

Tax Action Memo®

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It's Time to Add Exchange-traded Funds (ETFs) to Your Tax Planning Toolbox

<p>Type of Clients: Individuals.</p> <p>Situation: Exchange-traded funds offer unique tax planning benefits.</p> <p>Deadline: N/A.</p>	<p>Tax Action Required: Read this release to get up to speed on how clients can use ETFs to implement tax planning strategies.</p>
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Background

Exchange-traded Funds (ETFs) first came on the scene 15 years ago and since that time have proliferated rapidly. As of 9/30/08, there were 701 ETFs with \$580 billion in assets. Although this may be a drop in the bucket when compared to the assets invested in mutual funds, it certainly shows that ETFs are here to stay and for good reason. Although ETFs are similar to mutual funds, as we'll discuss in this release, they have some very unique characteristics that in the right circumstances can provide tax planning benefits that can't be obtained with any other investment vehicle.

What Makes an ETF So Unique?

Like mutual funds, ETFs offer investors a simple method of investing in portfolios of stocks that closely track the performance and dividend yield of specific indexes. ETFs give investors the opportunity to buy or sell an entire portfolio of stocks in a single security, as easily as buying or selling a share of stock.

ETFs are similar to traditional mutual funds in that they are an investment structure that pools the assets of its investors and uses professional managers to invest the money to meet clearly identified objectives, such as current income or capital appreciation. Unlike a mutual fund, ETFs are traded like other listed stocks. An ETF is created when an institutional investor deposits securities into the fund in exchange for creation units. In return for the deposit, the institutional investor receives a fixed amount of shares, some or all of which may be traded and priced throughout the day on a stock exchange. Noninstitutional investors (e.g., individual investors) do not purchase or redeem ETF shares directly from the fund. They buy or sell ETF shares on the stock exchange in the same manner they would purchase or sell any other listed stock.

All the buying and selling methods and strategies associated with stocks (e.g., market orders, limit orders, stop orders, and buying on margin) can be used when buying or selling ETFs.

The price of an ETF usually approximates, but is not directly linked to, the underlying net asset value of the fund. When demand for fund shares exceeds supply, the market price at which an ETF trades may be higher than its underlying net-asset-value, and vice-versa.



Some of the benefits of investing in ETFs include:

1. *No Sales Loads.* Brokerage commissions still apply to the same extent they would to the purchase or sale of any other stock.
2. *Ability to Buy and Sell at Any Time during the Trading Day.* Unlike open-end mutual funds that can only be redeemed at the end of the day, ETFs are priced throughout the day and can be bought or sold just like a stock.
3. *Ability to Buy on Margin.* This cannot be done with mutual funds.
4. *Ability to Sell Short.* This cannot be done with mutual funds.
5. *Relatively Low Management Fees.* Expense ratios are very similar between ETFs and open-end mutual funds. Usually, they range from .15% of the value of the fund to 1.0%.
6. *Instant Exposure to a Diversified Portfolio of Stocks.* There are ETFs representing broad-based market indexes and specific industry sectors or specific geographical sectors.
7. *Diversification.* By owning an ETF containing the stocks in an entire market index or industry sector, an investor owns a large, diversified number of companies, which gives a degree of protection in case the price of one company in the index goes lower.

These characteristics make ETFs nimble tax planning tools.

ETFs Are Tax Efficient Investments

ETFs provide a tax advantage not available with mutual funds. Mutual funds sell securities to cover redemptions. These sales create capital gains, which are distributed to owners of the fund. ETFs transfer securities out to redeeming shareholders instead of selling the securities, thus minimizing taxable capital gains. Investors who want to liquidate shares in an ETF simply sell them to other investors through exchange trading. Because of this unique structure, ETFs are not required to sell stocks to meet investor cash redemptions, potentially generating capital gains tax liability for remaining investors.

Bottom Line: Because gains and losses are not recognized until the investor sells the ETF shares, each ETF investor has the ability to time gains and losses to meet his or her own needs. They are not at the mercy of other fund investors.

Using ETFs to Get around the Wash Sale Rules

As you know, a taxpayer cannot deduct the loss realized on the sale of stock or securities if the taxpayer purchases substantially identical stock or securities within the period beginning 30 days before and ending 30 days after the sale [IRC Sec. 1091(a)].

Example 1: Triggering the wash sale rules.

Ernie sells 500 shares of Innovative Computer Corporation (INCC), a manufacturer of computers and peripheral equipment, at a loss of \$5,000. Three weeks later (less than 30 days), he reads a large brokerage firm's report indicating that computer sales are expected to increase substantially during the next year. That same day, Ernie purchases 500 shares of INCC to take advantage of any potential price appreciation. Because Ernie subsequently purchased stock substantially identical to the stock he originally sold less than 30 days before, the \$5,000 capital loss from the original stock sale must be deferred because of the wash sale rules.

The wash sale rules and required capital loss deferral can be avoided when the new investment (made within 30 days) is *not* substantially identical to that original investment. If a taxpayer believes a company's stock that was originally sold at a capital loss less than 30 days ago once a gain represents a good investment opportunity, he or she can purchase stock of another company in the same industry as an alternative to repurchasing stock in the same company. In this case, the new stock is not substantially identical to the original stock; therefore, the purchase does not trigger the wash sale rules or restrict capital loss recognition on the original stock and theoretically preserves the opportunity for appreciation if the new stock does well.

Example 2: Avoid the wash sale rules and maintain the capital loss.

Using the fact situation in Example 1, if Emie purchased stock in PECC Computer Corporation (PECC), another company in the same industry sector as INCC, to replace his original INCC stock, the \$5,000 capital loss from his original INCC stock sale would be maintained. In this scenario, the wash sale rules do not apply because the replacement shares in PECC are not substantially identical to the original shares in INCC.

As shown in Example 2, the taxpayer can avoid the wash sale rules, maintain a capital loss from an original stock sale, and have an opportunity for price appreciation by reinvesting (within 30 days) in the stock of a different company in the same industry sector. However, quite often companies within the same industry sector are similar in some aspects, but significantly different in others. Where no acceptable alternative individual company in the same industry sector represents a viable investment option, investing in a related industry ETF may be advantageous.

Where a taxpayer sells stock in an individual company at a loss and within 30 days purchases the stock of an ETF in the same industry sector as the original company, the wash sale rules are avoided and the capital loss from the original sale is preserved since an industry ETF is not substantially identical to any individual company. In addition, by investing in the industry ETF, the potential for appreciation is preserved if the industry performs well.

Example 3: Use exchange-traded funds to harvest tax losses.

Maureen sells 900 shares of Logistic Computer Corporation (LOCC), a manufacturer of laptop computers, with a current market value of \$27,000 at a loss of \$9,000. One week later, she reads a story in The Tech Stock Reporter indicating laptop sales are about to boom because of a new remote access technology that business travelers will require. Maureen does not want to miss the opportunity for investment gains resulting from the new technology and related laptop sales, but wants to avoid the wash sale rules and use her \$9,000 loss on LOCC to offset gains she has made on other investments this year.

As an alternative to reinvesting in LOCC, Maureen considers investing in Primary Computer Corporation (PRCC) because PRCC manufactures laptops. However, PRCC also manufactures and sells desktop computers, portable music players and sells music online. After completing her research on PRCC, Maureen is concerned that one or more of Primary's other business lines will falter and offset any profit from their laptop business.

Because Maureen cannot find a viable individual company replacement within the same industry as LOCC, she decides to reinvest her \$27,000 in the Current Technology Fund (CTF). CTF is a listed and actively traded ETF with investments in fifteen technology-related companies, including five that manufacture laptops. By investing in CTF, Maureen preserves her \$9,000 capital loss on LOCC since CTF is not substantially identical to LOCC and, thus, avoids the wash sale rules. She will also have the opportunity to participate in any price appreciation of CTF.

Warning: The IRS has not defined substantially identical. Until there is definitive guidance on what the IRS believes is substantially identical, the percentage of ownership the ETF maintains in the stock initially sold at a loss could be called into question. Practitioners should monitor this matter and watch for further guidance in this practice area.

Special Tax Considerations for Commodities Exchange-traded Funds

Commodities listed on U.S. futures and securities exchanges are now being traded in various forms as ETFs. These new ETFs are designed to track the investment performance of commodities such as silver, gold, crude oil, and Euros. Commodities based ETFs have been organized and operated as grantor trusts and limited partnerships. As a grantor trust, the ETF will generally be treated as a disregarded entity for federal income tax purposes. Practitioners should note that the tax treatment for the commodity-based ETFs can be quite different from that of the more traditional ETFs.

Precious Metals ETFs Organized as Grantor Trusts. An investment in a precious metal bullion-based ETF may be considered a direct investment in a collectible [IRC 408(m)(2)(C)]. If considered to be a collectible, long-term gains on a precious metal ETF held more than one year would be taxed at a maximum rate of 28%, rather than 15% [IRC Secs. 1(h)(4) and (5)].

In addition, collectibles generally are not permitted investments for IRAs and participant-directed Section 401(a) qualified plan accounts. Therefore, any direct investment in a precious metals ETF could be considered a taxable distribution equal to the cost of the collectible [IRC Sec. 408(m)(1)]. However, exceptions apply for certain coins and gold and silver bullion; see IRC Sec. 408(m)(3) and PLR 200446032, PLR 200732026, and PLR 200732027.

Finally, favorable Section 1256 treatment generally is not available for precious metals ETFs. (Under Section 1256 treatment, the securities must be marked to market at the end of each year and the resulting capital gain or loss is treated as 40% short-term and 60% long-term.)

Euro Currency ETFs Organized as Grantor Trusts. In general, foreign currency gain or loss is computed separately and treated as ordinary income or loss [IRC Sec. 988(a)(1)]. Therefore, any gain or loss on the sale of a foreign currency based ETF or currency contracts within the ETF will be considered ordinary income or loss for federal income tax purposes.

Ordinary treatment of losses can be favorable since the annual capital loss limitation will be avoided. However, any ordinary gains are subject to a marginal rate as high as 35%. Similar to the precious metals ETFs, favorable Section 1256 treatment is generally not available for currency-related ETFs.

Crude Oil ETFs Organized as Limited Partnerships. Favorable Section 1256 (60/40) treatment should apply for domestic oil futures contracts traded by a crude oil ETF organized as a limited partnership. This treatment will be reported on the investor's Form K-1 for the tax year. Gain or loss on the actual ETF shares will be treated as short-term or long-term capital gain, depending on the length of time the investment was held.

Conclusion

The unique characteristics of ETFs make them a very useful tax planning tool. Not only are they tax efficient investment vehicles in their own right, they can be used to harvest losses and preserve potential appreciation in specific industries without triggering the wash sale rules.

References:

IRC Sec. 1091(a).

Subscriber Note: This *Tax Action Memo* was written by Executive Editor, James D. Van Grevenhof, CPA, CFP®. It is based on material from *PPC's Guide to Tax Planning for High Income Individuals*. For additional information on this guide, visit ppc.thomson.com or call (800) 323-8724.