PART III: FUTURES

7580. What are securities futures contracts?

Under 2000 legislation, the definition of "equity option" (See Q 7554) was amended to include securities futures contracts (i.e., single stock futures and narrow-based stock index futures).[1] For purposes of the income tax rules, the term "securities futures contract" means a contract of sale for future delivery of a single security *or* a narrow-based security index.[2]

A securities futures contract will generally *not* be treated as a commodity futures contract for purposes of the Internal Revenue Code. (An exception exists for dealer securities futures contracts).[3] Thus, holders of these contracts generally are *not* subject to the mark-to-market rules of IRC Section 1256 (see Q 7586) and are not eligible for 60 percent long-term capital gain and 40 percent short-term capital gain treatment. Instead, gain or loss on these contracts will be recognized under the general rules relating to the disposition of property.[4] For the tax treatment of securities futures contracts generally, and the treatment of such contracts under the rules governing short sales, wash sales, and straddles, see Q 7581.

7581. How are securities futures contracts taxed?

Generally, gain or loss on securities futures contracts (see Q 7580) will be taxed under the rules relating to the disposition of the underlying property.[5] IRC Section 1234B provides that gain or loss from the sale, exchange, or termination of a securities futures contract (other than a dealer securities futures contract) will be treated as gain or loss from the sale, exchange, or termination of property of the same character as the property to which the contract relates has (or would have) in the hands of the taxpayer.[6] Thus, if the underlying security would be a capital asset in the taxpayer's hands, then gain or loss from the sale or exchange of the securities futures contract would be capital gain or loss.[7]

Holding period. If property is delivered in satisfaction of a securities futures contract to acquire property, the holding period for the property will include the period the taxpayer held the contract, provided that the contract was a capital asset in the hands of the taxpayer.[8]

Short sale treatment. In applying the short sale rules (See Q 7524 to Q 7533) a securities futures contract to *acquire* property will be treated in a manner similar to the property itself.[9] Thus, for example, the holding of a securities futures contract to acquire property and the short sale of property which is substantially identical to the property under the contract will result in the application of the rules under IRC Section 1233(b) (regarding short-term gains

1. See the Commodity Futures Modernization Act of 2000 and CRTRA 2000 Section 401, both incorporated by reference in the Consolidated Appropriations Act of 2001.
2. See IRC Sec. 1234B(c); Securities Exchange Act of 1934 Sec. 3(a)(55)(A).
3. H.R. Conf. Rep. No. 106-1033 (CRTRA 2000). See IRC Sec. 1234B(d).
4. H.R. Conf. Rep. No. 106-1033 (CRTRA 2000). See IRC Sec. 1256(b).
5. H.R. Conf. Rep. No. 106-1033 (CRTRA 2000).
6. IRC Sec. 1234B(a).
7. H.R. Conf. Rep. No. 106-1033 (CRTRA 2000).
8. See IRC Sec. 1223(16); H.R. Conf. Rep. No. 106-1033 (CRTRA 2000).
9. H.R. Conf. Rep. No. 106-1033 (CRTRA 2000). See IRC Sec. 1233(e)(2)(D).

and holding periods). (Because securities futures contracts are not treated as commodity futures contracts under IRC Section 1234B(d), the rule providing that commodity futures are not substantially identical if they call for delivery in different months does not apply). In addition, a securities futures contract to *sell* property is treated as a short sale, and the settlement of the contract is treated as the closing of the short sale.[1]

Except as otherwise provided in the straddle regulations under IRC Section 1092(b) – which treats certain losses from a straddle as long-term capital losses (See Q 7593) – or in IRC Section 1233 (gains and losses from short sales, special holding period rules), capital gain or loss from the sale, exchange, or termination of a securities futures contract to sell property (i.e., the short side of a futures contract) will be short-term capital gain or loss.[2]

Wash sale treatment. A 2002 Joint Committee report explained that "[t]he wash sale rules apply to any loss from the sale, exchange, or termination of a securities futures contract (other than a dealer securities futures contract) if, within a period beginning 30 days before the date of such sale, exchange, or termination and ending 30 days after such date: (1) stock that is substantially identical to the stock to which the contract relates is sold; (2) a short sale of substantially identical stock is entered into; or (3) another securities futures contract to sell substantially identical stock is entered into."[3]

Straddle treatment. Stock that is part of a straddle, at least one of the offsetting positions of which is a securities futures contract with respect to the stock or substantially identical stock, will be subject to the straddle rules (See Q 7587 to Q 7603).[4] The regulations under IRC Section 1092(b) applying the principles of IRC Sections 1233(b) and 1233(d) (regarding the determination of short-term and long-term losses) to positions in a straddle will also apply.[5] See Q 7593 for the treatment of a tax straddle. These rules are demonstrated in the following example from H.R. Conf. Rep. No. 106-1033 (CRTRA 2000):

> *Example*: Assume a taxpayer holds a long-term position in actively traded stock (which is a capital asset in the taxpayer's hands) and enters into a securities futures contract to sell substantially identical stock (at a time when the position in the stock has *not* appreciated in value so that the constructive sale rules of IRC Section 1259 do not apply). The taxpayer has a straddle. Any loss on closing the securities futures contract will be a long-term capital loss.

Constructive sale of an appreciated financial position. As indicated in the example, above, if a taxpayer holds a long-term position in actively traded stock (which is a capital asset in the taxpayer's hands) and enters into a securities futures contract to sell substantially identical stock at a time when the position in the stock has appreciated in value, the constructive sale rules apparently will apply (See Q 7606 to Q 7608).[6]

1. IRC Sec. 1233(e)(2)(E).
2. See IRC Sec. 1234B(b).
3. Joint Committee on Taxation, Technical Explanation of the Job Creation and Worker Assistance Act of 2002 (JCX-12-02); see IRC Sec. 1091(e).
4. H.R. Conf. Rep. No. 106-1033 (CRTRA 2000). See IRC Sec. 1092(d)(3)(B)(i)(II).
5. H.R. Conf. Rep. No. 106-1033 (CRTRA 2000).
6. See H.R. Conf. Rep. No. 106-1033 (CRTRA 2000), "Straddle Rules," p. 1035.

Mark-to-market treatment not applicable. Securities futures contracts (or options on such contracts) generally are *not* treated as IRC Section 1256 contracts. (An exception to the general rule exists for dealer securities futures contracts).[1] Thus, holders of these contracts are *not* subject to the mark-to-market rules of IRC Section 1256 (See Q 7586). Consequently, gains and losses from securities futures contracts are not eligible for 60 percent long-term capital gain and 40 percent short-term capital gain treatment.[2] Although a narrow-based security index is not subject to mark-to-market treatment, a broad-based security index remains subject to such tax treatment.[3]

7582. What is a futures contract?

Generally speaking, a futures contract is an executory contract (i.e., a contract which requires performance in the future) to purchase or sell a particular commodity for delivery in the future. A future may be either a "futures contract" or a "forward contract" See Q 7583 for a discussion of forward contracts.

Futures contracts are bought and sold (i.e., traded) on at least one of the various commodities or futures exchanges. All terms and provisions of a futures contract, except price and delivery month, are fixed by the bylaws and rules of the exchange. Price and delivery month are agreed to when the trade is made on the floor of the exchange. Although all futures contracts originate between a buyer and seller, the exchange's clearing organization, at the end of each business day, substitutes itself as the "other party" of each contract written that day. (That is, the clearing organization creates two new futures contracts by becoming the buyer to each seller and the seller to each buyer). Once written, futures contracts traded on a domestic exchange are subject to a "variations margin" under which they are marked to market daily (See Q 7585).

Until the date trading in futures contracts for a particular commodity and delivery month stops, an owner of a contract for that commodity and delivery month may close out the contract by making an offsetting purchase or sale (as the case may be) on the exchange of another futures contract. Once trading stops, the owners of "short" futures contracts (i.e., contracts to sell) are required to make delivery of the underlying commodity to the owners of the "long" futures contracts (i.e., contracts to buy) for that commodity and month on the basis of match-ups established by the clearing organization. Futures contracts traded on a domestic exchange are subject to regulation by the Commodity Futures Trading Commission (CFTC).

A taxpayer who enters into a futures contract to deliver property that is the same as or substantially identical to an appreciated financial position that he or she holds (see Q 7606) will generally be treated as having made a constructive sale of that position, unless certain requirements are met for closing out the futures contract[4] (See Q 7606 to Q 7608).

1. See IRC Sec. 1256(b)(1)(E), as amended by Wall Street Reform and Consumer Protection Act of 2010.
2. H.R. Conf. Rep. No. 106-1033 (CRTRA 2000).
3. See IRC Sec. 1256(g)(6); H.R. Conf. Rep. No. 106-1033 (CRTRA 2000).
4. IRC Sec. 1259(c)(1)(C).

A taxpayer who enters into a futures contract to acquire an equity interest in a pass-through entity may be subject to the "constructive ownership" rules under IRC Section 1260 (See Q 7591 to Q 7592).

Special rules apply to securities futures contracts (See Q 7573 and Q 7574).

7583. What is a forward contract? What is the difference between a futures contract and a forward contract?

Forward contracts (or "forwards"), in contrast to futures, exist only in the cash market, are not subject to CFTC regulation, are not standardized as to terms and provisions, and do not involve a variations margin. All terms and provisions of a "forward" are subject to negotiation between the buyer and seller.

A taxpayer who enters into a forward contract to deliver property that is the same as or substantially identical to an appreciated financial position that he or she holds (See Q 7606) will generally be treated as having made a constructive sale of that position.[1] But not all forward contracts will be subject to constructive sale treatment.[2] According to the Blue Book, a forward contract results in a constructive sale *only* if it provides for delivery, or for cash settlement, of a substantially fixed amount of property at a substantially fixed price. If the amount of property provided for by the forward contract is subject to significant variation under the terms of the contract, it will not constitute a forward contract.[3] Furthermore, an agreement that is not a "contract" under applicable contract law, or that is subject to "very substantial contingencies," was not intended to be treated as a forward contract.[4]

However, the Service distinguished a case in which, in addition to entering into a forward contract pledging to deliver property that was the same as or substantially identical to an appreciated financial position that he held, a taxpayer loaned and delivered the shares to the other party at the time of the contract. In that case, the IRS found a constructive sale.[5]

For those forwards that do result in a constructive sale under IRC Section 1259, unless certain requirements are met for closing out the forward contract, the constructive sale generally will result in immediate recognition of gain by the taxpayer as if the appreciated financial position were sold and repurchased on the date of the deemed sale[6] (See Q 7606 to Q 7608).

A taxpayer who enters into a forward contract to acquire an equity interest in a pass-through entity may be subject to the "constructive ownership" rules under IRC Section 1260 (See Q 7609 to Q 7610).

1. IRC Sec. 1259(c)(1)(C).
2. See General Explanation of Tax Legislation Enacted in 1997 (JCS-23-97), p. 176 (the 1997 Blue Book).
3. See Rev. Rul. 2003-7, 2003-1 CB 363.
4. 1997 Blue Book, p. 176.
5. TAM 200604033.
6. IRC Sec. 1259(a).

7584. What is a regulated futures contract?

For income tax purposes, a "regulated futures contract" is a "futures contract" (as described in Q 7582) that is traded on a domestic exchange *or* on a foreign exchange that employs a cash flow system similar to the "variations margin" system and is designated by the Secretary of the Treasury.[1] Besides calling for the delivery of many types of property (including agricultural commodities, T-bills, foreign currencies, and financial instruments), regulated futures contracts may cover things not generally thought of as property and call for settlement in cash rather than delivery (e.g., stock index or interest rate futures).

For income tax purposes, a regulated futures contract is one of several types of "IRC Section 1256 contracts" (See Q 7586).[2] Consequently, such a position is excluded from the definition of an *appreciated financial position* under IRC Section 1259(b)(2)(B) (See Q 7606). But depending on the taxpayer's other holdings, it appears that a constructive sale could result from entering into a regulated futures contract to deliver property that is the same as or substantially identical to an appreciated financial position held by the taxpayer (See Q 7606 to Q 7608).[3]

For an explanation of when a foreign currency contract will be considered a regulated futures contract or listed option and, thus, require mark-to-market treatment under IRC Section 1256, see FSA 200041006.

7585. What is a variations margin?

A *variations margin* is a daily cash flow system under which each owner of a "futures contract" (including a regulated futures contract) declining in value during a trading day must provide additional cash margin (i.e., cash payment to the owner's margin account) equal to the decline in value;. An owner of a contract which gained in value during the day is permitted to withdraw margin money from the account equal to the owner's "profit" for that day. Profit or loss (i.e., an increase or decline in value) for any trading day is measured by comparing the closing price of the "futures contract" on that day with the closing price on the previous day.

In other words, in a variations margin system each "futures contract" or regulated futures contract is "marked to the market" at the end of each trading day (See Q 7586).

7586. How are regulated futures contracts and other Section 1256 contracts taxed?

Regulated futures contracts are generally taxed under a mark-to-market tax rule that closely corresponds to the daily cash settlement system used for futures contracts on domestic exchanges (See Q 7585). Regulated futures contracts are one of the types of "IRC Section 1256 contracts" that are subject to those rules. Other types of instruments that are taxed in the same manner are foreign currency contracts and nonequity options (See Q 7576).[4] The term "IRC Section 1256 contract" generally does *not* include any "securities futures contract" or option on

1. IRC Sec. 1256(g).
2. IRC Sec. 1256(b).
3. IRC Sec. 1259(c)(1)(C).
4. IRC Sec. 1256(b).

such a contract (an exception exists for dealer securities futures contracts), and, as a result of changes made in the Wall Street Reform and Consumer Protection Act of 2010, it also 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.[1] For the definition of securities futures contract, see Q 7580.

Regulated futures contracts and IRC Section 1256 contracts, like other positions that are subject to the mark-to-market requirements, are excluded from the definition of an *appreciated financial position* under IRC Section 1259(b)(2)(B) (see Q 7606). However, depending on the taxpayer's other holdings, it appears that a constructive sale could result from the taxpayer's entering into a regulated futures contract (or another IRC Section 1256 contract) to deliver property that is the same as or substantially identical to an appreciated financial position held by the taxpayer[2] (see Q 7606 to Q 7608).

The owner of a regulated futures contract that is part of a tax straddle or a conversion transaction may be subject to different tax rules (see Q 7587 to Q 7605).[3]

Gains and losses on IRC Section 1256 contracts held for investment are capital gains and losses regardless of the nature of the underlying property.[4]

IRC Section 1256 contracts – other than those subject to the special rules for tax straddles (see Q 7598) – must be "marked to the market." Under the mark-to-market tax rules, gains and losses inherent in IRC Section 1256 contracts owned by an investor at the end of the year or at any time during the year must be reported annually, even if those gains or losses have not been realized by the investor. To accomplish this, any IRC Section 1256 contract that has not been terminated or transferred before the end of the tax year is treated as if it were sold for its fair market value on the last business day of that year.[5] Any gain or loss on such a "deemed" sale must be reported and gain taxed as discussed below. Any IRC Section 1256 contract terminated or transferred during the year is deemed to have been sold for its fair market value on the date it was terminated or transferred. (Termination or transfer may include offset, taking or making delivery, exercise, assignment, lapse, or any other transaction that terminates or transfers the taxpayer's rights or obligations under the contract.)[6] If the IRC Section 1256 contract was closed out during the year in an arm's-length transaction, its fair market value is considered to be the actual price paid or received in the closing transaction, and the amount of gain or loss required to be reported equals the amount actually realized. In all other cases, including where the IRC Section 1256 contract remains open at year-end, fair market value is ordinarily the settlement price on the exchange as of the appropriate date.[7]

1. IRC Sec. 1256(b), as amended by 2010 Act.
2. IRC Sec. 1259(c)(1)(C).
3. IRC Sec. 1256.
4. IRC Sec. 1234A(2); *Moody v. Comm.*, TC Memo 1985-20.
5. IRC Sec. 1256(a).
6. IRC Sec. 1256(c).
7. See General Explanation – ERTA, pp. 296-297.

Any gain or loss required to be reported by an investor on an IRC Section 1256 contract under the mark-to-market rules is treated as if 40 percent of the gain or loss is *short-term* capital gain or loss and 60 percent is *long-term* capital gain or loss.[1] The usual holding period rule for determining whether a gain or loss is short-term or long-term is ignored.[2] For the taxation of capital gains and losses, see Q 608.

IRC Section 1091 (relating to losses from wash sales of stock and securities) does not apply to any loss taken into account under the general rule governing losses for Section 1256 contracts.[3]

The mark-to-market tax rules do not apply to hedging transactions entered into as part of the taxpayer's trade or business.[4] According to the 1997 Blue Book,[5] it was the intent of Congress that the constructive sale provisions (see Q 7606 to Q 7608) would apply to such transactions.

An investor who has a "net IRC Section 1256 contracts loss" for a year may elect to carry such loss back three years and then, to the extent not depleted, carry it forward to succeeding years under the rules provided in IRC Section 1212(c). A United States District Court determined that IRC Section 1256 contract losses could be carried back to offset gains in a previous year even though the losses were attributable in part to contracts subject to a mixed straddle account election (see Q 7601).[6]

If an investor reports gain or loss on an IRC Section 1256 contract that was taxed to him or her in a prior year under the mark-to-market rules, that gain or loss is adjusted to reflect the gain or loss reported in that prior year (or years).[7]

1. IRC Sec. 1256(a)(3).
2. See IRC Sec. 1222.
3. IRC Sec. 1256(f).
4. IRC Sec. 1256(e).
5. General Explanation of Tax Legislation Enacted in 1997 (JCS-23-97).
6. *Roberts v. U.S.*, 734 F.Supp. 314 (D.C. Ill. 1990).
7. IRC Sec. 1256(a)(2).