Mo Money Mo Problems: Selected Tax Considerations for Traders in Foreign Currency Derivatives

By Vadim Novik*

Wolters Kluwer®

I. Introduction

The taxation[1] of a trader in derivatives that reference foreign currency (an "FX Trader") is an area of extraordinary complexity. FX Traders and their tax advisors in this context have to navigate numerous Code provisions, regulations, various complex overlap rules, and significant interpretive uncertainty. A good friend described this area as a "law school exam." This article attempts to help taxpayers and their advisors ace that exam by distilling the basic applicable tax provisions and overlapping rules and by presenting several "case studies" to provide a modicum of clarity in these muddy waters.

This Part I introduces the subject matter and defines the scope of the discussion. Part II lays out the background provisions of the Code and regulations that define the landscape for FX Traders. Part III discusses the various overlap rules among those provisions. Finally, Part IV walks through a number of examples (of increasing complexity) to put all the pieces together.

First, a few notes on scope. This article addresses FX Traders that are "United States persons" (as defined for U.S. tax purposes in Code Sec. 7701(a)(30))—*i.e.*, taxpayers that are engaged in the trade or business of "catch[ing] the swings in the daily market movements" from trades that are "frequent, regular and continuous"[2]—that invest in financial instruments linked to foreign currencies.

II. Background Tax Provisions

This Part II lays out the basic architecture of the various provisions of the Code and regulations that could apply to an FX Trader's transactions.

A. Code Sec. 988

1. Section 988 Transactions

Code Sec. 988 governs the tax treatment of "section 988 transactions"—*i.e.*, any of the transactions listed below if the amount the taxpayer is entitled to receive

VADIM NOVIK is a Partner at Fried, Frank, Harris, Shriver & Jacobson LLP in New York.

© 2025 V. NOVIK

(or is required to pay) is denominated in, or tied to the value of, nonfunctional currency ("FX")[3]:

- The acquisition of a debt instrument or becoming the obligor under a debt instrument[4];
- Acquiring or otherwise taking into account any item of expense, gross income or receipts to be paid or received after the date on which it is taken into account[5];
- Entering into or acquiring any forward contract, futures contract, option, or similar financial instrument (an "FX Derivative")[6]; or
- Disposing of FX.[7]

2. FX Derivatives

Let us take a deeper dive into FX Derivatives, the focus of this article. A forward contract, futures contract, option, or similar financial instrument is an FX Derivative, and thus a "section 988 transaction," only if the underlying property referenced by the FX Derivative is FX or another instrument that is a "section 988 transaction." The mere fact that a forward contract, futures contract, option, or similar financial instrument is denominated in FX (*e.g.*, a forward contract to purchase stock for Kuwaiti dinars) does not render it an FX Derivative.[8] A derivative that references an item of property other than FX or a "section 988 transaction" does not give rise to *any* exchange gain or loss for tax purposes, even though at least some of the economic gain or loss on such a contract will be attributable to changes in FX rates.

What is a "similar financial instrument"? The regulations provide that FX Derivatives generally include warrants and notional principal contracts, such as currency swaps, interest rate swaps, caps, floors, and collars.[9] Beyond that, taxpayers confronting the question of whether an instrument is an FX Derivative should consult with a tax advisor.

3. Character and Timing Rules

Generally, gain or loss attributable to a "section 988 transaction" is computed separately and treated as ordinary income or loss to the extent that such gains or losses are attributable to changes in exchange rates.[10] However, in the case of an FX Derivative, all gain or loss (not just gain or loss attributable to changes in exchange rates) is considered exchange gain or loss, and thus all gain or loss is ordinary (the "All Ordinary Rule").[11] Accordingly, losses on an FX Derivative attributable to a decline in the FX Trader's counterparty's credit would be ordinary under the All Ordinary Rule, even if the FX Derivative is a capital asset in the hands of the FX Trader.

Importantly, Code Sec. 988 provides for an election to treat any FX gain or loss attributable to an FX-linked forward contract, a futures contract, or option which is a capital asset in the hands of the taxpayer and not part of a straddle (as defined under Code Sec. 1092(c)) as capital gain or loss (the "Capital Asset Election").[12] Even though traders are engaged in a trade or business, they do not sell to customers. Thus, unless an exception applies (*e.g.*, for clearly identified hedging transactions), FX Traders' positions are generally capital assets and eligible for the Capital Asset Election.[13] Note that the Capital Asset Election is available only for FX-linked forwards, futures, and options; not for *any other* FX Derivative. The straddle rules are discussed below in Part II.D.

If the rules above are not sufficiently confusing, let us add one more to the pile (and presage one of the critical overlap rules addressed in more detail below). Under Code Sec. 988(c)(1)(D), a "section 988 transaction" does not include a regulated futures contract (an "RFC") or an exchange-traded currency option (a "QBE Option") that would be marked to market under Code Sec. 1256 if held on the last day of the tax year, unless the taxpayer makes an affirmative election under Reg. §1.988-1(a)(7)(ii) to apply Code Sec. 988 to such transactions (the "Ordinary Election"). The definitions and treatment of RFCs and QBE Options are discussed below in Part II.C.

B. Code Sec. 475

1. Taxpayers in Scope

We turn next to Code Sec. 475. Code Sec. 475 generally provides that a "dealer in securities"—*i.e.*, a taxpayer who, in the ordinary course of a trade or business, (i) regularly purchases securities from or sells securities to customers (which includes making loans or extending credit to its customers) or (ii) regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers—generally must mark all "securities" (as defined in Code Sec. 475(c)(2)) ("Section 475 Securities") to market and treat all resulting gains or losses as ordinary.[14] Certain taxpayers that meet this statutory definition nevertheless are not treated as dealers under the "negligible sales exception" (generally applicable to taxpayers that regularly purchase debt securities from customers in the ordinary course of a trade or business (including a customer lending business), but engage in no more than "negligible sales" of the securities acquired), unless such taxpayers elect into dealer status.[15]

Although this regime for securities dealers is *mandatory*, Code Secs. 475(e), (f)(1), and (f)(2) generally extend this regime—on an elective basis—to dealers in commodities,[16] traders in securities, and traders in commodities, respectively.

Wolters Kluwer

In the case of a securities trader who makes the Code Sec. 475(f)(1) election, any gain or loss on any Section 475 Security held in connection with such trade or business is recognized at the close of any taxable year as if such Section 475 Security were sold for its fair market value on the last business day of such taxable year.[17] Under proposed regulations, gain or loss with respect to a Section 475 Security that is marked to market under Code Sec. 475(f)(1) is ordinary.[18]

The taxation of a trader in derivatives that reference foreign currency (an "FX Trader") is an area of extraordinary complexity. FX Traders and their tax advisors in this context have to navigate numerous Code provisions, regulations, various complex overlap rules, and significant interpretive uncertainty.

In the case of a commodities trader that makes the Code Sec. 475(f)(2) election, the rules for traders in securities under Code Sec. 475(f)(1) apply to Section 475 Commodities (as defined below) held by the commodities trader in connection with its commodities trading business in the same manner that the rules apply to Section 475 Securities held by a trader in securities.[19] Note that separate elections are required if a taxpayer is engaged in both a Section 475 Securities trading business and a business of trading Section 475 Commodities (as defined below).

2. Section 475 Securities

As relevant to securities dealers and traders, Code Sec. 475(c)(2) defines Section 475 Security as any:

- Share of stock in a corporation[20];
- Partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust[21];
- Note, bond, debenture, or other evidence of indebtedness[22];
- Interest rate, currency, or equity notional principal contract[23];
- Evidence of an interest in, or a derivative financial instrument in, any security described in the preceding four categories, or any currency, including any option, forward contract, short position, and any similar financial instrument in such a security or currency[24]; and
- Position that is not itself a Section 475 Security but is a hedge with respect to a Section 475 Security described in the preceding five categories, which is clearly identified before the close of the day on which it was acquired or entered into.[25]

Is FX itself—and, for the avoidance of doubt, FX held outside of a deposit account—a Section 475 Security? The answer is not entirely clear. First, as noted above, Code Sec. 475(c)(2)(E) defines a Section 475 Security to include "evidence of an interest in ... any currency." This suggests that FX might be a Section 475 Security, because it is evidence of an interest in currency. Second, an example in the Code Sec. 475 regulations states that a taxpayer is a dealer when, in the ordinary course of its trade or business, it regularly holds itself out as being willing and able to enter into either side of positions in a FX with other banks in the interbank market.[26] Although the example does not specify whether these positions are physical FX (*e.g.*, Japanese yen), it may support the argument that FX is a Section 475 Security. Under the straddle rules, which are discussed below in Part II.D, actively traded physical FX is a "position" in the FX. Those rules define a "position" as an "interest (including a futures or forward contract or option) in personal property," which is similar to the language "evidence of an interest in" in Code Sec. 475(c)(2)(E).[27] Finally, nothing in the Code or the regulations appears to preclude treating physical FX as a Section 475 Security.

However, one article states:

> Based on informal discussions with the IRS National Office, we understand that the Service takes the position that holding physical foreign currency is not an evidence of an interest in the security under Code Sec. 475. We understand that the IRS view is that only foreign currency derivative transactions were meant to be securities under Code Sec. 475(c)(2)(E)."[28]

The resolution of this question may have little practical significance. If the foreign currency is deposited with a bank, rather than held in a safe or under a mattress, the deposit would constitute a debt instrument (essentially, a demand note), which would be a Section 475 Security under Code Sec. 475(c)(2)(C).

3. Section 475 Commodities

As relevant to commodities dealers and traders, Code Sec. 475(e)(2) provides an unhelpful and circular definition of "commodity"—*i.e.*, it is "any commodity that is actively

traded within the meaning of Code Sec. 1092(d)(1)" (a "Section 475 Commodity").[29] The straddle rules—which Code Sec. 475(e)(2)(A) cross-references—define "actively traded" as referring to property for which there is an "established financial market."[30] An "established financial market," in turn, generally includes a national securities exchange; an interdealer quotation system sponsored by a registered national securities association; a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission (the "CFTC"); a foreign securities exchange or board of trade that satisfies analogous regulatory requirements; an interbank market; or an interdealer market.[31]

The House version of Code Sec. 475(e)(2)(A) indicated that it would apply only to commodities of the kind customarily dealt in on an organized commodities exchange. The Conference Agreement, however, broadened Code Sec. 475(e)(2)(A) to apply to any commodity that is actively traded, within the meaning of Code Sec. 1092(d)(1).[32] This implies that an item can qualify as a Section 475 Commodity even if it is not the kind of item dealt in on an organized commodities exchange.

In analyzing the definition of a Section 475 Commodity, practitioners tend to look to Rev. Rul. 73-158.[33] The revenue ruling concluded that raw sugar was a "commodity" for purposes of Code Sec. 864(b)(2)(B)(iii), noting that "[t]he word 'commodities' is used in Code Sec. 864(b)(2)(B) of the Code in its ordinary financial sense and includes all products that are traded in and listed on commodity exchanges located in the United States." This passage indicates that "commodity" should be defined in its ordinary financial sense (if it is otherwise undefined). Moreover, practitioners believe this revenue ruling stands for the proposition that the Internal Revenue Service ("IRS") has deferred to the CFTC as to what constitutes a "commodity" for U.S. federal income tax purposes.[34]

Finally, although it may be reasonably clear from Code Sec. 475(e)(2) that the definition of a Section 475 Commodity is not limited to physical commodities (and may include intangibles, like derivatives), some practitioners draw additional comfort from the foreign-derived intangible income ("FDII") regulations. Reg. §1.250(b)-3(b)(10) notes that property for purposes of those rules includes a "commodity described in Code Sec. 475(e)(2)(A) that is not a physical commodity."

4. Improperly Identified Hedges

Code Sec. 475 contains a trap for the unwary that may be relevant to FX Traders. Under Code Sec. 475(d)(2)(B), if a taxpayer (i) holds a position that is not itself a Section 475 Security but is a hedge of a Section 475 Security and (ii) fails to identify the hedge under Code Sec. 475(c)(2)(F)(iii), from a timing perspective, the taxpayer is required to mark gains to market under Code Sec. 475 but generally is permitted to mark losses *only to the extent of prior marked gains*. The cognoscenti refer to this rule as the "higher of cost or market" ("HICOM") rule. For example, outside of the FX trading context, this could arise when a taxpayer holds a portfolio of single stocks and hedges with stock index futures.

C. Code Sec. 1256

Code Sec. 1256 has been described by a leading practitioner as a "non sequitur."[35] It reflects a series of compromises that often result in tax consequences that may be hard to explain from a rational policy perspective.

Code Sec. 1256 was enacted in 1981, as part of a slew of new rules intended to shut down straddle transactions involving futures contracts. Code Sec. 1256 contracts are generally marked to market at the end of the taxable year.[36] The resulting gain or loss is generally treated as 60% long-term and 40% short-term capital gain or loss.[37]

Code Sec. 1256(a) applies to any RFC, any foreign currency contract, any nonequity option, any dealer equity option, and any dealer securities futures contract.[38] Three of these categories—*i.e.*, RFCs, foreign currency contracts, and nonequity options—are relevant to FX Traders.

An RFC is a contract with respect to (i) which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market and (ii) which is traded on or subject to the rules of a qualified board or exchange (a "QBE").[39] Japanese yen futures traded on the Chicago Mercantile Exchange are an example of an RFC relevant to FX Traders.

A foreign currency contract is a contract (i) that 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 RFCs, (ii) that is traded in the interbank market, and (iii) which is entered into at arm's length at a price determined by reference to the price in the interbank market.[40] It is critical to note that a foreign currency contract is the *only* type of Code Sec. 1256 contract that is not required to be traded on, or subject to the rules of, a QBE. As a result, foreign currency contracts are generally over-the-counter ("OTC") contracts. The first requirement listed above (*i.e.*, that the underlying currency is also traded through RFCs) is important. A contract that otherwise satisfies the definition of a foreign currency contract will not be treated as such unless it references a currency traded through RFCs[41]—in the FX field, such currencies are referred to as "major" currencies (as opposed to "minor" currencies,

Wolters Kluwer

which are not traded through RFCs). The Euro is a "major" currency and contracts referencing the Euro can be foreign currency contracts; the Zimbabwe dollar is a "minor" currency; contracts referencing it cannot be foreign currency contracts. It is also worth pausing on the second requirement ("traded in the interbank market"), particularly since it is often overlooked. The legislative history to Code Sec. 1256 states that Congress intended to cover FX positions that were not traded through RFCs, but rather traded by banks through an informal market with terms similar to RFCs.[42] The legislative history also provides that Code Sec. 1256 does not apply to forward contracts entered into between two entities that are not participants in the interbank market (or futures commission merchants), such as two manufacturing corporations.[43] By contrast, if one of the parties to the contract is a bank or futures commission merchant, and the other two requirements listed above are satisfied, the contract should qualify as a Code Sec. 1256 contract. Along those lines, FSA 200025020 states that:

> The interbank market is not a formal market, but rather a group of banks holding themselves out to the general public as being willing to purchase, sell or otherwise enter into certain transactions. The Service broadly interprets the interbank market to include all banks and investment banks (as the terms are generally used in the marketplace).[44]

The tax treatment of OTC—that is, non-listed—options linked to FX has been something of a shambles, particularly since much of this history is mired in the IRS' attempts to battle FX straddle tax shelters.[45] The short story is that, historically, it has been uncertain whether FX-linked OTC options are "foreign currency contracts." For example, in the 2016 tax shelter case *Wright*,[46] the Sixth Circuit Court of Appeals held that OTC FX options are "foreign currency contracts" and thus subject to Code Sec. 1256. Many were surprised by this result, and it only compounded the uncertainty around the treatment of OTC FX options. However, on July 5, 2022, the IRS and Treasury released proposed regulations that clarify that *only a forward contract* on foreign currency is a "foreign currency contract" as defined in Code Sec. 1256(g)(2), based on the legislative history of Code Sec. 1256.[47]

A nonequity option is any "listed option"—*i.e.*, any option (other than a right to acquire stock from the issuer) which is traded on, or subject to the rules of, a QBE[48]—that is not an "equity option."[49] An "equity option" generally is any option to buy or sell stock or a "narrow-based security index."[50] Accordingly, an option referencing FX traded on or subject to the rules of a QBE will be a QBE Option (which is defined above for purposes of this article as an exchange-traded currency option subject to Code Sec. 1256).

D. The Straddle Rules[51]

The full cosmic horror of the straddle rules is beyond the scope of this humble article.[52] Very generally, among other things, the straddle rules can apply when a taxpayer realizes a loss while it has unrecognized gain with respect to an offsetting position.[53] Specifically, the straddle rules apply when a taxpayer holds multiple "positions"—*i.e.*, interests (including *via* a futures or forward contract or option) in—"actively traded personal property."[54] Positions are considered to be offsetting "if there is a substantial diminution of the taxpayer's risk of loss from holding any position ... by reason of his holding one or more other positions."[55] Special rules, not discussed herein, apply to straddles identified under Code Sec. 1092(a)(2)(B).[56]

Among other things, under the "Loss Deferral Rule," the straddle rules defer the recognition of any loss with respect to a straddle to the extent of the unrecognized gain in the offsetting position.[57] The deferred loss is carried forward and tested again for deductibility against the amount of unrecognized gain in the succeeding year; this process continues indefinitely.[58] To the extent that the amount of the unrecognized gain in a succeeding taxable year is less than the amount of the deferred loss, the taxpayer generally can deduct the deferred loss in that year.[59] Under the straddle rules, it appears that any loss recognized with respect to any position would be deferred to the extent of *any* unrecognized gain with respect to any "offsetting position."[60] For example, if an FX Trader owns 500 million Japanese yen and purchases a short RFC on 10 million yen, losses on the RFC could be deferred under the Loss Deferral Rule to the extent of *any gain* on *any* of the 500 million Japanese yen.

Under Code Sec. 263(g)(1), interest expense or other carrying costs must be capitalized to the extent they are incurred to purchase or carry any property that is part of a straddle (the "Capitalization Rule").[61]

Per Reg. §1.1092(b)-2T, the holding period of any straddle position generally is terminated and does not begin to accrue until the position is no longer a part of a straddle, unless the position had been held for the long-term capital gain holding period before it became part of the straddle (the "Holding Period Rule").[62] Moreover, under the Holding Period Rule, if the offsetting position *has* been held for the long-term capital gain holding period before it became part of the straddle, then any losses on the other position creating the straddle will be treated as long term.[63]

Wolters Kluwer®

Finally, under Reg. §1.1092(b)-1T(a), generally a taxpayer generally cannot deduct a loss from the sale of a stock or securities if, within the 61-day window that straddles the disposition date, the taxpayer has acquired, or has entered into a contract or option so to acquire, substantially identical stock or securities (the "Modified Wash Sale Rule").[64] The rule was intended to prevent taxpayers that have a straddle from disposing of the loss leg and replacing it thereafter to remain in a balanced position and protect the unrealized gain. This rule applies in lieu of Code Sec. 1091 to a loss from the disposition of a straddle position. The legislative history makes clear that this rule applies before the Loss Deferral Rule.[65] However, note that the Modified Wash Sale Rule applies only to "stock or securities." Reg. §1.1092(b)-5T(q) provides that term "security" for purposes of the Straddle Rules has the meaning provided in Code Sec. 1236(c), which defines "securities" as "any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing." FX Derivatives generally are not "stock." Moreover, FX Derivatives do not appear to be covered by any of the other items listed in the Code Sec. 1236(c) definition of "securities." Accordingly, some practitioners take the view that FX Derivatives are not "securities" for purposes of the Modified Wash Sale Rule. Rev. Rul. 74-218,[66] which predates Reg. §1.1092(b)-5T(q), reinforces this conclusion, because it ruled that foreign currencies are not "stock or securities" for purposes of Code Sec. 1091.

As a technical matter, it is clear that the straddle rules can potentially apply to losses recognized under Code Secs. 475 and 1256.[67] Special rules apply to "mixed straddles" consisting of Code Sec. 1256 contracts and non-Code Sec. 1256 contracts. Among other things, under the "Killer Rule," a loss from the disposition of one or more positions that are part of a "mixed straddle" (and which are not Code Sec. 1256 contracts) would be treated as 60% long-term capital loss and 40% short-term capital loss.[68] Because the Killer Rule leaves short-term gains on the non-Code Sec. 1256 position unaffected, the rule has "killer" consequences.

Critically, the straddle rules do not apply to properly identified hedges.[69]

III. Overlap Rules

This Part III discusses the various overlap rules that could apply among the tax provisions that govern an FX Trader's transactions.

A. Code Secs. 988 and 1256 Overlap

We have already mentioned one of the key Code Sec. 988/1256 overlap rules in Part II above—*i.e.*, RFCs and QBE Options generally are not treated as "section 988 transactions" unless the taxpayer makes the Ordinary Election.[70] If the taxpayer *makes* the Ordinary Election, such contracts are marked to market annually under Code Sec. 1256 and the character of any gains or losses is ordinary under Code Sec. 988. If the taxpayer *does not* make the Ordinary Election, such contracts are marked to market annually under Code Sec. 1256 and the character of any gains or losses is 60% long term and 40% short term.

What about foreign currency contracts? Both Code Secs. 988 and 1256 apply to an FX Derivative that is a foreign currency contract (*e.g.*, an OTC FX forward traded in the interbank market in a major currency). Such contracts are marked to market annually under Code Sec. 1256 and the character of any gains or losses is ordinary under Code Sec. 988.[71]

Note that if an FX Trader makes a Capital Asset Election with respect to its FX Derivatives, the character of the Code Sec. 1256 marks will be 60% long-term and 40% short-term capital gain or loss.[72]

B. Code Secs. 475 and 1256 Overlap

It appears that Code Sec. 1256 overrides Code Sec. 475 in the case of Section 475 Securities (other than contracts that are properly identified hedges of Section 475 Securities)—in other words, Code Sec. 1256 contracts can be treated as Section 475 Securities only if they are properly identified hedges of Section 475 Securities. As a technical tax matter, it seems reasonably clear that a Code Sec. 1256 contract cannot be a Section 475 Security in most cases. The flush language of Code Sec. 475(c)(2) provides that Code Sec. 475(c)(2)(E)—the portion of the definition of Section 475 Security that covers derivatives—does not apply to Code Sec. 1256 contracts. Because Code Sec. 1256 contracts are not described in Code Sec. 475(c)(2)(A)–(c)(2)(D), it seems that the only possibility for a Code Sec. 1256 contract to qualify as a Section 475 Security is as a Section 475(c)(2)(F) hedge of Section 475 Security.[73]

Not so for Section 475 Commodities. In the case of Section 475 Commodities that are also Code Sec. 1256 contracts, it is very likely that Code Sec. 475 overrides Code Sec. 1256. Code Sec. 475(d)(1) provides: "The rules of section[] ... 1256(a) shall not apply to securities to which [Code Sec. 475](a) applies." Code Sec. 475(a) applies to Section 475 Commodities in the hands of a trader, assuming the taxpayer made a Code Sec. 475(f)(2) election. Code Sec. 475(f)(1)(D) provides that the

Wolters Kluwer

"trumping" rule in Code Sec. 475(d)(1) applies to a securities trader. In turn, Code Sec. 475(f)(2) applies Code Sec. 475(f)(1)(D) to a commodities trader. Accordingly, it seems reasonably clear that, per Code Sec. 475(d)(1), Code Sec. 475 trumps Code Sec. 1256 in the case of instruments that satisfy both the definition of a Code Sec. 1256 contract and a Section 475 Commodity.[74]

IV. Case Studies

This Part IV puts all the pieces together and walks through numerous case studies that illustrate the application of the rules to various fact patterns. Note the significant amount of electivity available to the FX Trader, but keep an eye out for various traps!

Case Study 1: Assume an FX Trader that is a trader in securities enters into a forward contract with a bank to sell Japanese yen (a major currency). The contract is not a hedge,[75] and the trader has not made the Capital Asset Election.

- **Timing:** Because the contract is a foreign currency contract (*i.e.*, it is entered into with a bank and references a "major" currency), the contract is governed by Code Sec. 1256 and is subject to mark-to-market tax accounting. Note that it is irrelevant whether the FX Trader has elected into Code Sec. 475(f)(1), since Code Sec. 1256 contracts generally are not Section 475 Securities (*see* Part III.B).
- **Character:** Under Code Sec. 988, gain or loss resulting from the marks should be ordinary. Under the All Ordinary Rule, this is the case for all of the gain or loss, not just the gain or loss attributable to movements in exchange rates.

Case Study 2: Assume an FX Trader that is a trader in securities that *has* elected into Code Sec. 475(f)(1) enters into a forward contract to sell a "minor" currency. The contract is not a hedge.

- **Timing:** Since the contract references a "minor" currency, it cannot qualify as a foreign currency contract. The contract is, however, a Section 475 Security under Code Sec. 475(c)(2)(E)—*i.e.*, it is a "derivative financial instrument in ... currency." Thus, it is governed by Code Sec. 475 and is subject to mark-to-market tax accounting.
- **Character:** Under Code Sec. 475(d), all of the gain or loss resulting from the marks should be ordinary.[76]

Case Study 3: Assume an FX Trader that is a trader in securities purchases an RFC or QBE Option with respect to Japanese yen. The contract is not a hedge.

- **Timing:** Because the contract is an RFC or QBE Option, the contract is governed by Code Sec. 1256 and is subject to mark-to-market tax accounting. Note that it is irrelevant whether the FX Trader has elected into Code Sec. 475(f)(1), since Code Sec. 1256 contracts generally are not Section 475 Securities (*see* Part III.B).
- **Character:** Under Code Sec. 1256, gain or loss should be 60% long term and 40% short term, but the FX Trader can make the Ordinary Election to treat gain or loss from the marks as ordinary.

Case Study 4: Assume an FX Trader that is a trader in securities and commodities purchases an RFC or QBE Option with respect to Japanese yen. The contract is not a hedge. The FX Trader makes a Code Sec. 475(f)(2) commodities trader election.

- **Timing:** Some tax practitioners take the view that the RFCs and QBE Options should be treated as Section 475 Commodities, because, among other things, they are subject to the jurisdiction of the CFTC. As discussed above, because Code Sec. 475 trumps Code Sec. 1256 in the case of Section 475 Commodities, the contract would be governed by Code Sec. 475 and thus subject to mark-to-market accounting.
- **Character:** Under Code Sec. 475(d), all of the gain or loss resulting from the marks should be ordinary.

Case Study 5: Assume an FX Trader that is a trader in securities that has **not** elected into Code Sec. 475(f)(1) enters into forward contract with a bank to sell Japanese yen, but wants capital treatment. The trader makes the Capital Asset Election.[77]

- **Timing:** Because the contract is a foreign currency contract (*i.e.*, it is entered into with a bank and references a "major" currency), the contract is governed by Code Sec. 1256 and is subject to mark-to-market tax accounting. Note that it is irrelevant whether the FX Trader has elected into Code Sec. 475(f)(1), since Code Sec. 1256 contracts generally are not Section 475 Securities (*see* Part III.B).
- **Character:** The character is governed by Code Sec. 1256, since the FX Trader made the Capital Asset Election.[78] Under Code Sec. 1256, gain or loss should be 60% long term and 40% short term.

Wolters Kluwer®

Case Study 6: Assume a trader in securities that has **not** elected into Code Sec. 475(f)(1) enters into a forward contract with a counterparty that is neither a bank nor a futures commission merchant.

- **Timing:** As noted above, a foreign currency contract must be traded in the interbank market, and the legislative history provides that Code Sec. 1256 does *not* apply to forward contracts entered into between two entities that are not participants in the interbank market (or futures commissions merchants). Accordingly, the contract should *not* be a foreign currency contract, and should not be subject to Code Sec. 1256. The contract generally should be treated as an "open transaction" and the FX Trader will recognize gain or loss when it disposes of the contract.[79]
- **Character:** Under Code Sec. 988, gain or loss recognized will be ordinary. Under the All Ordinary Rule, this is the case for all of the gain or loss, not just the gain or loss attributable to movements in exchange rates.

Case Study 7: Assume an FX Trader that is trader in securities that has **not** elected into Code Sec. 475(f)(1) purchases an RFC or QBE Option with respect to Japanese yen. The contract hedges an offsetting position and substantially diminishes the risk of loss of the other position.

- **Timing:** Because the contract is an RFC or QBE Option, the contract is governed by Code Sec. 1256 and is subject to mark-to-market tax accounting.
  - However, because the FX Trader also holds an offsetting position that diminishes the risk of loss of the RFC or QBE Option, the straddle rules may affect the timing of gain or loss recognition, unless the FX Trader properly identifies the hedging transaction (as discussed below). The Loss Deferral Rule may apply and could affect the timing and character of gains and losses. Among other things, under the Loss Deferral Rule, negative marks on the RFC or QBE Option (*i.e.*, losses) would be deferred to the extent of unrecognized gains on the offsetting position, assuming the taxpayer has not done anything to mitigate the application of the straddle rules.
  - Moreover, if the other position is not eligible for mark-to-market tax accounting, the FX Trader will face timing mismatches between the RFC or QBE option and the other position.
- **Character:** Under Code Sec. 1256, gain or loss *ordinarily* would be 60% long term and 40% short term.
  - However, because the FX Trader also holds an offsetting position that diminishes the risk of loss of the RFC or QBE Option, the "mixed straddle" rules—specifically, the Killer Rule, may apply. This will be the case unless the offsetting position is also a Code Sec. 1256 contract, because the straddle rules do not apply to straddles that consist entirely of Code Sec. 1256 contracts.[80] If the FX Trader wants to avoid the application of the Killer Rule, it may be well advised to properly identify the Japanese yen forward as a hedge of the other position.[81] However, a taxpayer generally can only identify a position as a hedge when it hedges "ordinary property."[82] Because this taxpayer has not elected into Code Sec. 475(f)(1), it is likely that the other position is a capital asset (unless it is governed by Code Sec. 988).[83] The other transaction may be an "offsetting position" that is a non-section 988 transaction if it is, for example, a security denominated in FX. If the Japanese yen forward hedges a liability, however, the taxpayer may be able to make the identification.[84]
  - If the Killer Rule applies, the Holding Period Rule will *not* apply.[85]
  - Putting aside the Killer Rule, the FX Trader should consider whether character mismatches could arise between the RFC or QBE Option and the other position.

Case Study 8: Assume an FX Trader that is a trader in securities that has **not** elected into Code Sec. 475(f)(1). The FX Trader enters into a forward contract with a bank to sell Japanese yen, but wants capital treatment. The contract hedges an offsetting position and substantially diminishes the risk of loss of the other position.

- **Timing:** Because the contract is a foreign currency contract (*i.e.*, it is entered into with a bank and references a "major" currency), the contract is governed by Code Sec. 1256 and is subject to mark-to-market tax accounting.
  - However, because the FX Trader also holds an offsetting position that diminishes the risk of loss of the foreign currency contract, the straddle rules may affect the timing of gain or loss recognition. The Loss Deferral Rule may apply and could affect the timing of gains and losses. Among other things, under the Loss Deferral Rule, negative marks on the foreign currency contract (*i.e.*, losses) would be deferred to the extent of

Wolters Kluwer®

unrecognized gains on the offsetting position, assuming the taxpayer has not done anything to mitigate the application of the straddle rules.

- **Character:** Under Code Sec. 988, gain or loss resulting from the marks would be ordinary, but for the application of the Straddle Rules. Note that the Capital Asset Election is not available for positions that are part of a straddle.[86]
  - The character issues here "border on the mystical."[87] Does the Killer Rule apply to the position hedged by the foreign currency contract (assuming it is not a Code Sec. 1256 contract)?[88] The foreign currency contract technically *is* a Code Sec. 1256 contract. Reg. §1.1092(b)-5T defines a "mixed straddle" for purposes of Reg. §§1.1092(b)-1T–1.1092(b)-4T as any straddle (i) "*all of the positions of which are held as capital assets*"; (ii) at least one (but not all) of the positions of which is a Code Sec. 1256 contract; (iii) for which an election under Code Sec. 1256(d) has not been made; and (iv) that is not part of a larger straddle. Code Sec. 1221(a)(1) defines a "capital asset" as" *any* property held by the taxpayer (whether or not connected with his trade or business)," unless an exception applies (*e.g.*, inventory, depreciable trade or business property, hedges, *etc.*). None of the exceptions in Code Sec. 1221(a)(2)–(7) appear applicable here. Moreover, recall that a trader's positions generally are still capital assets, even though the trader is engaged in a trade or business.[89] Finally, note that the previous case studies have discussed an FX Trader making the Capital Asset Election for certain FX Derivatives; by definition, that election is available only for capital assets.
  - From a policy perspective, this seems an odd result. The foreign currency contract does not give rise to the character conversion opportunity that the Killer Rule is meant to prevent. Can the FX Trader argue that because it does not have the ability to generate capital gain or loss (and *a fortiori* does have the ability to generate Code Sec. 1256 60/40 gain or loss), the foreign currency contract should not be treated as a "capital asset" and the Killer Rule should not apply? The answer, unfortunately, is not entirely clear. The FX Trader should consider whether it can mitigate the application of the Killer Rule (*e.g.*, by identifying the foreign currency contract as a hedge).
  - If the FX Trader had made a Code Sec. 475(f)(2) commodities trader election with respect to its FX trading activities, this issue would not arise. A Code Sec. 475(f)(1) election would not be helpful since Code Sec. 1256 contracts are excluded from the definition of Section 475 Security unless they are identified hedges of such securities.[90]
  - Another interesting wrinkle is the Code Sec. 1256(d) election, which excludes from Code Sec. 1256 all Code Sec. 1256 contracts held as part of a mixed straddle.[91] If the FX Trader makes the Code Sec. 1256(d) election *and* a Code Sec. 475(f)(1) election, arguably the foreign currency contract would be subject to Code Sec. 475 for both timing and character purposes. Recall that Code Sec. 475 excludes Code Sec. 1256 contracts, other than identified hedges of Section 475 securities. If the foreign currency contract is no longer a Code Sec. 1256 contract as a result of the Code Sec. 1256(d) election, it could potentially qualify as a Section 475 Security under Code Sec. 475(c)(2)(E).
  - Even if the Killer Rule does not apply, the Holding Period Rule could affect the character of gains and losses.

Case Study 9: Assume an FX Trader that is a trader in commodities has elected into Code Sec. 475(f)(2) and entered into an RFC with respect to Japanese yen. The contract is not a hedge.

- **Timing:** The first question is whether the RFC is a Section 475 Commodity. As noted above, Code Sec. 475 trumps Code Sec. 1256 in the case of Section 475 Commodities.[92] Because the RFC is a futures contract and subject to the jurisdiction of the CFTC, most practitioners in this space likely would conclude that the contract *is* a Section 475 Commodity and that Code Sec. 1256 should not apply, but this is not entirely clear.[93] If this is the case, timing would be governed by Code Sec. 475 and is subject to mark-to-market tax accounting. Otherwise, timing would still be mark-to-market but under the rules of Code Sec. 1256. As a result, the timing of gains and losses should not be affected by the resolution of the question of whether the RFC is a Section 475 Commodity.
- **Character:** When it comes to character, however, it is quite relevant whether the RFC is a Section 475 Commodity. If the RFC is a Section 475 Commodity, marks would be ordinary under Code Sec. 475. Otherwise, under Code Sec. 1256, gain or loss should be 60% long term and 40% short term, but the FX Trader can make the Ordinary Election to treat gain or loss from the marks as ordinary.

Wolters Kluwer

Case Study 10: Assume an FX Trader that is a trader in securities that *has* elected into Code Sec. 475(f)(1) enters into a forward contract with a bank to sell Japanese yen. The contract *is* a hedge of a Section 475 Security, but the trader does not make a timely Code Sec. 475(c)(2)(F) identification. To keep things (relatively) simple, assume that the contract does not "substantially" diminish the risk of the loss of the Section 475 Security that it is hedging, and thus the straddle rules do not apply. To qualify as a hedge, a position merely must "manage risk," so it is possible for a position to constitute a hedge but not rise to the level of a straddle.[94] This could be the case, for example, if the Japanese yen forward hedges an equity security.

- **Timing:** Although the straddle rules do not apply, the FX Trader still has timing troubles. If the contract were *not* a hedge of a Section 475 Security, the timing would be governed by Code Sec. 1256 and subject to mark-to-market accounting. However, under Code Sec. 475(d)(2)(B), because the taxpayer has "improperly" failed to identify a nonsecurity that hedges a security, the timing is governed by the HICOM rule. However, the ABA has argued in a letter to the IRS and Treasury that it is possible that Reg. §1.446-4 may apply regular hedge timing principles (*i.e.*, mark to market) instead of "HICOM" if the relevant position is a Code Sec. 1221 hedge.[95] In similar contexts, one might argue that the contract should be subject to mark-to-market under Code Sec. 1256 and thus the HICOM rule should not apply, but query whether that argument is available here, since Code Sec. 475(d) provides that Code Sec. 1256 does not apply to Section 475 Securities to which Code Sec. 475(a) applies (and Code Secs. 475(f)(1)(D) and (f)(2) extend this rule to electing FX Traders).[96]
- **Character:** Under Code Sec. 988, gain or loss recognized will be ordinary. Under the All Ordinary Rule, this is the case for all of the gain or loss, not just the gain or loss attributable to movements in exchange rates.

V. Conclusion

As this article has hopefully demonstrated, FX Traders have to consider a plethora of complex overlapping rules in navigating their transactions in FX Derivatives. Although these rules in many cases provide significant optionality through the availability of elections and identification regimes, they are also rife with traps. A knowledgeable tax advisor can be an essential resource in helping navigate this exciting and treacherous landscape.

Wolters Kluwer®

ENDNOTES

* Vadim Novik thanks Joseph E. Fox, Joseph Pahl, Nate Tasso, Matthew A. Stevens, and Joshua Tompkins for their insightful comments. He assumes sole responsibility for any errors, oversights, and bad jokes.

1 All references in this article to "tax" or "taxation" are intended to refer solely to U.S. federal income taxation.

2 *See, e.g.*, *F. Chen*, 87 TCM 1388, Dec. 55,653(M), TC Memo. 2004-132; *C.H. Liang*, 23 TC 1040, 1043, Dec. 20,917 (1955); *L.B. Arberg*, 94 TCM 215, Dec. 57,066(M), TC Memo. 2007-244 ("Traders, like dealers, are engaged in the trade or business of selling securities, but they do so for their own account."). The *Arberg* case, sadly, bears no relation to the author's favorite Scotch whiskey, Ardbeg.

3 Code Sec. 988(c)(1)(A).

4 Code Sec. 988(c)(1)(B)(i).

5 Code Sec. 988(c)(1)(B)(ii).

6 Code Sec. 988(c)(1)(B)(iii). Special rules, not discussed herein, address certain tax consequences of currency swaps and other notional principal contracts that constitute "section 988 transactions." For a thorough and clear discussion of these rules, *see* G. Garner Prillaman, *Tax Aspects of Foreign Currency*, 6660-1st Tax Mgmt. Port. (BNA), at II.B.6.e(3) (2024).

7 Code Sec. 988(c)(1)(C).

8 *See* Reg. §1.988-1(a)(2)(iii)(A), which provides:

> [I]f the underlying property of an instrument is another financial instrument (*e.g.*, an option on a futures contract), then the underlying property to which such other instrument (*e.g.*, the futures contract) ultimately relates must be a nonfunctional currency. For example, a forward contract to purchase wheat denominated in a nonfunctional currency, an option to enter into a forward contract to purchase wheat denominated in a nonfunctional currency, or a warrant to purchase stock denominated in a nonfunctional currency is not [a section 988 transaction]. On the other hand, a forward contract to purchase a nonfunctional currency, an option to enter into a forward contract to purchase a nonfunctional currency, an option to purchase a bond denominated in or the payments of which are determined by reference to the value of a nonfunctional currency, or a warrant to purchase nonfunctional currency is [a section 988 transaction].

9 Reg. §1.988-1(a)(2)(iii)(B); Reg. §1.988-1(a)(2)(iii).

10 Code Sec. 988(a)(1)(A); Reg. §1.988-3.

11 Code Sec. 988(b)(3).

12 *See* Code Sec. 988(a)(1)(B); Reg. §1.988-3(b).

13 *See Arberg*, *supra* note 2 ("Traders, like dealers, are engaged in the trade or business of selling securities, but they do so for their own account. *Hence, their securities are not excluded from the definition of a capital asset due to the absence of customers, and sales thereof produce capital gains and losses under generally applicable principles.*") (citing *M. King*, 89 TC 445, 457-459, Dec. 44,174 (1987); *F. Chen*, 87 TCM 1388, Dec. 55,653(M), TC Memo. 2004-132; *N. Boatner*, 74 TCM 342, Dec. 52,211(M), TC Memo. 1997-379)) (emphasis added).

14 *See* Code Sec. 475(c)(1) (definition of "dealer in securities"); Code Sec. 475(a) (timing rules); Code Sec. 475(d) (character rules).

15 *See* Reg. §1.475(c)-1(c).

16 Code Sec. 475(e)(1). In the case of a commodities dealer that makes an election, the rules under Code Sec. 475 apply to Section 475 Commodities held by a dealer in commodities in the same manner that Code Sec. 475 applies to Section 475 Securities held by a dealer in securities. *See* Code Sec. 475(e)(1).

17 Code Sec. 475(f)(1).

18 Proposed Reg. §1.475(f)-2(b).

19 Code Sec. 475(f)(2).

20 Code Sec. 475(c)(2)(A).

21 Code Sec. 475(c)(2)(B).

22 Code Sec. 475(c)(2)(C).

23 Code Sec. 475(c)(2)(D).

24 Code Sec. 475(c)(2)(E).

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

[26] Reg. §1.475(c)-1(a)(2)(ii), Example 2.

[27] Code Sec. 1092(d)(2).

[28] Alan Munro & Jo Lynn Ricks, *Hot Issues in Section 475*, *in* Tax' Fin. Prods. Trans. 2014 (PLI) (Oct. 22, 2013).

[29] Note that, in other contexts, courts have interpreted a self-referential definition as an indication that items within the common meaning of the word are included. *See MoneyGram Int'l Inc.*, 153 TC 185, 153 TC No. 9, Dec. 61,580 (2019) (citing *Fathauer*, CA-FC, 566 F3d 1352, 1355 (2009)).

[30] Reg. §1.1092(d)-1(a).

[31] *See* Reg. §1.1092(d)-1(b)(1).

[32] *See* H.R. Rep. No. 105-220, at 516 (1997) (Conf. Rep.).

[33] 1973-1 CB 337.

[34] *See* N.Y.S. Bar Ass'n Tax Sec., Report on the Taxation of Cryptocurrency, Rep. No. 1433 (Jan 26, 2020) (citing Rev. Rul. 73-158, 1973-1 CB 337). The CEA defines "commodity" relatively broadly to include certain enumerated agricultural commodities, "all other goods and articles," and "all other services, rights, and interests ... in which contracts for future delivery are presently or in the future dealt in." 7 USC § 1a(9) (2006).

[35] *See* Michael S. Farber, *Capital Ideas: The History of the Treatment of Derivative Gains and Losses*, 26 Tax Notes 1493, 1494 (Mar. 22, 2010).

[36] Code Sec. 1256(a)(1).

[37] Code Sec. 1256(a)(3).

[38] Code Sec. 1256(b)(1).

[39] Code Sec. 1256(g)(1). A QBE is national securities exchange registered with the SEC, a domestic board of trade designated as a contract market by the CFTC, or any other exchange, board of trade, or other market that the Treasury Secretary determines has rules adequate to carry out the purposes of Code Sec. 1256. *See* Code Sec. 1256(g)(7). The IRS regularly publishes guidance identifying certain boards and exchanges as QBEs. *See, e.g.*, Rev. Rul. 2024-22, 2024-43 IRB 980 (ruling that Bourse de Montréal is a QBE). For a fascinating discussion of the issues that can arise when the IRS designates a certain board or exchange a QBE, *see* Angeliki Vlacho, *Did the Tax Treatment of Your Futures Contracts Just Change?* 21 J. Tax'n Fin. Prods. 31 (Mar. 3, 2025).

[40] *See* Code Sec. 1256(g)(2).

[41] The currencies so traded include the following: Australian dollar; Brazilian real; British pound; Canadian dollar; Chinese renminbi; Czech koruna; Euro; Hungarian forint; Israeli shekel; Indian rupee; Japanese yen; Korean won; Mexico peso; New Zealand dollar; Norwegian krone; Polish zloty; Russian ruble; South African rand; Swedish krona; Swiss franc; and Turkish lira. It is not always clear whether a currency will qualify, as trading volumes in the relevant futures contract can wax and wane (sometime almost to zero) over time.

[42] *See* H.R. Rep. No. 97-794 (1982).

[43] *See id.*

[44] FSA 200025020 (Jun. 23, 2000).

[45] For an excellent history of these issues, *see* Viva Hammer, *Section 1256 and Foreign Currency Derivatives: 30 Years of Uncertainty*, *in* Practicing Law Institute, Taxation of Financial Products and Transactions (2013).

[46] CA-6, CA-6, 2016-1 USTC ¶50,137, 809 F3d 877, *rev'g* 102 TCM 597, Dec. 58,838(M), TC Memo 2011-292.

[47] *Definition of Foreign Currency Contract Under Section 1256*, REG-130675-17 (July 6, 2022). The IRS and Treasury stated that whether a derivative contract is properly characterized as a forward contract for U.S. federal income tax purposes is determined under current law. *Id.*

[48] *See* 1256(g)(5).

[49] *See* Code Sec. 1256(g)(3).

[50] *See* Code Sec. 1256(g)(6).

[51] For a supremely excellent overview of the straddle rules, *see* Matthew A. Stevens, *Taxation of Non-Equity Derivatives*, 187-1st Tax Mgmt. Port. (BNA), at VII (2021).

[52] "The most merciful thing in the world, I think, is the inability of the human mind to correlate all its contents. We live on a placid island of ignorance in the midst of black seas of infinity, and it was not meant that we should voyage far." Howard P. Lovecraft, The Call of Cthulhu and Other Weird Stories 139 (Penguin Books 2016).

[53] *See* Code Secs. 1092 and 263(g).

[54] *See* Code Sec. 1092(d).

[55] *See* Code Sec. 1092(c)(2)(A).

[56] Very generally, under this regime, the Loss Deferral Rule does not apply, but the taxpayer must adjust the tax basis on the gain position to reflect the losses that would otherwise be deferred under the Loss Deferral Rule. *See* Code Sec. 1092(a)(2)(A)(ii). Importantly, under this regime, other positions outside of the identified straddle generally are not treated as part of the straddle. *See* Code Sec. 1092(c)(2)(C). A full discussion out of the identified straddle regime is outside of the scope of this article. For more information, *see* Matthew A. Stevens & Huvie Weinreich, *Planning Opportunities and Pitfalls Under the Identified Straddle Rules*, 81 Tax Notes Fed. 601 (Oct. 23, 2023); Stevens, *supra* note 45.

[57] *See* Code Sec. 1092(a)(1)(A).

[58] *See* Code Sec. 1092(a)(1)(B).

[59] *See id.*

[60] *See* Code Sec. 1092(a)(1)(A); Reg. §1.1092(b)-1T(a)(2).

[61] *See also* Proposed Reg. §§1.263(g)-1, 1.263(g)-2, 1.263(g)-3, and 1.263(g)-4.

[62] *See* Reg. §1.1092(b)-2T(a).

[63] *See* Reg. §1.1092(b)-2T(b).

[64] Critically, this rule applies even if there is no unrecognized gain with respect to the offsetting position.

[65] Staff of the Joint Comm. on Taxation, 97th Cong., 1st Sess., General Explanation of Economic Recovery Tax Act of 1981, at 286–87 (Joint Comm. Print 1981).

[66] 1974-1 CB 202. *See also D.E. Gantner*, 91 TC 713, Dec. 45,108 (1988) (holding that options were not "stock or securities" for purposes of Code Sec. 1091 prior to 1988 amendments to Code Sec. 1091 that explicitly provide that "contracts or options to acquire or sell stock or securities" are "stock or securities").

[67] *See* Code Secs. 475(d)(1) and 1092(d)(5).

[68] Reg. §1.1092(b)-2T(b)(2).

[69] *See* Code Sec. 1092(e).

[70] Code Sec. 988(c)(1)(E) provides special rules that allow a "qualified fund" to elect out of Code Sec. 988 with respect to with respect to FX forward contracts that would be marked to market under Code Sec. 1256 if held on the last day of the taxable year, RFCs, and QBE Options. *See also* Reg. §1.988-1(a)(8). Very generally, this election is available for widely-held partnerships that trade in commodities. More specifically, a "qualified fund" is any partnership, if at all times during the tax year (and during each preceding tax year to which an election under the section applied): (i) the partnership has at least 20 partners and no single partner owns more than 20% of the interests in the capital or profits of the partnership; (ii) the partnership's principal activity consists of buying and selling options, futures, or forwards with respect to commodities; (iii) at least 90% of the partnership's gross income consists of income or gains described in Code Secs. 7704(d)(1)(A), 7704(d)(1)(B), or 7704(d)(1)(G) or gains from the disposition of capital assets held for the production of interest or dividends; (iv) no more than a *de minimis* amount of the partnership's gross income was derived from buying and selling commodities themselves; and (v) the "qualified fund" election has been made. *See* Code Sec. 988(c)(1)(E)(iii).

[71] *See* Reg. §1.988-3(a) (providing that "exchange gain or loss realized with respect to a section 988 transaction (*including a Code Sec. 1256 contract that is also a Code Sec. 988 transaction*) shall be characterized as ordinary gain or loss") (emphasis added).

[72] *See* Reg. §1.988-3(b) (flush language) ("If a valid election under [Reg. §1.988-3(b)] is made with respect to a Code Sec. 1256 contract, Code Sec. 1256 shall govern the character of any gain or loss recognized on such contract.").

[73] For a magnificent overview of this issue, *see* Matthew A. Stevens, *Is Your Security on the Mark-to-Market Bus?*, Tax Notes Fed. 71, 73–75 (Jul. 6, 2020).

[74] Numerous commentators endorse this view. *See* Andrea S. Kramer, Financial Products: Taxation, Regulation and Design § 38.03[A] ("Unlike the definition of a 'security' that excludes Code Sec. 1256 contracts, the term 'commodity' includes contracts that would otherwise be treated as Code Sec. 1256 contracts. ... As a consequence, any Code Sec. 1256 contract that otherwise meets the definition of a commodity will be subject to Code Sec. 475, rather than the rules of Code Sec. 1256(a)."); Peter J. Connors, *The Mark-to-Market Rules of Section 475*, 543-2nd Tax Mgmt. Port. (BNA), at XII.A (2025) ("Because there is no statutory or regulatory carve-out from the definition of commodity in the case of a contract to which Code Sec. 1256(a) applies, any Code Sec. 1256 contract (for example, a regulated futures contract) that is a derivative financial instrument with respect to a commodity in

the hands of an electing commodities dealer may be accorded ordinary treatment — and not 40% short-term/60% long-term capital gain treatment."); *id.*, at XII.A n. 447 ("As a result of the extension of [Section 475(d)(1)] to commodities by Code Sec. 475(e)(1), the MTM rules of Code Sec. 1256(a) and the character rules of Code Sec. 1256(a) do not apply to commodities that are subject to the Code Sec. 475 MTM rules."). *See also* AM. BAR ASS'N SECTION OF TAX'N, COMMENTS ON MARK-TO-MARKET RULES UNDER SECTION 475, at 17 (2015) ("We note that Code Sec. 475(e)(2), unlike Code Sec. 475(c)(2), does not appear to have an exception for derivatives that are Code Sec. 1256 contracts. Therefore, if foreign currency is a commodity, foreign currency derivatives [that are regulated futures] could qualify as commodities under Code Sec. 475(e)(2)(C).").

[75] For simplicity, assume that the FX Trader wants short exposure to Japanese yen.

[76] Even without the application of Code Sec. 475(d), gain or loss would be ordinary under Code Sec. 988.

[77] In practice, in some cases, it may be inadvisable for an FX Trader to make the Capital Asset Election because of the consequences that could occur if the trader ends up with a straddle.

[78] *See* Reg. §1.988-3(b) (flush language) ("If a valid election under [Reg. §1.988-3(b)] is made with respect to a Code Sec. 1256 contract, Code Sec. 1256 shall govern the character of any gain or loss recognized on such contract.").

[79] *See* Reg. §1.988-2(a)(1)(i) (providing that generally, the recognition of exchange gain or loss upon the sale or other disposition of a forward contract, futures contract, option contract, or similar financial instrument is governed by the recognition provisions of the Internal Revenue Code which apply to the sale or disposition of property). *See generally Lucas v. N. Tex. Lumber Co.*, SCt, 2 USTC ¶484, 281 US 11, 50 SCt 184 (1930) (providing that a contract to sell property does not give rise to income until property actually is transferred).

[80] *See* Code Sec. 1256(a)(4).

[81] *See* Code Secs. 1092(e), 1256(e), and 1221(b)(2)(A). The FX Trader may have other options to avoid the Killer Rule. It could potentially (i) identify the straddle under Code Sec. 1092(a)(2), (ii) make a straddle-by-straddle identification under Temporary Reg. §1.1092(b)-3T, or (iii) establish a mixed straddle account under Temporary Reg. §1.1092(b)-4T. Since none of those other options completely alleviate the application of the straddle rules, a proper hedging identification is usually the best bet in practice (if available). Note that the FX Trader can also elect out of Code Sec. 1256 under Code Sec. 1256(d), which would turn off the Killer Rule, but the other adverse tax consequences of the straddle rules (*e.g.*, the Loss Deferral Rule) would continue to apply.

[82] *See* Code Sec. 1221(b)(2)(A)(i); Reg. §1.1221-2(b)(1); Reg. §1.1221-2(c)(2) (definition of ordinary property).

[83] *See supra* note 13 and accompanying text.

[84] *See* Code Sec. 1221(b)(2)(A)(ii); Reg. §1.1221-2(b)(2).

[85] The Holding Period Rule applies "except as otherwise provided in [Reg. §1.1092(b)-2T(b)]." Since the Killer Rule is a special rule in Reg. §1.1092(b)-2T(b)(2), it trumps the application of the Holding Period Rule.

[86] *See* Code Sec. 988(a)(1)(B); Reg. §1.988-3(b).

[87] David Mattingly, *Blocker Alchemy*, TAX NOTES FED. 1585, 1592 (Aug. 31, 2020).

[88] *See supra* note 80 and accompanying text.

[89] *See supra* note 13 and accompanying text.

[90] *See supra* note 73 and accompanying text.

[91] *See supra* note 81.

[92] *See supra* note 67 and accompanying text.

[93] *See* AM. BAR ASS'N SECTION OF TAX'N, *supra* note 74, at 16 ("The mere fact that a contract is traded on a commodities exchange should not make a contract with respect to securities a commodity.").

[94] *See* Code Sec. 475(c)(3) (defining a "hedge" for purposes of Code Sec. 475 as "any position which manages the dealer's risk of interest rate or price changes or currency fluctuations, including any position which is reasonably expected to become a hedge within 60 days after the acquisition of the position").

[95] *See* AM. BAR ASS'N SECTION OF TAX'N, *supra* note 74, at 19 ("The argument for 'pure' hedge timing is that section 475(d)(2)(B) timing is not an application of Code Sec. 475(a), so the exclusion from the regular hedge timing rules of Reg. §1.446-4 does not apply. In that case and under the facts (the hedge is of a security that is itself being marked), the hedge timing rule would be mark-to-market timing, removing the Code Sec. 475(d)(2) 'penalty' timing.").

[96] *See* Stevens, *supra* note 73, at 73 ("It is, however, possible to argue that the use of the phrase 'any loss under this section.' means that losses on a Code Sec. 1256 contract can still be marked at year end under Code Sec. 1256 (that is, that the rule turning off the downward mark under Code Sec. 475 does not also turn off the downward mark under Code Sec. 1256).").

This article is reprinted with the publisher's permission from JOURNAL OF TAXATION OF FINANCIAL PRODUCTS, a quarterly journal published by CCH Incorporated. Copying or distribution without the publisher's permission is prohibited. To subscribe to JOURNAL OF TAXATION OF FINANCIAL PRODUCTS or other journals, please call 1-800-344-3734. All views expressed in this publication are those of the author and not necessarily those of the publisher or any other person.