



Tax treatment, trader tax status and MTM

Tax treatment on new products is confusing. Add trader tax status and mark-to-market accounting to the mix and traders have a full plate of tax issues to consider this tax season. Use this resource for some quick answers to get the (tax) breaks you deserve.

By Robert A. Green, CPA

New trading products are being created almost as fast as new traders. But who is a business trader and who is a regular investor? It's potentially a \$64,000 question on your tax return.

What is the tax treatment on all these new products? There is widely varying tax treatment for securities vs. commodities and futures vs. forex (interbank currency trading) vs. precious and base metals.

Does it matter if you are a member of an exchange?

There are lots of good questions to consider this tax season; here is a good assortment.

Are you a business trader or investor? Start with the basics

By default, the IRS considers buying and selling of financial products (trading) to be an "investment activity."

Unless a trader rises to the level of trading as a business ("trader tax status"), they are required to follow the tax laws for investment activities.

There are many special tax laws for investment activities, including but not limited to: capital-loss limitations and carryovers; IRC 1256 contracts (commodities and futures) with special 60/40 treatment; forex with IRC 988 ordinary gain or loss transactions; restrictions on investment interest and other expenses; lower tax rates on qualifying dividends and long term capital gains (up to 15 percent); deferring realized losses on wash sales, straddles and constructive receipts; bond accrued interest, original issue discount and amortization of premiums; short selling; covered call options; and much more.

There are plenty of good tax resources around

The IRS Web site (www.irs.gov) is excellent. Start with IRS Publication 550 (Investment Income and Expenses). Chapter 4 (page 72), "Special Rules for Traders in Securities," is for business traders.

Another good resource is "A Guide for the Individual Investor – Taxes and Investing," prepared by Ernst & Young LLP and available at the CBOE Web site.

Also consider my book, "The Tax Guide for Traders," published by McGraw-Hill and available in most bookstores or at www.greencompany.com.

It's tough for the IRS to keep up with the tax treatment for all these new products

Tax treatment on the following new products is not always clear from the outset: single-stock futures, ETFs, indices (narrow and broad-based), options and futures (on indices and ETFs), foreign futures and other products, HOLDERS, LEAPS, and more to come soon.

Existing U.S. and foreign exchanges are forming alliances to create and list new hybrid products. However, hybrid products create challenges for tax treatment.

The problem is that the IRS historically placed products into a few different established tax-treatment baskets. Securities were treated differently from commodities and futures (IRC 1256 contracts) and forex (IRC 988).

For example, should single-stock futures be treated as stocks or futures? Find out below.

Brokerage firm reporting and trade accounting is also difficult

Brokers report most transactions on Form 1099s after year-end. They report securities on a separate 1099 from commodities and futures. They are not supposed to report forex.

The securities 1099 should list each stock sale and a total of option proceeds. The IRC 1256 contract 1099 should report aggregate profit or loss. Brokers are still not required to report single-stock futures and some other new products.

Brokers' tax and information reporting departments are stressed by all the changes, and some smaller firms don't quite get it right.

Taxpayers are obligated to report accurate income and taxes, and they can't get out of paying a tax bill from the IRS because a 1099 received was incorrect.

Many brokers offer online accounting reports, but many traders claim they are inaccurate.

Consider good trader-tax accounting software such as GTT TradeLog (sold by this writer's company) or Gainskeeper. Annual accounting formulas are in "The Tax Guide for Traders" by Robert Green.

Popular tax-treatment questions on new products

How are E-minis taxed vs. ETFs? After all, the two products are very similar in nature? The QQQQ ETF is a similar product to the NASDAQ 100 E-Mini; both trade the NASDAQ 100. ETFs are taxed like securities, but E-minis are IRC 1256 contracts.

How are options on ETFs taxed – like their underlying ETFs or otherwise? The IRS has still not issued guidance, so there is no clear answer.

How are foreign futures taxed – like U.S. futures (1256 contracts) or securities? We cover this question in-depth in my separate article in this issue on global tax.

How are precious and base metals taxed? Futures are IRC 1256 contracts, physical base metals are like securities and physical precious metals are collectibles. See more below.

How is spot forex taxed, like forward forex contracts or otherwise? Again, we are waiting on guidance from the IRS. A case can be made for treating spot forex like forwards in terms of electing out of IRC 988 for IRC 1256 treatment. See more below.

How are single-stock futures taxed, like stocks or futures? Like ETFs, they are treated like securities.

Securities involve short-term versus long-term treatment

Short-term capital gains on securities are taxed at ordinary income tax rates (currently up to a maximum of 35 percent).

If a trader or investor holds a security for 12 months or longer, they benefit from significantly lower long-term capital gains tax rates (currently up to a maximum of 15 percent). That's a 20-percent difference! Most active traders don't hold positions for 12 months, though.

The definition of "securities" includes stocks, stock options, bonds, mutual funds, single-stock futures, narrow-based indices (made up of nine or fewer underlying securities), and exchange traded funds (ETFs). Tax treatment for options on broad-based ETFs is still unclear at this time.

Commodities and futures are taxed very differently

First, lower tax rates apply (60/40 treatment). Secondly, unlike securities, commodities and futures are marked-to-market at year-end; this means unrealized gains and losses on open positions are reported during the tax year, not deferred to the next tax year.

Don't confuse IRC 1256 mark-to-market (MTM) accounting with IRC 475 MTM. IRC 1256 MTM applies to all commodities and futures, regardless of trader tax or investor tax status. IRC 475 MTM may be elected only by business traders, and it's recommended for securities only (commodities and futures traders must give up 60/40 treatment when they elect IRC 475 MTM).

IRC 1256 contracts also include a capital-loss carry-back feature, but only against IRC 1256 contract gains in the prior three tax years.

The definition of "commodities and futures" includes regulated futures contracts, non-equity options, broad-based indices such as E-Minis (made up of 10 or more underlying securities) and forex when a forex trader (vs. a manufacturer) elects out of IRC 988.

Learn more about the tax treatment for securities vs. commodities and futures at www.greencompany.com/EducationCenter/GTTRecSecuritiesVsCommodities.shtml

Forex is also taxed very differently

Traders in forex, both forward and spot contracts, are by default subject to ordinary gain or loss treatment under IRC 988 (foreign currency transaction rules).

IRC 988 is intended to address currency conversion in the large global economy. For example, manufacturers may exchange dollars for euros or yen, and the gain or loss is part of their ordinary course of doing business – so ordinary gain or loss rules make great sense.

But these rules don't make sense for traders, who are not hedging inventories of autos or otherwise; they are just speculating in forex as another product to trade.

Thankfully, there is an exception in IRC 988 for traders who trade in forex forward contracts as a capital asset. Traders may elect out of IRC 988 for the more tax-beneficial IRC 1256 60/40 treatment. Rather than pay taxes on forex gains at higher

ordinary tax rates (up to 35 percent), they are able to pay taxes at the lower 60/40 rates (up to 23 percent).

Notice the rule says forward contracts and it does not mention spot forex, which the majority of traders trade. An argument can be made for applying these same rules to spot forex, too. GreenTrader is working with the IRS national office to clarify these rules so there is no further uncertainty.

The IRS recently issued guidance saying that over-the-counter forex contracts on foreign exchanges are considered IRC 1256 contracts by default. Go figure.

The election must be made on a contemporaneous basis internally – that means in your own books and records, as opposed to an external election filed with the IRS. There is some vagueness on how to make the election. We suggest you make it on a global basis for the entire year.

If you have losses, you will wish you did not make the election to opt out of IRC 988. Ordinary losses are better than capital losses, which are subject to a \$3,000 limitation.

Forex is still the Wild West in terms of brokerage, trading, reporting and tax guidance, so tread carefully.

Brokers are not required to report forex transactions to the IRS, but you still must determine your gains and losses and report them properly.

Precious metals are taxed differently from base metals

Precious and base metal futures contracts on U.S.-regulated futures exchanges are IRC 1256 contracts with more-favorable 60/40 capital gains tax rates.

Precious metals held in physical form (warehouse receipts or otherwise) are considered “collectibles.” Short-term sales are taxed at ordinary income tax rates up to 35 percent and long-term sales (holding periods longer than 12 months) are taxed up to 28 percent – the collectibles rate. That is 13-percent higher than the maximum tax rate applicable to long-term capital gains on securities. It seems unfair to tax traders as owning collectibles when they are just trading to make a living.

Base metals held in physical form are taxed like securities.

Precious and base metals traded on foreign futures exchanges may or may not qualify for IRC 1256 favorable tax treatment. If they are not 60/40, then securities rules apply. See the discussion of foreign futures in this author’s other tax article in this same issue.

For more information on precious and base metals, see an article by Roger Lorence, JD LLM, in this issue.

Popular trader tax status questions

How can a trader achieve trader tax status (business treatment)? Read the very subjective case law and consult with a trader tax professional unless you trade every day all day, with thousands of trades per year and holding periods of at most a few days.

Must a taxpayer elect or merely claim (declare) trader tax status? You may claim it even after the year-end. It’s not elected.

What is mark to market accounting (MTM IRC 475) and how do traders elect or claim it? It exempts traders from wash sales and the annual capital loss limitation of

\$3,000. You must elect MTM on time (see below). MTM imputes sales of open business trading positions at year-end.

Must you apply MTM to your segregated investments positions, where you are hoping for long-term capital gains on a deferred basis? No, MTM only applies to business trading positions, not segregated investment positions.

Does the \$3,000 annual capital loss limitation mean you can only use \$3,000 of your carryover losses each year? No, you may utilize the entire capital loss carryover in the following tax year, and if you have sufficient gains you may apply it all. Otherwise, after all activity on Schedule D is combined the following tax year, you are limited to a \$3,000 net loss. Many traders mistakenly think they can only apply \$3,000 per year going forward.

If you elect MTM, do you automatically lose the more beneficial 60/40 treatment on commodities and futures? No, this is another misconception. Be careful to elect MTM on securities only.

Can you be a business trader in securities, commodities/futures, forex and a retirement plan at the same time? Yes, on all except retirement accounts. Be careful to draw a connection with the multiple activities if you need all to qualify for trader tax status.

Retirement-plan accounts can be actively traded, but you can't run a business in them and you can't deduct trading expenses in connection with a retirement plan.

What are the main tax breaks for business traders? There are two – ordinary loss treatment on expenses and trading losses, and retirement-plans and health-insurance premium deductions.

Trader tax status is much better than the default investor tax status

It makes sense that business traders would spend more money on trading expenses than investors; after all, they do it all day every day as a serious business activity.

So it's imperative and fair that business traders should be allowed to deduct all their business expenses as ordinary deductions. It's unfair for active traders to be denied tax deductions because of the arcane rules for investors.

Business traders may deduct interest in full, whereas investors may only deduct investment interest against investment income. When there is insufficient investment income, investors must carry over investment interest to future tax years.

Business traders may deduct every type of expense, including start-up expenses, home-office and education. Conversely, investors may only deduct a few types of expenses, not including start-up expenses, home-office or education. Plus, investors face so many haircuts and limitations, they often wind up with no deductions at all.

For example, miscellaneous itemized deductions for investment expenses must first exceed 2 percent of Adjusted Gross Income, the itemized deduction phase-out, and the standard deduction. Finally, it must not trigger the AMT. Good luck!

Business traders may deduct every conceivable business expense, and it offsets all gross income without limitation. Negative taxable income may generate a Net Operating Loss (NOL) two-year carryback (the rest is carried forward). Business expenses are part of NOLs.

Trader tax status saves the average trader around \$10,000 per year in taxes.

There are special rules for home-office deductions and education. Learn more in “The Tax Guide for Traders,” by Robert Green.

Business traders may also elect IRC 475 MTM

Business traders (only) may elect IRC 475 MTM accounting, converting capital gains and losses into ordinary gain or loss treatment.

It’s like having tax-loss insurance. If your trading house burns down, you get a large tax refund (insurance) from the IRS (and probably your home state, too).

IRC 475 MTM is a great election for securities business traders, but not for commodities/futures traders.

Securities business traders pay the same ordinary tax rates on short-term sales (so the insurance premium is free) and they unlock ordinary loss treatment, freeing themselves from capital-loss limitations (the insurance part).

Conversely, commodities and futures traders pay a stiff premium – the loss of 60/40 tax treatment on gains.

Existing taxpayers need to elect MTM “externally” (with the IRS) on time, by April 15 of the current tax year for individuals and partnerships (March 15 for corporations). Attach the election statement to your prior year tax return or extension.

New taxpayers (new entities, not new traders) need to elect “internally” (rather than externally with the IRS) within 75 days of inception.

If you miss the external election deadline, consider setting up a new entity that has time to elect later in the year (within 75 days of inception).

Learn more about MTM in The Tax Guide for Traders.

Don’t confuse trader tax status with MTM

They are two separate and related tax concepts.

You need trader tax status to elect MTM. It’s a prerequisite.

You can claim trader tax status after year-end (even up to three years later, with amended returns). However, you must elect MTM on time. If you don’t, the IRS will deny MTM treatment, and you can never win this point in a tax-court case or appeal.

Trader tax status is a concept you may argue about and win in appeals or tax court. It’s not clear in the statutory law, whereas an MTM election is.

Also make sure to complete your MTM election by filing a Form 3115 on time. New taxpayers (like new entities) adopt MTM rather than request a change of accounting and therefore don’t have to file Form 3115 (change of accounting method).

Business or investor tax status

If you don’t have many trading-related expenses and you are not worried about losing too much money on securities (although you should be unless you trade a very small amount), then don’t worry about business trader tax status. You won’t miss out on much.

On the other hand, if you frequently trade securities (and can lose much more than \$3,000 in any given tax year) and spend large amounts of money in this activity, you should determine if you qualify for trader tax status and make sure to elect MTM on time. No ifs, ands or buts!

Popular tax questions about exchanges

Are members of options and/or commodities exchanges taxed differently than traders who are not exchange members? Members pay self-employment (SE) tax and non-members do not.

What about the new corporate membership programs on the Chicago Mercantile Exchange? Do those members also have to pay SE tax? No, corporate members have a restricted type of membership.

If you are a member of an options or commodities exchange, you are subject to SE taxes on your trading gains on that exchange (IRC 1402).

All other types of traders are exempt from SE taxes. That currently saves non-exchange traders SE taxes of 15.3 percent on the base amount (currently around \$90,000) and 2.9 percent above that base amount. SE taxes are in addition to income taxes and they add up fast!

The good news is that if you pay SE taxes, not only do you earn social security and Medicare benefits in retirement, but you may also contribute to a tax-deductible retirement plan. In fact, by doing so you may save more in income taxes from the retirement-plan tax deduction than you pay in SE taxes. Learn more about retirement plans for traders at www.greencompany.com/Traders/TraderRetirement.shtml.

All exchange members are forced to pay SE taxes on their exchange trading gains, regardless of trader tax status or contributions to a retirement plan.

Non-exchange business traders have more flexibility in dealing with SE tax and retirement plans. They can form an entity to pay themselves a fee or salary and use that as the basis for a retirement plan. Learn more about entities at www.greencompany.com/Traders/TraderEntities.shtml.

Therefore, they can decide on whether or not to create earned income to drive the SE tax and retirement-plan strategies, so they can maximize income tax savings vs. SE tax costs. Consult with a trader tax advisor on the nuances.

Bottom line.

At tax time, don't pay the wrong tax rate on your trades. Try to pay 23 percent (with 60/40 treatment) rather than 35 percent ordinary tax rates. If you are entitled, claim trader tax status for business expense treatment. Plan the year ahead now by considering mark-to-market accounting and switching to lower tax-rate trading strategies. Your taxes require some portfolio adjustment, too.