

REPORT # 519

TAX SECTION

New York State Bar Association

Revenue Rulings 86-7 and 86-8

April 9, 1986

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TAX SECTION

New York State Bar Association

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April 9, 1986

Roscoe L. Egger, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Revenue Rulings 86-7 and 86-8

Dear Commissioner Egger:

Two rulings recently issued by the Internal Revenue Service under section 1256 of the Internal Revenue Code raise certain procedural questions. The two rulings are:

(i) Revenue Ruling 86-7¹, which holds that the Mercantile Division of the Montreal Exchange has rules adequate to carry out the purposes of section 1256,² with the result that futures contracts traded on the exchange will be treated as "regulated futures contracts" and "section 1256 contracts" as provided in section 1256; and

¹ 1986 - 4 I.R.B. 6.

² Section references are to the Internal Revenue Code of 1954, as amended.

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(ii) Revenue Ruling 86-8³, which holds that options on the High Technology Index of the Pacific Stock Exchange are "nonequity options" within the meaning of section 1256(g)(3), and that such options similarly constitute section 1256 contracts.

These published rulings apparently relate to "private" rulings issued previously, although identifying information has been deleted from the copies of the private rulings released to the public⁴.

Because the rulings change the tax treatment of the instruments at issue, specific public notice of the effective dates of the determinations seems advisable. This letter suggests procedures for handling the effective date issue in the future, and suggests possible effective dates for the two determinations in question.

In general, we believe that this type of determination should be effective no earlier than the date of publication by the Service. However, the two determinations at issue present some difficulty since the private rulings by their terms were stated to be effective on the date issued, and both rulings relate to

³ 1986-4 I.R.B. 6.

⁴ See L.T.R. 8528072 (April 18, 1985) (apparently relating to the Mercantile Division of the Montreal Exchange); L.T.R. 8526035 (April 1, 1985) (apparently relating to the High Technology Index of the Pacific Stock Exchange).

a status question rather than a particular transaction. These factors argue for using the dates that the private rulings were issued. On the other hand, some taxpayers may have been unaware of the private rulings (which were not made publicly available by the Service for several weeks after their issuance); these taxpayers may have an equitable argument for a later effective date. The situation was further confused by the absence of a stated effective date in the published Revenue Rulings.

The determinations were made pursuant to specific grants of authority. Section 1256(g)(7)(C) provides that a "qualified board or exchange", the existence of which is a prerequisite to treatment of a futures contract traded thereon as a "regulated futures contract," is:

"any . . . exchange, board of trade, or other market which the Secretary determines has rules adequate to carry out the purposes of [section 1256]".⁵

⁵ Rev. Rul. 86-7 holds only that the Mercantile Division of the Montreal Exchange is a "qualified board or exchange" and reaches no conclusion as to whether the contracts traded on the exchange meet the other statutory requirement for "regulated futures contract" treatment -- i.e., that the contracts be contracts "with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market". See section 1256(g)(1)(A). Compliance with this condition may be inferred, however, from the representations contained in L.R. 8528072.

With regard to the treatment of index options as "nonequity options", and, therefore as section 1256 contracts, section 1256(g)(6)(B) provides that:

"The term 'equity option' does not include any option with respect to any group of stocks or stock index if -- (i) there is in effect a designation by the Commodities Futures Trading Commission of a contract market for a contract based on such group of stocks or index, or (ii) the Secretary determines that such option meets the requirements of law for such a designation."

There are divergent tax consequences of section 1256 contract treatment and the absence of such treatment.⁶ Therefore, it is unquestionably desirable for the Service to continue to announce publicly its determinations that result in the treatment of instruments as section 1256 contracts. Public announcement of such determinations affords taxpayers certainty as to the tax consequences of their transactions, and eliminates any opportunity for

⁶ In general, instruments that are treated as section 1256 contracts (i) are marked-to-market (and treated as sold on the last day of the taxable year); and (ii) are treated as producing 60 percent long-term gain (loss) and 40 percent short-term gain (loss), irrespective of actual holding period. This treatment of section 1256 contracts differs materially from the tax consequences of holding options or futures contracts that are not section 1256 contracts. In general, gain and loss on such contracts is realized only when the position is closed out, and qualifies for long-term capital gain treatment only in the case of a "long" position, and only if the option or contract has been held for the long-term capital gain holding period at the time it is sold or closed out.

misreporting of transactions -- whether intentionally or inadvertently -- due to possible uncertainty regarding the applicable rules.

Almost as important as the Service's substantive determination regarding the status of products as section 1256 contracts is the time as of which the Service's determination takes effect. For determinations regarding index options as nonequity options, Congress anticipated the effective date issue and the Conference Committee Report states that such determinations should be prospective only⁷. We believe that this rule for index options is correct, and that the same principle should govern the designation of a "qualified board or exchange".

The issue remains, however, whether the effective date should commence with public announcement of the Service's determination, or, rather, with the date of issuance of a private ruling. We believe that, in general, the determinations should not apply to positions entered into prior to public announcement of the pertinent determination⁸. In our view, fairness requires

⁷ See H. R. Rep. No. 861, 98th Cong., 2d Sess. 909 (1984).

⁸ Indeed, consideration should be given to publishing such determinations at the same time that the related private ruling is issued. Such action would eliminate for future

(Footnote continued on next page)

that taxpayers have the opportunity to know the tax treatment of a transaction before they enter into the transaction. Obviously, this goal can be achieved only if public notice of a determination precedes (or corresponds to) the effective date of the determination.

The previous publication of the rulings in question as "private" rulings, which were stated to be effective on the date of their issuance, presents a special problem. Taxpayers probably took into account the effective date stated in the private rulings -- notwithstanding that each ruling states that it is directed only to the person requesting it, and that under section 6110(j), it may not be used or cited as precedent⁹.

(Footnote continued from preceding page)

determinations the question of the extent to which taxpayers may be permitted to rely on such private letter rulings. For example, it may be possible to circulate within the Service and Treasury a single "package" for approval containing the private ruling, the published ruling and a short press release. When final approval is received, the press release could be issued, announcing an immediate effective date for the determination.

⁹ It should be noted that these determinations by the Service under authority of section 1256 are not private rulings in the usual sense of a statement of the tax consequences of a proposed transaction or the like. This is not to say, however, that the ruling process may not be an appropriate means to consider whether such determinations should be issued. Nonetheless, the disclaimer under section 6110(j), the delay in releasing the ruling to the public (under the usual practice relating to private rulings), and the deletion of identifying information from the ruling perhaps may have led to some confusion on the part of taxpayers.

One approach would be for the Service to confirm now that the determinations are effective on the date stated in the pertinent private ruling, since that effective date was stated reasonably clearly in the ruling, and, in all events, the fact of the determination likely was made known to interested persons by the exchange in question. We recognize, however, that at least in theory, this approach could result in taxpayers who had no knowledge of the determination being accorded tax treatment different from what they might reasonably have expected. Moreover, allowing use of a later effective date on a case-by-case basis where the taxpayer had no knowledge of the determination seems impractical.

An alternative approach would be for the Service to announce publicly that taxpayers may apply the determinations effective for contracts entered into on or after the date on which the related private ruling was issued -- provided, of course, that the taxpayer takes a consistent position with respect to all such contracts. In all events, however, the rulings would apply to contracts entered into from and after the date of publication of the applicable public ruling. The obvious difficulty with this elective approach is that many taxpayers would have the opportunity to use hindsight to gain a tax benefit to which they are not otherwise entitled.

Given the apparent general knowledge regarding the private rulings, however, it seems clear that it would not be proper to use the publication date of the public rulings as the single, general effective date; that is, some at least, if not all taxpayers should be governed by the earlier effective date in the private rulings.

Although the 1985 tax filing season is under way, we think there would be significant value in the Service's making an announcement regarding the effective date of these determinations in the near future, and thereby providing clarification for the benefit of the many taxpayers who have not yet filed tax returns.

Very truly yours,

Richard G. Cohen

cc: J. Roger Mentz, Esq.
Assistant Secretary (Tax Policy) Designate
Department of Treasury