THE DEAL

By Allan Sloan

A Gift That Keeps Giving

Tired of paying taxes like ordinary people? This shelter is for you!

THANKSGIVING has just passed; the year-end holidays are around the corner. So in the spirit of the season, I've got a gift for you. Sort of. It's not spiritual or religious and doesn't even involve food. It's about money. To be specific, it's a way that average investors may one day be able to defer taxes on interest and dividends, unless Washington closes a newly opened loophole.

If I sound ambivalent about this gift, it's because I am. I'd love to delay (or even better, completely avoid) sharing my investment income with the taxman, but what's good for me personally would be horrible public policy. Wages are already taxed so much more heavily than investment income that the last thing we need is to cut the investor class yet another big break.

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Our tale begins in June of last year, when Barclays Bank, best known for its high-grade, low-cost institutional mutual funds, began offering exchange-traded notes to retail investors. The likes of Bear Stearns and Merrill Lynch now offer them, too, but Barclays has more than an 80% market share.

Like exchange-traded funds, exchange-traded notes (which we'll call ETNs) are traded on stock exchanges, unlike open-end mutual funds, whose shares are issued and redeemed by fund companies. But ETNs have a big advantage over their fund sibs: a nifty tax shelter, at least for now, because of a tax opinion issued to Barclays by the prestigious Sullivan & Cromwell law firm.

The opinion held that Barclays ETNs (other than those linked to foreign-currency exchange rates) don't generate taxable income to investors. That's because ETNs are "prepaid forward contracts" in which the issuer agrees to pay holders an amount based on specific criteria rather than offering them an interest in a pool of assets, which is what mutual funds and ETFs do.

An ETN's income—such as dividends generated by the Barclays Indian stock market index issue or Merrill Lynch's high-yielding "Dogs of the Dow"—gets added to the price of the security rather than being paid in cash. So holders don't pay tax on that income until they sell or redeem their ETN. And if holders are careful, they'll pay only at the tax-favored long-term-gains rate.

"Under current law the holder of a nondebt financial instrument does not include income in advance of receipts," explains David Hariton, a Sullivan & Cromwell tax partner. Hariton cautions (as do Barclays' offering statements) that this is his firm's opinion about ETNs; it's not settled law.

Right now this barely matters to tax collectors because there are only a bit more than $4 billion of ETNs in existence—impressive for a complex product less than two years old, but a rounding error compared with the $12 trillion of open-end mutual funds or even the $550 billion of exchange-traded funds.

But if ETNs retain their tax advantage, you can bet that the likes of Vanguard and Fidelity will turn them into mass products with minimal trading costs and lower annual fees than

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