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Commodities ETFs can be taxing

With these complex products, an unexpected bill and confusion sometimes may arrive

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The K-1s are coming! The K-1s are coming! Investors in hedge funds and limited partnerships are used to receiving these forms, which reflect an investor's proportionate share of a partnership's taxable income or loss. But this year, some investors in exchange-traded funds are going to be receiving K-1s, too. Be prepared for some major confusion.

Over the past few years, a lot of money has flowed into commodities-based ETFs, which are difficult to understand on many levels.
Some of these ETFs are vehicles that invest directly in the commodities themselves. The SPDR Gold Trust (GLD) is an example of this type.

Other commodities ETFs invest entirely through commodities futures contracts. The United States Oil Fund LP (USO) and the United States Natural Gas Fund LP (UNG) are prominent ETFs of this type.
Neither direct-invest nor futures-type commodities ETFs are set up as standard mutual funds.

Instead, they are created as either grantor trusts or limited partnerships in order to be non-taxable entities. As such, these limited partnerships and grantor trusts flow their taxable characteristics through to their owners.

Taxes are calculated and allocated proportionately to each investor monthly. Since the natural gas fund, as an example, rolls its futures contracts monthly, taxable events are likely to be passed through at each month's futures expiration or closing.

The income realized is allocated to whoever owned the units on the last day of the month. Any gain or loss passed through is to be included in the investor's tax return.
To be equitable and avoid double taxation, taxable gains adjust the investor's basis upward; losses adjust the basis downward.

The oil fund had massive income flow-through in 2009 and by our estimate will pass through $5.99 in gain for someone who held it throughout 2010. The natural gas fund, by contrast, will throw off a $3.82 loss for full-year holders.
Some investors will be surprised to learn of these complications.

Let's take Sally Investor, who bought shares of the oil fund March 26, 2010, at $40 and sold them six days later at the same price. Looking at the broker confirmations, Sally and her accountant assume that there is no gain or loss on the trades.

But because of its construction, the fund realized and passed through about $4 of gain in January 2010. Sally's taxes are now more properly calculated as if Sally bought her shares at $44 (not $40), because during her brief holding, she was allocated $4 a share in gain.

ETFs that use futures add another wrinkle: Futures contracts are treated as Section 1256 contracts, meaning that 60% of any gain or loss is taxed on a long-term basis and the other 40% is taxed at short-term rates.

Note that futures are taxed both on a realization basis as well as being marked to market at the end of the partnership's fiscal year. Futures losses can be carried back to offset Section 1256 gains for up to three years.

What should investors do?

Some advisers suggest holding commodities futures ETFs in individual retirement accounts or other tax-sheltered accounts to escape having to calculate flow-throughs. To avoid the annoyance and/or the unknown tax consequences of commodities futures ETFs, we suggest holding exchange-traded notes.

ETNs can be one of the most efficient ways to access an asset class — if you can stomach the credit risk. There is little or no tracking error, fees are competitive and their tax treatment is optimum.

There generally are no taxes or distributions while holding the ETN, and usually, there is capital gains treatment upon sale.

You might remember that the Internal Revenue Service explored changing this favorable taxation a few years ago, and then the Lehman Brothers Holdings Inc. collapse came. The fear of counterparty credit risk took the steam out of ETN issuance, and the Treasury Department's focus went elsewhere.

Many ETNs are based on exotic assets or strategies that are difficult to replicate. Commodities are in that category, as are volatility products, which also are popularly found as both futures-trading ETF partnerships and ETNs.

Phantom flow-through gains and losses can play havoc with after-tax returns. For those planning to hold commodities ETFs for a long time period, these machinations should be considered.

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