

TRADING FUTURES & OTHER SECTION 1256 CONTRACTS HAS TAX ADVANTAGES



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- GNM is a CPA firm dedicated to the needs of traders, investment managers and other types of clients.
- We focus on tax compliance (preparation/planning services), accounting, consultations, entity formations, and IRS/state tax controversy.
- Robert A. Green founded the firm in 1983, and we have clients throughout the U.S. and abroad using our virtual process.

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Description

Robert A. Green, CPA, of GreenTraderTax explains the tax benefits of trading futures, broad-based indexes, and other Section 1256 contracts.

- 60/40 capital gains rates are 4.2% to 12% lower vs. ordinary rates.
- List of 1256 contracts.
- Mark-to-market accounting includes unrealized gains and losses, which negates the need for wash sale loss adjustments.

Description

- Tax reporting: Forms 1099-B and 6781.
- Election to carryback Section 1256 losses against 1256 gains in prior three years.
- Election for Section 475 ordinary gain or loss treatment (requires qualification for trader tax status).

THE BIG PICTURE

There are various types of financial products with different tax treatments, and Section 1256 contracts have the best overall tax advantages.

Tax treatment varies

- Tax treatment of financial products affects investors, traders, and hedge funds. But sadly, many tax preparers overlook essential differences in tax treatment for these groups, resulting in overpayments. Education is key.
- It's important to distinguish between securities vs. Section 1256 contracts with lower 60/40 capital gains rates vs. other types of financial products like forex or swaps with ordinary income or loss treatment.
- Plus, there are various elections available to change tax treatment.

Capital gains vs. ordinary income

- Most financial instruments — including securities, Section 1256 contracts, options, ETFs, ETNs, indexes, precious metals, and cryptocurrencies held as a capital asset — are subject to capital gains treatment.
- However, some of these financial products qualify as Section 1256 contracts with lower 60/40 capital gains rates.
- By default, forex contracts and swap contracts are subject to ordinary gain or loss treatment.

Capital gains vs. ordinary income

- The distinction between ordinary and capital gains treatment makes a big difference.
- The capital-loss limitation is a problem for traders and investors who may have trouble using up large capital-loss carryovers in subsequent tax years.
- Traders with trader tax status (TTS) and a Section 475 MTM election have business ordinary-loss treatment, which is more likely to generate tax savings or refunds faster than capital loss carryovers.
- There is a Section 1256 loss carryback election.

60/40 CAPITAL GAINS RATES

Are 4.2% to 12% lower vs. ordinary rates.

60/40 capital gains rates

- 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 brackets for 2018 and 2019, the top Section 1256 contract tax rate is 26.8% —10.2% lower than the top ordinary rate of 37%.
- For example: Make \$100,000 in 1256 contracts in the 35% ordinary bracket, and save \$12,000 with 60/40 rates.

Tax savings throughout the brackets

- For 2018 and 2019, there is meaningful tax rate reduction throughout the brackets, including zero long-term rates in the 10% and 12% ordinary brackets.
- See all the brackets on the next slide.
- State tax rates apply; they do not include a long-term rate.

Section 1256 tax rates vs. ordinary rates (2018 & 2019 rates)

Ordinary Rates	Long-Term Capital Gains Rates	40% Short-Term Rates	60% Long-Term Rates	Blended 60/40 Rates	Savings In Rates
10%	0%	4.0%	0%	4.0%	6.0%
12%	0%	4.8%	0%	4.8%	7.2%
22%	15%	8.8%	9%	17.8%	4.2%
24%	15%	9.6%	9%	18.6%	5.4%
32%	15%	12.8%	9%	21.8%	10.2%
35%	15%	14.0%	9%	23.0%	12.0%
37%	20%	14.8%	12%	26.8%	10.2%

LIST OF 1256 CONTRACTS

Includes regulated futures contracts, options on futures, broad-based stock indexes, and various non-equity options.

U.S. futures contracts

- Regulated futures contracts (RFCs) on a qualified board or exchange (QBE).
- U.S. RFCs on commodities (food, energies, and metals), stock indexes, financials (U.S. Treasuries and bonds), currencies, and more.
- Options on U.S. futures (RFCs).
- Foreign futures with CFTC and IRS approval. (Only a handful of exchanges currently have this IRS revenue ruling, including Eurex, LIFFE, ICE Futures Europe, and ICE Futures Canada, see [blog post](#)).

Broad-based indexes

- Broad-based indexes are stock index futures made up of 10 or more underlying securities.
- Options on broad-based indexes are also 1256 contracts.
- Broad-based indexes are taxed differently from exchange traded funds (ETFs), which are securities.
- The S&P 500 **Index** (SPX) is listed on a commodities exchange, and is taxed as a Section 1256 contract.
- The SPDR S&P 500 **ETF** Trust (SPY) is listed on a securities exchange, and is taxed as a security.

Other Section 1256 contracts

- Options on commodities/futures ETFs taxed as publicly traded partnerships. (Options on securities ETFs are securities.)
- CBOE-listed options on volatility ETNs structured as prepaid forward contracts (the ETN itself is not Section 1256).
- Non-equity options. (Be careful in using this catchall.)
- Forex forward contracts on major currencies, if the taxpayer filed an opt-out election to use Section 1256(g) (we make a case for forex spot in major currencies, too).
- Forex OTC options (Wright tax court case).

MARK-TO-MARKET ACCOUNTING

Section 1256 MTM includes realized and unrealized gains and losses.

Mark-to-market accounting

- Section 1256 contracts are marked-to-market (MTM) on a daily basis.
- For income tax purposes, MTM means gain/loss calculations report both realized activity from throughout the year and unrealized gains and losses on open trading positions at year-end.

Wash sale loss adjustments do not apply

- With MTM, wash sale (WS) loss adjustments are a moot point; hence WS apply to securities, only, not 1256 contracts.
- With MTM, traders don't have to do "tax loss selling" at year-end, since they will report the unrealized losses, anyway.
- Many traders have small or no open positions on Section 1256 contracts at year-end.

Valuing thinly-traded contracts

- It might be hard to find an accurate MTM price for valuing long-term options (1256 contracts) at year-end.
- The broker might use one price on the December monthly statement and a significantly different value on the 1099-B for calculating unrealized gains and losses.
- Brokers use Options Clearing Corporation (OCC) for FMV, which might be from the last trade in the marketplace. That trade might not indicate the actual FMV.
- Some taxpayers use Black-Scholes modeling to determine a more accurate FMV.

TAX REPORTING

Broker 1099-Bs, and taxpayer Form 6781.

One-page 1099-B and Form 6781

- With Section 1256 MTM and summary reporting, brokers can issue simple one-page 1099-Bs reporting “aggregate profit or loss on contracts” 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.
- On the next slide, see a 2019 Form 1099-B lines 8 – 11 for 1256 contract reporting.

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VOID CORRECTED

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		Applicable checkbox on Form 8949		OMB No. 1545-0715	
				2019 Form 1099-B	
1a Description of property (Example: 100 sh. XYZ Co.)					
PAYER'S TIN		RECIPIENT'S TIN		1b Date acquired	1c Date sold or disposed
				1d Proceeds \$	1e Cost or other basis \$
				1f Accrued market discount \$	1g Wash sale loss disallowed \$
RECIPIENT'S name		2 Short-term gain or loss <input type="checkbox"/> Long-term gain or loss <input type="checkbox"/> Ordinary <input type="checkbox"/>		3 Check if proceeds from: Collectibles <input type="checkbox"/> QOF <input type="checkbox"/>	
Street address (including apt. no.)		4 Federal income tax withheld \$		5 Check if noncovered security <input type="checkbox"/>	
City or town, state or province, country, and ZIP or foreign postal code		6 Reported to IRS: Gross proceeds <input type="checkbox"/> Net proceeds <input type="checkbox"/>		7 Check if loss is not allowed based on amount in 1d <input type="checkbox"/>	
Account number (see instructions)		2nd TIN not. <input type="checkbox"/>		8 Profit or (loss) realized in 2019 on closed contracts \$	
CUSIP number		FATCA filing requirement <input type="checkbox"/>		9 Unrealized profit or (loss) on open contracts—12/31/2018 \$	
14 State name	15 State identification no.	16 State tax withheld \$		11 Aggregate profit or (loss) on contracts \$	
		\$		12 Check if basis reported to IRS <input type="checkbox"/>	
				13 Bartering \$	

**Proceeds From
Broker and
Barter Exchange
Transactions**

Copy A

**For
Internal Revenue
Service Center
File with Form 1096.**

**For Privacy Act
and Paperwork
Reduction Act
Notice, see the
2019 General
Instructions for
Certain
Information
Returns.**



Form **6781**

Department of the Treasury
Internal Revenue Service

Gains and Losses From Section 1256 Contracts and Straddles

▶ Go to www.irs.gov/Form6781 for the latest information.
▶ Attach to your tax return.

OMB No. 1545-0644

2018

Attachment
Sequence No. **82**

Name(s) shown on tax return

Identifying number

Check all applicable boxes (see instructions). **A** Mixed straddle election **C** Mixed straddle account election
B Straddle-by-straddle identification election **D** Net section 1256 contracts loss election

Part I Section 1256 Contracts Marked to Market

(a) Identification of account		(b) (Loss)	(c) Gain
1			
2	Add the amounts on line 1 in columns (b) and (c)	2 ()	
3	Net gain or (loss). Combine line 2, columns (b) and (c)		3
4	Form 1099-B adjustments. See instructions and attach statement		4
5	Combine lines 3 and 4		5
Note: If line 5 shows a net gain, skip line 6 and enter the gain on line 7. Partnerships and S corporations, see instructions.			
6	If you have a net section 1256 contracts loss and checked box D above, enter the amount of loss to be carried back. Enter the loss as a positive number. If you didn't check box D, enter -0-		6
7	Combine lines 5 and 6		7
8	Short-term capital gain or (loss). Multiply line 7 by 40% (0.40). Enter here and include on line 4 of Schedule D or on Form 8949 (see instructions)		8
9	Long-term capital gain or (loss). Multiply line 7 by 60% (0.60). Enter here and include on line 11 of Schedule D or on Form 8949 (see instructions)		9

Part II Gains and Losses From Straddles. Attach a separate statement listing each straddle and its components.

Section A—Losses From Straddles

(a) Description of property	(b) Date entered into or	(c) Date closed out	(d) Gross sales price	(e) Cost or other basis plus	(f) Loss. If column (e) is more than (d), enter	(g) Unrecognized gain on	(h) Recognized loss. If column (f) is more than (g), enter
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Issues on some broker 1099-Bs

- One might expect that broker-issued 1099-Bs would handle all tax treatment issues, but for some financial products, they do not.
- Some brokers categorize CBOE-listed options on volatility ETNs and ETFs as securities, but there is substantial authority to treat these CBOE-listed options as “non-equity options” included in Section 1256.
- The most complicated issue for 1099-Bs is wash sale loss adjustments on securities.

Mixed straddle election

- Section 1256 traders should also learn about the “mixed straddle election” and “hedging rules” in Section 1256(d) and (e), and as discussed on Form 6781.
- Offsetting positions between Section 1256 contracts and securities can generate tax complications under certain circumstances involving the hedging rule.
- The IRS is concerned about traders reporting Section 1256 MTM unrealized losses and deferring unrealized gains on offsetting securities positions, so there are rules intended to prevent this.

ELECTION TO CARRYBACK SECTION 1256 LOSSES

It's the only time traders can carryback a tax loss. TCJA repealed NOL carrybacks starting in 2018.

Tax-loss carryback election

- On Form 6781, select the “net section 1256 contracts loss election” in box D.
- Enter, but don’t deduct the loss on the current tax return. Remove the loss from Form 6781 on line 6.
- Apply the Section 1256 loss on amended tax return filings against Section 1256 gains only. (Form 1045 is preferable; otherwise, use Form 1040X.)
- It’s a three-year carryback, and unused amounts are then carried forward.

SECTION 475 ELECTION

Section 475 MTM election

- Traders eligible for trader tax status (TTS) are entitled to file a timely election for Section 475 ordinary gain or loss treatment on securities and or commodities (including Section 1256 contracts).
- Generally, Section 475 is smart for securities traders, but not most 1256 contract traders.
- Ordinary losses are usually better than capital losses; however, ordinary income rates are worse than 60/40 capital gains rates.

QBI deduction

- TCJA introduced a new Section 199A “qualified business income” (QBI) deduction.
- Trading is a “specified service trade or business” (SSTB) subject to an income threshold, phase-in, and cap on the QBI deduction.
- QBI includes Section 475 ordinary income. However, it excludes capital gains, 60/40 capital gains, portfolio income, and Section 988 and swap ordinary income.
- The QBI deduction is uncertain based on Section 864(b). Therefore, it’s better to remain in Section 1256.

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
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Individual tax returns for 2018 are due April 15, 2019, however, most active traders aren't ready to file on time. Some brokers issue corrected 1099Bs right up to the deadline, or even beyond. Many [...More](#)

03/06 **March 15 Is Tax Deadline For S-Corp And Partnership Extensions And Elections**

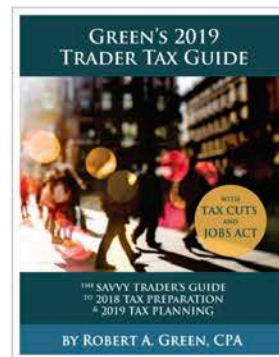
March 15, 2019, is the deadline for filing 2018 S-Corp and partnership tax returns, or extensions, 2019 S-Corp elections for existing entities, and 2019 Section 475 elections for a pass-through entity...[More](#)

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