

## The magic of exchange-traded notes: Tax deferral

By Robert N. Gordon

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Exchange-traded notes are the newest wrinkle from Barclays, the main sponsor of exchange-traded funds.

According to Barclays, its iPath ETNs were invented to allow investors to access difficult asset classes.

Akin to exchange-traded funds, ETNs trade on an exchange. And, like their ETF counterparts, ETN market makers rely on a redemption process to provide liquidity at net asset value.

But the similarities stop there.

Unlike ETFs, ETNs aren't mutual fund-like. Instead, ETNs are "senior, unsubordinated, unsecured debt securities," issued by Barclays Bank PLC of London, in which the investor takes on the counterparty credit risk of the sponsor.

Despite the name, ETNs aren't notes at all but actually forward contracts, specifically, prepaid forward contracts guaranteed by Barclays to pay at maturity the value of a notional amount invested in an index or strategy index.

Unlike a traditional note, there is no principal guarantee and no periodic interest payments.

And unlike an ETF, there are no distributions over the life of the contract. The value rises and falls with the designated index, and there is no tracking error, only a "management" fee.

The magic is that ETNs offer tax deferral and possible long-term capital gains. We are advised that ETNs are taxed like a derivative security that realizes profits only upon sale.

It is believed that if ETNs are held for more than 12 months, any profit or loss should be taxed at long-term capital gains rates. Although some reports have thrown doubt on this issue, our advisers are unanimous in this view.

The iPath website observes that "Barclays identified other issuers [not including Barclays] representing approximately 200 offerings, for an aggregate amount of approximately \$4.6 billion of securities. In

each of these filings, the issuer or issuer's counsel generally has provided tax disclosure or opinions similar to the tax opinion provided for iPath ETNs." (These other issues weren't listed on an exchange.)

The first ETNs were tied to a commodity index. Like commodity ETFs, they carry a fee of 0.75%.

But although a commodity ETF is a pool that owns futures and interest-bearing collateral, and distributes profits as realized — which then are subject to tax — the ETN makes no distributions during its life. Therefore, there is no tax due on an ETN until it is sold.

The ETN stable recently has been increased by three ETNs tied to currencies and one tied to the BXM Covered Call Index.

Currency ETNs are indexed to investments in the euro, yen or British pound. Like currency ETFs, these ETNs sport a 0.40% fee. Their purchase reflects an investment in interest-bearing instruments denominated in that currency.

With currency ETFs, interest income is taxed at the highest rate each year, and currency profits are taxed as ordinary income. ETNs, by contrast, pay no income distributions, and if a Section 988 (a)(1)(B) election is made, all currency profits can be capital gains that are taxed at a preferable rate.

The latest ETN — the Covered Call ETN (BWV due in 2027) — is tied to the BXM Covered Call index and can be best compared with the S&P 500 Covered Call Fund (BEP), a closed-end fund. The ETN has a 0.75% fee and no tracking error; BEP's fee is 0.90%. Other expenses bring total fees to slightly above 1%.

BEP rigorously tracks the BXM index, buying the S&P index and selling one-month calls, and incurring commissions and bid-ask spreads. These costs must cause a drag on performance.

BEP's profits from index options are taxed 60% long term and 40% short term, due to Internal Revenue Code Section 1256. (They also are marked to market at the end of each year.)

Dividends are taxed at 35%, not 15%, because under government guidelines, the calls sold aren't qualified. Ironically, I think that BEP would be considered to have qualified covered calls if its fund managers deviated from the BXM index slightly and sold 31-day, not 30-day, calls.

Last year, about 73% of BEP distributions were taxed at the highest rate, 17.5% as long-term gains and 9.5% as a return of capital. Additionally, since BEP is a closed-end fund, if the fund terminates on March 31, 2010, as planned, its current 15% premium to NAV will be lost over the next few years.

By contrast, the BXM ETN has a lower fee, has no distributions, is structured to have no "major" deviations from NAV and should create no taxable income until sold.

Clearly, the iPath ETNs are a product to keep in mind. With their tax-friendly characteristics, they are sure to be imitated.

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