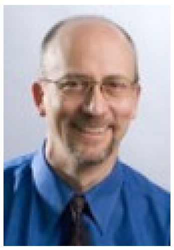
Beware The Tax Traps Of Commodity ETFs

By Keith Fitz-Gerald on November 18, 2009



Millions of investors who bought gold in the last 12 months are undoubtedly very happy at the moment – considering that the yellow metal has risen 60% since last November to a recent close of $1,138.60 an ounce on Monday.

But chances are good that many won't be smiling when they discover just what the taxman has planned for their gains.

Unbeknownst to most investors, gold is considered a collectible not a capital asset. In plain English, this means that despite the fact that many people believe they are *investing* in gold, the Internal Revenue Service (IRS) believes that they are *collecting* it.

This is no small distinction and hurts investors because it means that gold does not qualify for the 15% maximum tax bite that most of us employ as a matter of routine when we mentally calculate profits earned on investments held for more than a year. That 15% cut for Uncle Sam is the long-term capital gains tax rate that applies to most stock or mutual fund investments.

Precious metals are a completely different story. Profits from these "investments" can be subject to a 28% maximum tax rate if held for more than 12 months. And if they are sold in less than a year, the profits count as ordinary income.

The long and the short of it "is that as a result of gold's spectacular run-up, many investors may have a tax problem they haven't counted on when they go to sell," said Gary E. Ham Jr., of the Oregon-based accounting firm of Jones & Ham PC

This may be especially true for investors who have piled into such asset-backed, exchange-traded funds (ETFs) as the **SPDR Gold Trust** (GLD: 134.79 +0.67 +0.50%), the **iShares Silver Trust** (SLV: 28.78 +0.49 +1.73%) and the **iShares COMEX Gold Trust** (IAU: 13.50 +0.0625 +0.47%), for example, because precious-metals ETFs are set up as something called a "grantor trust." According to *Barron's*, ETF investors are treated as owning undivided interests in the actual metal that's owned by the fund. Therefore, when an investor sells shares in the ETF, the tax code treats that investor as having sold a share of the metal backing the fund.

Adding insult to injury, if the ETF sells some of its hard assets to pay expenses or management fees – as many have done recently, the resultant gains (or losses) flow directly through to investors and shareholders even if those investors don't receive any distribution or cash whatsoever.

And the net results can be mighty startling. For example, Doug Fabian, president of Fabian Wealth Strategies, a California-based investment advisor, noted several painful examples in an article on his firm's Web site about the tax traps of commodity ETFs, including:

- An investor who experienced a trading loss of $741 in the **United States Oil Fund LP** (USO: 38.60 +0.43 +1.13%) – with no interest received – but a K-1 tax form reporting a taxable profit of $9,136 and interest of $210.
- Another who had actual trading profits in the **United States Natural Gas Fund LP** (UNG) of $1,900, with no interest received, and a K-1 reporting taxable profits of $4,319 and $120 in interest.
- An investor who had an enviable trading profit of $4,335 in the **PowerShares DB Agriculture** (DBA: 32.147 +0.147 +0.46%), without receiving any interest – activity that triggered a K-1 form that reported profits of $6,963 and interest of $207.
- Finally, an investor who notched trading profits of $337 and no interest in the **PowerShares DB Commodity Index Tracking Fund** (DBC: 27.69 +0.25 +0.91%) triggered a K-1 listing profits of $3,406 and interest of $195.

K-1′s, in case you are not familiar with them, are tax forms used by partnerships, corporations and ETFs to report a partner or a shareholder's share of distributed profits and income. If you own one of the ETFs I've just mentioned, chances are you'll be getting one just after the New Year to file with your taxes.

Here's how this works.

Because the XYZ ETF does not pay income taxes itself, its profits are passed through to the actual owners – in this case, the shareholders, who must claim those profits as their own. If you own 50% of XYZ ETF, and XYZ files for a $100,000 profit in 2009, you'll receive a K-1 for 50% of the net profits – or $50,000 – which you then will have to claim on your personal 2009 income-tax return.

By the way, conventional gold and metals stocks – gold producers are a good potential example of what we mean – are treated "normally," so investors who have chosen to buy these more-traditional investment vehicles will escape these "unexpected" tax consequences.

If there is a moral to the story, it's that nothing is what it seems anymore – not even gold.

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Metals ETFs: Precious and Base

By Jonathan Bernstein, ETFzone.com Contributing Editor
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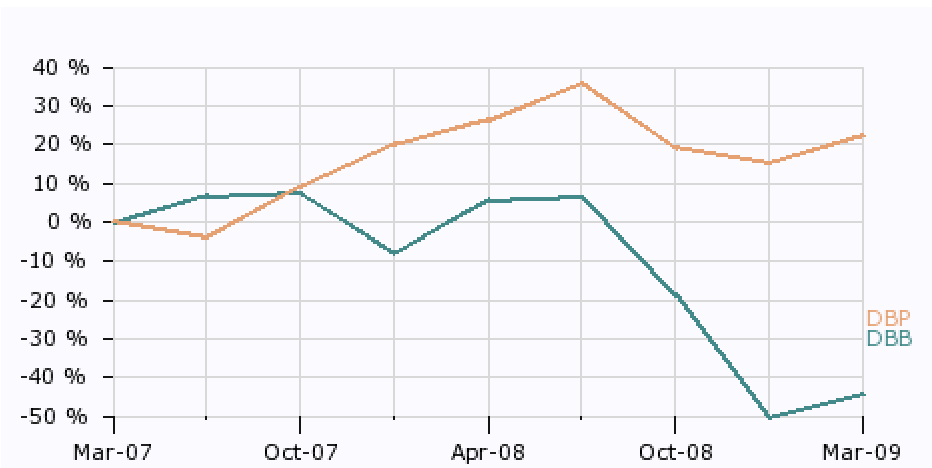
Investing in metals used to mean buying gold and silver bullion, gold Krugerrands and maybe American Silver Eagles. No longer: ETFs and ETNs offer easy access to both precious and base metals: gold, silver and platinum, copper, nickel, tin, even lead. These funds are compelling tools that have truly opened up a new horizon for investors.

Precious and base metals often demonstrate very different return and performance. Base metals tend to be highly cyclical and perform like basic materials such as oil, chemicals, or wood products. They tend to do well in a strong economy. Precious metals tend to be more counter-cyclical: popular with investors when things get tough, as a store of value in times of inflation and fear. The chart below confirms this phenomenon; it compares the chart of PowerShares DB Base Metals Fund ETF (NYSEArca:DBB), which has exposure to copper, aluminum and zinc with PowerShares DB Precious Metals Fund ETF (NYSEArca:DBP), which has exposure to gold and silver:



As the chart shows, precious metals fund DBP and base metals fund DBB parted ways in October 2008 as the financial crisis got underway.

Metals funds use three distinct strategies: ownership of the metal itself, ownership of futures contracts to buy the metal, and the ownership of a note to track the price of the metal. No strategy is perfect. All have advantages and disadvantages. Investors should consider fund liquidity, tracking error, counterparty risk, tax implications, and performance in times of market stress.

A good example of the direct ownership strategy is GoldShares (NYSEArca:GLD). The fund provides investors with advantages: a sense of security and a clear and unwavering sense of what is owned-- a physical commodity, a metal. Introduced in late 2004, GLD is the most established metals fund, holding close to 20 billion dollars invested in gold bullion. GLD has a modest expense ratio, 0.4% and competes with the iShares COMEX Gold Trust (NYSEArca:IAU). The iShares Silver Trust (NYSEArca:SLV) is similarly structured. It holds close to 4 billion dollars of silver bullion. Like the gold held in GLD and IAU, the silver owned by the SLV is the real stuff, bullion stored in the fund's custodian's vault, in the main London branch of J.P. Morgan Chase Bank.

Direct ownership of bullion is nice but has distinct disadvantages: storage fees and tax consequences. Whereas the long-term tax rate on stock is 15%, bullion trades are taxed by the IRS at the collectibles rate of 28%. It may not seem fair that the GLD and SLV look like stocks, trade like stocks and are about as collectible as any other ticker on your computer screen, but nonetheless are taxed so much higher. This is the consequence of owning a share of physical bullion stored in a physical vault.

An alternative to direct ownership of bullion is the ownership through futures contracts to buy bullion. PowerShares has a line of ETFs which take this tack. PowerShares DB Gold Fund ETF (NYSEArca:DGL) PowerShares DB Silver

Fund ETF (NYSEArca:DBS), PowerShares DB Precious Metals Fund ETF (NYSEArca:DBP) (80% gold, 20% silver), PowerShares DB Base Metals Fund ETF (NYSEArca:DBB) (holding contracts for copper, aluminum and zinc). Like other commodity products, this family of PowerShares ETFs is structured never to take delivery of the actual metal, so technically speaking no metal is owned. Instead, these ETFs roll over the contracts to buy the metal: before the contract comes due, the fund sells that contract and buys another near term contract. From a tax standpoint this can be an advantage to owning bullion because futures contracts are taxed at a lower maximum rate of 23%.

But there are disadvantages associated with this kind of ownership too. One problem for many investors is psychological: a futures contract is not the same as owning "the real thing:" there is no vault, no metal, only pieces of paper called futures contracts. A second and potentially far more serious problem with futures ownership will be familiar to ETF investors who follow United States Oil (NYSEArca:USO), which holds futures contracts on crude: the difficulty of accurately tracking the spot price. All this complexity means that these ETFs are far less popular. The market capitalization of the PowerShares funds put together for example is just a fraction of SLV.

In addition to the PowerShares funds there are several ETFs that use futures contracts to lever up, and increase metals exposure. These attempt to return double the movement of gold and silver and are available both the long and short side. These funds are the ProShares Ultra Gold ETF (NYSEArca:UGL), ProShares UltraShort Gold (NYSEArca:GLL), ProShares Ultra Silver (NYSEArca:AGQ), and ProShares UltraShort Silver (NYSEArca:ZSL).

A third general strategy involves exposure through notes or ETNs (Exchange Traded Notes). Until the recent market melt-down, the ETN was often thought to be a better mousetrap because its structure avoids many of the problems of other strategies. Because they are built to track an index and no securities ownership is prescribed, ETNs can be more flexible. Even better: ETNs are taxed at the same rate as stocks (15% for long term holdings), which beats the other strategies.

But ETNs do have one problem that ETFs-- whether they hold the metal itself or futures-- do not have: counterparty risk. ETNs are effectively promises made by their issuer. They are unsecured debt: promises to pay according to the performance of an index. A bank failure (or the threat of a bank failure) can cause these instruments to lose value independent of holdings, tracking error and how well the underlying index is performing.

The most diversified of the metals ETNs is the ELEMENTS Rogers International Commodity Metal ETN (NYSEArca:RJZ), which includes both precious and base metals. RJZ emphasizes aluminum, copper and gold but includes silver lead, zinc, platinum, nickel, etc. E-TRACS UBS Bloomberg CMCI Industrial Metals ETN (NYSEArca:UBM) provides exposure to five base metals, but is approximately 75% in copper and aluminum with smaller ratios of zinc, nickel and lead. The AIG Industrial Metals ETN (NYSEArca:JJM) is framed to track futures contracts of four metals: aluminum, nickel, zinc, and copper. MLCX Precious Metals ELEMENTS ETN (NYSEArca:PMY) holds a mix of gold, silver, platinum and palladium.

And then there are the many ETNs that reflect sub-indexes: iPath AIG Copper (NYSEArca: JJC), iPath DJ AIG Tin (NYSEArca:JJT), iPath DJ AIG Lead (NYSEArca:LD), iPath DJ-AIG Aluminum (NYSEArca:JJU), iPath DJ AIG Nickel (NYSEArca:JJN), and the precious metals: E-TRACS UBS CMCI Gold (NYSE Arca:UBG), the ELEMENTS MLCX Gold (NYSE Arca:GOE), E-TRACS UBS Bloomberg CMCI Silver ETN (NYSEArca:USV), E-TRACS UBS Long Platinum ETN (NYSEArca:PTM), and the iPath DJ AIG Platinum ETN (NYSEArca:PGM).

The ETN structure easily accommodates a variety of leverage and short strategies including the PowerShares DB Base Metals Double Long ETN (NYSEArca:BDD), PowerShares DB Base Metals Double Shrt ETN (NYSEArca:BOM), the PowerShares DB Base Metals Short ETN (NYSEArca:BOS), PowerShares DB Gold Double Long ETN (NYSEArca:DGP), PowerShares DB Gold Double Short ETN (NYSEArca:DZZ), PowerShares DB Gold Short ETN (NYSEArca:DGZ), and E-TRACS UBS Short Platinum ETN (NYSEArca:PTD). Leverage and short strategies of course involve additional risk.

Metals funds and expense ratios are listed below:

Bullion Ownership

SPDR GoldShares (GLD), 0.4%

iShares COMEX Gold Trust (IAU), 0.4%

iShares Silver Trust (SLV), 0.5%

Futures Based

PowerShares DB Precious Metals Fund ETF (DBP), 0.75%

PowerShares DB Base Metals Fund ETF (DBB), 0.75%

PowerShares DB Gold Fund ETF (DGL), 0.75%

PowerShares DB Silver Fund ETF (DBS), 0.75%

Short/Leverage

Ultra Gold ETF (UGL), 0.95%

ProShares UltraShort Gold (GLL), 0.95%

ProShares Ultra Silver (AGQ), 0.95%

ProShares UltraShort Silver (ZSL), 0.95%

Exchange Traded Notes

Diversified

ELEMENTS Rogers International Commodity Metal ETN (RJZ), 0.75%

E-TRACS UBS Bloomberg CMCI Industrial Metals ETN (UBM), 0.65%

iPath DJ AIG Industrial Metals ETN (JJM), 0.75%

ELEMENTS MLCX Precious Metals ELEMENTS ETN (PMY), 0.75%

PowerShares DB Base Metals Long ETN (BDG), 0.75%

Sub-Index

iPath AIG Copper (JJC), 0.75%

iPath DJ AIG Tin (JJT), 0.75%

iPath DJ AIG Lead (LD), 0.75%

iPath DJ-AIG Aluminum (JJU), 0.75%

iPath DJ AIG Nickel (JJN), 0.75%

E-TRACS UBS CMCI Gold (UBG), 0.65%

ELEMENTS MLCX Gold (GOE), 0.38%

E-TRACS UBS Silver (USV), 0.65%

E-TRACS UBS Platinum (PTM), 0.65%

iPath DJ AIG Platinum (PGM), 0.75%

Short/Leverage

PowerShares DB Gold Short ETN (DGZ), 0.75%

E-TRACS UBS Short Platinum ETN (PTD), 0.65%

PowerShares DB Base Metals Double Long ETN (BDD), 0.75%

PowerShares DB Base Metals Double Short ETN (BOM), 0.75%

PowerShares DB Base Metals Short ETN (BOS), 0.75%

PowerShares DB Gold Double Long ETN (DGP), 0.75%

PowerShares DB Gold Double Short ETN (DZZ), 0.75%

Jonathan Bernstein has been writing about ETFs since 2003 and is the author of Sector Trading: A Year in Exchange Traded Funds.