

Trading Foreign Futures? Know the Tax Rules before You Trade

Trading foreign index options (foreign futures) is hot. Big problem – not all futures are created equal. Foreign futures act like U.S. futures except at tax time. U.S. futures enjoy a tax break unlike their foreign counterparts. There is hope – some (but not all) foreign futures may be eligible for preferential tax treatment. You simply have to know the IRS rules applicable to futures and which foreign exchanges are CFTC blessed.

By Hannah M. Terhune, LLM and Roger D. Lorence, LLM

A hot new trading strategy is trading European index options, such as the DAX, when U.S. markets are closed. This strategy has been highlighted in the financial press a lot recently. Given that European markets are either five hours or six hours ahead of our markets, a trader in California, say, can be nine hours behind with respect to trading in these electronic index option markets in Europe. So, when it's noon in Frankfurt, Germany, the home of Eurex (the main European index option market), it's only 3 am in California (or 6 am on the East Coast), allowing plenty of time to concentrate on the foreign trading (if you're a night owl).

This is how the trading strategy works: each of the major European markets has an index (for the U.K. it is the FTSE-100, for France it is the CAC-40, for Germany it is the DAX-30), for which there is trading in options in that index. The stocks in each index make up the lion's share of the market value in that country's stock market. These index options are very similar to index options on U.S. stocks, and trade in very similar ways, except, of course, that the home markets for the stocks making up the index are in Europe, not the U.S.

Since U.S. traders can actively trade these major index options when U.S. markets are closed (including trading days in Europe that are legal holidays in the U.S. when our markets are closed). U.S. traders who cannot actively trade during the day find the ability to trade in these European markets a very exciting opportunity.

First, let's discuss the tax rules that apply to index options (futures). All tradable products are taxed as either securities or commodities. Securities include stocks, stock options, narrow-based indices, single stock futures, mutual funds, Exchange Trades Funds (like the QQQ) and bonds. Section 1256 of the Internal Revenue Code sets the definition of a commodity, requires mark to market accounting at year-end, and establishes certain tax breaks for commodities.

Commodities biggest tax benefit (when compared to securities) is that gains are taxed 60% at long-term capital gains rates and 40% at short-term capital gains tax rates (e.g., ordinary income tax rates), regardless of how long positions are held, how many

contracts are traded during the year, and without regard to what other types of trading, activity (if any) that the taxpayer is engaged in.

Section 1256 contracts include regulated futures contracts, foreign currency contracts, nonequity options, dealer equity options, and dealer securities futures contracts. For a partnership that is a qualified fund, Section 1256 contracts include bank forward contracts, foreign currency futures contracts and similar instruments. *Nonequity options* are options traded on qualifying commodities exchanges, and include index options based on broad-based indices (those indices with 10 or more stocks such as the Dow futures contract, the Nasdaq 100 futures contract, or the S&P 500 futures contract). *Equity options* are options on single stocks when the options are traded on a U.S. options exchange. Equity options are only treated as a Section 1256 contract when the taxpayer is a dealer in those option contracts.

As noted earlier, commodities, unlike securities, enjoy preferential tax treatment. Section 1256 applies to index options listed on U.S. exchanges (called “60/40 contracts” in the industry).

Congress keeps lowering the capital gains rates on long-term rates. Right now, there’s a 15% maximum long-term capital gains rate. As a result, a successful trader in Section 1256 contracts is taxed at a maximum rate of 23% at the Federal level (60% x 15% plus 40% x 35%) regardless of how long a contract is held. This is as good as it gets from a tax standpoint (especially if the trader lives in Nevada, or some other zero or low-tax jurisdiction).

Let’s put all of these rules together in an example. Assume that U.S. trader T’s only transactions in 2004 are trading in the S&P 100 index option and that T has \$400,000 of profits. Because all contracts are treated as marked to market at year end, T is taxed at a maximum federal income tax rate of 23%, or \$92,000. Note that the same profits from active trading in single stock options would be taxed at 35%, or \$140,000 in total.

Assume, instead, that T had traded DAX options in 2004 on Eurex. Would the \$400,000 of profits be taxed at \$92,000 or \$140,000?

That is the question under scrutiny here.

Foreign options exchanges are allowed to offer their facilities to traders based in the U.S. only if the U.S. Commodity Futures Trading Commission (CFTC) has issued rulings permitting the foreign exchange to offer their index contracts for trading by U.S. traders. Part 30 of the CFTC’s regulations establishes the regulatory framework governing the offer and sale of foreign futures and option contracts to U.S. persons acting as futures commission merchants, introducing brokers, commodity pool operators, and commodity trading advisors.

Section 30.10 of these rules allows the CFTC to exempt a foreign firm acting in the capacity of a futures commission merchant from compliance with certain CFTC rules.

To obtain such relief under Rule 30.10, the firm's home country regulator must demonstrate that it has a comparable system of regulation and must enter into an information sharing agreement with the CFTC.

In short, the CFTC makes sure that the foreign contract market has daily mark-to-market rules, margin requirements, and effective market supervision by the foreign exchange's regulator that would pass muster in the U.S.. Once a firm receives confirmation of Rule 30.10 Order, it can sell foreign futures and options to U.S. persons without registering with the CFTC.

While the CFTC has acted and blessed U.S. trading in certain foreign futures contracts, the IRS has not enacted the coordinative tax rules Congress mandated and expected. Some would take the position that the IRS has not yet gotten around to issuing rules that would favor traders is not surprising. However, this failure of the IRS to act could also be viewed as a blessing in disguise. Here's why.

Congress told the IRS to issue guidance for treating contracts traded on foreign exchanges as qualifying for Section 1256 treatment. Such guidance should have been issued as soon as the CFTC identified (via the Rule 30.10 process and other regulatory processes) foreign contracts traded under conditions analogous to those prevailing in U.S. contract markets (which are governed by the CFTC). Regulatory guidance take a long time to draft and they go through a long (and politicized within the IRS) approval process.

The IRS did issue two revenue rulings in the 1980's and then stopped altogether, even though the CFTC has gone on to issue many rulings enabling contracts trading on foreign exchanges to be offered to U.S. investors on grounds that the foreign markets have rules analogous to rules on U.S. exchanges. It well may be the IRS has been dragging its feet on issuing more rulings on foreign contracts – these rulings entitle the successful trader to the tax-advantaged treatment that applies to Section 1256 contracts.

The quandary for the successful trader in the European markets for the DAX is that it is not clear how to report these contracts for income tax purposes. It is clear that if the DAX contracts were listed on U.S. options markets (rather than, for example, the EUREX market in Frankfurt) these contracts would be eligible for 60/40 treatment and the maximum 23% rate. From the economic standpoint of the trader, the rules for trading index options on the EUREX or the CBOE or other U.S. options markets are the same. In practice, because the U.S. trader can trade on the EUREX through a U.S. account, the only real difference to the trader (apart from the tax treatment) is the time zone in which the exchange is located.

The fact of the matter is that all tradable products are taxed either as security or a commodity. It doesn't make any sense to treat CFTC approved foreign futures as a stock for tax purposes. European Index Options such as the he DAX and other broad-based indices should receive 60/40 treatment under Section 1256 because they are economically equivalent to contracts traded on U.S. futures markets The IRS issued

guidance last year dealing with the interpretation of other types of Section 1256 contracts in which the IRS took the position that the statute should be interpreted broadly and applies to certain over-the-counter options contracts that are economically equivalent to contracts that are clearly Section 1256 contracts.

Some would say that the IRS is intentionally hurting traders by thumbing its nose at its congressional mandate to create an environment of regulatory certainty. However, in some sense, the IRS's failure to act could be viewed as a preference for allowing the CFTC to take the lead in bringing regulatory certainty to this area.

Consider this. Congress passed the Commodity Futures Modernization Act of 2000 (Act) late in 2000. This Act established a framework for joint regulation of single stock futures and narrow based indices. Tax issues were also resolved as the Act updated the definition of Section 1256 nonequity options to include options on broad based indices. Under the Act, futures and option on narrow-based indices (indices with nine or fewer stocks) are taxed as securities. Futures and options on broad based indices are taxed as commodities. Under this logic, the DAX could be viewed as a broad-based option index that has been blessed by the CFTC, thus rendering 60/40 treatment as appropriate.

In fact, a reasonable interpretation of the income tax treaty in effect between the U.S. and Germany forces 60/40 tax treatment. This treaty (as do most U.S. tax treaties) specifically contains a non discrimination clause which prevents taxes from impeding the free flow of trade, investment, and people. In this particular case, allowing 60/40 to U.S. broad based indices and not to CFTC approved broad based foreign indices (such as the DAX) is discriminatory and violates, in this particular case, the U.S.-German income tax treaty, since it favors the U.S. futures markets.

Interesting, the U.S. has nearly 50 tax treaties in force and the CFTC has issued numerous Rule 30.10 Orders (and other influential regulatory guidance such as No Action Letters).

In some other cases a trader may be able to report certain broad-based foreign index option contracts as Section 1256 contracts, depending on the facts of the trader's case (the type of contract, whether it is broad based index, whether it is CFTC blessed, and the nature of the income tax treaty in effect, if any, between the U.S. and the country where the foreign exchange is located).

Given the IRS failure to honor its congressional mandate to keep pace with global market changes and CFTC regulatory activity, Congress should be lauded for its passage of the Act. The Act ensures that almost all stock index futures and options are treated as commodities eligible for 60/40 treatment. This is a very interesting development in the tax law treatment of foreign option contracts and we urge all active traders to monitor developments in this area. We will keep you posted in this space.

If you have any questions about foreign futures, contact us at legal@greencompany.com or [call us](#).