

What tax rate does your future hold? Securities and futures exchanges are competing for your business with lots of new products. When choosing which ones look most attractive, add taxation to the mix; it could help reduce your tax rate by 12 percent.

## **Don't Let the Taxing World of Investment Taxation Baffle You**

By Robert A. Green, CPA

Let's assume you are interested in trading a NASDAQ 100 instrument because you are not an expert in any one particular stock and like the broad nature of indexes instead. Next, notice that security and commodity exchanges are competing for your business by offering you a few choices in tradable NASDAQ 100 instruments. You can trade the NASDAQ 100 TRUST (QQQ), an exchange traded fund (ETF). Alternatively, you can trade the E-mini NASDAQ 100 (NQ), a smaller electronically traded version of the NASDAQ 100 stock indexes, compliments of the Chicago Mercantile Exchange.

What you may *not* know is that there are some significant differences in taxation for the above two choices.

The QQQ, like all ETFs, are taxed like securities, with short-term ordinary tax rates up to 35 percent. The NQ, however, is taxed like most futures contracts with the more tax-beneficial 60/40 tax treatment. Sixty percent of trading gains are considered long-term (with maximum tax rates up to 15 percent), and 40 percent are considered short-term (with maximum tax rates up to 35 percent). The maximum blended rate on commodities is 23 percent, which is 12 percent lower than the maximum rate on securities. Wow, it suddenly occurs to you that you can save a bundle on trading the NQ versus the QQQ. Just make sure that all other factors for these competing choices do not trump the tax benefits.

Commodities have lower tax rates than securities, and there are also other important differences in taxation. Simply, commodities are marked-to-market (by default) and, therefore, are exempt from important tax rules that affect securities including: wash sales; straddles and constructive receipt; and holding periods.

Certainly, there are many other rules and nuances that traders should understand before they start trading a given instrument, so be careful to read the fine print; a product name does *not* always indicate how an instrument is taxed.

### **The Markets Are Ahead of the IRS**

Former U.S. Treasury Secretary Paul O'Neil called the tax code an abomination that needed to be scrapped and redone from scratch. He "retired" early, and few pundits

expect his vision to be executed. Thus, we are all stuck with this abomination for some time to come.

And, of course, the tax code is a work in progress. Congress uses “fiscal policy” to encourage, reward and punish certain kinds of business and investment behavior. Some of it may be labeled pork-barrel politics, but some also is truly useful.

In the case of taxation for securities and commodities, the current state of the law does not have an equal playing field. Even though many types of securities trade like commodities with a “zero-sum game,” Congress has reacted to different events over the years and caused a “great divide” between taxation for securities versus commodities.

In the 2003 Act, Congress sought to close this gap, but powerful commodity exchanges and lobbyists saved their cherished 60/40 treatment from being repealed (in the last minute of a conference bill). It is anticipated that Congress will try to close current gaps (in securities versus commodities) again soon. In the meantime, many traders will seek to profit from these gaps.

### **In the Eyes of the IRS, It’s Either a “Security” or a “Commodity”**

In the mid-1980s, Congress acted to stop widespread abuse by professional commodity traders who were using straddles to avoid income taxes. They would have offsetting positions and close losing positions in the current tax year while keeping open their offsetting profitable positions through year-end. To stop this abuse, Congress passed new, sweeping legislation to provide for IRC Section 1256 contracts, which included most commodities and futures contracts on commodities exchanges. This was the first significant divorce of commodities and futures from securities.

The most important element of IRC Section 1256 contracts was mark-to-market accounting (MTM), which provided that all positions at year-end would be treated as if sold at year-end using year-end prices. This had the immediate chilling effect of killing off the use of commodity straddles for tax avoidance. Now, both losing and profitable offsetting positions would be reported in the current tax year. Clearly, MTM changed many important fundamentals in the tax code, which favored long-term investing.

### **Is It a “Capital Asset” or a Hedge for Business?**

Before Congress passed IRC Section 1256 legislation in the 1980s, all securities and commodities were subject to tax laws for “capital assets” versus ordinary business transactions. Traders and investors purchased securities as “capital assets” to potentially generate a gain from speculation, rather than as part of a business operation. Similarly, a trader speculated in corn futures without any commercial interest in the commodity, and generated more tax-favorable “capital” gain and loss treatment. But the corn farmer who *hedged* his crop with corn futures did it as part of his business’s risk-aversion strategy, and generated “ordinary” gain or loss treatment.

Unless an item is defined in IRC Section 1256, IRC Section 988 (the currency rules stated later in the article) or another code section, it is subject to the general rules for “capital assets.”

## **Congress Rewards Long-Term Investments In “Capital Assets” (Securities)**

The tax rules for businesses are fairly straightforward. Add up revenues, deduct all business expenses, and the resulting net profit is taxed at ordinary income tax rates.

Ordinary tax rates are high, but at least a business can deduct every possible business expense without restriction.

Congress passed a complex body of rules for investment activity, and these rules have not aged well. Here’s the bargain: Hold a “capital asset” long enough (currently 12 months), and pay a lower tax rate – currently 15 versus 35 percent – a significant difference per the 2003 Tax Act. But fiscal policy usually comes with both a carrot *and* a stick. To balance the budget on lower long-term capital gains rates, Congress applies a series of rules to prevent abuses and to raise revenue.

## **Don’t Let Congress Wash Your Savings Away With “Wash Sale” Rules**

Congress used MTM for Section 1256 to stop traders from avoiding taxes by reporting loss positions and deferring offsetting profitable positions. The original tax rule to stop a similar type of practice is still on the books, and it’s a royal pain for active securities traders – the wash sale rules.

If you re-enter a losing positions within 30 days before or after selling a losing position, you are hit with the dreaded wash sale loss deferral rule. These rules are highly complex and beyond the scope of this article. But, bottom line, if you trade commodities and futures (IRC section 1256 contracts) or elect IRC 475 (the new mark-to-market accounting rules for business traders), you are exempt from the wash sale rules. What a relief! Congress thinks the wash sale rules are fair because they don’t want traders taking short-term losses (at the higher tax rate for benefits) and then paying taxes later on at the lower long-term rates.

## **Have a Loss?**

### **Good Luck Trying to Deduct It.**

The greatest problem for traders is the dreaded “capital loss limitation” rules. It’s a puny net deduction on capital losses of \$3,000 per year for individuals (zero for corporations), and it has not been indexed for inflation or raised in decades. Come on! Please! What trader can’t lose \$3,000 in one hour’s time, let alone over a year?

Congress changed the laws in 1997 for those who qualify as business traders to allow ordinary gain or loss treatment like other businesses. If you elect IRC Section 475 on time, you are exempt from the dreaded capital loss limitation (and wash sale) rules and may take unrestricted ordinary deductions for your trading losses. But not every trader qualifies for business treatment, and most don’t know about MTM IRC 475 before it’s too late.

Commodity and futures traders catch another break. They are permitted to carry back IRC Section 1256 contract trading losses three tax years, but only to be applied against Section 1256 contract trading gains.

Capital loss limitations are an abomination for traders. Most traders do not hold positions for more than a month, and most day- or swing-trade. They have no reasonable prospect of ever getting that carrot – long- term capital gains benefits – so why penalize them with wash sales and capital loss limitations?

### **Is It a Security or a Commodity? That Is the Question**

There has been a bevy of new financial products launched by securities and commodities exchanges the past few years, including but not limited to ETFs, E-minis, single-stock futures, plenty of new indices, and options and futures on almost everything. Commodity futures exchanges rushed to market securities-like products to mimic the trading in indexes rather than miss the equities bubble boom. And electronic exchanges like OneChicago, LLC, and NQLX offered securities futures contracts (single stock futures) and ETF futures. Competing exchanges stepped on each other's turf.

But, product *names* are not indicative of tax treatment and are intended to draw attention and use by traders. Before starting to trade a new product, find out how it's taxed – as a security or a commodity.

### **Single Stock Futures – Security or Commodity?**

One of the new financial products to trade are “single stock futures” (SSF). Many traders and professionals alike are still confused about how they are taxed. Single stock futures, called “securities futures contracts” by the IRS, sound like (and trade like) a futures product, normally taxed as a commodity. However, SSFs are taxed like securities.

Here's the simplistic rule of thumb. Figure all new products are taxed as either a security or a commodity.

Next, consider that many new financial products are a combination or representation of other securities and/or commodities. Try to figure out whether the product resembles a security **or** a commodity. For example, with single stock futures, the product may act like a future, but the underlying product is one security and the SSF product resembles that underlying security. In fact, that is why the IRS states SSFs are taxed like securities.

### **Indexes – Security or Commodity? It Depends.**

Next, apply this same logic to stock indexes. There has been a rash of new stock indexes from various exchanges, providing traders with new means to trade securities markets. To date, most of these new indexes are, in fact, taxed like commodities, but some of the new ones are taxed like securities. New coordinated legislation in 2000 from the IRS, Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) set the new general rule.

Extending the above logic for SSFs, if the product trades like one or a few securities (the cut-off is set at nine), it is defined as a “narrow-based” index and taxed like a security. Conversely, if the index is comprised of ten or more securities, it is considered a “broad-based” index that resembles a commodity.

To date almost all indexes are comprised of ten or more securities, and therefore, are taxed like commodities with the beneficial 60/40 treatment. But a few aren't. OneChicago, LLC one of two U.S. futures exchanges originally established to offer single stock futures and related products, last summer introduced 15 futures on the Dow Jones MicroSector Indexes. Each of the 15 is a narrow-based index that includes five of the largest and most actively traded stocks in an industry sector. These narrow-based indexes are taxed like securities.

**Forget the Rule of Thumb:  
Give Me a List of Securities, Please**

OK, let's just break this down to make it easier. Securities include but are not limited to:

- Exchange Traded Funds (ETFs) including QQQ, DIA and SPDRs;
- Stocks, stock options, mutual funds, and bonds;
- Single stock futures, otherwise known as “non-dealer securities futures contracts;”
- By default, any “capital asset” that is not otherwise defined as an IRC Section 1256 contract (a commodity) or IRC Section 988 (currencies, inter-bank foreign exchange or FOREX). For example, gold bullion sounds like a commodity or currency, but physical gold is neither included in IRC section 1256 or 988, and it's taxed like securities. That means if you hold gold bullion bars for more than 12 months, you are entitled the *lower* long-term capital gains rate (currently 15 percent).

The taxability on options on ETFs, where the underlying portfolio or index is broad-based, is currently uncertain and requires guidance from the IRS.

**Which Do I Want to Trade,  
Security or Commodity?**

If you want to buy and hold a product for the long-term and are not worried about large non-deductible capital losses, then the best choice is a security. You can pay taxes at the lower long-term capital gains rates (up to 15 percent).

If you plan on buying and selling in a short period of time – the focus of most business traders, and want a built-in carry-back loss feature, then the best choice is a Section 1256 contract, which includes most commodities and futures traded on exchanges. You can pay taxes at the lower blended long-term/short-term (60/40) rates up to 23 percent.

If you are a securities business trader, then elect IRC 475 to have mark-to-market accounting on securities. Your trading gains are taxed at the higher ordinary tax rates (up to 35 percent) whether you elect MTM or not. And with MTM, you are exempt from the onerous wash sale loss and capital loss limitation rules.

It is possible to have the best of all worlds. You can trade 1256 contracts for 60/40 treatment, business trade securities with MTM loss protection, and “segregate” investments in securities for long-term capital gains with deferral (until you sell).

### **Here’s the Skinny on Section 1256 Contracts.**

Special tax rules apply to IRC section 1256 contracts. By definition, they include:

- Any regulated futures contract (i.e. commodities and futures contracts on U.S. commodities exchanges;
- Foreign currency contracts (traded on exchanges, but not including FOREX or inter-bank trading; see special rules for IRC 988 below);
- Non-equity options or dealer equity options (i.e. these are the “broad-based indexes” discussed above, including but not limited to the NASDAQ 100, Dow and S&P futures contracts);
- Any dealer securities contracts (not the same as “non-dealer” securities futures contracts – single stock futures. If you are not a dealer, then it’s non-dealer and not 1256).

Section 1256 contracts are marked-to-market (MTM) each day and at year-end. This means that you report both realized and unrealized gains and losses. MTM doesn't apply to certain hedging transactions.

There is a newer and different type of mark-to-market accounting treatment that is part of IRC Section 475; don't confuse IRC 475 with IRC 1256. In 1997, Congress expanded IRC 475 from covering “dealers” only to also covering “traders in securities and/or commodities.” IRC 475 converts “capital” gains and losses into “ordinary” gains and losses. Commodity traders usually skip IRC 475 elections because they want to retain the more favorable 60/40 lower capital gains rates on gains. Securities traders prefer to elect IRC 475 because their gains are already taxed at ordinary tax rates. So why not have ordinary loss treatment (rather than be encumbered with capital loss limitations)? To use IRC 475, a trader first must qualify for “trader tax status” (business treatment) and elect IRC 475 on a timely basis (by April 15 of the current tax year or within 75 days of inception for “new taxpayers”).

Section 1256 MTM is still considered “capital gains and losses” and, in fact, after reporting Section 1256 contracts on Form 6781, the net results are then transferred to Schedule D (Capital Gains and Losses). So, you are subject to the \$3,000 capital loss limitation, although you benefit from 60/40 tax treatment (the lower blended rate of 23%).

Many traders overlook a built-in loss carry-back feature in Section 1256. You can carry 1256 contract losses back three tax years, but only against Section 1256 gains in those years. This loss carry-back feature is narrower than the net operating loss carry-back benefit opportunities caused by ordinary loss treatment in IRC 475 MTM (for business traders only). Net operating losses can offset any type of income in the prior two tax years (Congress may extend to five-year carry-backs).

### **Now I'm Confused. Which MTM Is Right for Me?**

All traders in Section 1256 contracts automatically use MTM. That's the only way your brokers will report this activity to you.

When it comes to securities, all investors and business traders use the "cash method" by default. Business traders are entitled to elect the new MTM IRC Section 475 that converts restricted capital losses (and gains) into unlimited ordinary losses (and gains).

Profitable Section 1256 contract traders should not elect IRC 475 MTM to trump their Section 1256 MTM; that would raise their tax rate by 12 percent on gains and result in a better loss potential (but for most it's not worth the added tax rate).

If you trade ETFs, single stock futures and narrow-based indexes and qualify for trader tax status (business treatment), then IRC 475 MTM is a good election (so make sure to elect it *on time* by April 15<sup>th</sup> of the current tax year, or within 75 days of inception for "new taxpayers"). Gains are taxed at the same ordinary tax rates, but with MTM, you unlock unlimited ordinary loss potential (for immediate tax refunds, rather than deferred unutilized capital losses).

### **Skip It – Let My Broker Tell Me What I Made and How to Report It**

Well, that may be fine for Section 1256 contracts, but not for securities and currencies.

Around February, your broker mails you (with a copy to the IRS) a Form 1099-B, which reports some of your brokerage firm activity for the year. Actually, most brokers only report the minimum information required by IRS law.

Here's the bottom line. You cannot prepare your tax returns based on Form 1099s, but will have more luck with Supplemental Information provided by your broker. If you have lots of transactions or use a direct-access or online broker, you also will need more help. Accounting software programs can help a lot. GTT TradeLog from this writer's company was positively reviewed by the media, and it's considered a robust product for active traders.

Here are a few other things you need to know about the limitations of Form 1099-B:

- Currently may omit single stock futures;
- Only report proceeds on sales of securities, not purchases, and they do not match buys with sells;
- Does not report option proceeds or purchases, although most Supplemental Information pages do;
- Does not account for wash sales or MTM on securities;
- Does not account for FOREX trading;
- Are based on "trade date," but monthly statements showing opening and closing positions (needed for accounting), are based on "settlement date."

Remember, the Form 1099-B is an informational statement with *bare bones reporting*, and it's not meant to state what you made or lost with a brokerage firm. It's not like other 1099s (Misc or R) or a Form K-1 or W-2, all of which do report your actual income or loss.

Many brokers have online reports, but often there are unmatched trades and there's no account of wash sales and/or MTM.

If you don't properly report your income to the IRS, you are subject to penalties and interest, including some large extra penalties for understating your taxes with negligence. Get the help you need early on.

### **With SSFs, Start Holding Period Early For a Long-Term Capital Gain**

A securities futures contract is basically a contract of sale for the future delivery of a single security or a narrow-based security index. If a taxpayer takes deliver on the underlying security, their holding period starts from the date of the original purchase of the securities **futures** contract. That's helpful **for achieving a 12-month hold; for a lower long-term capital gains tax rate.**

### **Currency Trading – Special Tax Rules Apply**

Currency traders transact regulated futures contracts on regulated commodities exchanges (treated as Section 1256 contracts) or in the non-regulated "interbank" market (a collection of banks giving third-party prices on foreign current contracts (FCC) and other forward contracts).

By default, FOREX or inter-bank trading is not included in Section 1256; rather it's subject first to IRC Section 988, which specifies tax treatment for foreign currencies. The principal intent of IRC Section 988 is taxation on foreign currency transactions in a taxpayer's normal course of transacting global business. For example, if a manufacturer purchases materials in a foreign country in a foreign currency, then the fluctuation in exchange rates gain or loss should be accounted for pursuant to IRC 988.

So what's IRC 988? Simply, it provides that these fluctuations in exchange rate gains and losses should be treated as ordinary income or loss and reported as interest income or interest expense. IRC 988 considers exchange rate risk in the normal course of business to be like interest.

When a currency trader uses the interbank market to transact in foreign currency contracts and other forward contracts, he is exposed to foreign exchange rate fluctuations, similar to a manufacturer mentioned above. However, the currency trader looks upon his currency positions as "capital assets" in the normal course of his trading activity (business or investment). The "capital asset" rules apply. What this means is that a currency trader may elect out of ordinary gain or loss treatment in IRC section 988, thereby qualifying to use section 1256 contract treatment – which is 60/40 capital gains

and losses. Most currency traders will want to make this election for the tax-beneficial treatment of section 1256 (lower tax rates on gains).

And, those with large FOREX trading losses may be better to skip IRC 1256 and take an ordinary tax loss. You need to make the election on a “contemporaneous basis” in your own books and records; which means you are not supposed to pick and choose the best approach after-the-fact.

### **Bottom Line**

Don't let the tail (taxes) wag the dog (trading). Put your trading affairs in tax order. Buy and hold “segregated” investment securities for deferred 15-percent tax rates. Trade commodities, futures and broad-based indexes for a lower 23-percent blended tax rate (60/40 treatment on IRC Section 1256 contracts). Try to qualify for trader tax status and elect IRC 475 on securities only for added tax loss insurance. If you are not sure, ask your broker and accountant; this will prevent surprises at year-end. There are a number of other differences between all the new products besides taxes (margin, risk, investment sizes, selling features, and more).

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