

# What Makes ETFs Tax Efficient?

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Exchange-traded funds (ETFs) have many benefits that have caused them to expand in terms of assets and offerings over the past decade. In the United States alone, the ETF industry has grown to over \$2.7 trillion in assets.<sup>1</sup> Not only are ETFs typically low cost and extremely transparent, a key characteristic and an attractive feature is their [tax efficiency](#).

## Capital Gains

Let's start from the beginning. Capital gains taxes can occur in two ways. The first is on an individual level, when one sells an ETF or a mutual fund at a gain in a taxable account. For example, if an investor purchased an ETF for \$25 and later sold it for \$40, he or she would have to pay capital gains tax. The same exact taxation treatment exists for mutual funds and individual stocks; this cannot be avoided. The second way funds (both mutual funds and ETFs) are taxed is on a fund holdings level, when a holding of a fund is sold for a realized gain. At the end of each year if the fund has netted gains, this amount must be distributed to the fund's shareholders, who are then required to pay taxes on this distribution. Generally, investors would prefer funds that distribute no or little capital gains to defer any tax payments.

## ETFs Are Exchange Listed

So, how exactly are ETFs more tax efficient? There are two key differences to focus on when discussing tax efficiency in terms of fund holdings. The first reason why ETFs are more tax efficient is because they are exchange-traded. Shares of the ETF can be passed back and forth on an exchange, just like an individual stock, without creating turnover in the underlying portfolio. If there is no turnover in the underlying securities, a taxable event cannot occur. In contrast, mutual fund shares are always bought and sold directly to and from the mutual fund company, and they are not exchange listed. Almost all inflows and outflows in a mutual fund result in transactions within the portfolio. This can potentially cause a significant taxable event that affects all of the holders of the mutual fund. ETFs greatly benefit from being exchange-traded, especially when secondary market trading reaches critical mass.

## The Creation/Redemption Process

The second reason why ETFs are more tax efficient is because of how they often handle inflows and outflows by creating or redeeming shares "in-kind." Not all ETFs trade millions of shares a day, so to increase or decrease shares based on demand, ETF shares can be created or redeemed by an authorized participant. What does "in-kind" mean? Simply that in case of a redemption, for example, the issuer delivers the underlying holdings of the ETF to the authorized participant in [exchange for the ETF shares](#). The

reverse occurs for a creation. No buying or selling of the underlying securities occurred at the portfolio level. The in-kind transfer is not deemed a taxable event.

However, not all ETFs can be created or redeemed in-kind. There are some ETFs with a more esoteric underlyings, such as emerging markets, that cannot use the in-kind feature. While this does occur, these types of ETFs can still benefit from being exchange-traded. For example, the [WisdomTree India Earnings Fund \(EPI\)](#) trades roughly 3 million shares a day,<sup>2</sup> so demand can still be transferred without any activity occurring in the underlyings. Mutual funds do not have this benefit and will always have to sell securities to accommodate shareholder redemptions or to reallocate assets.

While ETFs and mutual funds are both [a fund wrapper around a basket of securities](#) and are taxed equally at the individual investor level, the exchange-traded and in-kind nature of the creation and redemption mechanism make ETFs significantly more tax efficient at the fund holdings level. The opportunity for a taxable event can be minimized by these two key characteristics, whereas whenever securities are sold for profit in a mutual fund, a capital gains tax event occurs. The ETF tax efficiency is just one of the many benefits of the ETF structure.

<sup>1</sup>Source: BlackRock Global ETP Landscape, 2/17.

<sup>2</sup>Source: Bloomberg, 4/3/17.

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