ETF taxation report for investors 2019

Japan

Commissioned by:

HKEX
香港交易所

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Introduction

Exchange Traded Funds (ETFs) continue to gain popularity by investors as an efficient mechanism to gain a broad array of desired market access. Whilst return on investment (ROI) is a key priority, costs play an important role in maximizing ROI. One significant yet lesser understood cost with investing in ETFs is taxation. This is especially true for any cross-border investment which are normally subject to multiple instances of taxation.

In this report we will examine the impact of different types of ETFs on Japan based investor returns across key markets, ETF types and domiciles.

Multiple instances of taxation on ETFs

An investor's ETF returns can generally be subject to tax at three levels:

Investment

- Withholding tax (WHT) on interests, dividends and capital gain
- Stamp duty/transaction taxes on investments

ETF

- Taxation of the fund (if any)
- WHT on distributions by the fund

Investor

- Taxation of the investor
  - Tax on income, capital gains, estate tax, etc.
  - Dependent on investor profile
- Availability of foreign tax credits

The extent of tax costs will vary widely depending on:

1. Domicile of the investor
2. Domicile and type of ETF*
3. Jurisdiction of the underlying portfolio investments

* Especially important because this should have an impact on the following:

- The applicable WHT rate at both the investment and investor levels
- The applicable taxes at the fund level
- Access to any available tax treaty benefits

Types of ETFs compared

Common forms of ETFs compared in this report include the following:

- Hong Kong domiciled fund, listed on the HKEX
- Irish Collective Asset-management Vehicle (ICAV) authorized as an Undertaking for Collective Investment in Transferable Securities (UCIT)
- Luxembourg Société d'Investissement à Capital Variable (SICAV)/Société d'Investissement à Capital Fixe (SICAF)
- US Regulated Investment Company (RIC)
- Securities Investment Trust in Japan (Japan Fund)

Basis of analysis

1. General in nature
2. Only consider the impact of tax on dividend and interest income
3. Also important to consider the impact of tax on exit giving rise to capital gains and the availability of foreign tax credits

Assumptions

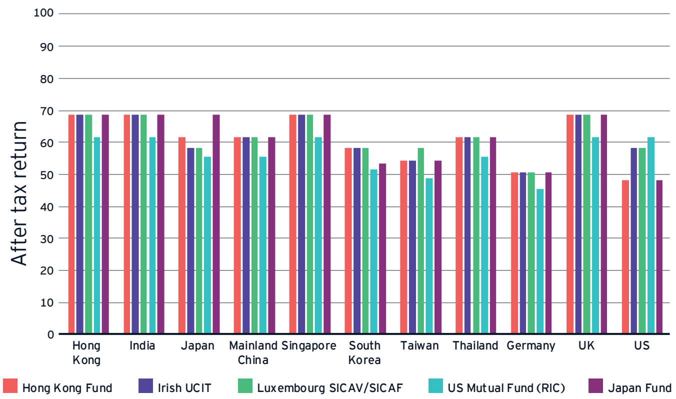
- The US ETF will qualify as a RIC for the relevant year and satisfy the relevant annual distribution requirements such that it should not be subject to US federal income tax on its investment company taxable income distributed to stockholders
- The Irish UCIT's principal class of shares is substantially and regularly traded on a recognized stock exchange
- All funds are eligible to enjoy the portfolio interest exemption in the US
- All investors are institutional corporate investors and tax residents in Japan**
- In making the comparison, it has been assumed that Japan Fund will not be able to obtain a certificate of residency for the purpose of enjoying tax treaty benefits **

** Ultimately, the ability to claim treaty benefits by Japan investor or the ETF will depend on their individual facts and circumstances, e.g., whether they can demonstrate to the local tax authority that they are the beneficial owners of such income. These requirements should be assessed in detail.

Japan investor after tax returns compared

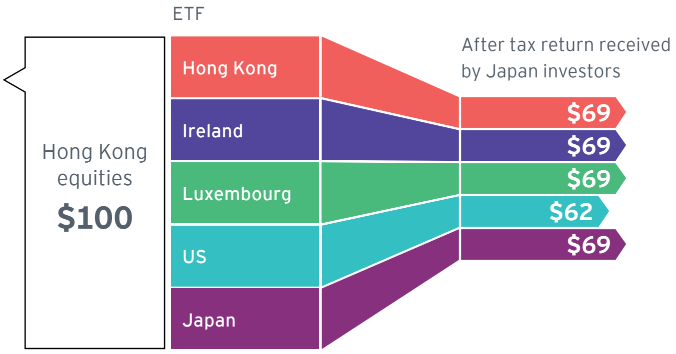
Figure 1. Dividends from equities

(The chart is for illustration purpose only.)



The German dividend withholding tax rate reflected above is the statutory withholding tax rate at source, i.e., 26.4%. A better outcome may be achieved where tax treaty relief can be availed.

Illustrative diagram for Hong Kong equities (Figure 1)



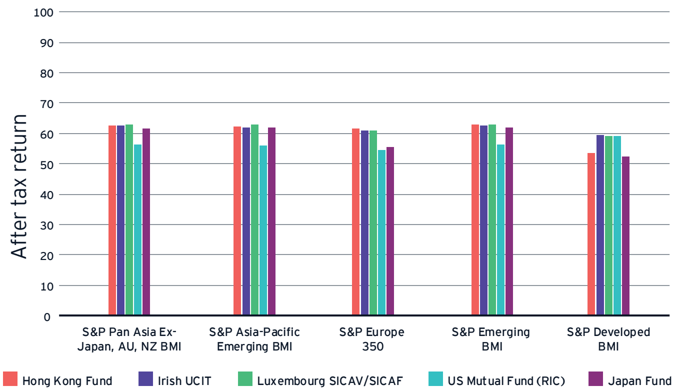
By investing in Hong Kong equities through a Hong Kong Fund, Japan investors would receive 69% after tax return for dividends versus 62% using an US Mutual Fund.

Key findings

In general, Hong Kong ETFs offer a tax efficient mechanism for Japan investors to access popular overseas markets. When investing into Japan equities and corporate bonds, Japan Fund should be more efficient. Also, when investing into US equities, certain other platforms could be more tax efficient.

Figure 2. Dividends from indices

(The chart is for illustration purpose only.)



Based on index constituents' jurisdiction domicile as of 31 December 2018

Conclusion

Hong Kong domiciled ETFs have traditionally been recognized for their unique access to the domestic market of Mainland China. However, with the HKEX now carrying over 130 ETFs[1] representing a wide range of global markets, investors now have an enhanced ability to use Hong Kong ETFs to achieve their desired market exposures.

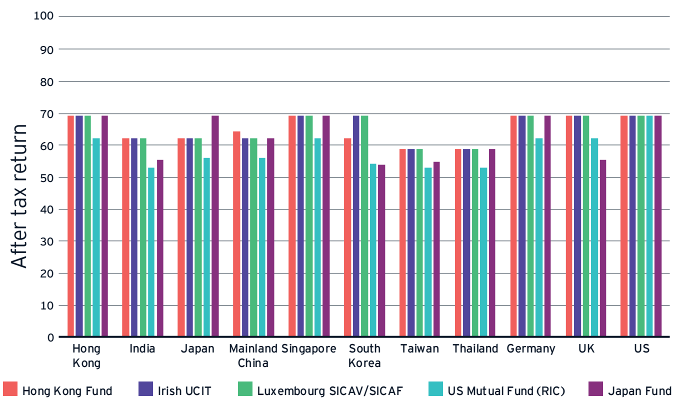
Furthermore, Hong Kong's expanding treaty network and domestic tax rules offer significant benefits for Japan based investors seeking to invest via Hong Kong ETFs to gain exposure to other Asian and global markets.

Japan investors should however be aware of the potential costs of investing into certain markets through a Hong Kong domiciled fund, such as the US.

1. Source: HKEX official webpage (March 2019)

Figure 3. Interest from corporate bonds

(The chart is for illustration purpose only.)



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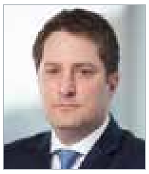

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