



Trading in metals is a hot concept. Many traders have been hit by the “gold bug” – gold is seen as the key to avoiding an impending catastrophic economic decline. Traders must be aware that while trading is subject to many special tax rules, there are extra-special tax rules for trading in metals. Many of these rules are arbitrary and hopelessly outdated compared to developments in the trading arena, particularly where the trader is long and short positions in the same metal. However, ignore these rules at your peril.

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The global economic expansion of this decade has seen enormous increase in the demand for all metals – both precious metals (gold, silver, platinum, palladium) and base metals (all others, but for traders, primarily copper, aluminum, iron, tin, and refined products such as steel and brass). The increase in trading in metals – both physical metals and financial contracts based on metals – has been exponential. In addition to the over-the-counter trading in physicals, there has been a huge increase in exchange-traded financial contracts, including futures contracts traded on the New York COMEX and in London, as well as other futures exchanges.

In addition to their industrial uses, the precious metals are also viewed by many traders and investors as financial assets, particularly as a hedge against a global recession, runaway inflation, or a worldwide energy crisis. While many individuals may sleep better at night knowing that they have gold bars wedged under the floorboards, not everyone finds this convenient. As a result, traders often have three mediums for trading in precious metals: physicals (assets such as gold bars, not gold coins), warehouse receipts (evidencing an ownership interest in underlying bullion) and financial contracts (typically futures contracts). Traders also have the opportunity to trade in ETFs (exchange traded funds) representing precious metals bullion and gold-oriented portfolios (including bullion and equities of gold miners).

### **Tax Results for Physicals Don’t Make Sense**

You must navigate the special rules for “collectibles.” Section 1(h) of the Internal Revenue Code provides that, in addition to tangible assets such as art, antiques, stamps, certain coins (but not certain U.S.-issued coins minted in precious metals), wines, single-malt Scotch whiskey, “any metal or gem” is covered. As a result, if you hold *any* physical metal for more than one year (whether in bullion or via warehouse receipts), the resulting gain is not long-term capital gain eligible for the maximum 15-percent federal rate, but rather “gain from collectibles,” taxed at a maximum 28-percent federal rate. Realized gains and losses from sales of all collectibles held for longer than one year must be aggregated; a positive net result is gain from collectibles, while a negative net result is a loss from collectibles. Into this computational mix is entered any carryover of collectibles loss from a prior year or years (that is, losses from collectibles that were not offset against gains from collectibles in prior years, and then from gains from other capital assets realized in prior years).

If you hold a physical metal for one year or less, the resulting gain is a short-term capital gain, taxed at the maximum 35-percent federal rate. Your total net short-term capital loss is subtracted from your positive net long-term capital gain (if any). If you have a net capital gain for the year, that is taxed at the maximum federal rate of 35 percent (plus state and local income taxes, if any).

When you hold physicals, either long or short, any gain or loss is not taken into effect until the position is disposed of in a taxable event (such as sale). Therefore, if you are long physical gold, and the price of gold skyrockets, there is no taxable event until you dispose of the long gold position in a taxable event.

**EXAMPLE 1.** On Dec. 15, 2005, Trader A purchases warehouse receipts for 1,000 ounces of physical gold at \$505 per ounce. A sells the gold on Dec. 28, 2006, when gold is \$1,000 per ounce, and has no other realized gains or losses in “collectibles” in 2006. A has collectibles gain of \$495,000, taxed at a maximum federal rate of 28 percent (plus state and local income taxes, if any).

**EXAMPLE 2.** Same as Example 1, except that A sells the gold on Jan. 28, 2006, when gold is \$555 per ounce. A has short-term capital gain of \$50,000, taxed at a maximum rate of 35 percent (plus state and local income taxes, if any). Any gain or loss realized by A in 2006 with respect to collectibles held for longer than one year is not entered into the tax results for this example.

**EXAMPLE 3.** Same as Example 1, except that A sells the gold on Dec. 28, 2006, when gold is \$450 per ounce. A has a collectibles loss of \$55,000. The treatment of this loss depends on the mix of A’s other capital gains and losses during the year, plus A’s capital loss carryovers into 2006 (if any).

Once you enter “collectibles land,” your tax accountant has extra work to do. These gains and losses are segregated, accounted for in a separate box, netted against each other, and then, if there is a net loss, netted against gains from other capital asset classes (such as the general class eligible for the 15-percent rate if held long-term). As always, if you are a member of a flow-through entity, such as a partnership, S-corporation or trust that is sitting on an unrealized gain from collectibles, any gain from disposing of your interest in this entity is clawed back and recharacterized as a collectibles gain.

You may well ask why copper ingots would be considered a “collectible” any more than warehouse receipts for platinum bullion. A bill introduced in Congress that would have reversed this arbitrary result died in Committee last year. It is clear that physical gold, for example, that is not going to be used in a business (that is, the trader is not a jewelry manufacturer) is a financial asset. It is even more obvious when the trader holds warehouse receipts, which are, after all, just a piece of paper, evidencing a right to gold bullion in a warehouse somewhere. Nonetheless, relief from Congress is not on the horizon.

A note of caution for traders thinking of trading in precious metals in their retirement accounts: Extra, extra-special rules apply here, in Section 408(m) of the Internal Revenue Code. Congress has not explicitly prohibited this, but the law is a minefield. The general rule is that the retirement account’s acquisition of a “collectible” is a distribution from the account, which is usually a tax disaster. For retirement

accounts, coins in precious metals issued by the U.S. and precious metals bullion are excluded from collectibles, if the bullion is held by the plan custodian.

### **Tax Results for Financial Contracts Don't Make Sense Either But Are More Favorable**

Holding long physicals is expensive – there are warehouse costs, interest costs, commissions – and, in any event, this is an over-the-counter market which has its own risks. As a result, many traders have found the trading of financial contracts in metals to be more efficient. In particular, many traders are trading in regulated futures contracts in both precious metals and base metals. Because these contracts are traded on markets regulated by the U.S. Commodity Futures Trading Commission (CFTC), they are “Section 1256” contracts. Therefore, the general tax result is that 60 percent of gains (or losses) realized on the contract are long-term capital gains, and 40 percent of gains (or losses) are short-term capital gains. This comes out to a maximum federal income tax rate of 23 percent, which is very advantageous. This is true even if the trader has an intra-day holding period for the contract.

An important aspect of Section 1256 is that all contracts are marked-to-market at year-end. Gain or loss is triggered at that point, measured by the contract's value when entered into, and the contract's value at year-end. Therefore, the special 23 percent on the upside applies both to Section 1256 contracts closed during the year, as well as positions open at year end.

This 60/40 tax treatment is the result of a special deal brokered by former House Ways & Means Committee Chairman, Dan Rostenkowski of Chicago. Even after he went to jail for stealing postage stamps from his Congressional office, “Rosty's” deal still stands. The law greatly favors profitable traders using U.S. commodity exchanges (many of which – surprise! – are located in Rosty's former Congressional district).

EXAMPLE 4. Trader B goes long one regulated March 06 futures contracts for gold for 1,000 ounces on Dec. 22, 2005, when gold is \$505 per ounce. On Dec. 30, 2005, gold is \$505 per ounce. On Jan. 28, 2006, when gold is \$555 per ounce, B closes the futures position. B realizes a Section 1256 contract gain of \$50,000. The maximum federal income tax rate for this transaction is 23 percent, plus federal and state income tax, if any.

EXAMPLE 4A. Same as Example 4, but on Dec. 30, 2005, gold is \$525 per ounce. A has a Section 1256 gain of \$20,000 in 2005, and a Section 1256 gain of \$30,000 in 2006.

EXAMPLE 4B. Same as Example 4A, except that on Dec. 30, 2005, gold is \$555 per ounce, and on Jan. 28, 2006, gold is \$444 per ounce. B has a realized 60/40 gain in 2005 of \$50,000, and a realized 60/40 loss of \$111,000 in 2006. Risk: B owes income taxes for 2005, and has a capital loss carryback to 2005 for the 60/40 loss (under special rules just for 60/40 contracts) that B may or may not be able to use. In the best case, this example is a cash-flow problem for B, who owes the tax (probably on an estimated tax payment basis) for 2005, but will not receive the 2006 tax refund until much later.

EXAMPLE 5. Trader B goes short one March 06 regulated futures contracts for gold for 1,000 ounces on Dec. 22, 2005, when gold is \$505 per ounce. On Dec. 30, 2005, gold is \$505 per ounce. On Jan. 28, 2006, when gold is \$450 per ounce, B closes the futures position. B realizes a Section 1256 contract gain of \$55,000. The maximum federal income tax rate for this transaction is 23 percent, plus federal and state income tax, if any.

EXAMPLE 6. Trader C goes long one March 06 futures contract in copper (25 tons) traded on the London Metals Exchange (LME) on Dec. 22, 2005, when copper is \$4,480 per ton. Trader C closes the futures position on Jan. 28, 2006, when copper is \$4,900 per ton, and realizes a gain of \$10,500 (25 tons \* \$420 per ton). Arguably, the maximum federal income tax rate for this transaction is 35 percent, not 23 percent.

EXAMPLE 6A. Same as Example 6, except that the contract is traded on the Lorenceland Metals Exchange, to which no CFTC Rule 30.10 exemption applies. The maximum federal income tax rate for this transaction is 35 percent.

In addition to trading in metals futures contracts on U.S. markets, many traders are trading on futures contracts on foreign exchanges, such as the huge market in copper futures on the LME. Many foreign futures markets have been designated by the CFTC under its Rule 30.10, authorizing qualifying foreign futures exchanges to offer futures trading to U.S. persons. The treatment of foreign futures is a very important factor for traders, as some metals contracts are only traded in London. For these, whether the less advantageous tax treatment for non-Section 1256 contracts applies must be taken into account.

### **The Long and Short of Straddles**

Many trading strategies involve being both long and short the same underlying property, using arbitrage techniques to produce gains from imperfect pricing in different markets. These transactions are termed “straddles” and are governed by special, generally taxpayer-unfriendly rules in Internal Revenue Code Section 1256. These rules exist because taxpayers under prior law took advantage of lapses in the rules for timing of income and loss.

EXAMPLE 7. On Nov. 15, 1980, when silver was \$6 per ounce, Taxpayer D went long 100,000 ounces of physical silver and simultaneously entered into a short forward contract to deliver 100,000 ounces of silver in 90 days. On Dec. 28, 1980, when silver was \$7 per ounce, D closed the short position for a loss of \$100,000, and still held the long position, with unrealized gains of \$100,000, at year-end. For economic purposes, D was hedged and had neither gain nor loss. For tax purposes, D had a short-term loss of \$100,000 recognized in 1980.

This was too good to last forever. Hence, the straddle rules were passed. There are three types of straddles: those in which all positions (termed “legs”) are Section 1256 contracts; those in which one (or more) positions are Section 1256 contracts and one (or more) positions are non-Section 1256 contracts (termed “mixed straddles”); and those in which no positions are Section 1256 contracts.

The straddles in which all positions are Section 1256 contracts are the easiest to deal with – all the positions are marked-to-market, with no possibility for postponing the taxing of gain or accelerating the taking of losses, so each contract's results are accounted for under the usual rules. Straddles in which all positions are non-Section 1256 contracts are accounted for under rules in which, in general, losses are not accounted for until the positions with unrealized gains (if any) are disposed of in a taxable event. Mixed straddles were viewed by Congress as having substantial potential for abuse. That is, the Section 1256 contract would be marked-to-market, and if it had a loss, the loss would be recognized automatically under the marking-to-market regime, even while the non-Section 1256 contract with unrealized gains in it was still held.

**EXAMPLE 7. All Section 1256 Contracts.** Taxpayer D, on Dec. 22, 2005, when high-grade copper is 218.70 cents per pound, goes long 10 March 06 regulated futures contracts for copper (25,000 pounds per contract, for a total of 250,000 pounds of copper). On that date, D shorts regulated futures contracts for 250,000 physical pounds of copper. D is both long and short the same quantity of copper; although this is clearly a straddle it is exempt from the straddle rules because all the positions are Section 1256 contracts. On Dec. 30, 2005, when copper is 224.00 cents per pound, D closes the short position. He has a loss of \$13,250, and has a realized gain of \$13,250 from marking-to-market the gain position. D closes the long futures contract on March 6, 2006, when copper is 235.00 cents per pound, for a further gain of \$27,500.

**EXAMPLE 8. All Non-Section 1256 Contracts.** Same as Example 7, except that D is long and short contracts in physical gold. The loss on Dec. 30, 2005, of \$13,250 is deferred until D closes the long position on March 6, 2006.

**EXAMPLE 9. Mixed Straddle.** Same as Example 7, except that the long leg is a forward contract in physical gold. If D takes no action, D is subject to detrimental tax treatment; D's right choice is to identify this transaction as an "Identified Mixed Straddle" in D's books and records, with the same tax results as Example 8.

### **Conclusion**

The trader contemplating joining the fray in the metals markets needs to understand the differing tax treatment for what are economically similar assets. The markedly favorable treatment for successful traders in the regulated futures market may sway you in favor of trading in those contracts. On the other hand, certain markets are really only available in the over-the-counter market, or in foreign futures. The special rules for collectibles make no sense at all (after all, economically, what is the difference between a long warehouse receipt for silver and a long futures contract for silver?). Nonetheless, we are stuck with these rules, and no relief from Congress is in view.