United States

US Taxation of Foreign Currency Derivatives: 30 Years of Uncertainty

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Foreign currency contracts were required to be marked to market in the United States in 1982, but since then practitioners have argued about the scope of the rule. Specifically, does the rule apply to foreign currency forwards only or to options, swaps and other derivatives as well?

1. Introduction

1.1. Opening comments

Mark-to-market taxation was considered "a fundamental departure from the concept of income realization in the US tax law"[1] when it was introduced in 1981. Congress would not have dared to propose the idea if not for the rampant use of "straddle" shelters by taxpayers that threatened to undermine both the US tax system and the commodities derivatives markets. The realization principle was enshrined in the law in a Supreme Court case, which limited Congress' taxing power based on an interpretation of the US Constitution. Policymakers felt confident imposing mark to market on exchange-traded futures contracts in 1981, despite the Constitution, because of a unique feature of the US exchanges: the daily variation margin system. However, when taxpayers themselves became enamoured of the character advantage that came with mark-to-market taxation, Congress felt comfortable extending the rule to non-exchange-traded foreign currency contracts, even though this market had no equivalent to the daily variation margin. Because of its opportunistic, rather than policy-driven, history, there has been a great debate amongst tax practitioners as to the scope of the mark-to-market rule governing foreign currency contracts. Even today, companies subject to tax in the United States are unsure of the correct treatment of foreign currency options and swaps, and related contracts.

1.2. The foreign currency market

Before proceeding with the technical discussion, a brief review of the types of foreign currency contracts and the markets on which they trade is in order. The market for global foreign currency activity is enormous and eclipses all other financial markets. According to the Federal Reserve Bank of New York, back in 1998, global foreign currency activity was estimated to be approximately USD 1.5 trillion a day.[2] For 2007, estimates for daily market activity were as high as USD 3 trillion.[3] In addition to being the largest, the foreign currency market is also the most liquid market in the world, with trades occurring on a 24-hour basis.[4]

Foreign currency is traded on established exchanges like the Chicago Mercantile Exchange (CME), as well as over the counter (OTC). In an OTC market, brokers and/or dealers negotiate directly with one another and there is no central exchange or clearing house. Unlike exchange-traded contracts, OTC transactions do not have standardized terms and settlement procedures. It is estimated that the OTC markets account for well over 90% of total US foreign exchange market activity.[5] Because a vast majority of foreign exchange market activity occurs OTC, the foreign currency market has been characterized as an OTC market with an exchange-traded segment.

1.3. Types of foreign currency contracts

1.3.1. Introductory remarks

The main types of foreign currency contracts considered in this article are futures, forwards, options and swaps (see 1.3.2. to 1.3.5.).

1.3.2. Futures contract

A foreign currency futures contract is a contract to buy or sell foreign currency at a fixed rate for delivery on a specified future date or period. Futures are by definition exchange traded. As a result, contract sizes, time periods and settlement procedures are all standardized. Margin payments, daily mark to market, and cash settlements all occur through a central clearing house. Futures exchanges are under the jurisdiction of the Commodities Futures Trading Commission.

1.3.3. Forward contract

A foreign currency forward contract is a contract to buy or sell a foreign currency at a fixed rate for delivery on a specified future date or period. Contract terms vary and are referred to as OTC, as there is no centralized trading location and transactions are conducted directly between parties via phone and online trading platforms. No consideration is paid until contract is settled.

1.3.4. Foreign currency option

A foreign currency option is a contract giving the buyer the right, but not the obligation, to purchase or sell a specific currency contract at a specific price on or before a specific date. The amount paid by the option buyer for the option is referred to as the premium. Options are more flexible than forward or futures contracts, as the option purchaser has choice over whether to exercise. Performance under a futures or forward contract is obligatory. The currency option holder's loss is limited to the premium paid. Holding an option eliminates downside risk and retains upside potential. A forward exchange contract eliminates downside risk, but has no upside potential. An OTC option can be tailored to meet the particular needs of an investor. It covers a much greater range of currencies than exchange-traded options and trades at significantly higher volumes.

1.3.5. Foreign currency swap

A foreign currency swap is a contract where the counterparties exchange equal initial principal amounts of two different currencies at the spot rate. At a predetermined future date the parties settle the contract by either exchanging the principal amounts in the respective currencies at the agreed rate or by netting the payments due. In particular:

> Currency swaps often involve – but need not involve – three steps. First the parties to a currency swap will (a) exchange equal initial principal amounts of two currencies at the spot exchange rate, (b) exchange a stream of fixed or floating interest rate payments in their swapped currencies for the agreed period of the swap, and then (c) re-exchange the principal amount at maturity at the initial spot exchange rate.[6]

Due to periodic exchanges over the life of the swap, a swap is sometimes characterized as a portfolio of forward contracts.

2. The Straddle Shelters of the 1970s

2.1. Opening comments

The straddle shelters arose out of several structural flaws in the US tax system. These were, most particularly, (1) the gulf between the tax rates for ordinary income (a maximum 70% rate) and long-term capital gain (a 28% rate), (2) the arbitrary distinction between capital gains and ordinary income, making it relatively easy to convert one to the other and (3) the non-economic tax treatment of derivative contracts.

Straddle shelters were so pervasive that, in 1978, it was estimated that more than 75% of the open interest in silver futures reflected tax straddles. The demand for delivery of US Treasury Bills also severely affected the US Treasury's debt management responsibilities.[7]

There were several types of straddle transactions.[8] These are discussed in 2.2. and 2.3.

2.2. Commodity straddles

Commodity (such as silver) straddles were used to defer capital gains and convert short-term capital gains into long-term capital gains.

In a commodity straddle, the taxpayer entered into two futures contracts on a commodity with very similar characteristics, except that one was a contract to buy the commodity and one was a contract to sell the commodity, and the contracts had different delivery months. Inevitably, after some time, one of the contracts would have fallen in value and the other would have increased in value, usually by virtually the same amounts. The taxpayer sold the futures contract that was in a loss position and entered into an identical futures contract, but with a different delivery date. The taxpayer deducted the loss in the contract sold in the year it was sold. The next year, the taxpayer sold both futures contracts. This combination of transactions resulted in a short-term capital loss (which could be offset against short-term capital gain) in the first year and a long-term capital gain (taxed at low rates) in the second year.

2.3. US Treasury bill straddles

US Treasury bill straddles were used to shelter ordinary income, such as interest, dividends and wages.

In a US Treasury bill straddle, a taxpayer entered into long and short futures contracts on US Treasury bills with delivery months at the end of the taxable year. The futures contracts were characterized as capital assets, but the US Treasury bills were ordinary property. At the end of the year, the taxpayer closed the futures contract that was in a loss position, but

the taxpayer took delivery of the US Treasury bills, rather than closing out the derivative, and took ar[illegible]en, the taxpayer replaced the futures contract with an identical one with a later delivery date. In the following year, the taxpayer recognized a long-term capital gain on the futures contract that had been held for the necessary long-term holding period.

2.4. Mark-to-market taxation

The idea of mark-to-market taxation was introduced in the Congressional debates of 1981 as an alternative to the principle solution to the straddle abuses. The principle solution was to deny a taxpayer a loss on a transaction to the extent that there was an unrealized gain in an offsetting position. An offsetting position was defined as a position in which there was a substantial diminution of risk of loss from holding one position as result of holding another. This was termed the "balanced position" rule. John Chapoton, Assistant Secretary for Tax Policy at the US Treasury, said that the balanced position rule could not apply for taxpayers with a significant volume of commodities transactions, because it required "the identification of particular positions, [and would be] cumbersome to apply. There is also the risk that such a rule could be avoided by these market participants".[9] Instead, the US Treasury proposed that a "special rule" would apply for these persons:

> In lieu of the balanced position rule, we propose that these persons be subject to a mandatory mark to market rule for their positions in futures contracts traded on an organized futures exchange. Because futures positions are marked to market on a daily basis under the normal operating rules of the exchange, with actual cash settlements on a daily basis, this rule does no more than make the tax laws reflective of the underlying market transactions.[10]

The US Treasury proposed to tax the mark-to-market gains and losses as ordinary in character. This had the advantage of making the losses offsetable against other ordinary income of a taxpayer (for example, wages and interest), and also allowed taxpayers to carry losses back to other years ("income smoothing"). But it had the disadvantage of the very high tax rates at which ordinary income was taxed as compared to long-term capital gain.

Taxpayers targeted by the mark-to-market rule objected strongly. A few examples of the disadvantages that could be suffered by those subject to mark to market were listed by Donald Schapiro, representing the New York State Bar Association Tax Section: (1) there would be no benefit of step-up in basis on death, (2) the taxpayer could not make gifts in a tax-advantaged fashion and (3) taxpayers could not skip the tax in a corporate liquidation.[11]

Schapiro, and the New York State Bar, thought that only a long-term gain and loss character for the mark would cause the taxpayer community to acquiesce to the change in law. The claim was that, as gains and losses were a "zero sum" in the public futures markets (when one taxpayer made money, the counterparty lost an equal and opposite amount), the US Treasury should be indifferent as to character. It was expected that taxpayers, eternally optimistic and sure of their gains in their derivatives trades, would consider long-term capital character a great attraction and would cooperate with mark to market if coupled with a rate advantage. Apparently, the New York Bar contained some shrewd psychologists.

Michael L. Maduff, of Maduff & Sons Inc., a commodities brokerage firm in Chicago, testified before the Committee on Finance at the US Senate on the proposed straddle rules. He protested vociferously against mark to market, dubbing it a "very bad scheme" and a "radical departure from our system of taxation".[12] But he did confess that "if the committee or Congress were to pass a bill which incorporated mark to market at a very favourable tax rate, I would be delighted to conduct my business under such a bill, under such a law...",[13] but insisted on maintaining "that would not make it right".

Congress and the US Treasury were aware that taxing futures contracts under a mark-to-market system was indeed a "radical departure" from the US system of taxation. In order to survive constitutional challenge, it would have to be framed as being consistent with the realization principle of income taxation, as articulated by the US Supreme Court in the case of *Eisner v. Macomber*.[14] In that case, the Court stated that income was:

> ... a gain, a profit, something of exchangeable value *proceeding from* property, *severed from* the capital however invested or employed, and *coming in* being "*derived*" that is, *received* or *drawn* by the recipient (the taxpayer) for his *separate* use, benefit and disposal... (emphasis added).[15]

Further, in *Commissioner v. Glenshaw Glass Co.*,[16] the Supreme Court had stated that income was "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion".[17]

3. Operation of Commodities Futures Exchanges

Anticipating a constitutional challenge to mark-to-market taxation, Congressional committees undertook a substantial amount of research on the operation of the commodities exchanges to justify the imposition of this novel kind of tax accounting.

The report of the Joint Committee on Taxation published in anticipation of the Hearing on straddles organized by the

Senate Committee on Finance[18] described the commodities futures markets. The report defined a commodities futures contract as a "standardized agreement either to buy or to sell a fixed quantity of a commodity to be delivered at a particular location in a specified month in the future".[19] The Joint Committee on Taxation isolated several unique features of an exchange-traded contract: (1) all trading in futures contracts had to be transacted through an exchange by exchange members, (2) a clearing association guaranteed performance on all contracts traded through an exchange by interposing itself as counterparty to every contract after the trade was made and (3) all futures contracts were standardized as to size, location of delivery and dates of delivery.[20]

The Joint Committee on Taxation also described a unique feature of the futures markets: the use of margin deposits. In order for an exchange to be able to guarantee all contracts, it must have little risk in any of the open positions. It accomplishes this by demanding a deposit upfront for every contract entered into. This is usually a percentage of the value of the contract, depending on the risk inherent in the contract and other positions held by the taxpayer. The most important aspect of the margining system is that the amount of margin held by the exchange changes daily. If the value of a taxpayer's position declines because the market has moved against the taxpayer, the taxpayer owes money to the exchange; if the value of the taxpayer's position increases because the market has moved in the taxpayer's favour, the taxpayer is entitled to withdraw money from the account. The daily margin adjustment is called "marking to market".[21]

Congress and the US Treasury reasoned that tax could imitate the system by which the futures exchanges conducted business – the mark-to-market margining system. And, as there was true cash movement, the constitutional requirement of "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion"[22] would be met. And so in 1981, exchange-traded commodities futures contracts began to be taxed under a mark-to-market accounting system with a 60% long-term and 40% short-term rate on gains and losses, under Section 1256 of the Internal Revenue Code (IRC). Although initially opposed to the accounting system, with the long-term character advantage, the industry accepted the compromise.

One of the concerns of the industry with mark to market was that contracts transacted off-exchange would be given an unfair advantage over exchange-traded contracts.[23] The New York State Bar, speaking through Donald Schapiro, thought:

> executory contracts, other than regulated futures contracts, that is puts, calls, forward contracts, and futures transactions on foreign exchanges should not be taxed on a mark to market basis, because they don't involve daily transfers of cash. They are not a sum zero system.[24]

The 60/40 rate advantage was so attractive that as soon as mark to market was imposed on futures contracts, those trading in off-exchange derivatives requested mark to market for their contracts as well.[25] In 1982, Congress enacted mark to market for "foreign currency contracts". The legislative history explicitly recognized that there is no equivalent to the margining mechanism in the OTC market, but is not troubled by that. The policy Congress favoured in that year appears to have been efficiency – to tax foreign currency contracts off exchanges equivalent to those on exchanges.[26] Congress provided for mark to market for foreign currency contracts as follows:

> Section 1256(g)(2) FOREIGN CURRENCY CONTRACT DEFINED. – The term "foreign currency contract" means a contract –
> - 1256(g)(2)(A)(i) which requires the 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,
> - 1256(g)(2)(A)(ii) which is traded on the inter-bank market, and
> - 1256(g)(2)(A)(iii) which is entered into at arm's length at a price determined by reference to the price in the inter-bank market.

The law clearly covers "foreign currency contracts", but confusion has arisen over the explanation in the legislative history, which discusses only "bank forward contracts". It is unclear why the law and history use different terminology. Some tax advisers believe the term "foreign currency contracts" means only currency forwards, following the legislative history. But those who put primacy on the language of the law, which appears to be clear, consider "foreign currency contracts" to include swaps, options and related derivatives as well.

No published guidance was offered by the government on this question for more than 20 years. There were, however, two private pieces of guidance that taxpayers seized on as giving comfort to those who rely on the legislative history as being the correct interpretation of "foreign currency contract".

4. Private Letter Ruling (PLR) 8818010 (4 February 1988)

4.1. Holding

PLR 8818010 involved a corporate taxpayer requesting a ruling on whether or not certain currency swap agreements

were foreign currency contracts within the meaning of Section. 1256(g)(2) of the IRC. The contracts were in which positions were traded through regulated futures contracts. As a result, they fulfilled Section 1256(g)(2)(i) of the IRC, but the PLR held that the swaps were not foreign currency contracts, as they failed to meet the requirements of Section 1256(g)(2)(ii) and (iii).

4.2. Reasoning

Whilst lengthy, the reasoning of the service is worth examining in its entirety:

> A review of the legislative history underlying section 1256(g)(2)(A) indicates that Congress intended to include within the definition of foreign currency contract bank forward contracts in currencies traded through regulated futures contracts because they are economically comparable and used interchangeably with regulated futures contracts.

The PLR went on to state:

> Currency swap contracts are significantly different than bank forward contracts in the way the interest rates differentials in the currencies which are the subject of the contracts are accounted for. Currency swaps typically account for interest rate differentials through a present and continuing exchange of notional interest payments over the life of the contracts while bank forward contracts account for such difference on maturity. Given this significant difference between bank forward contracts and currency swap contracts and the failure by Congress in the legislative history of the Technical Corrections Act of 1982 and the Tax Reform Act of 1986 (the 1986 Act) to indicate its intention to include currency swaps within the definition of a foreign currency contract, we conclude that the currency swap agreements fail to satisfy the requirements of section 1256(g)(92)(A)(ii) and (iii). Accordingly, we hold that the currency swap agreements are not section 1256 contracts.

4.3. Analysis

As an initial matter, it is important to recognize that this PLR (like all PLRs) was directed only to the taxpayer who requested it, and that Section 6110(j)(3) of the IRC provides that it may not be used or cited as precedent. Despite the fact that a PLR represents one of the lowest levels of authority for taxpayers, this PLR was adopted by taxpayers to establish the position that swaps are not Section 1256 contracts.

It is also unclear that the legislative history cited by the ruling necessarily results in the conclusions presented. For example, the ruling stated that that foreign currency swaps and forwards are significantly different because of the different ways in which they account for interest rate differentials. The ruling indicated that swaps account for these differences over the life of the loan, whilst forwards account for these differences at maturity. Whilst accurate, it is also true that sophisticated counterparties take this difference into account when structuring their transactions and price their contracts accordingly. Contrary to the reasoning of the PLR, the difference in payment of interest differentials between the two types of contracts is not fatal. As explicitly stated in the legislative history, significant differences existed between futures and forwards – the absence of an exchange-regulated daily mark-to-market margin requirement and a central clearing house being the most significant ones enumerated. Despite these differences, which are far more significant than timing differences with regard to the payment of exchange rate differentials, bank forwards were deemed similar enough to futures contracts to be Section 1256 contracts.

As discussed in 3., the reason Congress set aside these differences was the economic interchangeability of futures and forwards. It was recognized that the forward market was significantly larger and more liquid than the futures market. Congress wanted to equalize tax treatment of these contracts to prevent tax-motivated market distortion.[27] The same realism and flexibility that drove the inclusion of forwards into Section 1256 of the IRC support the conclusion that swaps and other contracts used for the same purpose should also be covered by Section 1256.

5. Field Service Advice (FSA) 200025020 (23 June 2000)

5.1. Holding

Non-regulated foreign currency option contracts are not foreign currency contracts as defined by Section 1256(g)(2) of the IRC.

5.2. Reasoning

The reasoning on the FSA was as follows:

> Although the definition of a foreign currency contract provided in §1256(g)(2) may be read to include a foreign currency option contract the legislative history of the Technical Corrections Act of 1982 ("TCA"), Pub. L. No. 97-448, 1983-1 C.B. 451, which amended §1256 to include foreign currency contracts, indicates that the

Congress intended to extend §1256 treatment only to foreign currency forward contracts that a[illegible] interbank market. See S. Rep. No. 592, 97th Cong., 2d Sess., reprinted in 1983-1 C.B. 475, 485-486; H.R. Rep. No. 986, 97th Cong., 2d Sess., reprinted in 1983-1 C.B. 498, 503-04. There is no indication that foreign currency option contracts were contemplated for inclusion in the statutory definition of a forward currency contract in §1256(g)(2)(A).

The FSA went on to say that:

> Sections 1256(g)(3) and (4) deal comprehensively with options listed on a qualified board or exchange. These provisions were added to the Code by section 102(a)(3) of the Tax Reform Act of 1984 ("TRA"), Pub. L. No. 98-369, 1984-3 (Vol. 1) C.B. 128. They provide that only dealer equity options (i.e. listed stock options) and listed options (other options listed on exchanges) are §1256 contracts. [Footnote omitted.] The legislative history to these provisions is silent regarding whether the failure to separately include a provision addressing the treatment of foreign currency options was due to their having been included within §1256(g)(2)(A).
>
> The legislative history to section 722(a)(2) of the TRA, however, which amended §1256(g)(2), indicates that only "certain" foreign currency contracts were treated as regulated futures contracts under that provision. See H.R. Rep. No. 432, 98th Cong., 2d Sess. 1646 (1984). This, coupled with the previously referenced provisions of the legislative history to the TCA, and our view that reading §1256(g)(2) expansively to apply generally to foreign currency options would effectively override the limitations of §1256(g)(3) and (4), leads us to conclude that foreign currency option contracts are not foreign currency contracts pursuant to §1256(g)(2).

5.3. Analysis

Whilst acknowledging that foreign currency options could technically fit the Section 1256(g)(2) definition, the FSA declined to do so. Its primary reasons can be summed up as follows: (1) foreign currency options are not specifically mentioned in the legislative history, and, therefore, it must be concluded they were not meant to be included and (2) including foreign currency options as foreign currency contracts effectively overrides the limitations of Section 1256(b)(3) and (4) of the IRC.

This reasoning places the FSA's authors in the awkward position of interpreting what was *not* said in the legislative history, rather than looking to the language expressly set out in the IRC. This language of Section 1256(g)(2)(B) of the IRC bears repeating here for emphasis:

> The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of subparagraph (A), including regulations excluding from the application of subparagraph (A) any contract (or type of contract) if its application thereto would be inconsistent with such purposes.

Accordingly, if certain foreign currency contracts are to be excluded Section 1256 foreign currency contracts, they are to be explicitly identified in regulations. To date, no regulations have been issued and, therefore, there are no statutory exclusions from the definition of a Section 1256 foreign currency contract. Consequently, exclusions from the definition of "foreign currency contract" that have been imputed by Internal Revenue Service (IRS) guidance have been misguided.

In addition, with regard to the assertion that including options in Section 1256 foreign currency contracts "effectively overrides the limitations of sections 1256(b)(3) and (4)", this assertion does not take into account the historical context of when these sections were added. These sections were added to Section 1256 of the IRC to equalize the treatment of commodity traders and options market-makers. The addition of non-equity options and dealer equity options were a product of industry lobbying and had no relation to foreign currency options.

Much has been made of this FSA, which is yet another taxpayer-specific ruling that may not be cited as precedent under Section 6110(k)(3) of the IRC. As, however, no explanatory regulations exist under Section 1256 of the IRC, this FSA and PLR 8818010 constitute the universe of the authority available for practitioners regarding the meaning of foreign currency contracts.

6. IRS Binding Guidance

6.1. Notice 2003-81[28]

Notice 2003-81 involves a specific foreign currency shelter. The notice designates it a "listed transaction" for purposes of the Tax Shelter Regulations, Sections 1.6011-4(b)(2), 301.6111-2(b)(2) and 301.6112-1(b)(2). The mechanics of the suspect transaction are as follows: a taxpayer purchases a put and a call on a foreign currency, in which positions are traded through regulated futures contracts which are foreign currency contracts within the meaning of Section 1256(g)(2)(a) of the IRC. The options are expected to move inversely in value to one another. As the value of the foreign currency changes, one of the Section 1256 contracts is certain to be in a loss position. The taxpayer also receives premiums for writing a call option and a put option on a different foreign currency in which positions are not traded through regulated

futures contracts. The written contracts are not foreign currency contracts within the meaning of Section 1256(g) of the IRC nor are they Section 1256 contracts within the meaning of Section 1256(b). The written options are also expected to move inversely in value to one another, thereby ensuring that, as the value of the foreign currency changes, the taxpayer holds a gain position in one of the two non-Section 1256 contracts.

The values of the two currencies underlying the purchased and written options: (1) have historically demonstrated a very high positive correlation with one another or (2) have officially been linked to one another. Accordingly, as the currency changes in value the taxpayer expects to have the following gains and losses in substantially offsetting positions: (1) a loss in a purchased option and a gain in a written option and (2) a gain in a purchased option and a loss in a written option. The taxpayer assigns to a charity the purchased option that has a loss; the charity also assumes the taxpayer's obligation under the offsetting written option that has a gain.

As the purchased option assigned to the charity is a Section 1256 contract, the taxpayer relies on Section 1256(c) of the IRC to mark the purchased option to market when it is assigned to charity and recognize a loss at that time. Because the assumed option is not a Section 1256 contract, the taxpayer claims not to recognize gain attributable to the option premium. Consequently, the taxpayer claims not to recognize the gain when the charity assumes the obligation, or on expiration or termination of the option.

The IRS determined that, when the option writer's obligation terminates, the transaction closes and the option writer must recognize any income or gain attributable to the prior receipt of the option premium. It further deemed this type of transaction is a listed transaction which requires disclosure under the tax shelter disclosure requirements.

Whilst interesting, the mechanics of the this particular transaction are secondary to the current discussion. Uncertainty and confusion arose after the release of Notice 2003-81 because of the following assumption which was included in the facts section:

> The currency is one in which positions are traded through regulated futures contracts, and the purchased options, therefore, are foreign currency contracts within the meaning of section 1256(g)(2)(A) of the Internal Revenue Code and section 1256 contracts within the meaning of section 1256(b).

This statement, apparently an aside, surprised many and was criticized by commentators.[29] The IRS was accused of reversing established course on foreign currency contracts and disregarding legislative history. In 2007, at least partially in response to these comments, the IRS revised its position and issued Notice 2007-71 modifying Notice 2003-81.

6.2. Notice 2007-71[30]

The correcting notice states:

> Although, as a general matter the "Facts" portion of Notice 2003-81 correctly describes the transaction at issue, it includes an erroneous conclusion of law. The second sentence in the "Facts" portion of Notice 2003-81 states: "The currency is one in which positions are traded through regulated futures contracts, and the purchase options, therefore, are foreign currency contracts within the meaning of §1256(g)(2)(A) of the Internal Revenue Code and §1256 contracts within the meaning of §1256(b)."

The Notice goes on to say that "This sentence should have stated "The taxpayer takes the position that the purchased options are foreign currency contracts...". The modifying Notice briefly refers to the legislative history of Sections 1256 and 988 of the IRC and concludes that a foreign currency option is not a foreign currency contract under Section 1256(g)(2).

6.3. Query

An error was admitted by the IRS (a mere typo if you will), which was subsequently corrected in Notice 2007-71, almost four years after the publication of the original Notice. What remains puzzling then, is the timing. Did it really require years to produce a simple correction that involved changing a statement of the IRS to an assertion by the taxpayer? At a minimum, the delay in the issuance of the correction highlights uncertainty and disagreement over the status of such options and the true definition of foreign currency contract for purposes of Section 1256 of the IRC.

7. Conclusions

After almost 30 years, taxpayers are still uncertain as to the treatment of very simple contracts: foreign currency options and swaps, swaptions and similar instruments. Although the statute appears to be clear, conflicting terminology in the legislative history, in informal guidance from the IRS, and in formal Notices gives very little comfort in the matter. Taxpayers should, therefore, be prepared for debate should an IRS agent or public auditor ever choose to examine their foreign currency portfolios!

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1. "Commodity Tax Straddles: Hearing before the Subcomm. on Taxation and Debt Mgmt. and the Subcomm. on Energy and Agric. Taxation of the S. Comm. on Fin.", 97th Cong. 67 (1981) (statement of Robert K. Wilmouth, President, The Chicago Board of Trade, Chicago, Ill.).

2. Sam Y. Cross, "All About the Foreign Exchange Market in the United States", Federal Reserve Bank of New York (1998), at 15.

3. Triennial Central Bank Survey, Bank for International Settlements (April 2007).

4. Id. at 15-16.

5. Id. at 21. For the purposes of comparison, the CME is the largest regulated marketplace in the world for trading foreign exchange, with daily liquidity of over USD 80 billion (source CME website, www.cmegroup.com).

6. Id. at 44.

7. "Commodity 'Tax Straddles': Hearing before the H. Comm. on Ways & Means", 97th Cong. 59 (1981) (statement of Hon. Benjamin S. Rosenthal (N.Y.)).

8. The examples are based on the written testimony of Representative Brodhead, found at "Commodity 'Tax Straddles': Hearing before the H. Comm. on Ways & Means", 97th Cong. 7 (1981) (statement of Hon. William M. Brodhead (Mich.)).

9. "Commodity 'Tax Straddles': Hearing before the H. Comm. on Ways & Means", 97th Cong. 71 (1981) (statement of John E. Chapoton, Assistant Secretary for Tax Policy).

10. Id. at 63.

11. "Commodity Tax Straddles: Hearing before the Subcomm. on Taxation and Debt Mgmt. and the Subcomm. on Energy and Agric. Taxation of the S. Comm. on Fin.", 97th Cong. 116 (1981) (statement of Donald Schapiro, Tax Section, N.Y. State Bar Association).

12. Id. at 202 (statement of Michael L. Maduff, Maduff & Sons, Inc.).

13. Id.

14. 252 U.S. 189 (1920).

15. Id. at 207.

16. 348 U.S. 426 (1955).

17. Id. at 431.

18. "Commodity Tax Straddles: Hearing before the Subcomm. on Taxation and Debt Mgmt. and the Subcomm. on Energy and Agric. Taxation of the S. Comm. on Fin.", 97th Cong. 15 (1981) ("Background on Commodity Tax Straddles and Explanation of S.626").

19. Id. at 19.

20. Id.

21. Id. at 23-24.

22. 348 U.S. at 431.

23. "Commodity Tax Straddles: Hearing before the Subcomm. on Taxation and Debt Mgmt. [illegible] hm. on Energy and Agric. Taxation of the S. Comm. on Fin.", 97th Cong. 90 (1981) (statement of Lee H. Berendt, President, Commodity Exchange, Inc.).

24. Id. at 111-12 (statement of Donald Schapiro, Tax Section, N.Y. State Bar Association).

25. Letter from Frank V. Battle, Jr. to Thomas Gallagher, U.S. Department of the Treasury (December 8,1981), Tax Notes Documents No. 81-12076 and letter from Donald C. Lubick to Robert Woodward, Department of the Treasury (July 12, 1982), Tax Notes Documents No. 82-7832.

26. S. Rep. No. 97-592 at 4172.

27. S. Rep. No. 97-592 at 4172.

28. 2003-2 C.B. 1223.

29. See Michael Feder, Chip Harter and David Shapiro: "Notice 2003-81: Are OTC Currency Options Section 1256 Contracts?", 2003 *Tax Notes Today*, pp. 246-33 (22 December 2003) and Lee Sheppard: "Foreign Currency Contracts and the Unintended Consequences of Informal Guidance", 2004 *Tax Notes Today*, pp. 32-35 (16 February 2004).

30. 2007-35 I.R.B. 472, 2007 WL 2285349.
