Take strategic advantage of ETFs' tax traits
Make the most of ETFs' potential by understanding how they're taxed

Advisors keen to deliver value for their clients know they need to consider the overall profile and key attributes of an investment, and that means taking taxes into account.

As you'll likely agree, it's not just about what your clients earn, it's also about what they get to keep. Therefore, taxation must be a strategic priority in selecting investments for their portfolios. While some advisors are familiar with the tax advantages of ETFs, others haven't explored them yet or have questions about tax mechanics and the related responsibilities.

This column won't cover all aspects of ETFs and taxes. It can't. That's the domain of textbooks and experts (like the one we spoke to). But it does offer an overview of ETF tax benefits and considerations. It largely focuses on the taxation of ETFs held in non-registered investments but does discuss registered accounts for some circumstances. It also addresses a manageable administrative aspect of ETF taxation, namely tracking the impact of reinvested capital gains distributions, known formally as "notional distributions," or colloquially as "phantom distributions" on the adjusted cost base (ACB) of investments. If you've lacked "phantom fluency" (and maybe refrained from using ETFs because of it), this column shows that it shouldn't be a stumbling block.

Mutual Funds, ETFs & Taxes

With mutual funds, investors buy/sell units directly from the fund. If enough unitholders choose to redeem units, the fund's portfolio manager may be compelled to divest some holdings to raise the necessary cash with which to pay the redemptions, thus potentially triggering capital gains for all unit holders of record. Similarly, if a portfolio manager decides to sell specific holdings to crystallize a gain, the same outcome occurs: a taxable event for everyone, in both cases, the taxable activity occurs within the fund itself.

However, purchases and sales of an ETF's units by individual investors does *not* affect other owners because the units are traded between investors on an exchange, and their value typically does not fluctuate dramatically from normal trading activity. Also, most ETFs are managed passively based on an index with only quarterly rebalancing. So, the turnover rate on portfolio investments of ETFs is generally lower compared to actively managed mutual funds, which diminishes the likelihood of triggering capital gains. Actively managed ETFs *may* incur capital gains rates comparable to some mutual funds but it depends on turnover, and they're still often available at a lower MER relative to mutual funds.

Trusts Versus Corporations: The Tax Implications

How Canadian ETFs are structured (whether as trusts or as corporations) impacts their taxation.

Most ETFs are structured as trusts and therefore enjoy various tax-related and other benefits. Like their mutual fund peers, ETFs pass on capital gains, interest, dividends, foreign income and return of capital (ROC) to their investors, which may create tax obligations or adjustments to ACB. An ROC is deemed "a non-taxable event" but does reduce an investment's ACB and, therefore, impacts the calculation of capital gains and losses when units are eventually sold – this has an impact on the taxes an ETF investor may pay.

Though they are still in the minority, ETFs structured as corporations provide specific tax management benefits and have growing appeal for investors. Why? Within a corporate structure, for example, realized capital losses of one class can be used to offset realized capital gains of another class The corporate structure therefore potentially reduces the level of capital gains distributable to investors.

In defining an ETF investment strategy for your clients, the tax implications of each structure should be a factor in your decision-making.

"Phantom Distributions" – *Not* Really so Scary

Because of their nickname, phantom distributions may conjure up negative sentiments that inhibit advisors from exploring ETFs, but they are really quite benign. “Phantom” simply refers to distributions that affect an investment’s ACB but are not actually paid in cash. Here is how they work.

Most ETFs make capital gains distributions that are reinvested and immediately reconsolidated, creating “notional” or “phantom” distributions. These phantom distributions increase an investor’s ACB of their investment in an ETF, thus reducing the capital gain (or increasing the capital loss) when these holdings are eventually sold; therefore, distributions that affect~~s~~ an investment’s ACB need to be tracked to avoid paying taxes twice: once on the distribution itself and again on the embedded gain when the investment is sold.

ACB tracking should *not* be a barrier to ETF investing. ETF providers publish their distributions by issuing news releases and by reporting through CDS Clearing and Depository Services. Many financial firms’ back offices (probably yours) have in-house solutions to calculate and track ACBs. If you operate on a fee-for-advice model or your clients engage in DIY investing, you may want to remind them to calculate their ACBs and mention that online tracking resources are available.

What About Withholding Taxes?

How an ETF gains exposure to international equities affects foreign withholding taxes and therefore the ETF an advisor would prudently recommend.

Generally, any type of foreign investment – whether held in a mutual fund or ETF – is subject to withholding taxes, and tax treaties between Canada and other jurisdictions determine the applicable rates. Whether an investment is open or is held in a registered account, withholding taxes may apply with varying financial effects and remedies. The two most likely scenarios an advisor will encounter are: a Canadian-listed ETF holding foreign stocks *directly* and a Canadian-listed ETF holding foreign stocks *indirectly* through a U.S.-based ETF. Regarding the former, withholding tax is recoverable if the ETF is held in an open account – but not in a registered account. And regarding the latter, only U.S. withholding tax is recoverable, but not if it’s in a registered account.

Choosing the right fund structure, and account type in which to hold international ETFs that you recommend for your clients, are essential because their combination can impact the level of withholding taxes your client is exposed to.

Don’t Go it Alone: Seek Out Tax Expertise

The tax obligations of exchange traded fund investing should *not* deter you from recommending ETFs any more than the taxes payable on mutual funds would. Expertise available within or beyond your firm can complement what you uniquely bring to your clients. CETFA applied this thinking to writing this column.

My former Trimark Investments colleague, Theo Heldman, is a CPA, CA and CFA charter holder with deep investment sector experience at the executive level. Now serving as an independent board director and an advisor to boards and associations, his insights materially informed this piece.

We asked Theo to summarize his thoughts about ETFs and taxes and here’s what he told us: “You owe it to your clients to check out ETFs because they can be used as a foundational tool for optimizing client portfolios. There are many Canadian-listed ETFs that offer a variety of investment mandates and exposure to foreign markets, and although there are always tax considerations when investing, ETFs can be more tax-efficient than traditional mutual funds. And while phantom distributions may appear complicated at first, they’re really not. They are manageable, and they shouldn’t prevent you from using ETFs for the benefit of your clients.”

At the CETFA, we could not agree more.

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