Precise in a world that isn't.

The Role of SPDR® ETFs in a Tax Efficient Portfolio

The Benefits of ETFs to the Tax-aware Investor

REDUCED TAX BITE AND TAX DEFFERALS

Investors can seek to minimise the impact of capital gains taxes by choosing tax-efficient investment products and keeping an eye on investment costs. Among their many advantages—intraday liquidity, transparency and ease of use—exchange traded funds (ETFs) are highly touted for their tax efficiency and low cost. (Note that tax efficiency refers to how well an investment minimises an investors' taxes while they own it.)

First and foremost, ETFs typically generate fewer capital gains distributions than unlisted funds for two reasons:

- **Low portfolio turnover:** Because they track an index, ETFs tend to have lower turnover than actively managed unlisted funds, thereby reducing the potential for capital gains distributions.

- **Secondary market transactions:** Unlike unlisted funds, when ETF investors sell their units, portfolio managers do not need to sell securities to raise cash for the redemptions. So, unlike traditional unlisted funds, one ETF investor's sell decision has no impact on other investors and capital gains distributions are kept low. These distributions, taxable to all investors, regardless of how long they have owned the fund, can result in a capital gains tax bill, even in years when the unlisted fund registers a loss.

The unique structure of ETFs gives tax-aware investors a chance to minimise capital gains distributions and allow for more assets to remain invested – increasing the growth potential of the investment.

THE ADVANTAGE OF DIVIDEND IMPUTATION AND FRANKING CREDITS

The dividend imputation system in Australia can represent an important advantage for investors over the dividend taxation schemes found in other countries because it essentially eliminates the double taxation of corporate profits in Australia. If Australian corporate taxes have already been paid on dividend distributions those taxes need not be paid again at the personal level by investors. The corporate taxes paid are attributed, or imputed, to the Australian investor through tax credits called franking credits. These franking credits can be used to reduce an investor's total tax liability to account for the taxes on dividends already paid by companies. For investors which are individuals or complying superannuation entities, any excess franking credits can also be refunded at the end of the year if the investor's tax liability is less than the amount of the franking credits. In effect, any dividends investors receive will only be taxed at their respective marginal tax rates.[1]

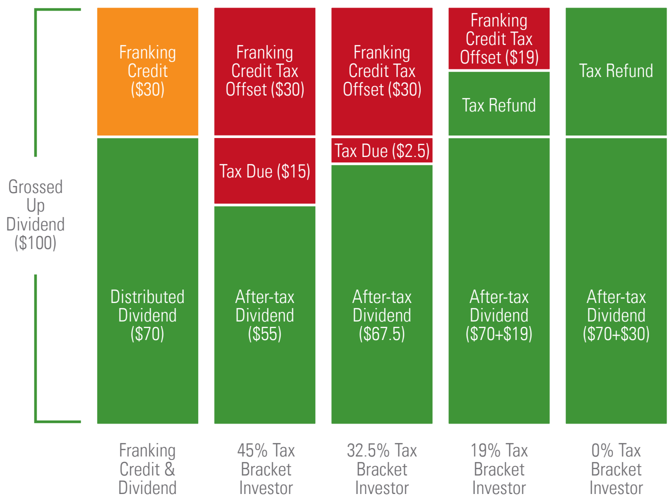
Let's look at an example to illustrate. ABC Corporation makes $1.00 per share in pre-tax profit during a given period and would like to pay it all out in the form of dividends. After paying the 30% corporate tax, ABC distributes $0.70 per share in fully franked dividends. To the Australian investor, this is equivalent to being paid an unfranked, "grossed up" dividend of $1.00 per share. The 30% corporate taxes already paid will accompany the dividend in the form of a $0.30 per share franking credit and act similar to an "IOU" from the tax office.[1]

From this we can see that:

Dividend + Franking Credit = Grossed Up Dividend

The taxpayer must now pay the appropriate level of tax on the grossed up dividend less any franking credit. In other words, the franking credit can be used to offset taxes due on the dividend (for 45% and 32.5% marginal tax rate investor) or entitle the investor to a tax refund (19% and 0% marginal tax rate investor). An investor with 0% taxes due will be entitled to receive the entire franking credit back as a tax refund. (See Figure 1 for example involving 100 shares of ABC.)

FIGURE 1: FULLY FRANKED DIVIDEND AT VARYING TAX RATES



Note: Table ignores medicare levy & flood levy if applicable.
Source: PWC and SSgA, as of 31 December 2013.

In countries without a tax imputation system, investors could have to pay personal taxes on top of corporate taxes already paid, i.e. corporate profits may be double taxed at the corporate as well as personal level.

UNDERSTANDING DIVIDENDS AND FRANKING CREDITS FOR THE AUSTRALIAN INVESTOR

A company that pays all its income tax domestically in Australia will usually pay a fully franked dividend, i.e. a dividend with a franking proportion of 100%. However, some companies' franking proportions can be less than 100%, especially for companies paying taxes outside of Australia. Other companies that do not pay any Australian tax, and have no franking credits from prior years available to roll forward, may pay an unfranked dividend. The franking proportion of a stock will therefore have a material effect on after-tax returns making it an important issue for all investors to consider.

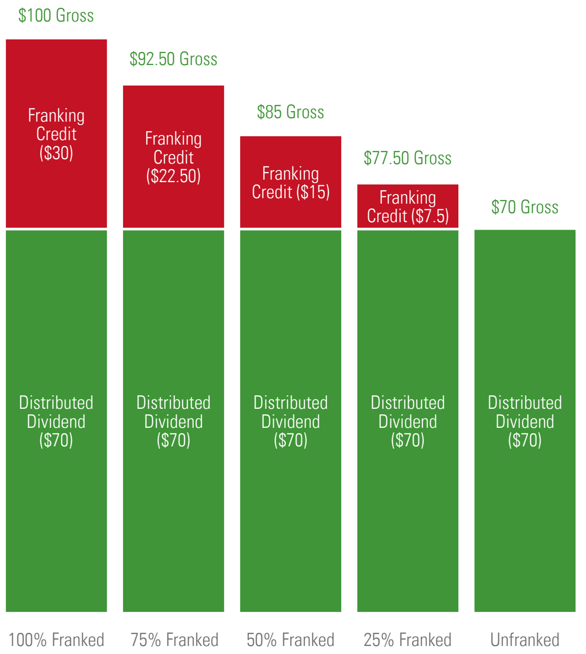
Let's look at another example that compares 100 shares of ABC for varying levels of proportional franking (see Figure 2). Before we can compare proportionally franked dividends we must first gross them up according to the following formulas:[2]

Franking Credit = Franking Proportion × Dividend × (t ÷ (1 – t))
where t = corporate tax rate

Then, as before:

Grossed Up Dividend = Franking Credit + Dividend

FIGURE 2: PROPORTIONALLY FRANKED DIVIDENDS



Source: PWC and SSgA, as of 31 December 2013.

FRANKING PROPORTION	DIVIDEND	t ÷ (1 -t)	FRANKING CREDIT	GROSSED UP DIVIDEND
100%	$70.00	0.3 ÷ (1 - 0.3)	$30.00	$100.00
75%	$70.00	0.3 ÷ (1 - 0.3)	$22.50	$92.50
50%	$70.00	0.3 ÷ (1 - 0.3)	$15.00	$85.00
25%	$70.00	0.3 ÷ (1 - 0.3)	$7.50	$77.50
0%	$70.00	0.3 ÷ (1 - 0.3)	$0.00	$70.00

Generally speaking, a higher franking proportion will mean a higher after-tax return on the $70 dividend for investors.

FRANKING CREDITS AND ETFS

Equity-based ETFs represent a basket of multiple companies that pay varying levels of dividends, at varying levels of franking proportions. Investors holding Australian ETFs on and around the distribution dates (which can be quarterly or semiannually for example, month end June and December) could receive valuable franking credits along with any distributions they receive.[3]

As an example at 31 December 2013, the SPDR® S&P®/ASX 200 Fund (ASX : STW) distributed $1.25 per units in dividends, 90% of which were franked at a rate of 31.1%.[4] Using the formulas for grossing up dividends, we can see that the dividend may also be accompanied by $0.51cents per units of franking credits. We also know that the $1.25 partially franked dividend may be equivalent to a $1.76 in unfranked dividends.

Foreign tax credits may also be applicable to further increase the after-tax value of the dividend. In order to assess the requirements and precise impact of these and other tax issues please consult your tax adviser.

TAX-FREE DISTRIBUTIONS

Under the capital gains tax (CGT) discount rules, certain tax breaks are available to ETF investors. Specifically, a percentage of the distributions received as a realised gain may be tax-free. Depending on individual situations, ETF investors may be eligible to receive up to half of their realised gains tax-free. Please speak to your adviser or accountant to learn more about how the benefits of ETFs may apply to your individual investments.

ABOUT SPDR ETFS

Offered by State Street Global Advisors, SPDR ETFs are a family of exchange traded funds that provide investors with the flexibility to select investments that are precisely aligned to their investment strategy. Recognized as an industry pioneer, State Street Global Advisors created the first ever ETF in 1993—the SPDR S&P 500®, which is currently the world's largest ETF. In 2001, SSgA introduced ETFs in Australia when it launched the SPDR S&P/ASX 200 Fund. Currently, State Street Global Advisors manages approximately US$413.6 billion of ETF assets worldwide.[1]

For comprehensive information on our ETFs, visit us at spdrs.com.au.

SALES AND MARKETING

For more information about our ETFs or how to invest, please call +612 92407600 or email info@spdrs.com.au.

[1] As of December 31, 2013. This AUM includes the assets of the SPDR Gold Trust (approx. $30.8 billion, as of December 31, 2013), for which an affiliate of State Street Global Advisors serves as marketing agent.

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[1] Australian Government: Australian Taxation Office, as of 31 December 2013.

[2] Taken in one step: Grossed Up Dividend = Dividend × (1 + Franking Proportion × (t ÷ (1 – t)))

[3] There are additional requirements that must be fulfilled in order to receive franking credits. Please consult your tax advisor.

[4] As the ETFs are unit trusts, it may offset expenses against the cash amount of franked dividends which can result in franking credits in excess of the 30% corporate tax rate.

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IMPORTANT RISK INFORMATION

All currency is in Australian dollars, unless otherwise stated.

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ETFs trade like stocks, are subject to investment risk, fluctuate in market value and may trade at prices above or below the ETFs net asset value. Brokerage commissions and ETF expenses will reduce returns.

These investments may have difficulty in liquidating an investment position without taking a significant discount from current market value, which can be a significant problem with certain lightly traded securities. Diversification does not ensure a profit or guarantee against loss.

Passive management and the creation/redemption process can help minimise capital gains distributions. Frequent trading of ETFs could significantly increase commissions and other costs such that they may offset any savings from low fees or costs.

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