



U.S. Taxation of Foreign Currency Futures, Options, and Forwards

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The globalization of the world economy has brought to the fore the importance of foreign currency derivatives. Corporate treasury departments use them to manage overseas investments, sales and purchases. Investment managers use them to shield against, or increase, currency exposure in their portfolios. Financial product developers include them when tailoring securities transactions to meet the needs of specific multinational clients. Recently, with the instability in the Asian markets, the importance of a sound currency hedging (or speculation!) policy has become increasingly apparent, and we should expect to see continued growth in the use of currency derivatives, both on exchanges and over the counter.

One factor that parties with a U.S. presence should be aware of when developing a foreign currency posture is the U.S. federal income tax consequences of using one kind of foreign exchange instrument, or combination of instruments, over another. The major U.S. federal income tax issues that arise when using derivative instruments include: the amount of tax income or loss generated by the instrument and the correct timing of its inclusion; the character of the income or loss as capital or ordinary; and the source of such inclusion for withholding tax and foreign tax credit purposes.¹ In this article, we will examine these issues separately for certain foreign currency transactions: foreign currency options, forwards, and futures.

Section 988 Transactions

The Internal Revenue Code has special rules for "§988 transactions." These are transactions in which

the amount the taxpayer is entitled to receive or required to pay is denominated in terms of a nonfunctional currency or determined by reference to the value of one or more nonfunctional currencies.² Transactions covered by §988 include entering into or acquiring any forward contract, futures contract, option or similar financial instrument.³ Timing of recognition of gain or loss under these contracts generally follows the normal recognition principles of the Code,⁴ but there are several exceptions. In addition, §988 has a special regime covering character and source.

Options

Timing

Generally, a taxpayer does not realize taxable income upon the receipt of an option premium.⁵ If the option expires unexercised, the premium income, less fees and commissions,⁶ becomes income to the grantor on the date of expiration, and is included in income in the year in which the option expires.⁷ In the case of a cash-settled option, the amount of income realized by the option grantor upon the exercise of an option is the amount of the premium less commissions and fees, adjusted by any payment between the parties. If the option is settled by delivery of property, the option grantor reduces its proceeds by its basis in such property.

The treatment of an option purchaser mirrors that of an option grantor. The mere payment of a premium for an option does not trigger immediate tax consequences. If the option expires unexercised, the taxpayer is treated as if it disposed of the option on the expiration date.⁸ The taxpayer will therefore have a loss for the amount of the option premium, plus commissions and fees, in the year in which the option expires. If a cash-settled option is exercised, the option purchaser will have gain equal to the difference between the premium paid, plus fees and commis-

¹ There are, of course, other significant factors, such as Subpart F treatment, foreign tax credit impact, UBTI issues, etc.

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² §988(c)(1)(A).

³ §988(c)(1)(B)(iii). In the case of regulated futures contracts and certain options, a taxpayer must elect treatment under §988. See discussion in text on character.

⁴ Reg. §1.988-2(d).

⁵ Rev. Rul. 78-182, 1978-1 C.B. 265, Rev. Rul. 58-234, 1958-1 C.B. 279, Rev. Rul. 71-521, 1971-2 C.B. 313.

⁶ Rev. Rul. 58-234, 1958-1 C.B. 279, Rev. Rul. 68-151, 1968-1 C.B. 363.

⁷ Rev. Rul. 78-182, 1978-1 C.B. 265.

⁸ §1234(a)(2).

sions, and the amount of cash received on settlement. If property is delivered in settlement, the purchaser's basis in the property received will be the exercise price plus the premium, as well as the fees and commissions paid.

Under a special rule for foreign currency contracts, if a taxpayer makes or takes delivery under the contract, then any gain or loss is realized as if the taxpayer had sold the contract for its fair market value on the delivery date.⁹

The exceptions to these general timing rules are numerous, and include the following:

Options that become part of a tax straddle. The U.S. tax law provides special treatment for "offsetting positions in personal property."¹⁰ These rules override the general §988 timing rules described above.¹¹ Most particularly, a taxpayer may not deduct a loss on one of the positions in a straddle to the extent of unrealized gains in any other offsetting positions;¹² it must capitalize all expenses associated with carrying positions that are part of a straddle;¹³ and its holding period on any position that is part of a straddle does not begin to run until the position ceases to be part of the straddle.¹⁴

For these purposes, a taxpayer will be considered to hold "offsetting positions in personal property" if holding one of the positions substantially diminishes the taxpayer's risk of loss from holding any other position.¹⁵ "Personal property" is any personal property of a kind that is actively traded.¹⁶ Actively traded property includes any property traded on:

- A national securities exchange;
- An interdealer quotation system sponsored by a national securities association (such as Nasdaq);
- A domestic board of trade;
- A foreign securities exchange or board of trade that satisfies analogous regulatory requirements under the law of the jurisdiction in which it is organized;¹⁷
- An interbank market;
- An interdealer market, *i.e.*, a system of general circulation that provides a reasonable basis to determine fair market value by disseminating recent price quotations.¹⁸

An example of a straddle in the currency context would be writing an option to sell Japanese yen and holding the Japanese yen currency in an account.

Since the value of the option to the writer will move in the opposite direction from the value of the Japanese yen, a loss on the option would be deductible only to the extent it exceeded the unrealized foreign exchange gain in the Japanese yen.

Transactions that are hedging transactions for tax purposes are excluded from the straddle provisions.¹⁹

Options that are "§1256 contracts." Currency options which are "§1256 contracts" are subject to special rules. The main timing impact of the application of §1256²⁰ is that the option will be subject to a mark-to-market regime. Two types of §1256 contracts could govern currency options:

- Nonequity options, *i.e.*, currency options listed on a qualified board or exchange; or²¹
- Foreign currency contracts, *i.e.*, contracts
 - (i) that require the delivery of, or the settlement of which depend on the value of, a foreign currency that is a currency in which positions are also traded through regulated futures contracts,
 - (ii) that are traded on the interbank market, and
 - (iii) that are entered into at arm's length at a price determined by reference to the price in the interbank market.²²

Some of the terms under the definition of "foreign currency contract" require explaining. A "regulated futures contract" is one with respect to which the amount required to be deposited and the amount that may be withdrawn depends on a system of marking to market, and that is traded on or subject to the rules of a qualified board or exchange.²³ The term "qualified board or exchange" means:

- (A) A national securities exchange that is registered with the Securities and Exchange Commission;
- (B) A domestic board of trade designated as a contract market by the Commodities Futures Trading Commission (CFTC); or
- (C) Any other exchange, board of trade or other market that the Secretary of the Treasury determines has rules adequate to carry out the purposes of §1256.²⁴

Thus far, the Treasury Department has ruled only three times under (C), as follows:

1. Futures and options contracts established under Mutual Offset System between the Chicago Mercantile Exchange and the Singapore International Monetary Exchange are considered traded on or subject to rules of exchange adequate for §1256 purposes.²⁵

⁹ §988(c)(5), Reg. §1.988-2(d)(4)(ii).

¹⁰ §1092.

¹¹ Reg. §1.988-2(d)(2)(i).

¹² §1092(a)(1)(A).

¹³ §263(g).

¹⁴ Reg. §1.1092(b)-2T(a)(1).

¹⁵ §1092(c)(2).

¹⁶ §1092(d)(1).

¹⁷ Such as the LIFFE, the Marche a Terme International de France, the International Stock Exchange of the U.K. and Ireland, the Frankfurt Stock Exchange and the Tokyo Stock Exchange.

¹⁸ Reg. §1.1092(d)-1.

¹⁹ §1092(e).

²⁰ §1256 also has a character component, *i.e.*, gain or loss is characterized as 60% long term capital gain or loss and 40% short term capital gain or loss without regard to the period for which the option has been held. At the taxpayer's election, these character provisions will not apply to forwards, futures, and options, and the gain or loss will be ordinary under §988. See text regarding character below.

²¹ §1256(g)(3).

²² §1256(g)(2).

²³ §1256(g)(1).

²⁴ §1256(g)(7).

²⁵ Rev. Rul. 87-43, 1987-1 C.B. 252.

2. The International Futures Exchange (Bermuda) Ltd. is a qualified board or exchange for purposes of §1256.²⁶

3. The Mercantile Division of the Montreal Exchange is a qualified board or exchange for purposes of §1256.²⁷

The key concept under §1256 is the system of marking to market. When a party enters into a futures or option contract on an exchange, that party (or its agent) will be required to put up a "margin," which serves to assure the exchange that the party will be able to fulfill its side of the contract when the time comes due. If the price of a derivative contract moves on any trading day, every party with an open contract in that market will either make a gain or a loss. That loss is not merely a book loss, as it would be for a forward contract, or an over-the-counter option, but is actually realized through the adjustment of the margin account. Those parties with contracts that appreciated in value compared with the previous trading day will have their accounts increased, and parties whose contracts declined in value will have their accounts decreased. This was the reason Congress believed that taxpayers holding exchange-traded instruments should have a recognizable tax event at year end, even if they did not dispose of their derivative contracts.

Congress extended the mark-to-market requirement to those foreign currency contracts that had sufficiently similar features to the exchange-traded instruments—namely those traded on the interbank market. Legislative history to §1256 indicates that contracts traded on the interbank market include contracts between a commercial bank and another person and contracts entered into with a futures commission merchant who is a participant in the interbank market. A "futures commission merchant" (FCM) is an entity that fulfills a number of functions as intermediary between customers and brokers in the pit. The CFTC requires registration of all FCMs, which it defines as entities

... engaged in soliciting or accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that, in or in connection with such solicitation or acceptance of such order, accepts any money, securities, or property ... to margin, guarantee, or secure any trades or contracts that result ... therefrom.²⁸

The application of §1256 to foreign exchange options is somewhat anomalous. Although a foreign exchange option may technically meet the three-prong test required for a foreign currency contract, the policy basis for requiring the contract to be marked to

market for tax purposes does not exist. As a result of asymmetry in the economics of the underlying contracts, there is no real gain or loss until the option is exercised, sold, or expires. There is no accumulation of profit or loss over the life the contracts and option positions are not marked to market on the exchanges, for example. Therefore, it is difficult to see why they should be marked to market either under §1256(g)(1) or (g)(2).²⁹

Transactions that are hedging transactions for tax purposes are excluded from this mark-to-market requirement.³⁰

Character

The character of gain or loss from transactions governed by §988 is generally ordinary.³¹ If a foreign currency option falls under the definition of a non-equity option, however, its character will be capital unless the taxpayer elects ordinary treatment.³² In addition, a taxpayer may elect to treat foreign currency gain or loss attributable to a foreign currency forward contract, futures contract, or option that is a capital asset in the taxpayer's hands and that is not part of a straddle (as defined above) as capital gain or loss if the transaction is identified on the close of the day on which the transaction is entered into.³³

Withholding

To the extent that an option contract is acquired from, or sold to, a foreign entity, the need to withhold U.S. tax on any income must be considered. There is no authority as to whether income received by a foreign person upon sale, or cash settlement, of an option constitutes fixed or determinable, annual or periodical (FDAP) income and is therefore subject to withholding tax under §871(a)(1). Moreover, there are no specific rules relating to the sourcing of income realized with respect to an option. The U.S. Treasury has authority to issue sourcing rules for options, forwards, and futures contracts, but this authority has not been exercised. Therefore, income realized under option, forward, and futures contracts is sourced under the general sourcing provisions of the Internal Revenue Code, and there is no clear authority on point.

For many taxpayers, the question of withholding is resolved by treaty rather than domestic law. Under the 1996 U.S. Model Treaty,³⁴ income from financial instruments not specifically covered by another treaty article will be covered by "Other Income" in Article 21 and will be subject to income tax only in the country of residence of the recipient. For taxpayers

²⁶ See Roberta Romano, "A Thumbnail Sketch of Derivative Securities and Their Regulation," 55 *Maryland L. Rev.* 1, at 43.

²⁷ §1256(e)(1).

²⁸ §988(a)(1)(A).

²⁹ §988(c)(1)(D).

³⁰ §988(a)(1)(B).

³¹ The U.S. Model Income Tax Convention of September 20, 1996.

²⁶ Rev. Rul. 85-72, 1985-1 C.B. 286.

²⁷ Rev. Rul. 86-7, 1986-1 C.B. 295.

²⁸ 17 CFR, Section 1.3(p).

with option gains or losses generated by a business in dealing in such instruments, the income or loss may be covered by the "Business Profits" articles of the model or other relevant treaty.³⁵

If the transaction in question is not covered by a treaty, additional analysis must be made to build the position that no withholding is required.

Forwards

Timing

A taxpayer that enters into a forward contract (*i.e.*, a non-exchange traded contract) to buy or sell foreign currency generally does not have to recognize gain or loss on the contract until it is terminated, assigned, offset, or otherwise disposed of by the taxpayer.

If a taxpayer makes or takes delivery under the forward contract, then any gain or loss is realized as if the taxpayer sold the contract for its fair market value on the delivery date.³⁶

Many of the exceptions to the option timing rules discussed above will also be applicable to currency forwards. Forward contracts in the major currencies are generally subject to the straddle rules because, for example, they are also traded on the interbank market, or through a foreign exchange that operates similarly to the U.S. exchanges. Such contracts will therefore be subject to the loss deferral rule.

In addition, a forward contract in a currency that is traded through regulated futures contracts and on the interbank market will generally be a §1256 contract.³⁷ Section 1256 requires that such forward contracts be marked to market at year-end. Recently, a very interesting question has arisen with respect to forward contracts in the Indonesian rupiah, Malaysian ringgit, and the Thai baht. The FINEX in New York originally listed these contracts for trading on its exchange. During 1997, the exchange stopped listing the currencies, but on Dec. 5, 1997, they relisted these currencies. However, for the rest of December 1997, there was virtually no trading on the FINEX in these currencies. The question arises as to what the following requirement under §1256(g)(2) means: 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*. (Emphasis added.) How much trading is required to be considered "also trad-

ed"? What if a contract on a particular currency is traded on a futures exchange at the beginning of the year, but trading ceases midway through the year? What if trading in a particular foreign currency contracts only begins midway through the year? These are questions for which §1256 provides no answers and there are no regulations or rulings under §1256 to provide taxpayers any guidance either. Considering the volatility of the rupiah, ringgit, and baht in 1997, the consequences to taxpayers and the Treasury of marking to market contracts on these currencies is considerable, and for that reason, some assistance from Treasury in deciding these questions would be very helpful.

Character

As in the case of foreign currency options, the character of gain or loss from currency forwards governed by §988 is ordinary.³⁸ A taxpayer may elect to treat foreign currency gain or loss attributable to a forward contract that is a capital asset in the taxpayer's hands—and not part of a straddle as described above—as capital gain or loss if the taxpayer identifies the transaction on the close of the day on which the transaction is entered into.³⁹

Withholding

As discussed above, in order to determine whether income to a non-U.S. person is subject to withholding tax, it has to be determined whether the income is sourced within or outside the U.S. under general sourcing principles. There is no clear guidance on this issue and, as discussed in the section on options, many of these issues will be resolved under the particular income tax treaty that governs the taxation of the parties to the transaction.

Futures contracts

Timing

Futures contracts are, by definition, exchange-traded, and therefore, those futures contracts that are traded in the United States are §1256 contracts. Accordingly, unless the contracts are hedges for tax purposes, they must be marked to market at year-end, and gain or loss would be taken into account at that time.

Character

As in the case of foreign currency options and forwards, the character of gain or loss from currency futures governed by §988 is ordinary.⁴⁰ A taxpayer may elect to treat foreign currency gain or loss attributable to a forward contract, futures contract, or option that is a capital asset in the taxpayer's hands and not part of a straddle (as described above) as capital gain or loss if the taxpayer identifies the

³⁵ Article 7 of the 1996 Model Treaty.

³⁶ §988(c)(5), Reg. §1.988-2(d)(4)(ii).

³⁷ §1256 requires that the contract be traded on the interbank market, and this concept is discussed in the legislative history to §1256. The House Amendment states:

Contracts traded in the interbank market generally include not only contracts between a commercial bank and another person but also contracts entered into with a futures commission merchant who is a participant in the interbank market. A contract between two persons neither of whom is a futures commission merchant or other similar participant in the interbank market is not a foreign currency contract under the provision.

³⁸ §988(a)(1)(A).

³⁹ §988(a)(1)(B).

⁴⁰ §988(a)(1)(A).

transaction on the close of the day on which the transaction is entered into.⁴¹

Hedging Transactions

Special rules apply to taxpayers that use financial instruments as "hedging" vehicles, as that term is understood in the tax law. Although foreign currency instruments will get ordinary income treatment whether they are used for hedging or not, the timing of inclusion of the income or loss on a hedging transaction will depend on the timing of the income or loss on the item being hedged. For these purposes, a hedging transaction is a transaction that a taxpayer enters into in the normal course of its business primarily to reduce the risk:

Of price changes or currency fluctuations with respect to ordinary property held or to be held by the taxpayer; or

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.⁴²

For this purpose, ordinary property is property that, upon disposition, will never give rise to capital gain or loss.⁴³

The principle the taxpayer must follow when taking into account income and loss under a hedging transaction is "clear reflection of income." To clearly reflect income, the accounting method chosen by the taxpayer must reasonably match the timing of income, deduction, gain or loss from the hedging transaction with the timing of income, deduction, gain and loss from the item being hedged.⁴⁴ The IRS is flexible in this regard and acknowledges that there may be more than one method of accounting that satisfies the clear reflection of income principle. However, once a method of accounting is adopted by the taxpayer, it must be used consistently and can be changed only with consent of the commissioner.⁴⁵ A taxpayer's books and records must contain a description of the accounting method used for each type of hedging transaction and the description must be sufficient to show how the clear reflection requirement is satisfied.⁴⁶

A taxpayer is permitted to hedge aggregate risk, but still is required to comply with the clear reflection of income requirement. In such a situation, the taxpayer must match the timing of income, etc., from the hedging transaction with timing of the income, etc., of the aggregate items being hedged.⁴⁷ There are special

rules for hedging transactions that take place within a consolidated group.

In order to avoid having to mark to market §1256 contracts that are used as hedging transactions and to avoid loss deferral under the straddle provisions, a taxpayer must identify the foreign exchange derivative contract as a hedging transaction. To do this, the taxpayer must identify the contract as a hedging transaction before the close of the day on which the transaction is entered into.⁴⁸ The taxpayer also must identify the item being hedged within 35 days of entering into the hedging transaction.⁴⁹ The identification must state the item, items, or aggregate risk being hedged by identifying the transaction that creates risk and the kind of risk the transaction creates. The identification must be included in the taxpayer's books and records and must be unambiguous. An identification for accounting or regulatory purposes is not sufficient, unless that there is clear indication that the identification is for tax purposes as well and contains all the relevant information required by the tax identification rules.

Securities Held by a Dealer

Taxpayers that are considered "dealers in securities" are subject to mark-to-market treatment on their securities portfolio. A "dealer" is very broadly defined as a taxpayer that regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.⁵⁰ A security includes stock, evidence of indebtedness, swap, or other derivative instrument.⁵¹ A currency option, for example, could be part of a dealer's portfolio, and unless the option is held by the taxpayer as an investment,⁵² or is a hedge of property or liabilities not subject to the mark-to-market requirement,⁵³ the taxpayer treats the option as if sold for its fair market value on the last business day of the taxable year, and takes the resulting gain or loss into account for that year.⁵⁴

Even those taxpayers that generally would not consider themselves to be "dealers" may find that they in fact are dealers under §475. For example, a trading or hedging subsidiary that generally enters into financial transactions with other members of its consolidated or affiliated group may be considered a dealer in securities. Taxpayers with "customers" that are limited to members of their own consolidated group are gov-

⁴¹ §988(a)(1)(B).

⁴² Reg. §1.1221-2(b).

⁴³ Reg. §1.1221-2(c)(5). Accordingly, a hedge of an ordinary income stream from a capital asset, for example, dividends or royalties, will not qualify as a tax hedge.

⁴⁴ Reg. §1.446-4(b).

⁴⁵ Reg. §1.446-4(c).

⁴⁶ Reg. §1.446-4(d).

⁴⁷ Reg. §1.446-4(e)(1)(i).

⁴⁸ §1256(e)(2)(C), Reg. §1.1256(e)-1 and §1092(e).

⁴⁹ Reg. §1.1221-2(e)(2).

⁵⁰ §475(c)(1).

⁵¹ §475(e)(2).

⁵² §475(b)(1)(A).

⁵³ §475(b)(1)(C).

⁵⁴ §475(a)(2).

erned by special rules and may be able to elect out of dealer status in the right circumstances.

Under the Taxpayer Relief Act of 1997 (P.L. 105-34), a taxpayer that is engaged in a trade or business as a trader in securities and makes an appropriate election will also be able to mark to market any security held in connection with the taxpayer's trade or business.⁵⁵

Summary

Foreign currency contracts generally produce ordinary income or loss (or do so at the election of the taxpayer for regulated futures and nonequity options). In certain circumstances, a taxpayer may elect capital treatment on some derivative foreign exchange

⁵⁵ §475(f)(1).

securities. The timing for taking into account gains and losses on these transactions will be determined by the type of instrument and the use to which it is put by the taxpayer. For example, a hedging transaction generally will be subject to a timing regime that matches the income, gain, deduction or loss from the hedging transaction with those items from the hedged item. In addition, if a taxpayer is a dealer in securities under §475, mark-to-market accounting is generally required on all securities. No clear guidance exists with respect to the appropriate treatment, for withholding tax purposes, of amounts paid pursuant to foreign currency contracts to nonresidents. To the extent not covered by treaty, separate analysis of each type of transaction will be required to determine the necessity for withholding on payments to nonresidents.