iShares
by BlackRock

iSHARES INVESTIGATES: THE ETF ECOSYSTEM

DEMYSTIFYING ETF DISTRIBUTIONS

Exchange traded funds (ETFs) in Australia have grown quickly in both size and scope over the past decade. The breadth of product choice now on offer has also resulted in a range of distribution outcomes for Australian investors. So, why is that the case?

While all ETFs listed in Australia pay distributions and produce a tax statement[1], it can be quite confusing to make sense of the jargon and terminology used in the documents, for example: Distribution Reinvestment Plan (DRP), Cents per Unit (CPU), Franking Credits, TOFA and AMIT to name a few.

This article aims to serve as a simple guide to demystifying the terms.

Fund distributions pay at set dates during the financial year, which is available in the distribution calendar. The calendar shows the important dates for each distribution.

Ex-Date	The ETF is trading post distribution on this date. The price is adjusted for the distribution on market open. Any trades on this day are not eligible for the distribution.
Record Date	All trades that are eligible for the distribution are settled on the register of unit holders.
Payment date	The date when the distribution proceeds are paid

The final distribution for the financial year is on the first working day in July. The distributions include the income inclusive up to the end of the financial year on the 30th of June and are taxable for that financial year.

The distribution is expressed as a cents per unit (CPU), this is the amount to be paid to investors for every unit held in an ETF. This amount is announced on the listing exchange at specified dates (estimate and final announcement) in accordance with the distribution calendar and is available on the iShares website. Investors can elect to receive the distribution in cash or to reinvest purchasing additional units via a Distribution Reinvestment Plan (DRP). The option to reinvest is available via the ETF registrar[2], and the details of this scheme is available to investors in the iShares DRP guide for investors.

Calculation of the Distribution Amount

At times, the distribution from an Australian ETF could be different from the income received from the underlying assets. It is important that the ETF manager considers this potential outcome, especially when the ETF has an objective of providing investors with income, such as in Property, Infrastructure and Fixed Income. When the distribution paid from the ETF is aligned to the tax attribution (i.e. the income elements on the tax statement sent to investors), then other elements can impact the fund distribution such as:

- Profit and loss for currency hedging
- Capital gains from selling securities
- Fees and expenses
- Income dilution – this is where the funds AUM grows after the receipt of income from the securities and before the distribution, hence the income is spread over more units[3]

There is some distribution flexibility for ETF managers that register the fund as an Attribution Managed Investment Trust (AMIT), under **legislation brought out in 2016. All iShares ETF have made the AMIT election which allows flexibility to distribute a consistent and stable amount in line with the income from the underlying assets**, which can be different to the tax attribution/Tax Statement. In determining the distribution outcome, iShares considers the tax attribution, the yield of the index and the fund objective.

1 Note that where an ETF is cross-listed from the US (in the format of a CDI), there is no local obligation to produce an Australian Tax Statement. iShares do not have any cross-listings in Australia.
2 For the iShares Registrar - access the Computershare Investor Centre website www.investorcentre.com/au or alternatively, contact Computershare on 1300 474 273 between 8:30 am and 5:00pm (AEST).
3 This effect, while it reduces the income payable, it is neutral from overall value perspective as the income lost is essentially replaced by capital in terms of a higher ETF price.

During Tax Time

Shortly after the financial year end, every ETF issuer will publish a tax statement for every corresponding ETF product (also called the Attribution Managed Investment Trust Member Annual (AMMA) Statement). This statement is available on the registrar's website,[4] and the data is sent to the ATO to be included in the pre-fill of investors' electronic tax return.

ETFs issuers may distribute an amount that is different to the attributable tax in an investor's tax statement. This difference is reflected through a process called a cost base adjustment, which effectively adjusts the purchase price of the ETF units and amends the capital gains tax obligation when the ETF units are sold. This process is effectively tax neutral for investors. The table below shows how this process works at tax time and then when the units are sold:

For the tax year when the income is received

Tax Time Scenario	Cost Base Adjustment
FUND A Distribution cash of $20 Attributable income subject to tax of $10	Cost base decrease of $10
FUND B Distribution cash of $10 Attributable income subject to tax of $20	Cost base increase of $10

Implication when selling the ETF units

When selling the ETF units, the proceeds may be subject to capital gains tax. Capital gain is calculated as:

Proceeds on sale of the ETF units minus cost of purchase

- **If Positive, capital gains tax may apply**
- **If Negative, the capital loss can be used to offset gains in other investments**

Note that for taxpayers eligible for discounted capital gains (for example a 50% discount for assets held for over 12 months) the calculation needs to take this adjustment into consideration.

The cost base adjustment impacts the cost of purchase, using the Fund A and Fund B example from above, the calculation is as follows:

For the tax year when the income is received

FUND A		FUND B	
Purchase price	$100	Purchase price	$100
Cost base decrease	-$10	Cost base increase	+$10
Sale price	$500	Sale price	$500
Capital Gain (subject to tax)	$410 ($500-$90)	Capital Gain (subject to tax)	$390 ($500-$110)

If investors choose to reinvest via DRP or by topping up an investment, every investment or 'tax parcel' will be separated when capital gains is calculated. iShares publishes the DRP reinvestment price on the exchange to help with this calculation.

4 iShares Register is Computershare, information about each investor's holdings including the Tax Statement is available by logging into the Computershare Investor Centre Website www.investorcentre.com/au .

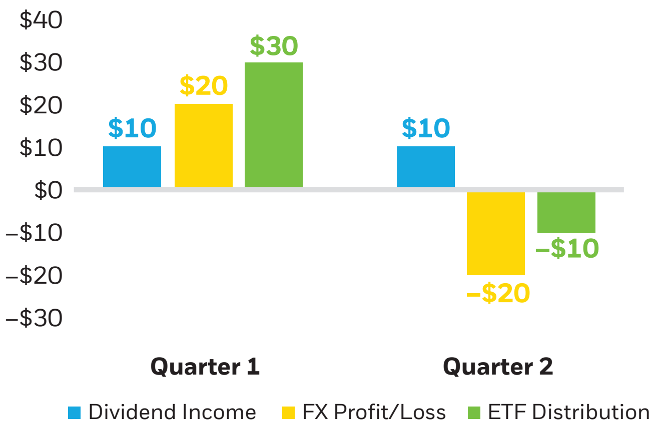
TOFA rules and the TOFA hedge election

TOFA stands for "Taxation of Financial Arrangements" and, one of the objectives of this legislation is to "more closely align the tax and commercial recognition of gains and losses"[5]. Every iShares ETF listed in Australia either elects for all financial arrangements to be subject to the TOFA rules or is automatically subject to TOFA.

The TOFA hedge election is a specific area of TOFA. Under the TOFA hedge election the TOFA rules provide a process to better align the tax attribution/Tax Statement income to the income from the underlying assets when currency hedging is applied. **The TOFA hedge election can vastly reduce tax administration and the need to apply cost base adjustments**.

From a tax perspective the profit and loss from the currency forward contracts used in the hedging process impact the overall income available to be attributed to investors. Referencing the graph example, in both quarters the fund receives a dividend income of $10, the currency forwards provide a profit of $20 in quarter 1 and a loss of $20 in quarter 2. Without the TOFA hedge election being applied, the result is an attributable income in the tax statement of $30 in quarter 1 and $0 (as a negative of -$10 amount cannot be applied) in quarter 2. This highlights that by applying currency hedging the income can be different to the income received from the underlying stocks/bonds.

THE IMPACT OF FX HEDGING



Making the TOFA hedge election enables more appropriate recognition of currency profit/loss from a tax perspective by linking the profit/loss to the securities held in the fund (at a tax parcel level). This means that the currency profit/loss only impacts the investor's tax statement when securities are sold and this profit/loss is realized (as capital) from a tax perspective. In reality, this a complicated process and therefore only a few managers have made the TOFA hedge election. Additionally, a poorly implemented hedge accounting methodology would attract significant risk that the TOFA hedge election is not valid.

Referencing the graph example, when hedge accounting is applied, (with no sale of securities over the period), the attributable tax applied to the tax statement is around $10 in both quarter 1 and quarter 2 with no currency profit/loss impact.

If the TOFA hedge election is made, the attributed income in your tax statement will better align to the distribution income received by the ETF and reduce tax administration for investors.

In summary, the AMIT rules provide additional flexibility regarding the cash distribution amount, but not the attributable income applied to the investor's tax statement. Hedge accounting better aligns the attributable income applied to the investors tax statement to the underlying assets.

What do we do at iShares Australia

- All iShares ETF listed in Australia have made the AMIT election. This means that for ETF's where the investment objective is to provide income, iShares will distribute in line with the underlying index/comparable exposures. **The iShares process in this regard provides increased certainty around the cash distributions**. ETFs with an investment objective on income include Property, Infrastructure and Fixed Income.
- Three hedged international fixed income ETFS and two hedged international equities ETFs'[6] have made the TOFA hedging election, with the methodology reviewed and agreed by the ATO in an ATO Class Ruling. Each of these ETF's provide taxable income attribution (as per the tax statement) and distribution cash payments that reflects the underlying assets. **Making the TOFA hedge election reduces tax administration and the need to apply cost base adjustments**.
- To achieve a similar outcome to hedge accounts, the IShares Global Aggregate Bond ESG (AUD Hedged) ETF (AESG) and iShares US Treasury Bond (AUD Hedged) ETF (IUSG) invests in a share class ETF listed in London which is hedged and valued to the AUD.

5 Source ATO: https://www.ato.gov.au/Business/Taxation-of-financial-arrangements-(TOFA)/In-detail/Guide-to-the-taxation-of-financial-arrangements-(TOFA)/
6 iShares JP Morgan USD Emerging Markets Bond (AUD Hedged) ETF (IHEB), iShares Global High Yield Bond (AUD Hedged) ETF (IHHY), iShares Core Global Corporate Bond (AUD Hedged) ETF (IHCB), iShares MSCI World ex Australia Quality (AUD Hedged) ETF (IHQL) and iShares MSCI World ex Australia Value (AUD Hedged) ETF (IVHG)

Want to know more?

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