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Why pick on exchange traded notes?

None of the proposed ‘fixes’ would solve the tax issues surrounding ETNs

By Robert N. Gordon

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The time is drawing near for comments requested by the Department of the Treasury regarding changing the taxation of exchange traded notes and other prepaid forward contracts.

ETNs have many attractive features: low expense ratios, no tracking error, public market trading and access to markets or trading strategies not easily executed by individual investors. Their main drawback is that the investor does not own a proportionate share of a portfolio but rather a security that promises a future return guaranteed only by the issuer. In today's environment, this credit risk should not be quickly dismissed.

ETNs, because they are prepaid forward contracts, have a tax advantage over exchange traded funds, as no taxes are due on ETNs until they are sold or the holder receives income. By contrast, ETFs must make distributions as they realize gains or take in dividends. Because of this, the Investment Company Institute, the Washington-based mutual fund trade group, wants Congress to level the playing field.

Unfortunately, none of the proposed "fixes" discussed in the Treasury's Notice 2008-2 would accomplish this goal; they would make ETNs inferior to ETFs.

A bill introduced by Rep. Richard E. Neal, D-Mass., would not level the playing field either. His bill would tax ETN owners on phantom in-come each year, the premise being that the investor has committed capital and foregone interest on that money so there should be an imputed interest that is to be taxed each year. Profits above the imputed interest rate would be capital gains. This isn't the worst solution, but it certainly does not level the field. If an investor buys an S&P 500 ETF, for example, they also are committing capital and forgoing interest, so why single out ETNs for harsh treatment?

The fact that ETNs are taxed differently than mutual funds shouldn't in itself give the tax writers pause. There are many instances where the choice of one investment over another dictates a different tax result. For example, profits from an exchange traded Standard & Poor's 500 stock index option are taxed at 23%, while the same option issued "over the counter" is taxed at regular rates (35% if held less than one year, 15% if held longer).

The Neal bill concept could be applied more properly to structured notes that guarantee investors' principal if held to maturity. Under current law, all profits from these principal-protected notes are taxed as interest. Why is any profit from stock market appreciation taxed as interest?

If an investor replicated a principal-protected note by purchasing a zero-coupon bond and an option on the S&P 500, the tax results would be very different from owning a structured note.

The bond would create taxable interest income, and the profit attributed to stock market gains would then be taxed at the more favorable capital gains rate, very much as the Neal bill proposes. I hope that if there is a "weight" put on ETNs, a counterbalancing weight will be removed from the notes with principal protection.

The Department of the Treasury testified that tax writers have twice thought about changing the rules on prepaid forward contracts and twice decided to leave them alone. Trying to tax derivatives with anything but a realization methodology proves complicated and administratively difficult.

As an example, it has been years since the government informed investors that it didn't like the "wait and see" taxation approach to swaps. While regulations dictating other tax methods were supposed to be forthcoming, nothing has materialized. The "wait and see" concept dovetails with the basic realization tenet of our tax code — as cash-basis taxpayers, we don't get deductions until we make a payment and we don't realize income until it's in our hands. Why should ETNs be different?

The only way to level the playing field would be to give the ICI what it really wants, which is legislation — the Generate Retirement Ownership Through Long-Term Holding Act of 2007, introduced by Rep. Paul Ryan, R-Wis. — that would exempt reinvested mutual fund distributions from current taxes. The ICI also has floated the idea that U.S. funds be taxed like European funds, where no taxes are levied at the fund level and there is no mandatory- distribution feature. Either of these proposals would offer investors more choices with equal tax footing.

We suggest that mutual fund investing be made more tax-friendly by passing the bill. There is no other way to level the playing field without completely rewriting an already complex set of rules on the taxation of financial products.

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