Forbes

William Baldwin

Personal Finance 7/13/2017

Tax Deals For Gold Bugs

Eight ways to hold precious metals: pick wisely.

Do you want a position in gold, either as an insurance policy against inflation or as a way to gamble? Pay attention to the tax angle. Tax rules vary according to how you hold the stake.

Bullion. Bars of gold, silver, palladium or the like are "collectibles," with a maximum 28% federal tax on long-term gains. That compares with the lower rate (for most people, 15% or 20%) on stocks or bonds held long.

Short-term gains on stocks, bonds and gold bars are taxed at your higher ordinary-income rate.

Bullion funds. The big exchange-traded funds holding precious metals are organized as "trusts," which means they get taxed the way their assets would be taxed if held directly. So, shares in SPDR Gold Shares (GLD) or iShares Gold Trust (IAU) get hit with a maximum rate of 28% if held for more than a year.

Like bullion and most other investments, precious metal ETFs get taxed only on sale, and gains unrealized at death escape income tax altogether. That deferral/escape feature is worth a lot.

Unlike most investments, metal ETFs are exempt from the wash sale rule limiting losses on securities sold and then immediately repurchased. Robert Gordon, president of Twenty-First Securities, explains: The IRS, avid to collect the higher collectible-rate tax, has decreed that the metal funds are not "securities." But the wash sale statute applies only to "securities."

Example: You buy 5,000 shares of IAU for $60,000 and then see their value sink to $51,000. You sell the shares and buy them back five minutes later. Now you have a $9,000 capital loss to offset gains elsewhere (or up to $3,000 a year of ordinary income). Your eventual capital gain will be $9,000 higher than if you had stood pat, but that gain may occur decades later or never.

Futures. Commodity futures are taxed per Section 1256 of the tax code. You owe tax, or can deduct losses, on paper gains and losses annually, even if you don't sell. (This is called "marking to market," and it's a rarity in U.S. tax law.) Also: Your gains/losses are presumed to be 60% long-term, 40% short-term, no matter how long you have held the position.

Example: In August you buy a March Comex future covering 100 ounces of gold, worth $120,000. Come Dec. 31 the position is worth $125,000. On this year's tax return you declare $3,000 of long gain and $2,000 of short gain. When the future wraps up in March, you will have, for that year's tax return, a gain or loss figured from a $125,000 starting point.

Is this a better deal than what applies to stocks and bonds? That depends on your trading habits. Short-term speculators, at least the ones who make money, are well served by Section 1256. The 60/40 formula gives them a blended top rate of 30.6% (= 0.6 times 23.8% plus 0.4 times 40.8%). That beats the 39.6% ordinary rate they'd owe on short-swing profits from flipping stocks.

But long-term investors are better off without Section 1256. If you want to own gold for many years, you'll do better with IAU than with futures. With the ETF you can selectively harvest losses and let the gains run.

Commodity funds. The classic exchange-traded commodity fund, typified by PowerShares DB Commodity Tracking ETF (DBC), is organized as a partnership. Its positions flow through onto investors' tax returns via a K-1 form. The fund's stakes in gold futures and other futures traded in the U.S. get the 60/40, mark-to-market treatment.

There's an IRS gotcha here. When a fund is organized as a partnership, the management fee turns into a "miscellaneous deduction," worthless to most taxpayers. So your taxable gain is artificially boosted (or your loss reduced) by the fee, 0.85% annually at DBC.

K-1-free ETF. Some newer funds bypass the partnership, and its messy-looking K-1s, by using an offshore subsidiary. The paperwork is easier but the tax treatment nasty. Losses cannot be claimed or carried forward (either by you or by the fund), and gains are taxed as 100% ordinary income. Example: PowerShares Optimum Yield Diversified Commodity Strategy No K-1 (PDBC).

Stay away from K-1-free funds in your taxable account.

Stocks. Instead of gold, you could buy shares of a miner that is sitting on a heap of the stuff. Because of operating leverage (a miner might spend $1,000 to get $1,200 of metal out of the ground) and financial leverage (debt on the balance sheet), mining shares are more volatile than gold.

For diversity, own VanEck Vectors Gold Miners (GDX). Or save yourself the fund's 0.5% management fee by copycatting its three top holdings: Barrick Gold (ABX), Newmont Mining (NEM) and Franco-Nevada (FNV).

Tax treatment? Way better than the five alternatives above. Your long-term gains will be taxed at a maximum 15% or 20% federally. You can selectively harvest losses while letting gains ride. And there's a way to avoid wash sales.

Let's say the market stumbles just after you get in and you want to claim a capital loss—without the risk of getting whipsawed by a rebound during the 30-day timeout required by the wash sale rule. If you own the fund, sell it and immediately buy the three miners. More than a month later, sell the miners and restore your fund position.

If you started out with the miners, GDX can hold your spot in the gold casino for a month. Then swap back. Despite the overlap, the fund is not "substantially identical" to a subset of its holdings, so the wash sale rule is not triggered.

Exchange traded note. UBS sells a piece of paper structured as bank debt but with a return tied to the price of gold: UBS Etracs CMCI Gold Total Return ETN (UBG). If gold goes down you sell and claim a capital loss (short-term, if this happens within 12 months). If gold goes up you hang on for a few decades and qualify for the long-term rates.

The note carries a low 0.3% expense ratio. But there are a few things things not to like. One is the tiny float ($7 million). That means a fat bid-ask spread coupled with the risk that UBS will fold the product, ending your tax deferral. Next is the small risk that the IRS will look through the note and call your investment a collectible; see the discussion here.

Finally there's the small risk that UBS will go under and deliver a -100% total return.

IRA. You can put ETFs in your retirement account, sidestepping the 28% collectibles rate (or the painful aspects of diversified commodity funds). But don't do this if you need room in the IRA to hold assets with even higher tax burdens, like junk bonds.

The tax rates cited here include neither the 3.8% surcharge on investment income, which Congress may or may not repeal, nor income taxes imposed by states. Another thing to think about is that the capital gain escape at death is not a sure thing. In the course of repealing the estate tax Congress could cap or zap it.