



TAXATION OF SPOT FOREX CONTRACTS – THE CASE FOR SECTION 1256 ('60/40') TREATMENT

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The rules for federal income taxation of foreign exchange trading are light years behind the developments in the marketplace. The Internal Revenue Code is stuck in 1984, when foreign exchange trading was a vastly different, and much smaller, world. Back then, nearly all foreign exchange trading was conducted between banks (or other financial institutions) or through regulated futures contracts. Foreign exchange trading at the retail level hardly existed in 1984; today, this is one of the biggest (by dollar value) areas in all of commodities and securities trading.

The tax treatment of spot forex contracts is (surprise) just a mess. The nominees for best tax treatment of a spot forex contract are:

1. All gain or losses are always ordinary, and open contracts at year-end are marked-to-market.
2. All gains or losses are always ordinary, and open contracts at year-end are not marked-to-market.
3. All gains or losses are ordinary, and open contracts are marked-to-market, but the taxpayer may make a valid, timely election to treat the contracts as "60/40" contracts (60% of gain or loss is long-term and 40% short-term).

While we are waiting for the awards presenter (Internal Revenue Service Office of Chief Counsel) to open the envelope, you should be aware that because of positions the IRS has taken recently on other types of forex trading, the last nominee may not be an unreasonable choice as the winner, as is discussed below.

The Marketplace

In the ever-expanding universe of retail forex trading, spot forex accounts (also termed "cash" accounts) are a huge part of the forex markets. A spot forex contract is one that settles no later than two business days later than the day the contract is entered into. In practice, the overwhelmingly majority of spot contracts are settled on a daily basis. Positions are rolled over from one day's settlement to the next – although a position in a particular currency can be held for a long time (theoretically, indefinitely so long as there is cash in the account to support the position) – technically (and we in a very technical world here) the contracts are settled in the spot market.

The definition of spot contract is vital, not only for tax, but for regulatory reasons. The spot forex market is not effectively regulated by any U.S. regulator. The Commodity Exchange Act of 1974 provides that only the U.S. Commodity Futures Trading Commission (CFTC) can regulate commodities (forex is clearly a commodity contract). However, the CFTC's position is that it does not have the authority to regulate the spot forex market – hence, no effective regulation of the traders and advisers. The forex brokers, however, are regulated by the CFTC as Futures Commission Merchants (that is, similar to broker-dealers in securities) or they are banks or other financial institutions regulated by one or another banking regulator.

As a result, what regulation that exists in this market is imposed by the FCM's, because they have their own risks. For example, if a trader in spot forex contracts wants to manage trading accounts for others, for compensation, that relationship (adviser-client) is not directly regulated by anyone. Rather, the forex broker, as an FCM or bank, requires that the client be given the appropriate written disclosures, which are similar to those that would be furnished by the adviser if he were a Commodity Trading Adviser (CTA) regulated by the CFTC. As a result, from a regulatory standpoint, the spot forex adviser is in a unique regulatory spot – not effectively regulated by anyone, apart from state law rules governing the duties of anyone who manages other people's money.

The Tax Rules

The Internal Revenue Code contains two main sections governing the treatment of forex trading: Sections 988 and 1256. They were drafted at different times by different Congressional staffers, and they fail to cross-reference each other effectively. Section 1256 provides for special treatment of qualifying contracts, termed “Section 1256 contracts.” Gain or loss is 60% long-term and 40% short-term, regardless of the trader's holding period for the contract. At current rates, this is a 23% federal rate, as opposed to a 35% federal rate for net gains from short-term trading or from ordinary income (such as wages and interest). You have to factor in your own state (and local, if applicable) income tax rates (state and local income tax rules usually tax all income at the same rate, but there are divergences from the general rule). If you are lucky enough to be a tax resident of Nevada, that means a 23% maximum effective tax rate; if you live in the People's Republic of New York City, it would be more like 35%. Still, that 12% savings at the federal tax level can really count for a lot if you are a successful trader.

Section 1256 – No Model of Clarity

Section 1256 provides that Section 1256 contracts include “foreign currency contracts.” There are three requirements:

1. The contract must require delivery or cash settlement for a contract in a foreign currency for which there are also positions traded through regulated futures contracts;
2. The contract is traded in the interbank market; and
3. The contract is entered into at arm's length at a price determined by reference to the interbank market price.

As you can see, requirement three is the easiest to satisfy: all spot forex contracts are entered into at arm's length (when, if ever, did the FCM take a dive on rates it charges its customers?). The first requirement, that there be trading in the underlying currency in the regulated futures market, is satisfied for all of the major currencies and many lesser currencies. For all of the currencies that are traded in the spot forex market, there is usually at least one regulated futures contract for that currency.

So, the second requirement has to be considered. The interbank market of 1984 was vastly different; the issue is whether the statute can be interpreted in a way that does justice to the intent – which is that there is an active market for these contracts, so that pricing can be determined objectively. This requirement was imposed by Congress because it was fighting tax shelters using manipulated forex contract prices. If objective pricing is the requirement, then the huge amount of trading in the spot forex market would certainly generate the type of objective prices the statute insists upon.

A notice about a recent type of foreign currency tax shelters, issued by the IRS in 2003, that involves over-the-counter forex options, seems to indicate that the interbank market requirement should not be taken literally. The IRS's interpretation of the law is that the taxpayer's actual contract does not have to be entered into in the interbank market, but only that similar contracts are traded in the interbank market. Given the gigantic size and diversity of contracts in the interbank market, it is safe to conclude that any contract entered into the retail spot forex market has an equivalent contract traded in the interbank market.

The IRS has yet to rule on the tax treatment of spot forex contracts under Section 1256. However, given the IRS's very broad reading of the statute in the 2003 notice, some tax practitioners have taken the view that the statute's reach extends to the spot forex contract, so long as requirement one (that there has to be at least one regulated futures contract for that same currency) is met. The IRS has indicated that they have this question under review, and may issue guidance on it. However, the reader is admonished that in most cases the wheels of the Internal Revenue Service grind exceedingly slowly. Therefore, it appears that a spot forex contract should be treated as a Section 1256 contract, with a big "however" – discussed below.

Section 988 – No Model of Clarity, Either

For the purposes of this discussion let us assume that a spot forex contract in a currency for which there is at least one regulated futures contract qualifies as a Section 1256 contract. What next? We must analyze Section 988, which deals exclusively with the tax treatment of foreign exchange contracts. Section 988 provides a general rule (laced with exceptions) that income or loss from foreign currency contracts is ordinary. Section 988 has specific rules for Section 1256 forex contracts that are either regulated futures contracts or regulated options (that is, forex options listed on CFTC regulated exchanges) – these retain their 60/40 treatment unless the taxpayer affirmatively elects out. This specific exception does not apply to spot forex contracts.

However, another rule in Section 988 provides that a taxpayer may elect out of ordinary treatment for “a forward contract, a futures contract, or option” if they are forex contracts. (The reference to futures is to futures traded on non-U.S. exchanges, as U.S. regulated futures are covered by the rule discussed immediately above). This election is made contract-by-contract, which is obviously impossible in today’s active forex trading world. In practice, an election made in the taxpayer’s books and records, covering all future spot forex contracts traded by the taxpayer, until the election is revoked by the taxpayer (through a notation in the books and records) is what is done.

The issue is whether a spot forex contract is sufficiently similar to forwards, futures and options that they should all be afforded the same tax treatment. The IRS’s 2003 notice, referred to above, has been interpreted by some tax practitioners as authorizing a very broad view of the statute’s scope, so that economically similar contracts should receive the same tax treatment. It is hard to differentiate a forward that settles in one week from a spot contract that settles in two days. Nonetheless, they would arguably be given very different tax treatment (35% rate versus 23% rate for net gains).

What’s a Spot Forex Trader to Do?

The IRS has not issued any guidance on this issue, although informally IRS lawyers have spoken of the need for more consistent tax treatment of economically similar contracts, whether securities or commodities. The issue for any spot forex trader is whether there is sufficient authority to take a tax return position that spot forex contracts (for which there is a regulated futures in that currency) are treated as 60/40 contracts, **provided** that the taxpayer has made a valid election to opt out of the normal Section 988 treatment of forex as ordinary.

This is an issue for the forex trader to consider after consulting with a tax adviser knowledgeable about the issues discussed here. Especially important is whether to make the Section 988 election opting out of ordinary treatment, and if so, when to make the election, how to make the election, and the duration of the election. It is clear that the statutory rules are a hopeless antique (Ronald Reagan was in his first term of office when Section 988 was enacted). Modernization of those rules may not be inappropriate.

For more information about spot forex taxation, contact us at legal@greencompany.com.