Understanding the Tax Implications of Exchange-Traded Funds

Forward

Barclays Global Investors Canada Limited (Barclays Canada) is pleased to present "Understanding the Tax Implications of Exchange-Traded Funds", a memorandum prepared by PricewaterhouseCoopers LLP. A key component of the exchange-traded fund (ETF) advantage is tax efficiency. Our goal with this memorandum is to provide Canadian individuals and institutions with a useful reference material regarding the taxation of ETFs, from an authoritative source, and to highlight the potential tax efficiencies that ETFs may offer.

We hope the reader will find this memorandum to be a useful tool in making the most of his or her investment in ETFs.

Barclays Canada is an indirect subsidiary of Barclays PLC and part of BGI, one of the largest institutional investment managers in the world and the largest manager of index funds. BGI leads the world in ETFs by a large margin, with funds covering a complete range of asset classes. As of October 2003, BGI offered more than 90 ETFs, including 12 in the UK, 12 in Canada, and more than 70 in the US. Barclays Canada currently manages more than $6 billion in ETFs. The i60 iUnits Fund is one of the largest mutual funds in the Canadian equity category and the largest index fund across all categories. With approximately $35 billion under management. Barclays Canada has offices in Toronto and Montreal.

Understanding the Tax Implications of Exchange-Traded Funds

Executive Summary **5**

Understanding the Tax Implications **7**

of Exchange-Traded Funds **7**
- Introduction 7
- What is Tax Efficiency? 7
- Tax Aspects of Traditional Mutual Funds 8

A Comparison of ETFs and Mutual Funds **9**
- Indexing and Low Turnover 9
- Redemptions 10
- Low Cash Balances 11
- Superficial Loss Rules Protection 11

Other Tax Aspects of ETFs **12**
- Asset Allocation Programs 12
- ETF Options 12
- Call Options 12
- Put Options 13
- Short Sales 13

U.S. Based ETFs: Canadian Tax Aspects **14**
- Introduction 14
- Redemptions 14
- Foreign Investment Entity (FIE) Rules 15
- Withholding Tax 16
- Canadian Tax on Holdings of US ETFs 16
- U.S. Estate Tax 17

Conclusion **20**
- Foreign Reporting 19
- ETFs May Be Tax Efficient 20
- U.S. ETF Tax Advantages 20

Appendix 1 .... **22**

Capital Tax Implications of Investing in ETFs **22**
- Corporations that are not Financial Institutions 22
- Corporations that are Financial Institutions 22

Appendix 2 23

US Withholding Tax Implications for Tax –Exempts holding ETFs 23

Appendix 3 24

An ETF Capital Gains Advantage for Insurance Companies and Other Financial Institutions 24

Appendix 4 26

ETF Advantage for Investment Corporations and Pooled Funds............................ 26

Appendix 5 27

Structure of Barclays Global Investors' ETFs 27

Executive Summary

Exchange-traded funds (ETFs), for purposes of this article, are funds that track or replicate a specific index and are listed and traded on major U.S. and Canadian stock exchanges just like individual stocks.[1] As is the case with any stock that trades on an exchange, buyers can purchase ETFs from current holders at any time throughout the trading day via their broker. This is different from a traditional mutual fund, of which units can only be bought or sold (usually at the end of the day) from the fund itself.

The impact of taxes is an important factor in evaluating and selecting investments. Most ETFs are structured to operate in a manner that may promote tax efficiency for the investor. Some of the tax advantages of Canadian ETFs include:

- Reduced capital gains distributions:
    - Low Portfolio Turnover: Index-linked ETFs track the underlying index and thus trade securities infrequently;
    - Reduced Redemptions: The market maker on the exchange and other dealers will take excess supply of units into their inventories when there are more sellers than buyers. Redemptions will be triggered only when these holdings are large and sustained over a significant period; and
    - In-Kind Redemptions: Redemptions from ETFs generally occur as in-kind redemptions. Where an in-kind redemption is made, certain ETFs are structured so that any capital gains realized by the ETF upon the transfer of its property to a redeeming unitholder are allocated specifically to that redeeming unitholder.[2] As a result, the remaining unitholders should not receive a distribution of capital gains realized by the ETF as a result of other investors' in-kind redemptions. Traditional mutual funds also have the ability to allocate capital gains realized as a result of redemptions to redeeming unitholders and many traditional mutual funds are currently reviewing whether to adopt such an approach. However, few, if any, traditional mutual funds have yet to adopt this approach; and

[1] While there are also ETFs based on bonds and other securities, this article will deal with ETFs that track shares traded on a particular stock exchange.

[2] It is our understanding that it is the intention of the iUnits Funds to allocate capital gains realized by the Funds as a result of in-kind redemptions to redeeming unitholders and that proper mechanisms are in place to allow the iUnits Fund to make such allocations.

- Superficial Loss Rules Protection: ETFs can provide an alternative investment for proceeds if after a sale of securities an investor desires ongoing exposure to a particular asset class.

The following memorandum summarizes the key tax implications of ETFs for Canadian individuals who hold their investments on capital account[3] and discusses how the structure of ETFs may promote tax efficiency. The summary also assumes that the ETFs are held outside a deferred income plan.[4]

U.S. ETFs are traded on U.S. stock exchanges in the same way as shares of a publicly held company. They have some of the same tax-related advantages as Canadian ETFs, and some other advantages:

- Capital gains dividends paid by U.S. ETFs to Canadian residents are not subject to withholding tax; and

- In-kind redemptions rarely, if ever, generate capital gains distributions to shareholders.

Investors must also bear in mind that U.S. ETFs are U.S. assets for U.S. estate tax purposes, regardless of the residence or citizenship of the taxpayer. Each of these considerations is discussed in further detail in the attached memorandum.

The attached memorandum is intended to provide general information only. It has been prepared at the request of Barclays Global Investors Canada Limited ("Barclays"), the investment portfolio manager of the iUnit Funds. The information provided by Barclays has not been verified by PricewaterhouseCoopers LLP. The attached memorandum is not an endorsement, an offer to buy or sell securities, and is not intended as, nor should it be relied upon, as advice of any kind. Tax, investment and all other decisions should be made, as appropriate, only with guidance from a qualified professional and in no circumstances in reliance upon the attached memorandum.

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[3] A gain or loss from the disposition of securities, including ETFs, will be taxed as either an income gain or loss, or as a capital gain or loss. Transactions of the former type are generally referred to as being on "income account" and transactions of the latter type as being on "capital account." The main difference is that a taxpayer is required to report only one-half of capital gains or losses for income tax purposes, whereas income gains or losses are fully reported.

[4] In this context, the term "deferred income plans" refers to registered retirement savings plans (RRSPs), registered retirement income funds (RRIFs), registered education savings plans (RESPs), and deferred profit sharing plans (DPSPs).

Understanding the Tax Implications of Exchange-Traded Funds

Introduction

Exchange-Traded Funds (ETFs), for purposes of this memorandum, are funds that track or replicate a specific equity index. Instead of actively trading a basket of stocks, ETFs track an index by selecting a representative group of stocks.

The impact of taxes on investment returns is a significant factor in evaluating and selecting investments. Mutual funds in particular have received press coverage about their “tax efficiency” – the manner in which the tax laws affect investment returns ultimately produced from owning mutual fund units. While taxes are, of course, only one factor in investment selection, they can be important. Returns from similar investment exposures can vary significantly over time, depending upon the manner in which taxes apply to the investments. This memorandum summarizes the key tax implications of Canadian ETFs held by Canadian resident individual investors on capital account and discusses how the structure of ETFs may promote tax efficiency. In addition, it describes some of the tax implications for Canadians who invest in U.S. ETFs.

What is Tax Efficiency?

In general, tax efficiency is driven by one simple concept: delaying tax payable on the appreciation of an investment normally enhances after-tax returns. Stated somewhat differently, if appreciation in an investment is taxed when the position is sold, the return on the investment will normally be higher than if some of the tax is paid earlier. The amount of the tax paid earlier can be viewed as having been removed from the amount invested, thereby reducing the positive effect of compounding. Accordingly, a securities investor who can control his or her tax position by realizing tax only when he or she disposes of securities at a gain will usually derive greater tax efficiency than an investor who incurs tax earlier.

Tax Aspects of Traditional Mutual Funds

Canadian ETFs are generally structured to qualify as mutual fund trusts under the *Income Tax Act* (Canada)[5] (the "Tax Act"). A mutual fund trust is taxed as an individual at the top marginal rate. However, when a trust calculates its income for tax purposes, it may deduct the amount of income (including taxable capital gains) paid (or made payable) to unitholders during the trust's taxation year. This income will, therefore, be subject to tax only at the unitholder level. A trust cannot allocate losses to its unitholders. However, non-capital losses and net capital losses can be carried forward to reduce income and capital gains earned by the trust in subsequent years.[6]

To ensure that the trust itself is not taxed, the mutual fund will make distributions, which generally are taxable to unitholders when they are made payable to them. The character of the type of income earned by the trust and distributed to unitholders is retained in the unitholders' hands. For example, a trust can designate a portion of its distribution to unitholders to be dividends received from taxable Canadian corporations. As a result, unitholders will be subject to the dividend gross-up and will be able to claim the dividend tax credit with respect to that portion of the distribution. Similarly, a trust can designate a portion of its distribution to be taxable capital gains. Unitholders will be taxable on only one-half of capital gains. Finally, a trust can designate a portion of its distribution to be foreign income and can allocate related foreign tax to unitholders so that they may claim foreign tax credits.

If a trust makes distributions that are more than its net income and the non-taxable portion of capital gains allocated to unitholders, the excess will be treated as a non-taxable receipt. This non-taxable receipt is not included in computing income of the recipient but rather reduces the adjusted cost base (ACB) of their units, thereby increasing (decreasing) the amount of capital gain (loss) realized on the subsequent disposition of those units.

Traditional mutual funds may realize gains that must be distributed at least annually and are taxable to unitholders (subject to any available capital gains refund). Realization of these gains may be prompted by a number of factors, including: (1) if the fund's portfolio is actively managed, there may be frequent sales of securities that can generate realized gains which must be distributed to unitholders (subject to any available capital gains refund), and (2) the fund, if classified like most mutual funds as an open-ended fund, may have to sell securities to meet redemption demands.

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5 RSC 1985, c. 1 (5th supplement), as amended.

6 Allowable capital losses may be deducted only against taxable capital gains. The resulting net capital losses can generally be carried back 3 years or forward indefinitely. Non-capital losses may be carried forward 7 years and carried back 3 years.

A Comparison of ETFs and Mutual Funds

Traditional mutual funds and Canadian ETFs that are both structured as mutual fund trusts are subject to the same tax regime. Both normally choose to distribute their net income, including gains, to unitholders by year-end in order to avoid being taxed at the top marginal rate. Accordingly, they share a number of the same tax-related advantages, including the following:

- Qualification as investments for RRSPs, RRIFs, DPSPs, RESPs and certain registered investments.[7]
- Eligibility for the capital gains refund mechanism: a refund of tax paid on capital gains, depending on, among other things, the level of redemptions. As a result, taxable distributions to unitholders may be reduced.
- Capital account tax treatment for unitholders of Canadian ETFs who make a subsection 39(4) election.[8]

Unlike traditional mutual funds, however, the manner in which ETFs are structured and managed may offer investors additional distinct tax efficiencies. In this connection, a number of points must be considered.

Indexing and Low Turnover

Unlike many traditional mutual funds, ETFs are based on indexing rather than active portfolio management. ETFs typically sell securities for portfolio management purposes only when a given security is removed from the index tracked by the fund. By seeking to replicate returns of a given index, ETFs may generate fewer sales of securities within the fund, thereby reducing the amount of gains that must be distributed and taxed to unitholders.

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[7] Certain types of entities may become a registered investment pursuant to Part X.2 of the Tax Act, subject to certain investment restrictions. Specifically, certain registered investments may only hold “prescribed investments”. Otherwise a tax under Part X.2 of the Tax Act may be imposed. A unit of a mutual fund trust is a “prescribed investment” for this purpose.

[8] If a taxpayer has disposed of a “Canadian security” (which includes a unit of a mutual fund trust) in a taxation year, subsection 39(4) of the Tax Act provides that the taxpayer may make an election to treat all Canadian security dispositions in that year and in all subsequent years as being on capital account. As a result, all Canadian security dispositions must be given capital gain or loss treatment and the election cannot be rescinded. This election is not available to a “trader or dealer in securities” and certain other taxpayers.

As well, there is a significant difference in the way index mutual funds and ETFs work when there is an index change involving a net increase to the index. Both index mutual funds and ETFs sell the stock leaving the index (triggering gains, if any), and both funds buy the stock entering the index. If the cost of purchasing the "new stock" is more than the proceeds received from the sale of the "old stock", index mutual funds sell other stocks in the index, potentially triggering more capital gains. In contrast, ETFs issue more units to the underwriters to finance the additional purchases, and do not need to sell as much stock, thereby minimizing the potential capital gain.

Redemptions

Probably the most significant tax-related distinction between ETFs and many traditional mutual funds arises from the manner in which unitholders dispose of their units. Generally, unitholders of traditional mutual funds may dispose of their units only by redeeming them. Traditional mutual funds must therefore often sell securities to generate the cash needed to fulfil redemption requests. These sales may give rise to gains that must be distributed and will be taxable to unitholders. A unitholder of a traditional mutual fund may therefore receive a capital gains distribution simply because other unitholders have redeemed their units. The capital gains refund,[9] which is meant to minimize the amount of these distributions, is valuable, but it is approximate in its effectiveness and may not shelter appropriate amounts of gains.

In contrast, holders of ETFs may dispose of their units in two ways: by selling them through an exchange or by redeeming them. Most holders of ETFs (including virtually all individual investors) choose to dispose of their units by selling them through the exchange. These trades will not result in the ETFs recognizing any gains since they do not require the ETFs to sell their investments, and so, holders of ETFs would not receive a capital gains distribution from the fund because of these trades. Generally speaking, dealers and market makers will hold excess units during normal periods of net selling, acting as a "buffer" to redemptions. However, dealers' willingness to hold inventory is not unlimited and if there is large sustained net selling, redemptions may occur.[10] Under these circumstances, the fund may recognize a gain regardless of whether the redemption proceeds are paid in cash or in-kind by the ETF. Generally, where redemption proceeds are paid in cash, the amount

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[9] The capital gains refund is available only to a trust that was throughout its taxation year a mutual fund trust. It is intended to address the fact that capital gains earned by a mutual fund trust can be subject to tax twice – once at the trust level and again at the unitholder level. The capital gains refund mechanism is intended to resolve this problem by giving a mutual fund trust a refund of the tax that would otherwise be paid on capital gains retained by the trust. In this way, a capital gain is only subject to tax once.

[10] ETF redemptions will be predominately in-kind, although it is possible to redeem for cash. In-kind redemptions are done in a prescribed number of units typically by institutional investors who receive a basket of shares and residual cash. Redemptions for cash are done at 95% of market value. These are unlikely, because many investors will choose to sell at full market value on the exchange.

of the redemption proceeds is equal to 95% of the closing price on the stock exchange on the effective day of the redemption. Therefore, it is expected that cash redemptions will rarely occur. Certain ETFs, including the iUnit Funds,[11] may allocate the gain specifically to the redeeming unitholder in the event of in-kind redemptions and, therefore, remaining unitholders should not receive a capital gains distribution as a result of capital gains realized by the ETFs on an in-kind redemption.[12]

Low Cash Balances

Because ETFs track indices, they tend to have very low cash balances. Traditional index mutual funds may hold larger levels of cash than ETFs in order to finance unitholder redemptions. The manager of an actively managed traditional mutual fund may also need to hold cash to take advantage of buying opportunities, or may feel that holding cash is a prudent defensive position given the state of the markets. From a tax perspective, this could result in unitholders of traditional mutual funds receiving higher distributions of fully taxable income than holders of ETFs might receive. ETFs have a mandate to be fully invested in the index being tracked so taxable interest income may be minimized.

Superficial Loss Rules Protection

If an investor decides to sell equity investments to realize a loss for tax purposes and then repurchases the securities within a 30-day period, the Tax Act will defer the loss, considering it a “superficial” or unreal loss. ETFs can provide an alternative investment for the sale proceeds if the investor still wants exposure to a particular asset class. The investor then has the option of retaining the ETFs or selling them and repurchasing the original equity investment after the 30-day period has passed. As with any tax planning, the potential application of the general anti-avoidance rule must be considered.

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[11] At the time of writing, Barclays has indicated its intention to allocate capital gains realized as a result of a redemption to the redeeming unitholder.

[12] Amendments to the Tax Act in 2002 affect in-kind redemptions and the calculation of the capital gains refund. These amendments can result in anomalous tax consequences for unitholders. A unitholder requesting an in-kind redemption for his or her units may receive the full fair market value of his or her investment without being subject to tax, while the trust may receive reduced capital gains refunds in the future. This result would be unfair to the remaining unitholders. However, certain Canadian ETFs, such as the iUnit Funds, may be structured such that this unfair treatment would not arise. Specifically, it is intended that any capital gains realized as a result of an in-kind redemption will be allocated directly to the redeeming unitholder.

Other Tax Aspects of ETFs

Asset Allocation Programs

The number of redemptions in a traditional mutual fund may increase when its unitholders hold units as part of an asset allocation program. The manager of an asset allocation program periodically rebalances a unitholder's investment in the various funds that are part of the program. When such asset allocation program accounts are invested in traditional mutual funds, the redemptions resulting from rebalancing can result in increased capital gains distributions for the funds' unitholders. This is not the case when ETFs are used as part of an asset allocation program and rebalancing occurs through exchange trades or in-kind redemptions.

ETF Options

In some cases, options to buy or sell units of a specific ETF are available. Investors may buy or write options to acquire or sell ETFs. Whether the gains or losses on ETF options ("options") are on income account or capital account is generally a question or fact.[13] This is determined on a case-by-case basis. The following comments assume that capital treatment applies.

Call Options

For the holder of a call option who does not exercise the option, the premium paid to acquire the option is considered a capital loss in the taxation year in which the option expires. If the holder closes out the option on the secondary market (i.e., sells it before it expires), the net gain or loss on the acquisition and disposition of the option is considered a capital gain or loss in the taxation year in which the option is closed out. If the holder exercises the option, the cost of acquiring the option is added to the cost of the ETFs purchased.[14]

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[13] See footnote 2 above. Generally, if the options transactions are entered into for speculative reasons, the transaction will be considered to be on income account. If the option transaction has been entered into to hedge risk associated with ETFs held on capital account, the option transaction could be considered to be on capital account. This determination is always a question of fact.

[14] The writer of a call option realizes an immediate capital gain equal to the premium received. If an offsetting option is acquired on the secondary market, the cost of that option is considered a loss at that time. If the option is subsequently exercised, the option premium is instead added to the proceeds from the ETFs disposed of under the option. If the option is granted in one year and gave rise to a disposition, but was exercised in a later year thereby cancelling the disposition, the writer may amend his or her tax return for the year of the grant; i.e., the year in which the call option was written.

Put Options

When the holder of a put option does not exercise the option, the premium paid to acquire the option becomes a capital loss in the taxation year in which the option expires. If the holder closes out the option on the secondary market, the net gain or loss on the acquisition and disposition is a gain or loss in the taxation year in which the option is closed out. If the put is exercised, the premium paid to acquire the option is deducted from the proceeds of the ETFs sold.[15]

Short Sales

Because investors buy and sell ETFs like stocks, investors can also employ traditional stock trading techniques, such as short sales. An investor may borrow ETFs and sell them short for proceeds. The investor will not be required to recognize any amount for tax purposes until the short position is closed out.

Generally, a profit made on the short sale of shares is considered income for tax purposes unless the taxpayer has made a subsection 39(4) election to guarantee capital gains treatment.[16] As noted above, because ETFs are mutual fund trusts, an interest in an ETF will qualify for this election.

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[15] The writer of a put option will realize an immediate capital gain equal to the premium received for the option. If an offsetting option is acquired on the secondary market, the cost of that acquisition will be a loss at that time. If the option is exercised, the option premium is deducted in computing the cost of the ETFs acquired.

[16] In IT-479R, the CCRA has stated that a Canadian security includes a security that is "sold short," thus, the subsection 39(4) election can be made in respect of short sales.

U.S. Based ETFs: Canadian Tax Aspects

Introduction

U.S. ETFs are traded on U.S. stock exchanges the same way as shares of a publicly held company. They generally represent an interest in an underlying portfolio that is designed to closely track the performance of a market index.

U.S. ETFs share some of the same tax-related advantages as Canadian ETFs:

- They are qualified investments for RRSPs, RRIFs, DPSPs, and RESPs (however, shares of U.S. ETFs are foreign property);[17]
- They experience few redemptions and, as a result, pay low capital gains distributions as a result of redemptions; and
- Most U.S. ETFs redemptions are in-kind, and rarely, if ever, will generate taxable capital gains due to redemption requests. Therefore, similar to a Canadian ETF, remaining unitholders should not receive distributions of capital gains as a result of other investors' in-kind redemptions. This assumes that the Canadian ETF has a policy and process in place allowing it to allocate capital gains, realized as a result of an in-kind redemption, to the redeeming unitholder.

In addition, capital gains dividends paid by U.S. ETFs to Canadian residents are not subject to withholding tax.

Redemptions

As with Canadian ETFs, probably the most significant tax-related distinction between U.S. ETFs and traditional open-ended mutual funds arises from the fact that holders of traditional mutual funds may dispose of their units only by redeeming them. Consequently, a unitholder of a traditional mutual fund may receive a capital gains distribution because other unitholders have redeemed their units.

When U.S. ETFs are traded through an exchange, the trades do not result in the ETFs recognizing any gains. As a result, other holders of U.S. ETFs will not realize any capital gains in respect of these trades.

[17] RRSPs, RRIFs and DPSPs are subject to foreign content restrictions, however, RESPs are not subject to these limits.

As with Canadian ETFs, holders of U.S. ETFs may redeem their shares,[18] although most sell their shares on an exchange. A provision in the U.S. tax code states, in effect, that in-kind redemptions do not generate taxable gains to a fund, even if the securities transferred by the fund to the shareholder have appreciated in value. For U.S. tax purposes, an ETF holder's U.S. adjusted tax basis in in-kind securities received from an ETF will be the same as the adjusted tax basis had been for the distributing ETF. Because most U.S. ETF redemptions are in-kind, they will rarely, if ever, generate taxable gains to meet redemption requests. This generates significant tax efficiency, particularly to investors (including both U.S. and Canadian investors) who remain in U.S. ETFs for an extended period.

Foreign Investment Entity (FIE) Rules

The Department of Finance released revised draft legislation regarding "foreign investment entities" ("FIEs") on October 30, 2003. This legislation is important for Canadians who invest in ETFs located outside of Canada and will apply to taxation years that begin after 2002. The rules are highly complex and you may wish to discuss this proposed legislation with your tax advisor.

The general scheme of the proposed FIE rules is aimed at preventing taxpayers from avoiding Canadian tax by investing offshore through FIEs. Where the proposed FIE Rules apply, a notional amount of income must be included in computing a taxpayer's income using the prescribed interest rate method, which is the default method, the mark-to-market method or the income accrual method. Under the prescribed interest rate method, a taxpayer will be required to include a prescribed percentage of the designated cost of the FIE into income. The prescribed percentage will be equal to the 3-month average treasury-bill rate plus 2 percentage points and is set quarterly. In certain circumstances, a taxpayer can elect to have the mark-to-market method apply, which requires the taxpayer to bring changes in the fair market value of the investment in the FIE into income. In certain other circumstances, a taxpayer can elect to have the income accrual method apply, which requires the taxpayer to include in computing income its pro-rata portion (based on the fair market value of the participating interest held in the FIE) of the FIE's income.

Where a U.S. ETF is a "Regulated Investment Company"[19] (RIC), whose shares are listed on a prescribed stock exchange, the proposed FIE rules should not apply to an investment in the U.S. ETF assuming that the investor (and persons not dealing at arm's length with

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[18] Because the U.S. ETFs are regulated investment companies (RICs), their interests are often referred to as "shares" even though legally they may be trust units.

[19] For the purposes of section 851(b) and 852(a) of the United States *Internal Revenue Code* of 1986. At the time of writing, Barclays has indicated that all of its U.S. ETFs qualify as Regulated Investment Companies.

the investor) does not hold more than 10% of the fair market value of all of the shares of the U.S. ETF and certain other conditions are satisfied.[20]

Withholding Tax

Distributions to Canadian residents in the form of dividends from a RIC, which includes U.S. ETFs, are generally subject to a 15% U.S. withholding tax.

However, capital gain dividends paid by U.S. ETFs to Canadian residents are not "fixed or determinable annual or periodical income" under the U.S. tax code. Therefore, such capital gains dividends are not subject to withholding tax.

In addition, U.S. withholding tax does not apply to sale or redemption proceeds received by a Canadian who has sold U.S. ETFs.

Also, US withholding tax will not apply to distributions of any kind made to RRSPs and other deferred income plans.

Canadian Tax on Holdings of US ETFs

For Canadian tax purposes, Canadian holders of U.S. ETFs, that are trusts, will be taxed on the portion of the US ETF's distribution that represents income, including capital gains income, as computed under the Canadian tax rules. It should be noted, however, that the capital gains portion of the income distributed by U.S. ETFs will be characterized, for tax purposes, simply as trust income and not capital gains.

Notwithstanding the characterization of capital gains distributed by US ETFs as trust income, it is possible, in principle, for such distributions to be taxed at a rate matching the preferred rate for capital gains. However, in most cases, it will not be possible in practice to gather the necessary information to support a claim for the preferred rate for capital gains in Canada.

Distributions received by a Canadian holder of a U.S. ETF that is a corporation will also be fully taxed in Canada, regardless of whether the distributions are characterized as capital gains in the U.S.

[20] The other conditions that must be satisfied are as follows: (i) the investor must include in income of a particular taxation year, the amount of net accounting income that has become payable by the U.S. ETF to the investor in the particular taxation year; (ii) it is reasonable to conclude that there are at least 150 persons owning shares of the U.S. ETF and each of those persons holds at least $500 worth of shares; and (iii) it is reasonable to conclude that the shares of the ETF can normally be acquired and sold by the public in the open market.

Finally, one-half of any capital gain arising from the disposition of U.S. ETFs will be taxable.

U.S. Estate Tax

Whether or not a person is a U.S. citizen or resident, he or she could be subject to U.S. Estate Tax upon death. Canadian residents who are not U.S. citizens are generally subject to U.S. Estate Tax on the value of their U.S. "situs" assets (U.S. assets) owned at death. If the Canadian resident's gross worldwide estate is valued at less than US$1.2 million, the estate tax will be applied only to U.S. real estate and U.S. business assets. If, however, the worldwide estate is valued at more than US$1.2 million, the tax will apply to all U.S. assets, including U.S. ETFs.

Unlike Canada's system, which generally taxes only the gains accrued on assets held at death, the U.S. estate tax system taxes their value. A Canadian resident could be subject to both U.S. Estate Tax and Canadian income tax upon death. Some relief from double taxation is available under U.S. domestic law and the Canada-U.S. Tax Treaty.

U.S. citizens currently are able to reduce or eliminate U.S. estate tax by claiming an exemption on the first US$1,000,000 of assets. The U.S. government passed legislation to increase the exemption amount over the next several years. The exemption amount increases gradually to US$3.5 million in 2009, and the U.S. estate tax is repealed for 2010. In 2011, the U.S. will return to existing law unless new legislation is enacted at that time.

Calendar Year	**Estate Tax Exemption (old law)**	**Estate Tax Exemption (new law)**
2003	$700,000	**$1 million**
2004	$850,000	**$1.5 million**
2005	$950,000	**$1.5 million**
2006	$1 million	**$2 million**
2007	$1 million	**$2 million**
2008	$1 million	**$2 million**
2009	$1 million	**$3.5 million**
2010	$1 million	**N/A (taxes repealed)**
2011 and thereafter	$1 million	**$1 million** (if no further congressional action is taken)

In addition to increasing the exemption amount, the new legislation also provides for a decrease in the highest estate tax rate from 55% to 45% by 2007.

Calendar Year	Highest Estate Tax Rate
2003	**49%**
2004	**48%**
2005	**47%**
2006	**46%**
2007	**45%**
2008	**45%**
2009	**45%**
2010	**N/A (taxes repealed)**
2011 and thereafter	**55%** (if no further congressional action is taken)

For Canadians who are not U.S. citizens, only the first US$60,000 of U.S. assets is automatically exempt from U.S. estate tax under U.S. domestic law. Although a Canadian is entitled to the same exemption as a U.S. citizen under the treaty, the exemption is pro-rated, based on the value of his or her U.S. assets divided by his or her worldwide assets. Canadians are entitled to shelter the greater of US$60,000 and the shelter determined under the treaty based on the pro-ration formula.

The bottom line is:

- For Canadians having worldwide assets valued at less than the estate tax exemption amount, the entire U.S. estate tax will be offset by the exemption (the exemption amount is US$1,000,000 in 2003 and increases to US$3.5 million by 2009).
- For Canadians having worldwide assets valued over the exemption amount but less than US$1.2 million, only U.S. real property and U.S. business assets are taxable. In that case, U.S. ETFs will not be subject to U.S. estate tax.
- Finally, for wealthier Canadians, being those with worldwide assets valued at more than US$1.2 million and more than the exemption amount, all U.S. assets are taxable. The greater the non-U.S. assets, the smaller the relief will be under the treaty because of the pro-ration formula.

Canada may give a foreign tax credit for U.S. Estate Tax paid on U.S. assets. In the end, an individual generally pays the higher of the two taxes. Because Canadian capital gains rates have declined significantly in recent years, the individual likely will pay tax at the U.S. higher estate tax rates. For example, the top U.S. estate tax rate currently is 49% (dropping to 45% by 2007), while the top capital gains tax rate in Ontario is only about 23%.

Canadian residents with large U.S. holdings, including U.S. ETFs, should consider obtaining estate planning advice to deal with the issue of U.S. estate taxes.

Foreign Reporting

T1135 – Foreign income verification statement. Canadian resident individuals, corporations, trusts and partnerships that own specified foreign property, the total cost of which exceeds $100,000 at any time during the year, will be required to file Form T1135. Because specified foreign property includes an interest in a non-resident trust[21] or a share of a non-resident corporation, investors in U.S. ETFs are subject to this reporting requirement.

[21] Including an interest in a trust that would be non-resident if the Tax Act were read without reference to proposed subparagraph 94(3)(a)(v), which deems certain non-resident trusts to be resident in Canada.

Conclusion

ETFs May Be Tax Efficient

Both Canadian and U.S. ETFs are structured to operate in a manner that may promote tax efficiency. The major advantage from a tax perspective arises from the fact that capital gains distributions are minimized. As discussed above, this results from the fact that ETFs have a low turnover of securities and are expected to have a low number of redemptions; in addition, dealers and market makers often act as a buffer when there are more sellers than buyers. Even in the event of in-kind redemptions, certain ETFs (including the iUnits Funds) have policies and processes in place to allow them to allocate capital gains realized as a result of the redemption to the redeeming unitholder. As a result, it is intended that remaining unitholders will not receive capital gains distributions as a result of other investors' in-kind redemptions. Lastly, as described above, ETFs can provide a possible means of addressing the superficial loss rules.

U.S. ETF Tax Advantages

As noted earlier, U.S. ETFs share some of the same tax-related advantages as Canadian ETFs. In summary, U.S. ETFs rarely will generate taxable gains to meet in-kind redemption requests, and capital gains dividends paid to Canadian residents are not subject to withholding tax.

While Canadian and U.S. ETFs trade much less than other open-end mutual funds, they may still pass along capital gains to shareholders from time to time. For example, the makeup of securities in an index may change, which prompts sales resulting in potential gains.[22]

[22] A further potential disadvantage may arise from the fact that a recently launched ETF is unlikely to have net capital losses to carry forward in order to offset capital gains for tax purposes.

Of course, while tax considerations are important, the ultimate return from an investment in ETFs will depend upon a number of factors, including the performance of the relevant index, fund expenses, transaction costs and other factors.

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Appendix 1

Capital Tax Implications of Investing in ETFs

Corporations are subject to federal and provincial capital tax.[23]

Corporations that are not Financial Institutions

Federally, large corporations tax applies at a rate of 0.225%[24]. The tax is based on the amount of a corporation's taxable capital that is generally equal to the sum of shareholders' equity and debt less an investment allowance that includes shares and debt of other corporations. The provincial capital tax rates vary by province from 0.25% to 0.60%.[25] The provincial computations are similar, based on the amount of a corporation's capital less an allowance for eligible investments, which includes shares and debt of other corporations.

While a share in another corporation is an eligible investment for federal and provincial capital tax purposes, an interest in a trust is not. Therefore, an investment in a Canadian ETF structured as a mutual fund trust or a US ETF structured as trust is not an eligible investment for capital tax purposes. An investment in a US ETF structured as a corporation *would* be eligible, because the investment is a share of a corporation.

See Appendix 5 for a listing of which Barclay's U.S. ETFs are Delaware business trusts and which are Maryland corporations.

Corporations that are Financial Institutions

Financial institutions are subject to different capital tax rules. An investment in any of the ETFs described above, including those that are structured as corporations, would not be eligible investments for a financial institution.

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[23] Both resident and non-resident corporations can be subject to capital tax. This appendix addresses Canadian resident corporations only.

[24] The large corporations tax rate will be gradually reduced in the next few years, with the tax being fully eliminated in 2008. The large corporations tax rate in each of the next 4 years will be as follows: 2004 – 0.2%; 2005 – 0.175%; 2006; 0.125%; 2007 – 0.0625%.

[25] Alberta, British Columbia, Newfoundland and Labrador, and Prince Edward Island do not levy capital tax.

Appendix 2

US Withholding Tax Implications for Tax –Exempts holding ETFs

The US withholding tax implications for Canadian pension plans and other tax-exempt investors differ depending on whether the investor holds a Canadian or US ETF. If the investor holds a Canadian ETF, there is no US withholding tax in respect of distributions made by the ETF. However, the Canadian ETF would be subject to US withholding tax in respect of the dividends and interest it receives from the US securities that it owns.[26] The tax-exempt investor in the ETF would indirectly bear this tax and could not recover it.[27]

In contrast, pension plans, retirement and employee benefit plans that own US securities directly (or through a trust established exclusively for them) would be exempt from US withholding tax on interest and dividends by virtue of the Canada-US tax treaty.[28] In addition, the treaty exempts from US withholding tax income derived by Canadian religious, scientific, literary, educational or charitable organizations but only to the extent that the income is exempt from tax in Canada.[29]

A pension plan or other tax-exempt investor that receives a dividend from a US ETF structured as either a Delaware business trust or a Maryland corporation may not be subject to US withholding tax in respect of the dividend if Article XXI of the treaty applies, as described above.[30]

See Appendix 5 for a listing of which Barclays U.S. ETFs are Delaware business trusts and which are Maryland corporations.

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[26] This assumes that the Canadian ETF's investors are a mix of taxable and non-taxable investors and consequently Article XXI of the Canada-US Treaty does not apply. See later discussion regarding this article.

[27] See IRS Private Ruling 200035027. The Canadian ETF could flow through the US tax to its investors which may permit them to claim a foreign tax credit in respect of the tax. However, because a tax-exempt investor pays no Canadian tax, a foreign tax credit will not be available.

[28] Paragraph 2(a) of Article XXI. Paragraph 2(b) of Article XXI exempts from tax a trust operated exclusively to earn income for pension, retirement and employee benefit plans.

[29] Paragraph 1 of Article XXI.

[30] Delaware business trusts have obtained IRS rulings recognizing them as partnerships for U.S. federal income tax purposes. However, a Delaware business trust that elects to be treated as a Registered Investment Corporation ("RIC") would be treated as a corporation for U.S. tax purposes instead of a partnership. All of the Barclays U.S. ETFs (iShares) that are Delaware business trusts are RICs. A pension plan or other tax-exempt investor that qualifies under Article XXI, paragraph 2(a) and (b) of the Treaty that owns an interest in the fund should not, assuming the Delaware business trust qualifies as a RIC, be subject to withholding tax on the distributions from the trust.

Appendix 3

An ETF Capital Gains Advantage for Insurance Companies and Other Financial Institutions

Holding Canadian ETFs can be particularly advantageous for insurance companies and other financial institutions ("FIs") compared to a direct investment in shares. The reason is that a financial institution may be able to record capital gains in respect of its investment in an ETF whereas it would be required to record ordinary income in respect of direct share investments. Earning capital gains is preferable because only 50% of capital gains are taxable. Moreover, the FI would not be required to recognize such gains until they are realized.

The Tax Act contains special rules that require FIs to "mark-to-market" their investments in certain types of property at the end of each year.[31] The FI is deemed to have disposed of its property for proceeds equal to its fair market value and any resulting gains or losses are treated as ordinary income or losses for income tax purposes. In addition, any actual dispositions of property throughout the year will similarly give rise to ordinary income or losses. The kinds of property affected by these rules include shares but not units of a Canadian ETF that qualifies as a mutual fund trust. All of BGI Canada's Canadian iUnits are mutual fund trusts.

An FI may earn capital gains in respect of its investment in a Canadian ETF in two ways: on the disposition of ETF units or through ETF distributions. Because an FI is not required to mark-to-market its ETF units, any gain arising on the disposition of the units will be a capital gain provided the facts relating to the disposition support this characterization. The facts to consider in making this determination include the period of ownership, the intention to earn a return from holding the investment, the number and frequency of transactions.[32]

Where an FI receives a distribution from an ETF that is designated as a taxable capital gain by the ETF, the FI would record a taxable capital gain equal to the amount of the taxable capital gains distribution paid by an ETF. In this situation, the tax rules would deem such a designated amount to be a taxable capital gain to the FI.[33] A recent technical interpretation from the Canada Customs & Revenue Agency has confirmed this.[34]

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[31] See sections 142.2 to 142.6.
[32] See IT-479R Transactions in Securities.
[33] Subsection 104(21).
[34] See Technical Interpretation 1999-01243A, April 17, 2002.

Where an FI owns units of a US ETF, its ability to record capital gains in respect of the investment will depend on whether the US ETF is legally structured as a corporation or trust. If the US ETF is a corporation, the FI will be required to apply the mark-to-market rules, described above, to the investment. However, if the US ETF is a trust, the FI may be able to record capital gains on the disposition of the US ETF units, provided the facts support this characterization.

Moreover, if financial institutions do not own more than 50% of the value of the US ETF, there is another potential advantage. Although the US ETF would not be taxable in Canada, this has relevance for determining the amount of a distribution received by an FI that must be included in its income. The FI would not be able to receive capital gains distributions from the US ETF because the rules that allow ETFs to designate part of their distributions as taxable capital gains only applies to Canadian ETFs.[35] Despite this, an FI that receives a distribution from a US ETF that is a trust would include in its income the portion of the distribution that would be the US ETF's income if it calculated its income under Canadian tax rules.[36] As a result, if the US ETF distributes an amount that represents capital gains earned by the trust, the FI may be entitled to include only 50% of the distribution in its income. However, in most cases, it will not be possible in practice to gather the necessary information to support a claim for the preferred rate for capital gains in Canada.

[35] Supra footnote 27.
[36] Subsection 104(13) and section 250.1.

Appendix 4

ETF Advantage for Investment Corporations and Pooled Funds

Investment corporations[37] are required to meet certain investment requirements one of which is that at least 80% of their property must consist of shares, bonds, marketable securities or cash. Some pooled funds are subject to a similar requirement.[38] ETFs are a permitted investment for these entities whereas traditional mutual funds are not. ETFs are marketable securities because they are listed on an exchange. The Canada Customs & Revenue Agency has expressed the view that a traditional mutual fund may not be a marketable security because it is not listed on an exchange.

[37] As defined by subsection 130(3) of the Tax Act.
[38] Such as pooled funds registered under paragraph 204.4(2)(a) of the Tax Act.

Appendix 5

Structure of Barclays Global Investors' ETFs

All of Barclays Global Investors Canadian iUnits exchange traded funds are Canadian mutual fund trusts.

All of Barclays Global Investors iShares exchange-traded funds are Delaware Business Trusts, with the exception of the following funds, which are all Maryland Corporations:

Fund Name		**Symbol**	**Maryland Corporation**
iShares	MSCI Australia Index Fund	EWA	x
iShares	MSCI Austria Index Fund	EWO	x
iShares	MSCI Belgium Index Fund	EWK	x
iShares	MSCI Brazil Index Fund	EWZ	x
iShares	MSCI Canada Index Fund	EWC	x
iShares	MSCI EMU Index Fund	EZU	x
iShares	MSCI France Index Fund	EWQ	x
iShares	MSCI Germany Index Fund	EWG	x
iShares	MSCI Hong Kong Index Fund	EWH	x
iShares	MSCI Italy Index Fund	EWI	x
iShares	MSCI Japan Index Fund	EWJ	x
iShares	MSCI Malaysia Index Fund	EWM	x
iShares	MSCI Mexico Index Fund	EWW	x
iShares	MSCI Netherlands Index Fund	EWN	x
iShares	MSCI Pacific ex-Japan Index Fund	EPP	x
iShares	MSCI Singapore Index Fund	EWS	x
iShares	MSCI South Korea Index Fund	EWY	x
iShares	MSCI Spain Index Fund	EWP	x
iShares	MSCI Sweden Index Fund	EWD	x
iShares	MSCI Switzerland Index Fund	EWL	x
iShares	MSCI Taiwan Index Fund	EWT	x
iShares	MSCI United Kingdom Index Fund	EWU	x