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The American Taxpayer Relief Act of 2012 raised the rates on both short-term and long-term capital gains. The rates in the article do not reflect these changes.

The complexity of ETF options

Key to ascertaining whether they will be taxed 'normally' lies in whether or not they are equities

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As they do with stocks, investors have the opportunity to trade listed options on many exchange-traded funds.

You would think, therefore, that the taxation of gains and losses on ETF options should be straightforward. It isn't.

Publicly traded options on corporations, technically labeled equity options, are taxed "normally." That means that profits or losses are treated as short-term if held for less than one year. Long-term gains are possible only after a holding period of one year or more.

Most ETFs are corporations.

Some also are regulated investment companies, which is the formal name for a mutual fund. Like any other corporation, a RIC is liable for tax on its taxable income; the big difference is that the RIC is allowed to take a deduction for the dividends it pays to holders.

These distributions usually reduce RIC taxable income to zero.

But not all ETFs are corporations or RICs. And publicly traded options on such ETFs are considered non-equity options and aren't taxed like equity options.

Nonequity options are taxed under Internal Revenue Code Section 1256 (similar to futures).

Under Section 1256, gains or losses are automatically taxed as if 60% of the gain/loss was captured as long-term and 40% of the profit/loss was short-term in nature. This mixture produces a 23% tax rate using current tax rates.

This seems like a great deal for the short-term trader. The trade-off is that profits and losses are marked to market for tax purposes at the end of each fiscal year.

This Section 1256 treatment applies even if the investor is short the option.

As a result of innovation in the ETF business, the legal structures of ETFs now vary widely. In addition to RICs, there are ETFs that are grantor trusts, U.S. taxable corporations (that are non-RICs), foreign passive investment companies and limited partnerships.

Because there are publicly traded options on all these types of ETFs, investors must be wary.

For tax purposes, the key is to ascertain the entity classification. If the underlying legal structure is a corporation, the option is taxed normally.

If the underlying legal structure is a not an equity, the option most likely will fall under the IRC Section 1256 regime.

It should be noted that over-the-counter options, which don't trade on an exchange, don't get Section 1256 treatment and are taxed normally.

Sometimes, choosing the best type of option depends on an investor's expected time horizon.

Consider the most popular gold ETF, SPDR Gold Trust Ticker:(GLD), which is a grantor trust. Because of its structure, listed options on GLD are taxed as Section 1256 contracts.

If an investor owned GLD for less than one year or was short GLD, any profits would be taken as short-term capital gains taxed at 35%. Profits on listed options on GLD would be taxed at 23%.

Because gold is a collectible, long-term gains on gold or GLD would be taxed at 28%. Alternatively, long-term gains realized from OTC options on GLD would be taxed at just 15%.

Investors can inspect the ETF's prospectus to ascertain the entity's classification. ETFs on master limited partnerships are taxable corporations.

Although they aren't RICs, their options are taxed normally. The most popular oil ETF is actually a commodities pool that trades futures; it is set up as a limited partnership.

Listed options on the oil ETF are thus nonequity options taxed as Section 1256 contracts.

These taxation oddities can wind up being either traps for the unwary that are discovered next April when preparing a tax return or opportunities to exploit that allow your clients to keep more of their investment profits.

For a list of all ETFs and the tax treatment of their listed options, visit twenty-first.com and go to: “How are your ETF options taxed?” under Investment Tools.

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