETFs are designed to neutralize the inherent long currency exposure that comes with holding local foreign stock by entering into one-month forward contracts each month and rebalancing at month-end. If the underlying currency depreciates against the U.S. dollar, the value of the forward contracts will likely increase. WisdomTree Funds elect to have gains from forward contracts treated as capital so the fund would realize capital gains from the forward contracts. These forward contracts cannot be traded in-kind so they can increase the possibility of a capital gain.

8. What is the difference between short-term and long-term capital gains?

The IRS does not treat all capital gains equally; the tax rate can vary depending on how long the asset was held before it was sold. Assets held for more than a year qualify as long-term capital gains and can benefit from a reduced tax rate. Assets held for one year or less are considered a short-term capital gain—these are taxed as ordinary income and do not receive preferential tax treatment. In addition, certain investments receive what's commonly called 60/40 treatment where the gains are split between long- and short-term.

9. Why are WisdomTree's distributions from forward contract gains taxed at a blended 60/40 rate?

The Funds make a tax election to treat gains on forward contracts as capital (not ordinary income). Under tax rules, major currencies are eligible for 60/40 treatment.

For definitions of terms discussed in this document, please go to our Glossary.

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