What to Know About ETFs and Taxes

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Key points

- Stock and bond ETFs are taxed just as the underlying stocks or bonds would be.
- Precious metals ETFs are currently taxed as collectibles at a 28% long-term rate.
- Commodity and currency ETFs have varying tax treatments.

Nobody wants an unpleasant surprise at tax time. While exchange-traded funds (ETFs) have a well-deserved reputation for tax efficiency, that doesn't mean there's nothing to learn about the subtleties of the tax code as it applies to ETFs. If you want to understand the ins and outs of capital-gains distributions, dividends, interest, K-1 statements, collectibles tax rates and more, read on. It just might save you some money at tax time.
Please note that the tax rates quoted in this article are current as of 2012, but could change in the future as many are set to expire at the end of the year.

Tax efficiency of stock and bond ETFs

As I've written before, tax efficiency in ETFs is mainly about stock ETFs being more tax-efficient than stock mutual funds because the ETFs tend not to distribute a lot of capital gains. This is in large part because index-tracking ETFs don't trade very frequently, and also because the way ETF shares are created and redeemed gives an ETF manager some flexibility to reduce capital gains.

Remember, though, that ETFs holding stocks that pay dividends will ultimately distribute those dividends to shareholders (usually once a year; more frequently for dividend-focused ETFs). Also, ETFs holding bonds that pay interest will have to distribute that interest to shareholders as well (monthly, in many cases).

Dividends and interest payments received via ETFs are taxed just like income from the underlying stocks or bonds, with the income being reported on your 1099 statement. Profits on ETFs sold at a gain are taxed like the underlying stocks or bonds as well: current 15% maximum rate on long-term gains and ordinary income rates on short-term gains, topping out at 35%.

Precious metals ETFs: collectibles tax rate

Investor interest in precious metals such as silver and gold has dramatically increased in recent years. The second-largest ETF by assets[1] in the United States invests in gold bullion. Investors have appreciated the opportunity to obtain exposure to precious metals in a relatively easy-to-trade vehicle such as an ETF.

It's important to understand how these precious metals ETFs are taxed, however. ETFs backed by the physical metal itself (as opposed to futures contracts or stock in mining companies) are structured as **grantor trusts**. A grantor trust does nothing but hold the metal; it doesn't buy and sell futures contracts or anything else. Thus, the IRS treats it as if you held the metal yourself.

Under current IRS rules, precious metals are treated as **collectibles**. Holding a stock or bond investment for more than a year and then selling it at a profit results in a capital gain subject to a maximum 15% tax rate. But with precious-metals ETFs, the rate on long-term gains is the collectibles tax rate, which currently tops out at 28%. (This would also be the rate for coins or ingots of precious metals; they're all treated as collectibles.) Short-term gains on these investments, as with other investments, are taxed as ordinary income at rates up to 35%.

This doesn't mean you should avoid precious metals as a tool for diversifying your portfolio. However, you should be aware of the different tax treatment so as to avoid surprises.

Other commodity ETFs: K-1s and the 60/40 rule

ETFs that invest in commodities other than precious metals do so via futures contracts on those commodities, such as oil, corn or aluminum. Holding the physical object in a vault is impractical for these commodities, which is why they use futures.

The use of futures can have a big impact on a portfolio's returns due to the effects of contango and backwardation—that is, whether the futures contracts are more or less expensive than the market price of the commodity. In addition, futures come with particular tax implications.

ETFs that use futures are structured as **limited partnerships**, meaning they report shareholders' share of partnership income on Schedule K-1 instead of Form 1099. Some investors worry about K-1s because they're more complex to handle on a tax return, they might arrive late, and they might incur Unrelated Business Taxable Income (UBTI) that could be taxable even within an IRA.

Fortunately, commodity ETFs overall have a track record of sending K-1s in a timely manner (though usually sometime after most 1099s are available) and not generating UBTI. K-1s are indeed more complex to handle on a tax return than 1099s, but professional tax preparers or well-informed individuals who do their own taxes should be able to handle K-1s correctly.

Another noteworthy tax feature of ETFs that hold commodity futures contracts is the 60/40 rule. This rule, from IRS Publication 550, states that any gains or losses realized by selling these types of investments are treated as 60% long-term gains (currently taxed at a maximum rate of 15%) and 40% short-term gains (currently taxed as ordinary income, at a maximum rate of 35%). This happens regardless of how long the investor has held the ETF.

Furthermore, at the end of the year the ETF must "mark to market" all of its outstanding futures contracts, treating them, for tax purposes, as if the fund had sold those contracts. Thus, if the ETF holds some contracts that have appreciated in value, it will have to realize those gains for tax purposes and distribute them to investors (who must then pay taxes on the gains, following the 60/40 rule).

Currency ETFs—it depends

Currency ETFs come in several different forms. Some are structured as open-end funds, also known as '40 Act Funds (much like most stock and bond ETFs). Gains from the sale of these funds are taxed just like stock and bond ETFs: 15% maximum long-term rate, 35% maximum short-term rate (again, both rates for tax year 2012, subject to change next year).

Some currency ETFs are structured as grantor trusts (similar to precious metals ETFs). Gains from selling these funds at this time are always treated as ordinary income (current maximum 35% rate).

There are also currency ETFs structured as limited partnerships, which are taxed just like commodity limited partnerships: with K-1 statements and 60/40 long-term/short-term capital gains treatment.

The bottom line with currency ETFs is that you should read a fund's prospectus to see how the particular ETF will be taxed.

What about ETNs?

We often caution investors to carefully consider credit risk before investing in exchange-traded notes (ETNs). Instead of being backed by a portfolio of securities independent from the assets of an ETF manager, ETNs are bonds backed by the credit of the issuer. Thus, if the issuer is unable to pay back the ETN shareholders, the shareholders will lose money.

That said, it's worth noting that ETNs have their own tax situations. Stock and bond ETNs work pretty much the same as their ETF equivalents, with long-term gains taxed at a maximum 15% rate and short-term gains taxed as ordinary income at a rate up to 35%. However, ETNs generally don't distribute any income or capital gains. Commodity ETNs are generally taxed much like stock and bond ETNs, with the 15% federal rate applying to long-term gains and the ordinary federal rate of up to 35% rate applying to short-term gains.

The true oddball here is the currency ETN, the gains of which have been specially ruled by the IRS to be taxed as ordinary income at a maximum rate of 35%, even if held for the long term. It's possible the IRS could expand this ruling to other types of ETNs in the future.

What does it all mean?

First of all, these tax issues generally shouldn't be a concern if you hold ETFs inside an IRA, only if you hold them in taxable accounts. If you invest in stocks and bonds via ETFs, you probably won't be in for many surprises. If you invest in commodities and currencies, things are certainly more complicated. As more exotic ETFs come to market, it's possible we'll see new tax treatments, and no tax law is ever set in stone. Be sure to consult with your tax professional for any questions about the taxation of ETFs.

1. Source: Morningstar, as of February 29, 2012.

Important Disclosures

Investors should consider carefully information contained in the prospectus, including investment objectives, risks, charges and expenses. You can request a prospectus by calling Schwab at 800-435-4000. Please read the prospectus carefully before investing.

Some specialized exchange-traded funds can be subject to additional market risks. Investment returns will fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost.

Commodity-related products, including futures, carry a high level of risk and are not suitable for all investors. Commodity-related products may be extremely volatile, illiquid and can be significantly affected by underlying commodity prices, world events, import controls, worldwide competition, government regulations, and economic conditions, regardless of the length of time shares are held. Investments in commodity-related products may subject the fund to significantly greater volatility than investments in traditional securities and involve substantial risks, including risk of loss of a significant portion of their principal value. Commodity-related products are also subject to unique tax implications such as additional tax forms and potentially higher tax rates on certain ETFs.

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