Tax implications of trading

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Compiled by Factor LLC for members of the Factor Service

Federal Regulations

Reg § 1.988-3. Character of exchange gain or loss.

(a) In general. The character of exchange gain or loss recognized on a section 988 transaction is governed by section 988 and this section. Except as otherwise provided in section 988(c)(1)(E), section 1092, §1.988-5 and this section, exchange gain or loss realized with respect to a section 988 transaction (including a section 1256 contract that is also a section 988 transaction) shall be characterized as ordinary gain or loss. Accordingly, unless a valid election is made under paragraph (b) of this section, any section providing special rules for capital gain or loss treatment, such as sections 1233, 1234, 1234A, 1236 and 1256(f)(3), shall not apply.

(b) Election to characterize exchange gain or loss on certain identified forward contracts, futures contracts and option contracts as capital gain or loss.

(1) In general. Except as provided in paragraph (b)(2) of this section, a taxpayer may elect, subject to the requirements of paragraph (b)(3) of this section, to treat any gain or loss recognized on a contract described in §1.988-2(d)(1) as capital gain or loss. but only if the contract—

(i) Is a capital asset in the hands of the taxpayer;

(ii) Is not part of a straddle within the meaning of section 1092(c) (without regard to subsections (c)(4) or (e)); and

(iii) Is not a regulated futures contract or nonequity option with respect to which an election under section 988(c)(1)(D)(ii) is in effect.

If a valid election under this paragraph (b) is made with respect to a section 1256 contract, section 1256 shall govern the character of any gain or loss recognized on such contract.

(2) Special rule for contracts that become part of a straddle after an election is made. If a contract which is the subject of an election under paragraph (b)(1) of this section becomes part of a straddle within the meaning of section 1092(c) (without regard to subsections (c)(4) or (e)) after the date of the election, the election shall be invalid with respect to gains from such contract and the Commissioner, in his sole discretion, may invalidate the election with respect to losses.

(3) Requirements for making the election. A taxpayer elects to treat gain or loss on a transaction described in paragraph (b)(1) of this section as capital gain or loss by clearly identifying such transaction on its books and records on the date the transaction is entered into. No specific language or account is necessary for identifying a transaction referred to in the

preceding sentence. However, the method of identification must be consistently applied and must clearly identify the pertinent transaction as subject to the section 988(a)(1)(B) election. The Commissioner, in his sole discretion, may invalidate any purported election that does not comply with the preceding sentence.

(4) Verification. A taxpayer that has made an election under §1.988-3(b)(3) must attach to his income tax return a statement which sets forth the following:

> (i) A description and the date of each election made by the taxpayer during the taxpayer's taxable year;
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> (ii) A statement that each election made during the taxable year was made before the close of the date the transaction was entered into;
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> (iii) A description of any contract for which an election was in effect and the date such contract expired or was otherwise sold or exchanged during the taxable year;
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> (iv) A statement that the contract was never part of a straddle as defined in section 1092; and
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> (v) A statement that all transactions subject to the election are included on the statement attached to the taxpayer's income tax return.
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> In addition to any penalty that may otherwise apply, the Commissioner, in his sole discretion, may invalidate any or all elections made during the taxable year under §1.988-3(b)(1) if the taxpayer fails to verify each election as provided in this §1.988-3(b)(4). The preceding sentence shall not apply if the taxpayer's failure to verify each election was due to reasonable cause or bona fide mistake. The burden of proof to show reasonable cause or bona fide mistake made in good faith is on the taxpayer.

(5) Independent verification.

> (i) Effect of independent verification. If the taxpayer receives independent verification of the election in paragraph (b)(3) of this section, the taxpayer shall be presumed to have satisfied the requirements of paragraphs (b)(3) and (4) of this section. A contract that is a part of a straddle as defined in section 1092 may not be independently verified and shall be subject to the rules of paragraph (b)(2) of this section.

(ii) Requirements far independent verification. A taxpayer receives independent verification of the election in paragraph (b)(3) of this section if—

(A) The taxpayer establishes a separate account(s) with an unrelated broker(s) or dealer(s) through which all transactions to be independently verified pursuant to this paragraph (b)(5) are conducted and reported.

(B) Only transactions entered into on or after the date the taxpayer establishes such account may be recorded in the account.

(C) Transactions subject to the election of paragraph (b)(3) of this section are entered into such account on the date such transactions are entered into.

(D) The broker or dealer provides the taxpayer a statement detailing the transactions conducted through such account and includes on such statement the following: "Each transaction identified in this account is subject to the election set forth in section 988(a)(1)(B)."

(iii) Special effective date for independent verification. The rules of this paragraph (b)(5) shall be effective for transactions entered into after March 17, 1992.

(6) Effective date. Except as otherwise provided, this paragraph (b) is effective for taxable years beginning on or after September 21, 1989. For prior taxable years, any reasonable contemporaneous election meeting the requirements of section 988(a)(1)(B) shall satisfy this paragraph (b).

(c) Exchange gain or loss treated as interest.

(1) In general. Except as provided in this paragraph (c)(1), exchange gain or loss realized on a section 988 transaction shall not be treated as interest income or expense. Exchange gain or loss realized on a section 988 transaction shall be treated as interest income or expense as provided in paragraph (c)(2) of this section with regard to tax exempt bonds, §1.988-2(e)(2)(ii)(B), §1.988-5, and in administrative pronouncements. See §1.861-9T(b), providing rules for the allocation of certain items of exchange gain or loss in the same manner as interest expense.

(2) Exchange loss realized by the holder on nonfunctional currency tax exempt bonds. Exchange loss realized by the holder of a debt instrument the interest on which is excluded from gross income under section 103(a) or any similar provision of law shall be treated as an offset to and reduce total interest income received or accrued with respect to such instrument. Therefore, to the extent of total interest income, no exchange loss shall be

recognized. This paragraph (c)(2) shall be effective with respect to debt instruments acquired on or after June 24, 1987.

(d) Effective date. Except as otherwise provided in this section, this section shall be effective for taxable years beginning after December 31, 1986. Thus, except as otherwise provided in this section, any payments made or received with respect to a section 988 transaction in taxable years beginning after December 31, 1986, are subject to this section. Thus, for example, a payment made prior to January 1, 1987, under a forward contract that results in the deferral of a loss under section 1092 to a taxable year beginning after December 31, 1986, is not characterized as an ordinary loss by virtue of paragraph (a) of this section because payment was made prior to January 1, 1987.

T.D. 8400, 3/16/92 .

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Dear ,

To provide comprehensive coverage on the taxation of futures and forward contracts under the current Internal Revenue Code[1] ("the Code"), the following is a review of the background and interplay of Section 1256, Section 988 and Section 1221.

Section 1256

Section 1256 was originally enacted by the Economic Recovery Tax Act of 1981 (ERTA 1981); its original intent was as an anti-abuse provision. With the growth in the commodities markets during the 1980's, Section 1256 has become one of the most significant single portions of the Code for commodities investors.

Prior to ERTA 1981, the following scenario could occur. An investor could enter into a long and short position in the same commodity, but with different delivery months. As one position would increase in value, the other position would decrease in value. The losing position would be closed and replaced by a new position. Because, at that time, there were no mark-to-market provisions, the only portion of this series of transactions that had a tax impact was the recognized loss. Therefore, the taxpayer was allowed to recognize a tax loss when little, if any, economic loss had occurred.

Section 1256 effectively put a stop to this practice by requiring that all positions in certain commodity futures held at year end be treated as if they were sold for fair market value on the last day of the tax year. This provision is one of three[2] contained in Section 1256 that impacts the taxation of commodity transactions. The second provision follows the first very closely; it provides that once a gain or loss has been recognized under the mark-to-market provisions, any subsequent gain or loss will be adjusted by the previously recognized amount to avoid double taxation. The third provision allows the gains or losses from the above to be treated as 60% long-term capital gain or loss and 40% short-term capital gain or loss, without regard to the actual holding period. This is commonly referred to as the 60/40 split of gain or losses.
As previously stated, these provisions are only applicable to certain commodity futures contracts; Section 1256 goes into great detail as to exactly which contracts are eligible for this treatment. The Code refers to these types of contracts as Section 1256 Contracts. Section 1256(b) defines a Section 1256 Contract as any (1) regulated futures contract, (2) foreign currency contract, (3) nonequity option and (4) dealer equity option. The last category, dealer equity options does not involve a commodity futures contract, and therefore, will

[1] Unless otherwise indicated, all section references herein are to the Internal Revenue Code of 1986 (the "Code"), as amended, and to the regulations promulgated thereunder.

[2] Internal Revenue Code Section 1256(a) contains four provisions, however, one of them deals with the interaction of the Section 1256 provisions with the straddle rules of Section 1092. Section 1092 will be discussed later.

foreign financial contract + exchanges
forward currency contract + Pilot Market

not be discussed further. A closer examination of each of the other three types of Section 1256 contracts is necessary for a complete understanding of these transactions.

Regulated Futures Contracts

A regulated futures contract ("RFC") is defined in Section 1256 as a contract "with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market..."[3] This type of a system is the daily settlement of a futures margin account as we know it. The more restrictive portion of the definition is that a RFC "is traded on or subject to the rules of a qualified board or exchange."[4] A qualified board or exchange is defined in Section 1256(g)(7) as being in one of three broad groups:

1. A national securities exchange which is registered with the Securities and Exchange Commission (SEC),
2. A domestic board of trade designated as a contract market by the Commodity Futures Trading Commission ("CFTC"), or
3. Any other exchange, board of trade or other market so designated by the Secretary of the Treasury.

Accordingly, all domestic commodities exchanges meet the first part of this definition; and, since they are required to be registered with the CFTC, they will also meet the second part of the definition. Therefore, all futures contracts traded on a domestic board of trade will meet this definition.

Foreign Currency Contracts

Section 1256 provides three criteria which must be met for a contract to qualify as a foreign currency contract. These criteria are as follows:

> A contract -
>
> (i) which requires the delivery of, or the settlement of which depends on the value of, a foreign currency which is a currency in which positions are also traded through regulated futures contracts,
> (ii) which is traded on the interbank market, and
> (iii) which is entered into at arm's length at a price determined by reference to the price in the interbank market.[5]

Section 1256(g)(2)(B) provides that the Secretary of the Treasury has broad regulatory authority over the application of this definition. This authority includes the express ability to exclude any contract from the above definition.

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[3] Code §1256(g)(1)(A)
[4] Code §1256(g)(1)(B)
[5] Code §1256(g)(2)(A)

Examining each part of the above definition should provide a clearer understanding of the types of contracts to which such definition applies. The first portion of the definition requires that the contract be settled in a foreign currency or be referenced by a foreign currency. It further requires that the currency be one that is also traded through RFCs. There are several significant parts to this definition. First, note that the contract must be one in which there are RFCs, which currently include the: Australian Dollar, British Pound, Canadian Dollar, Euro, Japanese Yen, Mexican Peso, New Zealand Dollar, Norwegian Krona, South African Rand, Swedish Krona and Swiss Franc. Because this list is not subject to the control of the Internal Revenue Service ("IRS"), it can change without their prior knowledge. Accordingly, it is incumbent to be aware of changes in the contracts. Also, note that the definition uses the word "traded," which generally the IRS interprets very literally. If there is no trading on an approved currency contract, the currency does not qualify as a foreign currency contract.

The second part of the definition indicates that the contract must be traded in the interbank market. There is no regulatory guidance as to what constitutes the interbank market; however, the legislative history surrounding the Technical Corrections Act of 1982 (TCA 1982) (the act that added this provision) indicated that the interpretation of the interbank market should not be overly broad. Consider the following:

> Contracts traded in the interbank market generally include not only contracts between a commercial bank and another person but also contracts entered into with a futures commission merchant who is a participant in the interbank market. A contract between two persons neither of whom is a futures commission merchant or other similar participant in the interbank market is not a foreign currency contract under the provision.[6]

The last part of the definition is a somewhat standard provision that the transaction not be between related parties at terms substantially different from those available in the markets.

Nonequity Options

The term nonequity option is defined in Section 1256(g)(3) as any option that is traded on a qualified board or exchange, and is not an equity option. A qualified board or exchange was defined above under the discussion of RFCs. Equity option is defined in Section 1256(g)(6)(A) as an option to buy or sell stock, or the value of which is determined directly or indirectly by reference to any stock (or group of stocks) or stock index. Section 1256(g)(6)(B) provides that the term equity option does not include any stock index or group of stocks if the CFTC has designated a contract market for a contract based on the stock index or group of stocks.

Section 988

Section 988 was added with the Tax Reform Act of 1986 (TRA 1986). Prior to the addition of this Section (and in fact all of Subpart J - Foreign Currency Transactions), there was no guidance in the Code as to the

[6] Report of the House ways and Means Committee on the House Amendment to the Technical Corrections Act of 1982. The final bill adopted the provisions of the House Bill and the House Amendment. Commerce Clearing House (CCH), Standard Federal Tax Reports, Paragraph 32,700.18.

proper tax treatment of the gains or losses resulting from transacting business in, holding or investing in foreign currencies.

Section 988 provides that "any foreign currency gain or loss attributable to a section 988 transaction shall be computed separately and treated as ordinary income or loss."[7] This definition contains two phrases that must be defined further: 1) foreign currency gain or loss, and 2) Section 988 transaction.

Foreign currency gain or loss is defined as any gain (loss) from a Section 988 transaction that does not exceed the gain (loss) realized by reason of changes in the exchange rates.[8] A Section 988 transaction is defined as any of the following transactions if the amount to be received (or required to be paid) is denominated in a foreign currency or is determined by reference to the value of at least one foreign currency. The transactions are as follows:

(i) The acquisition of a debt instrument or becoming the obligor under a debt instrument,
(ii) Accruing (or otherwise taking into an account) for the purposes of this subtitle any item of expense or gross income or receipts which is to be paid or received after the date on which so accrued or taken into account, or
(iii) Entering into or acquiring any forward contract, futures contract, option, or similar financial instrument.[9]

Item (iii) does not apply to any RFCs or nonequity options which would be marked to market pursuant to Section 1256 if held on the last day of the taxable year.[10] Item (iii) above is further limited by regulation to include futures, forwards and options "only if the underlying property to which the instrument ultimately relates is a nonfunctional currency or is otherwise described"[11] in Section 988(c)(1)(B).

In its simplest form, the above means that a Section 988 transaction includes the following:

- Acquisition of a debt instrument or becoming the obligor on a debt instrument,
- Payment of accounts receivable or payable, or
- Entering into certain futures, forwards or options contracts (except RFCs (Section 1256(g)(1)) or nonequity options (Section 1256(g)(3))).

With respect to futures, forwards and options contracts, trading in such contracts constitutes a Section 988 transaction only if the underlying property to which the instrument related constitutes a Section 988 transaction. For example, a futures contract on a Norwegian Krona denominated bond would be a Section 988 transaction. Likewise, a forward contract to buy British Pounds would be a Section 988 transaction; however, a futures contract to buy wheat denominated in Canadian Dollars would not be a Section 988 transaction.

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[7] Code §988(a)(1)(A)
[8] Code §988(b)(1) and (2)
[9] Code §988(c)(1)(B)
[10] Code §988(c)(1)(D)
[11] Income Tax Regulation (Regulation) §1.988-1(a)(2)(iii)(A)

Disposition of a Foreign Currency

Special rules relate to the disposition of a foreign currency. Any disposition of a foreign currency is considered to be a Section 988 transaction, and any gain or loss on such a disposition should be treated as foreign currency gain or loss.[12] Note that this definition does not allow for the accrual of a gain or loss on the holding of a foreign currency over a period of time. It only allows the gain or loss to be recognized upon the disposition of the foreign currency.

Determination of a Foreign Currency Gain or Loss

As discussed above, all of the gain or loss from either the disposition of a foreign currency or from the acquisition of a futures, forward or option contract is treated as gain or loss from a Section 988 transaction. Therefore, there is no need to determine the amount of foreign exchange gain or loss on these transactions.

Coordination of Sections 988 and 1256

It is significant that the definition of a Section 988 transaction excludes RFCs and nonequity options; however, it does not exclude foreign currency contracts. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA 1988) changed this exclusion from Section 988 transaction status. Prior to the enactment of TAMRA 1988, any Section 1256 contract was excluded from the definition of a Section 988 transaction. The report of the conference committee on TAMRA 1988 stated the following:

> Foreign currency-related forwards, other types of futures and options, and similar financial instruments are generally treated under the agreement as section 988 transactions without regard to whether the instruments are or would be marked-to-market under Section 1256 if held at year end. The agreement therefore treats foreign exchange gain or loss on these instruments as foreign currency gain or loss...[13]

As a result of the above, foreign currency contracts (as defined in Section 1256) are not treated as generating capital gains or losses. Instead, these contracts will generate ordinary income or loss. However, there is nothing contained in Section 988 that precludes these contracts from being marked-to-market as permitted under Section 1256. In fact, the conference committee report acknowledges that this mark to market provision is still available.

Recognition of Income under Section 988

For timing purposes, except as noted above for foreign currency contracts defined in Section 1256, gain or loss from Section 988 transactions is recognized only when the transaction is completed.

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[12] Code §988(c)(1)(C)(i)

[13] Report of the House/Senate Conference Committee on the Technical and Miscellaneous Revenue Act of 1988. CCH Standard Federal Tax Reports Paragraph 29,400.019.

Elections Available Under Section 988

There are three separate elections available under Section 988. Each election deals with a different set of transactions or circumstances. Two of the elections are binding once made and are only revocable with the consent of the Secretary of the Treasury.

The D Election

The first election is to treat RFCs or nonequity options as Section 988 transactions[14] (the D election). Such election must be made on or before the first day of the taxable year to which it applies or, if later, on or before the first day during the year in which such a contract is held.[15] In the case of a partnership, the election is made separately by each partner and not by the partnership.[16] It should also be noted that if a partnership has made a Qualified Fund Election ("QFE") (as discussed below) this election is not available to the partners with respect to the income now reclassified as Section 1256 under the QFE; it is however, still available with respect to income from RFCs and nonequity options transactions by the partnership. This election is binding once made and is revocable only with the consent of the Secretary of the Treasury.

The Section 988(a)(1)(B) Election

The second potential election is an election to treat the gain or loss from a Section 988 futures, forward or option transaction as a capital gain or loss.[17] This election is required to be made at the transaction level; however, this means that it is not binding on all transactions entered into by an entity. It must be made as the transaction is entered into, it must be clearly identified on the books of the taxpayer at the time it is entered, it cannot be part of a straddle and it cannot be made on a RFC or nonequity option for which the D election has been made. To the extent this election for capital treatment is made with respect to a Section 1256 contract, Section 1256 governs the character of the gain or loss (i.e., 60/40 treatment). The transaction must be identified at the time it is entered into (verified); however, there is no specific method of verification that must be adopted. Regulation Section 1.988-3 does provide a safe harbor. The safe harbor is that the taxpayer will be presumed to have satisfied the verification requirements if a separate account is maintained for all transactions subject to this election and if the Futures Commission Merchant (FCM) provides statements of activity that identify the account as being subject to an election under Section 988(a)(1)(B).[18]

The statement of activity should include the following: "Each transaction in this account is subject to the election set forth in Section 988(a)(1)(B)."

The Qualified Fund Election

This election can be made by a general partner on behalf of a partnership which meets an ownership, activity and income test. This election provides Section 1256 treatment to bank forward contracts (traded anywhere worldwide) and foreign currency futures contracts (traded on foreign exchanges only).

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[14] Code §988(c)(1)(D)(ii)(I)
[15] Code §988(c)(1)(D)(ii)(II)
[16] Code §988(c)(1)(D)(ii)(III)
[17] Code §988(a)(1)(B)
[18] Regulation §1.988-3(b)(5)(ii)

Ownership Test

The ownership test is met if a partnership has 20 or more unrelated partners none of whom own more than 20% of the capital or income. Note that interests owned by related parties (as defined in Section 267(b) and 707(b)) are treated as owned by one person. If a partnership is a partner, the test looks through to the owners of the partnership and counts them as owners.

In meeting the ownership of capital and income portion of the test, certain additional factors apply. Incentive compensation to the general partner does not disqualify the general partner (i.e., if the G.P. gets a special allocation of 25% of trading profits). Partners exempt from U.S. income tax will not disqualify the partnership with respect to the 20% test. There are certain other provisions applicable to general partners with large interests.[19]

Activity Test

A partnership will meet the activity test if its principal business activity consists of buying and selling options, futures and forwards with respect to commodities.[20]

Income Test

At least 90% of a partnership's gross income must be derived from income or gains described in Section 7704(d)(1)(A), (B) or (G), or from the sale or disposition of capital assets held for the production of interest or dividends.[21] Section 7704(d)(1)(A), (B) or (G) consist of interest, dividends or gains or losses attributable to the trading of futures, forwards or options on commodities.

Note further that no more than a de minimis amount of income of a partnership is allowed to be derived from the purchase or sale of physical commodities (without regard to the 90% test above).

If all of these tests are met, a partnership may elect to have Section 1256 supersede Section 988 with respect to bank forwards and foreign currency futures contracts traded on a foreign exchange.[22] If such an election is made, all capital gains or losses that result from contracts not otherwise Section 1256 contracts are treated as 100% short-term capital gain or loss (without regard to the holding period). Gains or losses resulting from contracts which would otherwise be treated as Section 1256 contracts (certain foreign currency forward contracts) retain their treatment as Section 1256 contracts (60/40 treatment).

Section 1221

Pursuant to Section 1221, a capital asset is defined as any property held by the taxpayer except:

1. Inventory in a trade or business,

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[19] Regulation §1.988-1(a)(8)(i)(A)
[20] Regulation §1.988-1(a)(8)(i)(B)
[21] Regulation §1.988-1(a)(8)(i)(C)
[22] Regulation §1.988-1(a)(i)(vi)(A)(1)

2. Depreciable trade or business property,

3. Copyrights, a literary, musical, or artistic composition, a letter or memorandum or similar property if held by the maker, the person for whom it was prepared or any person whose basis is determined by reference to the basis of one of the above persons,

4. Accounts or notes receivable acquired in the ordinary course of a trade or business,

5. A publication of the United States government which is acquired in a way other than by purchase and is held by the acquirer or a person whose basis is determined by reference to the basis of the acquirer.[23]

Because of the broad nature of this definition, any futures contract not covered by either Section 1256 or Section 988 will be considered a capital asset to the taxpayer. Such contracts will therefore be subject to the holding period rules of Section 1223. That is, gains or losses should be short-term if the asset was held for one year or less and long-term if the asset was held for more than one year.

Specifics to the Funds

Summarizing the above information, and incorporating it with the basic principles of character and timing related to any transaction would result in the transactions being categorized into four different categories, as follows (please note that the following table assumes that no Section 988 elections have been made):

Standard Tax Treatment (No Elections)

Category	Character	Timing
1. Section 1256 Contracts (generally regulated futures contracts and nonequity options)	Section 1256 Gain or Loss: 60% LT & 40% ST Capital	Marked-to-Market
2. Certain Foreign Currency Contracts (Section 988 for character; Section 1256 for timing)	Ordinary Gain or Loss	Marked-to-Market
3. Foreign Financial Futures (Section 988 for both character and timing)	Ordinary Gain or Loss	Gain/Loss Recognized at close of contract
4. Other Foreign Contracts (normal capital gain/loss rules under Section 1221)	Capital Gain or Loss	Gain/Loss Recognized at close of contract

[23] Code §1221(1) through (5)

Tax Treatment with the Section 988(a)(1)(B) election

Category	Character	Timing
1. Section 1256 Contracts (generally regulated futures contracts and nonequity options)	Section 1256 Gain or Loss: 60% LT & 40% ST Capital	Marked-to-Market
2. Certain Foreign Currency Contracts (Section 1256 for both character and timing)	Section 1256 Gain or Loss: 60% LT & 40% ST Capital	Marked-to-Market
3. Foreign Financial Futures (Section 1221 for both character and timing)	Capital Gain or Loss	Gain/Loss Recognized at close of contract
4. Other Foreign Contracts (normal capital gain/loss rules under Section 1221)	Capital Gain or Loss	Gain/Loss Recognized at close of contract

Tax Treatment with the Qualified Fund Election

Category	Character	Timing
1. Section 1256 Contracts (generally regulated futures contracts and nonequity options)	Section 1256 Gain or Loss: 60% LT & 40% ST Capital	Marked-to-Market
2. Certain Foreign Currency Contracts (Section 1256 for both character and timing and purposes)	Section 1256 Gain or Loss: 60% LT & 40% ST Capital	Marked-to-Market
3. Foreign Financial Futures (Section 1256 for both character and timing)	100% Short-Term Capital Gain or Loss	Marked-to-Market
4. Other Foreign Contracts (normal capital gain/loss rules under Section 1221)	Capital Gain or Loss	Gain/Loss Recognized at close of contract

It should be noted that while we have separated all transactions into four categories, specific transactions should be thoroughly reviewed to determine the proper treatment. We have listed on the attachment examples of various contracts by category.

For tax accounting purposes, realized and unrealized, gain or loss needs to be separately tracked for each of the four categories. Additionally, the Foreign Exchange Gain/Loss account should continue to be necessary.

To achieve the proper classification, it generally will require an analysis of the trading activity for each account statement and a sorting process into the four categories. Once the income and expense are sorted into the four categories, the transactions can then be posted to the general ledger.

It should be stressed that the analysis of trading may often have to be done on a transaction by transaction basis because some accounts will trade in contracts with different tax treatments (i.e., Long Gilt (#3) and FTSE Index (#4) or British Pound Forwards (#2) and Russian Ruble Forwards (#3)). Certain other trading accounts will contain only one of the above categories of income or loss (i.e., U.S. dollar regulated accounts (#1)).

Straddle Considerations

The following is a general overview of Section 1092 and the straddle rules, as well as the application of such rules to investment partnerships.

Straddle - *offsetting positions* in *personal property.*[24]

Personal Property - any personal property of a type which is *actively traded.*[25]

Positions - an interest in personal property including a futures or forward contract or option in personal property. The grantor of an option is deemed to hold a position.[26]

Offsetting Positions - a substantial diminution of the taxpayer's risk of loss from the holding of any position by reason of holding one or more other positions.[27] In general, offsetting means that an increase in the value of one position is met with a decrease in the value of the other position(s) in the same proportion.

Actively Traded Personal Property - any personal property for which there is an *established financial market.*[28]

Established Financial Market -

(i) A national securities exchange registered under Section 6 of the Securities Exchange Act of 1934,
(ii) An interdealer quotation system sponsored by a national securities association registered under Section 15A of the Securities Exchange Act of 1934,
(iii) A domestic board of trade designated as a contract market by the CFTC,
(iv) A foreign securities exchange or board of trade that satisfies analogous regulatory requirements under the law of the jurisdiction in which it is organized,

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[24] Code §1092(c)(1)
[25] Code §1092(d)(1)
[26] Code §1092(d)(2)
[27] Code §1092(c)(2)(A)
[28] Regulation §1.1092(d)-1(a)

(v) An interbank market,
(vi) An interdealer market, or
(vii) A debt market (with respect to debt instruments only).[29]

The Code provides the following situations where positions will be presumed to be offsetting (this presumption may be rebutted, however):

(i) The positions are in the same personal property,
(ii) The positions are in the same property, even though such property may be in a substantially altered form,
(iii) The positions are in debt instruments with similar maturities (or as prescribed in the regulations),
(iv) The positions are sold or marketed as offsetting positions (whether or not such positions are called a straddle, spread, butterfly, or any similar name),
(v) The aggregate margin requirements for the combined positions are less than the margin requirements for the positions if held separately, or
(vi) Other factors as prescribed in the regulations.[30]

In the case of situation (i), (ii), (iii), or (vi) above, the positions are only offsetting if the value of one or more positions ordinarily varies inversely with the value of one or more other positions.

A straddle in general is composed of two or more offsetting positions with respect to actively traded personal property. Pursuant to Section 1092(a), a taxpayer that realizes a loss on the disposition of one or more positions in a straddle can deduct the loss only to the extent that it exceeds the unrecognized gain (if any) in offsetting or certain successor positions of the straddle. A loss that is deferred is carried forward to the succeeding year and can be deducted in that year, provided the limitations of Section 1092 do not apply again in that year. Deferred losses are generally recognized in the first taxable year in which there is no longer any unrecognized gain in any offsetting or successor positions.

In addition, a number of complex rules apply to straddles involving Section 1256 contracts. First, if a straddle is composed entirely of Section 1256 contracts (a "pure Section 1256 straddle"), none of the straddle positions are governed by Section 1092 or Section 263(g) but instead remain subject to the mark-to-market and 60/40 characterization rules of Section 1256. In contrast, a mixed straddle generally arises where at least one, but not all, of the positions in the straddle are Section 1256 contracts. In this situation, a taxpayer can make certain elections to account for the mixed straddle (i.e., the mixed straddle election).

Selecting among the elections demands an immense effort of analyzing all the positions and sorting out possible combinations and permutations to identify any and all of the particular straddles. To qualify for

[29] Regulation §1.1092(d)-1(b)(1)
[30] Code §1092(c)(3)(A)

certain of the elections, a taxpayer must identify in advance all the positions that will ultimately be created in the process of managing risk.

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COMMODITY FUTURES, OPTIONS AND FORWARDS CONTRACTS BY TAX CATEGORY

1. Regulated Futures Contracts and Non-Equity Options - § 1256

All contracts (futures and options) on the following exchanges:

Chicago Board Options Exchange
Chicago Mercantile Exchange
  Including:
    Growth Emerging Markets (GEM)
    Index and Option Market (IOM)
    International Monetary Market (IMM)
Coffee, Sugar & Cocoa Exchange
Commodity Exchange, Inc.
Kansas City Board of Trade
MidAmerica Commodity Exchange
Minneapolis Grain Exchange
New York Cotton Exchange
  Including:
    FINEX
    NY Futures Exchange
    New York Mercantile Exchange
  Including:
    NYMEX Division
    COMEX Division
New York Stock Exchange
Pacific Stock Exchange
Philadelphia Stock Exchange

In addition, contracts traded on the following exchanges are also treated as Regulated Futures Contracts:

Mercantile Division of the Montreal Exchange
International Futures Exchange (Bermuda) Ltd.
Singapore International Monetary Exchange
(Trades cleared on Chicago Mercantile Exchange subject to mutual offset system)

2. Foreign Currency Contracts (§ 1256 timing, § 988 character)

Forward contracts traded on the interbank market on the following currencies:

Australian Dollar
Brazilian Real
British Pound
Canadian Dollar
Euro
Japanese Yen
New Zealand Dollar
Norwegian Krone
Russian Ruble
South African Rand
Swedish Krona
Swiss Franc

3. **Foreign Financial Futures (§ 988 timing & character)**

All Forward contracts on currencies other than those listed in (2) above.

Any Foreign Futures interest rate instrument or currency contract.

The following are examples of futures and options contracts meeting this requirement:

Japanese Government Bond
Euro Bund
Euro Bobl
Long Gilt
U.S. Treasury Bonds (LIFFE)
Canadian Government Bond
Canadian 3 month Bankers Acceptance
3 Year Australian Treasury Bond
90 Day Bank Accepted Bills (Australia)
Sterling Interest Rates
EuroYen (TIFFE)
10 Year Australian Treasury Bond
Euro Schatz
3 month Euribor

4. **Other Foreign Contracts (§ 1221 timing & character)**

These include all futures and options contracts on physical commodities and indexes traded on foreign exchanges.

Examples of Foreign Futures Index Contracts:

SPI 200 (Australia)
German Stock Index-DAX
SFE All Ordinaries Share Price Index (Australia)
Nikkei 225 Index (Japan)
CAC 40 Index (France)
FT-SE 100 Stock Index (Britain)
Hang Seng Index (Hong Kong)
Tokyo Stock Price Index (Topix)
IBEX 35 (Spain)
S&P Canada 60
DJ Euro Stoxx (Germany)
MCSI Taiwan Index
OMX (Sweden)

Examples of Foreign Futures Physical Commodities Contracts:

All metals (copper, nickel, gold, etc.)
All agricultural products
(red beans, cotton yarn, live cattle, etc.)

PLEASE NOTE THAT THE ABOVE CONTRACTS CAN BE SUBJECT TO INTERPRETATION OF THE CODE AND THE ASSOCIATED REGULATIONS AND THAT NEW CONTRACTS CAN BE ADDED TO THIS LIST.

Benefits Abound For Active Traders Who Incorporate

By Robert Stammers

With the proliferation of online and discount brokerage, people are trading the stock market in ever increasing numbers. However, as an individual or sole proprietor, traders cannot take advantage of the myriad of tax advantages and asset protection strategies available to companies. Trading the market can be a gainful way to make extra income, or even possibly a full-time living. Like any business, the income generated from trading is taxable and can create significant tax liabilities for the successful trader. (For more on this, read our *Brokers and Online Trading Tutorial.*)

In deciding on what structure to trade through, individuals can trade as individuals or sole proprietors, qualify for trader status, or trade through a business entity. For the active trader, creating a legal trading business will often provide the best tax treatment and asset protection.

Tax Issues

According to the IRS, "trading" is not a business activity. In fact, all income from trading is considered unearned, or passive, income. The presumption is that individuals are investors and that any trading activities are done for long-term capital accumulation and not for paying current liabilities. For this reason, unless an individual can qualify for trader status, he or she will be treated as any other tax filing individual. (For seven guidelines to help you keep more of your money in your pocket, read *Tax Tips For The Individual Investor.*)

Income from trading cannot be reduced by contributing to an IRA or pension. The only advantage to being considered a passive trader is that the income derived from trading is not subject to additional self-employment taxes. After that, deductions are the same as normally afforded to W-2 wage earners, which are generally limited to mortgage interest, property taxes and charitable deductions. The amounts of most deductions are restricted to a percentage of adjusted gross income. Because trading is not considered a business activity, all the expenses necessary to trade are excluded as deductions. For most active traders, the costs of necessities such as education, a trading platform, software, internet access, computers and the like can be considerable.

For most traders, the biggest tax issue they face is that deductions for trading losses are limited to gains. After that, only $3,000 can be deducted against ordinary income. In a year where net capital losses exceed $3,000, individuals can only carry forward $3,000 of that loss per year against future income.

Tax Remedies

In order to avoid such tax treatment, some active traders try to qualify for trader status. The qualified trader is allowed to file a Schedule C and deduct ordinary and necessary business expenses, which would include education, entertainment, margin interest and other trading-related expenses. Qualified traders can also take a Section 179 deduction and write off of up to $19,000 a year for equipment used in trading activities. Finally, a qualified trader can elect a Section 475(f) or the mark to market (MTM) election

Since the late 1990s, mark-to-market accounting has allowed traders to change their capital gains

and losses to ordinary income and losses. On the last day of the year, all positions are assumed to be sold at market value and a hypothetical gain or loss is calculated. For the following year, the basis for each of these positions is calculated by assuming they were also purchased at market value. The hypothetical gains and losses at year end are added to actual gains and losses for tax purposes. (Mark-to-market accounting can be a valuable practice, but all bets are off when the market fluctuates wildly. Read *Mark-To-Market: Tool Or Trouble? and Mark-To-Market Mayhem.*)

Because gains and losses are regarded as ordinary income under MTM, all losses are deducted in the year they occur. Under MTM, traders are not bound by the $3,000 net capital loss limitation and can deduct all losses in the year they occur, providing the maximum tax relief in the current year. Some traders will also elect MTM in order to avoid the 30-day wash sale rule, which disqualifies loss deductions on "substantially identical" securities bought within 30 days before or after a sale. (For related reading, see *Selling Losing Securities For A Tax Advantage.*)

How the IRS Defines a Trader

In IRS Publication 550 and Revenue Procedure 99-17, the IRS has set out general guidelines that provide guidance as to the activities that qualify trading as a business. To be engaged in a business as a trader in securities, a person must trade on a full-time basis, and derive most of his or her income through day trading. According to the IRS, a trader is someone who trades significantly and continuously in order to profit from the short-term fluctuations in security prices. (For more on this type of career, see *Quit Your Job To Trade Stocks?*)

Traders are individuals who make multiple trades daily to profit from intraday market swings and do so continuously throughout the year. They spend a considerable amount of time documenting and researching trades and strategies and incur a significant amount of expenses in order to conduct their business activities. Although not specifically required, most qualified traders will open and close multiple trades daily and hold their positions for less than 30 days.

For active traders, the benefits of qualifying are obvious, but these guidelines are open to interpretation by the IRS and the courts. Only a small percentage qualify, even some whose only income is derived through trading. (For more, see *Tax Effects On Capital Gains.*)

A Legal Trading Business

The only way to ensure that you are receiving the same tax treatment as a qualified trader is to create a separate corporate entity to trade through. By creating a limited liability company or a limited partnership, you can receive all the same tax treatment as a qualified trader without having to qualify. The legal entity usually receives less scrutiny by the IRS because the assumption is that no one would go through the trouble and expense of forming the entity, unless they were committed to trading as a business venture. It is extremely difficult for individuals to change election such as MTM once it has been chosen. With the company, if there is an advantage to changing accounting methods or the legal structure, the entity can simply be dissolved and re-formed accordingly.

More Success = More Entities

For highly successful traders , some advisors will suggest structures that include multiple entities to maximize the tax and protection benefits. Even though the actual structure is determined by an individual's financial goals, it usually includes a C corporation, which exists to be the general partner or managing member of several limited liability companies. In this way, extra income can be transferred to the corporate entity (usually up to 30% of revenue) through a contracted management fee to take advantage of the myriad of additional tax strategies available.

education expenses, while building Social Security and Medicare accounts. Medical reimbursement plans can be created to fund all types of elective healthcare and medical insurance premiums. Retirement accounts such as IRAs and 401(k)s can be transferred into a 401a, an ERISA pension fund that allows contributions of up to $49,000 per year and can never be attacked by creditors or through a legal claim. Because the corporation pays taxes on net income, the goal is to pay as many expenses as possible with pretax dollars and to minimize taxable income. (Find out how becoming a corporation can protect and further your finances in *Should You Incorporate Your Business?*)

This type of business structure also provides excellent asset protection because it separates the business from the individual. Long-term assets can be held by other limited liability companies that can use accounting methods better suited for investments. All assets are protected from creditors and the legal liabilities of the individual because they are held by separate legal entities. The amount of legal protection is determined by state law. Many advisors suggest forming these entities in states that will not allow the piercing of the legal structure. Most prefer Nevada because of its lack of corporate sales tax, flexibility to charge orders as sole remedy by creditors, the anonymity of not having to list shareholders, and the nomination of corporate officers. (Could incorporating your business help protect it? Find out in *Asset Protection For The Business Owner.*)

Conclusion

Although trading through a complex legal structure has obvious benefits, it also can add a significant amount of complexity to one's personal affairs. For traders who have been consistently profitable but cannot or do not want to qualify for trader status, trading through a simple business is essential. If you wish to set up a pension fund to defer taxes, pay salaries to loved ones or recoup significant medical expenses tax free, then the added complexity is a decent trade-off to gain the benefits of a compound structure. Either way, to receive the best tax treatment and legal protection, one should speak with advisors who understand the formation and operation of these entities for traders. (For related readings, see *Build A Wall Around Your Assets.*)

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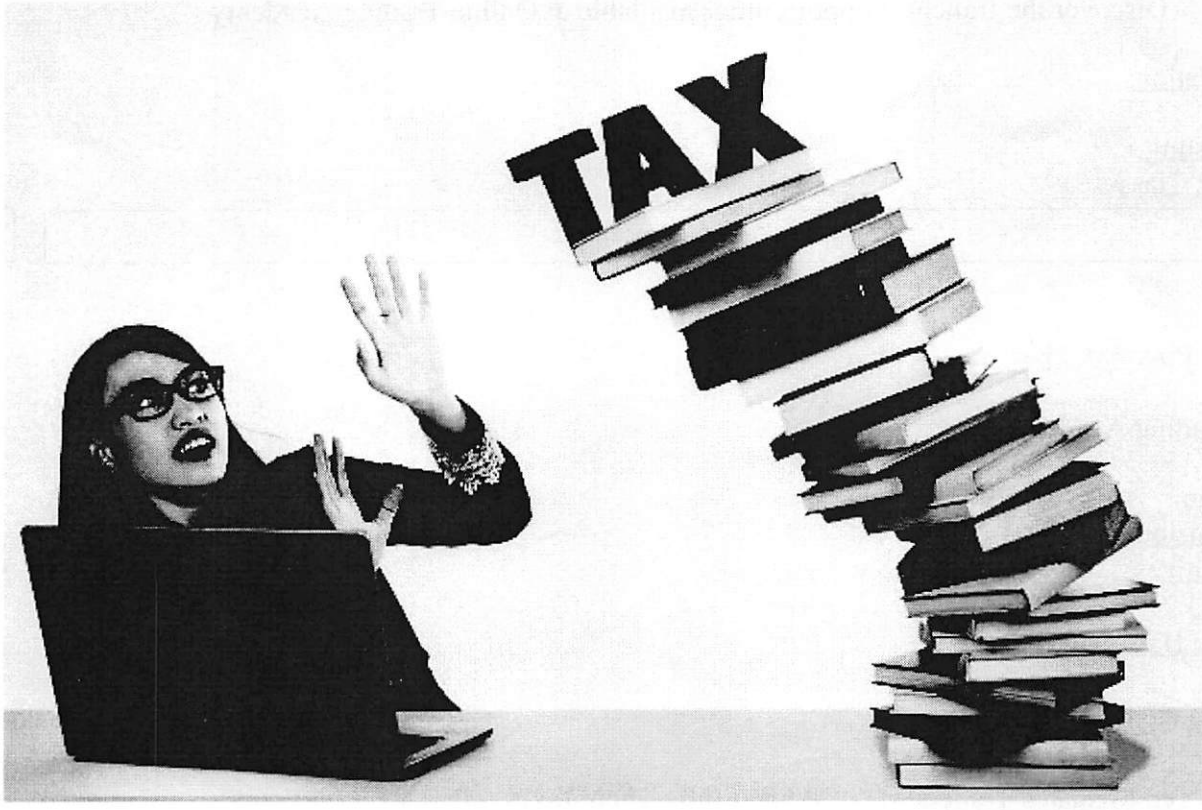
Top Ten Mistakes Traders Make When Filing Their Taxes – Part 1

Master Instructor Blog

The US tax code is a complex maze. It is 73,954 pages long and includes more than 1,999 different publications and tax forms. In order to win in the tax game, you need to have the proper knowledge and expertise that can help you reduce your tax liability and stay in compliance.

In this 3 part series, we are going to zoom in and focus on trader taxation laws and the top ten mistakes traders make when preparing their tax returns. These mistakes lead to IRS audits, penalties and fines. These mistakes are costly and may cause you to pay thousands of dollars in unnecessary taxes.



Let's count backwards from least to worst:

10. Not filing a tax return due to trading losses or minimal trading

There are people who are under the impression that they are required to file a tax return only if they had trading profits. Or, they are exempt from filing a tax return if they had a handful of trades, or experienced losses in the market. They are absolutely wrong! Failure to report your trading activity, even if you only had losses, or minimal gains may lead to IRS notices, penalties and interest. Take note that the IRS receives a copy of your 1099 from your brokerage company and if there is not a match between the trades on the 1099 form to the trades reported on your tax return they will send you a notice. What is worse is that the IRS will assume that your total

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- Top Ten Mistakes Traders Make When Filing Their Taxes – Part 1

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taxable profits equal your total proceeds, and you will be taxed at the highest tax bracket allowable. In the last 13 years, I have seen many IRS notices like this, asking taxpayers to pay up to hundreds of thousands of dollars in taxes. The clients typically are astonished when they receive these alarming notices. The issue is usually resolved by doing one simple action – filing a tax return.

9. Reporting your gains and losses on Schedule C:

Unfortunately, some traders experience losses that are greater than $3,000. In attempt to fully write off their losses they report it on Schedule C. They claim that they are business traders and therefore they are allowed to report their losses on Schedule C. This is a sure way to get on the IRS radar. The IRS code and publications clearly states that all capital transactions must be reported on Schedule D. Therefore, you are limited to claiming $3,000 of your losses in the year they occurred. The remainder of the disallowed losses gets carried over to future years. The only way to claim losses in excess of $3,000 is by electing the MTM accounting method which must be made by April 15th of the tax year in question. Most traders are not aware of this election and fail to make it on time. Reporting losses on your Schedule C will most likely generate an IRS notice or examination. The result of this notice will surely be additional tax liability, penalties and interest. Avoid this mistake and consult with your trader tax professional on strategies you can use.

8. Paying self-employment (SE) taxes on trading

Many traders elect to trade via a business entity such as a corporation, partnership or LLC. When doing so they report all of their trading income as ordinary income and they subject their trading income to self employment tax. You should know that trading income is not considered to be earned income and only earned income is subject to self-employment tax. Therefore, reporting your gains as earned income subjects you to an additional 15.3% of unnecessary taxes. Let's assume that Joe trader made $100,000 and reported all income as subject to self employment tax, this would mean that Joe would pay $15,300 in self employment tax. Only full members of futures exchanges are obligated to pay SE taxes on futures trading gains. However, too many traders out there are paying SE taxes on these gains. If you think the IRS will correct this error for you, you are simply wrong. The IRS hardly ever corrects mistakes in their favor.

7. Mixing up the tax treatment between securities, 1256 contracts, forex and options.

Stocks, bonds, and mutual funds belong to the securities group and are taxed at the long term capital gain rate if held more than a year. If the position is held for less than a year it is taxed at the short-term capital gain rate. Which essentially is your ordinary income tax bracket. Securities are also subject to the wash sale rule unless you have elected MTM accounting. Futures contracts are part of Section 1256 contracts which are entitled to a special tax treatment known as the 60/40 split. This allows futures traders to pay on 60% of their gains at long term capital gain rate of 15% and pay short-term capital gain rate on the remaining 40%; creating a maximum tax savings of up to 15%. **Misreporting Section 1256 contracts as securities** on Form 8949 rather than on Form 6781 causes you to lose your lower 60/40 tax treatment and potentially pay thousands of dollars in unnecessary taxes. Not all brokers report Section 1256 contracts correctly, especially instruments that are not clearly designated as such including some E-mini indexes and options on those indexes. You need to make sure you are reporting your trades correctly and not missing on any tax breaks available to you. Forex can be taxed either as ordinary income or as section 1256(g) that qualifies to the 60/40split mentioned earlier. You will need to know what tax election to make and when to make it. Failure to do so may cost you thousands of dollars in unnecessary tax payments.

Next week, we will continue with items 4-6 on our top ten mistakes traders make when filing their taxes. Until then, have a successful week.

To find out more about how you can avoid audits, reduce taxes legally and keep more of your profits, please visit OTA Tax Pros http://www.tradingacademy.com/otatax/.

ISSUE INDEX

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Forex

Many preparers mess up forex tax treatment, and IRS and state agents are confused over the reporting, too.

"Forex" refers to the foreign exchange market where participants trade currencies, including spot, forwards or over-the-counter option contracts. Forex differs from trading currency futures on futures exchanges. Like other futures, currency futures are Section 1256 contracts reported on Form 6781 with lower 60/40 capital gains tax treatment.

Many traders, preparers, and IRS agents misunderstand forex tax treatment, and we often see errors. The first problem is there is no 1099-B for spot forex and most trade spot forex, not forex forwards, or forex OTC options.

Most preparers err in thinking it's a capital asset for traders so capital gains and loss treatment should apply. That's incorrect: The default treatment in Section 988 forex rules is ordinary gains and losses, not capital gains and losses. That's a welcome relief for many new forex traders who have initial losses, who are grateful not to have a $3,000 capital loss limitation against other income.

Section 988 allows investors and business traders — but not manufacturers — to internally file a contemporaneous "capital gains election" to opt-out of Section 988 into the capital gain or loss treatment. One reason to do so is if you need capital gains to use up capital loss carryovers, which otherwise may go wasted for years. A trader may make or retract this election on a "good to cancel basis" during the year.

The capital gains election on forex forwards allows the use of Section 1256(g) treatment with lower 60/40 capital gains rates on the main currencies if the trader doesn't take or make delivery of the underlying currency. "Main currencies" means currencies for which currency futures trade on U.S. futures exchanges. Go to U.S. futures exchanges to find a listing of their currency pairs.

Using Section 1256(g) requires the forex broker to have direct access to the Forex Interbank market. A forex broker that takes the opposing trade with clients and only enters the Interbank market to make a few offsetting trades does not qualify for lower Section 1256(g) 60/40 tax rates.

In our tax guide, we make a case for treating spot like forwards for purposes of using Section 1256(g) treatment. Spot forex tax treatment is uncertain, so it's wise to consult with us about it.

Use summary reporting for forex trading, and most brokers offer good online tax reports. Section 988 is realized gain or loss, whereas with a capital gains election into Section 1256(g), use mark-to-market (MTM) treatment.

For in-depth information on forex tax treatment, accounting and CFTC/NFA rules for Americans, read Green's 2016 Trader Tax Guide and watch our best-selling recording Forex Tax Treatment 2016.

There are many nuances, myths and widespread errors with forex tax treatment, and GreenTraderTax is considered the leader in forex tax treatment. Forex tax is one case where we highly recommend our trader tax guide and the above recording for sale. Consider a consultation with us and our tax compliance service.

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Tax Treatment Can Be Tricky With Options and ETFs

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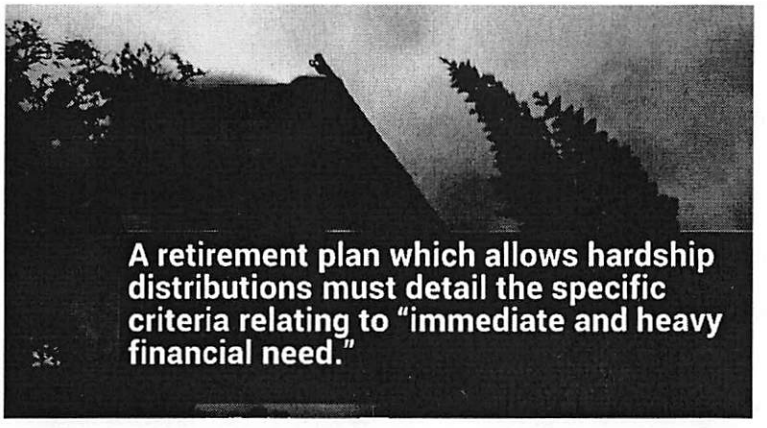

about how the various instruments are treated come tax time.

While you might expect that broker-issued 1099-Bs would handle all of these difficult issues, but for some tax treatments, they do not. Broker compliance rules are different than rules taxpayers must follow on Section 1091 wash sales on securities. Some brokers mislabel Section 1256 contracts, too. It depends on the taxpayer's facts and circumstances and elections made. You can't expect a broker to police your elections, determine if you qualify for trader tax status (TTS) and determine if you've filed a timely election for Section 475 MTM. Brokers should issue 1099-Bs for the "everyman," not based on your facts and circumstances and elections filed.

Capital gains vs. ordinary income?

Most financial instruments — including securities, Section 1256 contracts, options, ETFs, indexes, precious metals and bitcoin held as a capital asset — are subject to capital gains treatment. By default, forex contracts and swap contracts are subject to ordinary gain or loss treatment. The

traders and investors who may have trouble using up large capital-loss carryovers in subsequent tax years. Traders with TTS and a Section 475 MTM election have business ordinary-loss treatment, which is more likely to generate tax savings or refunds faster.

In this blog post, learn about: securities, Section 1256 contracts, options, and ETFs. In my next blog post, learn about: forex, swap contracts, precious metals, Nadex binary options, bitcoin and more.

Securities

Securities include:

- equities (stocks)

- equity (stock) options

- narrow-based indexes (an index made up of nine or fewer securities) and options on narrow-based indexes

- exchange-traded funds (ETFs) and options on ETFs taxed as Registered Investment

- mutual funds

- single-stock futures

Realized transactions in securities are reported on Form 8949, which feeds into Schedule D where short- and long-term capital gains rates apply.

Short-term capital gains rates are the ordinary tax rates, currently up to 39.6% (2015 and 2016). With the default realization (cash) method, only realized gains and losses on securities are reported for the tax year. Section 1091 wash-sale loss deferral rules apply throughout the year with IRAs and individual taxable accounts. (For a full explanation of wash sales, read my recent blog post Wash Sale Loss Adjustments Can Be A Big Tax Return Headache.)

Securities traders using the cash method may defer unrealized gains (or losses) on open positions until realizing a gain (or loss) on a sale. Long-term capital gains rates — up to 20% (2015 and 2016) — apply to sales of securities held for 12 months or longer.

I generally recommend that business traders in securities (with TTS) consider a Section 475 MTM election in order to have business ordinary loss treatment — navigating out of wash-sale loss rules and capital-loss limitations on business trades — since they already are paying ordinary rates on short-term capital gains.

Part II, as nothing is deferred. But, where Schedule D capital losses are limited to $3,000 per year against ordinary income, Section 475 MTM losses are unlimited as business losses.

Tax rules require reporting realized securities trades on a trade by trade (or line by line) basis on Form 8949, including reporting wash sales on each transaction.

Section 1256 Contracts

In the famous tax reform bill of the 1980s, Congress added Section 1256 contracts.

These contracts include:

- U.S. futures (regulated futures contracts) and options on futures

- foreign futures with CFTC and IRS approval

- broad-based indexes and options on broad-based indexes (a broad-based index is one that is made up of 10 or more securities)

- forward forex in major currencies with the opt out election into Section 1256g (I make a case for spot forex in major currencies too)

- options on commodities/futures ETFs taxed as publicly traded partnerships

- other non-equity options

Section 1256 contracts bring meaningful tax savings. These contracts have lower 60/40 tax rates, meaning 60% (including day

rate. At the maximum tax brackets for 2015 and 2016, the top Section 1256 contract tax rate is 28% — 12% lower than the top ordinary rate of 39.6%.

With zero long-term rates in the 10% and 15% ordinary brackets, there is meaningful tax rate reduction throughout the brackets. In the 15% ordinary tax bracket, the blended 60/40 rate is 6%. (Here's the math: 60% LT x 0% LT rate = 0%. Plus, 40% ST x 15% ST rate = 6%.) In the 10% ordinary tax bracket, the blended 60/40 rate is 4%. States don't apply a long-term rate, so regular state tax rates apply.

Section 1256 contracts are marked-to-market (MTM) on a daily basis. MTM means you report both realized and unrealized gains and losses at year-end. Many traders have small or no open positions on Section 1256 contracts at year-end.

With MTM and summary reporting, brokers are able to issue simple one-page 1099-Bs reporting "aggregate profit and loss" after taking into account realized and unrealized gains and losses. That amount is reported on Form 6781 Part I, which breaks it down to the 60/40 split and then moves those amounts to Schedule D capital gains and losses.

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