

# Legislative Perspectives

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## The Administration's Flawed Attempt to Eliminate 60/40 Tax Treatment for "Professional Option Traders and Professional Futures Traders"

In its revenue proposals for both fiscal year 2010 and fiscal year 2011 ("Green Book"), the Obama Administration recommends the elimination of so-called 60/40 tax treatment for transactions by "dealers" in exchange-traded options and futures contracts as defined by Code Sec. 1256.

The proposal released again on February 1, 2010, is in very summary form (the Green Book does not include proposed statutory language). But the proposal contains several conceptual mistakes and would create highly anomalous, if not highly inappropriate, tax results. In this column, we explain the present tax scheme for exchange-traded options and futures contracts and then point out some of the reasons the Green Book's proposal has been so poorly thought out.

### The Mark-to-Market and the 60/40 Tax Regime

In 1981, the Code was amended to require all domestic futures contracts (that are not hedges for tax purposes) to be treated as if they were sold at their fair market value on the last business day of each year ("Mark-to-Market Rule").

This extraordinary—and for the time quite radical—provision was enacted to stop the tax "abuse" available to taxpayers prepared to use futures contracts to push income from one tax year to the next (to "roll" income forward). The Mark-to-Market Rule was coupled with another highly unique provision: the 60/40 Rule.

The 60/40 Rule was designed to ameliorate the adverse impact on futures traders who were being forced to pay taxes on unrealized gains and losing the opportunity for long-term capital gains on positions established in the second half of a year. All futures transactions that are not tax hedges were, and are, taxed as capital, not



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ordinary transactions. The 60/40 Rule provides that gains and losses on all future contracts subject to the Mark-to-Market Rule are taxed as 60 percent long-term and 40 percent short-term capital gains and losses.<sup>1</sup>

The tax changes with respect to futures contracts that were enacted in 1981 made no reference to and had no relevance for “dealers,” given that *no one* effecting transactions in futures contracts was or ever could be a “dealer” (as defined by then Code Sec. 1221(1), now Code Sec. 1221(a)(1)), because no one had (or could have) “customers” as required by that definition.

In 1984, mark-to-market and 60/40 tax treatment were extended to (1) transactions in equity options by *dealers* in such options (as defined by newly enacted Code Sec. 1256(g)(8)(A) to mean persons registered with an exchange as “market maker[s] or specialist[s] in listed options”), and (2) transactions in nonequity options by anyone. The application of mark-to-market and 60/40 treatment to dealers in equity options was designed to correct the perceived tax inequality between professional option traders and professional futures traders. The application of these provisions to everyone trading nonequity options was designed to eliminate confusion and ambiguity as to the tax status of these products.

Finally, in 2000, the Mark-to-Market and 60/40 Rules were extended to transactions by dealers in securities futures contracts and options on such contracts by dealers in these contracts<sup>2</sup> in a manner essentially identical to dealers in equity options.<sup>3</sup> This extension was designed to assure tax equality between professionals trading securities futures contracts and professionals trading equity options.

To summarize the present state of mark-to-market and 60/40 tax treatment: it applies to transactions by everyone in regulated futures contracts and exchange-traded nonequity options, and it applies to transactions by registered market makers and specialists (and traders performing similar functions) in exchange-traded equity options and securities futures and options on securities futures contracts. As we will see, careful identification of when, and with respect to whom, this tax regime is applicable is very important and the Administration has failed to perform the exercise with appropriate, or it appears, with any care.

## **The Administration’s Proposed Repeal of 60/40 for “Dealers”**

There are several problems with the Administration’s proposal. For one, it proposes to repeal 60/40 tax treatment only for transactions by “dealers.” We

will address shortly the Administration’s conceptual confusion in its use of the term “dealers,” but for now let us assume we know what the Administration means: professional traders actively engaged in regularly effecting transactions in exchange-traded products. Thus, the 60/40 Rule would be repealed for transactions by professional traders whose activities improve market liquidity, while 60/40 tax treatment would be left in place for transactions in futures contracts and nonequity options by everyone else. In other words, 60/40 tax treatment would be retained for transactions by everyone who does not provide services to the markets and it would be eliminated for transactions by everyone who does provide such services. If the Administration had proposed exactly the opposite—namely, eliminating 60/40 tax treatment only for taxpayers who are not “dealers” and thus do not provide services to the markets—it might have made sense. But as the proposal now stands, it is conceptually illogical and potentially hurtful to the markets. Market makers might simply walk away from their services to the markets. It creates a serious tax disincentive for traders to continue to provide liquidity services to the exchange markets for futures contracts, nonequity options, and equity options.

Another problem with the Administration’s proposal is that it assumes that the elimination of 60/40 tax treatment for transactions by “dealers” in futures contracts will result in these transactions being taxed at ordinary rates. As we pointed out earlier, however, commodity futures contracts have never been treated as ordinary assets in anyone’s hands (except when they constitute tax hedges). Surely, if the Administration is serious about its proposal, it will have to address this issue, but to do so will require it to face up to the fact that it has made a complete muddle of the concept of “dealer.”

So let’s look at the Administration’s use of the term “dealer.” First, the Administration proposes to take 60/40 tax treatment away from “commodity derivatives dealers”<sup>4</sup> for their transactions in futures contracts and exchange-traded nonequity options. But “commodity derivatives dealers” are not “dealers” (under any definition of the term) in these products. The Administration argues that “commodity derivatives dealers” should lose 60/40 for their transactions in futures and nonequity options because dealers “generally treat the income from their day-to-day dealer activity as giving rise to ordinary income.” But “commodity derivatives dealers” do not engage in day-to-day or any other

kind of “dealer activities” in futures contracts or non-equity options.

Second, the Administration would eliminate 60/40 tax treatment for transactions in futures contracts and nonequity options by “commodity dealers” (as defined by Code Sec. 1402(i)(2)(B)). This recommendation is doubly puzzling. On the one hand, Code Sec. 1402(i)(2)(B) defines “commodity dealer” *solely* for purposes of imposing self-employment tax on exchange members that actively trade Code Sec. 1256 contracts. On the other hand, the Code Sec. 1402(i)(2)(B) definition does not have anything to do with identifying taxpayers who are engaged in “dealer activity.” The only activity required of these “commodity dealers,” aside from being exchange members, is being “actively engaged in trading.” They are not required to have customers in accordance with the definition of dealer in Code Sec. 1221(a)(1), nor are they required to provide any type of “dealer service” to the markets. So what the Administration is really proposing is that exchange members who “actively engage in trading” should be taxed at ordinary rates on their futures and non-equity option transactions, while non-exchange members engaged in *exactly* the same type of trading activity are taxed at the blended 60/40 rate. Again, the logic of the proposal is flawed and its practical implications appear perverse.

Finally, in arguing that “dealers” in equity options and futures contracts are like other dealers whose “dealer activities ... giv[e] rise to ordinary income,” the Administration is conspicuously ignoring the legislative history of the various extensions of the Mark-to-Market and 60/40 Rules. For example, in

1984, Congress expressly stated that the activities of options market makers are not of a type usually attributable to “dealers” giving rise to ordinary income treatment. Recognizing that the trading activities of these market makers are similar to those of professional commodity traders, Congress concluded that both options market makers and professional commodity traders “are [to be] treated as buying and selling capital assets.”<sup>5</sup> The Administration has provided no rationale for changing this settled tax principle.

## Conclusion

The 60/40 Rule is unquestionably controversial. Congress in both 1986 and 2003 considered proposals to repeal it, ultimately deciding on both occasions not to do so. Nevertheless, it should be acknowledged that there are substantive arguments on both sides of the repeal debate. It should also be acknowledged, however, that the Administration’s Green Book proposal is neither a thoughtful nor a coherent attempt to address the issue. If there is to be a serious policy discussion of the pros and cons of the 60/40 Rule, Congress will need to have before it a far more carefully crafted proposal than that which the Administration has served up.

## ENDNOTES

<sup>1</sup> Code Sec. 1256(a)(3).

<sup>2</sup> As defined in Code Sec. 1256(g)(9)(B).

<sup>3</sup> As defined in Code Sec. 1256(g)(8)(A).

<sup>4</sup> As defined in Code Sec. 1221(b)(1)(A).

<sup>5</sup> General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, H.R. 4170, 98th Cong. (1984).

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