Tax Benefits of ETFs Explained

There is a saying in investing: “It’s not how much you make, but how much you get to keep that matters.” Capital gains and other taxes can sometimes take a significant bite out of your investment earnings. Exchange-traded funds (ETFs), however, are tax efficient by design and can help you keep more of your investment returns simply because of the way they’re built.

THE MECHANICS OF SHARE CREATION

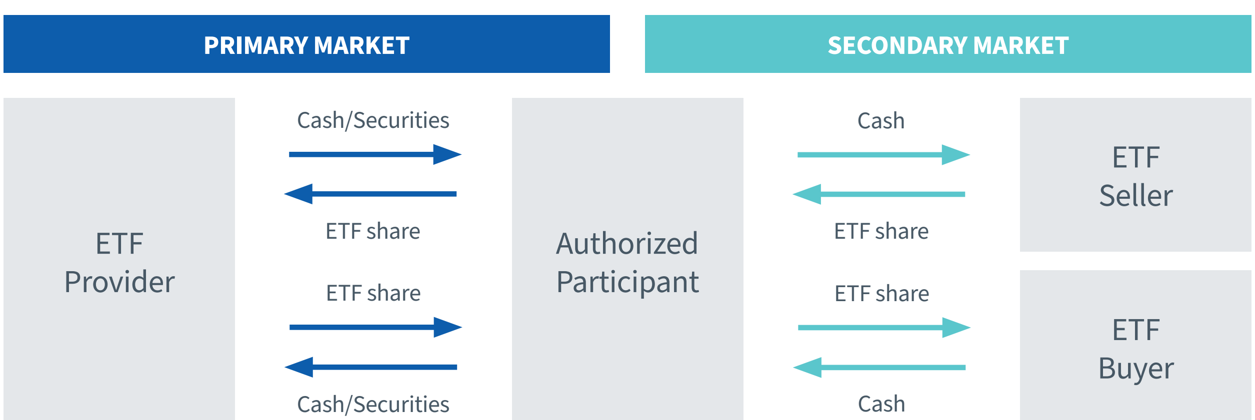
An ETF sponsor decides to create a new fund.

An authorized participant (AP)[1] purchases the underlying securities then exchanges them for a large block of ETF shares of equal value in what is called an “in-kind” transfer. It is an “in-kind” transaction because the AP is exchanging the same exact securities with the same value; rather than exchanging for cash.

+ The block of shares is called a “creation unit” and usually equals between 25,000 and 200,000 shares.

The AP sells those ETF shares to investors or market makers on an exchange.

Investors buy and sell ETF shares on the market from other investors, the AP or market makers.



[1] Authorized participant (AP): An entity, usually an institutional investor, that submits orders to the ETF for the creation and redemption of ETF creation units.

ADVANTAGEOUS CAPITAL GAINS RULES

Capital gains are created when you sell a share for more than you paid for it—the resulting profit is taxable. In a mutual fund, capital gains can be created by the Fund managers conducting their daily trades (for active management[2] or rebalancing[3]) or by shareholders redeeming their shares. When one sells mutual fund shares, the mutual fund company has to sell the underlying securities, which can result in a capital gain. By law, mutual funds[4] must distribute these capital gains immediately. And they are taxable to all fund investors, whether or not they reinvest the gains into the same fund. (It's worth noting that when someone buys shares of a mutual fund, the company has to purchase the underlying securities, which can also lead to costs and tax consequences for investors.)

As previously described the ETF share creation/redemption mechanism is a nontaxable event. And because of the way ETF shares are created and redeemed, an ETF company does not always have to sell securities when an investor wants out. Therefore:

+ You generally realize capital gains from underlying price appreciation when you sell your ETF shares.
+ Your sale of shares does not affect other shareholders.
+ You may be able to keep your money fully invested due to the lower probability of capital gains.

TAX LOSS HARVESTING

Tax loss harvesting involves using the losses in one investment to offset the gains in another for tax planning purposes. Generally speaking, investment losses can be used to offset current gains, gains in future years and/or up to $3,000 in income. But what if you think the investment you're selling is still a good long-term investment? You may want to buy it back, but you need to be careful.

In order to realize the loss, the original investment—or any "substantially identical" investment—cannot be repurchased within 30 days of the sale that triggers the loss. If this happens, it is considered a wash sale and the loss cannot be taken. Because of how they're classified, ETFs are not considered "substantially identical" to mutual funds. And this can make them very effective tools for tax loss harvesting.

With ETFs, you can maintain your investment exposure while still capturing the losses for tax purposes. This can be achieved in three main ways:

1. **MUTUAL FUND-TO-ETF TRANSFER.** Mutual fund investors can sell a mutual fund at a loss and buy an ETF with similar, or even exact, holdings, and the wash-sale rule would not apply.
2. **STOCK-TO-ETF TRANSFER.** Similarly, investors looking to take advantage of tax losses on a stock or a number of stocks can look for an ETF that holds the same security or has exposure to the same market sector. After 30 days, the ETF could be sold and the stock repurchased.
3. **ETF-TO-ETF TRANSFER.** Investors can also avoid the wash-sale rule by making a transfer from one ETF to another holding similar, but not identical, securities—as long as it tracks a different index.

[2] Active management: The use of a human element, such as a single manager, co-managers or a team of managers, to actively manage a fund's portfolio.

[3] Rebalancing: The process of realigning the weightings of a portfolio of assets. Rebalancing involves periodically buying or selling assets in a portfolio to maintain an original desired level of asset allocation.

[4] Mutual fund: An investment program funded by shareholders that trades in diversified holdings and is professionally managed.

TAXES AND SPECIALTY ETFS

While the tax advantages of typical market ETFs are clear, investors should be aware that specialty ETFs trading in currency, futures[5] and metals may be subject to different tax treatment. The IRS looks at an ETF's underlying assets to determine how the assets are taxed. While stocks and bonds are subject to the more favorable 15% capital gains rate, currencies, precious metals and highly leveraged securities may be subject to ordinary income taxes for short-term gains and 28% for long-term gains.

ETFs, by design, provide many tax advantages for investors and may make effective tools for tax planning. You should consult a tax professional for more details.

[5] Futures: Reflects the expected future value of a commodity, currency or Treasury security.