What Is the True Tax Rate on Investments in Precious Metals?

In periods of high stock market volatility, investors are drawn to alternative assets such as precious metals in the hope of acquiring a stable investment. This strategy may not result in the highest after-tax return. This article explains the tax rules related to precious metals and illustrates how real after-tax return should be measured.

An educated investor is aware that returns on investment should be calculated net of the tax effect. For example, interest rates on municipal bonds are lower than interest rates on corporate bonds, but the former isn't subject to federal income taxes while the latter is potentially taxed at the top marginal tax rate. But the marginal tax rate is only one piece of the puzzle. In preparing taxes over recent years, we have been rather perplexed by the notion that the true tax rate on most investment long-term capital gains is almost universally perceived to be equal to the maximum nominal capital gains rate—currently at 15%—if held for more than one year. According to the current tax code, however, precious metals are considered a "collectible" taxed at a capital gains rate of 28%. Note that this rate applies to actual gold bullion or coins as well as to stock of exchange-traded funds (ETFs) such

as SPDR Gold Trust (GLD) or iShares Silver Trust (SLV). Thus, an investor can't avoid being taxed at the higher rate by investing in ETFs.

This article looks at calculating a more accurate economic capital gains tax rate after allowing for inflation adjustment on the initial investment during holding periods of various lengths. We believe that the real tax rate for investment analysis purposes should be calculated by dividing the actual tax by the gain adjusted for inflation as follows:

$$Real\ Tax\ Rate = \frac{28\% * (Proceeds - Actual\ Basis)}{(Proceeds - Actual\ Basis * (1 + inflation^{holdingperiod}))}$$

To illustrate, we use three different precious metals—gold, silver, and platinum—and calculate actual and inflation-adjusted gain based on the metals' values for the past 40 years. Forty years ago, the average price for an ounce of gold, silver, and platinum was approximately $40, $1.40, and $150, respectively. In the first quarter of 2011, the average prices were $1,507, $34, and $1,792. Accordingly, the average returns were 12.1% (gold), $13.8% (silver), and 9% (platinum). Table 1 displays the actual gains for each of these metals for different holding peri-

ods, assuming an initial investment of $1,000 and a sale in 2011.

For the same time span, the average inflation rate according to CPI statistics was 4.4%. We use this number to modify the actual gains from Table 1. Adjusting the $1,000 assumed initial investment (actual basis) for inflation, the gains for each metal and holding period are less, as illustrated in Table 2.

Gold, silver, and platinum are considered collectibles and taxed at a maximum rate of 28%. In order to compute the tax, therefore, the actual gains (as computed in Table 1) are multiplied by 28%. The real tax rate (see Table 3) is then computed by dividing the actual tax due by the inflation-adjusted gains from Table 2.

Table 3 illustrates several interesting points:

◆ When adjusting gains for inflation, the actual (real) tax rate at which the investment is taxed is higher than the statutory marginal tax rate.

◆ The longer the holding period, the less the impact of inflation on the real tax rate. For example, holding any pre-

Table 1. Actual Gains for Holding Periods between 1 and 40 Years

Purchased for $1,000 in	Holding period	GOLD	SILVER	PLATINUM
2010	1 year	$ 121(*)	$ 138	$ 90
2006	5 years	$ 768	$ 911	$ 537
2001	10 years	$ 2,127	$ 2,652	$ 1,363
1996	15 years	$ 4,529	$ 5,980	$ 2,632
1991	20 years	$ 8,777	$ 12,338	$ 4,583
1986	25 years	$16,288	$ 24,490	$ 7,581
1981	30 years	$29,570	$ 47,714	$12,190
1976	35 years	$53,055	$ 92,095	$19,275
1971	40 years	$94,584	$176,911	$30,165

(*) This number is calculated as: $1,000 + ($1,000 * 12.1%) = $1,121; $1,121 − $1,000 (the original investment) = $121 (the actual gain).

Table 2. Inflation-Adjusted Gains for Holding Periods between 1 and 40 Years

Purchased for $1,000 in	Holding period	GOLD	SILVER	PLATINUM
2010	1 year	$ 77(*)	$ 94	$ 46
2006	5 years	$ 528	$ 671	$ 297
2001	10 years	$ 1,589	$ 2,114	$ 825
1996	15 years	$ 3,622	$ 5,073	$ 1,725
1991	20 years	$ 7,412	$ 10,974	$ 3,218
1986	25 years	$14,356	$ 22,558	$ 5,649
1981	30 years	$26,934	$ 45,078	$ 9,554
1976	35 years	$49,546	$ 88,586	$15,766
1971	40 years	$89,993	$172,320	$25,574

(*) This number is calculated as: $1,000 + ($1,000 * 12.1%) = $1,121 (proceeds); $1,000 (the original investment) + ($1,000 * 4.4%) = $1,044; the inflation-adjusted gain is therefore $77 ($1,121 − $1,044).

Table 3. Real Tax Rate for Holding Periods between 1 and 40 Years

Purchased in	Holding period	GOLD	SILVER	PLATINUM
2010	1 year	44.0%(*)	41.1%	54.9%
2006	5 years	40.7%	38.0%	50.6%
2001	10 years	37.5%	35.1%	46.2%
1996	15 years	35.0%	33.0%	42.7%
1991	20 years	33.2%	31.5%	39.9%
1986	25 years	31.8%	30.4%	37.6%
1981	30 years	30.7%	29.6%	35.7%
1976	35 years	30.0%	29.1%	34.2%
1971	40 years	29.4%	28.7%	33.0%

(*) The tax is paid on the actual gain of $121; $121 * 28% = $33.88; the actual rate is 44% ($33.88 / $77 (the inflation-adjusted gain)).

cious metal for less than 10 years results in a real rate that is higher than the current top marginal tax rate on ordinary income of 35%. After 40 years, however, the real rate is pretty close to the statutory rate for gold and for silver (but not for platinum) at 29.4% and 28.7%, respectively.

◆ A larger spread between the growth rate (rate of return) of the investment and average inflation is good for two reasons: It results in a lower real tax rate and leads to a faster decrease of the real tax rate (which asymptotically approaches the statutory rate). Platinum, which has a relatively low rate of return, therefore has a very high real tax rate at almost 55% for a short holding period of only one year, and the rate remains high at 33% (higher than the marginal tax rate on ordinary income) for a long holding period of 40 years.

Investors who have been moving into the precious metals markets, whether as a hedge against inflation or simply for investment gains, need to be aware of the tax consequences of these investments. Considering the current public debt, the marginal tax rate for collectibles is likely to remain high; thus, gains from the sale of precious metals and stock in ETFs are taxed higher than other long-term capital gains. High inflation may well reduce the real after-tax returns even more.

In addition, the Health Care and Education Reconciliation Act (P.L. 111-152) prescribes that, starting

in 2013, individuals with income of $200,000 or more ($250,000 for couples filing jointly) will have to pay an additional tax of 3.8% on their investment income, which includes gains from the sale of precious metals and stock in ETFs. This will increase the real tax rate and lower the after-tax return even more.

Interestingly, unlike the gains, losses from investments in precious metals or stock in ETFs aren't subject to special tax treatment. That is, for any net capital losses—be it from an investment in precious metals or in other capital assets—the same capital loss deduction limitations apply (i.e., for individual taxpayers, a deduction of $3,000 per year with indefinite carryover). **SF**

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