



KNOWLEDGE

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 is also an important consideration for investors.

This guide highlights 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, capital gains as well as returns of capital (ROC) to unitholders.

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 ETF receiving investments in dividend paying Canadian equity securities.	Canadian investors 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 (i.e. bonds) or earning income other than discussed.	Interest and other income are treated as ordinary income for tax purposes.
Return of Capital (ROC): 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 returning a portion of an investor's original investment amount.	This distribution is not taxable in the year of payment (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 ETF units, the lower ACB will increase any future capital gains and decrease any future capital losses on the sale of ETF units.
Reinvested Distributions (i.e., reinvested income or capital gain distributions): Where distributions are reinvested back into the ETF 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 Average Cost Base (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/RL16 tax slip for distributions received during that tax year (including cash and reinvested distributions).

2 | **Treatment of gain or loss realized on selling the ETFs:** Investors will realize a gain or loss on the disposition of ETF units which will be equal to the proceeds of the sale less ACB for tax purposes.

Adjusted Cost Basis (ACB) 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 ACB (referred to as “book value” by the brokers) they have on record at their firm while others leave this to investors to calculate.

While ROC is a form of distribution, it is considered a non-taxable event that will impact an investor’s ACB and therefore affect the calculation of capital gains and losses of the investor when units are sold.



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 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	\$1,000
Kate now has 200 units with a total investment of \$2,200	\$2,200

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

There are number of other adjustments made to ACB (e.g. return of capital payment) before calculating gains/losses for tax purposes. Please consult your tax advisor for detailed calculation of ACB.



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

To understand how a 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.

**Capital gain per unit =
\$15.00 - \$11.00 = \$4.00/unit**

**Total capital gain =
\$4.00 x 200 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 of an ETF typically happen between investors on the exchange – no taxable activity occurs within the ETF itself. In contrast, investors buying or selling traditional mutual fund units do this directly with the fund itself, which could result in the fund needing to either buy or sell underlying investments. This may result in more taxable activity when compared to an ETF.

While it is true an index fund may be potentially less taxable than an actively managed fund (where the fund manager may perform transactions more frequently), the actual structure of an ETF compared to a mutual fund is not a factor in the tax efficiency in this instance.

Where can information about distributions and tax considerations for a specific ETF be found?

For more information on the taxes and distributions associated with a specific ETF, please refer to the ETF's prospectus, your financial statements, or the Annual Financial Report for the ETF. It is also recommended that you contact a tax professional for additional information about taxes.



Investing

There are a number of tax considerations which are not covered above. Should you have any questions regarding potential tax implications relating to ETFs, please consult your **tax advisor** or **investment professional**.

You can also visit our **Tax Resource Centre** for more information.

Connect with TD Asset Management



The information contained herein has been provided by TD Asset Management Inc. and is for information purposes only. The information has been drawn from sources believed to be reliable. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, tax, or trading strategies should be evaluated relative to each individual's objectives and risk tolerance. Commissions, management fees and expenses all may be associated with mutual fund and/or exchange-traded fund ("ETF") investments (collectively, "the Funds"). Trailing commissions may be associated with mutual fund investments. ETF units are bought and sold at market price on a stock exchange and brokerage commissions will reduce returns. Please read the fund facts or summary documents and the prospectus, which contain detailed investment information, before investing in the Funds. The Funds are not covered by the Canada Deposit Insurance Corporation or by any other government deposit insurer and are not guaranteed or insured. Their values change frequently. There can be no assurances that a money market fund will be able to maintain its net asset value per unit at a constant amount or that the full amount of your investment will be returned to you. Past performance may not be repeated. TD ETFs and TD Mutual Funds are managed by TD Asset Management Inc., a wholly-owned subsidiary of The Toronto-Dominion Bank. ®The TD logo and other TD trademarks are the property of The Toronto-Dominion Bank or its subsidiaries.