



ETF tax efficiency

Fact or fiction?



Exchange traded funds (ETFs) are widely regarded as being more tax efficient than comparable mutual funds. This is one of the core selling points that ETF sponsors raise when discussing the “ETF advantage.”¹ And, it often is true.

But why is it true?

According to Deanna Flores, KPMG LLP (KPMG) Tax principal. “It’s essential to understand why ETFs are tax efficient before you include them in any investment strategy. Otherwise, you may end up holding an ETF whose tax advantages have been as overhyped as the reputation of most first-round NFL quarterbacks drafted.”

“ETFs do hold great attraction and offer significant benefits,” she added. “But, from a strictly tax point of view, the tax efficiency of an ETF or a mutual fund is driven by four key factors:

- Operational infrastructure
- Portfolio management and investment mandate
- Overall market conditions
- Investor behavior

Whether investors buy ETFs or mutual funds, they should keep their “eyes on the ball” and focus on the following:

- **What is their net return?** An ETF or mutual fund that permits investors to realize higher net returns over the long run may be the right choice, irrespective of tax efficiency in the short run.
- **Is the fund well-managed?** Smart choices by a fund sponsor may improve the tax efficiency of any fund, regardless of whether it is structured as an ETF or mutual fund.

Let’s take a closer look at the drivers of tax efficiency.

Operational infrastructure

Both ETFs² and mutual funds must:

- Recognize gains, losses and income at the fund level, but they’re not taxed at the fund level on these items to the extent they are distributed to shareholders
- Distribute net-realized gains and income to investors, which are then generally taxable to the investors as ordinary dividends, long-term capital gain dividends, exempt interest dividends, or returns of capital.

In addition, both ETFs and mutual funds may **redeem shareholders on an in-kind basis**.³ Generally, this means that when an investor wants to redeem ETF or mutual fund shares, the distributor could exchange the shares to be redeemed for a basket of securities held by the ETF or mutual fund.

In the case of ETFs, only certain institutional investors (called “authorized participants”) may redeem shares directly from an ETF. Conversely, the institutional investors are also allowed to contribute securities to an ETF in exchange for newly issued ETF shares. Retail ETF investors, on the other hand, must purchase or sell ETF shares through a broker or another intermediary.

In the case of a mutual fund, there ordinarily are minimum size requirements for redemptions in kind (say 50,000 or more shares). What’s more, retail investors typically want to be redeemed in cash, not securities. So, when mutual funds do use in-kind redemptions, it tends to be only for large redemptions by institutional investors.

¹Why Are ETFs So Tax-Efficient?, ETF.com

²Most ETFs are taxed as a regulated investment company (RIC). For the purposes of this article, we are comparing this type of ETF—a RIC ETF—to a mutual fund. However, it should be noted that an ETF may be structured for tax purposes as a RIC, C corporation, partnership, trust, or some combination of the foregoing. We are also assuming that the mutual fund or ETF shares are held in a taxable account, and not in a retirement or other tax-deferred investment.

³However, certain types of securities—for example, derivatives or thinly traded securities—can’t be redeemed by an ETF on an in-kind basis. In this case, the ETF typically will include cash or other securities, as needed, to complete the redemption. Other types of exchange traded products (ETPs), which are not discussed in this article, such as closed-end funds, do not permit in-kind redemptions.

“ There typically are more opportunities for ETFs with appreciated and liquid portfolio holdings to defer gain recognition. ”

– Jay Freedman, Tax Principal, KPMG

Redeeming shareholders on an in-kind basis means that ETFs and mutual funds don't have to liquidate securities to raise cash to pay the redeeming investor.⁴ In addition, the ETF or mutual fund can use appreciated securities for the in-kind redemption.

In this case, provided certain requirements are met, neither the ETF nor the mutual fund recognizes gain on the transaction. Thus, there is no need for the funds to make a taxable distribution of gains to its other nonredeeming shareholders. (However, redemptions in kind are not permitted to trigger losses for an ETF or a mutual fund.)

The redeeming investor, on the other hand, must recognize gain or loss just as if the investor had been redeemed in cash. The amount recognized is equal to the difference between the tax cost or “basis” of the investor's ETF or mutual fund shares and the fair market value of the securities received.

KPMG observation: “While both ETFs and mutual funds are permitted to use in-kind redemptions, ETFs are structured so that in-kind redemptions are the primary redemption mechanism,” observed Jay Freedman, KPMG Tax principal. “As a result, there typically are more opportunities for ETFs with appreciated and liquid portfolio holdings to defer gain recognition by shareholders—and that's a touchdown any way you look at it.”

Portfolio management and investment mandate

An ETF or mutual fund portfolio manager may make investment choices that are more or less tax efficient. For example, depending on the fund's investment mandate, market conditions and other factors, the portfolio manager may:

- Decide to “harvest losses” by selling underlying securities or indexes that have underperformed in order to offset or minimize realized gains in the fund
- Only sell securities with a higher cost basis in order to minimize any resulting gains

⁴ Where a mutual fund does not redeem shareholders on an in-kind basis, the fund typically would use cash on hand and/or cash received from new investors to meet redemptions, and liquidate portfolio holdings only as necessary. And, in any event, realized gains may be offset by other losses in a fund's portfolio.

Tax efficiency, not tax avoidance

The deferral of gains at the ETF or mutual fund level using in-kind redemptions for appreciated securities generally doesn't alter the **total amount** of taxable gains to be realized when the shareholder ultimately sells or redeems his or her ETF or mutual fund shares (although it may have the effect of converting short-term capital gains to long-term capital gains).

Bottom line: While the in-kind distribution strategy may foster tax efficiency by deferring tax on gains, it generally doesn't enable those gains to escape taxation.

- Minimize investments in securities (such as derivatives or illiquid securities) that can't be redeemed on an in-kind basis
- Use cash on hand, or cash received from new investors and reinvestments, to meet redemption requests
- Effectively manage selling of underlying securities by taking into consideration holding periods to maximize long-term capital gains.

"In some situations," noted Flores, "tax efficiency may be less dependent on the nature of the investment vehicle—ETF or mutual fund—than the choices of the portfolio manager. In other situations, the portfolio manager may not have as many opportunities to enhance tax efficiency."

"For example, relatively new types of ETFs, such as currency-hedged ETFs, may hold significant positions in derivatives, which can't be used for in-kind redemption requests," she continued. "And in the initial years, there may not be a sufficient reservoir of losses that can be used by the portfolio manager to offset any realized gains."

Another key factor impacting tax efficiency is portfolio turnover. Generally speaking, high portfolio turnover via the sale of the underlying securities creates more opportunity to trigger capital gains that must be distributed and potentially taxed to investors. This is particularly true in a rising market.

"Passive" funds that are designed to be more static and have less portfolio turnover, tend to be more tax efficient than those with actively managed portfolios and higher turnover. While this principle applies to both ETFs and mutual funds, since many (although certainly not all) ETFs employ fairly passive index strategies, they tend to have lower turnover than actively managed mutual funds.

That being said, if a passive mutual fund were required to sell appreciated securities to meet redemptions, it could trigger large taxable gains for nonredeeming shareholders. This could be the case where, for example, a passive mutual fund is shrinking due to net shareholder redemptions.

KPMG observation: "It should be noted that the perception of ETFs being a strictly passive product isn't set in stone," Freedman remarked. "Some ETFs with index strategies are mandated to rebalance frequently. And the increasing number of actively managed ETFs may change this equation."

He also pointed out that "some mutual funds are required to be managed in a tax-efficient way, which may cause the fund sponsor to adopt investment strategies to minimize capital gains distributions."

Overall market conditions

What's happening in the markets can also impact the ability of portfolio managers to achieve tax efficiency with ETFs and mutual funds. "For example, when markets are generally flat but there's significant volatility—that is, the markets may rise and fall hundreds of points on a daily basis, but basically wind up at the same level over the course of a year—there may be more opportunities for portfolio managers to realize losses and offset embedded gains in portfolio securities," Flores pointed out.

"They can do this even without utilizing the in-kind redemption mechanism," she added. "What's more, this type of market tends to help mutual fund managers achieve tax efficiency."

However, where markets are steadily rising, funds may hold mostly appreciated portfolio securities that generate taxable gains when sold to meet redemptions, for example. This means that a mutual fund is more likely to trigger gains to meet shareholder redemptions than an ETF, which primarily redeems investors on an in-kind basis.

KPMG observation: "For the most part, markets have been on a consistently upward trajectory for more than 20 years," Flores observed. "This has made it more difficult for portfolio managers to manage funds on a tax-efficient basis without utilizing the in-kind redemption mechanism, which, as noted, is primarily employed by ETFs, not mutual funds."

Investor behavior

When investors purchase ETF or mutual fund shares, they acquire a cost basis in those shares, which fundamentally reflects the amount paid by the investor, plus transaction costs. And when the investors ultimately sell or redeem the shares, they generally are taxed on the amount by which the sale or redemption price exceeds their cost basis.

Following an initial purchase, an investor's cost basis in the ETF or mutual fund shares is reduced to reflect returns of capital, adjusted, as appropriate, to reflect corporate actions (such as a fund merger or stock split), and increased when the investor reinvests distributions from the ETF or mutual fund to acquire additional shares.

However, an investor's cost basis doesn't increase as the ETF's market price or a mutual fund's NAV increases. It is also important to note that an investor's cost basis doesn't decrease as the ETF's market price or a mutual fund's NAV goes down. This also holds true for decreases in NAV due to distribution of dividends.

If, for example, an investor buys shares of a mutual fund or ETF whose market-derived price equals or is close to NAV **before** an ex-dividend date,⁵ the investor will:

- Pay current tax on the dividend distribution, and

⁵This is the date on which it is announced that a dividend payment will be made.

— Have an unrealized loss in its shares because the tax basis will be higher than the NAV after the NAV is reduced for the dividend payment.

This is commonly referred to as “buying the dividend.” It is generally something for investors to avoid, particularly near the end of the calendar year when ETFs or mutual funds may make their largest distributions.

KPMG observation: In addition, the frequency—and aggressiveness—with which investors tend to buy and sell funds can have an impact on the fund manager’s ability to achieve tax efficiency.

“This is particularly the case with mutual funds that do not use redemptions in kind as their primary shareholder redemption mechanism,” noted Flores. “For example, if a mutual fund has net cash inflows and growing assets under management, it may not be necessary for the portfolio manager to sell any underlying securities to meet redemptions by other shareholders.”

“However, where existing investors are exiting the fund and net inflows aren’t being replenished by new investors, or where an ETF is limited in its ability to use in-kind redemptions, such as where the ETF has significant holdings of derivatives, the portfolio manager’s hands may be somewhat tied; they’ll be forced to sell underlying securities without as much opportunity to achieve tax efficiency.”⁶

Final thoughts

The winning football team generally is the one that focuses on both the offense and defense and makes thoughtful decisions in designing a game plan. This is also a good approach when evaluating the tax efficiency of ETFs. It is true that ETFs are often more tax-efficient than mutual funds due to their routine use of in-kind redemptions. However, if the redemption feature is your primary focus, you may be overlooking some other important factors.

This includes determining whether a particular fund is **well managed** in terms of expense ratios, error tracking, investment mandates, and index methodologies, and what your **net return** will be.

To quote the legendary businessman and stock investor, Peter Lynch, “Know what you own and why you own it.”



⁶ Which ETFs Are Making Capital Gains Distributions This Year?, Morningstar, 12/2/15



ETFs versus mutual funds: The tax match-up

Below is a quick summary comparing ETFs and mutual funds, and their respective potential tax advantages and disadvantages:

Operational infrastructure:

- Both ETFs and mutual funds are permitted to use in-kind redemptions.
- But ETFs are structured so that in-kind redemptions are the primary redemption mechanism, so there typically are more opportunities for ETFs to defer gain recognition by shareholders.

Overall advantage – ETFs

Portfolio management and investment mandate:

- Investment choices: ETF or mutual fund portfolio managers may make investment choices that are more or less tax efficient, so tax efficiency may be less dependent on the nature of the investment vehicle—ETF or mutual fund – than the choices of the portfolio manager.
- Portfolio turnover: Generally, high portfolio turnover may create more opportunity to trigger potentially taxable capital gains for investors. ETFs typically—but certainly not always—employ fairly passive index strategies, so they tend to have lower turnover than actively managed mutual funds.

Slight advantage – ETFs

Overall market conditions

- Generally, rising markets during the past 20 years have made it more difficult for portfolio managers to manage funds on a tax-efficient basis without utilizing the in-kind redemption mechanism.
- In-kind redemptions are primarily employed by ETFs, not mutual funds.

Advantage – ETFs

Investor behavior

The frequency—and aggressiveness—with which investors buy and sell funds can impact a fund manager's ability to achieve tax efficiency.

This is particularly the case with mutual funds that do not use in-kind redemptions as their primary shareholder redemption mechanism.

However, where an ETF is limited in its ability to use in-kind redemptions (e.g., the ETF has significant holdings of derivatives) the portfolio manager's hands may be somewhat tied.

Slight advantage – ETFs

How KPMG can help

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We provide Audit, Tax, and Advisory services to a broad range of industry players—from start-ups to FORTUNE 50 diversified financial service firms—enhancing financial and operational structures, and helping our clients proactively take advantage of change rather than merely reacting to it.

We offer:

- Deep industry experience: Regardless of where your firm is in its evolution—from launch to globalization to exit—our professionals have the passion and experience to help you deal with the issues and challenges that impact you today, as well as prepare you for what lies ahead.
- Global strength and capabilities: Our global network of member firms includes professionals located in all of the world's commercial hubs, enabling us to serve our clients wherever they do business.
- Outstanding team leadership by senior professionals: Our engagement teams, led by senior partners and professionals, work with you to offer practical, customized, and appropriate insight and guidance, and deliver real, tangible results.
- Advanced technology and innovation: We supplement our hands-on approach with industry-leading technology capabilities that help enable you to operate and leverage your resources—people, vendors, legacy platforms and equipment—more efficiently.

Our firm provides professional services to:

80%

Top 50 U.S. stock-based mutual funds⁷

70%

50 leading asset management firms in the United States

95%

Top 20 public money managers and their funds.⁸

⁷ KPMG Analytics, Morningstar, June 2015

⁸ Pension & Investments/Towers Watson Top Money Managers, November 2014

Contact us

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