Article from:

Taxing Times

May 2011 – Volume 7 Issue 2

DEACTIVATING THE WEAPONS OF MASS VOLATILITY:
THE DODD-FRANK ACT, SECTION 1256 AND THE TAXATION OF DERIVATIVES

By John R. Newton

INTRODUCTION

In the wake of the financial crisis of 2008, much attention has been focused on derivatives and the alleged threat they pose to the economy at large. For life insurance companies, hedging with derivatives is a long-established and essential tool in managing business and financial risks. In the view of some, however, derivatives pose systemic risk to the global economy, and are perceived to be dangerously arcane instruments that are traded in a high-volume but unregulated "shadow market."[1]

In large part due to this sudden notoriety, derivatives market reform measures were enacted under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (referred to in this article as the "Act"), which was signed into law in July of 2010. Title VII of the Act requires that most types of derivatives that are currently bought and sold over-the-counter—that is, directly between two counterparties rather than on an exchange—be traded through a central clearinghouse. Title VII also requires margin posting for derivative trades, and imposes additional rules for derivative dealers and large-scale derivative market participants.

On the very last of the Act's 848 pages, one finds "Title XVI – Section 1256 Contracts." Title XVI contains a single section—1601—which is the only provision in the entire legislation that amends the Internal Revenue Code (the "Code"). Section 1601 provides that a "section 1256 contract" does not include "any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement."[2]

Section 1601 was aimed at ensuring that Title VII's new requirements for derivative trading would not inadvertently—or at least unthinkingly—sweep certain derivatives into the mark-to-market/capital gain regime of section 1256 of the Code. Section 1256 treatment for such contracts could have resulted in adverse tax consequences to companies that routinely use derivatives to manage risk by hedging, such as life insurers, including dramatically increased volatility in taxable income.

While section 1601's "fix" for these concerns is not perfect, for the most part it succeeds in maintaining the status quo for tax treatment of derivative contracts, under which income is required to be recognized only upon a realization event. Section 1601 may also have the important consequence of compelling the Internal Revenue Service (IRS) to provide much-needed guidance on certain financial products such as credit default swaps.

SECTION 1256—BACKGROUND

Section 1256 represents a departure from the general tax principle that income is not taxed until realized (either in cash, or in the case of an accrual-based taxpayer, when it accrues). It was enacted in 1981 at a time when Congress was concerned that taxpayers were using straddle schemes, frequently involving futures contracts, to delay payment of taxes.[3] For example, a taxpayer would enter into offsetting positions by buying a futures contract for the delivery of a certain amount of a particular commodity (the long position), and then selling a futures contract on the same commodity (the short position). Because the positions offset, the two contracts taken together would not fluctuate in value as market conditions changed. However, one contract would always be in a loss position and the other would be in a gain position. The taxpayer would close out the loss position and take a tax deduction. The taxpayer would then continue to hold the gain position, deferring the recognition of taxable gain until a later tax year.

Section 1256[4] addressed this timing play by introducing a mark-to-market system for certain derivatives, notwithstanding the view of some that mark-to-market tax accounting represented a "fundamental departure from the concept of income realization in the U.S. tax law."[5] Thus, a contract subject to section 1256 was now taxed as if its owner had sold the contract on the last day of the tax year, forcing recognition of the contract's change in market value.

Section 1256 initially applied only to a "**regulated futures contract**," defined as a contract:

CONTINUED ON **PAGE 34**

(A) 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
(B) which is traded on or subject to the rules of a **qualified board or exchange**.

The term "qualified board or exchange" means any of the following:

(A) a national securities exchange which is registered with the Securities and Exchange Commission,
(B) a domestic board of trade **designated as a contract market** by the Commodity Futures Trading Commission, or
(C) any other exchange, board of trade, or other market which the Secretary determines has rules adequate to carry out the purposes of this section.

Section 1256(g)(1). [Emphasis added.]

Later, section 1256 was expanded to cover "foreign currency contracts," a category which generally includes forward contracts in actively traded currencies, and non-equity options traded on or subject to the rules of a qualified board or exchange. The character of mark-to-market gain under section 1256 is split arbitrarily between 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss, regardless of how long the taxpayer has held the contract.

DODD-FRANK, DERIVATIVES AND SECTION 1256

At the time the Dodd-Frank Act began to take shape, there was little doubt that over-the-counter derivatives, (*i.e.,* derivative contracts not traded on an exchange) such as interest rate swaps and other notional principal contracts, were not subject to the mark-to-market/capital character regime of section 1256. Rather, the specific rules applicable to such contracts applied. For example, the notional principal contract rules of Treas. Reg. section 1.446-3 applied to interest rate swaps, as well as to currency swaps for which no principal amounts are exchanged. Under these specific derivative rules, marking-to-market is generally not required except for dealers in securities. Rather, taxable gain or loss is recognized on a realization basis—that is, when a contract terminates at a gain or loss (requiring an exchange of cash) or when periodic payments are made or have accrued.

Without section 1601 of the Act, the new derivative clearing requirements of Title VII could have changed this treatment for a large number of derivatives by forcing them within the definition of "regulated futures contract" under section 1256(g)(1) (quoted above). The reason for this is that Title VII requires most "swaps" to be cleared through a central counterparty (a "clearinghouse") and traded on a regulated exchange or facility that imposes a margin requirement.

Definition of swap. The term "swap" is broadly defined by section 721 of the Act, and covers a wide variety of derivatives such as interest rate swaps and credit default swaps, as well as energy and even weather-related derivatives. Although certain contract types such as futures are excluded from the "swap" definition, foreign currency swaps and foreign currency forwards are included unless the Secretary of the Treasury specifically excludes them in future guidance.

Trading requirement. Under the framework of Dodd-Frank, the Commodity Futures Trading Commission (CFTC) is directed to review categories of swaps on an ongoing basis to determine whether they should be cleared. If the CFTC makes a determination that a type of swap is to be cleared, and such swap is accepted for clearing by a clearing organization, the swap must be traded on either a "designated contract market" or "swap execution facility." Act, section 723. The significance of this requirement for tax purposes is that a "designated contract market" (a type of organization that is defined under existing law in the Commodity Exchange Act) is a "qualified board or exchange" under section 1256(g)(1)(B).

Margin requirement. Dodd-Frank also requires "a margin… from each member and participant of a derivatives clearing organization [that] shall be sufficient to cover potential exposures in normal market conditions." Additionally, money settlements are required at least daily. Act, section 725. This would result in swaps meeting the criteria of section 1256(g)(1)(A) by establishing a system of deposit based on marking contracts to market.

Again, but for section 1601 of the Act, this combination of the trading and margin requirements would have meant that "swaps" subject to the clearing requirement of Dodd-Frank would be section 1256 "regulated futures contracts" if traded on a "designated contract market."[6] Contracts traded on a swap execution facility would not be "regulated futures contracts" because such a facility is not a "qualified board or exchange." However, a swap execution facility could be treated as a qualified board or exchange if the Secretary of the Treasury determines that the facility has rules adequate to carry out the purpose of section 1256.

DISADVANTAGES OF SECTION 1256 TREATMENT

Why does expanded section 1256 treatment concern corporate taxpayers? The main reason is vastly increased taxable income volatility. Many corporate taxpayers use derivatives to manage business and financial risks. Typical derivatives used for this purpose may include interest rate swaps, currency swaps, and other contracts that are not marked-to-market under current law. For such taxpayers, an expanded mark-to-market system of tax accounting could result in dramatic changes in taxable income if interest or exchange rates shift by even a small amount. Since such shifts are by their very nature unpredictable, mark-to-market throws a wrench into the machinery of forecasting taxable income. Tax forecasting is essential to any company that needs to make intelligent decisions about entering into transactions that have tax implications.

The capital character treatment required by section 1256 has further disadvantages for corporate taxpayers. Capital losses have the ability to offset only capital gains and not ordinary income, and have a shorter carryforward period (five years) than net operating losses (15 years for life insurance companies; 20 years for all other corporations). Moreover, unlike individual taxpayers, corporations do not benefit from a lower rate on capital gains. Although gains and losses on foreign currency contracts would remain ordinary under IRC section 988, mark-to-market gain or loss on interest rate swaps, for instance, would become capital, thereby increasing the overall likelihood that a company will have a net capital loss carryforward.

Finally, expanding section 1256 to derivatives such as interest rate swaps would be detrimental to insurers who routinely hedge assets.[7] In particular, mark-to-market treatment exacerbates the challenges posed by the straddle rules. If offsetting positions form a straddle, as defined in IRC section 1092, any losses in one position generally must be deferred to the extent of unrecognized gains in the other position. Thus, mark-to-market gains on a derivative that is part of a straddle are recognized immediately, but losses could be deferred if there is unrecognized gain in the offsetting position. Enlarging the scope of section 1256 would increase the incidence of this asymmetrical result, and impose significant tracking and compliance burdens that are not necessary under current tax accounting rules (whereby, for instance, neither an interest rate swap nor a bond is marked-to-market for tax).

THE "FIX" OF SECTION 1601

For the above reasons, a number of taxpayers in the financial services industry, led by life insurance companies, urged Congress that the derivatives provisions of Dodd-Frank not be allowed to expand the scope of section 1256—that is, that the existing state of the tax law applicable to derivatives should be maintained. The result was section 1601 of the Act, which amends the definition of "section 1256 contract," by adding section 1256(b)(2)(B). As noted above, that section provides that "[t]he term 'section 1256 contract' shall not include … any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement."

Beyond its primary effect of mostly maintaining the status quo of the tax law affecting derivatives at the time of Dodd-Frank's enactment, section 1601 is noteworthy—and problematic—for a number of reasons. It was added at the very end of the Conference Committee deliberations. As noted above, it was the only provision of the only tax title in the Act. The derivatives excluded from section 1256 are identified by common market names without reference to any existing definitions in the Code, Treasury regulations, or in the Act itself. Taxpayers and the government now must assess any collateral impact section 1601 has by virtue of how it is drafted.

Since such shifts are by their very nature unpredictable, mark-to-market throws a wrench into the machinery of forecasting taxable income.

At a minimum, some guidance would appear to be necessary on the scope of the exclusion from section 1256. Indeed, most of the contract types specifically listed in section 1601 are not defined in the Code or by regulation. While the excluded contracts resemble those mentioned within the definition of "notional principal contract" found in Treasury regulations,[8] the list is not identical. What constitutes a "similar agreement" to those contracts specifically listed is also unclear—for example, whether "similar agreements" include contracts

CONTINUED ON **PAGE 36**

explicitly identified under the definition of "swap" elsewhere in the Act.

Section 1601 also represents the first time the term "credit default swap" has surfaced in the Code. The IRS had previously solicited public comment on the tax treatment of credit default swaps, which more than any other derivative type were an object of opprobrium following the financial crisis.[9] One wonders whether the explicit appearance of "credit default swap" in the Code creates additional incentive for the IRS to finally issue guidance on their treatment, whether as notional principal contracts, put options or as an entirely new type of derivative.[10]

CONCLUSION

Section 1601 of the Dodd-Frank Act prevents what would have been an expansion of the mark-to-market regime of section 1256 through a non-tax piece of legislation. The merits of broadening mark-to-market treatment to cover more types of financial instruments will continue to be debated.[11] The enactment of section 1601 at least assured that such broadening did not occur in a rushed manner, and without due consideration of tax policy goals and the potentially harmful volatility consequences for taxpayers that use derivatives for normal risk management purposes.

John R. Newton, J.D., is vice president and corporate counsel with Prudential Financial, Inc. and may be reached at *john.newton@prudential.com.*

END NOTES

1 In the aftermath of the 2008 financial crisis, this view has been pervasive in the popular media. *See, e.g., "Wall Street's Shadow Market," 60 Minutes,* first aired on CBS, 10/5/2008, as well as Warren Buffett's oft-quoted statement that derivatives are "financial weapons of mass destruction." *Wall Street Journal,* "Deal Near on Derivatives" (April 26, 2010).

2 New Internal Revenue Code section 1256(b)(2)(B).

3 Kleinbard, Edward, and Evans, Thomas, "The Role of Mark-to-Market Accounting in a Realization-Based Tax System," *TAXES – The Tax Magazine*, 12/1/1997. pp. 801–808.

4 Enacted by the Economic Recovery Tax Act of 1981, P.L. 97-34.

5 Hammer, Viva, "U.S. Taxation of Foreign Currency Derivatives: 30 Years of Uncertainty," *Bulletin of International Taxation,* March 2010, footnote 1, quoting statement of Robert K. Wilmouth, president, Chicago Board of Trade. It should be noted that the perceived timing abuse was also addressed by the simultaneously enacted straddle rules of IRC section 1092, arguably making section 1256 redundant in this respect.

6 At a recent panel discussion, representatives of the IRS stated that the IRS historically has held a narrow view of the scope of "regulated futures contract" under section 1256, such that contracts like interest rate swaps, for example, would not fall within that definition. "IRS Holds to Narrow View of Futures Under Dodd-Frank," *Daily Tax Report* (Bureau of National Affairs, 12/15/2010). However, this view is not specifically supported by the explicit language of the Code, which includes "any contract" in the definition of "regulated futures contract."

7 The ability to designate derivative contracts as IRC section 1221 tax hedges, or to integrate them with debt instruments under IRC sec. 988(d) or Treas.Reg. 1.1275-6, may mitigate volatility. However, these options have limited availability, particularly in respect of routine asset hedges of capital assets.

8 Treas.Reg. sec. 1.446-3(c)(1).

9 See footnote 1, *supra.*

10 The IRS previously requested public comment on how credit default swaps should be treated for tax purposes in Notice 2004-52. No guidance has been issued to date. Due to the increasing variability in how credit default swaps can be structured, issuing such guidance is perhaps an even greater challenge now than previously.

11 See Kleinbard and Evans, *supra* at 823, discussing the lack of necessity for section 1256's mark-to-market regime to curb abuse given the straddle rules, and describing section 1256 as "an odd provision," and "badly in need of repair." A more "pro-mark-to-market" position—though coupled with the view that section 1256 is in need of a general rewrite—may be found in Sheppard, Lee, "Dodd-Frank Bill Blows Up Section 1256," *Tax Notes Today* (Aug. 16, 2010).