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## Financial Reform Legislation Amends Section 1256 of the Internal Revenue Code to Provide Greater Certainty with Respect to the Tax Treatment of Swaps, Caps, Floors, and Similar Agreements

Among other things, the financial reform legislation signed by the President today mandates the formation of exchanges for certain types of derivative instruments. In response to the proposed legislation, concerns were raised that this aspect of the legislation would materially alter the U.S. federal income tax treatment of investments in these types of derivative instruments, specifically causing them to be subject to the mark-to-market requirement and special gain characterization rules of section 1256.

Section 1256 provides for "mark-to-market" treatment for "section 1256 contracts." In general, a taxpayer holding a section 1256 contract is treated for tax purposes as having sold that contract for fair market value at the end of the taxpayer's taxable year, recognizing any gain or loss in the contract. The gain or loss recognized is subject to a special rule: 40% of any gain or loss is treated as "short term" capital gain or loss (i.e., the type of gain or loss recognized on capital assets held by the taxpayer for less than one year), and 60% of any gain or loss is treated as "long term" capital gain or loss.

A "section 1256 contract" generally includes a contract that is traded on or subject to a qualified board or exchange. By requiring certain types of derivatives to be traded on exchanges, the legislation effectively would have subjected these transactions to the mark-to-market requirement and the special 40/60 capital gain characterization rule of section 1256. In order to prevent this unintended result, the legislation changes the scope of the term "section 1256 contract." The legislation excludes "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" from the definition of section 1256 contract, and therefore excludes these instruments from the mark-to-market requirement and the special 40/60 gain characterization rule.

The effect of this change is greater certainty with respect to the tax treatment of the swaps, caps, floors, and similar agreements enumerated in the exception to the definition of section 1256 contract.



*If you have any questions about this Legal Alert, please feel free to contact Robb Chase at 202.383.0194 ([robb.chase@sutherland.com](mailto:robb.chase@sutherland.com)), any of the attorneys listed below or the Sutherland attorney with whom you regularly work.*

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