

Taxation of sports event contracts

Part 1 (Income tax implications)



Executive summary

One of the most notable financial and gaming industry developments during 2025 was the explosion of sports event contracts on prediction markets such as Kalshi, Polymarket, or Crypto.com, and on more traditional exchanges such as the Chicago Mercantile Exchange (CME). While presenting a unique platform, particularly in states that have yet to legalize online sports betting, prediction markets have immediately attracted significant legal and regulatory scrutiny and differing views among industry stakeholders, as demonstrated in the recent decisions by FanDuel and DraftKings to surrender Nevada licenses, withdraw pending license applications, and leave the American Gaming Association.¹

This article provides a survey of the regulatory history and tax landscape, with emphasis on Commodity Futures Trading Commission (CFTC) oversight, potential tax classifications, and what such classification might mean for various user classes. There is much uncertainty, and a complex legal, regulatory, and legislative path likely lays ahead for the future of sports event contracts. Unless otherwise indicated, the discussion below (i) focuses solely on sports event contracts that are offered by CFTC-regulated contract markets (Kalshi, CME, etc.) and not those offered by unregulated exchanges and (ii) assumes that sports event contracts are CFTC-regulated financial derivatives (not gambling or gaming). Lastly, it should be noted that we are not offering an opinion on the legal classification of prediction markets contracts as financial derivatives or wagering transactions, nor are we advocating for or against any viewpoints held by respective industry stakeholders.

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¹ FanDuel, DraftKings abandon AGA trade group as rift over sports prediction markets grows, CNBC (Nov. 18, 2025).

1

Prediction markets—the basics

At their core, event contracts on the prediction markets, including sports event contracts, are derivative instruments whose payoff depends on the occurrence (or non-occurrence) of a specific, objectively measurable event. Unlike traditional financial derivatives that reference the value of an underlying asset (typically a commodity, stock, or debt instrument) these instruments instead reference discrete outcomes, including (but not limited to):

- Elections—For example, “Will Candidate X win State Y?” or “Will Congress pass Z bill by Y date?”
- Macroeconomic indicators—CPI release levels, non-farm payrolls, GDP prints.
- Digital assets—Will Bitcoin settle above/below \$100,000 on X date?
- Weather and climate events—Rainfall amounts, hurricane landfalls, temperature ranges.
- Sports—Whether a team wins a game, league, etc., or a player achieves a milestone.
- Financial index events—Whether the Fed raises rates at its next meeting.

Event contracts are generally referred to as “binary options” because the contract’s outcome is binary—the holder either receives a set value if the event occurs in the manner they selected or receives nothing and loses their initial investment. Until the contract settles as a result of the occurrence or nonoccurrence of the referenced event, these contracts trade in real-time with fluctuating prices on the market. Trades can easily be made on an app on one’s smartphone.

Following legal victories by prediction market exchanges with respect to the permissibility of election-based contracts,² 2025 saw a massive surge in sports event contracts, effectively trading on the outcome of particular sports games or contests, with significant growth anticipated during 2026. In recent months, several exchanges have launched predictive parlays, effectively combining multiple Yes/No trades into one contract that mimics the traditional sports gambling parlay bet.

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“Commodity” defined



The Commodity Exchange Act (CEA)³ defines the term “commodity” very broadly to not only include traditional agricultural products, but also “all services, rights, and interests (except motion picture box office receipts, or any index, measure, value or data related to such receipts) in which contracts for future delivery are presently or in the future dealt in.”⁴

Key points of CEA classification for event contracts include the following:

- Instruments may be classified as “commodities” when standardized, fungible, and traded on a derivatives platform.
- Binary event instruments often qualify as options or swap-like contracts.
- If instruments fall within the definition of a “contract of sale of a commodity for future delivery,” they become subject to the CEA and must be listed on a Designated Contract Market (DCM) or subject to an exemption.

Pursuant to the CEA, any contract on a commodity that involves future delivery or a contingent payment based on an event or index may fall within the CFTC’s jurisdiction. This broad definition allows the CFTC to treat many novel instruments (e.g., weather derivatives, cryptocurrency futures, and event contracts) as commodity interests.⁵ Indeed, the CFTC has repeatedly asserted its jurisdiction over event contracts structured as derivatives, regardless of the underlying event.

² See, e.g., *KalshiEX LLC v. Commodity Futures Trading Commission*, 119 F.4th 58 (D.C. Cir. 2024).

³ 7 USC § 1 *et seq.*

⁴ 7 USC § 1(a)(9).

⁵ P.L. 93-463, See Commodity Futures Trading Commission (CFTC), “The Commission,” <https://www.cftc.gov/About/AboutTheCommission>.

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CFTC's position on sports event contracts

The CFTC generally classifies “event contracts” as a type of commodity derivative, or in some cases as “excluded commodities” under the CEA,⁶ which includes events and occurrences not tied to tangible goods. However, not all event contracts are permitted, and the CFTC can generally prohibit event contracts based on:

- Gaming
- Unlawful activity
- Terrorism
- Assassination
- War
- Activities “contrary to the public interest”⁷



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Brief legislative and regulatory history

Early precedents (1990s–2000s)

- The Iowa Electronic Markets received academic no-action relief for trading small-dollar election markets.
- The CFTC invoked the Rule 40.11 review process and ultimately rejected of political events contracts that had been self-certified by Nadex.⁸

Dodd-Frank Act (2010)

Dodd-Frank expanded the CFTC's regulatory umbrella to include swaps, event-based instruments, and novel derivatives, reinforcing the agency's authority to prohibit derivatives deemed contrary to the public interest.

Event-based markets (2020s)

Much of the recent regulatory history largely revolves around Kalshi's requests to list election contracts. The CFTC has:

- Approved certain macroeconomic event contracts (e.g., inflation levels, weather, consumer sentiment).
- Initiated a Rule 40.11 review process of ErisX's self-certified futures contracts on NFL games,⁹ which were ultimately pulled prior to a CFTC decision being made.
- Attempted to reject or delay contracts involving elections, invoking CEA section 5c(c)(5)(C), which allows the CFTC to prohibit contracts contrary to the public interest.¹⁰
- Issued a Notice of Proposed Rulemaking (the “2024 NPRM”) to specify types of event contracts that fall within the scope of CEA section 5c(c)(5)(C) and are contrary to the public interest. The 2024 NPRM would also define “gaming” in detail, and the proposal lists illustrative examples of gaming that include staking or risking something of value on the outcome of a political contest, an awards contest, or a game in which one or more athletes compete, or an occurrence or non-occurrence in connection with such a contest or game.¹¹

⁶ 7 USC § 1(a)(19).

⁷ 7 USC § 7a-2(c)(5)(C)(i).

⁸ CFTC Issues Order Prohibiting North American Derivatives Exchange's Political Event Derivatives Contracts (Apr. 2, 2012), <https://www.cftc.gov/PressRoom/PressReleases/6224-12>.

⁹ CFTC Announces Review of RSBIX NFL Futures Contracts Proposed by Eris Exchange, LLC (Dec. 23, 2020), <https://www.cftc.gov/PressRoom/PressReleases/8345-20>.

¹⁰ KalshiEX LLC v. Commodity Futures Trading Commission, No.1:23-cv-03257, 2024 WL 4164694 (D.D.C. Sept. 12, 2024), *stay pending appeal denied*, 119 F.4th 58 (D.C. Cir. 2024).

¹¹ CFTC Issues Proposal on Event Contracts (May 10, 2024), <https://www.cftc.gov/PressRoom/PressReleases/8907-24>.

4. Brief legislative and regulatory history (Cont.)

- Issued CFTC Staff Letter 25-36 (the “2025 Staff Letter”), which stated that the CFTC had not been requested to take or taken any official action to approve the listing for trading of sports-related event contracts on any Designated Contract Market (DCM) and had not made a determination regarding whether any such contracts involve an activity prohibited under the CEA.¹²
- Issued Release No. 9185-26, an advisory asserting that it has full authority to police insider trading occurring on a prediction market registered as a DCM. This advisory followed public release of two incidents involving insiders trading event contracts based on nonpublic information.¹³

Sports event contracts

Sports-related derivatives raise concerns about conflicts with state sports-betting laws, overlap with gaming regulators, integrity risks in athletic contests, AML and Office of Foreign Assets Control regulations, lost federal and state gaming tax revenues, and responsible gaming initiatives. It should be noted that the CFTC has not yet specifically authorized sports-based contracts on a major DCM. Ultimately, the interpretation of “gaming” and whether sports outcomes fall into this category is currently the subject of numerous ongoing legal disputes and regulatory processes.¹⁴

It is worth noting that there has been a history of differing views among CFTC commissioners on event-based contracts. Prior to the current administration, the CFTC had taken the position, or at least suggested, that certain event contracts constituted gaming activity, as demonstrated by its 2023 order disapproving congressional control political event contracts self-certified by Kalshi, the 2024 NPRM, and the 2025 Staff Letter (discussed above).¹⁵ While Kalshi ultimately prevailed after a D.C. Circuit appeal,¹⁶ these examples highlight the fluid legal and regulatory uncertainty with respect to such contracts and even differing views among those who might carry ultimate responsibility for regulating such contracts, the resolution of which may well be driven by eventual Federal Circuit Court or Supreme Court decisions or potentially future acts of Congress. Such outcomes may be relevant to the taxation of these instruments. Indeed, recently appointed CFTC Chairman Michael S. Selig’s comments at the CFTC-SEC Event on Harmonization seemingly reflect a further shift in potential approach.¹⁷ Specifically, the CFTC has been instructed to

withdraw the aforementioned 2024 NPRM¹⁸ and 2025 Staff Letter.¹⁹ Chairman Selig also indicated that the CFTC would move forward with the following key steps:

- Drafting event contracts rules to establish clear standards and provide clarity to market participants.
- Reassess the CFTC’s participation in pending cases at federal district and circuit courts and defend its jurisdiction over commodity derivatives.
- Work with SEC counterparts to develop a joint interpretation of Title VII definitions and provide more clear and coordinated guidance with respect to commodity and security options, CFTC-regulated swaps, and SEC-regulated security-based swaps.²⁰

Consistent with these statements, on February 4, 2026, the CFTC announced that it had withdrawn the 2024 NPRM and the 2025 Staff Letter.²¹ The statements made by Chairman Selig in connection with the withdrawal and recent amicus brief would seem to suggest that guidance more favorable to prediction markets may be forthcoming.²²

Indeed, on March 12, 2026, the Division of Market Oversight’s Letter No. 26-08 highlighted compliance and product listing requirements for event contracts to which registered exchanges must adhere.²³

In addition, on the same day, the CFTC released an advanced notice of proposed rulemaking and request for public comment.²⁴



¹² CFTC Staff Advisory 25-36 (Sept. 30, 2025).

¹³ See <https://www.cftc.gov/PressRoom/PressReleases/9185-26>

¹⁴ Prediction Markets Legal Status Tracker (Apr. 21, 2025), <https://nexteventhorizon.substack.com/p/prediction-markets-legal-status-tracker>.

¹⁵ CFTC Disapproves KalshiEX LLC’s Congressional Control Contracts (Sept. 22, 2023), <https://www.cftc.gov/PressRoom/PressReleases/8780-23>.

¹⁶ KalshiEX LLC v. CFTC, No. 24-5205 (D.C. Cir. 2024).

¹⁷ The Next Phase of Project Crypto: Unleashing Innovation for the New Frontier of Finance, Remarks of Chairman Michael S. Selig at CFTC-SEC Event on Harmonization (Jan. 29, 2026), <https://www.cftc.gov/PressRoom/SpeechesTestimony/opaselig1>.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ CFTC Withdraws Event Contracts Rule Proposal and Staff Sports Event Contracts Advisory (Feb. 4, 2026), <https://www.cftc.gov/PressRoom/PressReleases/9179-26>.

²² CFTC Chairman Selig stated: “The 2024 event contracts proposal reflected the prior administration’s frolic into merit regulation with an outright prohibition on political contracts ahead of the 2024 presidential election. The Commission is withdrawing that proposal and will advance a new rulemaking grounded in a rational and coherent interpretation of the Commodity Exchange Act that promotes responsible innovation in our derivatives markets in line with Congressional intent.” *Id.*

See also <https://www.cftc.gov/PressRoom/PressReleases/9183-26>

²³ See <https://www.cftc.gov/PressRoom/PressReleases/9193-26>

²⁴ See <https://www.cftc.gov/PressRoom/PressReleases/9194-26>

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Are sports event contracts “futures” or “commodities”?

Sports event contracts are not considered traditional futures contracts on a physical commodity such as oil or corn. Instead, they are binary options where the payout depends on the outcome of an event. Said another way, assuming sports event contracts are not legally defined as a sports wager or not ultimately prohibited under the CEA as “gaming” event contracts, they likely fall under the *commodity derivatives* umbrella, as a specialized sub-category of *event contracts*, rather than classic futures. As noted above, this remains an evolving area as there are multiple ongoing legal cases related to prediction markets and their potential intersection with the state-by-state gambling law framework.



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How are sports event contracts taxed?



Classic tax answer incoming—it depends. Like many financial instruments, the tax treatment of a sports event contract depends on the classification of the instrument, the circumstances in which the transaction is entered into (e.g., in the context of a business or in the context of investment activities), and, in some cases, whether the taxpayer made certain elections or identifications.

As explained in greater detail below, the potential tax consequences vary significantly. In some potential situations, these contracts could produce ordinary income if the taxpayer “wins” and *completely* nondeductible losses if the taxpayer “loses.” This would actually be a far worse result than would occur if the activity was treated as a wagering activity because bettors who are either classified as professional gamblers or those who itemize deductions may be able to deduct up to 90 percent of their gambling losses for 2026 and prospectively.²⁵ However, in other situations, or under other interpretations of the law, a taxpayer could obtain capital gain/loss treatment under which gains could be subjected to lower tax rates and losses would generally be deductible for individuals (although perhaps not immediately). The attributes of the contract and the context in which it is entered into also inform the timing of income inclusions, with potential accounting methods including mark-to-market accounting, realization-based accounting, and hedge accounting. The complexity of this analysis and the uncertainty with respect to the tax law has led to a disjointed reporting environment, with different approaches taken by exchanges and a variety of positions espoused by commentators, ranging from treating these contracts as gambling income, ordinary income, or capital gains.

Below, we consider some of the potential permutations of this analysis, starting with the classification of these contracts.

²⁵ See Code Sec. 165(d), as amended by the One Big Beautiful Bill Act (OBBBA), which now provides that purposes of losses from wagering transactions, the amount allowed as a deduction for any taxable year is equal to 90 percent of the amount of such losses during such taxable year, and allowed only to the extent of the gains from such transactions during such taxable year. Unless otherwise indicated, all references to “Code Sec.” herein are to the Internal Revenue Code of 1986, as amended (the “Code”), and citations to “Treas. Reg. §” refer to the Treasury Regulations promulgated thereunder.

Tax classification of sports event contracts

Potential Section 1256 contract classification

Code Sec. 1256 establishes special rules for the recognition of gain or loss on certain qualifying contracts. Specifically, Code Sec. 1256(a) requires that each “section 1256 contract” held by the taxpayer at the close of the tax year be 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.

Any gain or loss recognized 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.²⁶

Section 1256 contract treatment is frequently viewed as a favorable classification for several reasons. First, many prediction market contracts are often held for relatively short periods of time, and the ability to generate long-term capital gains on short-term contracts may create significant tax savings for individual investors. Second, if prediction market contracts produce capital gains and losses, that means that they do not produce gambling losses that would be subject to the 90 percent gambling loss limitation (although this would have the drawback of offsetting the portion of capital gains taxed at preferential rates under Code Sec. 1256).

Types of section 1256 contracts

Under Code Sec. 1256(b)(1),²⁷ there are five types of section 1256 contracts:

- **Regulated futures contracts**—A contract (i) with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market, and (ii) which is traded on or subject to the rules of a qualified board or exchange.²⁸
- **Foreign currency contracts**—A contract (i) which requires delivery of, or the settlement of which depends on the value of, a foreign currency which is a currency in which positions are also traded through regulated futures contracts, (ii) which is traded in the interbank market, and (iii) which is entered into at arm’s length

at a price determined by reference to the price in the interbank market.²⁹

- **Nonequity options**—Any listed option which is not an equity option.³⁰ For this purpose, an option is “listed” if it is traded on (or subject to the rules of) a qualified board or exchange.³¹
- **Dealer equity options**—With respect to an options dealer, any listed option which (i) is an equity option, (ii) is purchased or granted by such options dealer in the normal course of his activity of dealing in options, and (iii) is listed on the qualified board or exchange on which such options dealer is registered.³²
- **Dealer securities futures contracts**—With respect to any dealer, any securities futures contract (as defined in the Securities Exchange Act of 1934³³), and any option on such a contract, which (i) is entered into by such dealer (or, in the case of an option, is purchased or granted by such dealer) in the normal course of his activity of dealing in such contracts or options, as the case may be, and (ii) is traded on a qualified board or exchange.³⁴

With the exception of foreign currency contracts, a common requirement across the various categories of section 1256 contracts is that the contract must be traded on a “qualified board or exchange.” That term includes “a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission.”³⁵ With respect to sports event contracts, multiple companies offering such contracts have been granted DCM status by the CFTC,³⁶ thereby satisfying the qualified board or exchange requirement for contracts on those particular exchanges.

However, trading on a qualified board or exchange is not the only requirement that must be met for an instrument to be classified as a section 1256 contract. To be considered a regulated futures contract, the contract must be subject to a margining system under which “the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market.”³⁷ Because prediction market contracts are binary, a taxpayer will never be required to post additional margin or collateral because

²⁶ If a contract is terminated prior to year-end (when the mark to market occurs), the resulting gain or loss is still treated as 60-percent long-term/40-percent short-term. Code Sec. 1256(c).

²⁷ The definitions of the various types of section 1256 contracts are included in Code Sec. 1256(g). Code Sec. 1256(b)(2) also excludes from the definition of a section 1256 contract most securities futures contracts and swap contracts.

²⁸ Code Sec. 1256(g)(1).

²⁹ Code Sec. 1256(g)(2).

³⁰ Code Sec. 1256(g)(3).

³¹ Code Sec. 1256(g)(5).

³² Code Sec. 1256(g)(4).

³³ Code Secs. 1256(g)(9)(C), and 1234B(c).

³⁴ Code Sec. 1256(g)(9).

³⁵ Code Sec. 1256(g)(7)(B).

³⁶ <https://www.cftc.gov/IndustryOversight/IndustryFilings/TradingOrganizations>

³⁷ Code Sec. 1256(g)(1)(A).

the full potential loss that could be sustained by the taxpayer is covered by the initial cash outlay. In other words, the exchange will, in all cases, be fully collateralized on each contract without the user posting additional collateral. If a user's event contract appreciates in value, the user may "cash out" the contract and receive the appreciation. However, unlike a typical margining system, a "cash out" would terminate the contract. Entering into a new contract once an existing contract is appreciated would be akin to a mark to market margining system but seems to fall short of the generally understood meaning of that phrase. In addition, terminating a contract and entering into a new contract would incur fees, making this dissimilar from a typical margining system not only in form but also in substance. Thus, it would not seem likely that the definitional requirements for a regulated futures contract are met.

However, classification of sports event contracts as "non-equity options" appears to hold more promise. To be classified as a nonequity option the contract must be (i) an option; (ii) not be an option to buy or sell stock or have a value determined by reference to stock or a narrow-based security index;³⁸ and (iii) "listed" (i.e., traded on or subject to the rules of a qualified board or exchange).³⁹ In the case of contracts that are traded on a qualified board or exchange, the "listed" requirement is met. It is also relatively self-evident that the second requirement is met, at least with respect to sports event contracts, because they do not reference securities.⁴⁰ The only requirement that is unclear is the first—whether event contracts are "options."

Meaning of the term "option"

Code Sec. 1256 does not define the term "option." In fact, even though the term "option" appears in other provisions of the Code, neither the Code nor the Treasury Regulations defines the term "option." Instead, the parameters of what may constitute an "option" for tax purposes appears to have been left to the courts. As noted by one commentator, an option is fundamentally a contract that is antecedent to some other, more fundamental transaction; that is, buyers in effect pay a nonrefundable amount in return for time to decide whether or not to conclude an underlying transaction.⁴¹

In other contexts, courts have defined an option contract as requiring the following two elements: "(1) a continuing offer to do an act, or to forbear from doing an act, which does not ripen into a contract until accepted; and (2) an agreement to leave the offer open for a specified or reasonable period

of time."⁴² Commentators have noted that while the courts have used varying language to describe an option, the three aspects of an option are "(i) a unilateral agreement entered into for consideration (ii) that binds [the option writer] to buy or sell property and (iii) gives [the option holder] the right, but not the obligation, to sell or buy that property."⁴³ Given the requirement in (iii), the parties' obligations to perform their respective sides are not symmetrical.⁴⁴

The meaning of the word "option" was recently considered in *GWA, LLC v. Commissioner*.⁴⁵ In that case, the Tax Court held that so-called "basket option" contracts entered into between the taxpayer and a third-party bank regarding various securities were not call option contracts; instead, the substance of the transactions was that the taxpayer owned the underlying securities. Put another way, the Tax Court determined that a purported option was not, in substance, an option. In doing so, the court considered whether the contracts: (i) provided for consideration, such as an option premium; (ii) were priced in the same manner as traditional options; (iii) had excessively long terms; (iv) allowed for changes to the reference assets; (v) allowed the grantor to terminate the purported option; (vi) provided for adjustments for dividends on the referenced stock; (vii) created risk to the option grantor; and (viii) created true optionality.

With the possible exception of factor (ii), i.e., whether the option is priced in the same manner as traditional options, these factors suggest option contract treatment may be appropriate for event contracts.⁴⁶ With respect to this factor, it is true that pricing of sports event contracts is based on relative demand for the contracts, rather than traditional option pricing methods. However, in many cases involving illiquid property traditional option pricing is not used, but the contract is nevertheless considered an "option." For example, courts and commentators have suggested that option treatment is appropriate for lending commitments, where the traditional option pricing methods are not applied.⁴⁷ Thus, it does not seem that this is a prerequisite to option treatment if the other factors are present.

In *GWA*, analyzing factor (viii) the Tax Court concluded that the purported options would be exercised in all cases and therefore lacked "optionality." In the case of sports event contracts, there will only be a payout or "exercise" if the contract is in the money. Thus, unlike the situation in *GWA*, event contracts are not exercised in all situations, such that this factor would appear favorable to option treatment.

³⁸ For this purpose, a narrow-based security index is defined in Code Sec. 3(a)(55) of the Securities Exchange Act of 1934.

³⁹ Code Sec. 1256(g)(3), (g)(5), (g)(6).

⁴⁰ For contracts that reference events such as corporate earnings or share prices, this conclusion may not be appropriate. This line of inquiry is outside the scope of this article.

⁴¹ Kevin J. Liss, *The Option Conundrum in Tax Law: After All These Years, What Exactly Is an Option?*, 63 Tax Law. 307 (2010). See also Bruce Kayle, *Realization Without Taxation? The Not-So-Clear Reflection of Income from an Option to Acquire Property*, 48 Tax Law 233 (1993).

⁴² Federal Home Loan Mortgage Corporation v. Commissioner, 125 T.C. 248, 259 (2005) ("Freddie Mac") (citing *Saviano v. Commissioner*, 87 T.C. 955, at 970 (1983), *aff'd*, 765 F.2d 643 (7th Cir. 1985)). See also *Old Harbor Native Corp. v. Commissioner*, 104 T.C. 191, 201 (1995).

⁴³ J. Walker Johnson & Bridget Kelly, *Tax Restrictions Can Impede the Use of Options to Manage Risk*, Tax Notes, Oct. 6, 2014.

⁴⁴ *Supra* note 41.

⁴⁵ T.C. Memo. 2025-34.

⁴⁶ More specifically, factors (i), (iii), (iv), (v), (vi), and (viii) would favor option treatment. Factor (vii) is inapplicable.

⁴⁷ See *Federal Home Loan Mortgage Corporation v. Commissioner*, 125 T.C. 248 (2005); New York State Bar Association, *Report on Certain Fees*, Report No. 1500 (Sept. 13, 2024) ("A substantial majority of the Executive Committee of the Tax Section believes that Capital Providers and issuers should treat Commitment Fees like option premiums, with 'Commitment Fees' defined as payments for a commitment to provide capital or purchase a Security, if the funding or issuance of the Security is at the election of the issuer as opposed to the Capital Provider (whether labeled commitment fees, ticking fees, unused fees, backstop fees, standby fees or some other term).") See also Shapiro, Yaghtmour, Schneider, *A Tax Field Guide to Debt-Related 'Fee' Income*, 106 Tax Notes 8 (June 3, 2014); Dunn, *How Could This Possibly Be? We Don't Know What to Do with a Fee*, The Tax Club (May 21, 2014).

However, we are aware that some practitioners question whether sports event contracts can be considered to have optionality because a contract will pay out automatically at maturity if it is a “winning” contract rather than as the result of a formal exercise by the taxpayer. However, it could be argued that sports event contracts payout mechanics are not unlike cash-settled options subject to automatic exercise immediately prior to lapse. In both cases the holder of the option may terminate the position prior to maturity and receive the value of the option contract. Further, in both cases the contract exercises automatically at maturity if it is in the money. Cash settled option contracts subject to automatic exercise are generally regarded as option contracts for tax purposes. More fundamentally, if a cash-settled contract is in the money, the holder should always exercise the contract immediately prior to exercise, so it is not clear that a mechanical exercise request should be necessary.⁴⁸ Therefore, it would not appear that optionality is necessarily lacking either.

A final point of potential distinction is in the payout profile of a sports event contract. Unlike a traditional option contract, an event contract payout is “binary” in the sense that the holder either loses its investment or receives a predefined payout at maturity if the referenced event occurs.

It is not clear that this feature should be sufficient to defeat option characterization. In this regard, the taxpayer in *GWA* attempted to analogize its option contracts to barrier options. Similar to binary options, barrier options have an “all-or-nothing” payoff based on whether an underlying asset’s price is above or below a specific strike price at expiration. In its decision, the Tax Court seemed to suggest that barrier options would generally be considered option contracts for tax purposes if they were not part of an abusive basket transaction that lacked the intrinsic substance of an option.⁴⁹

One final point for consideration is that the CFTC has referred to prediction market contracts as binary *options*.⁵⁰ Given that the characterization of a contract as a section 1256 contract looks in substantial part to CFTC determinations (e.g., whether the exchange is a qualified board or exchange) it would seem logical to also give some weight to CFTC interpretations in determining whether a financial instrument is an option.⁵¹

In addition to the considerations above, we also note that Code Sec. 1256(b)(2)(B) excludes from the definition of a section 1256 contract various types of swaps, including commodity swaps. Some have suggested that sports event contracts could be classified as commodity swaps for regulatory purposes. If that is the case, it is possible that such contracts would be excluded from section 1256 contract status.⁵²

Treatment of non-section 1256 contracts

Prediction market contracts may not qualify as section 1256 contracts because the exchange on which they are listed is not a “qualified board or exchange” or, potentially, because the contract does not meet the definitional requirements of an “option.” In those situations, the prediction market contracts may be classified as a non-section 1256 derivative instrument.

How might such an instrument be taxed? In general, if the taxpayer is an investor or trader, the taxpayer would realize gain or loss on the contract when the contract settles—that is, using a realization-based method of accounting. What is less clear is whether the resulting gain or loss is capital or ordinary.

A bit of background is necessary here. The definition of capital gain or loss under Code Sec. 1222 requires a “sale or exchange” of a “capital asset.” Event contracts are likely to be capital assets in the hands of most taxpayers. However, under a judicial “extinguishment doctrine” courts have held that the termination of an instrument is not a “sale or exchange” and therefore cannot, as a general matter, result in capital gain or loss. For example, in *Fairbanks v. United States*,⁵³ the Supreme Court held that “a payment and discharge of a bond is neither a sale nor exchange within the commonly accepted meaning of the words.”⁵⁴ In other words, the repayment of a debt simply terminates or extinguishes the obligation.⁵⁵ Relying on the theory that a payment in discharge of a debt obligation is not a sale or exchange, courts applied the same reasoning to the treatment of payments made or received to terminate or extinguish other contracts. For example, in *Commissioner v. Starr Brothers*,⁵⁶ the Second Circuit held that a payment to terminate an exclusivity contract was ordinary income to the taxpayer because there was no sale or exchange of the contract as it was merely extinguished as a result of the termination payment.⁵⁷

⁴⁸ One reason for the existence of automatic exercise features is to protect option holders from a loss of value that would occur if they forgot to exercise an in-the-money option prior to its lapse.

⁴⁹ T.C. Memo. 2025-34 (“The first question we must decide is whether the ‘option’ form of the Barrier Contracts should be disregarded for Federal income tax purposes, and whether GWA should be treated, in substance, as owning the securities in the underlying reference baskets. If GWA is determined to have been the owner of the basket securities for Federal income tax purposes, it would be required to recognize, on an annual basis, the profits it realized from trading those securities each year. By contrast, the holder of a standard option contract will recognize gain or loss only for the taxable year when the option is exercised, is terminated, or expires worthless.”) (citations omitted). See also Liss, *supra* note 41, at pp. 42-43.

⁵⁰ CFTC Staff Issues No-Action Letter Regarding Event Contracts (July 23, 2025), <https://www.cftc.gov/PressRoom/PressReleases/9099-25>.

⁵¹ Cf. Rev. Rul. 73-158, 1973-1 C.B. 337 (in determining whether the sale of sugar was a commodity transaction, the IRS looked to whether the actual commodity or commodity futures were traded on commodity exchanges in the United States, which suggests deference to CFTC determinations). Admittedly, the event contracts listed currently have been listed pursuant to self-certification rather than a definitive CFTC determination.

⁵² The legislative history to Code Sec. 1256(b)(2)(B) and IRS guidance interpreting that rule may suggest it is intended to cover instrument that would otherwise be notional principal contracts, which event contracts would not be. A full discussion of this rule is beyond the scope of this article.

⁵³ 306 U.S. 436, 437 (1939).

⁵⁴ Lower courts were in disagreement as to the correct treatment. *Compare* *Averill v. Commissioner*, 101 F.2d 644 (1st Cir. 1938) (holding that retirement of a debt was a sale or exchange), *with* *United States v. Fairbanks*, 95 F.2d 794 (9th Cir. 1938) (holding that the redemption of bond was not a sale or exchange). The Board of Tax Appeals initially treated the retirement as a sale or exchange in *Werner*, 15 BTA 482 (1929), and later reversed itself in *Watson*, 27 BTA 463 (1932).

⁵⁵ *Bingham v. Commissioner*, 105 F.2d 971, 972 (2d Cir. 1939) (“What may have been property in the hands of the holder of the notes simply vanished when the surrender took place and the maker received them.”).

⁵⁶ 204 F.2d 673 (2d Cir. 1953).

⁵⁷ See *Commissioner v. Pittston Co.*, 252 F.2d 344, 347-48 (2d Cir. 1958) (The payment received to terminate an exclusive contract to purchase the coal output of the counterparty was “solely for the termination of the right-duty relationship between the two parties to the agreement.” Thus, the court held that the payment was ordinary income to the taxpayer because the right was “a naked contract right, not in the nature of a lease or profit a prendre.”) See *Leh v. Commissioner*, 260 F.2d 489 (9th Cir. 1958); *General Artists Corp. v. Commissioner*, 205 F.2d 360 (2d Cir. 1953).

The scope of the extinguishment doctrine was uncertain; the termination of some types of contracts *were* treated as a sale or exchange of the right that was terminated. In those situations, the termination was treated as a transfer to the other party of an interest that arguably survived the termination of the contract. A payment to terminate a lessee's interest in a lease was treated as a transfer of the leasehold to the lessor, and a payment to terminate a life tenancy was treated as a payment for transferring the property interest to the remainderman.⁵⁸

This distinction was made clear in *Stoller*, where the court considered whether the cancellation of certain investment contracts should be treated as ordinary income or loss. For its part, the government argued that the cancellations were tantamount to a sale and should therefore be treated as a "sale or exchange" under substance-over-form principles. The court disagreed, stating: "the underlying contracts were canceled in substance as well as in form. When a contract was canceled, it did not merely change hands; it ceased to exist altogether."⁵⁹ Thus, in transactions where a contract ceases to exist (e.g., a termination as opposed to an assignment), the extinguishment doctrine may control as a general matter.

Over time, the scope of the extinguishment doctrine has been narrowed considerably by the enactment of Code Secs. 1234, 1234A, 1234B, 1241, and 1271. When applicable, these provisions generally deem a "sale or exchange" to create parity between the treatment of a sale or exchange of the contract and its termination.⁶⁰

If a sports event contract is viewed as an option contract that is not a section 1256 contract because it is not entered into on a qualified board or exchange, the character of gain or loss on the contract would generally be determined under Code Sec. 1234. If the contract is some other type of derivative contract, the character of gain or loss on the contract would generally be determined under Code Sec. 1234A. Both of these rulesets generally look to the character of the underlying property to determine the character of gain or loss realized in connection with the termination of the derivative instrument.

This begs the question—is there an "underlying" for a sports event contract? One cannot "own" the outcome of a sporting event—it simply is not "property" in the conventional sense.

In situations where there is no underlying "property" to the derivative, Code Sec. 1234 and Code Sec. 1234A would be inapplicable and the extinguishment doctrine would arguably control. Therefore, if a sports event contract falls outside the scope of Code Secs. 1234 and 1234A, it is not clear that the contract would give rise to capital gain or loss upon settlement.

If a sports event contract falls outside of Code Secs. 1234 and 1234A, taxpayers could potentially realize ordinary gain upon termination or maturity under the extinguishment doctrine, rather than more favorable capital gains treatment. Worse still, losses on contracts would be entirely nondeductible by individual taxpayers entering into a contract in an investment capacity, given that only certain deductions are allowed in computing adjusted gross income (above-the-line deductions), such as those arising in connection with a trade or business.⁶¹ All other deductions are itemized deductions, except for certain specified deductions (including the standard deduction). Under prior law, miscellaneous itemized deductions were allowed to the extent that the aggregate of the deductions exceeded two percent of adjusted gross income. However, the Tax Cuts and Jobs Act (TCJA)⁶² suspended the deductibility of miscellaneous itemized deductions through 2025 and the inability to deduct was made permanent by reason of the OBBBA.⁶³ Miscellaneous itemized deductions are defined generally as all itemized deductions other than medical and dental expenses, taxes, interest charitable contributions, casualty, and theft losses.⁶⁴ Ordinary losses on event contracts would not fall within any of these categories and would therefore be subject to the miscellaneous itemized deduction rules for individuals. Thus, outside of the context of a trade or business, this result may be even worse for individuals than treating the contract as a wagering transaction.

But again, the scope and ongoing validity of the extinguishment doctrine is not entirely clear, and the IRS has at times taken positions that would conflict with the extinguishment doctrine. For example, in two Field Service Advice Memoranda issued by the IRS in 1993⁶⁵ the IRS took the position that a payment made to terminate an interest rate swap is treated as capital loss, taking a broad view of the terms "property" and "sale or exchange." In one FSA the IRS noted that "an argument could be made that section 1234A also applies..." but went on to indicate that it would

⁵⁸ See *Commissioner v. McCue Bros. & Drummond, Inc.*, 210 F.2d 752 (2d Cir. 1954); *Commissioner v. Ray*, 210 F.2d 390 (5th Cir. 1954); *Commissioner v. Golonsky*, 200 F.2d 72 (3d Cir. 1952).

⁵⁹ *Stoller v. Commissioner*, 994 F.2d 855, 857 (D.C. Cir.), *amended*, 3 F.3d 1576 (D.C. Cir. 1993).

⁶⁰ Although a full discussion of the history of these rules is outside the scope of this article, we note that these rules were enacted to address concerns of taxpayer electivity. Courts had determined that the termination of a derivative instrument was not a "sale or exchange" because the derivative disappeared in the transaction (i.e., a sale or exchange necessarily requires the survival of the property being "sold" or "exchanged"). Thus, taxpayers with gain contracts could sell the contract to obtain favorable capital gains treatment and taxpayers with contracts in a loss would terminate the contract to obtain an ordinary loss. See Michael Kosnitzky and Rebecca M.G. Zuks, *Code Sec. 1234A and the Taxation of Gains and Losses From Terminated Agreements*, *Journal of Taxation* (January 2019); Matthew Stevens, *Taxing Derivatives: Do Look-Through Rules Work?*, *Taxes – The Tax Magazine* (March 2013); Michael S. Farber, *Capital Ideas: The Taxation of Derivative Gains and Losses*, *Tax Notes*, March 22, 2010.

⁶¹ Code Sec. 62(a)(1).

⁶² Pub. L. 115-97.

⁶³ Code Sec. 67(h).

⁶⁴ Code Sec. 67(b).

⁶⁵ Field Service Advisory (Mar. 22, 1993), *available at* 1993 WL 1470226; Field Service Advisory (Aug. 6, 1993), *available at* 1993 WL 1469628.

not litigate using that argument. In the second FSA, the analysis and conclusion included were largely consistent with the previous FSA. However, the IRS noted the intervening decision in *Stoller v. Commissioner*,⁶⁶ (discussed above) had created “substantial litigation hazards.” While perhaps not a ringing endorsement of the capital gain or loss position, this guidance may provide some basis for treating non-section 1256 event contracts as producing capital gain or loss because, similar to event contracts, interest rate swaps do not have an underlying asset and instead reference interest rates.

A third possibility—substance versus form

A third potential possibility is one related to substance versus form or asked more simply, “is it just gambling?” Given the frequent use of prediction markets to acquire event contracts on sporting events that resemble traditional sports wagers, it is worth considering whether the form and payout mechanics of a particular transaction is controlling as to its taxation. Should taxpayers really be able to obtain a markedly different taxation result by making what is arguably a sports bet through prediction market contracts?

While this is a reasonable question, we note that “form” is not entirely devoid of substance in the context of a contract offered on a DCM. Congress determined that qualified boards and exchanges had certain unique characteristics that warranted a different tax regime for certain contracts entered into on those exchanges. It is not clear a departure from the Congressionally sanctioned tax regime is warranted, even on account of parity concerns. In this regard, a comparison can be made to the evolution of Code Sec. 1256 with respect to foreign currency contracts. In the past taxpayers were able to achieve significantly different tax outcomes by choosing between regulated futures contracts over foreign currency and (economically similar) foreign currency forward contracts with bank counterparties. Regulated futures were subject to mark to market accounting under Code Sec. 1256 while foreign currency forwards were subject to a realization-based method of accounting. Concerns over taxpayer electivity led to the expansion of Code Sec. 1256 to cover currency contracts that were not entered into on a qualified board or exchange.⁶⁷ Congress, not the courts, addressed this issue and did it through legislative amendment to Code Sec. 1256. Congress could do the same with sports event contracts

In addition to the history of Code Sec. 1256, the Code and Treasury Regulations are replete with examples of taxation hinging upon the form of the contract in question. Many notional principal contracts are economically akin to a series of cash settled forward contracts but are not taxed in anything close to the same manner.⁶⁸ Similarly, a total return swap over an equity is economically akin to debt

financed purchase of the equity, but again, is subject to markedly different taxation. While perhaps not desirable as a policy matter, the realm of financial products is sometimes formalistic. Accordingly, if sports event contracts are properly regarded as financial products (which again is an open question), an argument can be made that they should be taxed under the general financial product rules, rather than by inquiry into the subjective motives of the parties that enter into the contracts.

So-called “meme stocks” and certain crypto assets offer a point of comparison. In many cases the price of these assets departs from any true notion of fundamental value, leading the venerable Warren Buffet to characterize that corner of the market as a “gambling parlor.”⁶⁹ Although it may be gambling in substance, there is general agreement that meme stock and highly speculative digital assets are nevertheless subject to the general rules governing gains and losses on capital assets. As the adage goes, perhaps the distinguishing factor between a gambling wager and a financial transaction is “the green felt.”⁷⁰

Door number four – the “hobby loss” rule

Code Sec. 183 is designed to prevent taxpayers from using losses from personal hobbies to offset other taxable income (e.g., from salary or investments), distinguishing between activities engaged in for-profit and activities that are primarily for personal pleasure or recreation. Prior to 2018, when an activity was determined to be a hobby, a taxpayer itemizing deductions could potentially deduct the associated expenses up to the amount of income generated from such hobby, subject to satisfying a “for profit” test under Treas. Reg. § 1.183-2(b) as well as the two percent of adjusted gross income limitation applicable to miscellaneous itemized deductions, which includes hobby expenses. As noted above, the TCJA eliminated such miscellaneous itemized deductions through the 2025 tax year, with permanent elimination due to the passage of OBBBA in 2025 (with the exception of qualified qualifying educator expenses).⁷¹ As a result, if the IRS were to determine, based upon all facts and circumstances, that taxpayers investing in sports event contracts were to be treated as engaged in a hobby activity, that would give rise to a significantly adverse tax result for such taxpayers. Specifically, they may be required to recognize ordinary income on contract gains with no ability to deduct contract losses or expenses associated with investing in such contracts. As one can imagine, this is potentially a far more unfavorable result for the casual investor than if the activity were treated as short term capital gains and losses or even income from wagering activities since some taxpayers may still be able to deduct wagering losses, subject to the 90 percent loss limitation under OBBBA.

⁶⁶ 994 F.2d 855 (1993).

⁶⁷ Technical Corrections Act of 1982, Pub. L. No. 97-448 (1982).

⁶⁸ TAM 9730007 (Apr. 10, 1997) (concluding that the periodic payments under a commodity swap gave rise to ordinary income and expense).

⁶⁹ Warren Buffett Says Markets Have Become a ‘Gambling Parlor,’ The Wall Street Journal, Apr. 30, 2022.

⁷⁰ As discussed below, for purposes of the federal excise tax a clear distinction is made in this regard. See Code Sec. 4421 and Treas. Reg. § 44.4421-1(c)(2).

⁷¹ Pub. L. 119-21 – section 70110.

8

Market-maker considerations

The prediction markets frequently rely on liquidity from market makers. In many situations, these entities' activities would qualify them as a dealer or trader.⁷² Dealers and traders in commodities may make elections under Code Sec. 475(e) and (f) (respectively) to mark commodity positions to market. The resulting gain or loss is ordinary in character.

Commodities for purposes these provisions include actively traded commodities, derivative positions in commodities, and hedges with respect to commodities that are identified as such before the close of the day on which the position is entered into.⁷³ The IRS has in the past deferred to CFTC determinations as to what is a commodity.⁷⁴ Although sports event contracts are not the tangible goods normally thought of as commodities, they are traded on exchanges designated as contract markets by the CFTC and might therefore plausibly be classified as commodities. This argument would be stronger if the CFTC affirmatively and formally designates sports event contracts as commodities in the future (currently event contracts are listed pursuant to self-certifications by the exchange).

Because Code Sec. 475 requires gains and losses to be characterized as ordinary, this result is likely most attractive to taxpayers that would not benefit from capital gains treatment. For example, a high frequency trader that is a corporation and provides liquidity on an exchange may prefer ordinary character treatment to ensure capital losses are not deferred. Similarly, a taxpayer engaging in arbitrage operations between exchanges may prefer uniformity of character that would not otherwise be possible if some exchanges are qualified boards or exchanges (on which the contracts are section 1256 contracts) and some are not qualified boards or exchanges (such that the contracts are not section 1256 contracts).⁷⁵

⁷² Whether such taxpayers are dealers or traders depends on exactly how their operation is run. For further discussion on whether market makers are dealers or traders, see Matthew Stevens and Huvie Weinreich, *Making Markets, Making Trouble?*, 185 Tax Notes Federal 1975 (Dec. 9, 2024).

⁷³ Code Sec. 475(e)(2).

⁷⁴ Rev. Rul. 73-158, 1973-1 C.B. 337.

⁷⁵ Unlike the rules for securities dealers and traders, which exclude Code Sec. 1256 contracts from the definition of a security under Code Sec. 475(c)(2)(E), the definition of a "commodity" under Code Sec. 475(e)(2) generally trumps Code Sec. 1256 treatment.

⁷⁶ Code Sec. 1221(a)(7); Treas. Reg. § 1.1221-2(a). The consequences of misidentification (or of non-identification) can be very high. If a taxpayer identifies a transaction as a Code Sec. 1221 hedge, but the transaction does not qualify as a Code Sec. 1221 hedge, any gain on the transaction will be ordinary gain, whereas the character of any loss on the transaction will be determined under general tax principles. Treas. Reg. § 1.1221-2(g)(1)(i). Similarly, if a taxpayer fails to properly identify a Code Sec. 1221 hedge that clearly qualifies as such, any gain on the Code Sec. 1221 hedge will be ordinary income, whereas the character of any loss on the transaction will be determined under general tax principles. Treas. Reg. § 1.1221-2(g)(2)(i). In certain cases, a taxpayer may qualify for an exception for inadvertent errors. See Treas. Reg. § 1.1221-2(g)(1)(ii), (2)(ii).

⁷⁷ Rev. Rul. 2003-127, 2003-2 C.B. 1245. The tax hedging rules do not, however, appear to override statutory timing rules. See, e.g., *Furlow v. United States*, 55 F. Supp. 2d 360, 364 (D. Md. 1999) ("It is a fundamental principle of American law that legislative statutes take precedence over conflicting administrative regulations.").

⁷⁸ Treas. Reg. § 1.446-4(b).

9

Special considerations for hedgers

One argument for allowing sports event contracts on prediction markets is that such contracts could serve a hedging function. For example, a restauranter near a sports venue might have significant economic exposure to the outcome of a sports event (e.g., fans might be more likely to celebrate after a win than after a loss). That taxpayer might enter into prediction market contracts to hedge exposure to a loss. Similarly, merchants in baseball cards and other memorabilia may wish to hedge exposure to various outcomes for particular players. In these situations, the event contracts economically offset transactions that produce ordinary income or loss. If the sports event contracts produce capital gain or loss (for example, if sports are appropriately classified as section 1256 contracts), a character mismatch could result. In addition, section 1256 mark-to-market accounting would likely not match the corresponding income or loss on the hedged transactions.

Might the hedging rules be a potential avenue of alignment? Under Code Sec. 1221, hedging transactions produce ordinary gain or loss, provided the transaction is identified as a hedge on or before the day it is entered into.⁷⁶ Tax hedging transactions generally are also subject to the hedge timing rules outlined in Treas. Reg. § 1.446-4. The hedge timing rules generally override other regulatory timing rules irrespective of whether the hedging transactions are properly identified.⁷⁷ Generally, the hedge timing rules require the matching of income, deduction, gain or loss on a tax hedging transaction with the income, deduction, gain or loss on the item (or items) being hedged.⁷⁸

A hedging transaction is defined in Code Sec. 1221(b)(2)(A) and Treas. Reg. § 1.1221-2(b) as any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily to (i) manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer, or (ii) manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer. With respect to the transactions described previously, it would seem that the hedger of sports memorabilia could potentially avail herself of the tax hedging rules under Code Sec. 1221. However, in situations where the hedged item is lost revenues, such as with a restaurateur near a sports venue, it is less clear that hedging treatment is available.

Convergence between gambling and trading

Although the classification of prediction market contracts and the base-case rules applicable on the basis of that classification are a significant portion of the overall tax analysis, it is not the only relevant consideration. Also relevant is the *context* in which the contract is entered into. If a taxpayer enters into a sports event contract in the context of a trade or business, ordinary loss on the contract would be deductible. For individual taxpayers this is especially significant given the limitations placed on miscellaneous itemized deductions (as noted above).

Might this potentially provide a more favorable tax regime for professional gamblers? The answer depends. Whether entering into financial product transactions constitutes a trade or business has generally been viewed through the dealer, trader, or investor lens. Professional gamblers do not have customers, so it would not appear that they would qualify as dealers. Taxpayers that regularly enter into sports event contracts and transact at significant volume with a view toward capturing short-term swings in contract pricing may qualify as traders. However, in some cases, certain professional gamblers may transact at relatively low volume

and with a view toward profiting off a mispricing of betting spreads vis-à-vis their likelihood of occurrence, rather than attempting to capture short-term swings in market pricing. This is similar to an investor acquiring a financial product on account of a view toward its fundamental value. The Supreme Court has indicated that investment activity is not necessarily a trade or business, even if carried out at scale.⁷⁹ In other cases, such as computer-aided horse wagering, professional gamblers can also transact at an extremely high volume, leveraging advance data and analytical tools as well as algorithmic models, and applying an approach closely mirroring an active trader mindset.

The “stakes” (pun intended) of this trade or business determination would be high because, as noted above, an individual not engaged in a trade or business might not be able to deduct any losses on sports event contracts. In a situation where an individual taxpayer has significant wins and offsetting losses, the individual may prefer to make wagers on more traditional platforms to avoid this potential risk (even with the 90 percent limitation on gambling loss now in effect).



⁷⁹ Higgins v. Commissioner, 312 U.S. 212 (1941).

What if sports event contracts are ultimately considered wagering transactions?

If sports event contracts are classified as a wagering transaction, then capital gain or loss classification and any potentially favorable 60/40 treatment under Code Sec. 1256 outlined above would not apply. Similarly, the “hobby loss” rules outlined above also would not apply. Gambling winnings are considered ordinary income for federal income tax 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. If sports event contracts are classified as a wagering transaction, then the netting of losses against winnings is likely available to bettors. For 2025, such losses are limited to the extent of winnings and, as noted above, beginning in 2026 the deduction for gambling losses is limited to 90 percent of such losses under the OBBBA.

- **Form W-2G and backup withholding**—If sports event-based contracts were to be defined as a gambling transaction for federal and state income tax purposes, then the broker or exchange may be required to provide the bettors with a Form W-2G to report gambling winnings. For tax years prior to 2026, 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. For 2026, the threshold for such form is a win of \$2,000 or more and at least 300 times the amount wagered (and adjusted annually for inflation thereafter). In addition, 24 percent of such winnings must be withheld for federal income taxes when the winnings exceed \$5,000. Applicable state W-2G (or equivalent) reporting and withholding vary from state to state.
- **Federal excise tax**
 - If event contracts, particularly sports and potentially election contracts, were to be defined as a gambling transaction for within in the meaning of the Code and applicable Treasury Regulations,⁸⁰ then the amounts wagered would likely be subject to the federal excise tax imposed under Code Sec. 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.

Stakeholders should keep the excise tax rate disparity between legal and illegal wagers in mind as well. To the extent the IRS determines such contracts are considered wagering transactions, given that sports betting is not legal in all 50 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 precedent 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.

- Who would pay the excise tax if it applies? Unclear...
 - DCMs—Code Sec. 4401 indicates that the excise tax liability is imposed solely on “the person who accepts the wager.”⁸¹ Further, Code Secs. 4411 and 4412 reinforce that the tax targets persons engaged in the business of accepting wagers. As currently structured, while the DCM operates the exchange, matches orders, clears trades, and collects fees, it also does not entirely demonstrate the characteristics of a person accepting wagers in that the DCM entity does not take the opposite side of trades, bear outcome-dependent risks, or pay winners from its own capital (although this may be done by a separate but affiliated legal entity in certain cases, a situation that raises other considerations and discussion points beyond the scope of this article). It is worth noting that courts have previously rejected attempts to impose the wagering excise tax on entities that merely facilitate wagering transactions without assuming wagering risk.⁸² In addition, applicable Treasury Regulations either distinguish the acceptance of wagers from ancillary or intermediary functions⁸³ or do not appear to directly contemplate the

⁸⁰ Code Sec. 4421 provides that the term “wager” for purpose of this excise tax means any “sports event” or a “contest” placed with a person engaged in the business of accepting such wagers. The Treasury Regulations define a “sports event” to include “every type of sports event, whether amateur, scholastic, or professional, such as horse racing, auto racing, dog racing, boxing and wrestling matches and exhibitions, baseball, football, and basketball games, tennis and golf matches, track meets, etc.” See Treas. Reg. § 44.4421-1(c)(2). These Treasury Regulations also define the term “contest” broadly to include “any type of contest involving speed, skill, endurance, popularity, politics, strength, appearances, etc., such as a general or primary election, the outcome of a nominating convention, a dance marathon, a log-rolling, wood-chopping, weight-lifting, corn-husking, beauty contest, etc.” See Treas. Reg. § 44.4421-1(c)(3).

⁸¹ Code Sec. 4401(c).

⁸² United States v. Calamaro, 354 U.S. 351, 358–59 (1957).

⁸³ Treas. Reg. §§ 44.4401-1, 44.4412-1.

concept of a betting exchange with respect to the excise tax (unlike the UK, for example, which regulates and subjects betting exchanges to gaming duties). More broadly, this aligns with the viewpoint held by some stakeholders that a DCM is not “the house.”

- **Market makers**—If one insists that *someone* must be “accepting” wagers, then the market makers (e.g., liquidity providers) could be a more likely candidate than the DCMs, although this is also far from certain. One can fairly state that a market maker often trades both sides of a market or exchange, is frequently (but not always) the economic counterparty to retail investors, and may manage inventory and pricing dynamically. In a way this does resemble a bookmaker laying odds and managing exposure, particularly in a thin or one-sided market (as can be the case with sports event contracts). Further, liquidity providers have been scrutinized at varying times under gambling or “bucket-shop” theories, and financial regulators do focus on the party that is systematically on the other side of customer trades.

However, this analogy may break down when one considers that the prices are arguably market derived and not “house” set and given that market makers do not guarantee outcomes and can lose money on contracts. Of course, one can debate whether market makers truly are at a real economic risk of loss in situations when the market maker is an affiliate of or related party to the DCM, realizes timing advantages on trading activities versus retail investors, can directly influence the odds or effectively set pricing based upon their own trading volume, possess insider information not available to the general public, and/or can negotiate rebates and other incentives from DCMs to either guarantee a minimum return on investment or informally hedge against potential trading losses (all of which are critiques currently leveled against DCMs offering prediction markets and/or the market makers themselves). Ultimately, while some hold the view that the market maker may be the *closest* analogy to the “person accepting the wager” and therefore subject to the federal excise tax, and it should be noted that such viewpoint also does not directly align with traditional gambling constructs nor the applicable Treasury Regulations governing the federal excise tax.

- **State gaming taxes**—If event 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.
- **Personal income taxes**—In addition to GGR taxes that would be borne by the exchanges (e.g., if treated as a betting exchange subject to GGR taxes) or the market makers under the premise they are the party(ies) accepting wagers, 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 or if the state excludes gambling winnings from taxation.
- **State-by-state gaming licenses**—While not the primary focus of this article, if event 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 United States since the 2018 repeal of the Professional and Amateur Sports Protection Act 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 (and even the market makers) 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.



12

Conclusion

Understanding the tax implications of trading CFTC-regulated event-based contracts is essential to remain in compliance with federal and state tax regulations. CFTC-regulated exchanges and both traders and investors should consult with their own tax advisers 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.

A number of CFTC-regulated exchanges have expanded their event contracts offerings an ever-increasing list of sporting events and introduced additional features that may more closely resemble traditional sports betting wagers (e.g., player props and predictive parlays). This continued industry convergence coupled with the unresolved classification of event contracts under CFTC regulations and the intersection of that classification with the federal sports betting excise tax rules, complex state-by-state gambling regulatory environment, and ongoing litigation in a number of states, adds further uncertainty to the overall tax picture, given the drastically different tax treatment and related reporting obligations for futures contracts versus sports betting.

Last, and certainly not least, there are a myriad of unresolved considerations around information reporting and withholding requirements that may be applicable to CFTC-regulated exchanges offering event contracts. Similar to the various tax implications covered herein, further resolution of the legal and regulatory framework around prediction markets may directly inform these requirements. We believe this merits its own detailed discussion and are already drafting Part 2 accordingly. Stay tuned for Part 2!

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How KPMG can help

The current regulatory and legal environment surrounding prediction markets, especially those offering sports event contracts, is highly complex and evolving in real time. This uncertainty, coupled with a lack of direct tax guidance, leaves stakeholders without clarity on a number of key tax considerations. The KPMG team draws upon its significant depth of tax experience in both the regulated gambling industry and financial services to assist clients in navigating these challenges.

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