VanEck®

Access the opportunities.

THE TAX ADVANTAGES OF ETFs

4 ways ETFs can offer better tax outcomes.

1. Lower capital gains tax liabilities than actively managed funds

ETFs hold a portfolio of shares or other assets that track an index. As an ETF's portfolio is automatically determined by the rules of the index, its portfolio only changes 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.

This brings forward capital gains that would otherwise not be payable until the ETF units are sold. The longer the investor holds the ETF, the more this advantage compounds.

2. Streaming: Removing the risk of a tax burden from other investors

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. This is due 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 ASX where they are purchased by other investors or an 'Authorised Participant'.

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

3. Access to 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.

4. Less tax for long-term investments

If you've owned an ETF for 12 months, the law allows the taxable capital gain to be reduced by 50% for individuals. This means that tax is only paid on half of the capital gain. The discount for SMSFs is one-third.

This 12 month rule also applies to shares and REITs held by the ETF. The tax liability on the payments you receive from the ETF may, in part, be subject to this discounted tax rate.

FOR MORE INFORMATION

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