US capital markets
Morrison & Foerster
New York

Tax disputes

One of the hottest products in the financial markets in the past few years, the exchange-traded fund (ETF), has now collided with a second hot product, exchange-traded notes (ETNs). In late October, the battle over the federal income-tax treatment of ETNs heated up.

ETFs are investment funds whose shares trade on a stock exchange. From a federal income-tax standpoint, ETFs are flow-through vehicles, which must distribute their income. For example, a Standard & Poor's (S&P) 500 index ETF must distribute dividends on the S&P 500 index (around 1.75%) annually. Gains recognised when portfolio stocks are sold, for example, when the index is rebalanced, must also be distributed. Taxable US investors must include these sums in their income annually.

ETNs are structured notes issued by a corporation, typically a bank or investment bank. They have a return that is linked to a specified index – stocks, commodities, currencies, real estate, or master-limited partnerships. As the name suggests, they are listed on an exchange, such as the American Stock Exchange. The prototypical ETN is the Barclays iPath ETN. It is a 30-year non-interest-bearing note, issued by Barclays Bank. The payment at maturity is indexed, and is not principal-protected. For US federal income-tax purposes, ETNs are treated as prepaid forward contracts. This means that investors do not realise income or recognise gains until they sell the ETN. And as long as investors have held the ETN for more than a year, they will be taxed at the 15% long-term capital gains rate. The popularity of ETNs has increased, with Barclays continuing to list new iPath ETNs. Other investment banks such as Goldman Sachs and Deutsche Bank are rolling out their own variants.

The Wall Street Journal first reported the controversy brewing over ETNs in late October. In early November the Investment Company Institute (ICI), the mutual fund trade group, wrote a letter to the House Ways and Means Committee of the US Congress, asking it to enact legislation that would require accrual of income on ETNs. 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 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 to the House Ways and Means Committee arguing against legislative action. SIFMA suggested that ETNs are more like stock than mutual funds: forcing ETN investors to report income would be as inappropriate as requiring holders of stock to report income regularly. Reports have also circulated that the IRS and the Treasury Department are reviewing the tax treatment of ETNs.

At the time of writing, the House Ways and Means Committee has not released draft legislation, although on Capitol Hill, rumours are rampant that such legislation is circulating. In any event, the battle lines are drawn. We can expect voices to grow louder in the coming weeks and months, as the world of ETNs, and the stakes, grow larger. It is difficult to predict the timing, or the result, of a resolution.

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