

The Tax Drag Inside Commodity Futures Funds

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Investors often add commodity exposure for diversification or as a hedge against inflation. Many reach for a commodity futures fund to do it. What they may not see is a tax cost built into how those funds are structured, one that never appears in the expense ratio.

Most commodity futures funds sold in the U.S. route their futures positions through a wholly owned offshore subsidiary. That structure keeps the fund in good standing with the IRS. It also changes how and when shareholders are taxed, and the difference can compound into a meaningful gap in after-tax results.

Why a fund's tax status depends on what it earns

Mutual funds and ETFs are typically organized as regulated investment companies, or RICs. A RIC deducts the dividends it pays, so its income is taxed once, at the shareholder level. The fund itself owes no federal income tax on what it distributes.

A fund that loses RIC status is taxed as a C corporation: 21% federal tax on its taxable income, with shareholders taxed again on distributions. The same dollars are taxed twice.

To keep its status, a fund must pass three tests on an ongoing basis:

- **Income:** at least 90% of gross income must come from dividends, interest and gains on securities or currencies.
- **Diversification:** at the close of every quarter, no more than 25% of total assets may sit in the securities of any one issuer.
- **Distribution:** at least 90% of investment company taxable income must be paid out, with a 4% excise tax on shortfalls.

The income test is where commodities create a problem. Gains on commodity futures are not qualifying income.

The offshore workaround

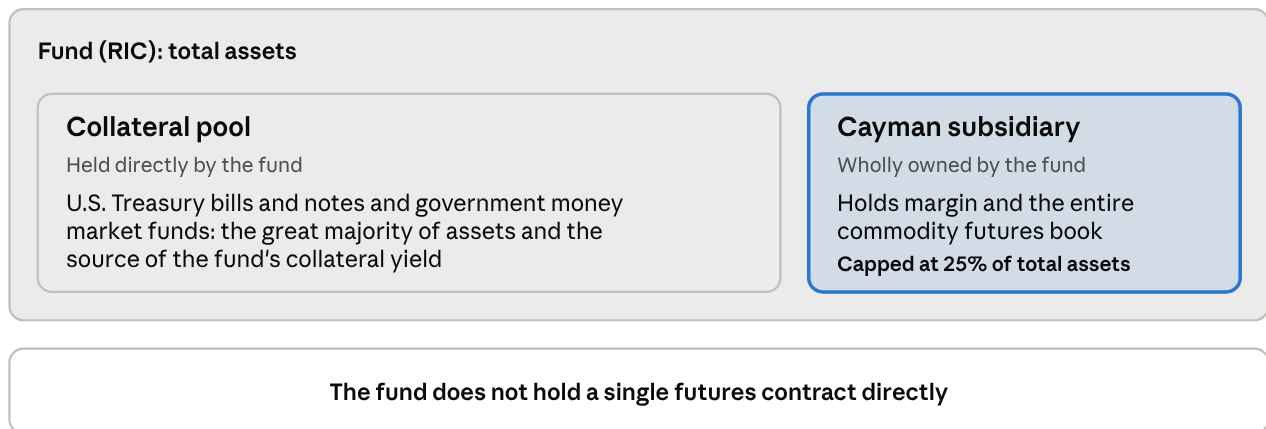
The common solution is a wholly owned subsidiary organized in the Cayman Islands. As a controlled foreign corporation, the subsidiary's commodity income reaches the parent fund as a Subpart F inclusion, which does count as qualifying income. Cayman is used because an exempted company there pays no local tax, adds no entity-level drag and is well understood by auditors and counsel.

In practice, a commodity futures fund owns two things:

- **A collateral pool held directly by the fund.** U.S. Treasury bills and notes and government money market funds make up the great majority of assets and generate the fund's collateral yield.
- **An equity stake in the subsidiary.** The subsidiary posts margin and holds the entire futures book. Initial margin is roughly 9% of notional, which lets a small slice of assets support futures exposure close to the fund's full net asset value.

The fund itself may not hold a single futures contract directly. Because the subsidiary counts as a single issuer under the diversification test, it is capped at 25% of the fund's total assets at the close of every quarter. That cap is a hard constraint: a breach puts pass-through treatment for the entire fund at risk.

The fund holds collateral; every futures contract sits in the subsidiary

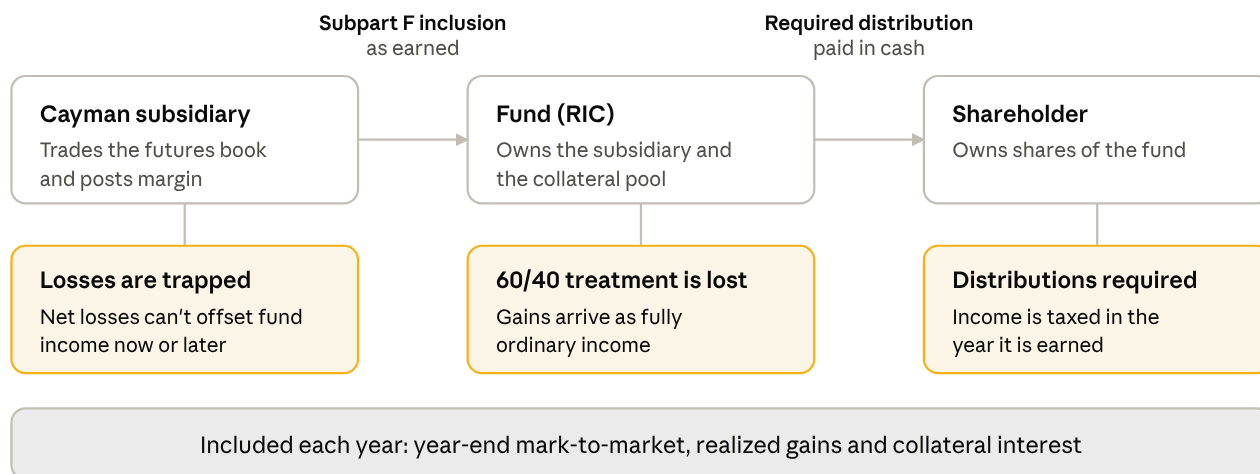


What a commodity futures fund owns

What the structure costs shareholders

The subsidiary keeps the fund compliant, but income travels a fixed path: the subsidiary earns it, the fund includes it as earned, and the fund distributes it to shareholders. Three consequences follow.

Gains reach shareholders as ordinary income, every year



How subsidiary gains reach the shareholder

- 1. The 60/40 benefit is lost.** Held directly, commodity futures are Section 1256 contracts, taxed 60% long-term and 40% short-term regardless of holding period. Routed through a foreign corporation, the same gains arrive as fully ordinary income. Section 1256 still forces year-end mark-to-market on open positions, so unrealized gains are included too, along with realized gains and interest on the collateral pool.
- 2. Subsidiary losses are trapped.** Net investment losses of the subsidiary cannot be deducted by the fund in the current year or carried forward to offset future taxable income. Gains flow through; losses stay behind.
- 3. Distributions are not optional.** Because income is included as earned, the fund must distribute it to remain a RIC. Large taxable distributions are a consequence of the structure, not a choice by the portfolio manager.

The result is that much of a commodity futures fund's return can be taxed in the year it is earned, at ordinary income rates. By contrast, price appreciation in an equity fund generally stays untaxed until the shareholder sells.

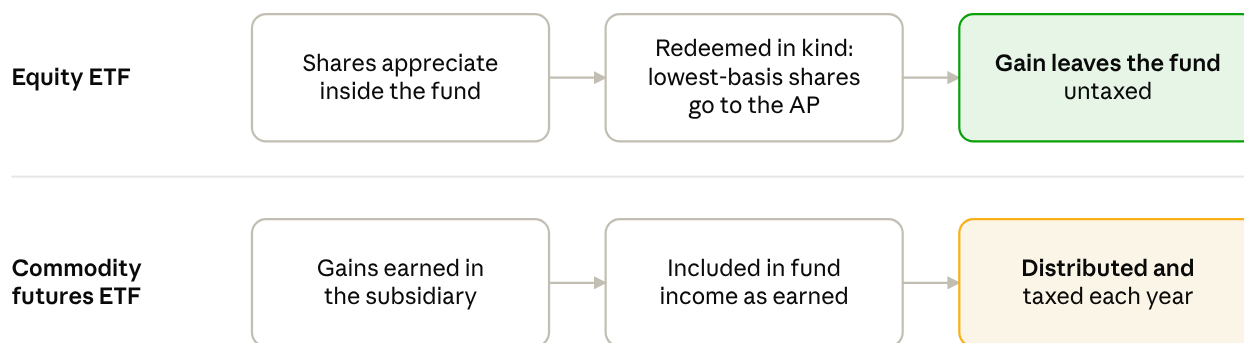
Why the ETF wrapper doesn't fix it

ETFs earn their reputation for tax efficiency through in-kind redemptions. When an authorized participant redeems shares, an equity ETF can hand over its lowest-basis holdings and recognize no gain. Appreciation leaves the fund without ever becoming a capital gain distribution.

None of that helps with commodity futures. The gains are earned inside the subsidiary and included in the fund's income as they arise, before any redemption happens. Futures cannot be delivered in kind, and these funds generally create and redeem in cash. There is nothing for the in-kind mechanism to carry out.

Whether the fund is an ETF or a mutual fund, the qualifying income test, the subsidiary and the Subpart F inclusion apply the same way.

In-kind redemptions shelter equity gains; futures gains are taxed first



Futures cannot be delivered in kind, and these funds generally create and redeem in cash.

Equity ETF vs. commodity futures ETF

What deferral is worth: a hypothetical

Two investments earning the same 15% pre-tax return can end up more than 3 percentage points apart after tax. Consider \$100,000 invested for five years in each of two hypothetical funds.

- **Commodity futures fund:** the entire return is distributed each year as ordinary income and taxed at the top federal rate.
- **Equity fund:** a 1% qualified dividend is taxed each year; the remaining appreciation is deferred until sale in year five.

	Commodity futures fund	Equity fund
Total tax paid over five years	\$36,539	\$23,957
After-tax value at year five	\$153,017	\$176,703
After-tax annual return	8.88%	12.06%

The commodity investor pays \$12,582 more in tax but ends with \$23,686 less. The shortfall is larger than the extra tax because money paid in tax in year one cannot compound for the next four. Deferral is worth more than the rate difference alone.

Hypothetical illustration only. Does not represent the performance of any fund. Assumes a \$100,000 investment, a 15% annual total return in both cases and top federal marginal rates including the 3.8% net investment income tax. Commodity fund: entire return distributed annually as ordinary income taxed at 40.8% and reinvested net of tax. Equity fund: 1% qualified dividend yield taxed at 23.8% annually and reinvested net of tax, with remaining appreciation taxed at 23.8% on sale in year five. Excludes fund expenses, state and local taxes and transaction costs.

Questions to ask before choosing commodity exposure

The structure behind a fund can matter as much as its strategy. When evaluating ways to gain exposure to commodities or real assets, advisors may want to ask:

- How does the fund obtain its exposure: commodity futures through a subsidiary, or another approach such as natural resources equities?
- How much of the fund's recent total return was distributed as taxable income?
- What is the character of those distributions, as reported on Form 1099-DIV?
- Will the investment sit in a taxable account, where annual distributions reduce what is left to compound, or a tax-deferred account, where they matter less?

Pre-tax returns tell only part of the story. For taxable investors, the path a return takes to reach them can shape how much of it they keep.

Important information

This material is for informational and educational purposes only and does not constitute tax, legal or investment advice. Tax laws are complex and subject to change, and their application depends on individual circumstances. Investors should consult their own tax adviser. Distributions may consist of ordinary income, capital gains and/or return of capital; the final tax character of a distribution is reported to shareholders on Form 1099-DIV. Commodity-related investments may be more volatile than other investments.

Social media post (LinkedIn)

Two funds. Same 15% pre-tax return. More than 3 points apart after tax.

Most commodity futures funds hold their futures in an offshore subsidiary to stay compliant with IRS rules. The trade-off: gains arrive as ordinary income, losses can get trapped and distributions aren't optional. Even the ETF wrapper can't fix it.

Our latest insight explains the hidden tax cost inside commodity futures funds and the questions advisors may want to ask before adding commodity exposure.

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Hypothetical illustration; does not represent any fund. Not tax advice.