Did the Tax Treatment of Your Futures Contracts Just Change?

By Angeliki Vlachou*

Introduction

The Internal Revenue Service ("IRS") recently released Rev. Rul. 2024-22,[1] which designated the Bourse de Montreal ("MX") as a qualified board or exchange ("QBE"), and Rev. Rul. 2024-23,[2] which designated the European Energy Exchange ("EEE") as a QBE.

These designations will cause certain contracts traded through these exchanges to be treated as Code Sec. 1256[3] contracts after the effective date of the rulings. This raises several complications, including the following:

- The impact on previous reporting provisions;
- The effective date of the guidance and transition rules for affected contracts;
- The scope of affected contracts;
- The interaction of the new Code Sec. 1256 status for affected contracts with the mixed straddle rules;
- The interaction of the new Code Sec. 1256 status for affected contracts with the rules for dealers and traders in securities under Code Sec. 475.

An overview of the rulings and each of these issues is evaluated in further detail in this article.

Background and Details of the Rulings

Code Sec. 1256 establishes special rules for the recognition of gain or loss on "Code Sec. 1256 contracts." Specifically, Code Sec. 1256 requires that each Code Sec. 1256 contract held by the taxpayer at the close of the tax year is treated as sold for its fair market value on the last business day of such tax year.[4] This method of accounting is commonly referred to as "mark-to-market" accounting. In general, any gain or loss under the mark-to-market method of accounting is treated as 60-percent long-term capital gain or loss and 40-percent short-term capital gain or loss, regardless of the amount of time the taxpayer actually held the contract.[5]

The term "Code Sec. 1256 contract" means any (i) regulated futures contract; (ii) foreign currency contract; (iii) nonequity option; (iv) dealer equity option; and (v) dealer securities futures contract.[6] With the exception of foreign currency contracts (which are traded on the interbank market), contracts must be traded on or subject to the rules of a QBE to qualify as a Code Sec. 1256 contract.[7]

ANGELIKI VLACHOU is a Senior Manager in the Financial Institutions and Products Group of the Washington National Tax Practice of KPMG LLP.

Code Sec. 1256(g)(7) defines the term QBE to include: (i) a national securities exchange that is registered with the Securities and Exchange Commission; (ii) a domestic board of trade that is registered by the Commodity Futures Trading Commission; or (iii) any other exchange, board or trade, or other market that the Secretary determines has rules adequate to carry out the purposes of Code Sec. 1256.[8] In contrast to domestic future exchanges, a foreign futures exchange cannot qualify as a domestic board of trade designated by the Commodity Futures Trading Commission. Accordingly, foreign futures exchanges constitute a QBE only if Treasury determines that the exchange has rules adequate to carry out the purposes of Code Sec. 1256 and exercises its authority to designate the exchange as a QBE. Treasury and the IRS exercised this authority in the revenue rulings and designated MX and the EEE as QBEs.

Impact of this Guidance on Previous Reporting Provisions

Previously, in Rev. Rul. 86-7,[9] the IRS determined that the Mercantile Division of the Montreal Exchange had adequate rules to carry out the purposes of Code Sec. 1256 and designated the exchange as a QBE.[10] The Mercantile Division was a derivatives exchange associated with MX. However, since Rev. Rul. 86-7 was issued, MX was acquired, the Mercantile Division ceased operations, and the exchange rules that referenced the Mercantile Division were removed. Because of these developments, most tax practitioners concluded that MX in its present form did not inherit the QBE status set forth in Rev. Rul. 86-7.

In Rev. Rul. 2024-22, the IRS appears to confirm that MX did not inherit the QBE status of the Mercantile Division after the division ceased operations. However, due to potential uncertainty on this matter, Rev. Rul. 2024-22 indicates that the IRS will not challenge positions taken by taxpayers prior to November 1, 2024 (the effective date of the ruling), with respect to transactions occurring before that date if the taxpayer reasonably relied on the conclusion in Rev. Rul. 86-7. Although the IRS' accommodating position is certainly welcome, it does perhaps raise the question as to what exactly constitutes reasonable reliance. For example, if a taxpayer was aware that the Mercantile Division was no longer in operation, would reliance on Rev. Rul. 86-7's conclusion be reasonable?

It should be noted that there was no prior uncertainty on the QBE status of the EEE. This foreign exchange (or any prior division) did not qualify as a QBE under Code Sec. 1256(g)(7) prior to Rev. Rul. 2024-23.

Effective Date and Transition Rules

Both revenue rulings are effective for contracts entered into on or after November 1, 2024. The Commissioner granted consent to taxpayers changing their method of accounting for contracts entered into on or after November 1, 2024, and waived the requirement to file a Form 3115, *Application for Change in Accounting Method*. The accounting method change is made on a cut-off basis and therefore is inapplicable to contracts that were entered into before November 1, 2024.

Although no effective date would be perfect, this mid-year bifurcation may make tracking this change more administratively difficult, because taxpayers will need to apply different methods of accounting to various MX and EEE contracts entered into during calendar year 2024.[11]

Scope of the Affected Contracts

The revenue rulings apply to "MX Contracts" and "EEE Contracts," which are defined as futures contracts and futures contract options that are: (i) traded on or subject to the rules of the respective exchanges; (ii) described in Code Sec. 1256(g)(1)(A); and (iii) not covered by the exception in Code Sec. 1256(b)(2).

It is not entirely clear what requirement (ii) is intended to address.[12] Code Sec. 1256(g)(1)(A) is a component of the definition of a regulated futures contract and requires that "the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market."[13] Because this requirement is only applicable to regulated futures contracts, this might imply that both futures contracts and futures contract options traded on those exchanges are considered "regulated futures contracts."

In the case of MX and EEE, this distinction is perhaps one without much practical significance, as futures contract options presently offered on these exchanges do not appear to reference equities and would therefore qualify as Code Sec. 1256 contracts (nonequity options) in the event they failed to meet the definitional requirements to be classified as regulated futures contracts.[14] Although such a possibility is not explicitly addressed in the rulings, it would seem to follow from the holdings that MX and EEE are QBEs.

Interplay with the Straddle Rules

In general, the straddle rules under Code Sec. 1092 limit the recognition of a realized loss to the extent that a taxpayer has unrecognized gain in an offsetting position.[15] A taxpayer holds offsetting positions if there is a substantial diminution of the taxpayer's risk of loss from holding any position by reason of holding one or more other positions.[16]

If a taxpayer realizes a loss from a position in a straddle, the taxpayer can only deduct the loss to the extent that the loss exceeds any "unrecognized gain" at the end of the tax year in an offsetting position.[17] Otherwise, the taxpayer must defer the loss and determine whether the loss remains subject to the loss deferral rule at the end of the next tax year.[18]

Special rules apply in the case of a "mixed straddle," which is generally a straddle comprising Code Sec. 1256 contracts and positions that are Code Sec. 1256 contracts.[19] Absent certain elections, positions that are part of a mixed straddle could be subject to unfavorable timing and character rules. From a timing standpoint, positions in the straddle that are Code Sec. 1256 contracts are marked to market, but the non-Code Sec. 1256 positions are not. This generally results in the deferral of mark-to-market losses to the extent of unrealized gains on the offsetting position (but no change in the recognition of mark-to-market gains). Mixed straddles can also result in unfavorable character treatment, as losses that would otherwise be short-term may be treated as 60-percent long-term/40-percent short-term loss under the mixed straddle rules.[20]

There are several ways to mitigate the otherwise negative tax consequences of straddles. One approach is to establish a mixed straddle account ("MSA"), which results in all positions in the MSA being marked to market daily and subject to special character netting rules. An election to establish a MSA for a tax year must be made by the due date (without regard to extensions) of the taxpayer's income tax return for the immediately preceding tax year.[21]

After the effective date of the revenue rulings (November 1, 2024), the futures contracts entered into on MX and EEE will be Code Sec. 1256 contracts, which could potentially create mixed straddles. This would generally be expected to result in adverse timing consequences in situations where the offsetting straddle position is subject to a realization-based method of accounting (which will usually be the case). In addition, the November 1, 2024, effective date of the revenue rulings is after the unextended tax return due date. Therefore, taxpayers entering into MX and EEE derivative after November 1, 2024 will be unable to address any negative tax consequences of mixed straddles through an MSA. Those taxpayers might consider making straddle-by-straddle identifications[22] or, alternatively, making a Code Sec. 1256(d) election[23] to mitigate the otherwise adverse tax consequences of any mixed straddles.

Interplay with the Code Sec. 475 Rules

In general, a taxpayer that qualifies as Code Sec. 475 dealer in securities must apply mark-to-market tax accounting with regard to its securities. Traders in securities may elect to be subject to the mark-to-market rules of Code Sec. 475. Any mark-to-market gain or loss recognized under section 475 is generally treated as ordinary income or loss.[24]

The term "security" is defined under Code Sec. 475(c)(2) to include any: (i) share of stock in a corporation; (ii) partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust; (iii) note, bond, debenture, or other evidence of indebtedness; (iv) interest rate, currency, or equity notional principal contract; (v) evidence of an interest in, or a derivative financial instrument in, any security described above, or any currency, including any option, forward contract, short position, and any similar financial instrument in such a security or currency; and (vi) position that is not a security (as described above) but is a hedge of a security and is clearly identified as such in the dealer's records before the close of the day on which it was acquired or entered into. With respect to category (v), there is an important carveout—that category does not include contracts to which Code Sec. 1256 applies.[25] Code Sec. 1256 contracts may nevertheless be securities, but only if they are clearly identified as a hedge of a security in the dealer's records before the close of the day on which it was acquired or entered into.[26]

After November 1, 2024, futures contracts entered into on MX and EEE will no longer qualify as securities under category (v) due to the Code Sec. 1256 contract carveout. In situations where these instruments serve as a hedge against a Code Sec. 475 security, adverse character mismatches could occur because the futures contracts would generally create capital gain or loss, while the hedged item would create ordinary gain or loss under Code Sec. 475. This could be mitigated if the MX and EEE traded futures are properly identified as hedging transactions under Code Sec. 1221 or identified as hedges of other securities as described above.[27]

Conclusion

The recent revenue rulings will make important changes to the taxation of MX and EEE futures contracts. Although the IRS' statement that it will not challenge positions previously taken with respect to MX contracts is a relatively accommodating one, complications will likely arise on account of the mid-year effective date and the limited transaction guidance, which does not address items such as the availability of the MSA election and transition rules for Code Sec. 475 identifications.

Taxpayers with affected contracts would be well advised to revisit their elections and identifications to ensure that they are optimal in light of the new base case treatment of MX and EEE futures.

ENDNOTES

* The information in this article is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP.

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1 2024-43 IRB 1.

2 *Id.*

3 Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "Regulations").

4 There are certain exceptions to this rule. For example, mark-to-market accounting does not apply to properly identified hedging transactions unless that method of accounting would clearly reflect income under the hedge timing rules. *See* Code Sec. 1256(e); Reg. §1.1256(e)-1. *See also* Reg. §1.446-4.

5 Code Sec. 1256(a)(3). In the case of Code Sec. 1256 contracts that are also Code Sec. 988 transactions, the resulting gain or loss is generally ordinary unless the contract is a regulated futures contract or nonequity option. Code Sec. 988(a)(1), (c)(1)(D); Reg. §1.988-3(a). For contracts that would generally result in ordinary gain or loss, taxpayers may elect capital treatment provided certain requirements are met. *See* Code Sec. 988(a)(1)(B); Reg. §1.988-3(b). In addition, for regulated futures contract and nonequity options that are generally capital transactions, taxpayers may elect ordinary character. *See* Code Sec. 988(c)(1)(D)(ii).

6 Code Sec. 1256(b)(1). Code Sec. 1256 contracts do not include any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract, or 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. Code Sec. 1256(b)(2).

7 *See generally* Code Sec. 1256(g).

8 Code Sec. 1256(g)(7).

9 1986-1 CB 295.

10 *See also* LTR 8528072 (April 18, 1985).

11 For MX contracts, an exception to this general state of the affairs would be situations where the taxpayer reasonably relied upon the conclusion of Rev. Rul. 86-7 and previously treated MX contracts as Code Sec. 1256 contracts.

12 Similar phrasing was used in Notice 2007-71, 2007-2 CB 47, and Notice 2003-81, 2003-2 CB 1223.

13 The other requirement is encompassed in (i) above (the contract must be traded on or subject to the rules of a QBE). *See* Code Sec. 1256(g)(1)(B).

14 Code Sec. 1256(b)(1)(C) defines the term "Code Sec. 1256 contract" to include any nonequity option. Code Sec. 1256(g)(3) defines "nonequity option" to mean any listed option which is not an equity option. For this purpose, "listed option" is defined by Code Sec. 1256(g)(5) as any option (other than a right to acquire stock from the issuer) which is traded on (or subject to the rules of) a QBE.

15 Code Sec. 1092(a).

16 Code Sec. 1092(c)(2).

17 Code Sec. 1092(a)(1). Loss also may be deferred to the extent of any unrecognized gain at the end of the tax year in so-called successor positions (or offsetting positions to successor positions). *See* Temporary Reg. §1.1092(b)-1T(a).

18 Code Sec. 1092(a)(1)(B).

19 The definition of a mixed straddle is provided under Temporary Reg. §1.1092(b)-5T(e). Requirements not listed above include: (i) all the positions in the straddle are held as capital assets; (ii) an election under Code Sec. 1256(d) has not been made; and (iii) the straddle is not part of a larger straddle.

20 Temporary Reg. §1.1092(b)-2T(b)(2).

21 Temporary Reg. §1.1092(b)-4T(f)(1). There is a limited exception to this general rule for situations where a taxpayer begins trading or investing in positions in a new class of activities during the tax year. In that case, the election with respect to the new class of activities must be made by the taxpayer by the later of the due date of the taxpayer's return described above, or 60 days after the first mixed straddle in the new class of activities is entered into.

22 To make an election to treat a straddle as an identified mixed straddle, a taxpayer must clearly identify on a "reasonable and consistently applied economic basis" each position that is part of the straddle before the close of the day on which it is established. Temporary Reg. §1.1092(b)-3T(d)(1). The regulations state that, in the case of an individual, the close of the day is midnight (local time) in the location of the taxpayer's principal residence. As to all other taxpayers, the close of the day is midnight (local time) in the location of the taxpayer's principal place of business.

A taxpayer is presumed to have timely identified an identified mixed straddle if the taxpayer receives independent verification of the identification. Temporary Reg. §1.1092(b)-3T(d)(2). For this purpose, "independent verification" is established through the placement of one or more positions of an identified mixed straddle in a separate account designated as such and that is maintained by a broker, futures commission merchant, or similar person where notations are made by such person identifying all positions of the straddle and stating the date that the straddle is established. Temporary Reg. §1.1092(b)-3T(d)(4)(i). However, independent verification also occurs if the taxpayer receives a written confirmation from these persons, or from the party from which one or more positions of the straddle are acquired, stating the date the straddle is established and identifying the other positions of the straddle. Temporary Reg. §1.1092(b)-3T(d)(4)(ii). The regulations state that other methods of independent verification may be approved by the IRS at its discretion. Temporary Reg. §1.1092(b)-3T(d)(4)(iii). This presumption, however, may be rebutted by clear and convincing evidence to the contrary. Temporary Reg. §1.1092(b)-3T(d)(2). If the presumption does not apply, the burden falls on the taxpayer to establish that an election was made by the time specified. Temporary Reg. §1.1092(b)-3T(d)(3).

23 A taxpayer may elect, under Code Sec. 1256(d), to exclude from Code Sec. 1256 all Code Sec. 1256 contracts that are part of a mixed straddle. If this election is made, the Code Sec. 1256 contract will be excluded from the mark-to-market method of accounting, but subject to the loss deferral, modified wash sale and short sale rules under Code Sec. 1092. The election avoids the harmful effects of the mixed straddle character rules described above, although the benefits of 60/40 character rule, if any, are lost.

24 Code Sec. 475(d)(3).

25 Code Sec. 475(c)(2) (flush language).

26 Code Sec. 475(c)(2)(F).

27 Note, dealers and traders in commodities may elect into Code Sec. 475. The definition of a commodity for Code Sec. 475 purposes is unlike the definition of a security in the sense that the term "commodity" includes derivatives on commodities and does not have a carve out for Code Sec. 1256 contracts. Thus, if a Code Sec. 1256 contract references a commodity, it would be subject to the rules of Code Sec. 475, rather than the rules of Code Sec. 1256, as a general matter. *See* Code Sec. 475(e)(2).