Tax Savings on All That Glitters

Strategies clients can use for getting more out of gold investments.

BY ROBERT GORDON

At times of turbulence in global markets, it is not uncommon for some clients to consider adding gold to their portfolios. Whether that turns out to be a wise decision will be known only in the future.

What we do know, however, is that there are many ways to invest in gold. Choosing carefully can enhance clients’ pretax and post-tax returns.

In order to make it easier for investors to buy gold, Wall Street has created publicly traded investments tied to gold. These vehicles differ in the levels of fees, liquidity and taxation.

The first gold ETF, SPDR Gold Shares (GLD) has a 0.4% expense ratio. GLD was set up as a grantor trust that owns gold — one-tenth of an ounce for each share of GLD.

The grantor trust is ignored for tax purposes, however, and the investor is taxed as if he is holding gold directly. This means that long-term gains on gold are taxed at a maximum rate of 28% instead of the usual 20% for long-term gains (note these tax rates do not include the 3.8% Medicare tax).

Another sponsor, iShares, followed with the iShares Gold Trust (IAU), which has an expense ratio of 0.25% and has the same characteristics. There are also other gold ETFs that are not as actively traded as these first two.

For clients thinking short term (less than one year), exchange-traded options on GLD, IAU or gold itself may offer the best overall deal. There are no management fees on exchange-traded options and the taxation can also be more attractive.

Exchange-traded options on equities are taxed normally, but all exchange-traded options whose underlying security is anything but an equity, is automatically taxed as an IRC Section 1256 contract.

These 1256 contracts are taxed as if 60% of any gains are long term and the other 40% are short term, no matter how long you hold them; this creates a maximum rate of 27.84%. This is clearly superior to the 39.6% tax rate on short-term gains.

These listed options can also be useful to those who contemplate shorting GLD because all profits on short sales are taxed at the maximum tax rate no matter how long the short sale has been in place.

For those with a longer-term outlook, there are vehicles that could offer maximum taxation of 20% instead of the collectible rate of 28%.

Exchange-Traded Notes

Another possibility is the exchange-traded note issued by UBS tied to gold’s price. ETNs trade like ETFs but do not hold physical gold; an ETN is debt issued by the sponsor. Thus, investors in ETNs take a credit risk related to the issuer that investors in ETFs do not.

The ETN is taxed normally for holders (less than 12 months at 39.6%, and gains from holdings of more than 12 months at 20%). UBG, the UBS ETN, has an annual fee of 30 basis points and would offer a
lower long-term gain tax rate than the tax rate on gold ETF profits.

**Over-The-Counter Options**

If a client is comfortable taking a credit risk, there are also possibilities for better tax results than that of GLD through the use of over-the-counter options.

Oddly, the identical option can be taxed differently based on where the option trades. Over-the-counter options on gold (or on GLD for that matter) are taxed normally, in contrast to exchange-traded options on gold. A profitable long-term over-the-counter option profit will be taxed at a maximum of 20%

This is true even if the profit came from owning a put (even though it is a bearish bet). Thus, any client wanting to bet against gold should not short GLD but instead could be better off buying exchange-traded options for bearish bets of less than a year and better off buying an over-the-counter option for time horizons spanning over a year.

Last, the Sprott Physical Gold Trust (PHYS) is a fund in Canada that considers itself an ETF because it allows conversion into gold just like other ETFs. But, because the fund is headquartered in Canada, it is taxed as a passive foreign investment company.

The taxation of long-term gains on such a company (holding gold) could turn out to be either the best way to own gold or the worst depending on how closely you follow the tax rules.

If, as the prospectus suggests, you make a qualified electing fund choice to your files the day you buy the Sprott fund and complete the appropriate form on your tax return; profits are taxed normally at no more than 20%. If you do not know to make this election, then all profits from the Sprott fund will be taxed as ordinary income, no matter how long you hold the fund. The chart below illustrates these differences.

The price of gold has been in the doldrums the last few years and it may be that most people who own gold have an unrealized loss on their gold investments.

**Harvest a Loss on Gold**

It should be welcome news to those folks that the wash sale rules do not apply to gold, only to securities.

Thus, an investor could harvest his or her loss on gold without worrying about being out of the position for more than 30 days.

It could make a lot of sense for investors to take losses in GLD and immediately reinvest in one of these other vehicles that might be better positioned taxwise if the gold price retraces its price upward. As always, don't let the tail wag the dog, but there are lots of ways for advisors to explore the alternative ways to invest (long or short) in gold.

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**Robert Gordon** is a contributing writer for *On Wall Street*, adjunct professor at the New York University Stern School of Business and president of Twenty-First Securities.

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**Getting the Most Out of Gold**

A breakdown of the tax rates on investments.

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<thead>
<tr>
<th>HOLDING PERIOD</th>
<th>GLD ETF</th>
<th>LISTED OPTION ON GOLD</th>
<th>GOLD ETN</th>
<th>SPROTT ETF</th>
<th>SPROTT ETF (WITH QEF ELECTION)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-Term Gains</td>
<td>39.6%</td>
<td>27.84%</td>
<td>39.6%</td>
<td>39.6%</td>
<td>39.6%</td>
</tr>
<tr>
<td>Long-Term Gains</td>
<td>28%</td>
<td>27.84%</td>
<td>20%</td>
<td>39.6%</td>
<td>20%</td>
</tr>
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**Source:** Twenty-First Securities