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Proposed regulations: Foreign currency contract under section 1256 includes only foreign currency forward contracts (text of regulations)

The U.S. Treasury Department and IRS today released for publication in the Federal Register proposed regulations (REG-130675-17) that would provide that the term “foreign currency contract” as defined in section 1256(g)(2) applies only to foreign currency forward contracts.

The [proposed regulations](#) [PDF 243 KB] (five pages as published in the Federal Register on July 6, 2022) are proposed to apply to contracts entered into on or after the date that is 30 days after the date of publication of the Treasury decision adopting these proposed rules as final regulations in the Federal Register. This proposed applicability date is intended to provide taxpayers in the Sixth Circuit with time to transition from the holding in *Wright v. Commissioner*, 809 F.3d 877 (6th Cir. 2016), rev’g T.C. Memo. 2011-292, to the rule described in these proposed regulations.

However, for contracts entered into before the proposed applicability date by taxpayers in other circuits, the IRS intends to continue to adhere to its prior published position that foreign currency options are not foreign currency contracts under section 1256(g)(2). See Notice 2007-71, 2007-35 I.R.B. 472.

Overview

The legislative history to section 1256 indicates that Congress’s purpose in amending the definition of foreign currency contract in 1984 was merely to include cash-settled foreign currency forward contracts within the definition of foreign currency contract. It would be inconsistent with this purpose to construe the term foreign currency contract as including options or other derivatives.

The proposed regulations do not change the status of foreign currency options that otherwise qualify as section 1256 contracts. Specifically, nonequity options are separately listed as section 1256 contracts in section 1256(b)(1)(C). Section 1256(g)(3) provides that a nonequity option is any listed option which is not an equity option. Section 1256(g)(5) defines a listed option as “any option . . . which is traded on (or subject to the rules of) a qualified board or exchange.” Therefore, a foreign currency option that is listed on a qualified board or exchange is a “nonequity option” and remains subject to section 1256.

The proposed regulations do not define the term “forward contract.” For purposes of the proposed regulations, whether a derivative contract is properly characterized as a forward contract for U.S. federal income tax purposes is determined under current law. In addition, the IRS may consider applying existing anti-abuse rules and judicial doctrines to a contract and any related transactions in order to evaluate whether a transaction is properly characterized as a forward contract or whether a transaction characterized as some other type of derivative contract should be treated as a forward contract.

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