

Tax Treatment of Derivatives

1. Introduction

The US federal income taxation of derivative instruments is determined under numerous tax rules set forth in the US tax code, the regulations thereunder (and supplemented by various forms of published and unpublished guidance from the US tax authorities and by the case law).¹ These tax rules dictate the US federal income taxation of derivative instruments without regard to applicable accounting rules.

The tax rules applicable to derivative instruments have developed over time in piecemeal fashion. There are no general principles governing the taxation of derivatives in the United States. Every transaction must be examined in light of these piecemeal rules. Key considerations for issuers and holders of derivative instruments under US tax principles will include the character of income, gain, loss and deduction related to the instrument (ordinary vs. capital) and the timing of recognition of income, gain, loss and deduction. Other issues include the source of the income, gain, loss and deduction, the treatment for foreign tax credit purposes and the treatment for Subpart F purposes. This article will concentrate on the major issues of timing and character.

As a general matter, in evaluating the taxation of a particular derivative instrument under the Code, taxpayers must make determinations regarding a number of aspects of the instrument including the nature of the instrument (e.g. over-the-counter or exchange-traded, option, future, forward or swap), the intended use of the instrument (e.g. speculative or business hedge), the nature of the taxpayer (dealer, trader, or investor, business or individual), whether the transaction takes place within or outside the United States, and whether the counterparty is a US or non-US person. In addition, taxpayers must consider the applicability of numerous anti-abuse rules in the Code that apply to certain transactions involving derivative instruments (e.g. the so-called straddle rules, the constructive sale rules of section 1259).²

1.1. Character: capital versus ordinary

Under the Code, the character of income, gain, loss and deduction relating to a derivative instrument is determined by a combination of rules unique to derivative

instruments, as well as principles of general applicability. Often, the nature of the derivative instrument will dictate whether it is taxed as a capital asset or an ordinary asset (*see* discussion of section 1256 contracts, below). In other instances, the nature of the taxpayer will dictate whether it is taxed as a capital asset or an ordinary asset (*see* discussion of dealers versus traders, below).

Generally, the starting point will be to determine whether the instrument is a “capital asset” or an “ordinary asset” in the hands of the taxpayer. Section 1221 defines “capital assets” by exclusion – unless an asset falls within one of eight enumerated exceptions, it is viewed as a capital asset. Exceptions to capital asset treatment relevant to taxpayers transacting in derivative instruments include the exceptions for (1) hedging transactions³ and (2) “commodities derivative financial instruments” held by a “commodities derivatives dealer”.⁴

1.2. Nature of contract and section 1256

Determining whether a particular derivative instrument is subject to the special rules of section 1256 is a key question under the Code. Section 1256 provides special timing and character rules pursuant to which income, gain and loss with respect to certain derivative instruments is taxed on a “mark-to-market” basis as capital gain (or loss). Under this mark-to-market method, derivative instruments are treated as sold (and repurchased) for fair market value on the last day of each year (i.e. marked to market), and any gain or loss resulting from this deemed sale is realized by the taxpayer as short-term capital gain or loss to the extent of 40% of the gain or loss; the remaining 60% is treated as long-term capital gain or loss (this special character rule is commonly referred to as the 60/40 rule).⁵

Determining whether section 1256 applies to a particular derivative instrument hinges on consideration of the various types of contracts defined under the statute. Contracts subject to section 1256 include “regulated futures contracts”, “foreign currency contracts”, “non-equity options”, “dealer equity options”, and “dealer securities futures contracts”.⁶ This article will discuss when the various common types of derivative instruments covered by this comparative survey might qualify as section 1256 contracts.

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1. Unless otherwise indicated, all section references are to the US Internal Revenue Code of 1986, as amended (the Code), and Treas. Reg. or Treasury regulation references are to the Treasury regulations promulgated thereunder.
2. A discussion of all the anti-abuse rules that may be applicable to transactions involving derivative instruments is beyond the scope of this article. For discussion of these rules, *see* generally A. Kramer, *Financial Products: Taxation, Regulation, and Design* (CCH, 2006).

3. Section 1221(a)(7). *See* below for further discussion of the hedging rules.
4. Section 1221(a)(6). *See* below for further discussion.
5. *See* section 1256(a).
6. *See* section 1256(b)(1). For discussion of when option contracts might qualify as section 1256 contracts, *see* section 2.1.1. For discussion of when futures contracts (and similar contracts) might qualify as section 1256 contracts, *see* section 2.1.2. A detailed discussion of the class of contracts subject to section 1256 as dealer securities futures contracts, is beyond the scope of this article. As a general matter, this category of section 1256 contracts will cover certain contracts traded and sold by taxpayers qualifying as securities futures dealers.

1.3. Dealers versus traders, and taxpayer elections

Certain taxpayers are subject to special character and timing rules under section 475. Namely, “dealers” in certain “securities” are required to account for their securities transactions related to their trade or business of dealing in such securities on a mark-to-market basis. Much like the section 1256 mark-to-market regime, securities subject to this mark-to-market regime will be treated as sold (and repurchased) for fair market value on the last day of each year.⁷ However, unlike section 1256, any resulting gain or loss for a dealer in securities will be treated as ordinary income (or loss).⁸ Whether a taxpayer constitutes a dealer in securities for these purposes is determined based on a facts and circumstances test which looks to a number of factors, including the frequency and regularity of the taxpayer’s transactions in securities, the intent of the taxpayer, the presence of customers, the nature of the taxpayer’s profit from the activity (distinguishing between a dealer-like markup on the one hand and a speculative or investment type profit on the other) and how the taxpayer holds itself out to the general public.⁹ Only certain “securities” are subject to this mandatory mark-to-market regime.¹⁰

Additionally, certain taxpayers may make certain elections under section 475 to account for their securities and commodities transactions under a similar mark-to-market methodology. These elections are available for dealers in certain commodities,¹¹ as well as traders in securities or commodities.¹² A taxpayer wishing to make any of these elections must file a statement no later than the due date (without regard to extensions) for the tax return for the taxable year immediately preceding the election year. Once such an election is made, it applies to the tax year for which the election is made and all subsequent tax years, unless revoked with the consent of the US tax authorities.¹³

Finally, under section 1221(a)(6), various types of derivative instruments¹⁴ which do not meet the definition of a

7. See section 475(a).
8. See section 475(d)(3).
9. See generally CCA 200817035 (discussing numerous authorities considering when a taxpayer is a dealer for purposes of section 475).
10. See section 475(c)(2) (defining securities for purposes of section 475). Dealers in securities may also take steps to identify certain securities as held for investment and thus avoid applying the mark-to-market regime to such securities. See section 475(b).
11. The commodities dealer election is provided for in section 475(e).
12. The trader elections are provided for in section 475(f) and are commonly referred to as the section 475(f) election. A taxpayer seeking to make one of these trader elections will need to satisfy a facts and circumstances test which looks to factors similar to those examined in determining whether a taxpayer is a dealer under section 475. Moreover, a taxpayer must ensure that its activities are sufficiently regular and continuous enough to avoid being characterized as merely an “investor” (in which case the election will not be available). See generally *Chen v. Commr*, TCMemo 2004-132.
13. See section 475(e)(3) and section 475(f)(3).
14. Section 1221(a)(6) generally applies to any commodities derivative financial instrument held by a taxpayer. The statute defines “commodities derivative financial instrument” as “any contract or financial instrument with respect to commodities (other than a share of stock in a corporation, a beneficial interest in a partnership or trust, a note, bond, debenture, or other evidence of indebtedness, or a section 1256 contract (as defined in section 1256(b))), the value or settlement price of which is calculated by or determined by reference to a specified index” (with “specified index” being defined as referencing “financial or economic information with respect to commodities which is not within the control of any of the parties to the contract or instrument and is not unique to any of the

section 1256 contract (see discussion above) and which are held by a commodities derivative dealer are generally treated as ordinary assets. For these purposes, a “commodities derivatives dealer” is a person which regularly offers to enter into, assume, offset, assign or terminate positions in commodities derivative financial instruments with customers in the ordinary course of a trade or business.¹⁵

1.4. Tax straddle rules and section 1092

Section 1092 contains a set of rules commonly referred to as the “straddle rules”, the primary effect of which is to potentially defer the recognition of a portion of realized losses on a transaction meeting the statutory definition of “straddle”. Under section 1092, “straddle” is defined generally as “offsetting positions with respect to personal property”.¹⁶ The term “personal property” is defined as “any personal property of a type which is actively traded”, which can include, for example, debt instruments, futures, forwards, swaps and index options.¹⁷ Under section 1092(c)(2)(A), a taxpayer “holds offsetting positions with respect to personal property if there is a substantial diminution of the taxpayer’s risk of loss from holding any position with respect to personal property by reason of his holding [one] or more other positions with respect to personal property (whether or not of the same kind)”. Section 1092 contains certain rebuttable presumptions pursuant to which two or more positions will be presumed to be offsetting if the value of such positions “ordinarily varies inversely with the value of [one] or more other positions”.¹⁸

Certain types of “straddles”, commonly referred to as “mixed straddles”, present unique tax accounting issues for

parties’ circumstances”). See section 1221(b)(1)(B). With the important exception of section 1256 contracts (which fall outside of the universe of contracts eligible for ordinary treatment under section 1221(a)(6)), many swaps, caps, floors, forward contracts and similar financial instruments with respect to commodities will meet the definition of “commodities derivatives financial instrument”.

15. See section 1221(b)(1)(A).
16. See section 1092(c)(1). A special set of rules applies where a taxpayer holds corporate stock and certain offsetting positions. See generally section 1092(c)(4) and the discussion following Case Study (4) below.
17. Section 1092(d)(1) and the regulations thereunder. To determine whether property is “actively traded”, the regulations set forth a number of factors that a taxpayer must look to, depending on the type of property in question. See Treas. Reg. section 1.1092(d)-1.
18. See section 1092(c)(3) (flush language). The presumption is potentially subject to rebuttal, although no clarification has been provided by the US tax authorities as to what steps a taxpayer must take to overcome the presumption. See section 1092(c)(3)(A). Notably, two or more positions “in debt instruments of a similar maturity” are presumed to be offsetting if the value of the positions ordinarily move inversely to the other(s). See section 1092(c)(3)(A)(iii). The other examples of positions that are presumed to be offsetting are: (1) positions in the same personal property (whether established in such property or a contract for such property); (2) positions in the same personal property, even though such property may be in a substantially altered form; (3) positions sold or marketed as offsetting positions (whether or not such positions are called a straddle, spread, butterfly or any similar name); and (4) positions for which the aggregate margin requirement is lower than the sum of the margin requirements for each such position (if held separately). See section 1092(c)(3)(A)(i)-(v). Apart from these rebuttable presumptions, neither the Code nor the regulations provide guidance on when a taxpayer’s position in personal property is considered to “substantially diminish” the taxpayer’s risk of loss from holding other positions in personal property. As such, taxpayers and tax practitioners have been largely left to reach their own determinations as to what level of risk reduction is enough to rise to the level of “substantial diminution”.

taxpayers. Generally, under section 1092, a “mixed straddle” is a “straddle” containing a mix of non-section 1256 contracts and section 1256 contracts (a straddle composed only of section 1256 contracts or only of non-section 1256 contracts is not a “mixed straddle”).¹⁹ A taxpayer deemed to hold a mixed straddle has a variety of options for accounting for such a straddle. Initially, and provided that the taxpayer does not make one of the elections discussed below, the taxpayer may simply apply the general straddle rules described herein and the section 1256 rules in tandem. Very generally, this means that (1) the mark-to-market regime of section 1256 will apply to the section 1256 contracts in the mixed straddle and (2) the general straddle rules will apply to potentially defer recognition of losses and truncate holding periods of positions in the straddle (thereby increasing the likelihood that gain/loss upon disposition will be taxed as short-term capital gain/loss).

A taxpayer that enters into transactions subject to the straddle rules must comply with a number of specific rules briefly summarized below. The primary objective of these rules is to prevent taxpayers from selectively recognizing losses by disposing of only one leg of a straddle or from aging the holding period of positions that are offset economically. The application of these anti-abuse rules is significantly modified if a taxpayer makes one of several elections available to taxpayers holding straddles (*see below*).

Loss deferral. Section 1092(a)(1) provides, with certain limited exceptions, that any loss with respect to one or more positions in personal property is taken into account only to the extent that it exceeds the unrecognized gain in one or more offsetting positions. Any losses deferred by virtue of this rule are carried over into ensuing tax years and may be recognized in such years, subject to the same limitation.²⁰ Detailed regulations provide that for purposes of this loss deferral rule, certain “successor” positions and positions offsetting to successor positions must be taken into account.²¹ As discussed below, a taxpayer may in certain circumstances make one of several elections in order to avoid the application of this loss deferral rule.

19. See Treas. Reg. section 1.1092(b)-5T(e) (defining “mixed straddle” as “a straddle (1) [a]ll of the positions of which are held as capital assets; (2) [a]t least one (but not all) of the positions of which is a section 1256 contract; (3) [f]or which an election under section 1256(d) has not been made; and (4) [w]hich is not part of a larger straddle”). The question of exactly how much section 1256 contract exposure needs to be held by the taxpayer in order for a series of positions to constitute a mixed straddle is unclear, but no minimum amount is specified in the regulations.

20. See section 1092(a)(1)(B) and Treas. Reg. section 1.1092(b)-1T(b). Thus, for example assume that on 1 July 2012, the taxpayer enters into a forward contract to sell commodity X with a Jan. 2013 delivery date and holds a long position in commodity X. By Dec. 2012, the price of commodity X has increased and the taxpayer closes out the short position at a loss of USD 1 million. During 2012, the taxpayer sells half of its long position for a gain of USD 750,000; at 31 Dec. 2012, the taxpayer’s remaining long position would settle at a USD 400,000 gain based on the prevailing spot price. In June 2013, the taxpayer sells the remaining long position at a gain of USD 350,000. In this case, assuming that section 1092’s loss deferral rule applied to the transaction, recognition of USD 400,000 of the USD 1 million loss realized in Dec. 2012 would be deferred into the following year.

21. See Treas. Reg. section 1.1092(b)-1T(a)(2). A successor position is generally defined as a position that is or was at any time offsetting to a second position if (1) “[t]he second position was offsetting to any loss position disposed of” and (2) the position “is entered into during a period commencing 30 days prior to and ending 30 days after, the disposition of the loss position” referred to in subparagraph (i). See Treas. Reg. section 1.1092(b)-5T(n).

Modified wash sale rules. Rules contained in Treas. Reg. section 1.1092-1T (also known as the “modified wash sale rules”) generally provide that any loss sustained from the disposition of shares of stock or securities that constitute positions of a straddle is not taken into account if, within a prescribed period, the taxpayer acquires or enters into a contract or option to acquire substantially identical stock or securities.²² These rules apply to defer loss on the disposition of a leg of a straddle prior to the application of the loss deferral rule described above.²³

Modified short sale rules. The modified short sale rules of section 1092 can truncate the holding period of positions held as a part of a straddle, thereby limiting the potential for taxpayers to realize long-term capital gain upon disposition of the position.²⁴ Yet another aspect of these modified short sale rules may cause loss realized upon exercise or lapse of certain positions in a straddle to be treated as long-term capital loss.²⁵

Interest and carrying cost capitalization. Under section 263(g), taxpayers are denied a deduction for “interest and other carrying charges” (as defined therein) that are allocable to personal property that is part of a straddle. Instead, such amounts must be capitalized into the basis of the associated personal property and will accordingly reduce the gain or increase the loss recognized upon the disposition of the property.

Straddle reporting. To the extent that a taxpayer disposes of a straddle position at a loss, the straddle rules require the taxpayer to disclose all of its positions that have unrecognized gain at the close of the taxable year and the amount of unrecognized gain in each of the positions.²⁶ Such reporting is to be made on IRS Form 6781 on a yearly basis.

A taxpayer holding derivative instruments subject to the straddle rules may potentially make one of a number of different elections which will materially affect how the taxpayer accounts for its straddle transactions:

- *Mixed straddle account election.* A taxpayer may elect to establish one or more “mixed straddle accounts” (MSAs) to account for any mixed straddles it may hold in its portfolio.²⁷ “MSA” is defined generally as “an account for determining gains and losses from all positions held as capital assets in a designated class of activities by the taxpayer at the time the taxpayer elects to establish a mixed straddle account”.²⁸ The election is made on a yearly basis.²⁹ The chief benefit to tax-

22. See Treas. Reg. section 1.1092(b)-1T(a)(1). The relevant period is the period beginning 30 days before the date of such disposition and ending 30 days after such date.

23. See Treas. Reg. section 1.1092(b)-1T(a).

24. See Treas. Reg. section 1.1092(b)-2T(a)(1). However, this holding period termination rule does not apply to a position held by the taxpayer for at least the long-term capital gain holding period before the straddle that includes the position was established. See Treas. Reg. section 1.1092(b)-2T(a)(2).

25. See Treas. Reg. section 1.1092(b)-2T(b).

26. See section 1092(a)(3)(C). This disclosure must be made whether or not the positions are part of a straddle. See section 1092(a)(3)(C)(i)(I).

27. See section 1092(b)(2)(A)(i)(II).

28. See Treas. Reg. section 1.1092(b)-4T(b)(1).

29. See Treas. Reg. section 1.1092(b)-4T(f)(1)-(2). The election is made on IRS Form 6781 which must be filed with the taxpayer’s income tax return (or request for extension) by the due date (without regard to extensions)

payers from establishing an MSA is the substantially simplified rules for accounting for gain and loss with respect to positions within the MSA. Taxpayers that elect to create an MSA may avoid tracking deferred losses on a straddle-by-straddle basis and may avoid the modified wash-sale and short-sale rules described above. Generally, under the regulations all positions in the MSA will be marked-to-market on a daily basis and the resulting gain/loss recognized annually.³⁰ On the last business day of the taxable year, the “annual account net gain or loss” for each MSA is determined, and the taxpayer must then net such amounts across all of its MSAs.³¹ Should a taxpayer decide in the future that MSA accounting for any of its mixed straddles is not desirable, the taxpayer may stop making the MSA election in the following tax year.

- *Mixed straddle election.* Another option available to taxpayers engaging in straddle transactions, the section 1256(d) election (sometimes referred to simply as the “mixed straddle election”) has the effect of excluding from section 1256 all section 1256 contracts held as part of a mixed straddle.³² Thus, this election simply turns off the mark-to-market regime and 60/40 treatment provided for under the section 1256 rules, while the general straddle rules would continue to apply to the positions in the straddle. The section 1256(d) election is made on a one-time basis and may be revoked only with consent of the US tax authorities.³³
- *Identified straddle election.* The “identified straddle election” has a principal benefit of not subjecting positions held by a taxpayer as part of a straddle to the loss deferral rule of section 1092(a)(1). Rather, under a special set of rules, losses realized on disposition of a leg of a straddle are capitalized into the basis of the offsetting position.³⁴ This election requires the taxpayer to separately identify each straddle on the day acquired as subject to the special rules.³⁵
- *Identified mixed straddle-by-straddle election.* The “identified mixed straddle-by-straddle election” is an election whereby the taxpayer can elect to have a special mark-to-market regime apply to certain iden-

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 of the taxpayer’s income tax return for the immediately preceding taxable year (or part thereof).

- 30. See Treas. Reg. section 1.1092(b)-4T(c)(1). Under the regulations, an adjustment (to basis or otherwise) is made to any subsequent gain or loss determined to take into account any gain or loss determined for prior days.
- 31. See Treas. Reg. section 1.1092(b)-4T(c)(2). No more than 50% of the taxpayer’s total annual account net gain for the taxable year may be treated as long-term capital gain, and any long-term capital gain in excess of this limit is treated as short-term capital gain. See Treas. Reg. section 1.1092(b)-4T(c)(4). Similarly, no more than 40% of the taxpayer’s total annual account net loss for the taxable year may be treated as short-term capital loss, and any excess short-term capital loss is treated as long-term capital loss.
- 32. See section 1256(d)(1).
- 33. See section 1256(d)(3).
- 34. See generally 1092(a)(2). The making of the identified straddle election also permits a taxpayer to ring off positions within an identified straddle from positions outside of such identified straddle for purposes of applying the offsetting position rules of section 1092. See section 1092(c)(2)(B).
- 35. See section 1092(a)(2)(B).

tified mixed straddles.³⁶ Very generally, under this mark-to-market regime, gains and losses on positions within the identified straddles will be netted and realized on a mark-to-market basis (in a manner generally similar to that applicable to taxpayers that choose to establish a MSA as described above).³⁷ Again, like the section 1256(d), “mixed straddle election” and the “identified straddle election”, each mixed straddle transaction that is to be subject to this regime must be specifically identified on the date the transaction is entered into.³⁸

- *Section 475(f) trader elections.* As discussed above, section 475(f) permits a taxpayer “engaged in a trade or business as a trader in securities or commodities” to elect mark-to-market accounting for those securities or commodities held by the taxpayer in connection with such trade or business.³⁹ Generally, a trader operating under the mark-to-market regime will take into income on a yearly basis the net unrealized appreciation or depreciation on securities or commodities held and subject to the mark-to-market regime as ordinary gain or loss.⁴⁰ As relates to straddle transactions, the application of this mark-to-market regime will substantially simplify accounting for the taxpayer (i.e. the application of the mark-to-market regime will ensure that no unrecognized gain (that would otherwise potentially implicate the loss-deferral rule) will exist with respect to positions in a straddle that are subject to the mark-to-market regime).

Any taxpayer considering whether to make any of these elections is urged to consult with a US tax advisor, as each election will materially impact the accounting for the taxpayer’s straddle transactions in different fashions and each election is subject to varying requirements and rules.

1.5. Taxation of hedging transactions

The Code provides a notable exception to many of the character and timing rules discussed herein for derivative instruments entered into in connection with so-called “hedging transactions”. Generally, assuming a transaction qualifies as a “hedging transaction” and a taxpayer makes a proper and timely identification of the transaction as such, special rules (referred to here as the “tax hedge rules”) will apply to determine the timing and character of income, deduction, gain and loss associated with the transaction.⁴¹ At their core, the tax hedge rules are generally intended to match both the method of recognition (timing) and character (ordi-

- 36. See section 1092(b)(2)(A)(2)(i)(I) and Treas. Reg. section 1.1092(b)-3T.
- 37. See Treas. Reg. section 1.1092(b)-3T(b).
- 38. See Treas. Reg. section 1.1092(b)-3T(d).
- 39. See section 475(f)(1)(A).
- 40. See section 475(f)(1)(D) and Prop. Reg. section 1.475(f)-2(b); see also Preamble to Prop. Reg. section 1.475(f). Note that a trader making the section 475(f) election may seek to identify certain property which will not be subject to the mark-to-market regime. See Prop. Reg. section 1.475(f)-2(a)(2); see also section 475(f)(1)(B)(i).
- 41. See generally section 1221(a)(7), Treas. Reg. section 1.1221-2, and Treas. Reg. section 1.446-4. Rules very similar to those discussed here apply to hedges involving certain foreign currency contracts subject to section 988 (see discussion of section 988 in section 2.1.2.). For an example of how these foreign currency hedging rules might apply, see the discussion following Case Study (5) (modified) below.

nary versus capital) of items of income, gain and loss on the hedging instrument with the item(s) hedged. However, derivative instruments are taxed under general tax principles when the tax hedge rules do not apply. Unlike the treatment of hedging transactions for financial accounting purposes, the tax hedge rules are mandatory and could apply to both physical and financial instruments.

The tax hedge rules contain an anti-abuse rule. This rule is intended to deter taxpayers from trying to choose the desired tax result of a transaction by choosing whether or not to identify the position as a hedging transaction. Under the anti-abuse rule (also referred to as the “whipsaw” rule), if a transaction qualifies as a hedging transaction, and there is no reasonable basis for not treating the transaction as such, the US tax authorities may step in and recharacterize the gains from the transaction as ordinary in nature even if the taxpayer has not made a tax identification to treat the transaction as a tax hedge. See Treas. Reg. section 1.1221-2(g)(2)(iii). This rule causes gains to be ordinary and losses to be taxed according to the general character rules for the applicable instrument. The general rule may be capital, in which case the taxpayer on a transaction-by-transaction basis may have capital losses and ordinary income. In applying this rule, the reasonableness of the taxpayer’s failure to make the tax identification will be evaluated in light of several factors, including the taxpayer’s treatment of the transaction for financial accounting or other purposes and the taxpayer’s treatment of similar transactions.

Several conditions must be satisfied for a transaction to qualify as a hedging transaction. These conditions focus on both the motivation for the transaction and the nature of the underlying hedged item(s). To begin, the financial instrument must be used primarily to manage certain risks associated with the hedged item, determined based on all the facts and circumstances.⁴² Additionally, the hedged item(s) must constitute ordinary property (or obligations) of the taxpayer.⁴³ To the extent that an asset is held for investment (or speculative) purposes, hedging treatment will not be available.

As set forth in the Code and accompanying regulations, the risk management standard is interpreted fairly broadly.⁴⁴ Macro or global hedges (e.g. where the taxpayer hedges an overall risk associated with the taxpayer’s operations) as well as partial or micro hedges (e.g. reducing only in part the risk associated with the holding of the hedged item) may qualify for hedging treatment.⁴⁵ Similarly, the inability to trace a derivative instrument to a particular item of inventory does not in and of itself mean that hedging treatment

will be unavailable.⁴⁶ The US tax authorities generally take the position that whether an instrument is entered into for risk management is evaluated based on the documented statements regarding the purpose of the instrument (e.g. board resolutions and minutes, financial statements, risk management policies), combined with the objective relationship between the purported hedge and hedged item.⁴⁷

The final key component of qualifying for the tax hedge rules is the proper identification of the transaction as a “hedging transaction”.⁴⁸ There are three items that must be identified: the hedge, the hedged item and the method of accounting used for the hedge.⁴⁹ As a general matter, in order for the tax hedge rules to apply, a hedging transaction must be identified as a tax hedging transaction in the taxpayer’s books and records before the close of the day on which the taxpayer enters into the transaction.⁵⁰ Notably, identification for financial accounting purposes is not sufficient to identify the transaction as a hedging transaction for income tax purposes unless the books and records of the taxpayer clearly indicate that the identification is being made for both purposes.⁵¹ Recognizing that hedge-by-hedge identifications can be extremely onerous for some taxpayers (given the volume and frequency of their transactions), the applicable regulations provide flexibility in defining permissible methods for making the identification. The regulations contemplate at least two alternative approaches:

- designating an account as containing only hedges of a particular risk with respect to a particular item (and then placing hedges in this account); and
- incorporating into the books and records a blanket statement designating all contracts of a particular type as hedges of a specified item(s).⁵²

Timing rules applicable to hedging transactions. As noted above, the tax hedge rules generally seek to achieve a “match” between the hedge instrument and the hedged item. The applicable regulations begin by permitting taxpayers to adopt a method of accounting of their own choosing for their hedge transactions, with the important caveat that such method must, in the opinion of the US tax authorities, result in a “clear reflection of income”.⁵³ Generally, a method will yield such a clear reflection of income if the timing of income, deduction, gain or loss from the hedging transaction is reasonably matched with the timing of recognition of income, deduction, gain or loss from the item

42. See section 1221(b)(2)(A). The statute provides that a hedging transaction must either manage price risk or currency risk with respect to ordinary property held or to be held by the taxpayer or interest rate, price or currency risk with respect to debt issuances and ordinary obligations of the taxpayer.

43. For these purposes, “ordinary property” is property that could not produce capital gain or loss in the hands of a taxpayer. See Treas. Reg. section 1.1221-2(c)(1).

44. This should be contrasted to the relatively more stringent standard under financial accounting standards (e.g. ASC 815) for applying hedge accounting, which generally requires the taxpayer to prove that the hedge is highly effective in managing risk associated with the hedged item.

45. See Treas. Reg. section 1.1221-2(d).

46. Id.

47. See Treas. Reg. section 1.1221-2(c)(4).

48. See section 1221(a)(7) and Treas. Reg. section 1.1221-2(f). If a taxpayer enters into a hedging transaction but fails to make the necessary tax identification in a timely and/or proper manner, the transaction may still be taxed under the tax hedge rules if the taxpayer can demonstrate that the failure was due to “inadvertent error” as that term has been interpreted by the US tax authorities. See Treas. Reg. section 1.1221-2(g). This inadvertent error exception has been narrowly interpreted in relatively recent guidance from the IRS to apply only in those cases where the failure to make the identification is the result of an accidental oversight or the result of carelessness. See CCA 201034018; CCA 200851082.

49. See Treas. Reg. section 1.1221-2(f).

50. Id.

51. See Treas. Reg. section 1.1221-2(f)(4)(ii).

52. See Treas. Reg. section 1.1221-2(f)(4)(iii)-(iv).

53. See generally Treas. Reg. section 1.446-4.

or items hedged.⁵⁴ Thus, for example, if a hedging instrument is used to hedge price risk with respect to an asset that is marked to market under the taxpayer's method of accounting, clear reflection of income would dictate that the hedging instrument also be marked to market with the same frequency as the hedged asset. The regulations provide further colour on this matching principle with respect to other specific types of hedging transactions, including hedges of aggregate risk and hedges of inventory items.⁵⁵

This matching of income, deduction, gain or loss from the hedge with the item being hedged generally yields a favourable result for taxpayers by reducing book-tax differences (assuming that hedge accounting is available for the transaction) and reflecting the underlying economics of the hedge transaction more accurately. Once a method of accounting for a particular transaction is adopted, the taxpayer will apply that method to the transaction, and there is no need for an evaluation of the effectiveness of the transaction as a hedging tool. Moreover, the application of the tax hedge rules to a hedging transaction will have the important effect of turning off other timing rules that might otherwise apply to a hedging instrument (such as the mark-to-market timing rule of section 1256 or the loss-deferral rule of section 1092).⁵⁶

The complexity of applying the timing rule depends on the nature of the strategies used to manage risk. Strategies that involve using forwards or swaps with settlement dates and amounts that match the forecasted dates and amounts of the hedged items frequently are taxed on a realization basis. More complicated strategies involving frequent rebalancing of positions or strategies that hedge macro risk may be taxed using other approaches, including mark-to-market and mark-and-spread. In all instances, the approach taken must be reasonable and meet the clear-reflection-of-income requirement (and a statement describing the approach taken should be set forth in the books and records).

Character rules applicable to hedging transactions. With respect to character, the tax hedge rules have the important consequence of treating any income, deduction, gain or loss with respect to the hedging instrument as ordinary in nature.⁵⁷ Absent this rule, certain items of income, deduction, gain or loss with respect to hedging contracts would not qualify for ordinary treatment under the rules discussed herein and general tax principles.

1.6. Section 1259 and constructive sales

For a holder or issuer of appreciated financial positions, the rules relating to constructive sales under section 1259 can require gain to be recognized as if the financial positions

54. See Treas. Reg. section 1.446-4(b).

55. See Treas. Reg. section 1.446-4(e).

56. See section 1256(e) and section 1092(e) (providing that the timing and character rules of section 1256 and section 1092 do not apply to properly identified hedging transactions).

57. Due to the fact that hedge tax treatment is available only where the underlying hedged item is an item of ordinary property (or obligation) (see discussion above), the character from the hedge and the hedged item will necessarily match.

were sold. A taxpayer is considered to have made a constructive sale under section 1259 with respect to a financial position if the taxpayer or related person enters into:

- a short sale of the same or substantially identical property;
- an offsetting notional principal contract with respect to the same or substantially identical property;
- a futures or forward contract to deliver the same or substantially identical property; or
- one or more transactions (or acquires one or more positions) that have substantially the same effect as a transaction previously described and included in Treasury regulations.

2. Corporate Income Tax Treatment

2.1. Options and futures

2.1.1. Options

2.1.1.1. Equity (non-section 1256) options

Generally, for tax purposes an option is a contractual, binding right to purchase or sell specified property at a stipulated price on or before a specific future date.⁵⁸ Whether a particular property right constitutes an option for US federal income tax purposes is determined under numerous rulings by the US Internal Revenue Service (IRS) and case law. The terminology adopted by the parties (i.e. merely calling a contract "option") does not control for tax purposes. Thus, contractual arrangements which on their face appear to permit a party to purchase property on a given date at a predetermined price, but which are not binding on the parties are not considered options for US federal income tax purposes.⁵⁹ Similarly, a traditional right of first refusal is not an option for US federal income tax purposes.⁶⁰ Thus, careful examination of a contract is necessary to determine whether it will be treated as an option for US federal income tax purposes.⁶¹

As a general matter, and with certain exceptions noted below, option transactions are taxed on an open-trans-

58. See generally Rev. Rul. 78-182 (discussing call and put options).

59. See e.g. *Saunders v. US*, 450 F.2d 1047 (9th Cir. 1971) (finding that the agreement did not constitute an option for US federal income tax purposes because the agreement did not bind the owner of the underlying property to deliver the property pursuant to the agreement).

60. See e.g. *Anderson v. Comm'r*, 468 F. Supp. 1085 (Minn. DC 1979) (right of first refusal to acquire certain real estate was not option subject to section 1234 because taxpayer had no unconditional right to purchase under the contract).

61. A substantial body of law has developed over time regarding the issue of when property rights associated with stock or debt will be treated as separate and distinct contractual rights (options) from the related property (stock/debt) or when such rights are treated as a component of the related property for US federal income tax purposes. See e.g. Rev. Rul. 88-31 (contingent payment rights issued in combination with common stock held to be separate "cash settled options" for tax purposes; number of factors cited, including fact that rights were separately tradable); Rev. Rul. 75-33 (IRS held that a contingent right attached to convertible preferred stock was right inherent in the stock; ruling stressed that the right extinguished upon conversion of the preferred stock into common stock); FSA 20121201 (holding that certain repurchase rights associated with preferred stock constituted put options; guidance cites Rev. Rul. 88-31 as support); see also Bittker and Eustice: *Federal Income Taxation of Corporations & Shareholders*, para. 4.60 (7th Edition 2006 and Supp. 2012-1) (discussing the taxation of convertible debt instruments and noting that generally the option feature in convertible debt instruments is ignored for tax purposes and treated as a part of the debt instrument).

	Holder	Grantor
Call option	Premium added to holder's basis in property acquired on settlement. Holding period begins on the date of purchase of underlying property.	Premium increases amount realized on sale of underlying property. Assuming property is capital asset, gain or loss is long term or short term depending on holding period of underlying property.
Put option	Premium received reduces amount realized on sale of underlying property. Assuming property is capital asset, gain or loss is long-term or short-term capital gain or loss depending on holding period of underlying property.	Premium received decreases basis in property purchased. Holding period in purchased property begins on the date of purchase.

action (or wait-and-see) basis for both the writer/issuer and holder/purchaser of the option.⁶² Thus, any option premium paid by the holder is not immediately deductible, but is capitalized into the holder's basis in the option. The recipient of any premium will not have any immediate income inclusion. Similarly, any other associated transaction costs (e.g. fees, commissions) paid by the purchaser are not immediately deductible and are capitalized into the basis of the option contract; any costs paid by the issuer of the option will offset the premium received by the issuer such that the net premium is deferred. These items will then be taken into account upon the subsequent closing of the option position (by exercise, lapse/expiration or sale/exchange of the option) in determining the net gain or loss from the option transaction or, if the option is exercised, the basis of property received or gain on the property delivered, as the case may be.

2.1.1.2. Taxation of options upon lapse or sale

For the holder of an option, the character of gain or loss attributable to the sale, exchange lapse or expiration of an option will generally be capital in nature (treated as long- or short-term depending on the holding period of the option by the holder).⁶³ On the other hand, for writers/issuers of options, the premium received on writing the option (less any costs incurred by the writer in connection with entering into the transaction) will generally be taxed as short-term capital gain at the time of the lapse or expiration of the option.⁶⁴ Similarly, any gain or loss realized by a grantor and resulting from a closing transaction (i.e. a termination of the grantor's obligations under the option other than through exercise or lapse of the option) will be treated as short-term capital gain or loss.⁶⁵

2.1.1.3. Physically settled options

When a holder exercises a call option via physical settlement, the cost of the option (the premium paid and any other associated transaction costs) will increase the holder's basis in the property acquired pursuant to the option.⁶⁶ The

holding period of the acquired property begins on the day the option is exercised and the property acquired.⁶⁷ Similarly, a holder of a put option that is exercised via physical settlement will reduce the amount realized on the sale of the underlying property by the amount of any cost incurred to acquire the put option.⁶⁸ Assuming the underlying property is a capital asset in the hands of the holder of the put option, the gain or loss will be treated as long-term or short-term capital gain depending on the holding period of the underlying property.

When written options are exercised by the counterparty, the writer will take into account the deferred tax asset inherent in the premium received at the outset of the transaction as either an increase in amount realized (in the case of a call option) or as a decrease to basis in the property acquired (in the case of a put option).⁶⁹ For a grantor of a call option, and assuming the underlying property is a capital asset in the grantor's hands, the amount realized upon physical settlement will be long-term or short-term capital gain or loss depending on the holding period of the underlying property.

Table 1 summarizes the tax consequences for holders and grantors of call and put options assuming physical settlement.

2.1.1.4. Cash-settled options

The tax treatment of cash-settled options (defined for these purposes as options which upon exercise settle in (or could be settled in) cash or property other than the underlying property) is generally equivalent as an economic matter to the tax treatment of physically settled options.⁷⁰ Thus, the gain or loss will equal the difference between the premium paid (or received) and any cash received (or paid) upon settlement. For grantors of options, this gain or loss will be treated as short-term capital gain or loss, while for holders of options the resulting gain or loss will be long-term or short-term capital gain or loss depending on the holding period of the option (again assuming in both cases that the underlying property is a capital asset in the taxpayer's hands and the taxpayer is not a dealer in options).

In discussing each of the case studies below, it is assumed that:

- neither the writer nor the holder of the option contracts described are dealers in option contracts;

62. See generally section 1234 and Rev. Rul. 78-182, 1978-1 CB 265.

63. See section 1234(a). However, this result can be altered in certain circumstances, including where the property subject to the option is not a capital asset or the taxpayer is deemed to have dealer status with respect to the option, in which case gain or loss will be treated as ordinary. See section 1234(a)(3).

64. See section 1234(b)(1).

65. Id. While section 1234(a) applies to holder options on property generally, section 1234(b) applies only to written options on stocks and securities (including stock and securities dealt with on a when-issued basis), commodities and commodity futures. See section 1234(b)(2)(B).

66. See Rev. Rul. 78-182.

67. Id.

68. Id.

69. Id.

70. See section 1234(c)(2).

- the underlying property (Company X shares) is a capital asset in the hands of the taxpayers;
- the option is not part of a straddle unless specifically provided; and
- all transactions take place in the United States with US counterparties.

2.1.1.5. Case Study (1)

Company A writes a put option on listed shares of company X (X shares) at an exercise price of 50. The premium received is 4. The current price of the X shares is 55. During the holding period the listed price decreases to 44.

Assuming no other costs are incurred by Company A in writing the put option and the counterparty chooses to exercise the put option when the listed price of the X shares is USD 44 by requiring Company A to purchase the X shares at the strike price, A will realize no gain or loss upon exercise of the option and will decrease its basis in the Company X shares acquired from the counterparty by the amount of the premium received on writing the option.⁷¹ Thus, Company A will take a USD 46 basis in the Company X shares (equal to amount paid for the Company X share under the put option (USD 50) less the premium received (USD 4)). The holding period of the underlying stock in Company A’s hands will begin on the date of the purchase of the Company X shares.

2.1.1.6. Case Study (2)

Company B has bought a put option on X shares at an exercise price of 50. The current listed price of the X shares is 55. Company B has a portfolio position in X shares, and the tax basis/book value is 45. The premium paid is 4. During the holding period the listed price of X shares decreases to 49.

Assuming no other costs are incurred by Company B in acquiring the put option and ignoring for the moment Company B’s participating interest in the Company X shares at the time of purchase of the put option (see discussion below), Company B’s basis in the put option will be USD 4 (equal to the premium paid by Company B). Company B may not immediately deduct the premium paid to the counterparty. Assuming further that Company B chooses to exercise the in-the-money option by selling the Company X share held in its portfolio to the counterparty for the strike price of USD 50, Company B will realize a net capital gain of USD 1 from the option transaction which is equal to USD 5 (the difference between the strike price (USD 50) and Company B’s basis in the X share (USD 45)), less the USD 4 premium paid by Company B to acquire the option.⁷² Whether this capital gain is taxed as short-term or long-term capital gain will depend on Company B’s holding period with respect to the Company X shares used to settle its obligations under the put option (but see below for discussion of a potential anti-abuse rule that may affect the holding period).⁷³

71. See Rev. Rul. 78-182.
 72. Id.
 73. Id.

How would Company B’s position be treated in Case Study (2) if it already held a participating interest in X shares, or it is a short transaction?

If Company B held a participating interest in the Company X shares at the time it purchased the put option, it is likely that certain aspects of the straddle rules of section 1092 (discussed above) would apply. In particular, regulations issued under section 1092 contain so-called “modified short sale” rules⁷⁴ which can affect transactions in put options where the holder holds the underlying property at the time of acquisition of the put. In the case of a put option relating to stock, if the taxpayer holds a position in the underlying stock, the existing holding period of this underlying stock is terminated and deemed to begin only when the put is exercised or lapses (this holding period termination rule does not apply to a position that was held by the taxpayer for at least the long-term capital gain holding period before the offsetting put option was acquired by the taxpayer).⁷⁵ This can often cause gain recognized on disposition of the underlying stock to be treated as short-term in nature.

As applied to Case Study (2), to the extent that Company B held a position in Company X shares at the time it acquired the put option and such position in Company X shares had been held for less than 12 months (i.e. the long-term holding period), the holding period with respect to such shares would be terminated under these modified short-sale rules at the time it acquired the put option.⁷⁶

2.1.1.7. Case Study (3)

Company C buys a call option on X shares at an exercise price of 53. The current listed price of the X shares is 55. The premium paid is 2. During the holding period the listed price of X shares decreases to 50. What would the treatment of C’s position be in Case Study (3) if it already held a portfolio or participating interest in X Shares?

Assuming no other costs are incurred by Company C in acquiring the call option and assuming Company C chooses to let the out-of-the-money option expire unexercised at a Company X share listed price of USD 50, Company C will realize a USD 2 loss on the contract (equal to the USD 2 premium paid). Assuming the Company X shares would

74. See generally Treas. Reg. section 1.1092(b)-2T. A very similar set of anti-abuse rules is found in section 1233 (often referred to as the original short-sale rules, given that they were enacted prior to the promulgation of the regulations under section 1092). However, given the similarity in intent underlying the modified short sale rules under section 1092 and those found in section 1233, the Code provides that the rules under section 1092 trump the rules of section 1233 where a transaction would potentially be subject to both rules (although beyond the scope of this article, note that certain short sale transactions will not be subject to the rules under section 1092, but may be subject to the rules under section 1233, a determination that will principally turn on the nature of the property underlying the short sale transaction).
 75. See Treas. Reg. section 1.1092(b)-2T(a).
 76. On the other hand, assuming that Company B had held the Company X shares for more than the long-term holding period of 12 months at the time it acquired the put option, this holding period termination rule would not apply and Company B would retain its existing holding period in the Company X shares. See Treas. Reg. section 1.1092(b)-2T(a)(2). These special holding period rules and loss characterization rules also do not apply to positions that constitute part of a hedging transaction (within the meaning of section 1256(e)); are included in straddles comprised only of section 1256 contracts; or are included in a “mixed straddle account” as that term is defined in section 1092 and the regulations thereunder.

be a capital asset in Company C's hands, this loss will be treated as a short-term or long-term capital loss depending on the holding period in the option contract.⁷⁷ The taxation of this particular transaction would generally be unaffected by Company C holding a portfolio position in the Company X shares at the time it acquired the call option.

2.1.1.8. Case Study (4)

Company E writes a call option on X shares at an exercise price of 58. The current listed price of the X shares is 55. The premium received is 1. Company E has a portfolio position in X shares, and the tax basis/book value is 50. During the holding period the listed price of X shares decreases to 49. Is there a difference in treatment in entering in-the-money and out-of-the-money options? Is there a difference in treatment in Case Study (4) if Company E held a naked position?

Ignoring in the first instance the application of the straddle rules to this transaction (and the qualified covered call rules discussed below), and assuming no other costs are incurred by Company E in writing the option and the counterparty chooses to let the out-of-the-money option expire unexercised at a Company X share listed price of USD 49, Company E will realize a USD 1 short-term capital gain (equal to the premium received).⁷⁸

However, given that Company E is stated to hold a portfolio position in the Company X shares at the time of writing the call option, this transaction would likely be subject to the straddle rules of section 1092 unless it qualifies as a so-called "qualified covered call option transaction". This exception, found in section 1092(c)(4), exempts from the loss-deferral and other rules of section 1092, certain transactions consisting of the sale (granting) of a call option to purchase stock held by the taxpayer at the time of grant of the option (or stock acquired by the taxpayer in connection with the granting of the option).⁷⁹

The statute imposes numerous conditions that must be met in order for a grant of a call with respect to stock held by the grantor to qualify for this exception as a qualified covered call option (QCC option). Generally, an option will qualify as a QCC option only if (1) such option is traded on a national securities exchange that is registered with the SEC (or other IRS-designated markets), (2) the option is granted more than 30 days before the day on which the option expires, (3) such option is not a deep-in-the-money option (see discussion below); (4) such option is not granted by an options dealer (as defined under the section 1256 mark-to-market rules) in connection with the dealer's activity of dealing in options; and (5) gain or loss with respect to such option is not ordinary income or loss.⁸⁰ "Deep-in-the-money option" is defined as an option having a strike price lower than the "lowest qualified bench-

mark".⁸¹ Generally, the lowest qualified benchmark is the highest available stock price that is less than the "applicable stock price" (i.e. the closing price on the stock on the most recent day the stock was traded before the date on which the option was granted or the opening price of the stock on the day the option was granted, but only if the price is greater than 110% of the closing price of the stock on the most recent day the stock was traded before the date on which the option was granted).⁸²

To the extent that the transaction described in Case Study (4) did not qualify as a "qualified covered call" under section 1092(c)(4), the full set of straddle rules under section 1092 (see discussion above) would need to be considered in evaluating the taxation of Company E from the transaction.

2.1.1.9. Other considerations regarding options

Be mindful that the discussion of the above case studies assumes that the options described are relatively plain-vanilla equity options issued (and purchased) by non-dealers. Dealers in securities including equity options are subject to a special timing regime under section 475 which generally requires such taxpayers to mark-to-market securities held in connection with their trade or business as a dealer in securities and to treat the gain or loss on such mark as ordinary.

Additionally, other special rules apply to certain options and/or transactions with respect to options. First, options that are part of hedging transactions as defined in section 1221(a)(7) will be subject to special character and timing rules. Likewise, options used as compensation and options on partnership interests and deep-in-the-money options are subject to special rules that are beyond the scope of this summary.⁸³ Transactions commonly referred to as "collars" (generally involving a combination of a put and a call option with respect to the same property) also raise certain tax issues that are beyond the scope of this summary.⁸⁴

Under section 1256, a special mark-to-market regime and character rule (see above) may apply to certain options that qualify as so-called "section 1256 contracts". Options subject to section 1256 include "listed" options that are considered "non-equity options" under the definition set forth

81. See section 1092(c)(4)(C).

82. See section 1092(c)(4)(D). Special rules are used to determine the lowest qualified benchmark if (1) the option is for a period more than 90 days and the strike price exceeds USD 50, (2) if the applicable stock price (as defined above) is less than USD 25 or (3) the applicable stock price is USD 150 or less. Id. Detailed regulations accompanying section 1092(c)(4) have been issued by the IRS which substantially elaborate on several aspects of the QCC exception, including how the strike price benchmarking is to be done with respect to certain types of options, and also extend the scope of the exception to cover certain options (including over-the-counter options) not covered by the statute. See Treas. Reg. section 1.1092(c)-1, -2 -3 and -4.

83. See generally secs. 421-423 (taxation of certain compensatory options), section 83 (taxation of non-statutory options and other property issued as compensation), REG-103580-02 (proposed regulations regarding the taxation of non-compensatory options on partnership interests), Rev. Rul. 85-87 (deep-in-the-money put option) and Rev. Rul. 82-150 (deep-in-the-money call option).

84. See generally Rev. Rul. 2002-66.

77. See section 1234(a) and Rev. Rul. 78-182.

78. See section 1234(b).

79. The exception from the straddle rules for qualified covered call options and the optioned stock does not apply if the straddle is composed of positions other than such call options and stock or is part of a larger straddle. See section 1092(c)(4)(A).

80. See section 1092(c)(4)(B)(i)-(v).

in section 1256.⁸⁵ A listed option is any option (other than a right to acquire stock from the issuer of the stock) that is traded on (or subject to the rules of) a qualified board or exchange (for further discussion of what constitutes a qualified board or exchange for these purposes, see section 2.1.2.).⁸⁶ A “non-equity option” is a listed option that is *not* an “equity option”, which is defined as “any option to buy or sell stock, or any option the value of which is determined directly or indirectly by reference to any stock (or group of stock) or narrow-based stock index”.⁸⁷ Carved out of the definition of “equity option” (and thus potentially qualifying as “non-equity options” subject to section 1256) are certain options with respect to a group of stocks (i.e. stock index) if such group fails to meet the requirements to qualify as a “narrow-based security index” as defined in section 3(a)(55) of the Securities Exchange Act of 1934.⁸⁸ For example, an exchange-traded option on a broad stock index (e.g. an option on the S&P 500) would likely qualify as a “non-equity option” and a section 1256 contract under this exclusion. On the other hand, equity options on stock of particular listed companies likely qualify as equity options falling outside the scope of section 1256. However, taxpayers should consult their US tax advisors before concluding that any option constitutes a “non-equity option” or “equity option” under this test.

2.1.2. Futures and forwards

Forward and futures contracts are taxed under entirely different regimes under the Code, notwithstanding their common economic features. Most (although not all) futures contracts traded on US exchanges (as well as several non-US exchanges) will be taxed under the principles of section 1256, while most forward contracts will be taxed under general tax principles on an open-transaction basis. It is therefore of the utmost importance to determine whether a particular derivative instrument is a forward (non-section 1256) contract or a futures contract subject to section 1256. Additionally, special rules under section 988 apply to certain contracts with respect to foreign currency as further discussed below. Special rules will apply to the extent a forward or future contract is entered into by a dealer and the forward or future contract is dealer property in the dealer’s hands.⁸⁹ Finally, the timing and character of gain or loss recognized with respect to forward and futures contracts can be affected by numerous other rules including where a constructive sale transaction is deemed to result under section 1259, where the contract is held as part of a transaction subject to the straddle rules of section 1092 or

85. See section 1256(g)(3). Also subject to the rules of section 1256 are dealer equity options, which are generally defined as any listed options purchased or granted by a options dealer in the normal course of his, her or its activity of dealing in options and that is listed on the qualified board or exchange on which such options dealer is registered. See section 1256(g)(4). For these purposes, an options dealer is any person registered with an appropriate national securities exchange as a market maker or specialist in listed options or any person whom the IRS determines performs functions similar to those performed by an exchange-registered market maker or specialist in listed options. See section 1256(g)(8).

86. See section 1256(g)(5).

87. See section 1256(g)(6).

88. *Id.*

89. See section 475.

where the contract is held as part of a hedging transaction (see above for discussion of these various rules).

2.1.2.1. Forward contracts

There is no precise definition for US federal income tax purposes of a “forward contract”. Generally, a forward contract subject to open-transaction treatment will consist of an over-the-counter (privately negotiated) executory contract where one party is obligated to buy a specific quantity of a specific asset on a specified future date for a specified amount of cash or property from a counterparty that is obligated to deliver the property on the agreed upon terms. The forum and manner in which a forward contract is entered into is the principal distinguishing feature relative to a futures contract subject to section 1256; as noted below, a futures contract subject to section 1256 is one that is traded on or subject to the rules of certain exchanges (a qualified board or exchange, as discussed below), while a forward contract (not subject to section 1256) will typically (although not always) be traded over-the-counter.⁹⁰

Assuming a forward contract is not subject to the rules of section 1256 or section 988 (see below) and that none of the various anti-abuse rules or other rules discussed above apply, a forward contract will be taxed on an open-transaction or wait-and-see basis. Thus, entering into a forward contract generally has no immediate tax consequences to either party.

Physically settled forwards. If a forward contract is settled by delivery of the property underlying the contract, the taxpayer delivering the property recognizes gain or loss at the time of settlement based on the difference between the price received and the taxpayer’s basis in the underlying property (as determined under general tax principles). On the other hand, the forward buyer accounts for the contract price as the basis for the property acquired, and gain or loss (if any) is deferred until the time of a subsequent sale or exchange of the property so acquired.

If the forward is physically settled via delivery of the underlying property, any gain or loss realized on subsequent disposition of this property by the forward purchaser will be treated as capital or ordinary by reference to general tax principles.⁹¹ Thus, if the property is a capital asset in the hands of the forward buyer, such gain or loss will be treated as capital in nature (short-term or long-term depending on the holding period, which will begin on the date of acquisition of the property under the contract). Likewise, for the forward seller, the gain or loss realized on sale pursuant to the contract will be capital or ordinary depending on the nature of the seller’s activities (i.e. whether the seller is a dealer in the underlying property).

Cash settled forwards. Cash settlement of a forward contract is treated as if the forward purchaser bought the underlying property for the price set when the contract was entered into and sold for the spot price on the settlement date, while the forward seller is deemed to have purchased the prop-

90. However, certain forward currency contracts are section 1256 contracts. See discussion of “Foreign Currency Contracts” in text below.

91. See generally section 1221.

erty at the prevailing spot price on the settlement date and then sold for the contract price. For example, assume on 1 January 2012 Party A enters into a forward contract to sell quantity X of commodity Y to Party B on 1 January 2013 for USD 10,000. On the settlement date (1 January 2013), quantity X of commodity Y is selling for USD 15,000. Party A and Party B agree to cash settle the contract. In this scenario, Party A will realize a loss of USD 5,000, equal to USD 10,000 (the amount deemed realized on the sale of the property at the contract price) less USD 15,000 (the amount deemed paid to purchase the property at the spot price on the settlement date). On the other hand, Party B will realize a gain of USD 5,000, equal to USD 15,000 (the amount deemed realized on the sale of the property at the spot price on the settlement date) less USD 10,000 (the amount deemed paid to purchase the property at the contract price).

This process, commonly referred to as “booking out”, will result in the forward buyer and the forward seller realizing gain or loss in an amount equal to the difference between the spot price on the settlement date and the contract price.⁹² As in the case of physical settlement, the resulting gain or loss will be capital or ordinary to the parties under general tax principles.

Sale/termination/cancellation of forwards. If a forward contract is sold, the party selling the contract will realize gain or loss at the time of such sale in an amount equal to the amount realized from the sale less its basis in the contract (if any)⁹³ and the purchaser will take a basis in the contract equal to the price paid. The character of the gain or loss realized by the seller of the contract will generally be capital if the forward contract itself (as distinguished from the underlying property) is a capital asset in the hands of the selling taxpayer.

On the other hand, if a forward contract is cancelled or otherwise terminated (i.e. by payment of an agreed upon amount by one party to the other), the amount paid in connection with such termination or cancellation will be taken into income by the recipient on the date of payment. Under section 1234A, gain (for the recipient of the payment) or loss (for the party making the cancellation/termination payment) realized in connection with a cancellation/termination transaction will generally be capital in nature.⁹⁴ While the tax rules generally dictate that there must be a “sale or exchange” of a capital asset to produce capital gain or loss,⁹⁵ section 1234A provides an important exception to this general rule in certain circumstances. Thus, under section 1234A, payments made to terminate a forward con-

tract are likely to be treated as capital in nature (assuming the underlying property is or would be a capital asset in the hands of the taxpayer).

2.1.2.2. *Futures contracts and section 1256*

Futures contracts that fall under section 1256 are taxed under the mark-to-market regime discussed above.⁹⁶ Very generally, under current law, this mark-to-market regime will require the holder of the section 1256 contract to treat the contract as sold (and repurchased) as of the last day of each year for its fair market value with the resulting “deemed” gain or loss to be taken into income as part short-term capital gain/loss (to the extent of 40% of the gain/loss realized) and part long-term capital gain or loss (to the extent of the remaining 60% of the gain/loss realized).

2.1.2.3. *Regulated futures contracts*

Contracts meeting the definition of “regulated futures contracts” are among the class of futures contracts subject to section 1256. “Regulated futures contracts” are defined as contracts (1) 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 (2) which are traded on or subject to the rules of a qualified board or exchange.⁹⁷ For these purposes, “qualified board or exchange” is defined as:

- a national securities exchange which is registered with the US Securities and Exchange Commission;
- a domestic board of trade designated as a contract market by the US Commodities Futures Trading Commission; or
- any other exchange, board of trade or other market designated by the Secretary of the US Treasury Department.⁹⁸

This definition is broad enough to cover futures contracts traded on a number of US-based exchanges including the NYSE, NASDAQ, NY Mercantile Exchange (NYMEX) and Chicago Mercantile Exchange (COMEX).⁹⁹ By compari-

96. A similar mark-to-market timing regime can apply to forward contracts held by a taxpayer deemed to be a dealer under the principles of section 475. The discussion here assumes that such special dealer rules do not apply.

97. See section 1256(g)(1).

98. See section 1256(g)(7).

99. Section 1256(g)(7)(C) authorizes the Department of the Treasury to determine whether a particular exchange has rules adequate to carry out the purposes of section 1256 and designate such an exchange as a qualified board or exchange for purposes of section 1256. As of the date of this article, the non-US based exchanges accorded this status by the Treasury are as follows: International Futures Exchanges (Bermuda) Ltd. (Rev. Rul. 85-72), Mercantile Division of the Montreal Exchange (Rev. Rul. 86-7), Mutual Offset System (a partnership between the CME and Singapore International Monetary Exchange Ltd. (Rev. Rul. 87-43), ICE Futures (Rev. Rul. 2007-26), Dubai Mercantile Exchange (Rev. Rul. 2009-04), ICE Futures Canada (Rev. Rul. 2009-24) and LIFFE (Rev. Rul. 2010-3). In September 2011, the US Treasury Department promulgated proposed regulations addressing numerous items impacted by the Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act). See REG-111283-1 (15 Sep. 2011), 76 Fed. Reg. 57684 (16 Sep. 2011). Among other things, these proposed regulations provide that certain boards and exchanges that have previously been recognized as qualified boards or exchanges may potentially lose their status as designated qualified boards or exchanges for section 1256 purposes. This may necessitate reapplication to the Commodities Futures Trade Commission by certain boards or exchanges in order to retain designated

92. The same treatment should apply to the parties to a forward contract closed out via a closing transaction, pursuant to which a party extinguishes its obligations under a forward contract on the settlement date by purchase of a perfectly offsetting forward contract.

93. A taxpayer will generally have a zero basis in its forward contracts, but may have a positive basis in the contract if the forward provides for some type of prepayment.

94. See section 1234A (providing generally that gains or losses attributable to the cancellation, lapse, expiration or other termination of (1) a right or obligation with respect to property that is (or on acquisition would be) a capital asset in the taxpayer's hands or (2) a section 1256 contract (see discussion above) which is a capital asset in the hands of the taxpayer, must be treated as gains or losses from the sale of a capital asset).

95. See Treas. Reg. section 1.1001-1(a).

son, forward and futures contracts acquired in over-the-counter transactions will generally not be subject to section 1256 and will instead be taxed under the principles discussed above relating to forward contracts.

2.1.2.4. Foreign currency contracts

A foreign currency contract is also among the class of contracts subject to section 1256. A foreign currency contract is a contract that: (1) requires delivery of, or settlement based on the value of, foreign currency positions that are traded through regulated futures contracts; (2) is traded in the interbank market; and (3) is entered into at arm's length at a price determined by reference to the interbank market.¹⁰⁰ Some examples of foreign currency forwards which would be subject to section 1256 are forward contracts with respect to the following currencies: Canadian dollar, British pound, euro, yen, Australian dollar, New Zealand dollar and Mexican peso. On the other hand, over-the-counter foreign currency options and swaps are not subject to section 1256.¹⁰¹

2.1.2.5. Contracts with respect to foreign currency and section 988

Section 988 requires a taxpayer to identify its functional currency and treat various interests or positions in non-functional currencies as personal property the sale or disposition of which results in ordinary income or loss. Certain section 1256 contracts are exempted from the rules of section 988, which means that they generate capital rather than ordinary gain or loss. This exception applies to any regulated futures contract or non-equity options (for discussion regarding these contracts, see sections 2.1.2. and 2.1.1., respectively).¹⁰² A taxpayer may elect to have the rules of section 988 apply to these excluded contracts otherwise subject to section 1256 (in which case section 1256 will not apply to the contracts).¹⁰³ This election, once made, applies to all such contracts held by the taxpayer and/or acquired in the future, and may be revoked only with the consent of the US tax authorities.¹⁰⁴ Additionally, foreign currency forward contracts subject to both section 988 and section 1256 generate ordinary gain or loss unless a taxpayer elects to have gain or loss treated as capital in nature.¹⁰⁵

2.1.2.6. Case Study (5)

Company *F* enters into a forex future. Company *F* is obliged to buy USD 100 at a price of EUR 100 at T2. The current exchange rate is USD 95 : EUR 100. During the holding period the exchange rate changes to USD 101 : EUR 100.

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 status. As of the date of this article, further guidance has not been issued with regard to this issue and any taxpayer should consult its US tax advisor and monitor developments in this respect before adopting a position with respect to whether section 1256 applies to a particular contract traded on a heretofore qualified board or exchange.

100. See section 1256(g)(2).

101. See *Summitt v. Comm'r*, 134 T.C. 12 (2010) and IRS Notice 2007-71.

102. See section 988(c)(1)(D)(i).

103. See section 988(c)(1)(D)(ii).

104. *Id.*

105. See section 988(a)(1)(B).

Assuming the forex futures contract qualifies as a regulated futures contract subject to section 1256 and the taxpayer has not made the election to have the rules of section 988 apply (see discussion above), Company *F* will be taxed on the contract under the mark-to-market regime of section 1256, and the resulting gain or loss will be treated as capital in nature pursuant to the 60/40 rule of section 1256.

On the other hand, assuming the forex futures contract does not qualify as a "regulated futures contract" (e.g. perhaps the contract was traded on a board or exchange that does not meet the definition of a "qualified board or exchange" under section 1256) (and taking it as given that the contract is not a "non-equity option" as defined under section 1256), then the contract may potentially qualify as a "foreign currency contract" subject to both section 1256 and section 988. In such a scenario, absent an election by the taxpayer to have gain or loss from the contract treated as capital in nature, the contract will result in ordinary income or loss based on a mark-to-market methodology.

Finally, assuming that the futures contract does not qualify as either a "regulated futures contract" or a "foreign currency contract" subject to section 1256, it will be taxed under the general tax principles applicable to forward contracts (see discussion above), with any resulting gain or loss treated as ordinary in nature under section 988.

For discussion of how the taxation of this instrument might be altered under the hedging rules of section 988, see section 2.2.1.

2.2. Case Studies (5) – (8)

2.2.1. Hedge accounting – Case Study (5) (modified)

Company *F* enters into a forex future. Company *F* is obliged to buy USD 100 at a price of EUR 100 at T2. The current exchange rate is USD 95 : EUR 100. During the holding period the exchange rate changes to USD 101 : EUR 100. Assume further that Company *F* has entered into the future to hedge an existing forex liability.

Assume that Company *F* (having as its functional currency for section 988 purposes the US dollar) has made a timely and proper election to treat the forex contract and Company *F*'s issuance of a forex-denominated debt instrument (i.e. borrowing in non-functional currency) as an integrated hedging transaction under section 988 and the accompanying regulations.¹⁰⁶ Under these rules, the forex debt instrument and the futures contract will be treated as a single synthetic dollar-denominated debt instrument. Accordingly, the forex-denominated payments that Company *F* makes under the debt instrument will be ignored for US tax purposes and effect will be given only to the dollar payments made under the futures contract.¹⁰⁷

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 106. Numerous conditions must hold for this treatment to apply. These conditions look to the nature of the debt instrument to be hedged and the type of hedge instrument, among other factors. Additionally, similar to the general hedging rules discussed above, detailed identification requirements also must be met in order for this treatment to apply. See generally Treas. Reg. section 1.988-5.

107. See Treas. Reg. section 1.998-5(a)(9).

2.2.2. Swap payments and manufactured income

A special set of regulations proscribe both timing and character rules for a subset of derivative contracts known as notional principal contracts (NPCs).¹⁰⁸ Common derivative contracts subject to taxation as NPCs include commodity swaps, interest rate swaps, basis swaps, total return swaps and similar agreements.¹⁰⁹ (The taxation of so-called “credit default swaps” and similar agreements remains subject to substantial uncertainty under US federal income tax principles; see discussion following Case Study (8), below).

The timing and character of income from NPCs depends on the nature of the payment under the contract. Generally, periodic payments (those payments payable at intervals of one year or less during the entire term of the contract) must be accrued by the taxpayer in ratable daily portions for the tax year to which the payment relates.¹¹⁰ On the other hand, so-called “non-periodic payments” (generally those payments that are not periodic payments or termination payments (discussed below)) must generally be recognized in ratable daily portions over the entire term of the contract.¹¹¹ Examples of non-periodic payments include the premium paid for acquiring a cap or a floor and prepayment of part or all of one leg of a swap contract. Both periodic and non-periodic payments should be taxed as ordinary income under general tax principles.¹¹²

Regulations provide a number of alternative methods for recognizing non-periodic payments over the term of an NPC. Special timing rules apply to certain non-periodic payments that are deemed contingent under proposed regulations issued by the US tax authorities (an example of a contingent non-periodic payment might be a payment by one party to a swap to the counterparty that represents the appreciation, if any, in a designated basket of securities). See Prop. Reg. section 1.446-3(g)(6). Very generally, these contingent NPC rules require the taxpayers to estimate the expected amount of such a contingent non-periodic payment at the outset of the NPC and then spread this estimated amount over the term of the swap. The estimates are retested on an annual basis, with any resulting adjustments spread over the following year.

Finally, termination payments (very generally those payments made to terminate or extinguish any remaining rights under the contract) are to be recognized in connection with the event giving rise to termination of the con-

tract.¹¹³ While the character of periodic and non-periodic payments is generally thought to be ordinary in nature, there is some uncertainty regarding the character of termination payments. In many cases, termination payments may be treated as capital in nature under section 1234A which, as discussed in section 2.1.2., provides that gain or loss attributable to the cancellation, lapse, expiration or other termination of certain types of rights, obligations and contracts is characterized as capital without regard to whether a sale or exchange has occurred.¹¹⁴ However, the application of section 1234A to NPC termination payments is not clear in all instances and will turn on consideration of the features and characteristics of each particular NPC; taxpayers considering the taxation of NPC termination payments are urged to consult their US tax advisors.

2.2.3. Case Study (6)

Bank G has entered into an interest rate swap with Bank H. Bank G buys long-term interest rate of 3% against variable 6 months Euribor (at start 1.4%) on a notional principal of EUR 10 million at a maturity of 2 years.

Assuming that Bank G has not entered into the interest rate swap with the intent of hedging an ordinary borrowing or obligation, the timing and character rules applicable to an NPC will dictate the taxation of the transaction for Bank G. Accordingly, any periodic payment and non-periodic payments made under the NPC will be recognized over the term of the NPC in ratable daily portions according to one of the methodologies specified in the NPC regulations.¹¹⁵ Such payments will generally be treated as ordinary in nature. Any termination payment made under the NPC will be recognized at the time of such payment;¹¹⁶ as discussed above, the character of the termination payment will turn on consideration of the features and characteristics of the contract and the potential application of section 1234A.

On the other hand, were Bank G to enter into the interest rate swap with the intent of hedging a debt issuance by Bank G, and assuming further that this transaction qualifies as a “hedging transaction” and Bank G made the necessary tax identifications as discussed above, then gain or loss from the NPC will be ordinary in nature to Bank G (including any termination payments that might otherwise be capital in nature). Timing of recognition under the NPC will be dictated by the timing regulations discussed above.

2.2.4. Case Study (7)

Company I has entered into a total return swap with Bank J whereby Company I pays 6 months Euribor to receive the total return of an amount of EUR 15 million of listed Z shares. At T2 the Z shares list at EUR 12.5 million and Z has paid out a dividend of 500,000 during the term of the total

108. See generally Treas. Reg. section 1.446-3.

109. Under current law, “NPC” is technically defined as a “financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts”. Treas. Reg. section 1.446-3(e)(1). Recently proposed regulations would alter this definition (as well as some components of the definition of section 1256 contract). See section 3.4. for further discussion.

110. See Treas. Reg. section 1.446-3(e)(2).

111. See Treas. Reg. section 1.446-3(f)(2).

112. The regulations addressing NPC taxation do not provide any guidance on the character of periodic and non-periodic payments. However, given that these payments are not made with respect to the sale or exchange of a capital asset (a prerequisite for capital asset treatment, see Treas. Reg. section 1.1001-1(a)), it is generally recognized by taxpayers and tax practitioners that such payments should be treated as ordinary in nature.

113. See Treas. Reg. section 1.446-3(h)(2).

114. Indeed, the IRS has indicated in proposed regulations (which have not yet been finalized and are accordingly not effective as of the date of this article) that gain or loss from an NPC termination payment should be treated as capital in nature under section 1234A and the proposed regulations. See Prop. Treas. Reg. section 1.1234A-1(a) and 69 Fed. Reg. 8886, 8891 (26 Feb. 2004).

115. See Treas. Reg. secs. 1.446-3(e) and -3(f).

116. See Treas. Reg. section 1.446-3(h).

return swap. How are dividend equivalents received under the total return swap of Case Study (7) treated?

It is assumed that the total return swap entered into between Company *I* and Bank *J* is not part of a hedging transaction for either party, that the total return swap is an over-the-counter swap not qualifying as a section 1256 contract and that the total return swap will be characterized as an NPC for US tax purposes.¹¹⁷ In this case any payments (including any dividend equivalent payments made by Bank *J* to Company *I* with respect to Company *Z* dividends paid during the total return period) must be evaluated under the rules applicable to NPCs. Dividend equivalent payments will likely be characterized as periodic payments if paid during the term of the total return swap when the dividends are paid by Company *Z*. Bear in mind that recent legislation has fundamentally altered the withholding rules applicable to dividend equivalent payments under certain NPCs (see discussion of section 871(m) in section 3.1.).

2.2.5. Case Study (8)

Company *K* has entered into a credit default swap with Bank *L* whereby Company *K* buys protection from Bank *L* on the credit risk of Bond *W* at a payment of 1 month Euribor. Company *K* has a long position in Bond *W*. How is the position of Company *K* in Case Study (8) treated? Is there a difference in treatment if Company *K* has a naked position?

2.3. Taxation of credit default swaps

The US federal income taxation of derivative instruments commonly referred to as “credit default swaps” has been controversial and uncertain ever since these instruments first appeared on the financial scene. Much of this uncertainty stems from the fact that these credit default swaps may potentially be characterized in various fashions with different tax results according to the characterization adopted by the parties to the contract.¹¹⁸ For example some taxpayers have taken the position that credit default swap contracts are akin to insurance contracts, while others have treated them as option contracts. Yet other taxpayers have taken the view that credit default swap are NPCs subject to some or all of the timing and character rules described above.¹¹⁹ The classification of a credit default swap may be

117. A number of areas of uncertainty in respect of total return swaps exist under current law. In certain cases, the nature of the transaction and the facts and circumstances of the parties to the contract may lead to different results than those described here. For example, there is some risk that where the total return payer is the owner of the referenced security during the period of the contract, the contract may be recharacterized as a transfer of tax ownership of the referenced security. Additionally, the character of certain payments under total return swaps is unclear. A detailed discussion of these issues is beyond the scope of this article, and accordingly persons considering investments in total return swaps and similar instruments are urged to consult with their US tax advisors.

118. See generally Notice 2004-52, 2004-2 CB 168 (identifying numerous issues under US tax laws relating to the taxation of credit default swap and requesting comments from taxpayers on the appropriate method for taxing credit default swap).

119. One approach many taxpayers adopted was to take a wait-and-see approach pursuant to which periodic payments under the credit default swap were recognized currently but recognition of the protection payment upon termination was deferred until known. Query whether such an approach is consistent with the timing rules applicable to

affected by whether the taxpayer holds the protected bond, particularly if required by the contract (a factor supporting characterization as insurance).

Recently proposed regulations (discussed in more detail in section 3.4.) take important steps in resolving some of this uncertainty, although much remains. In particular, these proposed regulations would clarify that credit default swaps are NPCs subject to the timing and character rules described above.¹²⁰ However, the proposed regulations fail to provide any definition of “credit default swap” (or any examples of a contract that would be treated as a credit default swap under the proposed regulations), and it is therefore currently unclear exactly which contracts will be subject to the NPC rules (assuming the proposed regulations are finalized in substantially their current form).

The transaction described in Case Study (8) may be of the type potentially subject to the straddle rules of section 1092. As discussed above, the primary effect of section 1092 is to potentially defer the recognition of a portion of realized losses on a transaction meeting the statutory definition of “straddle” (see below). Under the rule, the taxpayer must defer recognition of any losses realized with respect to the loss leg(s) of the straddle that are in excess of unrecognized gain (if any) on the other offsetting positions forming part of the straddle.

Very generally, under section 1092, a “straddle” is defined to capture the holding of offsetting positions with respect to personal property if the holding of one (or more) leg(s) of the transaction substantially diminishes the taxpayer’s risk of loss from holding the other position(s). In Case Study (8), it is possible the US tax authorities would take the view that entering into the credit default swap with respect to credit risk in Bond *W* substantially diminishes the taxpayer’s risk of loss from holding a long position in Bond *W*. Accordingly, if the taxpayer in Case Study (8) were to realize a loss on one leg of the straddle (Bond *W* or credit default swap), it is possible that recognition of such loss would be deferred to the extent of any unrecognized gain in the other leg of the straddle.

The loss deferral rule of section 1092 that is described above will not apply to the extent a taxpayer timely and properly identifies a transaction as a hedging transaction (see discussion above). Additionally, taxpayers may make certain elections discussed above which may materially alter the taxation of their straddle transactions.

3. Other Taxes

3.1. Withholding taxes

3.1.1. Generally

With the exception for withholding with respect to certain dividend-equivalent payments under section 871(m) (discussed immediately below), payments with respect to derivative instruments are subject to general withholding

contingent non-periodic payments discussed above. See also Prop. Reg. section 1.446-3(g)(6).

120. See Prop. Reg. 1.446-3(c)(1)(iii).

principles set forth in the Code.¹²¹ The application of these withholding principles is complex and a detailed discussion is beyond the scope of this article.

3.1.2. Section 871(m) and withholding for dividend-equivalent payments

Section 871(m) was enacted in 2010 in order to restrict the use by non-US investors of certain NPCs as a means for avoiding US withholding tax that would be imposed on dividends received by those investors in respect of stock of US companies. Under this rule, certain payments made under specified NPCs (*see below*) are treated as US-source dividend-equivalent payments subject to US withholding tax (at a 30% rate under current law, subject to reduction pursuant to an applicable tax treaty). A dividend equivalent includes any payment made under a specified NPC that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States.¹²² A dividend equivalent also includes any other substantially similar payment as determined by the Secretary.¹²³

For this purpose, under current temporary rules effective through 31 December 2012, a specified NPC is any NPC that has any one of the following four characteristics:

- in connection with entering into the contract, any long party to the contract transfers the underlying security to any short party to the contract;
- in connection with the termination of the contract, any short party to the contract transfers the underlying security to the long party to the contract;
- the underlying security is not readily tradable on an established securities market; or
- in connection with entering into the contract, any short party to the contract posts the underlying security as collateral with any long party to the contract.

Dividend-equivalent payments made on or after 14 September 2010 and through 31 December 2012 with respect to such NPCs are accordingly subject to withholding under section 871(m) under these temporary rules.¹²⁴

Recently proposed regulations would expand the scope of specified NPCs to include several other types of NPCs and require withholding with respect to this broader group of NPCs effective as from 1 January 2013.¹²⁵ Because these regulations are only in proposed form as of the date of this article, taxpayers are urged to consult with their US tax advisors in considering the ramifications of section 871(m) for their NPC transactions.

3.2. VAT and stamp duty

US federal tax laws do not currently provide for any VAT, stamp duty or similar taxes.

3.3. Insurance premium tax

As noted in section 2.3., it is possible that certain credit default swap contracts may be treated as insurance arrangements or contracts for US federal income tax purposes. In this case, if the credit default swap contract is written by a non-US issuer that meets the definition of “foreign insurer” under section 4371, the credit default swap contract could be subject to tax under section 4371.¹²⁶ However, as noted above, recently proposed regulations would clarify that credit default swaps are to be treated as NPCs for US tax purposes, in which case the section 4371 tax would likely not apply; the proposed regulations do not define credit default swap for these purposes, so uncertainty remains as to what credit default swap contracts will be treated as NPCs under these regulations.¹²⁷

3.4. New proposed regulations affecting NPCs and section 1256 contracts

Any taxpayer considering an investment in derivative instruments subject to US taxation is advised to consider and discuss with their US tax advisors the impact of recently proposed regulations affecting section 1256 contracts and NPCs.¹²⁸ Although a detailed summary of these proposed regulations is beyond the scope of this article, it can be said that the proposed rules would clarify certain aspects of the NPC and section 1256 rules. These clarifications include:

- providing that credit default swaps (a term not defined in the proposed regulations, as discussed in section 2.3.) and weather-related swaps are financial instruments that qualify as NPCs for US federal income tax purposes;
- excluding guarantees from the definition of “NPC”;
- providing a rule pursuant to which the fixing of an amount is treated as a payment, even if actual payment reflecting that amount is made at a later date (a rule that could cause so-called “bullet” swaps to be subject to the NPC rules); and
- modifying the scope of the defined term “section 1256 contract” to clarify that any contract that is an NPC will not be treated as a section 1256 contract. Because these regulations are only in proposed form as of the date of this article, taxpayers are urged to consult with their US tax advisors regarding the potential impact these proposed changes could have on their derivative transactions.

121. *See generally* section 865. The US tax authorities have been granted, under section 865(j), the authority to issue certain regulations applying the source rules for personal property sales to income derived from trading in options, forwards, futures and other instruments. However, as of the time of this article, the authorities have failed to issue any such regulations and therefore taxpayers are left to determine the source of income by analogy to existing source rules.

122. *See* section 871(m)(2).

123. *Id.*

124. *See* section 871(m)(3).

125. *See* Prop. Reg. section 1.871-16.

126. Section 4371 generally subjects certain insurance policies to an excise tax assessable on the premiums paid to acquire the policy. Thus, for example, casualty insurance and indemnity bonds are subject to this tax at 4 cents per dollar of premium paid on the policy. *See* section 4371(1).

127. *See* Prop. Reg. 1.446-3(c)(1)(iii).

128. *See* REG-111283-1 (15 Sep. 2011), 76 Fed. Reg. 57684 (16 Sep. 2011).