Tax Considerations for Exchange Traded Funds

AN OVERVIEW OF REQUIREMENTS AND COMPLIANCE

GLOBAL TAX AND REGULATORY SERVICES

BNY MELLON

Tax Considerations for Exchange Traded Funds (ETFs)

GLOBAL REACH, HANDS-ON SERVICE

To compete in today's crowded ETF market requires scale and agility. BNY Mellon combines support needed to help address the most complex operational requirements. Our expertise and relationship driven approach will successfully launch your products to market both quickly and efficiently. We're poised to support the needs of ETF issuers to manage, launch, redeem and navigate tax administration with ease.

INTRODUCTION

The financial markets have experienced tremendous change in the last 20 years, providing an unprecedented range of new investment vehicles that offer opportunities for more efficient and better diversified portfolios.

Recognizing the importance and influence of ETFs, BNY Mellon is engaged enterprise-wide to support fund managers with the capabilities and expertise they need to quickly employ ETF strategies.

Our technology platform offers flexibility allowing clients to execute any investment or product strategy, in key global markets, with ease. Our ETF Services team works closely at every stage of the ETF lifecycle, offering deep industry perspectives and hands on support to address your most complex requirements.

BNY Mellon's straight-through processing delivers convenience and added value. Through our capital markets business, we allow investors to easily access ETFs across a range of asset classes. And, with our partners at Pershing, we provide a gateway to the investment advisor community.

TAX EFFICIENCY

Tax efficiency has traditionally been the key attraction of ETFs when compared to traditional fund structures and many of their tax implications are well understood. However, as the ETF industry continues to grow and expand into new markets, creating products that are as increasingly innovative and complex, the tax implications and tax consequences are also increasing in complexity.

TAX IMPLICATIONS OF ETFS

OPERATIONAL INFRASTRUCTURE

Leveraging ETFs can assist with keeping administrative costs low depending on the structure. The ETF dictating the transparency and efficiency of the entity. ETFs are categorized into five legal structures for tax purposes in the U.S.:

- **Open-ended funds (registered under the 1940 Act)**
- **Unit investment trusts (registered under the 1940 Act UITs)**
- **Grantor trusts**
- **Limited partnerships (LPs);**
- **Exchange-traded notes (ETNs)**

The investment strategy generally dictates the legal formation of the ETF. These legal structures can result in varied domestic tax implications. For example:

U.S. Equity Income ETFs generally operate within three structures which will result in domestic capital gains tax rates as noted:

Open End Fund	LTCG 20%	STCG 37%
UIT	LTCG 20%	STCG 37%
Grantor Trust	n/a	n/a
Limited Partnership	n/a	n/a
ETN	LTCG 20%	37%

U.S. Currency ETFs list below all result in domestic capital gains tax rates as noted:

Open End Fund	LTCG 20%	STCG 37%
UIT	n/a	n/a
Grantor Trust	LTCG 37%	STCG 37%
Limited Partnership	26.8%	26.8% (blended K1 rate)
ETN	LTCG 37%	37%

The structure of an ETF and what the entity invests in will play significant role in determining the ultimate taxability for a shareholder both domestically and internationally. The entities' choice of domicile can also have an impact on the taxability. Portfolio level taxes, particularly cross-border withholding taxes, may have a significant impact on the ultimate taxability of the entity due to treaty access.

For example, a U.K.-domiciled person investing in a U.S. listed S&P 500 ETF will see the U.S. levy of 15% withholding tax (with the appropriate U.S. documentation, otherwise it will be levied at 30%). The U.K. will impose an additional tax of between 25% and 27.5%. However, this may in turn be reduced based on tax paid to the U.S., leading to a total tax rate of 25% (15% + 10% = 25%).

Another example, is an Irish-domiciled investor investing in a London listed S&P 500 index ETF. The investor will still automatically have the same 15% as above withheld, however without the reduction in U.K. domestic taxes the net rate ends up being increased to 40% (15%+25%=40%).

Additional tax issues to consider when looking at overall tax efficiency include items such as VAT and stamp duty. They may also play a role in the attractiveness of various domiciles. ETFs distributed internationally, may have unforeseen tax consequences.

As sponsors look at entering a new market they may find it important to consider whether a physical presence is required given the implications of having what is considered a 'permanent establishment' in certain jurisdictions, based on a physical presence there.

MANAGEMENT OF THE PORTFOLIO

ETFs tend to be tax efficient by nature when compared to traditional fund structures, because they can be transacted on an 'in-kind' basis, rather than in cash. In-kind transactions result in fewer capital gains incurred by the fund, and indirectly by the investors.

Investors seeking to sell their ETF position do not receive cash directly from the sponsor, rather they sell through an authorized participant and, in the case of an in-kind redemption, the security, cash and other asset positions equal to the redemption value are delivered back to the Investor or to the Authorized Participant. However, currency hedged ETFs or an ETF with significant derivative holdings would not offer this benefit.

ETFs are structured for tax efficiency in that many participate in what is considered a passive index strategy which results in a low turnover within the portfolio, and helps reduce gains in the portfolio from passing on to the investors. Conversely, an actively managed portfolio that is constantly required to rebalance may result in additional gains incurred and passed onto the shareholder.

BNY MELLON GLOBAL TAX AND REGULATORY SERVICES

BNY Mellon's Global Tax and Regulatory Services team provides support to navigate the global tax and regulatory environment throughout the investment lifecycle. Our team of professionals monitor and research tax and regulatory developments impacting BNY Mellon Asset Servicing clients, working proactively to support them through the development and enhancement of tax and regulatory products and services. Our engagement with regulators and tax authorities around the world, and our active participation in industry associations, gives us early insight into developing legislation and enables us to directly advocate for clients' best interests. We share these insights with clients through frequent thought leadership papers, tax and regulatory forums, communications and events.

LEARN MORE

If you would like to receive further information, please contact your BNY Mellon Relationship Manager or a member of the BNY Mellon Global Tax and Regulatory Services team.

BNY MELLON GLOBAL TAX AND REGULATORY SERVICES CONTACTS

Mariano Giralt Head of Global Tax and Regulatory Services
Tel: +44 207 163 6463
E: mariano.giralt@bnymellon.com

Conor Begley Director, Global Tax and Regulatory Services
Tel: +353 1 900 8143
conor.begley@bnymellon.com

Sydney Shriver Senior U.S. Tax Manager and Global Head of ETF Tax Services
Tel: + 1 617 382 4234
E: sydney.shriver@bnymellon.com

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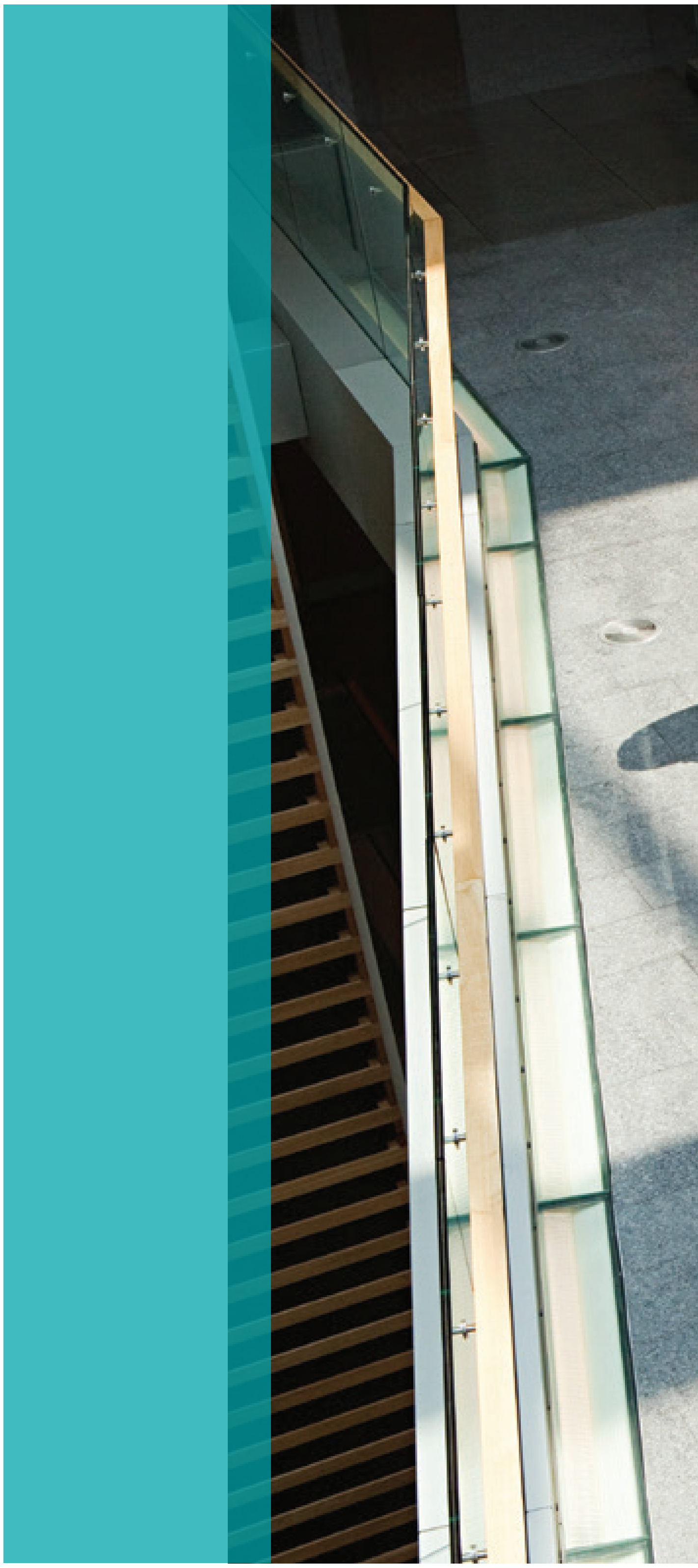

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