Marking Without Section 1256?

**by Lee A. Sheppard**

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Readers will recall there was a concern that the presumed movement of derivatives onto exchanges because of changes to financial regulation would mean that they would become section 1256 contracts. So the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA, P.L. 111-203) tried to address the problem by means of midnight addition to section 1256.

Existing problems with section 1256 are exacerbated no matter how the fix is interpreted, according to Stephen Larson, IRS associate chief counsel (financial institutions and products), and Phoebe Mix, IRS special counsel and associate chief counsel (financial institutions and products).

The addition of section 1256(b)(2)(B) was billed as a clarifying change designed to preserve the law as it was before any derivatives began to be traded. It was a stopgap measure drafted by tax people and accepted by the banking bill drafters.

New section 1256(b)(2)(B) excludes from the definition of a section 1256 contract "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."

The DFA exposed all kinds of current flaws in section 1256, which was the tax law's first primitive attempt to force marking to market, but only as a punishment for commodities straddle shelters of the 1970s. After 60/40 treatment became popular with taxpayers, section 1256 became a layer cake of political rewards and punishments.

Because of 60/40 treatment on the one hand, and the legislative propensity to fiddle with the statute for each financial development on the other, the IRS has always interpreted section 1256 narrowly, in what Mix called "almost an originalist" view. That is, the IRS was loath to grant the privilege of 60/40 treatment to every contract that taxpayers might voluntarily submit for clearing on exchanges.

But the DFA changed all that. Not only does it positively encourage or even require the players to clear their contracts, Congress for the first time took a broad view of the literal wording of section 1256.

Congress added section 1256(b)(2)(B) because it was convinced that many derivatives that did not exist in the early 1980s would be swept into 60/40 treatment.

"Congress was trying to maintain the status quo, and did not think it through, missed the other implications," said Larson. He added that Commodity Futures Trading Commission regulators have no reason to care whether a contract is a swap or a future.

The Obama administration has suggested repeal of 60/40, but there may be another route to allowing marking when it is appropriate. Marking positions to market is an accounting method. Section 446 gives the IRS plenary power over accounting methods.

When Viva Hammer of KPMG LLP's Washington National Tax practice asked whether section 1256 is the exclusive route to marking to market for non-dealers, Larson said no.

"Mark to market is an accounting method. We have to think about authority, but we don't fear that treating mark to market as a method is out of the question," said Larson.

That is, it is not out of bounds for the IRS to broadly accept the use of a mark-to-market method for derivatives by taxpayers using this method for book purposes.

What about the undefined terms in section 1256(b)(2)(B)? They have to be anchored to something, and because there are no tax law definitions, that anchor may have to be the DFA itself.

The IRS does not appear anxious to define section 1256 terms further. Taxpayers appear inclined to fit their contracts under the closest term. Larson and Mix admitted that the IRS may have to define a futures contract.

Section 1256 requires regulated futures contracts to be marked to market, with gain or loss being treated as capital. Section 1256(g)(1) clarifies that a regulated futures contract is a contract "with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market, and . . . which is traded on or subject to the rules of a qualified board or exchange."

But the DFA changed everything we thought we knew, Mix explained. "Subject to" seems to require an audit trail of daily marking, Mix mused. But there is no meaningful, principled way to differentiate economically equivalent contracts that are inside and outside section 1256, she explained.

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| **Code** **Sections:** |   | Section 446 -- Methods of AccountingSection 475 -- Mark-to-Market AccountingSection 1256 -- Futures Marked to Market  |
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