

**TECHNICAL EXPLANATION OF
THE TAX PROVISIONS OF
H.R. 4541, THE "COMMODITY FUTURES
MODERNIZATION ACT OF 2000"**

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I. INTRODUCTION

This document¹ prepared by the staff of the Joint Committee on Taxation provides a technical explanation of the tax provisions of H. R. 4541, the “Commodity Futures Modernization Act of 2000.” The bill is scheduled for consideration by the House of Representatives on October 19, 2000. The non-tax portions of the bill provides for exchange trading a “securities futures contract”, which will be a contract for future delivery of a single security or a narrow-based security index. The bill provides for the tax treatment of these instruments in a manner generally consistent with the present-law treatment of transactions in stock and stock options.

¹ This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of the Tax Provisions of H. R. 4541, the “Commodity Futures Modernization Act of 2000”* (JCX-108-00), October 19, 2000.

II. EXPLANATION OF THE TAX PROVISIONS OF THE BILL

Tax Treatment of Securities Futures Contracts (sec. 124(c) and (d) of H. R. 4541 and secs. 1234B and 1256 of the Code)

Present Law

In general

Generally, gain or loss from the sale of property, including stock, is recognized at the time of sale or other disposition of the property, unless there is a specific statutory provision for nonrecognition (sec. 1001).

Gains and losses from the sale or exchange of capital assets are subject to special rules. In the case of individuals, net capital gain is generally subject to a maximum tax rate of 20 percent (sec. 1(h)). Net capital gain is the excess of net long-term capital gains over net short-term capital losses. Also, capital losses are allowed only to the extent of capital gains plus, in the case of individuals, \$3,000 (sec. 1211). Capital losses of individuals may be carried forward indefinitely and capital losses of corporations may be carried back three years and forward five years (sec. 1212).

Generally, in order for gains or losses on a sale or exchange of a capital asset to be long-term capital gains or losses, the asset must be held for more than one year (sec. 1222).² A capital asset generally includes all property held by the taxpayer except certain enumerated types of property such as inventory (sec. 1221).

Section 1256 contracts

Special rules apply to “section 1256 contracts,” which include regulated futures contracts, certain foreign currency contracts, nonequity options, and dealer equity options. Each section 1256 contract is treated as if it were sold (and repurchased) for its fair market value on the last business day of the year (i.e., “marked to market”). Any gain or loss with respect to a section 1256 contract which is subject to the mark-to-market rule is treated as if 40 percent of capital gain or loss. This results in a maximum rate of 27.84 percent on such gain for taxpayers other than corporations. The mark-to-market rule (and the special 60/40 capital treatment) is inapplicable to hedging transactions.

A “regulated futures contract” is a contract (1) which is traded on or subject to the rules of a national securities exchange registered with the Securities Exchange Commission, a domestic

² The holding period for futures transactions in a commodity is 6 months. The 6-month holding period does not apply to futures which are subject to the mark-to-market rules of section 1256, discussed below.

board of trade designated a contract market by the Commodities Futures Trading Commission, or similar exchange, board of trade, or market, and (2) with respect to which the amount required to be deposited and which may be withdrawn depends on a system of marking to market.

A “dealer equity option” means, with respect to an options dealer, an equity option purchased in the normal course of the activity of dealing in options and listed on the qualified board or exchange on which the options dealer is registered. An equity option is an option to buy or sell stock or an option the value of which is determined by reference to any stock, group or stocks, or stock index, other than an option on certain broad-based groups of stock or stock index³. An options dealer is any person who is registered with an appropriate national securities exchange as a market maker or specialist in listed options, or who the Secretary of the Treasury determines performs functions similar to market makers and specialists.⁴

Mark to market accounting for dealers in securities

Under present law, a dealer in securities must compute its income from dealing in securities pursuant to the mark-to-market method of accounting (sec. 475). Gains and losses are treated as ordinary income and loss. Traders in securities, and dealers and traders in commodities may elect to use this method of accounting, including the ordinary income treatment. Section 1256 contracts are not treated as securities for purposes of section 475.⁵

Short sales

In the case of a “short sale” (i.e., where the taxpayer sells borrowed property and later closes the sale by repaying the lender with substantially identical property), any gain or loss on the closing transaction is considered gain or loss from the sale or exchange of a capital asset if the property used to close the short sale is a capital asset in the hands of the taxpayer, but the gain is ordinarily treated as short-term gain (sec. 1233(a)).

The Internal Revenue Code (the “Code”) also contains several rules intended to prevent the transformation of short-term capital gain into long-term capital gain or long-term capital loss into short-term capital loss by simultaneously holding property and selling short substantially identical property (sec. 1233(b) and (d)). Under these rules, if a taxpayer holds property for less

³ Rev. Rul. 94-63, 1994-2 C.B. 188, provides that the determination made by the Securities and Exchange Commission will determine whether or not an option is “broad based”.

⁴ A special rule provides that any gain or loss with respect to dealer equity options which are allocable to limited partners or limited entrepreneurs are treated as short-term capital gain or loss and do not qualify for the 60 percent long-term, 40 percent short-term capital gain or loss treatment of section 1256(a)(3).

⁵ As discussed above, dealers in equity options are subject to mark-to-market accounting and the special capital gain rules of section 1256.

than the long-term holding period and sells short substantially identical property, any gain or loss upon the closing of the short sale is considered short-term capital gain, and the holding period of the substantially identical property is generally considered to begin on the date of the closing of the short sale. Also, if a taxpayer has held property for more than the long-term holding period and sells short substantially identical property, any loss on the closing of the short sale is considered a long-term capital loss.

For purposes of these short sale rules, property includes stock, securities, and commodity futures, but commodity futures are not considered substantially identical if they call for delivery in different months.

For purposes of the short-sale rules relating to short-term gains, the acquisition of an option to sell at a fixed price is treated as a short sale, and the exercise or failure to exercise the option is considered a closing of the short sale.⁶

The Code also treats a taxpayer as recognizing gain where the taxpayer holds appreciated property and enters into a short sale of the same or substantially identical property, or enters into a contract to sell the same or substantially identical property (sec. 1259).

Wash sales

The wash-sale rule (sec. 1091) disallows certain losses from the disposition of stock or securities if substantially identical stock or securities (or an option or contract to acquire such property) are acquired by the taxpayer during the period beginning 30 days before the date of sale and ending 30 days after such date of sale. Commodity futures are not treated as stock or securities for purposes of this rule. The basis of the substantially identical stock or securities is adjusted to include the disallowed loss.

Similar rules apply to disallow any loss realized on the closing of a short sale of stock or securities where substantially identical stock or securities are sold (or a short sale, option or contract to sell is entered into) during the applicable period before and after the closing of the short sale.

Straddle rules

If a taxpayer realizes a loss with respect to a position in a straddle, the taxpayer may recognize that loss for the taxable year only to the extent that the loss exceeds the unrecognized gain (if any) with respect to offsetting positions in the straddle (sec. 1092). Disallowed losses are carried forward to the succeeding taxable year and are subject to the same limitation in that taxable year.

⁶ An exception applies to an option to sell acquired on the same day as the property identified as intended to be used (and is so used) in exercising the option is acquired (sec. 1233(c)).

A “straddle” generally refers to offsetting positions with respect to actively traded personal property. Positions are offsetting if there is a substantial diminution of risk of loss from holding one position by reason of holding one or more other positions in personal property. A “position” in personal property is an interest (including a futures or forward contract or option) in personal property.

The straddle rules provide that the Secretary of the Treasury may issue regulations applying the short sale holding period rules to positions in a straddle. Temporary regulations have been issued setting forth the holding period rules applicable to positions in a straddle.⁷ To the extent these rules apply to a position, the rules in section 1233(b) and (d) do not apply.

The straddle rules generally do not apply to positions in stock. However the straddle rules apply if one of the positions is stock and at least one of the offsetting positions is either (1) an option with respect to stock or (2) a position with respect to substantially similar or related property (other than stock) as defined in Treasury regulations. Under proposed Treasury regulations, a position with respect to substantially similar or related property does not include stock or a short sale of stock, but includes any other position with respect to substantially similar or related property.⁸

If a straddle consists of both positions that are section 1256 contracts and positions that are not such contracts, the taxpayer may designate the positions as a mixed straddle. Positions in a mixed straddle are not subject to the mark-to-market rule of section 1256, but instead are subject to rules written under regulations to prevent the deferral of tax or the conversion of short-term capital gain to long-term capital gain or long-term capital loss into short-term capital loss.

Transactions by a corporation in its own stock

A corporation does not recognize gain or loss on the receipt of money or other property in exchange for its own stock. Likewise, a corporation does not recognize gain or loss when it redeems its stock with cash, for less or more than it received when the stock was issued. In addition, a corporation does not recognize gain or loss on any lapse or acquisition of an option to buy or sell its stock (sec. 1032).

Explanation of the Tax Provisions of the Bill

In general

Except in the case of dealer securities futures contracts described below, securities futures contracts are not treated as section 1256 contracts. Thus, holders of these contracts are not subject to the mark-to-market rules of section 1256 and are not eligible for 60-percent long-term capital

⁷ Reg. sec. 1.1092(b)-2T.

⁸ Prop. Reg. sec. 1.1092(d)-2(c).

gain treatment under section 1256. Instead, gain or loss on these contracts will be recognized under the general rules relating to the disposition of property.⁹

A securities futures contract is defined in section 3(a)(55)(A) of the Securities Exchange Act of 1934, as added by the bill. In general, that definition provides that a securities futures contract means a contract of sale for future delivery of a single security or a narrow-based security index. A securities futures contract will not be treated as a commodities futures contract for purposes of the Code.

Treatment of gains and losses

The bill provides that any gain or loss from the sale or exchange of a securities futures contract (other than a dealer securities futures contract) will be considered as gain or loss from the sale or exchange of property which has the same character as the property to which the contract relates has (or would have) in the hands of the taxpayer. 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. The bill also provides that the termination of a securities futures contract which is a capital asset will be treated as a sale or exchange of the contract.

Capital gain treatment will not apply to contracts which themselves are not capital assets because of the exceptions to the definition of a capital asset relating to inventory (sec. 1221(a)(1)) or hedging (sec. 1221(a)(7)), or to any income derived in connection with a contract which would otherwise be treated as ordinary income.

Except as otherwise provided in regulations under section 1092(b) (which treats certain losses from a straddle as long-term capital losses) and section 1234B, as added by the bill, any capital gain or loss from the sale or exchange of a securities futures contract to sell property (i.e., the short side of a securities futures contract) will be short-term capital gain or loss. In other words, a securities futures contract to sell property is treated as equivalent to a short sale of the underlying property.

Wash sale rules

The bill clarifies that, under the wash sale rules, a contract or option to acquire or sell stock or securities shall include options and contracts that are (or may be) settled in cash or property other than the stock or securities to which the contract relates. Thus, for example, the acquisition, within the period set forth in section 1091, of a securities futures contract to acquire stock of a corporation could cause the taxpayer's loss on the sale of stock in that corporation to be disallowed, notwithstanding that the contract may be settled in cash.

⁹ Any securities futures contract which is not a section 1256 contract will be treated a "security" for purposes of section 475. Thus, for example, traders in securities futures contracts which are not section 1256 contracts could elect to have section 475 apply.

Short sale rules

In applying the short sale rules, a securities futures contract to acquire property will be treated in manner similar to the property itself. 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 of section 1233(b).¹⁰ In addition, as stated above, a securities futures contract to sell is treated in a manner similar to a short sale of the property.

Straddle rules

Stock which 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 of section 1092. Treasury regulations under section 1092 applying the principles of the section 1233(b) and (d) short sale rules to positions in a straddle will also apply.

For 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 section 1259 do not apply). The taxpayer has a straddle. Treasury regulations prescribed under section 1092(b) applying the principles of section 1233(d) will apply, so that any loss on closing the securities futures contract will be a long-term capital loss.

Section 1032

A corporation will not recognize gain or loss on transactions in securities futures contracts with respect to its own stock.

Holding period

If property is delivered in satisfaction of a securities futures contract to acquire property (other than a contract to which section 1256 applies), 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.

Regulations

¹⁰ Because securities futures contracts are not treated as futures contracts with respect to commodities, the rule providing that commodity futures are not substantially identical if they call for delivery in different months does not apply.

The Secretary of the Treasury or his delegate has the authority to prescribe regulations to provide for the proper treatment of securities futures contracts under provisions of the Internal Revenue Code.

Dealers in securities futures contracts

In general, the bill provides that securities futures contracts and options on such contracts are not section 1256 contracts. The bill provides, however, that “dealer securities futures contracts” will be treated as section 1256 contracts.

The term “dealer securities futures contract” means a securities futures contract which is entered into by a dealer in the normal course of his or her trade or business activity of dealing in such contracts, and is traded on a qualified board of trade or exchange. The term also includes any option to enter into securities futures contracts purchased or granted by a dealer in the normal course of his or her trade or business activity of dealing in such options. The determination of who is to be treated as a dealer in securities futures contracts is to be made by the Secretary of the Treasury or his delegate not later than July 1, 2001. Accordingly, the bill authorizes the Secretary to treat a person as a dealer in securities futures contracts or options on such contracts if the Secretary determines that the person performs, with respect to such contracts or options, functions similar to an equity options dealer, as defined under present law.

The determination of who is a dealer in securities futures contracts is to be made in a manner that is appropriate to carry out the purposes of the provision, which generally is to provide comparable tax treatment between dealers in securities futures contracts, on the one hand, and dealers in equity options, on the other. Although traders in securities futures contracts (and options on such contracts) may not have the same market-making obligations as market makers or specialists in equity options, many traders are expected to perform analogous functions to such market makers or specialists by providing market liquidity for securities futures contracts (and options) even in the absence of a legal obligation to do so. Accordingly, the absence of market-making obligations is not inconsistent with a determination that a class of traders are dealers in securities futures contracts (and options), if the relevant factors, including providing market liquidity for such contracts (and options), indicate that the market functions of the traders is comparable to that of equity options dealers.

As in the case of dealer equity options, gains and losses allocated to any limited partner or limited entrepreneur with respect to a dealer securities futures contract will be treated as short-term capital gain or loss.

Treatment of options under section 1256

The bill modifies the definition of “equity option” for purposes of section 1256 to take into account changes made by the non-tax provisions of the bill. Only options dealers are eligible for section 1256 with respect to equity options. The term “equity option” is modified to include an option to buy or sell stock, or an option the value of which is determined, directly or indirectly, by

reference to any stock, or any “narrow-based security index,” as defined in section 3(a)(55) of the Securities Exchange Act of 1934 (as modified by the bill). An equity option includes an option with respect to a group of stocks only if the group meets the requirements for a narrow-based security index.

As under present law, listed options that are not “equity options” are considered “nonequity options” to which section 1256 applies for all taxpayers. For example, options relating to broad-based groups of stocks and broad based stock indexes will continue to be treated as nonequity options under section 1256.

Definition of contract markets

The non-tax provisions of the bill designate certain new contract markets. The new contract markets will be contract markets for purposes of the Code, except to the extent provided in Treasury regulations.

Effective Date

These provisions will take effect on the date of enactment of the bill.