

Providing clarity – ETFs & taxes

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It's that time of year again: May will likely bring spring rain and warmer temperatures, but it will also almost certainly bring tax questions from clients. Minimising tax liabilities and understanding implications of various product structures is an important part of the financial planning process. After all, the net return of an investment after taxes and fees is often the only return that really matters to clients. And taxes will have an even bigger impact on potential returns after the 50 percent rate is implemented. As more advisers are beginning to use ETFs as a piece of their client portfolios, we felt now was an appropriate time to clear up commonly asked questions surrounding ETFs and taxes.

How are iShares ETFs taxed?

The easy answer is that capital gains and distribution payments from the iShares Dublin-domiciled ETFs are taxed the same way as UK onshore funds. The only exception lies in ETFs that do not have either UK Distributor Status or UK Reporting Fund Status. In that case, any capital gains would be taxed as offshore income at personal income tax rates.

The chart below is a brief summary of the tax implications for UK resident investors:

Tax for UK Residents	
Equity Distributions (GROSS)	Taxed as dividends - 10% (for lower and basic rate taxpayers), 32.5% (higher rate tax payers) 42.5% (additional rate taxpayers, applicable from 6 April 2010)
Fixed Interest Distributions (GROSS)	Taxed as interest, normal margin rates apply (20% (for lower and basic rate taxpayers), 40% (higher rate tax payers) and – 50% (additional rate taxpayers, applicable from 6 April 2010)
Capital Gains Tax	
Funds holding UK Distributor Status	UK Individuals disposing of iShares funds will normally be liable to Capital Gains Tax at 18%, subject to usual exemptions and reliefs
Funds <u>NOT</u> holding UK Distributor Status	On disposal gains would be an 'Offshore Income Gain' subject to full marginal income tax rates

Why has the tax regime changed?

UK Distributor Status (UKDS) was replaced by a new 'Reporting Fund' regime as of 1st December 2009. The purpose of UKDS was to provide an equal footing for both UK and offshore mutual funds. To qualify, a fund must prove that during the past fiscal year, it has distributed 85 percent of the income paid to the fund to its shareholders. There is also a requirement that holdings in other 'funds' (which could include Real Estate Investment Trusts) must be less than 5 percent of the overall portfolio. These criteria have led to the following drawbacks to UKDS:

- Accumulation funds are not tax efficient for UK investors as they do not meet the 85 percent distribution criteria
- Fund managers are restricted by the 5 percent rule as funds holding foreign REITs will not have UKDS and the entire fund will be tax inefficient as a result
- Ex post certification – Investors have to trust that the fund manager will successfully apply for status year by year.

What is the new UKRF system?

The UK Reporting Fund regime requires that the fund report the UK Taxable Income rather than physically distribute the income. There are several benefits to the new system, but the most significant implication is that accumulating offshore funds will now be tax efficient for UK investors. A summary of both regimes and the differences between the two is as follows:

Regime	UK Distributor Status	UK Reporting Fund
Distribution Requirements	85% of income which comes into the fund must be distributed.	No distribution requirements, but must calculate and publish 100% of UK taxable fund income per share.
Holdings in other 'funds', including REITs	Cannot hold more than 5% in any other collective investment scheme within the portfolio.	Does not have a 5% limit on collective investment scheme holdings.
Application process	Ex post certification – fund managers apply for status at the end of a year and must continue to do so on a year by year basis.	The fund applies on a one-time basis and will maintain UKRF unless the manager is found to be in breach of the conditions.

What are the implications?

There are several important things to remember regarding the change to UKRF when looking at iShares ETFs. First, provided either UKDS or UKRF is in place during the investors holding period, the Offshore Income Gain tax will not apply. Second, it is the intention that all iShares funds currently holding UKDS will obtain UKRF. Third, the iShares funds will apply for UKRF at the 2010 fiscal year-end. Finally, no US or German iShares funds have UK tax status or intend to apply for tax status in the future. Please ensure that you check our website for up-to-date information on a specific fund's tax status.

Conclusion

We hope the article has answered the questions we hear most often regarding ETFs and taxes. The tax code is constantly being revised therefore, we encourage advisers to check with a tax professional to ensure any changes are taken into consideration. If you have additional questions, please feel free to contact our IFA team. You will find our contact information on the following link:

<http://uk.ishares.com/en/pc/campaign/adviser-contacts>

Please refer to the fund prospectus or the fund facts page at www.iShares.co.uk to confirm whether a fund has distributor status or not.

Please note, this information does not consult tax advice, for further detail investors are strongly advised to consult their own tax professional. The tax implications mentioned are for Dublin-domiciled iShares funds and apply to UK residents only.