

Dealers in Securities Futures Contracts; Request for Comments

Notice 2001-27

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of solicitation of comments.

SUMMARY: This notice was published in the Federal Register on March 7, 2001, as BPG-132413-00. The IRS and Treasury Department are soliciting comments on the criteria that should be used to determine whether a taxpayer is a dealer in securities futures contracts (or options on such contracts) for purposes of section 1256 of the Internal Revenue Code.

DATES: Written and electronic comments are requested on or before May 5, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (BPG-132413-00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (BPG-132413-00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by submitting comments directly to the IRS Internet site at http://www.irs.gov/tax_regs/regslst.html.

FOR FURTHER INFORMATION CONTACT: Concerning the notice, Patrick E. White (202) 622-3920; concerning submission and delivery of comments, Treena Garrett, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

The Commodities Futures Modernization Act of 2000, enacted as part of the Consolidated Appropriations Act, 2001 (Public Law 106-554, 114 Stat. 2763), authorizes the trading of securities futures contracts, a new type of derivative financial product. Another portion of the same enactment—the Community Renewal Tax Relief Act of 2000 (the Act)—prescribes the tax treatment of these financial products. In general, gain or loss is recognized on securities futures contracts upon disposition, and the character of such gain or loss is determined by newly enacted section 1234B.

The timing and character of gains and losses on *dealer* securities futures contracts, however, is determined by section 1256. Thus, dealer securities futures contracts are subject to mark-to-market treatment, and capital gains or losses are

treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. Section 1256(g)(9) defines *dealer securities futures contracts* as securities futures contracts (and options on such contracts) that are traded on a qualified board or exchange and are entered into by a dealer in the normal course of the dealer's business of dealing in such contracts or options. For this purpose, a person is a *dealer* in securities futures contracts or options on such contracts if the Secretary of the Treasury determines that the person performs functions with respect to such contracts or options similar to the functions performed with respect to stock options by persons registered with a national securities exchange as a market maker or specialist in listed options. The Act requires the Secretary of the Treasury or his delegate to make this determination no later than July 1, 2001.

The legislative history of the Act states the following with respect to the determination process:

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.

H.R. Conf. Rep. No. 106-1033, 106th Cong., 2d Sess. 1036 (2000).

The IRS and Treasury Department, therefore, seek taxpayers' suggestions concerning both the substance of these determinations and the manner in which they should be made. As described in more detail below, of particular interest are comments that will aid in establishing objective criteria and processes for making the determinations. In addition, comments are solicited in certain specific areas.

First, comments are requested about the activities and obligations of equity options dealers, especially those activities and obligations that contribute to the establishment and maintenance of an orderly market. For purposes of this notice, the term *equity options dealer* means a market maker or specialist described in section 1256(g)(8) with respect to options that are described in section 1256(g)(6) without regard to the requirement that indices be narrow based. Any relevant way in which the activities and obligations of market makers differ from those of specialists should be described; and the significance of this difference for any comment or other response to this notice should be explained when relevant.

Among the questions on which information is sought are the following: What are the activities imposed on, or undertaken by, equity option dealers that are considered making a market? Do equity option dealers engage in activities that extend beyond making a market but that contribute to the establishment and maintenance of orderly markets? For example, equity options dealers trading for their own accounts (and not in response to orders placed by an off-exchange customer) may be a significant source of market volume. Is that the case? If so, to what extent does this added volume contribute to market liquidity? Are there other ways in which these dealers contribute to the markets in which they participate? What differences are there, in scale or kind, between the activities of equity options dealers and similar activities of other market participants?

Although some relevant activities of equity options dealers may be ongoing, other critical activities may commence, or change significantly in nature or scope, during periods of market disequilibrium. Information with respect to equity options dealers' activities at these times will be particularly welcome.

Second, information is requested regarding activities of traders¹ on futures markets. Although traders on futures markets may not have specific market-making obligations, their trading activities may contribute to the establishment and maintenance of orderly markets. Is that typically the case? Descriptions of trading activities on futures markets generally will be helpful, and insights and supporting data on the nature and extent of trading by specific groups of futures traders will be particularly useful. Relevant groups for this purpose may be based on the type of contract traded, the extent of trading for one's own account (as opposed to trading in response to orders from off-exchange customers), and the class of exchange membership.

This discussion should be accompanied, if possible, by an explanation of the extent to which the activities of traders in securities futures contracts are expected to resemble the activities of the specific groups described. In general, expectations of how trading in securities futures contracts may or may not differ from trading in current products will also be helpful.

Third, comments are solicited on administrable and economically meaningful criteria for identifying any traders that should be treated as dealers in securities futures contracts. Criteria for identifying these persons might include, among others, the nature and extent of trading activities (including the extent to which the person's trading is concentrated in certain products), class of exchange membership, capital, and share of net income derived from trading activities. Should it be possible for a person to be a dealer in securities futures contracts with respect to some such contracts but not with respect to others?

If a taxpayer's satisfaction of the suggested criteria may vary over time, comments are also requested respecting rules for determining when a taxpayer becomes, or ceases to be, a dealer in securities futures contracts. For example, should it be possible for the status as a

¹ The references here, and in the following paragraphs, to *traders* are not intended to exclude any taxpayers who are not treated as traders for tax purposes but who may perform functions similar to the functions performed by equity options dealers.

dealer in securities futures contracts to change within a single taxable year or only between taxable years? Does a taxpayer need to know before it enters a transaction whether it is treated as a dealer for purposes of that transaction? Will special rules be required for taxpayers who have not previously traded in the contracts? (Initially, all taxpayers fall into this category.) Comments regarding both substantive criteria and the method of application will be useful.

Comments

Written or electronic comments (a signed original and eight (8) copies, if written) should be timely submitted (in the manner described in the ADDRESSES portion of this notice) to the IRS. All comments will be available for public inspection and copying.

Drafting Information

The principal authors of this notice are Patrick E. White, Office of Associate

Chief Counsel (Financial Institutions and Products), and Matthew J. Eichner, Office of Tax Analysis, United States Department of the Treasury. However, other personnel from the IRS and Treasury Department participated in its development.

Lon B. Smith,
Acting Associate Chief Counsel
(Financial Institutions & Products)
