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Foundations of ETF tax efficiency

ETF Academy

Improved tax efficiency is often cited as a benefit of an ETF in comparison to a mutual fund. While most investors will buy and sell ETFs on an exchange, it's important to understand the key behind tax efficiency occurs at the fund level, through a mechanism known as in-kind creation/redemption.

A closer look at the in-kind create/redeem process and how it impacts tax efficiency

WHO

Authorized Participants (APs) are large financial institutions and market makers who have an agreement with an ETF issuer allowing them to create or redeem ETF shares.

WHAT

The number of ETF shares in the market is dictated by investor demand. ETF shares are brought to market in large blocks called creation units, and can vary in size, from 10,000 to over 600,000 shares! Creation units are bought (via a creation) or sold (via a redemption) by an AP from an ETF issuer at the ETFs net asset value (NAV).

HOW

Create/redeem can be accomplished by two different approaches:

In-kind: For a creation, APs exchange the underlying basket of securities for shares of the ETF (or vice versa for a redemption). For most ETFs, the underlying basket of securities is published daily before market open and is publicly available on the ETF provider's website.

Cash: For a creation, APs exchange cash for shares of the ETF (or vice versa for a redemption).

Whether or not an ETF has the capability to use the in-kind method depends on the fund's underlying markets, investment strategy and regulations.

WHY

When shares are created or redeemed via the **in-kind method**, this is a non-taxable event for a fund because no cash is exchanged. This allows imbalances between supply and demand for ETF shares to be satisfied without having an adverse taxable effect on existing ETF shareholders. This in-kind exchange also applies to fund rebalances for both indexed and actively managed ETFs.

Conversely, a mutual fund either receives cash for subscriptions or must sell securities to raise cash for redemptions, potentially creating capital gains for existing shareholders, some of whom may have an unrealized loss on the overall mutual fund investment.

Tax efficiency case study

Generally, holding an ETF in a taxable account will generate less tax liabilities than if you held a similarly structured mutual fund in the same account.

- Over the last ten years, ETFs have generally experienced fewer capital gains than mutual funds. As shown in the table, this is not limited to any particular asset class or management styles.
- This may be a driving force behind mutual fund to ETF conversions. Since March 2021, 126 mutual funds have converted to ETFs, representing $143.6 billion in combined assets or 17% of all active ETF assets.[1]

1. Source: Morningstar. As of 12/31/24.

Percentage of ETFs and Mutual Funds that Paid Capital Gains

For 10-year Period Ending December 31, 2024[2]

Asset Class	Investment Type	Strategy Type	% of Funds with Capital Gains
Equity	ETF	Active	**15.7**
		Indexed	**5.9**
	Mutual Fund	Active	**65.7**
		Indexed	**57.9**
Fixed Income	ETF	Active	**20.5**
		Indexed	**11.9**
	Mutual Fund	Active	**24.2**
		Indexed	**39.8**

2. Source: Morningstar. Past performance does not guarantee future results.

Bottom line: ETFs can play an important role in an investors tax management planning.

When due to creations and redemptions occur **in-kind**, ETFs have improved tax efficiency compared to mutual funds.

BUT… 'Tax efficiency' **does not** mean that an investor avoids paying taxes on their capital gains.

It means they have more control and typically only **pay when they choose** to sell their shares.

IMPORTANT INFORMATION

All investments involve risks, including possible loss of principal.

ETFs trade like stocks, fluctuate in market value and may trade at prices above or below the ETF's net asset value. Brokerage commissions and ETF expenses will reduce returns.

Before investing, carefully consider a fund's investment objectives, risks, charges and expenses. You can find this and other information in each prospectus or summary prospectus, if available, at www.franklintempleton.com.

ETF shares may be bought or sold throughout the day at their market price, not their net asset value (NAV), on the exchange on which they are listed. Shares of ETFs are tradable on secondary markets and may trade either at a premium or a discount to their NAV on the secondary market.

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