TAX TREATMENT ON FINANCIAL PRODUCTS - PART II (BASED ON 2016 TAX LAW)

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Robert A. Green Bio

- Robert A. Green is a CPA and founder and CEO of Green & Company Inc. (GreenTraderTax.com), a publishing company, and Managing Member and Founder of Green, Neuschwander & Manning, LLC, a tax and accounting firm catering to traders, investment management, and small business. He is a leading authority on trader tax.

- Mr. Green is a contributor to Forbes. He is also the author of The Tax Guide for Traders (McGraw-Hill, 2004), Green's 2016 Trader Tax Guide and wrote the "Business of Trading" column for Active Trader magazine for 14 years until the magazine closed in 2015.

Robert A. Green Bio

- Mr. Green is frequently interviewed and has appeared in the New York Times, Wall Street Journal, Forbes, and Barron's. Mr. Green has also appeared on CNBC, Bloomberg Television, and Forbes.com Video Network.

- He is the chief tax speaker at the MoneyShow University and Traders Expo and taught "Trader Tax 101" for CCH to tax professionals.

Disclaimer

- 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.
- I base this presentation on 2016 tax law, and I expect tax reform and changes in 2017.

TAX TREATMENT ON FINANCIAL PRODUCTS

Which financial products you trade and where you trade them can make a huge difference in tax savings.

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 gain or loss treatment.

- By default, forex contracts and swap contracts are subject to ordinary gain or loss treatment. 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.

SECURITIES

Securities traders need to watch out for higher ordinary tax rates, wash sale losses, 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) and options on narrow-based indexes
- Exchange-traded funds (ETFs) and options on securities ETFs structured as Registered Investment Corps
- Bonds
- Mutual funds
- Single-stock futures

Realization (Cash) Method

- Report realized transactions in securities 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% (2016).
- With the default realization (cash) method, report only realized gains and losses on securities for the tax year.
- Wash sale loss deferral rules apply throughout the year.
- 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 Tax Rate Benefit

- Long-term capital gains rates apply to sales of securities held for 12 months or longer.
- The long-term capital gains rate is zero for the 10% and 15% ordinary income tax brackets and 15% for all higher tax brackets, except it is 20% for the top 39.6% tax bracket (2016 rates).

CAPITAL LOSS CARRYOVERS

It is important to enter your entire capital loss carryover on Schedule D each year. Otherwise, you could jeopardize this deferred tax asset.

Don't Omit Capital Loss Carryovers

- Some self-preparers mistakenly think they should only report a $3,000 capital loss carryover each year since they figure that is all they can use against other income. That is a mistake: Report the entire capital loss carryover on Schedule D, short term vs. long term. (You would otherwise lose the rest of the carryover to the next year.)
- Others overlook inputting a capital loss carryover. Some figure not reporting them until they have capital gains to use them up. However, it can become too late, since the capital loss carryover year closes after three years.
- Capital loss carryovers do not expire, so don't omit them.

Use Capital Loss Carryovers Correctly

- Capital losses are unlimited against capital gains.
- Deduct up to $3,000 of net capital losses against other income. It’s automatic, and not optional.
- For example, carry over $50,000 of capital losses and use it against $30,000 of current year capital gains, leaving a $20,000 net capital loss. Use the $3,000 capital loss limitation against other income and carry over $17,000 of the remaining capital loss to the subsequent tax year.

COST-BASIS REPORTING AND FORM 8949

Securities traders face challenges with cost-basis adjustments including wash sale losses.

Cost-Basis Reporting And Form 8949

- Accounting for trading gains and losses is the responsibility of securities traders; they must report each securities trade and related wash-sale loss and other adjustments on IRS Form 8949, which then feeds into Schedule D (capital gains and losses).

- Form 8949 came about after the IRS beefed up compliance for securities brokers starting in 2011, causing confusion and additional tax compliance cost.

Cost Basis:
Latest Phase-In Rules

- Options and less complex fixed income securities acquired on Jan. 1, 2014 or later were reported for the first time on Form 1099-Bs for 2014.

- Options and less complex fixed income securities transferred from another broker on Jan. 1, 2015 or later were reported for the first time on Form 1099-Bs for 2015.

- Complex debt instruments acquired on Jan. 1, 2016 or later shall be reported for the first time on Form 1099-Bs for 2016.

- Complex debt instruments transferred from another broker on Jan. 1, 2017 or later shall be reported for the first time on Form 1099-Bs for 2017.

WASH SALE LOSSES

Avoid getting stuck with a wash sale loss at year-end, as that can raise your capital gains income and related taxes owed.

Tax Loss Selling At Year-End

- Consider “tax loss selling” of investments and trading positions. That's where you let profits run on open securities positions and sell losing positions to realize tax losses before year end.
- Be careful not to trigger a wash sale loss by buying back a substantially identical position 30-days before, or after, incurring the loss.
- A wash sale loss with a taxable account at year-end postpones the loss to 2017, which would ruin your plan to accelerate losses with tax loss selling.

Avoid Wash Sale Losses

- Avoid getting stuck with a wash sale loss at year-end in taxable accounts, and avoid them throughout the year with IRAs.

- If you have a large capital loss carryover, then wash sales with taxable accounts may not change your $3,000 capital loss limitation – but you must account for wash sales, anyway.

- Wash sales are a primary concern for securities traders using the default realization (cash) method, but not Section 1256 contract and forex traders as those instruments are exempt from wash sales.

IRS Wash Sale Rules Differ For Brokers Vs. Taxpayers

- A concern for tax preparers is that the IRS requires brokers to prepare 1099-B wash sale loss adjustments based on identical positions, per that one account.

- The IRS asks taxpayers to go a step further: To calculate wash sales on Form 8949 based on substantially identical positions, across all accounts, including IRAs.

- Example: A broker 1099-B does not calculate a wash sale on Apple equity vs. Apple options because they are not identical positions (symbols), but the IRS asks taxpayers to do so because they are substantially identical positions. (Including options at different expiration dates.)

Avoid Wash Sale Losses Between Taxable And IRA Accounts

- Consider a "Do Not Trade List" to avoid permanent wash sale losses between taxable and IRA accounts.
- For example, trade tech stocks in your individual 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 Wash Sales At Year-End Among Taxable Accounts

- Break the chain on wash sale losses at year end in taxable accounts to avoid wash sale loss deferral to 2017.
- If you sell Apple equity on Dec. 20, 2016, at a loss, don't repurchase Apple equity or Apple equity options until Jan. 21, 2017, avoiding the 30-day window for triggering a wash sale loss.
- Wash sale loss adjustments during the year in taxable accounts can be realized if you sell/buy those open positions before year-end, and don’t buy/sell them back in 30-days.

Many Preparers Rely On Broker 1099-Bs

- Many tax preparers, including CPAs, import or attach broker 1099-Bs to generate tax return Form 8949 (Sales and Other Dispositions of Capital Assets); they don't account for wash sales based on IRS rules for taxpayers.

- Interactive Brokers furnishes clients with a draft Form 8949 based on their trades at Interactive Brokers only. You should consider whether you may need to use trade accounting software that’s compliant with wash sale rules.

Industry Practice

- It's become a widespread industry practice among preparers to import 1099-Bs, and I have not heard about the IRS challenging this practice to date.
- If you plan to use this industry practice (at your risk), it's wise to avoid wash sale loss conditions in the first place, so there are few gaps in broker vs. taxpayer rules.
- The crucial period is Dec. 1 through Jan. 31, covering the 30-day window on each side of year-end for triggering wash sales among taxable accounts. (That includes both spouses accounts on a married filing joint tax return.)

Consider Trade Accounting Software

- If you trade options and equities, which are substantially identical positions, and/or you have multiple brokerage accounts, including IRAs, and you know you have wash sale loss conditions that the broker will not account for on 1099-Bs, then you should consider trade accounting software that's compliant with wash sale rules for taxpayers.

- Download the original trade history from your broker's website into a compliant program to generate Form 8949 or Form 4797 with Section 475.

SECTION 1256 CONTRACTS

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

Section 1256 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 with the opt-out election into Section 1256g on the major currencies, for which futures trade (we make a case for spot forex too)
- Options on commodities/futures ETFs (taxed as publicly traded partnerships)
- Other non-equity options (be careful how you apply this)

Lower 60/40 Capital Gains Rates

- Sec. 1256 contracts have lower 60/40 tax rates, meaning 60% (including day trades) are long-term capital gains, and 40% are short-term capital gains taxed at ordinary tax rates.

- At the maximum tax brackets for 2016, the 60/40 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. (4% and 6%, respectively.)

Section 1256 Contracts: Form 1099-B Reporting With MTM

- 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.
- Form 1099-B reporting for Section 1256 contracts is concise and reliable for tax reporting purposes.
- With MTM reporting, there are no wash sale losses to consider.
- See 1099-B line 11 “aggregate profit or (loss) on contracts” and enter that summary amount on Form 6781 Part I.

Section 1256
Loss Carryback Election

- Taxpayers can elect to carry back a Section 1256 loss.
- On top of Form 6781, check box D “Net section 1256 contracts loss election.”
- Report the net Section 1256 loss on amended tax returns (Form 1040X) for the prior three tax years, in order of oldest year first. The loss can only offset Form 6781 gains, not other income.
- Any unused loss can be carried forward as a capital loss.

OPTIONS

Tax treatment for options is diverse.

Options Cover The Gamut Of Tax Treatment.

- They are a derivative of their underlying instrument and in almost all cases have the same tax treatment.
- For example, equity options are a derivative of the underlying equity, and both have securities tax treatment.
- Wash-sale loss rules apply between substantially identical positions in securities, which means between equity and equity options, such as Apple stock and Apple stock options at different expiration dates.

Equity vs. Non-Equity Options:

Equity options are securities, and they include:

- 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)

Simple vs. Complex Option Trades

- There are simple option trading strategies like buying and selling call and put options known as “outrights.”

- And there are complex options 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.

Simple vs. Complex Option Trades: Tax Treatment

- Tax treatment for outright option trades is relatively straightforward.

- Tax treatment for complex trades triggers a bevy of complex 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. (It's beyond the scope of this Webinar.)

- (Learn more on the GreenTraderTax Blog athttp://greentradertax.com/tax-treatment-for-trading-options/)

EXCHANGE-TRADED FUNDS (ETF)

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

Securities ETFs

- Securities ETFs are generally structured as 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.

Commodities/Futures ETFs

- Commodities/Futures ETFs use the publicly traded partnership (PTP) structure.
- PTPs issue annual Schedule K-1s to investors, passing through Section 1256 income or loss, as well as other taxable items. (Investors must report these pass-through items on their tax returns, like Section 1256 income on Form 6781.)
- Selling a commodities ETF is deemed a sale of a security, calling for short-term and long-term capital gains tax treatment.

Commodities/Futures ETFs: Cost-Basis Adjustment

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

- In the case of pass-through income, add that amount to cost-basis to reduce the capital gain, since you already report that income on Form 6781.

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

Precious Metals ETFs: Schedule K-1

- Physically-backed precious metals ETFs use the publicly traded trust (PTT) structure, also known as a grantor trust.
- A PTT issues an annual Schedule K-1, 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).

Precious Metals ETFs: Tax Treatment On Sale

- 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% (2016 rates).
- That rate is higher than the top long-term capital gains rate of 20% (2016 rates).

Options On ETFs

- The IRS hasn't explicitly stated tax treatment on sales of options based on ETFs – it's unclear.
- Our position is that options on securities ETF RICs are securities since they are like equity options.
- But, options on commodities ETFs structured as PTP are Section 1256 contracts since they are non-equity options.
- Tax treatment of options on precious metals ETFs is unclear; some tax professionals make a case for Section 1256 treatment as a non-equity option.

FOREX

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

Forex vs. Currency Futures

- “Forex” refers to the foreign exchange market where participants trade currencies, including spot, forwards or over-the-counter (OTC) 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.

Forex Is Ordinary Income/Loss By Default

- 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 tax 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.

Forex Capital Gains Election

- 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 unutilized for years.

- A trader may make or retract this election on a “good till canceled basis” during the year. (Document your election.)

Using 60/40 Capital Gains Rates In Section 1256(g)

- The capital gains election on forex forwards allows the use of Section 1256(g) treatment with lower 60/40 capital gains rates on the major currencies if the trader doesn't take or make delivery of the underlying currency.

- "Major 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. (Some retail forex trading platforms do not.)

Spot Forex:
Tax Treatment Is Uncertain

- In Green’s 2016 Trader Tax Guide, I make a case for treating spot forex like forwards forex for purposes of using Section 1256(g) treatment.

Forex Tax Treatment & Reporting

- 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.

- Report rollover trades as realized trades, even though brokers may show them as open trades. Rollover interest is part of the trading gain or loss.

- Report Section 988 losses of $50,000 or more on Form 8886 (Reportable Transaction Disclosure Statement).

OTHER FINANCIAL PRODUCTS

Foreign futures, precious metals, volatility products, ETNs, Bitcoin and swap contracts.

Foreign Futures

- Foreign futures require an IRS revenue ruling allowing Section 1256 tax treatment.

- There are only a handful of foreign futures exchanges that currently have this IRS revenue ruling.

- Without Section 1256 treatment, report foreign futures like securities on Form 8949.

- Learn more on the GreenTraderTax Blog. http://greentradertax.com/tax-treatment-for-foreign-futures/)

Precious Metals

- Physical precious metals are “collectibles” which are a special class of capital assets. If collectibles are held over one year (long-term), sales are taxed at the “collectibles” tax rate — the taxpayer’s ordinary rate capped at 28% (2016 rate).
- If collectibles are held one year or less, the short-term capital gains ordinary tax rate applies no different from the regular STCG tax rate.
- Realized gains and losses in collectibles are reported on Form 8949 and Schedule D along with other capital gains and losses, which means the capital loss limitation of $3,000 against ordinary income applies on individual tax returns.

Volatility Products

- There are many different types of volatility-based financial products to trade, and tax treatment varies. For example, CBOE Volatility Index (VIX) futures are taxed as 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 is uncertain tax treatment on ETNs.

Exchange Traded Notes (ETN)

- ETNs are “prepaid forward contracts,” and tax treatment calls for deferral of taxes until sale, and long-term capital gains rates apply if held 12 months.

- In Rev. Ruling 2008-1, the IRS “looked through” a currency ETN to the underlying market bet on the Euro and market interest rates; thereby using Section 988 treatment.

- Learn about possible alternative tax treatments http://greentradertax.com/tax-treatment-for-volatility-products-including-etns/)

Bitcoin

- The IRS issued guidance stating Bitcoin is an “intangible asset” for investors and traders.
- That’s good news on some fronts as it allows lower long-term capital gains tax rates on realized trades held over 12 months.
- As an intangible asset, use the realization method as with securities.
- A Section 475 election does not apply to intangible assets (See Webinar Part I.)

Swap Contracts

- When Dodd-Frank was enacted, traders *hoped* that clearing swap contracts on futures exchanges would allow Section 1256 tax treatment.

- They were wrong: Congress and the IRS immediately communicated that Section 1256 <u>would not apply</u> to swap transactions, and they confirmed ordinary gain or loss treatment.

Thank You

- Please visit our Website at www.GreenTraderTax.com.