TAX TREATMENT ON FINANCIAL PRODUCTS – 2018 UPDATE

August 14, 2018 @ 12:00 pm EST
(Interactive Brokers Webinar)

Presenter:

Robert A. Green, CPA

Managing Member

GNM TraderTax
GREEN, NEUSCHWANDER & MANNING, LLC

green TraderTax

Robert Green’s content

- Mr. Green is a leading authority on trader tax.

- He is the author of Green’s 2018 Trader Tax Guide, which GreenTraderTax published as an annual tax guide every year since 1997. The 2018 edition discusses the Tax Cuts and Jobs Act’s impact on investors, traders, and investment managers.

- Mr. Green has been a contributor to Forbes.com since 2010. Leading brokerage firms and other financial media feature Mr. Green's blog posts and Webinar content.

Webinar disclaimers

- This information is educational. It is not intended to be a substitute for specific individualized tax, legal, or investment planning advice. Where specific advice is necessary or appropriate, you may wish to consult with a qualified tax advisor, CPA, attorney, financial planner, or investment manager.

- Robert A. Green and the Green companies are not affiliated with Interactive Brokers.

Webinar description

- Join trader tax expert Robert A. Green, CPA, of GreenTraderTax as he explains tax treatment of various financial products.

- Mr. Green will discuss securities subject to wash sale loss adjustments, Section 1256 contracts including futures and broad-based indexes, options of several types, ETFs, ETNs, volatility products, forex, foreign futures, precious metals, swap contracts, and cryptocurrencies.

SECURITIES

Securities traders need to watch out for higher tax rates, wash sales, capital-loss limitations and accounting challenges.

Securities include:

- equities (stocks)
- equity (stock) options
- narrow-based indexes (an index made up of nine or fewer securities)
- options on narrow-based indexes
- ETFs structured as registered investment companies (RIC)
- options on securities ETFs structured as RIC
- bonds
- mutual funds
- single-stock futures

Short-term vs. long-term capital gains and losses

- With the default realization (cash) method, report realized gains and losses on securities for the tax year. Defer unrealized gains (or losses) on open securities positions at year-end.

- Short-term capital gains rates are the ordinary tax rates, currently up to 37% for 2018.

- Long-term capital gains rates — up to 20% for 2018 — apply to sales of securities held for 12 months or longer.

Wash sale loss adjustments

- Congress doesn't want taxpayers to realize "tax losses" that are not "economic losses." If you close a securities transaction and re-open it right away, you haven't closed your financial position in that security.

- At year-end, many taxpayers do "tax loss selling" of securities in December, and the IRS wash sale (WS) rules defer the loss if the taxpayer re-purchases a substantially identical position within 30 days before or after, which means into January of the subsequent year.

- 30 days before or after is an eternity for day and swing traders.

Different IRS rules for brokers vs taxpayers

- Section 1091 requires taxpayers to calculate wash sales based on “substantially identical” positions, which means between equity and equity options at different expiration dates.
- That’s different from the rule for brokers that require “identical” positions - the same symbol.
- Another difference: Brokers calculate WS per account, whereas, taxpayers must calculate WS across all accounts, including IRAs.

Avoid WS between taxable and IRA accounts

- Consider a “Do Not Trade List” to avoid permanent wash sale losses between taxable and IRA accounts throughout the tax year.
- For example, trade tech stocks in your taxable accounts and energy stocks in your IRA accounts.
- Otherwise, you can never report a wash sale loss with an IRA, as there is no way to record the loss in the IRA.

Avoid WS in taxable accounts

- Break the chain on wash sale losses at year-end in taxable accounts to avoid wash sale loss deferral to 2019.

- Example: If you sell Xy equity on Dec. 20, 2018, at a loss, don’t repurchase Xy equity or Xy equity options until Jan. 21, 2019, avoiding the 30-day window for triggering a wash sale loss.

Accounting for securities with WS

- If you have multiple brokerage accounts, and or trade equities and equity options, consider using a trade accounting software program like TradeLog software.

- Download all your trades into the accounting program, calculate wash sale loss adjustments in an IRS-compliant manner across all accounts, properly account for Section 1256 contracts, and generate tax forms 8949 and 6781.

Section 475 election

- Traders, eligible for trader tax status, should consider a Section 475 MTM election for securities.
- Section 475 securities trades are exempt from wash sale loss adjustments.
- Section 475 is ordinary gain or loss, so it's exempt from the capital loss limitation, too.

SECTION 1256 CONTRACTS

Section 1256 contract traders enjoy lower 60/40 tax rates, summary tax reporting, and no need for an accounting program.

Section 1256 contracts include:

- U.S. futures (regulated futures contracts)
- options on futures
- foreign futures with CFTC and IRS approval
- broad-based indexes (a broad-based index is one that is made up of 10 or more securities)
- options on broad-based indexes
- forward forex contracts with the opt-out election into Section 1256g on the main currencies, for which futures trade (we make a case for spot forex too)
- options on commodities/futures ETFs structured as publicly traded partnerships (PTP)
- CBOE-listed options on volatility ETNs, structured as prepaid forward contracts, or as debt instruments
- non-equity options
- forex OTC options (Wright court)

Section 1256 contracts bring meaningful tax savings

- These contracts have lower 60/40 tax rates, meaning 60% (including day trades) are taxed at the lower long-term capital gains rate, and 40% are taxed at the short-term rate, which is the ordinary tax rate.

- At the maximum tax bracket for 2018, the blended 60/40 rate is 26.8% — 10.2% lower than the highest ordinary rate of 37%.

- There are significant tax savings throughout the income brackets.

Mark-to-market (MTM) accounting

- 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.

- With MTM and summary reporting required, brokers issue one-page 1099-Bs for Section 1256 contracts, reporting “aggregate profit or loss on contracts” after taking into account realized and unrealized gains and losses.

- Report the aggregate profit or loss 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.

Loss carryback election

- On Form 6781, you can select the Section 1256 loss carryback election.
- Rather than deducting the loss in the current tax year, deduct it on amended tax return filings, against Section 1256 gains only.
- It's a three-year carryback and unused amounts are then carried forward.

OPTIONS

Tax treatment for options is diverse, including simple and complex trades on securities vs. Section 1256 contracts.

Options

- Options cover the gamut of tax treatment
- They are a derivative of their underlying instrument and sometimes have the same tax treatment.
- For example, equity options are a derivative of the underlying equity, and both are taxed as securities.

Equity options are securities, and they include:

- equity (stock) options

- options on narrow-based indexes

- options on securities ETFs organized as registered investment companies (RIC)

Non-equity options are Section 1256 contracts, and they include:

- options on futures

- options on broad-based indexes

- options on commodity ETFs organized as publicly traded partnerships (PTP)

- CBOE-listed options on volatility ETNs structured as prepaid forward contracts, or as debt instruments

- forex OTC options

Simple option trades

- There are simple option trading strategies like buying and selling call and put options known as “outrights.”
- Tax treatment for outright option trades is relatively straightforward.
- It’s similar to reporting securities or 1256 contracts.

Complex option trades

- There are complex option trades known as "option spreads" which include multi-legged offsetting positions like iron condors; butterfly spreads; vertical, horizontal and diagonal spreads; and debit and credit spreads.

- Tax treatment for complex trades triggers a bevy of sophisticated IRS rules geared toward preventing taxpayers from tax avoidance schemes: deducting losses and expenses from the losing side of a complex trade in the current tax year while deferring income on the offsetting winning position until a subsequent tax year.

Option tax treatment

- Three things can happen with outright option trades:

  - Trade option (closing transaction).
  - Option expires (lapses).
  - Exercise the option.

- There are special rules for the holding period for long-term capital gains.

- For more in-depth information on options tax treatment, read Green's 2018 Trader Tax Guide.

EXCHANGE-TRADED FUNDS (ETFS)

Securities, commodities and precious metals ETFs use different structures and tax treatment varies.

Securities ETFs

- Securities ETFs are registered investment companies (RICs).
- Selling a Securities ETF is deemed a sale of a security, calling for short-term and long-term capital gains tax treatment on the realization method.

Commodities ETFs

- Commodities/Futures ETFs use the publicly traded partnership (PTP) structure.
- They issue annual Schedule K-1s passing through Section 1256 tax treatment on Section 1256 transactions to investors, as well as other taxable items.
- Selling a commodity ETF is deemed a sale of a security, calling for short-term and long-term capital gains tax treatment using the realization method.

Adjust cost basis on commodities ETFs

- Taxpayers invested in commodities/futures ETFs should adjust cost-basis on Form 8949 (capital gains and losses), ensuring they don't double count Schedule K-1 pass through income or loss.

- Form 1099-B and trade accounting software does not make this adjustment, so you need to make a manual adjustment.

Precious metals ETFs

- Physically backed precious metals ETFs use the publicly traded trust (PTT) structure, also known as a grantor trust.
- A PTT issues an annual tax reporting statement, passing through tax treatment to the investor, which in this case is the "collectibles" rate on sales of physically backed precious metals (such as gold bullion).
- Selling a precious metal ETF is deemed a sale of a precious metal, which is a collectible.
- If you hold a collectible over one year (long-term), sales are taxed at the "collectibles" rate — the taxpayer's ordinary rate capped at 28%.

Options on ETFs

- The IRS hasn’t explicitly stated tax treatment on sales of options based on ETFs.
- Our position is that options on securities ETFs (RICs) are taxed as securities.
- But, options on commodities ETFs structured as PTP are Section 1256 contracts since they are non-equity options.

FOREX

Get the best of both worlds with forex taxes: Ordinary losses in Section 988 or elect capital gains for a chance to use lower 60/40 rates in Section 1256(g)

Forex trading

- Forex transactions start off receiving an ordinary gain or loss treatment, as dictated by Section 988 (foreign currency transactions).

- Section 988 allows investors and traders to internally file a contemporaneous “capital gains election” to opt-out of Section 988 into a capital gain or loss treatment.

- Make, or retract, that election on a "good to cancel" basis at any time during the year.

Section 1256(g)

- The capital gains election on forex forwards allows the trader to use Section 1256(g) treatment with lower 60/40 capital gains rates on "major" currencies if the trader doesn’t take or make delivery of the money.
- “Major currencies” means currency pairs, which also trade as futures on U.S. futures exchanges.
- We make a case for including "spot" forex in Section 1256(g) in our blog post, "A Case For Retail Forex Traders Using Section 1256(g) Lower 60/40 Tax Rates."

Forex tax reporting

- Summary reporting is used for forex trades, and most brokers offer good online tax reports.
- Spot forex brokers aren’t supposed to issue Form 1099-Bs at tax time.
- Section 988 is realized gain or loss, whereas, with a capital gains election into Section 1256(g), use mark-to-market (MTM) treatment.

OTHER FINANCIAL INSTRUMENTS

Foreign futures, precious metals, volatility products including exchange traded notes (ETNs), and swap contracts

Foreign futures

- By default, futures contracts listed on exchanges located outside of the U.S. are not Section 1256 contracts.
- Some foreign-futures exchanges applied for and received, a "no action letter" from the CFTC, permitting them to market to U.S. customers.
- If the foreign-futures exchange also wants Section 1256 tax breaks, they must apply for and receive, an IRS Revenue Ruling.
- Only a handful of exchanges have Section 1256 treatment. (See a list, which includes Eurex, LIFFE, ICE Futures Europe, and ICE Futures Canada.)

Precious metals

- Physical precious metals are “collectibles” which are a particular class of capital assets.

- If you hold collectibles over one year (long-term), sales are taxed at the “collectibles” tax rate — the taxpayer’s ordinary rate capped at 28%.

- If you hold collectibles one year or less, the short-term capital gains ordinary tax rate applies no different from the regular STCG tax rate.

Volatility products

- There are many different types of volatility-based financial products to trade, and tax treatment varies.
- For example, the CBOE Volatility Index (VIX) futures are Section 1256 contracts with lower 60/40 MTM tax rates.
- The NYSE-traded SVXY is an exchange-traded fund (ETF), taxed as a security.
- The iPath S&P 500 VIX Short-Term Futures (VXX) is an exchange-traded note (ETN), and while tax treatment is similar to an ETF, there are some differences.

Volatility exchange traded notes (ETNs)

- Many issuers structure volatility ETNs as "prepaid forward contracts," which provides a deferral of taxes until sale (realization). Long-term capital gains rates apply if held 12 months or longer.

- Prepaid forward contracts are not securities, which means they are not subject to wash sale loss adjustments and Section 475 if elected by traders eligible for trader tax status.

- Some ETNs, like VELOCITYSHARES 3X LNG NTRL GS ETN (UGAZ), are debt instruments taxed as securities, which means they are subject to wash sale losses and Section 475, if elected.

Swap contracts

- Swap contracts are ordinary gain or loss treatment.

- NADEX contracts are likely swap contracts, even though NADEX issues 1099-Bs for Section 1256 contracts.

CRYPTOCURRENCIES

Selling, exchanging or using cryptocurrency triggers capital gains and losses for investors.

Intangible property

- Cryptocurrency users may call it “digital money,” but it’s not sovereign government-issued money. That means almost every use of cryptocurrency is a taxable event.

- The SEC labeled some ICO tokens securities, but not Bitcoin or Ethereum. Some CFTC officials called cryptocurrency a commodity.

- The IRS labeled cryptocurrency “intangible property.”

Capital gains and losses

- If you invested in cryptocurrencies and sold, exchanged, or spent some during the year, you have to report a capital gain or loss on each transaction, including coin-to-currency sales, coin-to-coin trades, and purchases of goods or services using a coin.

- Chain splits or hard forks might require ordinary income recognition if the holder has control over the new cryptocurrency, and there is a fair market value supported by trading. Otherwise, defer income recognition until sale, exchange or use.

Imputed income

- The big problem for the IRS is that many crypto transactions are not evident for tax reporting, including coin-to-coin trades, hard forks (chain splits), and using a coin to purchase goods and services.

- The coin investor should “impute” a sales or exchange transaction to report a capital gain or loss on coin-to-coin trades and using a coin to purchase items.

Problems with like-kind exchanges

- The new tax law bars using Section 1031 like-kind exchanges on intangible property, starting in 2018.
- Many crypto traders used Section 1031 tax deferral before 2018. They may have problems with the IRS.
- I doubt that Bitcoin is a like-kind property with Ethereum.
- Many crypto traders and exchanges did not comply with other requirements of Section 1031, either.

Coinbase exchange issued 1099-Ks

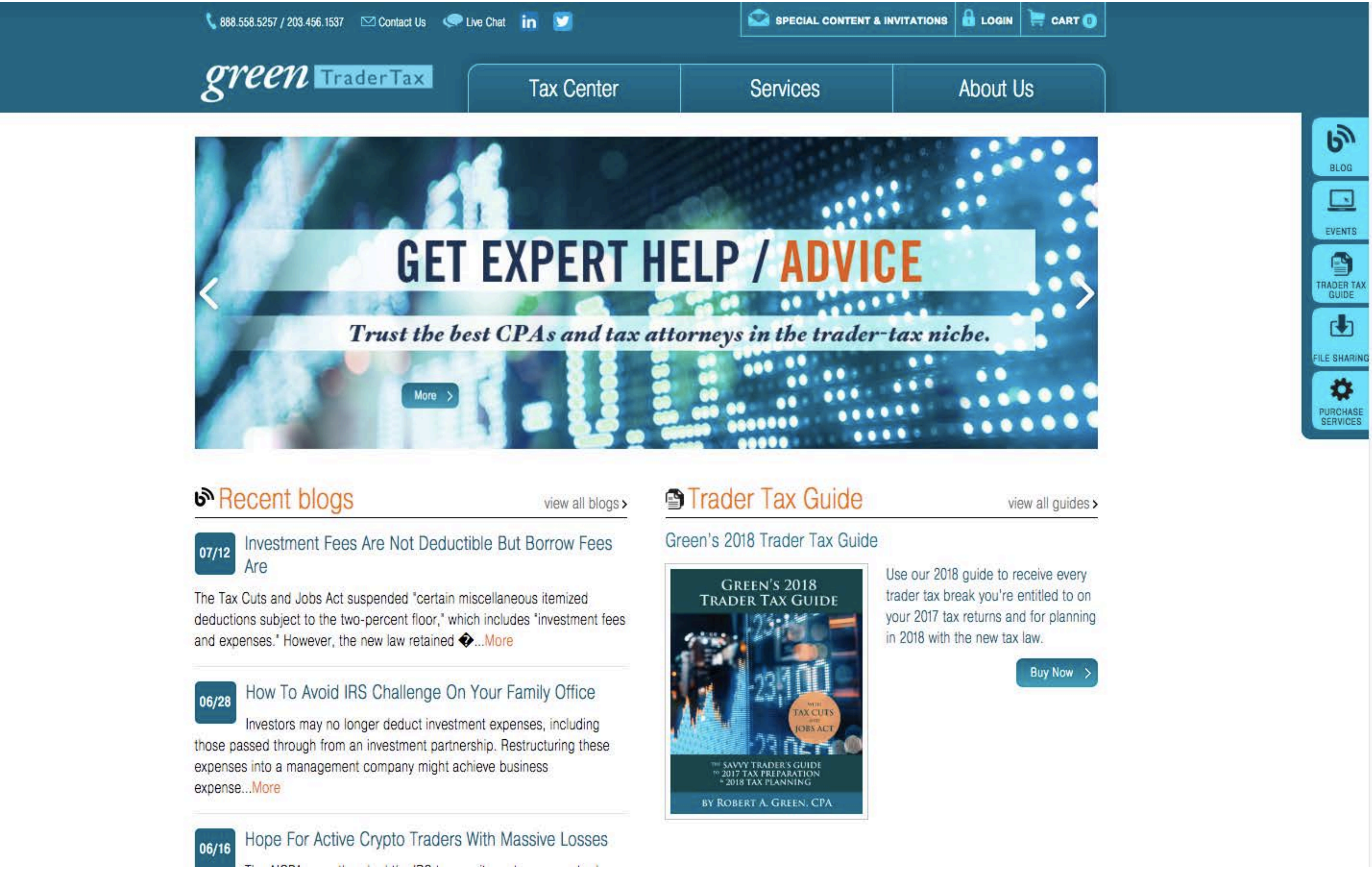
- Coinbase, the largest U.S. crypto exchange, issued 2017 Form 1099-Ks to “qualifying customers,” including businesses, and traders, over specific volume thresholds.

- The IRS intended 1099-K for businesses (merchants) to report "Payment Card and Third Party Network Transactions."

CLOSING REMARKS, QUESTIONS & ANSWERS

Closing Remarks

- Thank you for attending this Webinar or watching the recording.
- Visit www.GreenTraderTax.com for additional information.
- Call us toll free at 888.558.5257 or 203.456.1537
- Email us your questions at info@greentradertax.com


888.558.5257 / 203.456.1537
Contact Us
Live Chat
SPECIAL CONTENT & INVITATIONS
LOGIN
CART 0
green TraderTax
Tax Center
Services
About Us
GET EXPERT HELP / ADVICE
Trust the best CPAs and tax attorneys in the trader-tax niche.
More
BLOG
EVENTS
TRADER TAX GUIDE
FILE SHARING
PURCHASE SERVICES
Recent blogs
view all blogs
07/12
Investment Fees Are Not Deductible But Borrow Fees Are
The Tax Cuts and Jobs Act suspended "certain miscellaneous itemized deductions subject to the two-percent floor," which includes "investment fees and expenses." However, the new law retained �...More
06/28
How To Avoid IRS Challenge On Your Family Office
Investors may no longer deduct investment expenses, including those passed through from an investment partnership. Restructuring these expenses into a management company might achieve business expense...More
06/16
Hope For Active Crypto Traders With Massive Losses
Trader Tax Guide
view all guides
Green's 2018 Trader Tax Guide
GREEN'S 2018 TRADER TAX GUIDE
TAX CUTS JOBS ACT
BY ROBERT A. GREEN, CPA
Use our 2018 guide to receive every trader tax break you're entitled to on your 2017 tax returns and for planning in 2018 with the new tax law.
Buy Now