



Memorandum

Date: August 21, 2005

Re: Spot Forex Traders – Section 988(a)(1)(B) Election into Section 1256

Summary

Spot forex traders should qualify for electing out of section 988 and into section 1256 based on two fundamental considerations –

(1) section 988 and its regulations effectively include non-straddle spot contracts that are terminated other than with physical delivery as “other similar instruments;” and

(2) a spot forex transaction fits comfortably within the section 1256 definition of “foreign currency contract.”

Section 988

The election out of section 988 is not limited to forwards and futures. It also is available for “similar financial instruments.” Sections 988(a)(1)(B), -(c)(1)(B)(iii). In other words, certain instruments or transactions not generally classified as either forwards or futures are specially covered notwithstanding. This includes spot contracts as long as there is no “making or taking delivery” of the particular nonfunctional currency. Reg. sections 1.988-1(a)(2)(iii), -1(b), -2(d)(1).

The “solely for purposes of this paragraph (d)” limitation in -2(d)(ii) actually strengthens the case – a spot contract terminated (etc.) before “making or taking delivery” of the nonfunctional currency is “considered a forward contract or similar transaction.” Therefore, gain or loss is to be recognized in accordance with section 1001, 1092 or 1256, whichever is applicable. -2(d)(2).

Section 1256

“Foreign currency contracts” are treated as section 1256 contracts without regard to whether they amount to either “forwards” or “futures.” Spot forex contracts easily satisfy the definitional elements of section 1256(g)(2)(A)(i) and -(iii).

The phrase “traded on the interbank market” in section 1256(g)(2)(A)(ii) is neither defined nor limited anywhere in the Code. Informally the Service has indicated that it refers to “the OTC market maintained by banks to purchase and sell foreign currency and financial products,” and noted that “Congress intended to include within the definition of a foreign currency contract bank forward contracts in currencies that are [also] traded through RFCs because bank forward contracts are economically comparable to and used interchangeably with RFCs.” FSA 200025020 (June 23, 2000).

One might quibble that this comment only begs the question of whether spot forex transactions are within the meaning of “bank forward contracts.” It is suggested that someone with access should check for any relevant commentary in Keyes, Federal Taxation of Financial Instruments and Transactions (Warren, Gorham & Lamont).

Caveat

It reasonably could be assumed that the Service ought to be neutral or essentially neutral as to spot traders electing out of section 988 since section 1256 is no panacea, as its treatment of losses makes obvious.

Nevertheless, it is worth noting that section 1256(g)(2)(B) grants authority to the Service to promulgate regulations “including regulations excluding from subparagraph (A) any contract (or type of contract)...” It is not inconceivable that, whenever the Service issues such regulations, it might take the position that trading spot forex is, say, covered by section 1001 rather than by section 1256 (in which case all gains and losses would be short-term).

In fact the Service has a pending regulations project that likely will address the matter. See item 2487 (“Additional guidance regarding mark-to-market accounting for traders in securities and/or commodities, including foreign currency instruments”) in the Treasury Department’s 5/16/05 corrected semi-annual regulatory agenda (2005 TNT 102-39), and/or Financial Institutions and Products item 13 (“Guidance on the definition of foreign currency contracts under section 1256(g)(2)”) in its 8/8/2005 Priority Guidance Plan (2005 TNT 152-18).

If you have any questions, contact us at info@greencompany.com.