



cutting through complexity

Interaction between Sec. 475(f) and Sec. 1256

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Jay Freedman
Principal – Alternative Investments
(212) 954-3693
jayfreedman@kpmg.com

Section 1256 contracts

Certain types of contracts are Section 1256 contracts

- Regulated Futures Contracts
- Non-equity Options
- Dealer Equity Options, and
- Foreign Currency Contracts
- Dealer Securities Futures Contracts

Section 1256 contracts are:

- 1) Marked to market on last day of taxable year (if not sold)
- 2) Gain/Loss is 60% Long Term and 40% short term, regardless of actual holding period
 - This character rule does not apply to any gain or loss that would otherwise be ordinary rather than capital in nature (e.g., foreign currency contracts that are subject to sec. 988)
 - Regulated Futures Contracts or Non-Equity Options are excluded from 988 definition, so 60/40 treatment governs (although special elections to obtain ordinary treatment may be available)

Section 1256 contracts (continued)

(A) Regulated futures contract

- Must be traded on a qualified board or exchange
- Most U.S. exchanges and boards of trade (major exchanges) and a few foreign exchanges
 - International Futures Exchange (Bermuda)
 - Mercantile Division of The Montreal Exchange (Canada)
 - SIMEX (Singapore)
 - ICE Futures (U.K.)
 - Dubai Mercantile Exchange (Dubai)
 - LIFFE (U.K.)
 - ICE Futures (Canada)
 - Eurex Deutschland (Germany)

Section 1256 contracts (continued)

(B) Foreign currency 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,

- Australian dollar
- Brazilian real
- British pound
- Canadian dollar
- Chinese renminbi
- Columbian peso
- Czech koruna
- Euro
- Hungarian forint
- Indian rupee
- Israeli shekel
- Japanese yen
- Korean won
- Mexico peso
- New Zealand dollar
- Norwegian krone
- Polish zloty
- Russian ruble
- South African rand
- Swedish krona
- Swiss franc
- Turkish lira

(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.

Notice 2007-71 – Foreign currency options are not Foreign Currency Contracts as they may expire unexercised and thus do not require delivery of or settlement of the contract in foreign currency.

- But see Wright Case (January 2016) where the Sixth Circuit found that, the plain language of the statute clearly provides that a foreign currency option can be a “foreign currency contract.”

Section 1256 contracts (continued)

(C) Non-equity option

- Any listed option (other than a right to acquire stock from the issuer) which is not an equity option (“over the counter” options are not listed options)
- Equity option – value of which is determined directly or indirectly by reference to any stock or any narrow-based security index
- Non-equity options include options on broad-based stock indexes (such as the Standard & Poor’s 500 index).
- Options on ETFs which mimic indices are typically not considered 1256 contracts leaving some planning opportunities
 - SPX (S&P 500) option is 1256
 - SPY (SPDR S&P 500 ETF) option is not 1256

(D) Dealer equity option

(E) Dealer securities futures contract

Section 1256 contracts (continued)

Excluded:

- Any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract (on theory of being too similar to an equity option)
- Any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement. (under Dodd Frank clarifying treatment as a result of centralized clearing of these contracts)
- Identified hedges under section 1221 are not subject to mark to market rules

Scope of 1256

- Centrally cleared swaps
 - 1256(b)(2)(B) provides that a section 1256 contract does not include:

Any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, interest rate floor, equity index swap, credit default swap, or “similar agreement”
- Listed contracts that are thinly traded?
 - General view is that contracts that are very thinly traded should not be treated as 1256 contracts
 - What is “thinly traded”?
 - Can a contract change from 1256 to non-1256 depending on trading volume?
- Financial transmission rights?
 - ISO is currently not a qualified board or exchange
- Exotics?

Scope of 1256 (continued)

New products – Swaps or futures?

- Conversion of Swaps to Futures – Intercontinental Exchange Inc. mandatorily converted all of its energy swaps and options into futures contracts through a block trade and “exchange for related position” (EFRP) transaction.
- Non-Deliverable Swap Futures Contract – Exchange-traded and cleared futures contracts that are intended to replicate the economics of an OTC interest rate swap but are entirely cash settled at the end of the contract period according to a formula using fixed and floating reference amounts. They function in a manner similar to traditional financial futures contracts with daily mark to market and variation margin.
 - ERIS interest rate swap futures contract – “replicate the net cash flows associated with plain-vanilla, fully collateralized [over-the-counter] interest rate swaps while retaining all of the operational and economic efficiencies of traditional futures contracts”
- Deliverable Swap Futures – Exchange-traded and cleared futures contracts that settle into a cleared interest rate swap. Swap is thus often initiated at a off-market rate and would require an-upfront payment.
- Are these 1256 contracts, notional principal contracts or something else?

Section 475

Section 475 (a) generally

- Requires “dealers in securities” to use the mark-to-market method of accounting for their securities (475 (a))
- Allows “traders” in securities (475(f)(1)) and commodities (475(f)(2)) to elect mark-to-market method of accounting

General rule

- Mark-to-market (current realization)
- Character is ordinary

Section 475 – Timing and character

What is a security? See Section 475(c)(2)

- Corporate Stock – (c)(2)(A)
- Publicly traded or widely held partnership interests or trust – (c)(2)(B)
- Notes or other evidence of indebtedness – (c)(2)(C)
- Interest rate, currency, or equity notional principal contracts – (c)(2)(D)
- Interest in or derivative in any security above, or any currency, including any option, forward, short position, and similar financial instrument – (c)(2)(E)
- Any position that is not a security that hedges a MTM security – (c)(2)(F)

Section 475(f) – Trader elections

Section 475(f) elections – Trader elections

- Trader in securities – 475(f)(1)
 - Must be “engaged in the business as a trader in securities”
 - Facts and circumstances test to determine whether election is available
 - MTM timing and ordinary income character
 - Uses definition of security in 475(c)(2)
 - Flush language states that “security” shall not include any contract to which section 1256(a) applies.
 -

- Trader in commodities – 475(f)(2)
 - Similar requirement to trader in securities elections
 - MTM timing and ordinary income character
 - Uses definition of commodity in 475(e)(2)

Section 475(f) – Trader elections

- Section 1256 contracts
 - 475(f)(1) - Securities are defined in 475(c)(2)
 - Flush language states that “security” shall not include any contract to which section 1256(a) applies.
 - Therefore, 1256 contracts are generally not a security within 475(c)(2) and thus outside the scope of 475(f)(1) election.
 - 475(f)(2) - Commodities are defined in 475(e)(2)
 - No similar flush language carving out 1256 contracts.
 - Therefore, 1256 contracts are a commodity within 475(e)(2) and thus within the scope of 475(f)(2) election
 - Are 1256 contracts on non-commodities (S&P 500) within the scope of 475(f)(2) election?
 - 1256 contracts that not a security/commodity, but are a hedge of such, and clearly and timely identified, may be included in the definition of security/commodity, respectively.
 - Identification may be challenging where some contracts are hedges and some are speculative, or for contracts that are partial hedges.



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