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Taxing Exchange-Traded Notes and the Future of Variable Prepaid Forward Contracts

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Abstract

While the taxation of prepaid forward contracts as a deferral instrument was blessed by the Internal Revenue Service (the Service) in 2003, Congress has targeted prepaid forward contracts multiple times for potential reform. Further, the Service considers the future of the treatment of prepaid forward contracts an open question and a high-priority for rule making. With the advent of exchange-trade notes (ETNs) by Barclays in 2006, the market saw the first publicly traded prepaid forward contracts and enhanced the spotlight on tax deferral through structured products. In this article, I provide an overview of ETNs, their tax treatment and their future in the market. I provide both a qualitative and a quantitative analysis of ETNs comparing the economics of these investments with the underlying assets and mutual funds that they are often compared to. In the quantitative analysis I use linear regressions and principal component analysis to demonstrate that ETNs do not perfectly track their underlying assets in pricing but rather have another factor driving the daily pricing changes in the investment. The article then discusses other potential taxation approaches suggested for prepaid forward contracts and assesses whether these are better options for the future.

Keywords: exchange traded notes, ETN, variable prepaid forward contract, VPFC, tax deferral, structured products**JEL Classification:** K34[Suggested Citation](#) >[Show Contact Information](#) >

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