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ETFs

Maximize ETF tax efficiency

Know your ACB or you'll pay more.

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Exchange-traded funds (ETFs) are viewed as more tax efficient than actively managed mutual funds. But investors could end up paying more tax on ETFs than mutual funds if they overlook an important step or otherwise do that step incorrectly.

That key step involves the calculation of the Adjusted Cost Base (ACB). To explain why, it may be useful to provide some context first.

Like mutual funds, ETFs may sell holdings at a capital gain during the year and pass them onto their unitholders at the end of the year. If the units are held in a taxable account, the ETF investor will have to pay tax on the capital gain distributed to them.

ETFs don’t usually do this very often compared to mutual funds. They passively track their indexes and don’t need to raise cash for redemptions. So there is relatively little turnover in their portfolios and capital gains are not often realized — hence the tax-efficient designation.

Nevertheless, ETF portfolios can still experience turnover when their underlying indexes change. Index makers may add or drop companies for a number of reasons. For example, there might be mergers, acquisitions or spin-offs within the basket of companies tracked.

Also, some index constituents may no longer be eligible for inclusion because they no longer meet the index’s market cap, liquidity or other criteria. And indexes with capped weights need to sell securities pressing up against those caps.

When taxable mutual-fund and ETF investors sell their funds, they get to reclaim the taxes paid on capital-gains distributions. This is done by adding the distributions to the ACB of the units when calculating the capital gain to be reported to Canadian Revenue Agency (CRA).

For example, if you had bought a fund at $10 and received capital-gain distributions of $2 before selling the fund at $22, your capital gain reported to CRA would be $10 [22-(10+2)]. If the capital-gain distribution is not included in the ACB, your capital gain reported to CRA is $12 [22-10], and more tax is paid.

Mutual-fund companies generally keep track of the ACB for their clients on their account statements. This makes it easier to remember and correctly calculate the gain.

ETF providers don’t keep track of the ACB for ETF investors because units are purchased from other market participants, not from the ETF provider. So, investors have to do the ACB calculations themselves.

“It is important to keep track of ACB because if you do not, you will be paying taxes twice on reinvested distributions — once when reporting the gain on the T3 and again when you sell part or all of the holding,” says Jean Lesperance in his blog, HowToInvestOnline.com.

To track your ACB, check your T3 slips. The capital-gains distributions can be found in Box 21. Or you can visit the website of your ETF provider and get the data for current and past years’ distributions there.

Even if one does remember their capital-gains distributions, it can sometimes be a challenge to correctly calculate the ACB. Other items need to be included. Reinvested income and dividends are added into ACB. Return of capital is subtracted out. As well, previous sales need to be factored in.

For advisors, accountants and investors who find tracking and computing ACB a time-consuming and tedious process, there is a service called ACB Tracking Inc. that calculates (for a fee) the ACB for transactions entered by the user (and not just for ETFs, but for other securities such as income trusts, closed-end funds and so on).