

Leveraged Exchange Traded Funds

Understanding Taxable Distributions

Traditional ETFs are generally tax efficient because the in-kind creation and redemption mechanism limits portfolio turnover. Conversely, leveraged index ETFs have extremely high portfolio turnover as they rebalance portfolios daily in response to market movements and do not experience a significant level of in-kind creation or redemption transactions. As a consequence, leveraged ETFs are generally not tax efficient, at least by the standards of traditional ETFs.

Distributions are generally not good for long-term investors in taxable accounts because such investors seek to (a) delay recognition of gains to allow such gains to compound through time (before paying taxes on the gains) and (b) benefit from the lower tax rate on long-term capital gains. Market commentators seem to look at distributions from the perspective of the long-term investor and therefore view distributions negatively.

Long-term investors are not appropriate users of leveraged index ETFs. Dynamic asset allocators and traders, however, are appropriate users and they do not have the same sensitivity to distributions as long-term investors. Traders generally do not seek to delay recognition of gains (or deferral or taxes) and, as a consequence, generate short-term capital gains, which are taxed as ordinary income. As a consequence, a trader will be negatively impacted from a tax perspective by a distribution only if the distribution exceeds the amount of the trader's short-term capital gains in the current calendar year.

The following hypothetical example illustrates the point:

For Calendar year 2009, Trader Mary has net short-term capital gains of \$200,000 from trading stocks and ETFs before she liquidates all of her positions and heads out on her annual two week Thanksgiving holiday on November 15th.

Assuming an effective tax rate of 35%, before she went on vacation, Trader Mary owed \$70,000 in taxes on her \$200,000 in short-term capital gains.

Refreshed from her vacation, Trader Mary resumes trading.

- On December 1st, she invests \$100,000 in a leveraged ETF, buying 10,000 shares at an NAV of \$10.00.
- On December 5th, with the NAV still at \$10.00, the leveraged ETF makes a distribution of \$1.00, all of which is short-term capital gain which when distributed by the ETF, is treated and taxed as ordinary income by the ETF shareholders. The NAV of the ETF declines by \$1.00 from \$10.00 to \$9.00.
- On December 10th, with the leveraged ETF NAV at \$9.00 (meaning that the NAV has not moved due to market action during Trader Mary's holding period), Trader Mary sells all her shares. She now has her original \$100,000. Since she was an owner of the ETF when it made a distribution, she will be taxed on the \$10,000 distribution she received as ordinary income.

Has Trader Mary been harmed by the distribution?

As a consequence of her investment in the leveraged ETF, Trader Mary now has:

- \$10,000 of ordinary income from the distribution and a \$10,000 short-term capital loss caused by the sale of the position at the lower (due to the distribution) NAV.
- The \$10,000 short-term capital loss reduces her \$200,000 short-term capital gain, leaving Trader Mary with \$190,000 of short-term capital gains and \$10,000 of ordinary income.

	Short Term Capital Gains	Ordinary Income
From Trading	\$200,000	
Directly From Distribution		\$10,000
From Sale of Shares (Indirectly From Distribution)	(\$10,000)	
Aggregate Taxable Income	\$190,000	\$10,000

Short-term capital gains and ordinary income are taxed at the same rate (35%). Therefore, Trader Mary's tax liability is still \$70,000. She is no worse off because of the distributions.

In practice, few people like distributions. However, for traders, the issue tends not to be an economic one centered on taxes but rather a practical one based on market exposure: distributions reduce exposure.

Capital losses generally cannot be used to offset distributions of income or short term capital gains, which are treated as ordinary income when distributed by the ETF, so a trader (unlike Trader Mary) who has no short-term gains that can be offset by the short term capital losses she recognized on the sale of her ETF shares in a year in which she receives a distribution will be disadvantaged by the distribution. If instead the distribution comprises long-term gains, short-term capital losses from the sale of the position will generally offset the distribution under special US Federal Income Tax Rules, and therefore, there is no negative tax impact.

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There is no guarantee the funds will achieve their objective. An investor should consider the investment objectives, risks, charges, and expenses of Direxion Shares carefully before investing. The prospectus contains this and other information about Direxion Shares. To obtain a prospectus please visit www.direxionshares.com. The prospectus should be read carefully before investing.

Investing in index funds may be more volatile than investing in broadly diversified funds. The use of leverage by a fund means the Funds are riskier than alternatives which do not use leverage.

ETFs are not suitable for all investors and should be utilized by only sophisticated investors who understand leverage risk, consequences of seeking daily leveraged investment results and intend to actively monitor and manage their investments. The funds are not designed to track the underlying index over a longer period of time.

The risks associated with the funds are detailed in the prospectus which include: adverse market condition risk, adviser's investment strategy risk, aggressive investment techniques risk, concentration risk, counterparty risk, credit and lower-quality debt securities risk, equity securities risk, currency exchange risk, daily correlation risk, daily rebalancing and market volatility risk, depository receipt risk, foreign and emerging markets securities risk, sector securities risk, interest rate risk, inverse correlation risk, leverage risk, market risk, non-diversification risk, shorting risk, small and mid cap company risk, tracking error risk, and special risks of exchange-traded funds, market timing activity and high portfolio turnover risk, investing in other investment companies and ETFs risk, commodities securities risk, geographic concentration risk, valuation time risk, derivatives risk, commodity-linked derivatives risk, wholly-owned subsidiary risk, tax risk, options and futures contracts risks, security selection risk, Debt Instrument Risk, Gain Limitation Risk, U.S. Government Securities Risk, and Special Risks of Exchange-Traded Funds.

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