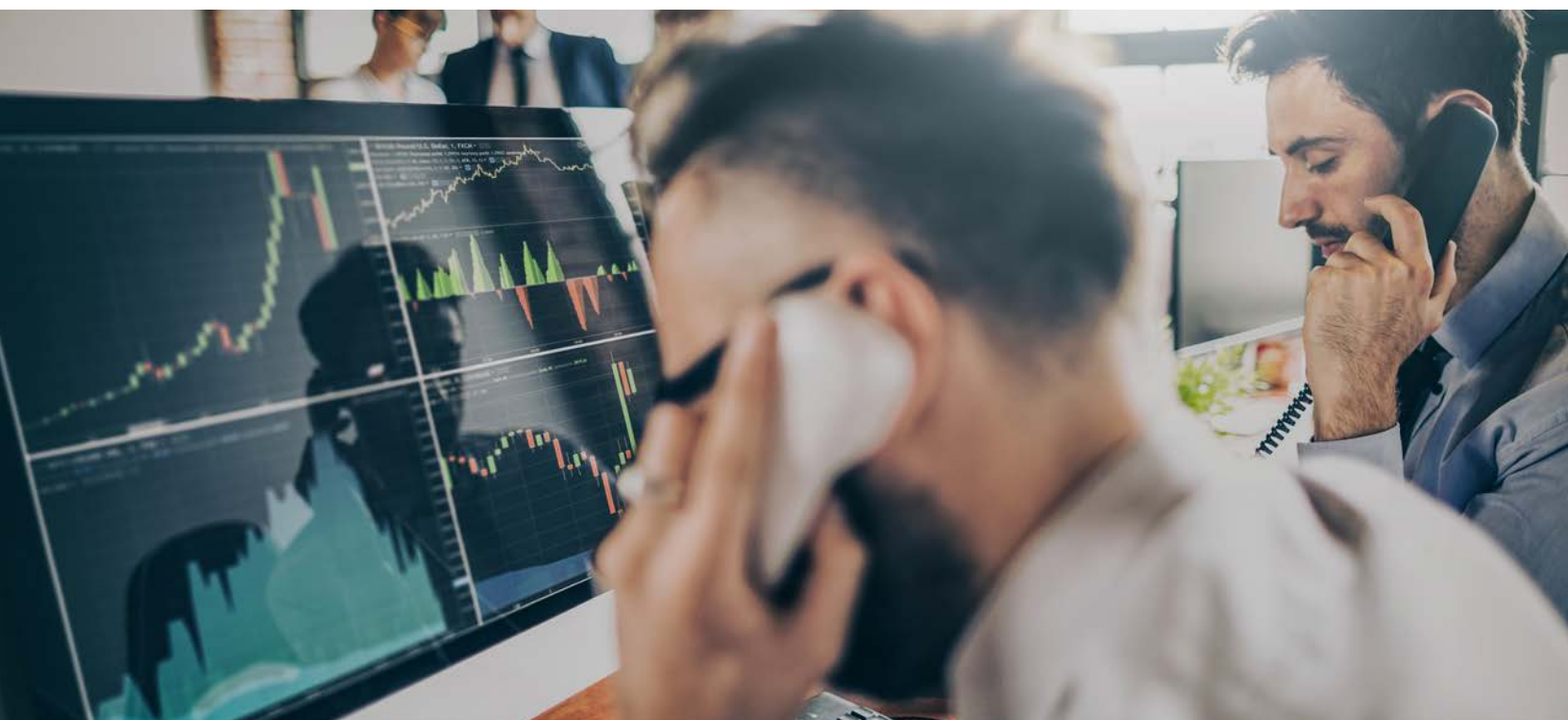


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How Exchange-Traded Funds are Taxed



Exchange-Traded Funds (ETFs)

continue to gain in popularity for a variety of reasons which can include their low cost and convenience. The way in which they are taxed may also become an important consideration for investors.

This article will provide some insight into the different types of ETF distributions and their respective tax treatment when held in non-registered accounts.

ETF tax considerations

As an ETF investor, there are two tax considerations that you need to consider:

- 1 Tax treatment of distributions paid by the ETF:** ETFs may make distributions of Canadian dividends, interest, foreign income as well as returns of capital (ROC) to unitholders. Capital Gains can also be realized from the underlying investments in the ETF when securities are bought and sold within the ETF.

Types of Distributions and their respective tax treatment

ETF Distribution	Tax Treatment
Capital Gains: result from the sale of investments within the ETF portfolio at a price above the purchase price (i.e. adjusted cost base (ACB) for tax purposes).	In Canada, 50% of capital gains are subject to tax and need to be included in the investor's taxable income.
Canadian Dividends: result from the ETF being invested in dividend paying equity securities.	Canadians qualify for dividend tax credits that are intended to compensate them for income tax paid by the underlying Canadian companies the ETF has invested in. Eligible dividend income is generally taxed at a lower rate than regular income due to the mechanism of the dividend tax credit.
Foreign Income and Foreign Tax Paid: arise from the ETF's foreign investments. As an investor, you would receive the distribution net of any foreign taxes withheld.	Under the Income Tax Act (Canada), investors invested in ETFs with exposure to foreign markets may be able to take advantage of foreign tax credits, based on the foreign withholding tax allocated to them in respect of foreign income distributions.
Interest and Other Income: result from the ETF being invested in fixed income securities (ex: bonds).	Interest and other income are treated as ordinary income.
Return of Capital (ROC): ¹ Sometimes an ETF may pay investors distributions that exceed the taxable income earned by the ETF. This amount is classified as return of capital. The fund is basically returning a portion of their investment to the investor.	This distribution is not taxable in the year of distribution (unless the ROC distribution exceeds the holder's ACB) but does result in a decrease in the investor's ACB. As a result, when the investor eventually sells his/her ETF units, the lower ACB will increase any capital gains and decrease any capital losses that would have been realized by the sale without the ROC distribution.
Phantom Distributions (i.e. reinvested income or capital gain distributions): Where the unitholder has elected to enrol in a Distribution Reinvestment Plan, distributions are reinvested back into the fund rather than being paid out to investors in cash.	The reinvested distributions will be taxable to the holder in the year they are received. In addition, a reinvested distribution will result in an increase to the holder's total ACB of their ETF units held. This will allow for the appropriate calculation of any capital gain or loss realized when the investment is eventually sold.

If the ETF investment is held in a non-registered account, you will receive a T3 tax slip for distributions received during that tax year.

- 2 Treatment of gain or loss realized on selling the ETFs:** While return of capital is a form of distribution, they are considered a non-taxable event that will impact an investor's book value and therefore affect the calculation of capital gains and losses of the investor when units are sold.

¹For more information about ROC, please read "[Return of Capital \(ROC\) – How it works](#)"

Book Value and Capital Gains/Losses

If you sell units of an ETF, you may receive a tax form or report from your broker detailing the proceeds of the sale. Some brokers may provide details of the gains or losses based on the book value they have on record at their firm while others leave this to investors to calculate.

A

Adjusted Cost Basis (ACB) (sometimes referred to as book value) is used for calculating capital gains or losses for tax purposes when an investment is sold. Most brokerages will show book values on their online platform and in their client statements.

To understand how Adjusted Cost Base (ACB) is calculated, see the following example:



Kate's ETF Purchase

Kate purchases 100 units of an ETF at \$10.00/unit	\$1,000
At another time, Kate purchases 100 more units of an ETF at \$12.00/unit	\$1,200
Kate now has 200 units with a total investment of \$2,200	\$2,200

$$\text{ACB per unit} = \frac{\$2,200 \text{ total investment}}{200 \text{ units}} = \$11.00/\text{unit}$$

B The difference between your ACB and the price the ETF is sold at is your capital gain/loss,

To understand how capital gain/loss is calculated, we'll build upon the previous example:

If Kate sold her units for **\$15.00/unit** and has an ACB of **\$11.00/unit** she would realize a capital gain.

$$\text{Capital gain per unit} = \$15.00 - \$11.00 = \$4.00/\text{unit}$$

$$\text{Total capital gain} = \$4.00 \times 200 \text{ units} = \$800$$

Why are ETFs touted as being tax efficient vs. traditional mutual funds?

The efficiency of ETFs generally refers to the taxable activity that occurs within the ETF compared to a traditional mutual fund. Buys and sells typically happen between investors on the exchange – no taxable activity occurs within the ETF itself. In contrast to this, investors buying or selling a traditional mutual fund unit do this directly with the fund, which may result in the fund having to either buy or sell underlying investments at the time that investors transact. This may result in more taxable activity in a traditional mutual fund than an ETF.

Another way ETFs may be more tax efficient than traditional mutual funds is based on their investment objectives. The majority of ETFs in Canada track an underlying index while the majority of traditional mutual funds are actively managed. By nature, most index strategies tend to have lower turnover than active strategies which may result in lower capital gains realized and distributed to unit holders.

Where to find information about distributions and tax considerations for a specific ETF?

For detailed information on the tax situation of a specific ETF, please refer to the ETF prospectus, your financial statements, or the Management Reports of Fund Performance (MRFP).



There are a number of tax considerations which are not covered above.
For further information, please speak with your **tax advisor**.



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