

Tax Implications of Trading the Forex (Spot) Market

Forex Trading tax tips tricks and traps

This article will discuss the tax implications for U.S. Citizens and resident aliens that file Individual U.S. Tax Returns.

Gains and losses incurred while trading foreign currency contracts (FCC) on the open FOREX (interbank, cash, spot) market is subject to the provisions of the United States Internal Revenue Code Section (IRC) 988. IRC 988 states that fluctuations in the exchange rate gain or loss should be treated as ordinary income or loss.

Section 988 was written to tax companies that earn income from fluctuations in foreign currency exchange rates in their normal course of business. For example, a U.S. based company purchases goods in another country and the resulting fluctuations in the currency exchange rate must be considered. Accordingly, any gain or loss on the transaction is treated as ordinary income or loss to the business entity subject to ordinary income tax rates versus a capital gains tax rate.

Individual Forex traders have some additional options on the taxation of FOREX gains and losses, that actually, can be very beneficial from a U.S. individual tax perspective.

The question then becomes does an individual FOREX trader treat his gains/losses as ordinary income/loss or affirmatively elect out of IRC 988 for capital gain/loss treatment under IRC 1256?

Should I elect out IRC 988 or stay in IRC 988?

TIP

For the individual Forex (Cash) trader there is an election under IRC 988 (a)(1)(B) to convert these otherwise ordinary Forex gains and or losses to capital gains and or losses.

Trick

For the individual Forex (Cash) trader the real tax benefit of electing out of IRC 988 is converting your Forex gains from ordinary income tax rates as high as 35% to the much preferred capital gains maximum tax rate of 15%.

Trap

However, as an individual trader, if you have net Forex (Cash) losses you MAY NOT want to elect out of IRC 988 as you will have ordinary loss treatment that can fully offset

your other income (i.e., wages from your job, interest and dividend income). If you elect out of IRC 988 and then fall under IRC 1256, and have Forex trading losses, the losses are limited to \$3,000 under the regular capital loss limitation rules.

If I decide to elect out of IRC 988, how do I accomplish that?

Tip

If you decide to elect out of IRC 988, you must make an affirmative election and attach it to your U.S. Individual Income Tax Return. In addition, according to the U.S. Treasury regulations, Reg 1.988-3(b)(4) you must attach to the tax return the 5 items requested in this regulation on a per trade basis (Note: for an active Forex trader, that could mean a very, very thick return).

A word of caution, there is very limited information regarding the U.S. taxation of the FOREX market. It is very clear, however, that an affirmative election must be made to elect out of IRC 988. However, based on my research the above reference REG is also very clear that the election on a per trade basis must also be attached to the Individual Tax Return. However, the CPA I spoke with who prepares many Forex traders returns DID NOT attach this election on a per trade basis. This CPA Firm only attached to the Individual Tax Return an affirmative election out of 988, followed with a blanket statement electing out of 988 covering all trades during the year within the specific trading account(s). My reading and understanding of this reg indicates otherwise that you must identify each trade.

TRICK

You must elect out of IRC 988 prior to each trade or make a blanket election covering all trades. The election must be kept as part of your “books and records”. In addition, the election must be attached to your U.S. individual 1040 filed on an annual basis.

So, it would be important to maintain good records to verify if you either elect out or opt to stay in IRC 988. The problem with this is that an individual could very easily wait until year end to determine which is better: electing out of IRC 988 for capital gain treatment or staying in IRC 988 for the ordinary losses. Short of getting a notarized statement I am not sure what a good alternative might be. Even then there are many “games” an individual can play with this election.

TRAP

Remember, the IRS commissioner in his sole discretion, may invalidate any or all elections made during the taxable year under § 1.988-3(b)(1) if the taxpayer fails to verify each election as provided under § 1.988-3(b)(4). The preceding sentence shall not apply if the taxpayer’s failure to verify each election was due to reasonable cause or bona

fide mistake. The burden of proof to show reasonable cause or bona fide mistake made in good faith is on the taxpayer.

Just remember that a good “reasonable cause” can be your reliance on the advice from a tax professional.

How do I show my Forex gains/losses on my U.S. Individual tax return?

If you decide to NOT elect out of IRC 988, your net gain/loss from your Forex trading activities are treated as ordinary income/loss, the net number should be reported on Line 21, Other Income, of your U.S. Individual Tax Return, form 1040. I would reference the income/loss number with a notation such as “Forex Currency Contract gain/loss under IRC 988”. Or some such notation that gives an accurate description of the line item number.

If you decide to elect out of IRC 988 you will fall under IRC 1256 rules. IRC 1256 gains and losses are taxed at a blended rate, 60% of the gains are taxed at the long term capital gains tax rate (maximum rate of 15%) and 40 percent at the short term capital gains rate (i.e., ordinary income rates). The long term capital gains rate applies **IRRESPECTIVE** of how long you held the contract(s). The net gain or loss is reported on Form 6781 which then flows to your Schedule D and ultimately to the front page of your 1040 return. Please remember, too, that if you elected out of IRC 988 and have net Forex losses, those losses can be carried back under IRC 1256 against prior net IRC 1256 gains. In general, though, for most U.S. Taxpayers ordinary losses are more valuable than capital losses that are limited to only \$3,000.00.

Also, be advised that if you have “substantial” net trading losses and you are offsetting other income on your tax return this will surely “prick” the interest of the Internal Revenue Service (IRS). Accordingly, make sure that your tax return is “squeaky” clean and you can verify all numbers, especially, your Forex loss number.

What if I have or my tax preparer has made a mistake classifying my Forex gains/losses on a prior tax return(s)?

If you treated your Forex gains as capital gains in the past, without making the election under IRC 988, you may want to consider amending your tax return. However, this may result in additional tax due, plus interest and penalties.

Likewise, if you did not elect out of IRC 988, and you or your tax preparer treated any Forex losses as capital losses subject to the overall \$3,000 loss limitation, you may want to consider amending your return to take advantage of the ordinary loss deduction. In this instance, you may be due a refund. However, an amended return showing a refund request will surely create some level of interest on the part of the IRS, so be absolutely certain that you have good records and a clean return.

What is the tax treatment if I have a professional Forex trader managing my account?

You still need to make an election out of IRC 988 treatment prior to the beginning of trading. Attach this election to your Individual Tax Return that shows the net gain/loss from the managed FOREX account. *Remember, according to the U.S. Tax Regulations, the election is made on a transaction by transaction basis PRIOR to each transaction. It would be impossible to make such an election on a trade by trade basis with a managed account. Accordingly, a blanket election would seem to suffice.*

What about my expenses that I incur in Forex trading?

For example, computer(s), supplies, books, reference manuals, internet connections, monthly fees, travel, etc....

The focus of this article is just on the income side of Forex trading. However, if you are not considered a “trader” in the eyes of the IRS all of the above deductions (plus other trading related expenses) will be considered “investment related” and deducted on Schedule A, subject to the 2% of adjust gross income (AGI) limitation. If you don’t itemize your deductions and or have high AGI, these investment related deductions may be significantly reduced or eliminated.

Disclaimer:

Remember this article ONLY addresses individual U.S. citizens and resident aliens who trade the Forex (SPOT) interbank market and file a U.S. Individual Tax Return. It does NOT apply to individuals who trade commodities, securities and or Forex Futures.

The information above should not be relied upon or taken as a substitute for professional tax advice. If you need professional tax advice, you should contact a qualified CPA or other tax professional.

Additional Information:

If you have any questions about this article, please feel free to contact me at 407-896-9688, Orlando, Florida, USA.

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Research Resources:

- 1) The Tax Guide for Traders. By Robert A. Green, CPA