



TRADING ACROSS BORDERS

Americans are increasingly trading on foreign exchanges and non-residents are increasingly trading on American exchanges. Money may cross borders with few restrictions, but taxes are another matter. Learn about some tax benefits, costs and pitfalls involved in trading globally.

By Robert A. Green, CPA

Global competition among the world's financial exchanges is intensifying as these exchanges attempt to capture more business in the worldwide trading marketplace.

What used to be the domain of institutions and professional traders is now within reach of individual traders thanks to the Internet, new retail-friendly trading platforms, and cross-border-friendly monetary and fiscal (tax) policy.

The new conventional wisdom calls for diversification of portfolios and trading instruments, among both U.S. and international exchanges.

Exchanges and brokerage firms are hungry for global growth. They are crafting new alliances and exchanges, and sometimes crossing borders themselves. On its Web site, OneChicago – the single-stock futures exchange – says it “is an electronic exchange committed to becoming the global leader in futures on individual stocks, narrow-based indexes and ETFs. We are a joint venture of the world's premier options and futures exchanges: the Chicago Board Options Exchange (CBOE), Chicago Mercantile Exchange Inc. (CME) and the Chicago Board of Trade (CBOT).”

Eurex, the No. 1 futures exchange in the world from a volume standpoint, is a joint venture between Swiss and German exchanges.

Employing the same strategy that Mercedes and BMW used in opening U.S.-based automobile factories to overcome import, monetary, fiscal and other U.S. market restrictions, Eurex opened Eurex U.S. in 2004. Its Web site says, “Eurex U.S. is a Chicago-based futures exchange with connection points across the globe, ensuring smooth, seamless trading access world-wide.”

Large institutional traders have the support of their company's revenue departments in dealing with cross-border tax issues, but retail traders must fend for themselves.

This article gives retail traders plenty of tax support.

Are U.S. and foreign futures treated the same tax-wise?

U.S.-regulated futures contracts are considered “IRC 1256 contracts” and are given the more tax-beneficial 60/40 tax treatment.

Regardless of how long the position is held, 60 percent of gains are long-term capital gains taxed up to 15 percent, and the other 40 percent are short-term capital gains taxed up to 35 percent (depending on your ordinary tax rate). The maximum blended 60/40 tax rate is 23 percent. Therefore, it pays to trade U.S. futures vs. securities.

But what about foreign-regulated futures contracts, such as the Eurex-listed DAX? Do foreign-regulated futures contracts also qualify as IRC 1256 contracts?

Technically, no – unless the foreign exchange gets permission from the Commodity Futures Trading Commission (and few have), and/or the IRS specifically says it's OK (and the IRS is very late in issuing regulations on foreign futures).

Ask yourself this: Do the CFTC and IRS want to rush to give foreign exchanges a level playing field? Of course not. But don't give up on 60/40 treatment on foreign futures yet.

Notwithstanding the maze the CFTC and IRS has put us in, the underlying spirit of the tax law is in favor of 60/40 treatment on foreign futures, and a case can be made for it on tax return filings.

GreenTraderLaw attorneys wrote about this problem and possible solution in "Trading Foreign Futures? Know the Tax Rules before You Trade," SFO January, 2005.

In this article, our attorneys addressed the unfairness of IRC 1256 not applying to foreign futures. They argued the fundamental premise of income-tax treaties (between the U.S. and foreign countries) are to provide for equitable tax treatment. They argued that by not granting IRC 1256 to foreign-regulated futures contracts, the US may be in contravention of some tax treaties. They further argued the IRS has not issued guidance, but that should not be interpreted to mean the IRS will deny 60/40 treatment on foreign futures.

In summary, our attorneys made a case for filing a tax return with 60/40 taxation on foreign futures, but only under certain circumstances. However, we suggested consulting with an expert tax advisor on this issue.

Perhaps this confusion is the main reason Eurex opened Eurex U.S. in the first place – to guarantee its foreign futures contracts would be afforded the more favorable tax treatment.

Is 60/40 tax treatment the private tax booty of Chicago?

It's fair to question why the IRS and CFTC have been slow to level the playing field on 60/40. The media has reported often about the Chicago commodities and futures exchanges vigorously fighting Eurex U.S.

Chicago exchanges have had great success in pork barrel tax politics, too. Chicago's infamous former House Ways and Means Committee Chairman Dan Rostenkowski first passed the 60/40 tax treatment rules in the mid-1980s. Chicago exchanges and politicians together successfully thwarted a last-minute Senate attack to repeal 60/40 in the 2003 Tax Act.

But does the Windy City need this break, or can it compete on a level playing field? Foreign exchanges are not the only ones coveting 60/40. So are the New York exchanges, as they consider their new products to be similar to the ones sold in Chicago.

Is all this confusion and inaction planned, to force foreign vendors to set up shop in the U.S. in the best interests of the U.S. economy? Or is it designed to limit competition?

It's happened before in other industries, such as the auto industry.

American traders are waking up to international opportunities in all markets

Individual business traders have shown increased interest in trading the world's major currencies (euro, yen, British pound and Swiss franc) on a 24-hours-per-day, seven-days-per-week schedule.

While U.S. stock markets suffered through bear markets, international markets went on a bullish stampede. U.S. traders are not willing to miss out on that good action.

Larger hedge funds, mutual funds and other professionals have always touted the gains to be made in foreign markets. Now retail traders are following suit.

First, you need to report your foreign accounts

When Americans trade outside the U.S., there are special tax matters that come into play.

Unless one buys and sells foreign instruments (such as ADRs) listed on U.S. exchanges, a trader may need to open a foreign brokerage or bank account and then convert U.S. dollars into foreign currencies.

If a U.S. resident has a foreign bank or brokerage account exceeding \$10,000 in value (at any time during the year), they are required to file a Form TD F90.22-1 (for each account) with the Department of Treasury by June 30 of the following tax year. No extensions are permitted. See this form and instructions at www.irs.gov.

Many taxpayers are unaware of this form, and there are significant penalties for not filing it. In fact, the IRS has started a tax exam audit campaign to catch taxpayers they suspect as being tax cheats for hiding offshore accounts.

Some taxpayers were snagged for using hidden offshore accounts along with credit cards. The IRS successfully sued the credit card companies to get their lists of customer names. Those taxpayers are in severe trouble.

Next, you need to report foreign income

Besides reporting a foreign account, a U.S. resident must also report all income generated on those accounts. U.S. residents are taxed on their worldwide income.

Many U.S. residents opened foreign brokerage accounts to trade foreign stocks. They transferred dollars abroad, converted into the local currency and then traded.

They may not need to convert the foreign currency back into U.S. dollars for many years – not until they choose to repatriate those funds back to the U.S.

We often get this tax question: Must a U.S. taxpayer account for a foreign account in U.S. dollars on their tax return each year – in other words, must they report the gain or loss of the U.S. dollar?

For example, suppose you opened an account a few years ago and traded European stocks using the euro. Assume you had no gain or loss on trading positions and broke even.

Must you report the change of value in this foreign account (in dollars), since the account appreciated in dollar terms (the euro increased in value vs. the dollar)?

The good news is you have a choice.

Here is how you can skip reporting that economic currency conversion gain on the euro vs. the U.S. dollar. Add the following footnote to your tax return:

“Pursuant to Sections 985(b)(1), 989(a) and Treasury Regulation Section 1.985-1(c)(1), the foreign brokerage account is a separate business activity of the taxpayer that is a Qualified Business Unit. The Functional Currency of this activity is the Euro. Cash flows, revenue and expenses are recorded in the Euro and the QBU maintains its books and record in the Euro. See also Treasury Regulation Section 1.989(a)-1(b)(2)(ii). This taxable income for this QBU has been translated into the taxpayer's overall functional currency at an average exchange rate for the year, as required by Section 989(b)(4).”

Income tax withholding may apply

When opening a new account, banks and brokerage firms ask their clients where they are residents.

U.S. brokers ask customers to fill out either tax form W-9 (for U.S. residents) or W-8 (for foreign residents). This drives how they do business with that customer.

If you file W-9 as a U.S. resident, you are not subject to tax withholding on portfolio income (interest and dividends). Your broker sends you a Form 1099 at the end of the year, you report your income on a U- resident income tax return and pay your taxes accordingly.

But if you file a W-8 as a non-resident of the U.S., your broker is required by the IRS to withhold U.S. income taxes on interest, dividends and some other types of income – but not capital gains.

The U.S. taxes non-residents on some types of portfolio income, and withholding is a means for brokers to act as tax policeman to make sure non-residents pay U.S. taxes. After all, most non-residents skip filing a U.S. tax return, even when it's in their best interests (i.e., when they are due a tax refund).

Tax treaties override standard schedules for withholding; it varies by country. See more on tax treaties below.

Most other countries also utilize tax withholding on interest and/or dividends. Americans often see foreign tax withholding on their Form 1099s when they buy foreign equities through their U.S. broker. U.S. taxpayers may claim foreign tax credits or deductions. See more on this below.

Many proprietary trading firms should withhold U.S. income taxes on non-resident traders, but they often don't.

Non-residents are taxed differently in the U.S.

If you are a U.S. citizen, green card holder or resident under the physical presence test, you are taxed in the U.S. on your worldwide income.

If you are domiciled in or a statutory resident of any state, you are also liable for state tax on your worldwide income. Some states are tax-free, while others have low taxes on only certain types of income. Still other states are known as high-taxing states. Learn more about state versus federal tax policy at

www.greencompany.com/Traders/AdvocacyTaxReform2005.shtml.

If you are a non-U.S. resident and open a U.S.-based brokerage account to trade on U.S. exchanges, you generally (subject to tax treaty override) do not owe U.S. income (or state) taxes if you are living in the U.S. for less than 183 days per year. Non-resident traders can learn more about these special rules at

www.greencompany.com/EducationCenter/GTTRecTraTypNonResident.shtml.

If a non-resident joins a U.S.-based proprietary trading firm (organized as a pass-through entity, as most are) as an owner (a K-1 member), they are subject to U.S. and possibly state taxation on that “source income,” regardless of if they spend any time in the U.S. or not. Proprietary traders can learn more about taxation at www.greencompany.com/PropTraders/TradersTax.shtml.

To avoid U.S. source income and related taxes, consider switching to independent contractor status. Independent income only becomes U.S. source income if you spend sufficient time in the U.S.

Similar tax law applies to hedge funds. That’s why non-residents invest in offshore or international hedge funds rather than U.S.-based hedge funds. U.S. and foreign investment advisors utilize master/feeder hedge fund structures to accommodate funds for U.S. investors and foreign investors. You can learn more at www.greencompany.com/HedgeFunds/OffDocMasterFeeder.shtml.

Proprietary traders may also want to consider opening a retail (customer) trading account instead of joining a proprietary trading firm as a K-1 owner. A retail account is not U.S. source income.

There are tax breaks for Americans who live abroad (IRC 911)

When a U.S. citizen or legal resident (green card holder) trades on an exchange in Chicago, New York, London, or Tokyo, they are taxed on their worldwide income all the same, whether they live in the U.S. or abroad.

However, there are special tax breaks for U.S. citizens and residents who live abroad (and meet the time test). Learn more about these breaks at the IRS site (search foreign income exclusion and reference Pub. 54).

Here are the basics of IRC 911: It provides for a foreign income exclusion (\$80,000 for 2005) and a housing allowance deduction. This means you may deduct these combined amounts from gross income (which already includes foreign income). You need to be a bona fide or physical resident abroad; the tests are on the IRS site.

However, traders face difficulty in collecting these tax benefits. Technically, only “foreign earned income” paid by a U.S. company qualifies; trading gains are not earned income, nor are they paid by a U.S. company.

It’s a challenge to squeeze trading gains while living abroad into the exclusion definitions. There are two possible ways.

One, if the trader is a member of a U.S. options or commodities exchange, they have earned income. This can be squeezed into the definition of “personal services income” (one of the definitions for foreign earned income). It doesn’t matter in this case that the income is not paid by a U.S. company.

The second way helps many more traders and it requires some tax structuring.

A trader needs to form a U.S. entity that is technically the trader and then have the U.S. company pay itself an administration fee. This is foreign earned income for the exclusion.

The housing allowance goes along with any foreign income exclusion. The housing allowance includes all housing expenses over a small base amount.

You can save lots of money on your tax returns with these special breaks.

Note that IRC 911 works together with foreign tax credits. You don’t get both benefits at the same time.

A note about state taxes: When Americans move abroad to trade, they still owe U.S. taxes because of legal residency. But they often also give up domicile residency in their state. They become exempt from state taxes going forward.

Some states allow you to easily break residency (i.e. California), while other states do not (i.e. Utah). It depends on whether or not the state is considered a domicile state. Even though you may be considered a resident in a foreign country, some states do not recognize a foreign country as a new domicile.

There is relief from double taxation

International tax law tries to avoid double taxation – a citizen or resident of one country pays taxes on the same income in another country as well.

That's just plain unfair; almost all countries agree on this point and have adopted laws for relief.

There are two ways to prevent double taxation.

The first is to prevent double taxation from happening in the first place. This is usually accomplished with tax treaties between countries.

Second is the concept of foreign tax credits (or deductions). If you pay or owe taxes in one country, you should be able to claim a foreign tax credit in your home country.

States in the U.S. utilize a similar system for double taxation with state tax credits.

You may pay taxes in a higher-taxing country and later claim a tax credit in your lower-taxing home country. Hence, you pay higher taxes, but at least you are not stuck with double taxation. The U.S. has fairly low tax rates vs. many countries, so this is often the case in the U.S.

You can't double dip on tax benefits from IRC 911 and FTC. You may not take a foreign tax credit for taxes related to the foreign income exclusion amount.

Tax Treaties often apply

Income tax treaties often come into play; they are complex and vary significantly by country.

It's sort of like country-by-country trade negotiations – each case is different.

Your first step when you go abroad (physically or just with your money) is to find out if the U.S. has a tax treaty with that other county, and what the treaty provides for. Start at www.irs.gov and search tax treaties. Next, consult a professional.

Note that you still must file a regular tax return and then override the regular tax return positions with the tax treaty provisions that apply to you (and cite them accordingly). The IRS wants to know specifically what you are claiming.

Tax treaties often try to define which country should get tax payments on which income in the first place, so one country doesn't just grab all taxes and leave the home country to give tax credits.

Bottom line.

Open your horizons and trade globally for diversification and new lands of opportunity. Just understand the international tax laws and know that when you cross (tax) borders, there are potential tax benefits, pitfalls and costs. Be a smart global trader.