Horizons HXT ETF

Jamie Golombek & Debbie Pearl-Weinberg
Tax & Estate Planning, CIBC Financial Planning and Advice

In the search for tax-efficient investments, there are two main characteristics to consider: the nature of the return you're getting (interest income, dividends, or capital gains) and when you have to pay tax on it.

In a perfect world, all of your returns would come in the form of capital gains, which are taxed at 50% of your marginal tax rate. Capital gains are more tax favourable than interest income and foreign income. For those in higher marginal tax brackets, capital gains are also more favourable than eligible Canadian dividends, even after the dividend tax credit.

And, while no one wants to pay any tax, it's far better to defer tax until some period in the future than pay tax today, allowing gains to compound pre-tax.

The Horizons HXT ETF ("HXT") which builds upon the characteristics that investors already love about ETFs (low cost, low tracking error, and intraday liquidity) may also provide an element of tax-efficiency.

HXT offers exposure to the total return of the S&P/TSX60 Index (the "Index"), a measure of the performance of the large-cap market segment of the Canadian equity market. It is also the least expensive ETF in Canada, with a current[1] effective management fee of only 0.03%. Furthermore, HXT's unique structure provides a lower tracking error and greater after-tax performance than other Canadian index ETFs.

How does HXT work?

Rather than investing directly in the underlying securities of the Index, as would a typical index fund that's attempting to replicate an index, HXT instead replicates the return by entering into a total return swap agreement with two bank counterparties, under which the bank counterparties agree to pay HXT the total return of the Index. Because HXT does not physically hold the Index securities, it is never in receipt of dividends paid on those securities. Instead, the value of the dividends is factored into the return HXT is entitled to under the swap agreement, rather than resulting in dividend income to HXT which would otherwise be potentially payable to unitholders. This increases HXT's Net Asset Value (NAV), and therefore an investor's unrealized gain, by the amount of the dividends that would have been received had the securities been held directly by HXT. When investors dispose of their HXT units, they will realize the total return of the Index, inclusive of these dividends, and that return should, in most circumstances, be treated as a capital gain at that time.

It is not expected that any income will be distributed to investors throughout the period they hold HXT units. HXT was established in September 2010, and to date, no distributions have been paid to investors.

The total return attributable to the index will not be realized for tax purposes by HXT, nor distributed to investors, until the swap is settled or matures. It is anticipated that this should only occur if liquidity is required to fund redemptions. In such a case, the gain or loss realized by HXT (including the portion of the profit attributable to dividends paid on underlying index securities) would be ordinary income to HXT, and subject to tax at the same rate as ordinary income. HXT allocates this income to those who choose to redeem their HXT units (vs. selling them in the open market on the exchange), and this income would be taxable in their hands.

Jamie.Golombek@cibc.com

Jamie Golombek, CPA, CA, CFP, CLU, TEP is the Managing Director, Tax & Estate Planning with CIBC Financial Planning and Advice in Toronto.

Debbie.Pearl-Weinberg@cibc.com

Debbie Pearl-Weinberg, LLB is Executive Director, Tax & Estate Planning, CIBC Financial Planning and Advice in Toronto

[1] MER as of March 1, 2018