

## End of Year Tax Accounting - Reviewing the benefits of Futures

While Tax Day is still a few months away in the US, many investors use the last week of the year to adjust their holdings for tax purposes - perhaps booking a loss in 2004 to offset capital gains - or vice versa. Investors utilizing futures based trading systems want to know if there are any tax related adjustments they should be making as well.

The quick answer is nothing special needs to be done with a futures investment. Unlike stocks, futures based investments are based on their value at the end of the year, so any open trade profits or losses in the account are treated as realized profits or losses as of the last day of the year. As the profits or losses will be treated as "realized", there's no reason to take some "realized" losses or gains as is commonly done with stock investments.

In addition, futures based investments do not require the accounting of individual trades. Taxes on the security side are trade by trade based, and depend when you got into a certain investment and when you got out. Conversely, taxes on your futures based investments are only concerned with the gross profit or loss achieved using commodity futures contracts for the year. This is good news for all those investors utilizing a day trading system which may trade up to 200 times a year.

While both stocks (securities) and futures are eventually recorded as investment income or losses, there are big differences between the two for the purposes of your tax return. These differences are often overlooked by the average investor, but can add up to real tax savings. Let us first look at the securities side of things, which includes stocks, mutual funds, and ETFs (such as the SPDRs and QQQs).

As most Americans know, gains on securities such as stocks are taxed at either the short term capital gains rate of up to 35% or the long term capital gains rate of 15%. To receive the long term capital gains treatment, the securities investment must be held for longer than one year. One important thing to remember is that you are not taxed on the gain from a security until you sell that security. Thus if you bought GE in 1985 and have held it ever since, you haven't paid any taxes on the gains of that investment, and won't until you sell. Conversely, if you are an active trader and bought and sold the QQQs a few times in 2003, you are responsible for taxes equaling 35% of the gains.

The taxation of commodities investments, i.e. trading futures, is much different than that of securities. The main difference being that futures gains or losses are treated as 60% long term capital gains (at up to a 15% maximum rate) and 40% short term capital gains (at up to a 35% maximum rate), NO MATTER the holding period. For example, an investor who holds a futures position for just a few minutes, or hours, can book 60% of the profits on that trade as long term gains - eventhough the trade was anything but long term. What a deal!

The enormity of this benefit for active traders should not be overlooked. Consider an investor weighing the differences between trading the QQQs and the e-mini Nasdaq futures. Equal profits in each instrument would be anything but equal after taxes, with the maximum combined rate for the e-mini NQs just 23% (calculation =  $60\% * 15\% + 40\% * 35\%$ ), versus a maximum rate of 35% for the QQQs. That's a savings of 12% by using e-mini futures over the exchange traded funds. It's no wonder e-mini volume has steadily grown for every year since being launched, and the CME's stock price is at all time highs. For active traders, e-minis are simply the more cost effective choice.

But how did futures get such preferential treatment? It all started in the 1980s as the government tried to get a handle on the widespread use of "tax straddles" by professional commodities traders. Before the 1986 tax reform, commodities were taxed in much the same manner as securities, with insanely high short term capital gains taxes (of over 50%).

To help offset the often gaudy gains professional traders were making, they would initiate a spread or straddle (Chicagoans call them spreads, New Yorkers straddles) in a seemingly non-volatile contract such as Gold or Bonds. The traders would buy September Bonds, for example, and sell December Bonds. As the

market rose or fell - one side of the spread would gain while the other would lose, generating no real profits or losses for the trader. But, traders would offset the losing leg at the end of the year, so as to generate losses to be written off against gains for that year. Once the losses were booked, the trader then put the spread back on by selling that leg again.

The government's answer to the "tax spread" was the introduction of Section 1256 contracts, which was a label for futures and commodities investments. Under the new rules, section 1256 contracts were to be marked to market as of the last day of the year, and thereby considered sold (or bought) with the end of year prices for tax purposes. The age of the tax spread was dead, as now both profits AND losses were reported in the current year.

For honest commodities investors who may have had no intention of selling their positions at year end, having to mark their positions to market put them out a great deal; and the government compromised by allowing 60% of the marked to market profits to be deemed as long term gains. This preferential treatment has endured ever since, even as Congress tried to reduce it in the 2003 tax reform act.

To achieve similar restrictions against selling losers and keeping winners at the end of the year, securities laws have the Wash Sale rule, which disallows losses if the losing position is reentered within 30 days. Section 1256 contracts are exempt from the wash sale rule, giving commodities another benefit over securities. It should be noted that investors can achieve active trader status and become exempt from the wash sale rule on the securities side.

The 60/40 treatment of futures makes futures the better choice when considering profits, but what about losses - which investment has the edge there? The answer once again is futures. Losses in securities can only offset gains by a puny \$3,000 a year. (Again - those with active trader status can treat losses as ordinary gains/losses). Conversely, losses in futures(section 1256 contracts) can be carried back 3 years against section 1256 gains. This is especially poignant coming off a year in which many systems underperformed. Imagine an investor who had made \$20,000 in 2001; \$30,000 in 2002; and \$40,000 in 2003 - only to lose a net \$100,000 in 2004. This imaginary investor would have paid taxes at the 60/40 split in each of the previous three years - but could now carry the 2004 losses back three years - effectively wiping out the gains made in those years to earn a hefty refund on the taxes paid in '01, '02, and '03.

In conclusion, the verdict on whether an active trader should utilize exchange traded funds like QQQs and SPDRs or index futures such as e-mini SPs and e-mini Nasdaq appears to be no contest, as investments in futures appear to have more beneficial tax treatment at virtually every turn. It is no wonder e-minis have become so popular amongst both professional and novice investors.

Some of the information in this article was verified on the very comprehensive website of [www.GreenTraderTax.com](http://www.GreenTraderTax.com); a professional tax service; as well as an article by Robert A. Green, CPA, in the August 2003 issue of Active Trader magazine.

### Tax Savings - e-mini NQ vs. QQQ

	Maximum Tax Rate	Tax Liability	Tax
\$100,000 Profits trading QQQs	35%	Pays IRS \$100,000 * 0.35	= \$35,000
\$100,000 Profits trading NQ futures	60% @ 15%	Pays IRS \$60,000 * 0.15	= \$9,000
	40% @ 35%	Pays IRS \$40,000 * 0.35	= \$14,000
		NQ Total	= \$23,000
		Tax Savings	= \$8,000