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IRS Defends Discretion to Withhold Section 1256 Exchange Designation for ISOs

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The IRS defended its decision not to designate independent system operators as qualified board or exchange (QBE) principally on the grounds that, as a matter of law, it is not required to designate *any* exchanges as QBEs under Category 3 of Section 1256 Contracts.

In *Sesco Enterprises, LLC* (Civ. No. 10-1470, D.N.J. Nov. 16, 2010), the Internal Revenue Service (IRS) defended its discretion to refrain from extending qualified board or exchange status under Code Section 1256 to U.S. Federal Energy Regulatory Commission (FERC)-regulated independent system operators. The district court dismissed the taxpayer's claim that the IRS acted arbitrarily and capriciously when it refused to classify electricity derivatives that traded on independent system operators as "Section 1256 Contracts.

Section 1256 Contracts in General

For federal income tax purposes, a limited number of derivative contracts are classified as Section 1256 Contracts. Absent an exception, Section 1256 Contracts are subject to mark-to-market tax accounting and the 60/40 rule. The 60/40 rule characterizes 60 percent of the net gain or loss from a Section 1256 Contract as long-term and 40 percent as short-term *capital* gain or loss. Corporate taxpayers often view Section 1256 Contracts as tax disadvantageous, relative to economically similar derivatives that are not taxed as Section 1256 Contracts, such as swaps, unless the business hedging or some other exception is available.

Section 1256 Contract classification is limited to regulated futures contracts, foreign currency contracts, nonequity options, dealer equity options and dealer securities futures contracts, as each is defined in the Internal Revenue Code. Unless a derivative falls within one of these categories, it is *not* a Section 1256 Contract, regardless of its economic similarity to a Section 1256 Contract.

Except for foreign currency contracts, Section 1256 Contracts are limited to derivative positions that trade on or are subject to the rules of a qualified board or exchange (or QBE). QBE status is extended only to national securities exchanges registered with the U.S. Securities and Exchange Commission (SEC) (a Category 1 Exchange); domestic boards of trade designated as contract markets by the U.S. Commodities Futures Trading Commission (CFTC) (a Category 2 Exchange); or *any other exchange, board of trade or other market* that the Secretary of the Treasury Department determines has rules adequate to carry out the purposes of Code Section 1256 (a Category 3 Exchange).

Category 1 and Category 2 Exchange status is automatic. Category 3 Exchange status, however, requires a determination by the IRS. In recent years, Category 3 Exchange designation has been extended to four non-U.S. futures exchanges offering products in the United States: ICE Futures (UK), Dubai Mercantile Exchange, ICE Futures (Canada) and LIFFE (UK).

Sesco Challenges IRS Discretion to Withhold Category 3 Exchange Designation

According to its website, the taxpayer in *Sesco* (Taxpayer) is an electricity and natural gas trading company. The facts of the case indicate that it traded electricity derivatives (presumably INCs, DECs, Virtuals and/or FTRs) on various independent system operators or regional transmission organizations regulated by the FERC (collectively, ISOs). Because ISOs are not regulated by the SEC or the CFTC, they cannot be considered Category 1 or Category 2 Exchanges for purposes of Code Section 1256. To date, no ISO has been designated as a Category 3 Exchange by the IRS.

According to the facts in *Sesco*, the Taxpayer took the position on its return that derivatives trading on ISOs were Section 1256 Contracts eligible for 60/40 capital treatment. The IRS denied Section 1256 Contract status on audit. Somewhat surprisingly, a footnote in *Sesco* suggests, without any further discussion, that the IRS agreed with the Taxpayer's position that these electricity derivatives qualified as "regulated futures contracts" under Code Section 1256 except for satisfying the QBE requirement.

During the examination process, the Taxpayer apparently requested a private letter ruling from the IRS that the relevant ISOs were Category 3 Exchanges. According to the district court, "The IRS refused, asserting that the request for a QBE determination must be made by the exchange itself." The Taxpayer then asked one of the ISOs to request Category 3 Exchange status, but the ISO declined to do so. Taxpayer then filed suit challenging the IRS's adjustments and asserted that the IRS "acted arbitrarily and capriciously and abused its discretion when it refused to make a QBE determination except upon request from the ISO." In essence, the Taxpayer was attempting to force the IRS to designate the ISOs at issue as QBEs.

The IRS defended its decision not to designate the ISOs as QBEs principally on the grounds that, as a matter of law, it is not required to designate any exchanges as QBEs under Category 3. After briefly considering the wording of Code Section 1256 and the relevant legislative history, the court agreed with the IRS position and dismissed the case on procedural grounds (lack of jurisdiction).

Observations

Although the District Court's decision in *Sesco* may be of little or no precedential value due to the procedural aspects of the case, the decision nevertheless is important in that it reflects what has long been understood to be the IRS' position regarding Category 3 Exchange status, which is that Category 3 Exchange status is not automatic and requires a formal determination by the IRS. *Sesco* also confirms that the IRS believes QBE classification can only be requested by the exchange at issue, not by exchange participants.

Unfortunately, *Sesco* does not address the separate question of whether the IRS could have unilaterally designated the ISOs at issue as QBEs without the participation of the exchanges. *Sesco* also raises, but does not address, the issue of whether derivatives traded on exchanges that are not "futures" exchange can be considered "regulated futures contracts" for purposes of Code Section 1256. These are critical questions that will become more relevant in the near future as the exchange-trading and exchange-clearing requirements imposed by the Dodd-Frank derivatives reform legislation begin to take effect.