CHAPTER 5

Commodities, Securities, and Currencies

COMMODITIES AND FUTURES TRADING

Commodities and futures are taxed differently from securities. You need to learn about IRC Section 1256 contracts, Form 6781 and special carrybacks, and how they relate to IRC Section 475(f), the new mark-to-market rules.

MTM (IRC § 475) is not a preferred method for profitable commodities and futures business traders for one reason: With the default accounting method, commodities and futures trading gains are 60 percent long term (i.e., lower rates) and 40 percent short term; MTM (IRC § 475) commodities and futures trading gains are all short term. So, commodity traders experience a trade-off. The default method (IRC § 1256—another type of MTM) is better if you have gains.

Section 1256 also has a loss carryback feature; you can carry back commodities and futures trading losses three tax years, but only against commodities and futures trading gains in those years. This loss carryback feature is not as useful as MTM IRC § 475 losses, which are full net operating losses (NOLs) and may offset any type of income in the prior two tax years.

In summary, commodities and futures business traders usually skip electing MTM IRC § 475 because they would increase their taxes on gains and only marginally improve their ability to carry back losses. This result is a stark contrast to securities business traders who get tax loss insurance with MTM IRC § 475 for no cost (same tax on gains).

Here is one idea: If you incur large commodity trading losses before the MTM election deadline for the current tax year, elect MTM IRC § 475 so you can deduct your commodity trading losses as ordinary losses. That deduction will offset any type of income in the current tax year, and excess losses can generate refunds in the prior two tax years (regardless of whether you have commodities or futures trading gains in prior years).

If you trade both securities and commodities/futures, you may elect MTM IRC § 475 for "securities only" and not also for commodities and futures—a wise move for many business traders. If your trading in securities and commodities/futures are unrelated activities (e.g., you trade stocks and also currency and interest futures rather than securities indexes), the IRS may deem you have separate and unrelated businesses and require you to qualify for trader tax status in each business, meaning you must trade each enough to rise to business treatment.

Distinguishing Between a Security and a Commodity

The universe of trading instruments is growing every day, providing traders with many new opportunities for profits. Taxwise, the IRS forces all these instruments into two main tax categories: securities or commodities. Figuring out how to treat all the new products is a challenge.

For securities, business traders report capital gains and losses on Schedule D (default cash method) or ordinary gains and losses on Form 4797 Part II (if mark-to-market accounting is elected). Securities traders rarely hold positions for more than twelve months, so the bulk of their trading gains are short-term capital gains subject to the ordinary income tax rates.

Tax Rates on Commodities Versus Securities

Commodities are section 1256 contracts taxed 60 percent at long-term capital gains tax rates and 40 percent at short-term capital gains tax rates (i.e., ordinary income tax rates).

60% × 15% (maximum long-term capital gains tax rate) = 9%
40% × 35% (maximum short-term capital gains tax rate, or ordinary rate) = 14%.
Net maximum 60/40 blended tax rate = 23 percent

Securities are usually all short-term for traders, because they hold positions for less than twelve months (maximum short-term capital gains tax rate [ordinary rate] of 35 percent).

It is important to note the net maximum tax rates are significantly better for commodities traders versus securities traders (23 percent versus 35 percent, respectively).

Regulated Futures Contracts

Regulated futures contracts (RFC) are traded on commodities exchanges and, as the regulated label suggests, are regulated by the exchange and the Commodity Futures Trading Commission (CFTC). Exchange-traded commodities, including currency RFCs are covered under IRC section 1256 contracts. Business traders and all investors report RFC section 1256 contracts as capital gains and losses on Form 6781 (Gains and Losses from Section 1256 Contracts and Straddles). This approach allows them to split the gains and losses 60/40 on Schedule D: 60 percent long-term, 40 percent short-term.

A 60/40 split gives commodities traders and investors an advantage over securities traders. For this reason, most profitable commodities business traders don't elect MTM IRC § 475. With § 475, commodities traders can have full tax loss insurance, (ordinary loss treatment), but they are reluctant to give up their beneficial tax rates on gains (the 60/40 split).

Section 1256 Contracts

Section 1256 contracts include regulated futures contracts, foreign currency contracts, nonequity options, dealer equity options, and dealer securities futures contracts. For a partnership that's a qualified fund, section 1256 contracts include bank forward contracts, foreign currency futures contracts, and similar instruments prescribed by IRS regulations.

Commodities are IRC section 1256 contracts. Section 1256 contracts are marked to market at the end of each tax year, so all traders and investors report realized and unrealized gains and losses. No election is necessary here. Do not confuse section 1256 mark-to-market accounting with IRC § 475(f):

- What is and is not a section 1256 contract? See the area titled Definitions in IRC Section 1256 law. Great confusion among trader taxpayers surrounds what is a §1256 contract and what is not.
- Section 1256 was introduced into law by the Economic Recovery Tax Act of 1981. Section 1256 contains special rules for reporting gains and losses from "section 1256 contracts."
- Section 1256(b) defines the term *section 1256 contract* (e.g., commodities) as including any regulated futures contract, any foreign currency contract, any nonequity option, any deal equity option, and any dealer securities futures contract. The Commodities Futures Modernization Act (CFMA) of 2000 established that broad-based indexes are also considered commodities.
- Section 1256(g)(1) provides that the term *regulated futures contract* means a contract (1) 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, and (2) which is traded on or subject to the rules of a qualified board or exchange.

A futures contract is not defined in section 1256. The CFTC defines a futures contract as "an agreement to purchase or sell a commodity for delivery in the future: (1) at a price that is determined at initiation of the contract; (2) which obligates each party to the contract to fulfill the contract at the specified price; (3) which is used to assume or shift price risk;

and (4) which may be satisfied by delivery or offset." Only a futures contract that has actually been traded on a CFTC-designated contract market or subject to its rules is a regulated futures contract for purposes of § 1256(g)(1).

A regulated futures contract can be traded by either a taxpayer as a principal or by a third party acting on the taxpayer's behalf as an agent. Futures contracts that have been traded by two private parties over the counter (OTC) are not traded on a contract market and are not regulated futures contracts for purposes of § 1256(g)(1). See Revenue Ruling 87-43, 1987-1 C.B. 252.

A futures contract that does not meet these terms may be a nonregulated futures contract. The difference between forward contracts and futures contracts is that the parties to a forward contact generally intend to make and take delivery.

Parties to a futures contract are speculators who intend to close out their positions by offset before delivery.

Section 1256(g)(7) provides that the term *qualified board or exchange* means (1) a national securities exchange that is registered with the Securities and Exchange Commission, (2) a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, or (3) any other exchange, board of trade, or other market the Secretary determines has rules adequate to carry out the purposes of this section. Even though the Secretary of the Treasury has not taken up its congressional mandate to create legislative certainty in this area, it can be argued that the CFTC, by default, has filled the interstitial legislative gap.

Three-Year Carryback of Losses from Section 1256 Contracts

In the Form 6781 instructions, see the directive for Box D (Net Section 1256 Contracts Loss Election). When preparing Form 6781, all individual taxpayers may mark Box D, thereby electing to carry back a net section 1256 contract loss three tax years.

You then file an amended return for the carryback year and you may apply the section 1256 carryback loss on your Form 6781 for that prior tax year.

Note: If you don't have Form 6781 gains in that prior carryback year, you won't get any benefit from this carryback. So check this aspect before you make this election. Unlike IRC § 475(f)(2), you can make this section 1256 carryback election when you prepare your tax return.

Why 60/40 Treatment Is Viable for Some Foreign Futures

Since the enactment of section 1256 in 1981, a number of contract markets throughout the world have implemented adequate rules and could be determined to be a qualified board or exchange within the meaning of section 1256(g)(7). The Treasury Department's recognition of the appropriate extension of 60/40 tax treatment to foreign exchanges, boards of trade, and other markets pursuant to section 1256(g)(7)(C) is long overdue and is not likely to be forthcoming anytime soon.

Although a formal designation as such by the Treasury would expressly make futures contracts traded on these foreign exchanges eligible for treatment as a section 1256 contract (e.g., eligible for 60/40 capital gain or loss treatment), the lack of such designation does not necessarily preclude 60/40 tax treatment.

OPERATIVE ANALYSIS

For purposes of determining the tax consequences of a transaction, it is necessary to ascertain the legal relationships that exist between the parties to the transaction. In the typical exchange clearing process for a futures or option contract, an exchange clearinghouse is interposed between the original parties to the transaction, namely, the clearing members who represent the purchaser and seller under the contract.

Because a series of steps are involved in the typical exchange clearing process, the step transaction doctrine provides that these steps are not analyzed separately but are viewed as component parts of a single transaction.

In the typical exchange clearing process, the legal relationship between the investor and the broker remains unchanged notwithstanding the fact that an exchange clearinghouse is interposed between the original parties to the transaction. Relying on this type of analysis, in Revenue Ruling 85-72, 1985-1 CB 286, the IRS determined that International Futures Exchange (Bermuda) Ltd. was a qualified board or exchange.

The Tax Court, in Johnson v. CIR, T.C. Memo (1993-178), stating that the purpose of section 1256 is to provide the system of taxation based on marking to market of regulated futures contracts, held the taxpayers' trading in futures contracts and in futures transactions on the London Metal Exchange were conducted subject to the rules of a board of trade or commodity exchange within the meaning of § 1256(g)(7).

However, in Revenue Ruling 87-43, 1987-1 CB 252, the IRS ruled that Singapore International Monetary Exchange Limited (SIMEX) was a foreign board of trade that was not a qualified board or exchange. In that ruling, the Chicago Mercantile Exchange (CME) and the SIMEX established the Mutual Offset System (System) to provide a process by which customers could establish new positions or offset existing positions on one exchange, during hours in which that exchange is closed for trading, by the execution of a contract on the other exchange.

COMMODITY FUTURES TRADING COMMISSION ON FOREIGN FUTURES

The same type of legal analysis can be extended to decisions of the CFTC with respect to foreign contract markets. Part 30 of the CFTC's regulations establishes the regulatory structure governing the offer and sale of foreign futures and options contracts to U.S. persons by persons acting as futures commission merchants, introducing brokers, commodity pool operators, and commodity trading advisors.

Section 30.10 of these regulations allows the CFTC to, among other things, exempt a foreign firm acting in the capacity of a futures commission merchant from compliance with certain CFTC rules and regulations. To receive such relief under Rule 30.10, the firm's home-country regulator must demonstrate that it provides a comparable system of regulation and must enter into an information sharing agreement with the CFTC.

Once a firm receives confirmation of Rule 30.10 relief, it may engage in the offer or sale of foreign futures and options contracts to U.S. persons without registering with the CFTC on the terms specified in the Rule 30.10 Order.

A reasonable basis in fact and law allows the conclusion that futures traded on foreign contract markets with a Rule 30.10 exemption are entitled to classification as section 1256 contracts (e.g., commodities) with the result that 60/40 tax treatment is appropriate. All that is needed is a determination by the Treasury Secretary.

In the absence of a forward determination by the Secretary, it may be possible to develop an appropriate and reasonable tax return position in support of 60/40 tax treatment for futures contracts traded on the foregoing foreign contract markets.

The CFTC has effectively determined that the foregoing contract markets are exchanges, boards of trade, and other markets qualified within the meaning of § 1256(g)(7) as such boards and exchanges have rules adequate to support the purpose of section 1256. In addition, it can be posited because of the extensive review conducted by the CFTC's Division of Market Oversight, futures traded through the following foreign entities receiving No Action Letters from the CFTC are eligible for section 1256 60/40 tax treatment, pursuant to the preceding analysis.

- MEFF AIAF SENAF Holding de Mercados Financieros S.A. (MEFF), Madrid and Barcelona, Spain
- Bourse de Montreal, Inc., Montreal, Quebec, Canada
- London Metal Exchange Ltd., (LME) London, U.K.
- Eurex Zurich (Eurex CH), Zurich, Switzerland
- OM London Exchange Ltd., (OM), London, U.K.
- Hong Kong Futures Exchange Ltd. (HKFE), Hong Kong, China

- SGX-DT, Singapore
- International Petroleum Exchange of London Ltd., (IPE), London, U.K.
- Eurex Deutschland (Eurex), Frankfurt, Germany
- SFE Corporation Ltd., Sydney, Australia, and Auckland, New Zealand
- Euronext Paris, Paris, France
- London International Financial Futures and Options Exchange (LIFFE), London, U.K.

The IRS has not ruled on the argument that any foreign board or exchange that has received notification from the CFTC under Rule 30.10 is a qualified board or exchange under Section 1256(g).

The 1993 Johnson TC Memo case cited above holds that the London exchange was a board or exchange, under prior law dealing with the definition of a capital asset and holding periods, former Section 1222.

The court did not hold that the London exchange was a qualified board or exchange under Section 1256(g), as the case's facts arose before the enactment of Section 1256. Therefore, while Johnson is favorable, there is still a gap, which is made clear above.

Should an aggressive taxpayer conclude that a gap should be filled in by default? Our writing above certainly gives fair disclosure and leaves it up to the taxpayer. There is a reasonable basis for a return position. The IRS itself has acted recently to extend these interstitial gaps, in the area of "foreign currency contract" by arguing that the term includes not just interbank traded forwards but other OTC Forex contracts as well.

CURRENCIES AND FOREX TRADING

Special Tax Rules for Currency Trading

Currency traders transact in contracts on regulated commodities exchanges or in the nonregulated interbank market, which is a collection of banks giving third-party prices on foreign current contracts (FCC) and other forward contracts.

Currency traders are taxed similar to commodities traders, except that interbank currency traders must "elect out" of IRC § 988 (the ordinary gain or loss rules for special currency transactions) if they want the tax-beneficial 60/40 capital gains rate treatment of IRC § 1256.

Currency traders electing out of IRC § 988 are treated the same as other commodities traders in that their trading gains and losses are treated as section 1256 contracts. Business traders and all investors report section 1256 contracts as capital gains and losses on Form 6781 (Gains and Losses from Section 1256 Contracts and Straddles). This treatment allows them to split the gains and losses 60/40 on Schedule D: 60 percent long-term, 40 percent short-term.

IRC Section 988

The principal intention of IRC § 988 is taxation on foreign currency transactions in a taxpayer's normal course of transacting global business. For example, if a manufacturer purchases materials in a foreign country in a foreign currency, then the fluctuation in exchange rates gain or loss should be accounting for pursuant to IRC § 988.

IRC § 988 provides that these fluctuations in exchange rate gains and losses should be treated as ordinary income or loss and reported as interest income or interest expense. IRC § 988 considers exchange rate risk in the normal course of business to be like interest. Currency traders who trade regulated futures contracts (RFCs) are not affected by IRC § 988 because they are not trading in actual currencies. RFCs based on currencies are just like any other RFC on an organized exchange.

Additionally, because RFCs are marked to market at the close of each day (and year), in accordance with section 1256, the economic and taxable gain or loss is the same. IRC § 988 specifically mentions that RFCs and other mark-to-market instruments are exempt transactions:

> (i) In general. Clause (iii) of subparagraph (B) shall not apply to any regulated futures contract or nonequity option which would be marked to market under section 1256 if held on the last day of the taxable year.

Section 988 Effects on Foreign Currency Contracts

A currency trader using the interbank market to transact in foreign currency contracts and other forward contracts is exposed to foreign exchange rate fluctuations, similar to a manufacturer as stated earlier. However, the currency trader looks upon currency positions as capital assets in the normal course of trading activity (business or investment). In other words, a currency trader may elect out of ordinary gain or loss treatment in IRC § 988, thereby using section 1256 contract treatment, which is 60/40 capital gains and losses.

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

IRC § 988(a)(1)(B) provides currency traders with an exception to the general ordinary gain or loss rule:

> Special rule for forward contracts, etc. Except as provided in regulations, a taxpayer may elect to treat any foreign currency gain or loss attributable to a forward contract, a futures contract, or option described in subsection (c)(1)(B)(iii) which is a capital asset in the hands of the taxpayer and which is not a part of a straddle (within the meaning of section 1092(c), without regard to paragraph (4) thereof) as capital gain or loss (as the case may be) if the taxpayer makes such election and identifies such transaction before the close of the day on which such transaction is entered into (or such earlier time as the Secretary may prescribe).
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> (c)(1)(B)(iii) Entering into or acquiring any forward contract, futures contract, option, or similar financial instrument (with exception above for RFCs).

The Tax Differences on Stock Indexes, Single-Stock Futures, and Other New Products

New financial products launched by securities and commodities exchanges the past few years include but are not limited to ETFs, E-minis, single-stock futures, new stock indexes, and options and futures on almost everything.

In particular, a rash of new stock indexes from various exchanges provide traders with new means to trade in securities markets. To date, most of these new indexes are, in fact, taxed like commodities, but some are taxed like securities. Coordinated legislation in 2000 from the IRS, Securities and Exchange Commission (SEC), and Commodity Futures Trading Commission (CFTC) set the new general rule.

- **Single-stock futures:** The IRS considers single-stock futures to be "securities futures contracts." Single-stock futures are taxed like their underlying securities (stock, options, and narrow-based indexes) and not like commodities (commodities, futures, Forex, and broad-based indexes). Plus, gains on single-stock futures are always short-term capital gains.
- **Stock indexes:** A narrow-based index is taxed like a security. Conversely, if the index is comprised of 10 or more securities, it is considered a broad-based index that resembles and is taxed like a commodity. E-minis are broad-based indexes taxed as commodities.
- **Securities:** These instruments include but are not limited to exchange-traded funds (ETFs) including QQQ, DIA, and SPDRs; stocks, stock options, mutual funds, and bonds; single-stock futures, otherwise known as "nondealer securities futures contracts"; and by default, any capital asset that is not otherwise defined as an IRC section 1256 contract (a commodity) or IRC § 988 (currencies, interbank foreign exchange, or Forex). For example, gold bullion sounds like a commodity or currency, but physical gold is neither included in IRC section 1256 or 988, and it's taxed like securities. Therefore, if you hold gold bullion bars

for more than twelve months, you are entitled to the lower long-term capital gains rate (currently up to 15 percent).

Tax Implications

If you are a business trader, understand ahead of time how incorporating some of these new products into your trading program may affect your trader tax status and MTM election. For example, if you elected MTM for your securities trading business only (and not for commodities) and you revise your business plan to trade E-Minis almost exclusively, you won't have ordinary loss protection on the E-Minis, because they are taxed as commodities.

Before the Internet revolutionized online trading in 1997, a trader's business and tax universe was in balance. The SEC and CFTC kept to their respective turfs for securities and commodities, and the IRS taxed all instruments as either securities or commodities. The lines of demarcation were clear for all. Most traders focused on securities or commodities trading and few actively traded both. Things changed dramatically with the passage of the Commodity Futures Modernization Act and the simultaneous creation of an entire assortment of new product hybrids.

Newly Created Products

The online trading revolution brought tremendous growth in the securities markets with the advent of hot IPOs. Trading in tech and NASDAQ stocks were all the rage in the late 1990s. By 2000, the stock market bubble burst and securities and commodities exchanges actively began to compete for customers by creating new products that mirrored products created by the other exchange.

Commodities exchanges felt they missed the stock market windfall, so they rushed to market new flavors of broad-based stock indexes. Commodity exchanges were successful, partially because of the tax advantages for commodities traders over securities traders.

These new hybrid products created with the CFMA raised the ire of the SEC. This new act solved many of the outstanding regulatory and tax treatment issues raised by these new products. The CFMA established a framework for joint regulation (by the SEC and the CFTC) of single-stock futures and narrow-based security indexes. IRS issues were also solved because the CFMA updated the IRS definition of "nonequity options" in IRC section 1256 contracts (commodities). Now, both the IRS and regulatory definitions of broad-based indexes are the same—10 or more stocks in an index. This definition is great news for traders because now almost all indexes are broad-based and taxed at the lower commodity tax rates.

Regulation-wise, broad-based security indexes, which are not considered security futures products, continue to trade under the sole jurisdiction of the CFTC. Security futures products (i.e., single-stock futures) are subject to the joint jurisdiction of the CFTC and the SEC. Methods for determining when an index is broad- or narrow-based (for tax and regulatory purposes) are discussed at www.cftc.gov/sfp/sfpbackground.htm. For indexes excluded from the definition of narrow-based security index, see www.cftc.gov/sfp/sfpcontractsapprovedprecfma.htm.

The main effect of the CFMA was to significantly expand the definition of a broad-based index, which is considered a commodity. Narrow-based indexes are considered securities. Under the CFMA, almost all futures and options on stock indexes, and smaller variations of indexes (commonly known as E-Minis), are considered broad-based indexes, and treated as commodities.

Single-Stock Futures Taxed as Securities

The IRS states,

> [A] gain or loss on the sale, exchange, or termination of a securities futures contract generally has the same character as gain or loss from transactions in the underlying security.
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> For example, if the underlying asset would be a capital asset in the hands of the taxpayer, gain or loss from the sale of the contract is a

capital gain or loss. This rule does not apply to securities futures contracts that are not capital assets (they are inventory assets), nor does it apply to products identified as hedging transactions, or any income derived in connection with a contract that would otherwise not produce a capital gain. Except as provided in the regulations, capital gain or loss from the sale, exchange or termination of a securities futures contract to sell property is treated as short-term capital gain or loss.

A securities futures contract generally is defined as a contract of sale for future delivery of a single security or a narrow-based security index.

TAX HELP FROM CONGRESS

Congress should be applauded for acting in a smart manner in their passage of the CFMA. Traders are not investing in long-term securities, but instead looking to trade any feasible instrument for a quick swing in price for profit. For traders, it's a zero-sum game. Now with the CFMA, all those new indexes are treated as commodities and commodity tax law is better for traders. Commodities are marked to market at the end of each day (which is the way a trader thinks), and the tax rates are lower.

Congress needs to do more work and help more traders avoid the tax pitfalls of securities taxation. Traders can help themselves with an IRC § 475 mark-to-market election to avoid wash sales, straddle rules, and capital loss limitations.

CHAPTER SUMMARY

For tax purposes, securities and commodities are not alike. Commodities traders have a tax benefit over securities traders; they are taxed at a mixed 60/40 tax rate, regardless of how long they hold a position. Before you trade, it's important to know whether your trade will be taxed as a security or a commodity, because a new breed of hybrid products have characteristics of both. And, if you trade currencies, you must deal with entirely different tax implications.