# The U.S. Tax Treatment of Exchange-Traded Notes – The Brewing Battle Between Mutual Fund Advisers and ETN Sponsors

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One of the hottest products in the financial markets in the last several years has been the exchange-traded fund ("ETF"). That product has now collided, tax-wise at least, with a second hot product, exchange-traded notes ("ETNs").

This memorandum briefly describes the two instruments and the brewing battle over the federal income tax treatment of ETNs.

**ETFs – Current Income Inclusions**

ETFs are investment funds whose shares trade on a stock exchange. The twist is that large investors can purchase fund shares by tendering a basket of the same investments that the fund owns in so-called "creation units." Large investors can also request in-kind distributions of the investment basket in exchange for their fund shares. These mechanisms serve to substantially eliminate the classic problem for closed-end funds: their shares often trade at a discount to net asset value. From a federal income tax standpoint, ETFs are flow-through vehicles that generally must distribute their income currently. For example, an S&P 500 index ETF must distribute dividends on the S&P 500 index (with a current dividend yield of around 1.75%) annually. Gains recognized when portfolio stocks are sold (*e.g.*, when the index is rebalanced) must also be distributed currently. Taxable U.S. investors must include these amounts in their income annually.

**ETNs – "Wait and See"**

ETNs are structured notes issued by a corporation (typically a bank or investment bank) with a return linked to a specified index (including stocks, commodities, currencies, real estate, and master limited partnerships). As the name suggests, ETNs are listed on an exchange, such as the American Stock Exchange. The prototypical ETN is the Barclays iPath ETN, which is a 30 year non-interest bearing note issued by Barclays Bank PLC. The payment at maturity is indexed and is not principal protected. ETNs are treated as prepaid forward contracts for U.S. federal income tax purposes. This means that an investor does not realize any income or recognize any gain until he sells the ETN. And as long as the investor has held the ETN for more than a year, he will be taxed at the 15% long-term capital gains rate. This treatment is different than the tax treatment of investors in ETFs who, as noted above, are taxed on the income realized and gain recognized by the ETF on an annual basis.

**First Salvos**

The popularity of ETNs has increased significantly with Barclays continuing to list new iPath ETNs and other investment banks, such as Goldman Sachs and Deutsche Bank, rolling out their own variants. The tax controversy brewing over ETNs was first reported in The Wall Street Journal in late October.[1] In early November, the Investment Company Institute ("ICI"), the mutual fund trade group, wrote a letter to the House Ways & Means Committee of the U.S. Congress urging that legislation be enacted that would require current accrual of income on ETNs.[2] ICI views the tax treatment accorded to investors in ETNs as superior to the treatment of investors in mutual funds and ETFs. In its letter, ICI asserted that the tax treatment accorded to ETNs is inappropriate and anti-competitive. A few days later, the Securities Industry and Financial Markets Association ("SIFMA"), an industry group representing securities firms, banks and asset managers, wrote the House Ways & Means Committee arguing against any legislative action.[3] SIFMA argued that ETNs are more akin to stock than to mutual funds and that requiring ETN investors to currently report income would be as inappropriate as requiring holders of stock to report income on a current basis. There have also been reports that the IRS and the Treasury Department are reviewing the tax treatment of ETNs.

**Through the Lens of a Policymaker**

As a tax policy matter, the tax treatment of ETNs is simply one more illustration that different financial instruments with similar economic profiles are taxed differently in our system. For example, the "put-call parity" theorem states that economic returns on stock can be replicated through the combination of a zero coupon bond, a written put and a purchased call on the same stock. Even so, the tax treatment of the stock on the one hand and the bond-option package on the other are materially different. An attempt to change the tax treatment of any one instrument (*e.g.*, ETNs) would avoid addressing, or in the worst case, would exacerbate, the fundamental problem – our system of taxing financial instruments is outdated and could use a complete overhaul.

Another issue is whether a change affecting ETNs would also affect the tax treatment of prepaid forward contracts in general. That may open a Pandora's Box of technical issues and unintended consequences.[4] For example, a taxpayer might have different tax consequences if he or she buys stock and also a prepaid forward on the same stock. While it may be possible for Congress to draft a relatively narrow ETN provision affecting only publicly listed instruments, one can expect that even a "rifle shot" provision will result in unintended tax consequences.

**Outcome Unknown and Unpredictable**

In Congress, the ETN issue is being raised in the context of a constant search for revenue to pay for a "patch" for the U.S. alternative minimum tax ("AMT"). If Congress does not modify the law, it is estimated that in 2007 23 million families will pay AMT – a tax originally designed to affect no more than 100 wealthy families. However, as of this writing, no formal revenue estimate has been associated with any potential ETN tax provision. Moreover, no draft legislation has been released by the House Ways & Means Committee although rumors are rampant that such legislation is circulating on Capitol Hill. Finally, because there is no draft legislation, there is no proposed effective date. "Grandfathering" existing notes might create a two tier market while no grandfather provision would be extremely harsh medicine for existing holders.

In any event, the battle lines have been drawn. We can expect voices to grow louder during the coming weeks and months as the universe of ETNs, and with it the stakes involved, grows ever larger. The end result and also the timing of any resolution is impossible to predict.

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**Footnotes:**

[1] See "Enjoy the Tax Status of ETNs? Watch Out – US Studies Treatment the Cousins of ETFs Get; Barclays at the Forefront" by John Spence, The Wall Street Journal, October 30, 2007, Page C17 and "Big Banks Flock to 'Notes,' Try to Cash in on ETF Boom" by Shefali Anand, The Wall Street Journal, November 2, 2007, Page C1.

[2] Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to the Honorable Charles B. Rangel, Chairman, Committee on Ways & Means, U.S. House of Representatives, and to the Honorable Jim McCrery, Ranking Member, Committee on Ways & Means, U.S. House of Representatives (November 1, 2007).

[3] Letter from Marc E. Lackritz, President & CEO, Securities Industry and Financial Markets Association, to the Honorable Charles B. Rangel, Chairman, Committee on Ways & Means, U.S. House of Representatives, and to the Honorable Jim McCrery, Ranking Member, Committee on Ways & Means, U.S. House of Representatives (November 5, 2007).

[4] In 2001, the New York State Bar Association published a report that recommends imputing income on prepaid forward contracts and also describes the effects of such a change.