The tax advantages of ETFs

One of the reasons ETFs are proving popular is their tax advantages.

Index funds are better than actively managed funds

ETFs are passively managed 'index funds'. They hold a diversified portfolio of shares that tracks an index. For example, an equity ETF buys the shares that are in its index and only changes its portfolio when the index changes. The contrast to this is 'actively managed funds' where the fund manager picks the shares that they think are going to perform the best.

The tax problem with the active management process is that it causes a lot of shares to be sold each year, whereas the index fund process does not. The more shares that are sold by the active fund manager in a year, the higher the investor's capital gains tax liability for that year.

Investors prefer their capital gains tax liability to be in the future. They want the money in their hands so that it is working for them as long as possible, rather than in the hands of the tax man. The high capital gains tax liabilities with actively managed funds can be a leak in investors' savings.

Index funds such as ETFs have lower portfolio turnover and this capital gains tax problem does not arise.

ASX listed funds are better than unlisted funds

Like their name suggests, ETFs are managed funds that are traded on ASX, just like shares. This gives them a tax advantage over unlisted funds. It all comes down to the mechanism by which investors withdraw from the fund.

In unlisted funds the units held by the withdrawing investor are cancelled and a portion of shares in the fund are sold to pay the investor out. The sale of the shares creates a capital gains tax liability inside the fund. The problem is that this capital gains tax liability doesn't fall on the investor who is withdrawing. It falls on the investors who are still in the fund.

If a lot of investors withdraw from the fund in the same year, this mechanism creates a capital gains tax burden which can become significant for the remaining investors.

In an ETF this doesn't happen because the withdrawal mechanism is totally different. An investor who wants to withdraw from an ETF simply sells their units on the ASX.

The sale of units does not require a sale of shares in the fund because the ETF units are not cancelled, they are purchased by other investors or an 'Authorised Participant'. An 'Authorised Participant' ensures that buys and sells of ETF units are done close to its net asset value (NAV) by taking the other side of each trade. So the departing investor may be selling to the Authorised Participant.

Only Authorised Participants may withdraw (redeem) from the ETF. If they do, most of the capital gains in the ETF can be passed to the Authorised Participant rather than being left behind for remaining investors.

ETFs deliver better capital gain tax outcomes than unlisted managed funds because they are traded on the ASX.

Franking credits

When a company pays tax to the Australian Tax Office (ATO) it is able to attach franking credits to its dividends. Investors who receive the dividends then get the tax credited to them against their Australian tax liability. If they are an Australian resident and don't have a tax liability, the ATO will refund the franking credits to them.

When an ETF holds shares that pay franked dividends, the franking credits flow through to investors to reduce their tax liability. The level of franking credits that flow out of an ETF depends on its underlying shares portfolio. VanEck Vectors Australian Banks ETF (ASX code: MVB), for example, generates a lot of franking credits because bank shares pay a high level of franked dividends (ASX code: FDIV).

Tax deferred distributions

Investments in property get certain deductions that can shelter the rental income from tax. Some of the rental income is distributed to investors by Real Estate Investment Trusts (REITs) benefits from this tax relief. This part of their distribution is called 'tax deferred'.

When an investor receives a distribution with a tax deferred component, they do not have to pay tax on that component in that year. The amount is however added to the capital gain they make when they eventually sell their investment in the REIT. The tax on the capital gain happens later in time and is at a discounted tax rate so receiving a 'tax deferred' component can be a significant tax benefit.

REITs can be accessed through ETFs. For example, through the VanEck Vectors Australian Property ETF (ASX: MVA).

Summary

ETFs are popular because:

- They are passively managed funds so do not create large capital gains tax liabilities;
- They are listed on ASX so have a mechanism for overcoming the large capital gains tax liabilities that you can get in unlisted funds;
- Franking credits flow through;
- They can provide tax deferred distributions.

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