Invesco PowerShares

Exchange-Traded Funds

Tax Advantages for Shareholders

Taxes may be the most overlooked and critical factor in wealth creation. Exchange-traded funds (ETFs) – when compared with mutual funds – offer tax efficiencies because of their unique product structure. Structural differences between a mutual fund and an ETF can significantly affect the taxable capital gain distribution.

What does this mean for shareholders? The unique structure of ETFs may allow them to substantially decrease or possibly avoid capital gain distributions. Shareholders of ETFs can expect to defer some, most and possibly all capital gains until they sell their shares.

- ETFs may create and redeem shares with in-kind transactions that aren't considered sales and therefore don't create tax events.
- ETFs offer greater tax efficiencies than mutual funds because the structure of ETFs allows them to substantially decrease or possibly avoid capital gain distributions.

Tax Overview of ETFs

An ETF's ability to significantly decrease or possibly avoid capital gain distributions stems from two unique traits:

- Unlike mutual funds, shares of ETFs are traded on an exchange in the secondary market, just like a stock. When one investor sells ETF shares and another investor buys them on the exchange, the underlying securities of the ETF don't need to be sold in order to raise cash for the redemption.
- An in-kind redemption process enables the fund manager to purge the lowest cost-basis stocks through stock transfers during the creation and redemption process.

The result may be greater tax efficiency because shareholder activity and the resulting portfolio turnover don't affect the portfolio to the same extent as with mutual funds. These traits can also mean a substantial difference in the after-tax rate of returns from a mutual fund versus an ETF – even if they both replicate the same underlying index. Understanding the structural differences between ETFs and mutual funds helps shareholders understand how tax treatment differs for each type of investment.

How Shares are Created and Redeemed

This discussion assumes that both the mutual fund and the ETF track the same underlying index to eliminate as many extraneous differences as possible.

Mutual Funds

When an investor purchases mutual fund shares, the mutual fund creates new shares by using the investor's capital to buy the appropriate number of shares in the fund's constituent stocks. When the investor decides to redeem his investment, fund shares are sent to the fund, which redeems them. The fund may have to sell the appropriate number of shares in the constituent stocks to be able to send the cash to the redeeming investor.

Shares are not individually redeemable and owners of the shares may acquire those shares from the Fund and tender those Shares for redemption to the Fund in Creation Unit aggregations only, typically consisting of 100,000 shares.

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ETFs
There are two types of investors in an ETF. The first type, known as authorized participants (APs), holds large blocks of fund shares called creation units. Generally, a creation unit is 100,000 shares. The second shareholder type includes those holding fewer shares than the number in a creation unit.

An AP wishing to acquire a creation unit sends the fund a "basket" containing appropriate numbers of constituent stocks. The fund then creates the necessary number of fund shares for the AP. Unlike a mutual fund investor, an AP does not send cash to the fund. This exchange of the basket of stocks for fund shares is called an "in-kind" transaction.

When an AP wants to redeem fund shares – again, only in blocks of a creation unit's worth of fund shares – the fund delivers a basket containing appropriate numbers of shares in the constituent stocks to the AP. Unlike a mutual fund, the ETF doesn't sell stocks for cash to pay the redeeming shareholder. Redemption is also completed through an in-kind transaction.

When a smaller investor wants to invest in the ETF, he simply buys the ETF shares from another shareholder in the exchange where the ETF is listed. When this occurs, no new fund shares are created. Conversely, when the investor no longer wants the investment, the shares are sold on the exchange. No new shares are created – and no existing shares are redeemed – during these trades. The shares simply change hands like other stocks trading in the secondary market.

Tax Events
A tax event for an investor or a fund occurs when a stock has been bought and subsequently sold or sold short and subsequently bought. Since this article concerns funds that carry no short positions, the discussion below focuses on a buy followed by a sell.

Shareholder Redemption
A mutual fund sells stocks – creating a tax event – under three circumstances:

1. **Shareholder redemption.** When a shareholder wishes to redeem fund shares, the fund may have to sell the appropriate numbers of shares of the constituent stocks. In practice, several investors may buy fund shares, while several others redeem fund shares, on the same day.
   - A net cash flow occurs when the total number of fund shares created by entering shareholders exceeds the total number of fund shares redeemed by exiting shareholders. A net cash flow results in the fund purchasing shares of constituent stocks.
   - Conversely, a net redemption occurs when the total number of fund shares redeemed by shareholders exceeds the total number of fund shares by entering shareholders. A net redemption may result in the fund having to sell shares of constituent stocks.

2. **Portfolio turnover.** The fund's underlying index generally experiences turnover in constituent stocks or changes in the weighting of each constituent stock.
   - The index is rebalanced when stocks are added or removed and sold.
   - It is rebalanced when the relative weightings of constituent stocks change. Rebalancing results in the fund buying additional shares of the stocks that acquire more weighting and selling shares of stocks that lose weighting.

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3. **Corporate actions.** These include stock splits, acquisitions and similar events. For example, an acquisition may force a sale of stock when the fund holds 100 shares of Alpha. If Beta acquires Alpha for a one-to-one exchange, the fund now has 100 shares of Beta. But, if the fund's underlying index does not include Beta as one of its constituents, the index rules may require the disposition of the shares of Beta, thus creating a sale.

Understanding tax treatment of stock sales requires understanding how "lots" work. To illustrate, a fund experiences net creations on three consecutive days, requiring the purchase of 100 shares of Zeta on each day at the respective prices of $20, $22 and $24. On the fourth day, a net redemption occurs, requiring the sale of 100 shares of Zeta at $27. What is the taxable gain recorded by the fund?

Most funds recognize that if the sale is matched with the first lot at a purchase price – also called the "basis" – of $20, the taxable gain is $700 (100 times the difference between $27 and $20). If the sale is matched with the last lot with the basis of $24, the taxable gain is only $300 (100 times the difference between $27 and $24). Since this gain has to be distributed to the fund's shareholders – who have to pay taxes on the gain – the fund generally prefers to match the sale with the lot with the highest basis to record the lowest taxable gain.

Although the fund generally maintains the average basis at as low a level as possible, a sale resulting from rebalancing, reconstitution or corporate action raises the taxable gain recorded because the lower basis lots are matched with the sale.

ETFs

Tax treatment of stock sales in an ETF differs from stock sales in a mutual fund.

- Shareholder redemption. As previously discussed, a small shareholder can dispose of fund shares without affecting trades at the ETF level. Redemptions at the ETF level occur when an AP redeems fund shares. The ETF hands over a basket of stocks in an in-kind transaction but doesn't sell stock. Since in-kind transactions aren't considered sales, redemptions aren't considered tax events. As a result, the tax implications of selling stocks at the ETF level and recording capital gains for mutual funds don't apply to ETFs.
- Lot accounting. ETFs and mutual funds account for lots in opposite ways. To illustrate, 100 shares of Beta are acquired by an ETF – not bought, but received as an in-kind transaction – on three consecutive net-creation days, with basis prices of $20, $22 and $24. On the fourth day, the ETF delivers 100 shares as an in-kind transaction. Since no tax event occurs, the 100 shares disposed of don't have to be matched with the highest basis lot. In fact, the matching will be made with the lowest basis lot. This means that over a period of time of creations and redemptions, the average cost basis of the holdings in any stock will be as high as possible.

It is possible that such forced sales can result in losses if the current market price is below a certain tax lot's purchase price, creating an embedded loss in the ETF that can be carried forward to offset future gains. Within an ETF, these losses will be as high as possible, reducing the likelihood of future capital gain distributions. In a comparable mutual fund, such losses would be as low as possible because of lot-matching, which results in the average basis being as low as possible. This creates a smaller embedded loss in the mutual fund and increases the likelihood of future capital gain distributions.
Net distributable taxable gain is the net amount of these gains and losses. Typically, a mutual fund nets high gains and low losses, while an ETF nets low gains and high losses. As a result, an ETF may record and distribute few or no capital gains to its shareholders, while a comparable mutual fund does the opposite.

Beta is a measure of relative risk and is the slope of regression. Alpha is a measure of performance on a risk-adjusted basis.

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The bottom line for shareholders? Differences between how ETFs and mutual funds distribute capital gains affect shareholders in these ways:

- Redemptions can create tax events in a mutual fund, but they may not create no tax events in an ETF.
- When a forced sale of stock occurs, mutual funds may record and distribute a higher level of capital gains than an ETF.
- These differences may substantially affect the overall rate of return, even if both the mutual fund and ETF replicate the same underlying index.

Important Disclosures

There are risks involved with investing in ETFs, including possible loss of money. Index-based ETFs are not actively managed. Actively managed ETFs do not necessarily seek to replicate the performance of a specified index. Both index-based and actively managed ETFs are subject to risk similar to stocks, including those related to short selling and margin maintenance.

ETFs are not a tax shelter, and their structure was not designed with tax benefits as the objective. If you buy a share of an ETF and then sell it at a higher price, you owe taxes on the gain. ETFs do not reduce these taxes but merely minimize or remove the distortions embedded in the mutual fund structure.

This discussion is for informational purposes only and should not be regarded as tax advice. Each shareholder is urged to consult with his/her tax advisor. Note that a shareholder buying shares of an ETF and selling them later at a higher price is subject to taxation on the gains from these secondary market trades, just as a purchase and sale of any other stock is taxable.

Invesco PowerShares may engage in active and frequent trading of its portfolio securities, which could result in an increase in taxable capital gains distributions to shareholders, as well as higher brokerage costs. Dividends from net investment income, if any, are taxable as ordinary income.

Like any investment, ETFs have risks. These include the general risks associated with investing in securities, potential tracking error and the possibility that particular indexes may lag other market segments or active managers.

Invesco PowerShares Capital Management LLC makes every effort to use reliable, comprehensive information, but the Company makes no representation that it is accurate or complete.

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An investor should consider the funds' investment objectives, risks, charges and expenses carefully before investing. For a copy of the prospectus, which contains this and other information about the fund, call 800 983 0903 or visit invescopowershares.com. Please read the prospectus carefully before investing.

Note: Not all products, materials or services available at all firms. Advisors, please contact your home office.

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