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SPECIALIZED TAX GUIDE 04 OF 06 • 2026 EDITION

Prediction Markets Taxation in 2026: Kalshi, Polymarket, Event Contracts, Capital Gains, Gambling, and Section 1256

A practical, legally careful U.S. federal tax guide for individuals, active traders, investors, and tax professionals.

> **THE RULE THAT MATTERS MOST**
>
> A platform name, a CFTC registration, or a sports-related event does not by itself establish the federal income tax classification of a particular contract.

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Executive summary: Seven rules to know

• Prediction-market profits generally must be considered for federal income tax, even without a tax form.

• Classification must be determined contract by contract: wagering, capital asset, Section 1256, or another ordinary/derivative regime.

• CFTC oversight does not automatically mean Section 1256 tax treatment.

• If a contract is a qualifying Section 1256 contract, mark-to-market and 60/40 capital treatment generally apply, subject to exceptions.

• If an activity is wagering, the 2026 90% wagering-loss limitation may apply.

• Fees, basis, settlement timing, open positions, and tax forms must be reconciled.

• State gambling law, federal commodities regulation, and federal income tax law are different legal questions.

1. What is a prediction market?

A prediction market allows a customer to buy or sell a contract whose value depends on an outcome: an election, economic release, weather event, sports result, company milestone, or other measurable event. Some contracts pay a fixed amount if an outcome occurs and zero if it does not. Others can be sold before settlement.

Kalshi and Polymarket are widely recognized examples. The exact platform, jurisdiction, legal entity, product terms, and transaction date matter; not all contracts offered through a brand have the same structure or reporting treatment.

Event category	Illustrative question	Tax issue
Politics	Will a candidate win?	Contract rights and settlement
Economics	Will CPI exceed a level?	Financial derivative classification
Weather	Will temperature exceed a level?	Contract structure and applicable rules
Sports	Will a team win?	Wagering versus derivative analysis
Corporate events	Will a merger close?	Capital/derivative analysis

2. Four possible federal tax pathways

Possible pathway	Core consequence	Important qualification
Wagering / gambling	Winnings generally included in income; losses subject to IRC §165(d)	Whether the particular contract is a wager requires legal analysis
Capital asset under §§1221, 1001	Gain/loss and holding period; Schedule D / Form 8949 may apply	Character, basis, realization, and exceptions must be established
Qualifying §1256 contract	Generally year-end mark-to-market and 60% long-term / 40% short-term capital treatment	Must satisfy statutory definition; swaps and similar agreements can be excluded
Other derivative or ordinary income	Treatment depends on instrument, activity, and applicable provisions	May involve §446, §475, §988, or other rules; do not assume

NOT A TAX ELECTION

A taxpayer cannot choose the most favorable pathway simply because it produces a lower tax bill. Classification must follow the contract and applicable law.

3. Why CFTC regulation is not the same as tax classification

The Commodity Futures Trading Commission regulates certain derivatives markets. Its public product filings identify event contracts, including instruments described as swaps or binary options. Those descriptions can be useful evidence about the product, but federal income tax is governed by the Internal Revenue Code and tax authorities.

Legal disputes about whether sports-event contracts are swaps, and whether state gaming laws are preempted, have produced differing appellate rulings in 2026. Those regulatory questions do not themselves resolve whether an individual taxpayer has wagering income, capital gain, or Section 1256 gain.

Primary sources: CFTC Designated Contract Market Product Filings; Sixth Circuit decision in Kalshi-related sports-event contract litigation, Sept. 25, 2026.

4. Section 1256: The 60/40 rule

IRC §1256 generally covers defined classes such as regulated futures contracts and nonequity options, subject to statutory exceptions. Qualifying positions generally are treated as sold at fair market value at year-end, and qualifying gain or loss is generally 60% long-term and 40% short-term regardless of actual holding period.

A regulated futures contract must satisfy the specific definition in §1256(g), including a qualifying mark-to-market margin system and trading on or subject to the rules of a qualified board or exchange. Section 1256(b)(2) also excludes enumerated swaps and similar agreements. Exchange registration alone does not establish eligibility.

Illustration: qualifying §1256 gain	Amount
Recognized gain	$10,000

Illustration: qualifying §1256 gain	Amount
Long-term component (60%)	$6,000
Short-term component (40%)	$4,000

This example applies only after a supported determination that the instrument is within §1256. Do not use 60/40 merely because a platform calls a product a futures contract.

5. Capital gain treatment: When it may apply

If the contract is a capital asset and no overriding rule applies, gain or loss may be determined using amount realized less adjusted basis under §1001. Holding period generally determines short-term versus long-term character. Sales, expirations, settlements, and fees must be evaluated.

Illustrative capital transaction	Amount
Cost of contract	$350
Cash received on settlement	$1,000
Trading fee allocated to transaction	$10
Illustrative gain	$640

The fee treatment and the character of the instrument must be substantiated. This is a computation example, not a conclusion that all Kalshi or Polymarket trades are capital assets.

6. Gambling classification and the 2026 loss limitation

If an event contract is properly characterized as wagering, IRC §165(d) is central. For tax years beginning after December 31, 2025, the deductible wagering loss is generally limited to 90% of qualifying losses and cannot exceed wagering gains. Recreational taxpayers generally must itemize to claim a separate wagering-loss deduction.

Illustrative wagering outcome	Amount
Qualifying wagering gains	$100,000
Qualifying wagering losses	$100,000
Maximum 2026 loss deduction	$90,000
Income remaining after maximum deduction	$10,000

This $10,000 is not the tax bill. It illustrates income remaining after the maximum wagering-loss deduction; other tax-return items affect final liability. Do not apply this example to a contract before establishing wagering classification.

7. Three scenarios: Same profit, different tax rules

Classification	Example	General tax result
Qualifying §1256	Net $20,000 gain	60/40 capital character; possible year-end mark-to-market
Capital asset	Net $20,000 realized gain	Holding period and capital rules determine character
Wagering	Gains $100,000; losses $80,000	2026 maximum loss deduction $72,000; $28,000 remains

The examples are deliberately not equivalent tax calculations. Their purpose is to show that transaction classification changes both timing and character, and that a simple net-profit figure may be inadequate.

8. Trading, selling early, and contract settlement

A taxpayer may buy a Yes contract, sell it before the event, hold it to a cash settlement, or allow it to expire worthless. These are not necessarily identical tax events. The preparer must identify the legal instrument, cost, fees, date acquired, date sold or settled, cash proceeds, and any year-end valuation rule.

Example: Selling before the event

A trader buys 1,000 contracts at $0.35 ($350 total) and sells them at $0.60 ($600 total). Before fees, the economic gain is $250. The federal character and reporting form still depend on the applicable tax classification.

Example: Open contract on December 31

A contract purchased for $4,000 has an estimated fair value of $6,000 on December 31 but has not been sold or settled. A qualifying Section 1256 contract generally is marked to market; a non-§1256 capital asset generally is not taxed merely because its value increased. Other derivative rules may change that result.

9. Kalshi: What a tax preparer must verify

- Exact exchange and clearing entity involved in each trade.
- The contract specifications, event definition, settlement terms, and trading dates.
- Whether the instrument is legally a swap, option, regulated futures contract, wager, or another right.
- Any Form 1099, broker statement, tax summary, or customer transaction export.
- Whether the platform report uses a tax classification or only an economic profit/loss calculation.
- Any applicable §1256 exclusions or other derivative provisions.

Do not issue a blanket opinion that every Kalshi contract is taxed at 60/40 or that every sports-related Kalshi contract is gambling.

10. Polymarket: Offshore, on-chain, and U.S. issues

Polymarket-related products and access arrangements can differ by jurisdiction and period. A U.S. taxpayer must identify the actual contracting platform, account owner, wallet, collateral asset, trading mechanism, and governing terms. Access through a non-U.S. venue does not make otherwise taxable income exempt.

On-chain transactions may require separate analysis of digital-asset dispositions, token transfers, fees, and the event contract itself. If cryptocurrency is used to acquire a contract, exchanging appreciated cryptocurrency may trigger an independent taxable disposition. Do not assume that every token movement is income or that every wallet transfer is a sale.

11. Fees, commissions, and trading costs

Exchange fees, settlement fees, spreads, and financing charges can affect the economics. Their tax treatment depends on classification: some may adjust amount realized or basis, some may be business expenses, and others may be limited or nondeductible. Keep the platform fee schedule and trade-level detail. Avoid subtracting every fee twice.

12. Forms and federal reporting map

Tax form	When potentially relevant
Form 1040 / Schedule 1	Certain other income, including gambling winnings
Schedule A	Potential recreational wagering-loss deduction
Form 8949 / Schedule D	Capital-asset sales and exchanges
Form 6781	Qualifying §1256 contracts and certain straddles
Schedule C	Trade-or-business income where factually and legally appropriate
Form 1099-B / other 1099	Information reporting; not conclusive on character
Form 1040-ES	Estimated tax payments
Form 8949 and digital-asset reporting	Where digital assets are sold or exchanged in related transactions

A Form 1099 does not override the Code. If a taxpayer disagrees with a platform statement, obtain a correction if appropriate and document the reporting position.

13. Employees who trade event contracts after work

A taxpayer with full-time W-2 employment may trade event contracts actively. Employment status alone does not determine whether gains are capital, wagering, or business income. A trading business requires separate factual and legal analysis; frequent trading alone does not automatically establish Schedule C treatment or allow personal costs as business deductions.

If the taxpayer claims trader-in-securities status or a §475(f) election, determine whether the actual instruments and activity satisfy the relevant requirements. An election cannot be assumed, and strict deadlines may apply.

14. State income tax and legal access

Federal tax classification and state gaming legality are separate. A resident state may tax worldwide income, while a different state may assert sourcing or withholding rules. Treatment of gambling losses and capital gains varies. State-specific law should be checked for the transaction year, the taxpayer residence, and where the activity occurs.

The legality of trading a contract in a particular state should not be inferred from the federal income tax reporting method. Regulatory litigation and platform access restrictions may change.

15. Recordkeeping: The audit-ready transaction file

Field	What to capture
Contract ID and market	Full event name and product code
Platform and entity	Exchange, broker, wallet, and clearing arrangement
Acquisition	Date/time, quantity, price, fees, currency
Disposition	Sale, expiration, or settlement date; proceeds and fees
Year-end open positions	Quantity, cost, fair value, and valuation source
Classification support	Contract terms, CFTC filings, tax analysis, platform forms
Cash and digital assets	Deposits, withdrawals, wallet movements, FX, basis
Tax reporting	Forms received, federal/state entries, reconciliation

CONTROL STANDARD

Reconcile opening cash + deposits − withdrawals + trading results − fees = closing cash, adjusted for unsettled trades, transfers, and any collateral movements. Keep both the raw export and the preparer reconciliation.

16. Client document request checklist

- All platform tax forms and annual account statements.
- Complete trade-level CSV exports, not just a profit/loss screenshot.
- Contract specifications and product terms for material positions.
- Open positions and fair values as of December 31.
- Bank and payment records, deposits, withdrawals, and transfers.
- Crypto wallet addresses, blockchain transaction IDs, and basis records if applicable.

- Records of fees, commissions, rebates, promotions, and incentives.
- Evidence of residency and states where activity occurred.
- Prior-year returns, carryforwards, §475 elections, and IRS notices.
- Descriptions of any hedges, offsetting positions, straddles, or related-party activity.

17. Tax planning and risk management

- Determine character before choosing a reporting form.
- Set aside cash for tax; settlement gains can occur without withholding.
- Monitor year-end open positions for possible §1256 mark-to-market.
- Model capital-loss limitations separately from wagering-loss limitations.
- Avoid assuming a 2026 wagering loss is fully deductible.
- Evaluate estimated tax requirements under §6654.
- Document material uncertain positions and seek specialized advice before filing.
- Review state tax and crypto consequences independently.

18. Common mistakes and audit risks

Mistake	Correct approach
“Kalshi is always §1256.”	Apply statutory definition and exclusions contract by contract.
“Sports contracts are always bets.”	Analyze instrument terms and governing tax law.
“CFTC-approved means 60/40.”	CFTC regulation does not establish §1256 status.
“I can net all activity together.”	Separate classifications and applicable limitations.
“No 1099 means no tax.”	Taxability does not depend solely on information reporting.
“Crypto collateral is irrelevant.”	Analyze digital-asset basis and disposition events.
“Open positions never matter.”	Check §1256 and other mark-to-market provisions.

19. Frequently asked questions

Is Kalshi income taxable?

Generally, taxable gains must be evaluated and reported. Character depends on the contract and transaction.

Is Polymarket income taxable?

U.S. taxpayers generally must consider worldwide taxable income, including qualifying gains from offshore or on-chain activity.

Are prediction markets gambling?

Some contracts may be analyzed as wagering; others may involve derivative or capital-asset rules. No universal answer applies.

Does CFTC registration guarantee 60/40 treatment?

No. Section 1256 has its own statutory requirements and exclusions.

Can I use Form 6781 for every event contract?

No. Form 6781 generally requires qualifying Section 1256 or other applicable transactions.

Can I deduct losing sports event contracts?

It depends on classification and substantiation; wagering, capital, and derivative losses follow different rules.

Does the 2026 90% gambling rule apply to all prediction contracts?

No. It applies where the activity is properly treated as wagering and the other requirements are met.

Can I net Kalshi profits against stock losses?

Only under the applicable character, limitation, and reporting rules. Do not automatically combine them.

Do I owe tax when I sell before settlement?

A sale may trigger a realization event, subject to the applicable instrument rules.

Do I owe tax on an open year-end contract?

Possibly if a mark-to-market regime applies; otherwise unrealized appreciation generally is not taxed solely because value increased.

What if I have no Form 1099?

Retain transaction records and report taxable items as required.

Does my W-2 job prevent business treatment?

Not necessarily, but business status requires its own factual and legal support.

Can I deduct my home office?

Only if the taxpayer actually qualifies for a trade or business and meets §280A requirements, including exclusive and regular qualifying use; trading alone does not guarantee a deduction.

Can I carry forward losses?

Rules differ materially by character: capital, wagering, and §1256 losses have distinct limitations and possible carryback/carryforward provisions.

What if my platform statement uses the wrong character?

Request clarification or correction, and document a legally supportable return position.

20. Primary legal and regulatory authorities

Authority	Why it matters
IRC §§61, 1001, 1221, 1222	Gross income, realization, capital assets and holding periods
IRC §1256	Defined contracts, mark-to-market, 60/40, swap exclusions
IRC §§165(d), 63	Wagering losses and itemization
IRC §§446, 475, 988, 1092	Accounting methods, dealer/trader, FX, straddles where applicable
IRC §§6001, 6654	Records and estimated tax
Public Law 119-21 §70114	2026 wagering-loss amendment
CFTC product filings	Regulatory product descriptions, not tax determinations
IRS Instructions for Form 6781	§1256 and straddle reporting
IRS Instructions for Forms 8949 / Schedule D	Capital-asset reporting

Official references:

https://uscode.house.gov/view.xhtml?req=granuleid:USC-prelim-title26-section1256

https://www.irs.gov/instructions/i6781

https://www.irs.gov/instructions/i8949

https://www.irs.gov/taxtopics/tc419

https://www.cftc.gov/IndustryOversight/IndustryFilings/TradingOrganizationProducts

https://www.govinfo.gov/content/pkg/PLAW-119publ21/pdf/PLAW-119publ21.pdf

21. JS Morlu LLC: How we help

Prediction-market reporting requires more than copying a platform profit-and-loss figure. JS Morlu LLC assists taxpayers with contract classification research, trade and wallet reconciliations, capital and §1256 reporting, wagering-loss analysis, federal and state returns, estimated-tax planning, and IRS notice responses.



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