Many people decided to get out of exchange-traded notes over the past nine months due to their inherent credit risk exposure. The duress of the backing banks fully justified such a move by savvy investors. After all, investors were seeking only the returns on their respective indexes. They were not seeking credit risk to financial institutions, nor were they compensated adequately by all ETNs for such risk.

The most notable use for ETNs was to gain commodity exposure, and the most popular means was previously iPath Dow Jones-AIG Commodity Index DJP. Many people sold DJP and other ETNs last year, and we completely understand why investors seeking commodity exposure would opt for a different investment vehicle during a dire economic climate for banks. We wrote about the credit issues regarding ETNs in our articles titled “ETN Credit Risk Rears Its Ugly Head,” “ETNs Demystified,” and “Our New ETN Outlook.”

The fall from grace of the ETN structure during the global financial crisis is unfortunate for investors. ETNs are the most tax-efficient and well-understood investment vehicles for gaining commodity exposure. Because you are taxed only upon sale of the fund under normal capital gains rates, the filing process is easy and efficient. (Every rule has an exception; currency ETNs are taxed at higher ordinary income rates upon sale.)

Here is a summary of taxation rules regarding ETNs (other than currency-tracking funds):

1) It holds no real assets; it’s a promissory note.
2) You will be taxed only upon sale.
3) Short-term capital gains apply when held less than one year.
4) Long-term capital gains rates apply when held more than a year.
5) There are typically no dividends or interest income.

What is a Schedule K-1?
Perhaps you went a different route and decided to garner commodity exposure by purchasing an exchange-traded fund like PowerShares DB Commodity Index Tracking Fund DBC instead of an ETN. You gained broad commodity exposure by going this route, but you likely received something new in the mail recently regarding taxation; a Schedule K-1. Most investors are used to receiving a Form 1099 for tax purposes, so first-time receivers of K-1 forms are often intimidated. This form accompanies any investment in a Limited Partnership, which is the legal structure under which DBC was formed. Another popular limited partnership "ETF" that invests only in futures contracts is United States Oil USO, so the same rules would apply there.

Even those investors that have purchased other "shares" of publicly traded limited partnerships may be surprised to learn that DBC (and all other commodity trusts issued by PowerShares, excluding its ETN lineup) and USO (and all other commodity funds provided by its issuer) are structured as limited partnerships. Dealing with the issue in a taxable account may just seem like a bit more paperwork to these folks, but some have felt some unnecessary stress when the funds are held in a tax-deferred account, such as an IRA.

There is a special IRS clause regarding shares of publicly traded limited partnerships that can cause tax-deferred accounts to suddenly become taxable. The clause is known as Unrelated Business Taxable Income, and fear of being subject to this clause has lead many investors to avoid shares of limited partnerships in the past. The best examples of this case are pipeline companies, like Kinder Morgan KMP, which are often structured as Master Limited Partnerships rather than as corporations. The main difference between pipeline MLPs and funds like DBC and USO is that the pipeline MLPs engage in business activities to generate income. DBC and USO generate their income passively, or through investments in commodities. There are no "business" operations in these funds currently. So long as these funds maintain their current practices, the IRS has determined that they are not subject to UBTI.

Now that we have UBTI out of the way, let's talk about the general tax treatment of the aforementioned funds for individual investors. Caveat emptor: Before you read anymore, please be aware that I am NOT a registered tax advisor. Please understand that every tax situation is unique, so I cannot misrepresent my qualifications by saying that I can provide you with tax advice. You should consult your accountant for verification of your tax status regarding this (or any other) investment product. That said, I am going to discuss generally the tax ramifications for individual investors of the aforementioned funds in both a taxable brokerage account and a tax-deferred account, like an IRA. Again, every tax situation is unique, so these rules may not apply to you.
LP Overview for Futures-Based Funds

Here is a generalized summary for when a Limited Partnership ‘ETF’ that owns only futures contracts is held in a traditional taxable brokerage account:

1) It holds futures contracts.
2) You will be taxed each year regardless of sale.
3) Cap gains are 60% at long-term rates, 40% at short-term rates.
4) The fund does not distribute realized capital gains.
5) You must recognize interest income.
6) Currently, there is no UBTI to report.

When held in an IRA, taxation is generally shielded in the following manners. First, because an IRA is not subject to capital gains taxation until withdrawal, the 60%/40% rule does not apply. Furthermore, you don’t pay taxes on interest income in a tax-deferred account until funds are withdrawn. Finally (I’m sure you get the point by now), the IRA would become taxable if UBTI crossed a threshold, but these commodity-trading funds should not produce any UBTI. Again, there should be no UBTI to report because these funds do not engage in business activities.

If you chose to gain your commodity exposure from ProShares’ lineup, your taxation should be slightly different. These funds do not limit themselves only to futures contracts; they also use swaps and options. Depending on which contract type is used, the 60%/40% taxation rule may not apply for all gains. However, you will still be taxed every year regardless of whether you sell the fund. You will have to take a closer look at your tax statement to determine your reportable income and capital gains.

Grantor Trust Rules

Another common structure employed by some commodity ‘ETFs’ is the Grantor Trust. The most prominent examples of this structure are SPDR Gold Shares GLD, iShares COMEX Gold Trust IAU, and iShares Silver Trust SLV. Direct investments in precious metals are taxed at ordinary income rates (currently 28%) upon sale of the trust. Oddly enough, you might not receive either a K-1 or a Form 1099 for an investment here, so make sure you are diligent about your reporting.

If your Grantor Trust fund holds physical metals, like gold bullion, here is a taxation guide:

1) The fund holds physical metals.
2) You will be taxed upon sale at ordinary income rates.
3) Ordinary income rates are higher than capital gains rates.
4) The fund does not distribute realized capital gains.
5) The fund generates no interest income.
Taxation of Leveraged ETFs

Leveraged and inverse-themed ETFs are another example of how the tax-efficiency that a vanilla ETF offers isn't always universal. In 2008, numerous funds of this type paid out eye-popping distributions to investors who held them in taxable accounts. Additionally, many investors were shocked to find out that regardless of how long they held these funds their gains were deemed short-term capital gains by the IRS. We discussed this issue in more detail in an article titled "The Tax Man Cometh for Leveraged and Inverse ETFs."

So, why do these leveraged exchange-traded products tend to be less tax efficient than their traditional counterparts? Unlike other ETFs, leveraged and short ETFs do not use a portfolio of exchange-traded assets (namely stocks and bonds) to track their benchmark index. Instead, they keep their assets in a pool of cash and enter custom swap agreements to produce the desired returns. This means that when authorized participants create or redeem new shares of UltraShort S&P500 ProShares SDS for example, they merely exchange the shares for a set amount of cash as opposed to a basket of securities.

Generally, this does not incur large distributions. The pool of cash produces interest income that needs to be paid out to shareholders quarterly, but it rarely exceeds 1% of assets. However, if the fund goes into net redemptions and starts to shrink in assets, the managers must sell some of the derivatives they used to replicate their benchmark instead of passing them off to the authorized participants. As a result, that can lead to some hefty capital gains payments for the shareholders remaining in the fund. Now, if you were a new holder of the fund, this would simply be a return of capital to you and you wouldn't incur a taxable event. But, for investors who held the fund during the period of gains, the distributions will generate a taxable event sooner than they may have expected or planned for.

Finally, investors should be aware of the unusual tax issues that result from the underlying holdings of these funds. Index swaps, the derivatives used by leveraged and inverse funds to produce their daily returns, are always taxed at short-term capital gains rates. Because ETFs are taxed on a look-through basis, by which investors pay what they would have if they'd directly held the underlying securities, any investor who sells this fund for a gain will face a hefty tax bite equal to the short-term capital gains rate, even if the fund was held for more than a year.

This is not a reason to avoid short and leveraged ETFs, but it is a reason for caution. These funds still have the trading advantages of liquidity, timeliness, and low commissions just like every other ETF. They still provide hedging and speculative opportunities that are otherwise inaccessible to the individual investor. They do not possess the impressive tax advantages of most ETFs, but they should still perform no worse than a traditional open-end mutual fund on this point.
Here is a summary for the typical leveraged and inverse fund held in a taxable account:

1) The fund holds options and swaps secured by a pool of cash.
2) Interest income from the cash pool is taxed as ordinary income.
3) Gains will be taxed as short-term capital gains.
4) You will pay taxes annually, even if you don't sell the fund.
5) Funds will occasionally make large taxable distributions after periods of gains.

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