Managed Funds Association
The Voice of the Global Alternative Investment Industry
Washington, D.C. | New York | Brussels

September 6, 2022

Via Electronic Submission:

Internal Revenue Service
CC:PA:LPD:PR (REG–130675–17)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Definition of Foreign Currency Contract Under Section 1256; REG–130675–17

Managed Funds Association[1] ("**MFA**") appreciates the opportunity to provide comments to the Treasury Department ("**Treasury**") and the Internal Revenue Service ("**IRS**") on the Proposed Regulations under section 1256 (the "**Proposed Regulations**")[2] of the Internal Revenue Code of 1986, as amended (the "**Code**").[3] MFA represents the global hedge fund and alternative asset management industry and its investors. MFA's more than 150 member firms collectively manage nearly $2.6 trillion across a diverse group of investment strategies. Active currency management strategies can provide strong diversification benefits while adding a valuable source of return, and our members are some of the most active users of both listed and over-the-counter ("**OTC**") foreign currency options to implement such strategies.

We believe it is sound public policy to provide similar tax treatment for economically comparable and interchangeable instruments. We are concerned that the definition of "foreign currency contract" under the Proposed Regulations is too narrow and results in different tax treatment for economically similar contracts (more specifically, OTC foreign currency options and listed foreign currency options). While we welcome Treasury's and the IRS's effort to provide certainty to taxpayers, we respectfully request that Treasury and the IRS reconsider the Proposed Regulations, with consideration given to the legislative history's focus on economic comparability and interchangeability, and allow OTC foreign currency options to be treated as "foreign currency contracts" under section 1256.

Congress intended, in amending section 1256 in the Deficit Reduction Act of 1984,[4] to include cash-settled foreign currency contracts within section 1256's definition of "foreign currency contract." Treasury and the IRS have reasoned by reference to Congress's silence that Congress gave no indication

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[1] Managed Funds Association ("**MFA**") represents the global hedge fund and alternative asset management industry and its investors by advocating for regulatory, tax, and other public policies that foster efficient, transparent, and fair capital markets. MFA's more than 150 member firms collectively manage nearly $2.6 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time. MFA has a global presence and is active in Washington, Brussels, London, and Asia. www.managedfunds.org.

[2] Proposed Regulations section 1.1256(g)-2. "Definition of Foreign Currency Contract Under Section 1256," 87 Fed. Reg. 40,168 (July 6, 2022). The Proposed Regulations, if adopted, would apply to contracts entered into on or after the date that is 30 days after the date of publication in the Federal Register of a Treasury decision adopting the Proposed Regulations as final regulations.

[3] Unless otherwise indicated, all "section" or "§" references are to the Internal Revenue Code of 1986, as amended (the "**Code**").

[4] Deficit Reduction Act of 1984, Public Law 98–369 at section 102(a)(3) (98 Stat. 494 (1984)).

that it intended to include option contracts within the scope of the definition of "foreign currency contract."[5] However, this reasoning is belied by Congress's strong reliance on economic comparability and interchangeability as driving principles in rationalizing the scope of section 1256. We are concerned that the Proposed Regulations apply inconsistent tax treatment to economically comparable contracts that are interchangeable and may create mismatches in timing and character for taxpayers trading in both OTC and listed foreign currency options markets.

MFA COMMENTS

Taxpayers generally recognize gain or loss in the taxable year in which they sell or dispose of an asset.[6] The Code, however, contains special rules relating to the taxation of certain derivatives which are considered as section 1256 contracts. Under section 1256(a)(1), a section 1256 contract held by a taxpayer at the close of the taxable year is treated as sold for its fair market value on the last business day of that taxable year. Adjustment is made in the amount of any gain or loss subsequently realized to take into account the gain or loss previously recognized under section 1256(a)(1).[7] Any gain or loss on a section 1256 contract is treated as 60% long-term capital gain or loss and 40% short-term capital gain or loss.[8]

Under current law, the definition of a section 1256 contract includes any regulated futures contract, any foreign currency contract, any nonequity option,[9] any dealer equity option, and any dealer securities futures contract.[10] Any securities futures contract or option on such a contract (unless it is a dealer securities futures contract), and 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 is excluded from the definition of a section 1256 contract.[11]

Section 1256(g)(2)(A) defines the term "foreign currency contract" as a contract that: (1) requires delivery of, or the settlement of which depends on the value of, a foreign currency which is a currency in which positions are also 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 price in the interbank market.

When enacted in 1981, section 1256 applied only to regulated futures contracts which require delivery of foreign currency traded on futures exchanges.[12] The section's scope was soon expanded to include similar foreign currency forward contracts that were traded on the interbank market and other OTC markets.[13] According to the House Report, this expansion was due to the *economic comparability* of trading foreign currency through forward contracts in the interbank market to trading foreign currency through regulated futures contracts and the *interchangeability* of the two types of contracts by traders:

[5] *See* Notice 2007-71, 2007-35 I.R.B. 472.

[6] Section 1001.

[7] Section 1256(a)(2).

[8] Section 1256(a)(3).

[9] Section 1256(g)(3) defines the term nonequity option as any listed option (generally, an option traded on or subject to the rules of a qualified board or exchange) that is not an equity option.

[10] Section 1256(b)(1).

[11] Section 1256(b)(2).

[12] Economic Recovery Tax Act of 1981, Public Law 97–34, section 503(a) (95 Stat. 172 (1981)).

[13] Technical Corrections Act of 1982, Public Law 97–448, section 105(c)(5)(B) and (C) (96 Stat. 2365 (1983)).

> Prior to [the Economic Recovery Tax Act of 1981], taxpayers who used both the futures exchanges and the interbank market to conduct short-term trading in foreign currency were subject to substantially comparable tax treatment for both types of contract[s]. Although bank forward contracts differ from regulated futures contracts, the volume of trading through forward contracts in foreign currency in the interbank market is substantially greater than foreign currency trading on futures exchanges, and prices are readily available. Such contracts are economically comparable to regulated futures contracts in the same currencies and are used interchangeably with regulated futures contracts by traders.[14]

The legislative history makes clear that the amendment was intended to eliminate mismatches in timing and character for taxpayers trading in both markets.[15] As further confirmation, in 1988, the IRS concluded that Congress intended to bring OTC forward contracts within the scope of section 1256 because "they are economically comparable to and used interchangeably with" regulated futures contracts.[16]

Section 1256 was further expanded to include foreign currency forward contracts that provide for cash settlement by reference to the value of foreign currency, and the physical delivery of foreign currency was no longer required.[17] The House Report indicates that Congress's reason for this change was as follows:

> Because certain contracts may call for a cash settlement by reference to the value of the foreign currency rather than actual delivery of the currency, the bill provides that the delivery of a foreign currency requirement is met where the contract provides for a settlement determined by reference to the value of the foreign currency.[18]

Section 1256 was also amended to apply to dealer equity options and non-equity options, which include listed foreign currency options. Only OTC foreign currency options appear to be excluded, and after inclusion of OTC forward contracts and listed foreign currency options under section 1256, economically there is no basis for the exclusion of OTC foreign currency options from the scope of section 1256. OTC foreign currency options and listed foreign currency options are economically comparable. They are also interchangeable in the eyes of market participants.[19] By treating OTC foreign currency options as being excluded from the definition of section 1256 contracts while listed foreign currency options are included, the Proposed Regulations apply inconsistent tax treatment to economically comparable contracts that are interchangeable. Allowing similar tax treatment to apply to economically comparable contracts was the reason for the enactment of section 1256(g)(2).[20]

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[14] H.R. Rep. No. 97–794, at 23 (1982).

[15] *See* S. Rep. No. 97–592, at 25-28 (1982); H.R. Rep. No. 97–986, at 24-26 (1982) (Conf. Rep.).

[16] *See* P.L.R. 8818010 (Feb. 4, 1988).

[17] Deficit Reduction Act of 1984, Public Law 98–369 at section 102(a)(3) (98 Stat. 494 (1984)).

[18] H.R. Rep. 98–432 (Part 2), at 1646 (1984).

[19] Frequently, foreign exchange traders are simply looking to compare prices across multiple different liquidity pools (*i.e.*, between both OTC and listed foreign currency options markets) to ensure that they are delivering best execution. In such cases, the only meaningful difference between OTC and listed foreign currency options is the implied volatility at which the options contracts are being offered in the respective markets, which should have no bearing on the tax treatment of the options contracts.

[20] We note that OTC foreign currency options and listed foreign currency options are subject to the same set of rules in other areas of the Code such as section 988(a)(1)(B).

We accept that the statute as originally enacted was intended to be applied only to forward contracts which required delivery of the foreign currency; however, the statute was expanded over the course of the years, and the current definition of foreign currency contract under section 1256(g)(2)(A) refers to contracts which require delivery of, or the settlement of which depends on the value of, a foreign currency which is a currency in which positions are also traded through regulated futures contracts. The legislative history does not indicate that the occurrence of settlement was required; rather, the legislative history focuses on the contract providing for a settlement determined by reference to the value of the foreign currency. As the Sixth Circuit noted,[21] the plain language of section 1256 provides that a "foreign currency contract" is a contract "the settlement of which depends" upon the value of a foreign currency and does not require that contract mandate that any such settlement occur:

> Further, contrary to the Commissioner's assertion, the inclusion in § 1256 of a rule that applies to the cash settlement of a contract does not make it "implicit" that a settlement of the contract must actually occur. Instead, § 1256 provides that if a settlement of a "foreign currency contract" does occur, any such settlement must depend on the value of a foreign currency.[22]

Section 1256(g)(2)(B) grants Treasury and the IRS the authority to prescribe regulations as may be necessary or appropriate to carry out the purposes of the foreign currency contract definition, including the authority to exclude any contract or type of contract from that definition if it would be inconsistent with those purposes. The legislative history indicates that Congress gave Treasury and the IRS the authority to treat other instruments (for example, options) as section 1256 contracts,[23] and we believe it would be sound public policy and consistent with the purpose of section 1256 for Treasury and the IRS to allow OTC foreign currency options to be treated as foreign currency contracts under section 1256.

We appreciate Treasury's and the IRS's concern regarding tax avoidance with respect to taxpayers entering into "major-minor" transactions using OTC foreign currency options with offsetting gains or losses in such options. However, we believe that this concern can be addressed as a matter of tax policy through introduction of an anti-avoidance rule, as opposed to excluding OTC foreign currency options from the definition of foreign currency contracts under section 1256. We believe that it would be appropriate for Treasury and the IRS to tackle the "major-minor" transactions through anti-avoidance tax provisions, rather than by excluding OTC foreign currency options from the scope of section 1256. We respectfully request that Treasury and the IRS reconsider the definition of foreign currency contract in the Proposed Regulations and, instead, propose an anti-avoidance rule to prevent taxpayers from claiming losses based upon "major-minor" transactions.

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[21] *Wright v. Commissioner,* 809 F.3d 877 (6th Cir. 2016).

[22] *Id.* at 883.

[23] H.R. Conf. Rep. No. 100–1104 (Vol. 2), at 189.

We appreciate the opportunity to provide our comments to Treasury and the IRS on the Proposed Regulations, and we would be pleased to meet with Treasury and the IRS to discuss our comments. If Treasury or the IRS has questions or comments, please do not hesitate to contact Joseph Schwartz, Director and Counsel, or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Jennifer W. Han

Jennifer W. Han
Executive Vice President
Chief Counsel & Head of Global Regulatory Affairs
Managed Funds Association