2023 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 WisdomTree's ETFs 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 can be more tax efficient than mutual funds with similar investment strategies.

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 shareholder subscriptions 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 but not limited to:

- Selling investments to rebalance the portfolio.
- Selling investments to meet AP redemptions in markets where in-kind transfers of investments are restricted.
- Realizing gains on securities, such as securitized debt and senior loan securities, and derivative instruments, such as options or forwards, which are not eligible to be transacted in-kind. Since these securities and derivative instruments either cannot or are traditionally not transacted in kind, their sales can generate taxable events within an ETF.
- Taxable corporate action events on securities held within an ETF.

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 shareholder base grows, the tax impact of gains per share diminishes. Conversely, a shrinking shareholder base amplifies the per share tax impact of gains.

5. How can a fund’s fiscal year-end 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 calendar year-end substantially all of their capital gains incurred during the twelve-month period ending October 31st – so if gains are realized close to October 31st, 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 net realized gains and losses from all the sales of individual securities and other investments, and other realized gain and loss recognition occurrences (such as those recognized on options and forwards) in a fund during the relevant tax periods. Therefore, even if the overall value of the securities in a fund's portfolio have decreased during the period due to unrealized losses, and consequently the ETF's NAV as well, the sale of the securities that occurred during the period can still result in realized capital gains that are distributable to fund shareholders since unrealized losses on securities cannot be offset against realized gains.

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

The IRS does not tax all capital gains equally; the tax rate can vary depending on how long the asset was held before it was sold. Realized gains on assets that were held for more than a year qualify as long-term capital gains and can benefit from a reduced tax rate. Realized gains on assets that were 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, gains on certain derivative investments, such as forward contracts, receive what is commonly called 60/40 treatment where 60% of the gain is taxed at the lower long-term capital gains tax rate and 40% of the gain is taxed at the short-term capital gains tax rate (which is the ordinary income tax rate).

8. Why are WisdomTree's distributions from gains on certain derivative investments taxed at a blended 60/40 rate?

Under current IRS tax rules, forward contracts on major currencies, as defined by the IRS, option contracts on broad-based indexes and futures contracts that trade on a qualified board or exchange, as defined by the IRS, are eligible for 60/40 treatment.

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

The information above is not intended as tax advice. The tax consequences of Fund distributions vary by individual taxpayer. You should consult your tax professional or financial advisor for more information regarding your tax situation.

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