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When ETFs pass along gains

Exchange traded funds can minimize taxes, but that isn't always the case

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Investors often ask me why an exchange traded fund they own paid a big gains distribution. The answer is simple, but the lessons can affect the advice you give your clients.

First, let's review ETF distributions.

Just like their open-end and closed-end mutual fund cousins, ETFs pass through underlying portfolio gains to fund holders. Contrary to what some investors may believe, ETFs have no special exemptions from these rules.

The reason ETFs are thought to make little or no capital gains distributions is due to "distributions in kind," which give shareholders their proportional slice of the portfolio when they cash out. For tax purposes, funds recognize no gain when they pay out shares this way.

In fact, distributions in kind are the linchpin of ETFs; an entire industry has been built on the distribution-in-kind "glitch."

If that is the case, why don't open-end funds also use distributions in kind? Actually, most mutual fund prospectuses do allow for such distributions, but the mechanics of the process would be a nightmare.

Investors selling an open-end index fund, for example, would have to receive 500 different stock certificates when they left the fund. These investors would need a facilitator to collect the shares from the fund and turn them into cash from sales in the market.

If such an investor-based facilitator existed, all mutual funds could avail themselves of the benefits of distributions in kind.

ETFs have such facilitators. They are called market makers, and they assemble shares from investors who don't want a distribution in kind.

The exchange marketplace allows an easy meeting between those who don't want their share of the portfolio and a market maker who is willing to receive the portfolio.

The Vanguard Group Inc. offers the best of both worlds. The Malvern, Pa.-based company's ETFs, called Vipers, aren't stand-alone entities; they are nothing more than another share class of the giant Vanguard open-end funds.

Lucky shareholders in the open-end funds get to reap the benefits of the distributions in kind made by their ETF brother. Sellers of Vipers can be paid with low-basis shares held by the long-standing open-end fund.

In this way, the Vanguard ETF can act as a dialysis machine, ridding the Vanguard fund of potential gain realizations.

So the question remains, why do ETFs pay big distributions?

Distributions in kind don't eliminate the recognition of gains when the portfolio changes. Even passive index funds change the composition of their portfolios.

When companies are acquired, for example, an index fund must deliver the target shares and realize a gain. Similarly, as the components of an index change, the portfolio is reconstituted and capital gains or losses are realized.

While changes in the Standard & Poor's 500 stock index may be minimal, think of the changes in the indexes of Tacoma, Wash.-based Russell Investments.

As ETFs strayed from simple passive strategies, surprisingly large capital gains distributions became inevitable. As indexes become less passive, the trend will accelerate.

Some new rules-based ETFs, in fact, have portfolios that are changing, which typically involves selling winners.

While nothing negative is on the horizon, there is a chance that distributions in kind no longer will be treated favorably.

With that in mind, take a look at ReFlow Management Co. LLC of San Francisco, a service provider to the open-end-mutual-fund industry. ReFlow offers three products, including a redemption-in-kind service that its web-site says "levels the playing field between mutual funds and ETFs," and "reduces transactions and taxable distributions to fund shareholders."

This is how it works: ReFlow stands ready (for a fee) to buy into a mutual fund in an amount equal to a redemption request from shareholders. The fund then doesn't need to sell any shares to raise cash.

Later, the fund repays ReFlow in shares, not cash, so that the fund realizes no gains. By using the service, the fund sidesteps the need the sell shares.

There is no dearth of innovation in this area, so look for new fund company initiatives. Meanwhile, passive index funds should be able to continue in their successful tax minimization, while actively managed ETFs should prove no more tax-efficient than their open-end cousins.

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