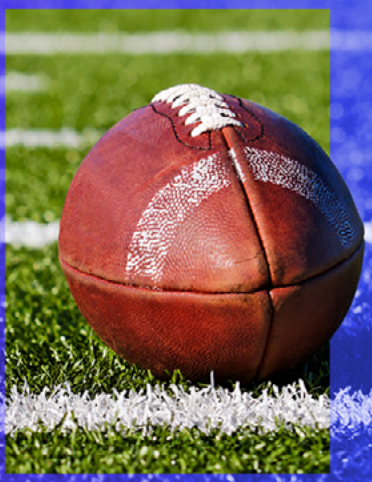
Potential tax implications for CFTC sports events futures contracts



Scope

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. The information contained herein is not intended to constitute tax advice for any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

Introduction

The trading of sports events futures contracts has gained popularity, with platforms like Kalshi, Polymarket, and Crypto.com offering them, beginning in conjunction with the 2025 Super Bowl. As with any financial instrument, understanding the tax implications is crucial for futures traders and investors. This document is intended to provide a high-level outline of certain significant tax considerations related to CFTC-regulated sports events futures contracts, including potential tax implications if sports events futures contracts were to be considered gambling transactions for federal and/or state purposes.

KPMG acknowledges that the legality of CFTC-regulated exchanges offering sports event futures is an evolving area, with the CFTC and state gambling regulators currently analyzing such contracts.

Tax treatment of futures contracts

1 Financial instruments or gambles?

The classification of sports futures contracts as either financial instruments or wagers/gambles is crucial for determining their tax treatment. If classified as financial instruments, then the character and timing of income or loss may depend on the characterization of the contract for tax purposes and the status of the holder.

2 Section[1] 1256 contracts

If sports futures contracts are viewed as financial instruments, then the first question on the tax analysis is whether these contracts would be treated as section 1256 contracts.

Generally, section 1256 establishes special rules for the recognition of gain or loss on "section 1256 contracts." Specifically, section 1256 requires that each section 1256 contract held by the taxpayer at the close of the tax year is treated as sold for its fair market value on the last business day of such tax year. This method of accounting is commonly referred to as "mark-to-market" accounting.

[1] Any reference in this document to the Internal Revenue Code (the Code) is a reference to the Internal Revenue Code of 1986, as amended. Any reference to a "section" (§) is a reference to a section of the Code. Any reference to Treasury Regulations or "Treas. Reg." is a reference to Treasury Regulations issued pursuant to authority contained in the Code and published in Title 26 of the U.S. Federal Register.

Any gain or loss under the mark-to-market method of accounting is treated as 60-percent long-term capital gain or loss and 40-percent short-term capital gain or loss, regardless of the amount of time the taxpayer actually held the contract.

For a contract to be considered a section 1256 contract, it must be traded on a "qualified board or exchange" such as "a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission."[2] With respect to sports futures contracts, it should be mentioned that as of March 2025, both Kalshi and Crypto.com have been granted Designated Contract Market status by the CFTC.

In addition, section 1256 defines five types of contracts traded on a qualified board or exchange that are treated as section 1256 contracts. A sports futures contract might be treated as either a "regulated futures contract" or a "nonequity option." In order to be treated as a regulated futures contract, the exchange on which the contract is traded must impose a margin requirement that would increase or decrease daily depending on the fluctuation in value of the position. If a sports futures contract is traded on a qualified board or exchange but does not satisfy the margining requirement to be treated as a regulated futures contract, then it might be treated as a nonequity option. However, given that the payout is defined with respect to the outcome of a sporting event rather than the change in value of a nonequity asset or index, it is not certain that this characterization would apply. Consequently, the mere fact that a sports futures contract is traded on a qualified board or exchange does not guarantee that the contract would properly be treated as a section 1256 contract.

Finally, it should be noted that certain contracts currently offered by exchanges are referred to as "swaps." Section 1256(b)(2)(B) explicitly excludes certain "swap" contracts from treatment as section 1256 contracts.

3 Alternative tax treatment: Ordinary income or loss

If sports futures are not treated as section 1256 contracts, then the question is whether they could qualify as an "option" under section 1234. This does not appear to be the case because sports are not based on "property" within the meaning of section 1234 and may not qualify as an "option" under section 1234.

Alternatively, sports futures could be viewed as a novel type of capital asset under section 1221. The contract would receive "open transaction" treatment with no income or loss realized until the contract settles or is disposed of (assuming that sports futures allow disposition prior to settlement). Selling a contract on the exchange could result in capital gain or loss while holding the contract to maturity and making or receiving the settlement payment would be treated as ordinary in character because the payoff occurs under the terms of the contract and thus is not made pursuant to a disposition of the contract. It should be noted, however, that the recognition of any loss might be deferred under the straddle rules of section 1092 or the matching rules for hedges could apply to income or loss if the contract is properly identified as a tax hedge (see below discussion on whether sports futures could qualify as tax hedges).

In addition, the "extinguishment doctrine" could potentially apply to make the settlement ordinary in nature. Finally, it could be argued that section 1234A, which requires capital gain or loss treatment on settlement of certain contract rights on property that would be a capital asset in the hands of the taxpayer, does not seem to apply to make the settlement amount capital in nature because there is no capital asset underlying a sports betting futures contract. Although Proposed Regulation (Prop. Reg.) 1.1234A-1(c) would treat gain or loss on settlement (including a payment made pursuant to the terms of the contract) of a "bullet swap" or "forward" contract as gain or loss from disposition of the contract, this regulation is merely proposed and it is not certain that a sports futures contract would fit within the scope of the contracts intended to be addressed by this Prop. Reg.

[2] Section 1256(g)(7)(C).

4 Alternative tax treatment: Status of the taxpayer with respect to the contract

The character of gain or loss from a financial instrument may also depend on the taxpayer's status with respect to the contract. Dealers in securities are generally required to mark their securities to market annually, and the character of the resulting gain or loss is generally ordinary. However, the definition of "security" in section 475(c)(2) excludes section 1256 contracts unless these contracts are identified as "hedges" of securities that are marked. It is not clear what types of securities, if any, listed in section 475(c) could be hedged by sports futures contracts. Moreover, the same uncertainty would apply to a trader in securities who elects mark-to-market treatment under section 475(f) and wants to consider using sports futures contracts as hedges of its securities. Consequently, it is not clear whether or how sports futures contracts could fit in with the securities portfolios of section 475 dealers and traders.

However, taxpayers could act as dealers in property outside the scope of section 475. In this case, for the purposes of determining the character of any income or loss on these contracts, the distinction between a "dealer" and a "broker" in exchange-traded contracts could be significant, because dealers trade as principals while brokers act as agents.

On the other hand, for investors in sports futures contracts, there are potential limitations on deducting any losses and expenses, especially as deductions for section 212 expenses are currently disallowed.

5 Industry convergence consideration—gambling winnings

If sports events futures contracts are classified as a sports betting transaction, then the capital gain or loss and any potentially favorable 60/40 treatment under section 1256 outlined above likely does not apply. Gambling winnings, including from sports betting, are considered ordinary income for federal purposes and in the vast majority of states. Such winnings are reportable regardless of whether a person receives a Form W-2G, which reports winnings above a certain threshold.

6 Industry convergence consideration—Hedging with a sports bet

If sports events futures contracts are treated as a financial instrument rather than a gambling transaction, then the ability to treat these contracts as tax hedges may be limited.

In general, a timely and properly identified hedging transaction is excluded from the definition of a capital asset under section 1221(a)(7) and thus produces ordinary gain or loss. In addition, Treasury Regulation (Treas. Reg.) 1.446-4 contains the hedge timing rules and requires the method of accounting for a hedging transaction to clearly reflect income by reasonably matching the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the items or items being hedged (the matching rule). It should be noted that the timing rules of Treas. Reg. 1.446-4 generally apply to hedging transactions regardless of whether the transactions have been timely and properly identified as tax hedging transactions.

With respect to what transactions could qualify for tax hedging treatment, section 1221(b)(2) defines a short list of specific types of risk, and specific types of assets and liabilities subject to those risks, that can be hedged for tax purposes. General "business risk," e.g., the risk of a general decline in business revenue that a taxpayer perceives might result from an adverse outcome of the event underlying a sports events futures contract, is not a specified risk that can be hedged for tax purposes. However, if a taxpayer is a merchant who sells sports memorabilia and fears that a particular outcome to a sports event might cause the value of the memorabilia to decline, the merchant might be able to support the position that a sports futures contract could be used as a tax hedge of the price risk of its inventory. On the other hand, if an individual engages in gambling as a trade or business, it is not certain whether the risk of loss on a sports event gamble can be treated as risk of "price changes" on "ordinary property" held by the individual that could be hedged for tax purposes by a sports futures contract.

Offsetting positions in "actively traded personal property" that do not fit the requirements for a tax hedge might create tax straddles under section 1092, which could result in deferral of losses and capitalization of carrying charges of the positions in the straddle. Although these effects might seem to be limited in the case of short-term contracts, the existence of a straddle can be extended under the rules for treating a straddle as part of a larger straddle or the rules for "successor positions."

Deductibility of losses

1 Capital losses

Capital losses from futures contracts can offset capital gains from other investments. If a trader's capital losses exceed their capital gains, then the excess loss can offset up to $3,000 ($1,500 if married filing separately) of ordinary income annually. Unused capital losses can be carried forward to future tax years. In addition, special rules under section 1212(c) may allow a noncorporate taxpayer to carry back loss from section 1256 contracts.

2 Deduction of trading or investing expenses

Traders may deduct expenses related to their trading activities, such as platform fees, research subscriptions, and other costs. Such amounts are typically deducted as business expenses under §162 in arriving at adjusted gross income.

Investors may also deduct similar expenses related to their trading activities, such as platform fees, research subscriptions, and other costs. However, such amounts are claimed under §212 as itemized deductions and subject to specified limitations. As noted above, deductions for §212 expenses are currently disallowed. It is not certain whether or when deductions for these expenses will be again allowed.

3 Industry convergence consideration—Gambling losses

A person is also permitted to deduct any gambling losses to the extent of gambling winnings as an itemized deduction on their personal tax return (subject to retaining adequate documentation for such losses). If sports events futures contracts are classified as a gambling transaction, then the netting of losses against winnings is likely available to bettors.

Tax reporting requirements

1 Form 6781

Traders and investors must report gains and losses from section 1256 contracts on Internal Revenue Service (IRS) Form 6781, "Gains and Losses from section 1256 Contracts and Straddles." This form details the mark-to-market calculations and the 60/40 split for tax purposes.

2 Form 1099-B

Brokerage firms or other exchanges offering sports events futures contracts will typically issue Form 1099-B to traders and investors, summarizing their annual transactions, including sales of securities and any related capital gains or losses. State equivalents may also be filed.

3 Industry convergence consideration—Gambling information reporting and excise taxes

a. W-2G and backup withholding

If sports events futures contracts were to be defined as a gambling transaction for federal and state tax purposes, then the broker or exchange may be required to provide the bettors with a Form W-2G to report gambling winnings. Such form is required to be issued in connection with a sports betting win of $600 or more and at least 300 times the amount wagered. In addition, 24 percent of such winnings must be withheld for federal taxes when the winnings exceed $5,000. Applicable state W-2G (or equivalent) reporting and withholding requirements may vary.

b. Federal excise tax

If sports events futures contracts were to be defined as a gambling transaction for federal tax purposes, then the amounts wagered would likely be subject to the federal excise tax imposed under section 4401. The applicable tax rates are 0.25 percent on legal wagers and 2 percent on illegal wagers. Such amounts are paid by the organization that records and processes the wager.

Exchanges offering sports events futures contracts should keep the excise tax rate disparity between legal and illegal wagers in mind. To the extent the IRS determines such contracts are considered wagering transactions, given that sports betting is not legal in all states, there is a potential risk that the IRS would take a position that such contracts executed by residents of states in which betting is legal are considered legal wagers subject to the 0.25 percent rate, while contracts executed by residents of states in which sports betting is not legal might be considered illegal wagers subject to the 2 percent rate. It is worth noting that there is some precedence for application of the disparate excise tax rates based on the IRS's stated position that fantasy sports entry fees are subject to the federal excise tax on sports betting.

State and local taxes

1 Futures contracts, in general

In addition to federal taxes, traders and investors must consider state and local tax obligations. Tax treatment can vary significantly by state, and both traders and investors should be aware of the specific rules and rates applicable to their jurisdiction. For example, certain states (e.g., California and New York, among others) tax capital gains at the same rate as ordinary income, while other states do not have a personal state income tax at all (e.g., Florida and Texas, among others).

2 Convergence consideration—State gaming and personal income taxes

If sports events futures contracts were to be defined as gambling transactions for state tax purposes, then not only would exchanges need to consider their ability to offer such contracts under each state's applicable gambling laws, but also the amounts wagered would likely be subject to the gross gaming revenue (GGR) taxes levied by the respective states that have legalized sports betting. GGR is the amount retained by sports betting operators after processing all wagers, paying out winning bets, and deducting additional expenses that may be allowable in each jurisdiction (e.g., promotions). Tax rates vary significantly by state, ranging from 6.75 percent in Nevada to 51 percent in New Hampshire, New York, and Rhode Island.

In addition to GGR taxes that would be borne by the exchanges, individuals with gambling winnings are also generally subject to state tax rates on ordinary income unless they are residents of a state without a personal income tax.

State-by-state gambling licensing requirements

While not the primary focus of this document, if sports events futures contracts are deemed to be gambling transactions for federal and/or state purposes, then it must be noted that the overall regulation of sports betting in the US since the 2018 repeal of the Professional and Amateur Sports Protection Act (PASPA) has broadly been administered on a state-by-state business, rather than at the federal level. Each state has its own specific regulations governing wagering activities, including sports betting. Brokers or exchanges offering such contracts will likely need to closely analyze and work with experienced legal counsel to address any specific state-by-state licensing requirements, as well as identifying states in which offering such contracts may not be permissible.

Conclusion

Understanding the tax implications of trading CFTC-regulated sports events futures contracts is essential for maximizing after-tax returns and remaining in compliance with federal and state tax regulations. CFTC-regulated exchanges and both traders and investors should consult with their tax providers to ensure they satisfy all applicable tax reporting requirements, recognize items of income and loss properly, and consider the availability of any possible tax elections.

Certain CFTC-regulated exchanges have announced their intent to expand the futures contracts offering to other sporting events and introduce additional features that may more closely resemble traditional sports betting wagers (e.g., player props and parlays). This continued industry convergence coupled with the unresolved classification of sports events futures contracts under CFTC regulations and intersection of those regulations with the federal sports betting excise tax rules and complex state-by-state gambling regulatory environment adds further uncertainty to the overall tax picture, given the drastically different tax treatment and related reporting obligations for futures contracts versus sports betting.

KPMG Gaming

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