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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
ASSOCIATE DISTRICT COUNSEL

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL CC:DOM:FS

SUBJECT: Section 1256 Contracts and Section 988 Transactions

This Field Service Advice responds to your memorandum dated November 23, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

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F =
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K =
L =
M =
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Year 2 =
Year 3 =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =

ISSUES

1. Whether A traded regulated futures contracts ("RFCs") as defined in I.R.C. §§ 1256(b)(1) and 1256(g)(1).

2. What constitutes a foreign currency contract as defined in § 1256(g)(2).

3. Whether foreign currency option contracts that are not traded on a qualified board or exchange are foreign currency contracts under § 1256(g)(2).

4. Whether losses incurred on I.R.C. § 988 transactions may affect the taxpayers' net operating losses ("NOLs") pursuant to I.R.C. § 172.

5. What is the effect of A's status as a shareholder in C on his transactions in foreign currency futures, forwards and options.

6. Whether the taxpayers have properly amended their Tax Court petition.

CONCLUSIONS

1. A may have traded in RFCs as defined in §§ 1256(b)(1) and 1256(g)(1). Additional factual development is required.

2. A foreign currency contract may include a non-regulated foreign currency futures contract and a forward contract in foreign currency traded on the interbank market.

3. Foreign currency option contracts are not foreign currency contracts pursuant to § 1256(g)(2). Transactions in these contracts may qualify as § 988

transactions. The gains or losses on foreign currency options contracts that are not nonequity options will be characterized as ordinary gains or losses, pursuant to § 988(c)(1)(B)(iii).

4. To the extend that A was in the trade or business of engaging in § 988 transactions, any losses incurred could affect the taxpayers' NOL.

5. If C is viewed as an agent of A, its trading activity may be aggregated with A's activity in determining whether he was a trader or investor.

6. The taxpayers have properly amended their Tax Court petition in this case to raise the new issues with respect to the carryforward to the Year 3 tax year of NOLs allegedly incurred by the taxpayers in the Year 1 through Year 2 tax years.

FACTS

A is the taxpayer. From Year 1 through Year 2, A engaged in various types of trading[1] in foreign currency contracts. On their tax returns for these years, the taxpayer and B (collectively referred to as the "taxpayers") with whom he filed jointly, identified these contracts as "§ 1256 contracts", and marked to market the contracts which resulted in capital gains and losses.

On Date 2, the Service issued the taxpayers a Statutory Notice of Deficiency for their tax year ended Date 1. The Service determined that the taxpayers had a deficiency of $N, and disallowed their charitable deductions totaling $O claimed on their return.

On Date 3, the taxpayers filed a Petition in the Tax Court, challenging the deficiencies in the Statutory Notice.

On Date 4, the taxpayers filed an Amended Petition in the Tax Court. In this Amended Petition, the taxpayers argued that they had erroneously treated the foreign currency gains and losses as capital gains and losses on their Year 1 through Year 2 tax returns, and that the Commissioner failed to allow the taxpayers to deduct an NOL carryforward deduction under § 172 in the amount of $S in their Year 3 tax year. The taxpayers stated in the Amended Petition that A engaged in "§ 988 transactions" pursuant to § 988(b)(3). As a result, the gains and losses from his trading in options, forwards, futures and swap contracts in foreign currency from

[1] We use the words "trading" and "trader" here for convenience only.

Year 1 through Year 2 constituted ordinary gains and losses.[2] They allegedly incurred NOLs in the amount of approximately $P. The first time that these issues were raised was by the taxpayers in the Amended Petition.

The taxpayers argued that the trading activities conducted by A and C, a subchapter S corporation wholly owned by A, on A's behalf, resulted in a NOL in the amount of $Q in Year 1 which was available for either carrying back for three years or for carrying forward to subsequent taxable years. C owned a seat on the E.

On Date 5, the taxpayers filed a Second Amendment to Petition ("Second Amendment") with the Tax Court. In this Second Amendment, the taxpayers argued that, to the extent that C's gains and losses in foreign currency forwards, futures, options or swaps are not ordinary under § 988, such gains and losses are properly treated as ordinary income or loss because C was a "dealer", and a dealer's gains and losses are ordinary income under I.R.C. § 1221(1) or I.R.C. § 1234(b)(3). The taxpayers also argued that income or losses that they received from D, a partnership, were erroneously reported as capital gains and losses on their return.

The taxpayers' Year 1 through Year 2 tax years have not been audited. The Service did not determine a deficiency for the taxpayers' Year 1 through Year 2 tax years on the issue of the § 1256 contracts.

LAW AND ANALYSIS

Issue 1

I.R.C. § 1256 requires mark-to-market treatment for any "§ 1256 contract," defined in § 1256(b) as: (1) any regulated futures contact ("RFC"), (2) any foreign currency contract, (3) any nonequity option, and (4) any dealer equity option. Each § 1256 contract is marked to market on the last business day of each taxable year, and any gain or loss is then taken into account. I.R.C. § 1256(a)(1). Of the gain or loss realized by the taxpayer with respect to a § 1256 contract, 40% is treated as short-term capital gain or loss, and 60% is treated as long-term capital gain or loss. I.R.C. § 1256(a)(3)(A) and (B).

However, mark-to-market treatment under § 1256(a) does not apply to a § 1256 contract that is a hedge clearly identified before the close of the day on which the taxpayer entered into the transaction. I.R.C. § 1256(e). Capital gains treatment is

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[2] We identify A's transactions here as "futures" and "forwards" for convenience only.

denied for property that the taxpayer identified as being part of a hedging transaction under § 1256(e)(2)(C).

Section 1256(a)(3) does not apply to any gain or loss which, but for that provision, would be ordinary income or loss. I.R.C. § 1256(f)(2). Gain or loss from trading in a § 1256 contract is treated as gain or loss from the sale or exchange of a capital asset, unless if the contract is held as a hedge. I.R.C. § 1256(f)(3)(A) and (B). Additionally, whether a taxpayer is actively engaged in dealing in or trading § 1256 contracts is not taken into account for purposes of determining whether the gain or loss with respect to property related to the § 1256 contract is ordinary income or loss. I.R.C. § 1256(f)(3)(C).

An RFC is defined in § 1256(g)(1) as a contract (A) 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, and (B) which is traded on or subject to the rules of a qualified board or exchange. A qualified board or exchange includes a domestic board of trade designated as a contract market by the Commodities Futures Trading Commission ("CFTC"), or any other exchange, board of trade, or other market which the Secretary determines has rules adequate to carry out the purposes of this section. I.R.C. § 1256(g)(7)(B) and (C).

In its Annual Report to Congress, Futures and Option Contract Designations, the CFTC lists the markets and boards of trade that it has designated as "contract markets" and the commodities for which the markets or boards of trade are designated. The CFTC has jurisdiction to regulate the commodities futures markets. 7 U.S.C. §§ 1a, 2. The CFTC regulates transactions in foreign currency conducted on a board of trade. 7 U.S.C. §2(ii). The CFTC has the jurisdiction to designate a board of trade and an exchange as a contract market. 7 U.S.C. §§ 2a, 7.

A futures contract is not defined in § 1256. The CFTC defines a futures contract as "an agreement to purchase or sell a commodity for delivery in the future: (1) at a price that is determined at initiation of the contract; (2) which obligates each party to the contract to fulfill the contract at the specified price; (3) which is used to assume or shift price risk; and (4) which may be satisfied by delivery or offset." See CFTC Glossary: A Layman's Guide to the Language of the Futures Industry.

Only a futures contract for a designated foreign currency that has actually been traded on a CFTC designated contract market or subject to its rules is an RFC for purposes of § 1256(g)(1).[3] An RFC can be traded by either a taxpayer as a

[3] The Secretary has determined that only certain exchanges or boards of trade have rules adequate to carry out the purpose of this section. See Rev. Rul. 85-72, 1985-1 C.B. 286; Rev. Rul. 86-7, 1986-1 C.B. 295; Rev. Rul. 86-8, 1986-1 C.B. 295.

principal or by a third party acting on the taxpayer's behalf as an agent. See, e.g., 17 C.F.R. § 1.2. Thus, futures contracts that have been traded by two private parties "over the counter" ("OTC") are not traded on a contract market and are not RFCs for purposes of § 1256(g)(1). See Rev. Rul. 87-43, 1987-1 C.B. 252. A futures contract that does not meet these terms may be a non-regulated futures contract.

The taxpayers have made additional arguments to support the position that A did not trade RFCs, but, rather, non-regulated futures contracts.

First, they argued that a number of the entities with whom A traded were not registered futures commission merchants ("FCMs") pursuant to 7 U.S.C. § 1a(12) and were not qualified to solicit or accept futures orders on a contract market; therefore, the futures were not RFCs. A firm or a person must be a registered FCM as defined under 7 U.S.C. § 1a(12) and 17 C.F.R. § 3.10, in order to solicit or accept futures contract orders on a contract market.[4]

Whether the counterparties were FCMs is not necessarily relevant to our inquiry because the remedy for any such violation is not one that causes a regulated futures contract to become unregulated. We do not have a complete list of all of the counterparties with whom A traded. Of the counterparties that we know, only L and M are FCMs. We recommend additional factual development, as discussed below.

Second, a trader in futures who holds more than 200 reportable positions in foreign currency contracts at the close of the market on a business day on a contract market is required to file a Form 40, "Statement of Reporting Trader" with the CFTC, pursuant to 17 C.F.R. §§ 18.04, 15.00, 15.03. Because A did not file a Form 40, the taxpayers argued that the futures that he traded were not RFCs.

Whether this required form was filed by A is not relevant to our inquiry because the remedy for any such failure to file is not one that causes an RFC to become unregulated.

Third, the taxpayers argued that the confirmation slips ("confirms") that A received from his counterparties did not conform with the formal documentation requirements established by 17 C.F.R. §1.35. Whether the counterparties complied with this requirement is not relevant to our inquiry because the remedy for any such violation would not cause an RFC to become unregulated.

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[4] A list of FCMs is publicly available from the National Futures Association through its internet site, http://www.nfa.futures.org/.

Fourth, the taxpayers argued that RFCs must have: (1) an expiration date in one of four specific calendar months, March, June, September, and December; (2) the expiration date of the contract that will be the Friday before the third Wednesday of March, June, September, or December; (3) the expiration date in nine months or less after the date the contract was entered into. They argued that certain of A's futures contracts did not conform to these specifications; therefore, these futures contracts were not regulated.

We disagree with the taxpayer's assertion that all futures contracts must have these specifications to qualify as RFCs for purposes of § 1256(g)(1). The CFTC does not require each exchange to have identical specifications for each futures contract. Each exchange or board of trade has its own rules and regulations for contract specifications for each commodity that may be either identical to or different from the contract specifications for another commodity on another exchange's specifications.

A § 988 transaction is defined as a transaction described as entering into or acquiring any forward contract, futures contract, option or similar financial instrument if the amount which the taxpayer is entitled to receive or is required to pay by reason of such transaction is denominated in terms of a nonfunctional currency or by reference to the value of one or more nonfunctional currencies. I.R.C. § 988(c)(1)(A). Foreign currency gain or loss attributable to a § 988 transaction is ordinary gain or loss. I.R.C. § 988(a)(1).

For tax years prior to 1988 and for the taxable year 1988 for transactions entered into prior to October 22, 1988, RFCs were excluded from the definition of § 988 contracts because RFCs were marked to market under § 1256. I.R.C. § 988(c)(1)(B)(iii), as enacted in the Tax Reform Act of 1986, P.L. 99-514 § 1261(a). Accordingly, any RFC held during this period would be marked to market and any gain or loss realized on the RFC would be capital, unless § 1256(e) or (f) applied. I.R.C. § 1256(a)(1) and (3).

An RFC is not included in the definition of a § 988 transaction for transactions entered into, or contracts acquired, after October 21, 1988, pursuant to § 988(c)(1)(D), unless the taxpayer elected during that taxable year under § 988(c)(1)(D)(ii) to treat these transactions as § 988 transactions. If the taxpayers elected in the manner prescribed under § 988(c)(1)(D)(ii) and Treas. Reg. § 1.988-1(a)(7)(iii) to treat these transactions as § 988 contracts, then the taxpayers will receive ordinary gains or losses on those RFCs. We have no facts that indicate that the taxpayers elected to treat their RFCs as § 988 contracts.

Issue 2

A foreign currency contract is defined in § 1256(g)(2) as a contract-

> (i) which requires delivery of, or the settlement of which depends on the value of a foreign currency which is a currency in which positions are also traded through RFCs,
> (ii) which is traded in the interbank market, and
> (iii) which is entered into at arm's length at a price determined by reference to the price in the interbank market.

Congress equated foreign currency contracts (forward contracts) economically with RFCs. In the Committee Report, H. Rept. 97-794, 97th Cong., 2d Sess., 23 (1982), Congress stated the following:

> Foreign currency contracts.-- Trading in foreign currency for future delivery is conducted through regulated futures contracts, and is also conducted through contracts negotiated with any one of a number of commercial banks which comprise an informal market for such trading (bank forward contracts). Bank forward contracts differ from regulated futures contracts in that they are private contracts in which the parties remain entitled to performance from each other. They further differ from regulated futures contracts in that they do not call for daily variation margin to reflect market changes, and in that the interbank market has no mechanism for settlement terminating a taxpayer's position prior to the delivery date. Prior to ERTA, taxpayers who used both the futures exchanges and the interbank market to conduct short-term trading in foreign currency were subject to substantially comparable tax treatment for both types of contract. Although bank forward contracts differ from regulated futures contracts, the volume of trading through forward contracts in foreign currency in the interbank market is substantially greater than foreign currency trading on futures exchanges, and prices are readily available. Such contracts are economically comparable to regulated futures contracts in the same currencies and are used interchangeably with regulated futures contracts by traders.

Congress intended to include within the definition of a foreign currency contract bank forward contracts in currencies that are traded through RFCs because bank forward contracts are economically comparable to and used interchangeably with RFCs. A non-regulated futures contract is economically comparable to both an RFC and a bank forward contract; therefore, a non-regulated futures contract may qualify as a foreign currency contract.

One expert has explained a forward contract as:

> similar to a futures contract in that it contemplates delivery of a specified quantity of goods, at a specified price, at some

> specified date in the future. Forward contracts differ, however, because they are private contracts in which the parties remain entitled to performance from each other. No organized market or established mechanism is available for terminating a taxpayer's position prior to the delivery date. . . . In addition, the terms of a forward contract are usually not standardized. . . .

Kevin M. Keyes, Federal Taxation of Financial Instruments and Transactions, ¶13.03[2][a] (Warren Gorham & Lamont)(1997).

The Internal Revenue Code offers no definition of the interbank market. The interbank market refers to the OTC market maintained by banks to purchase and sell foreign currency and financial products. The interbank market is not a formal market, but rather a group of banks holding themselves out to the general public as being willing to purchase, sell or otherwise enter into certain transactions. The Service broadly interprets the interbank market to include all banks and investment banks (as the terms are generally used in the marketplace). We conclude that the parties with whom A traded foreign currency forward contracts (F, G, H, I, J, and K) were members of the interbank market.

Foreign currency futures contracts that do not qualify as RFCs under § 1256(g)(1) but do qualify as foreign currency contracts under § 1256(b)(2) and (g)(2) will be marked to market pursuant to § 1256(a)(1). For tax years prior to 1988, and for the taxable year 1988 for transactions entered into prior to October 22, 1988, all non-regulated futures and forward contracts that were marked to market pursuant to § 1256(b)(2) were excluded from the definition of a § 988 contract.

Foreign currency contracts acquired or entered into after October 21, 1988, that were § 1256 contracts will be treated as both § 1256 contracts and § 988 transactions. Section 1256(f)(2) provides an exception from capital treatment for income that, but for § 1256(a)(3), would be ordinary. The losses will be characterized as ordinary losses unless the taxpayer elected out of ordinary treatment, pursuant to § 988(a)(1)(B) and Treas. Reg. § 1.988-3(b)(4). In order for an election to be valid, a verification statement must be attached to the return. We have no facts that indicate that the taxpayers made this election.

A foreign currency forward contract that was not a § 1256 contract may qualify as a § 988 contract pursuant to § 988(c)(1)(B)(iii) for all tax years at issue. Accordingly, for all of the taxable years at issue, losses incurred on these contracts are characterized as ordinary losses under § 988(a)(1)(A).

Issue 3

Although the definition of a foreign currency contract provided in § 1256(g)(2) may be read to include a foreign currency option contract, the legislative history of the

Technical Corrections Act of 1982 ("TCA"), Pub. L. No. 97-448, 1983-1 C.B. 451, which amended § 1256 to include foreign currency contracts, indicates that the Congress intended to extend § 1256 treatment only to foreign currency forward contracts that are traded on the interbank market. See S. Rep. No. 592, 97th Cong., 2d Sess., reprinted in 1983-1 C.B. 475, 485-486; H.R. Rep. No. 986, 97th Cong., 2d Sess., reprinted in 1983-1 C.B. 498, 503-04. There is no indication that foreign currency option contracts were contemplated for inclusion in the statutory definition of a forward currency contract in § 1256(g)(2)(A).

Sections 1256(g)(3) and (4) deal comprehensively with options listed on a qualified board or exchange. These provisions were added to the Code by section 102(a)(3) of the Tax Reform Act of 1984 ("TRA"), Pub. L. No. 98-369, 1984-3 (Vol. 1) C.B. 128. They provide that only dealer equity options (i.e., listed stock options) and listed options (other options listed on exchanges) are § 1256 contracts.[4] The legislative history to these provisions is silent regarding whether the failure to separately include a provision addressing the treatment of foreign currency options was due to their having been included within § 1256(g)(2)(A).

The legislative history to section 722(a)(2) of the TRA, however, which amended § 1256(g)(2), indicates that only "certain" foreign currency contracts were treated as regulated futures contracts under that provision. See H.R. Rep. No. 432, 98th Cong., 2d Sess. 1646 (1984). This, coupled with the previously referenced provisions of the legislative history to the TCA, and our view that reading § 1256(g)(2) expansively to apply generally to foreign currency options would effectively override the limitations of § 1256(g)(3) and (4), leads us to conclude that foreign currency option contracts are not foreign currency contracts pursuant to § 1256(g)(2)(A).

Losses on foreign currency options that do not qualify as nonequity options under § 1256(g)(3) will be treated as § 988 transactions, for which the gains or losses will be ordinary.

Issue 4

For an individual or other qualified noncorporate taxpayer, an NOL is determined under § 172(c) by subtracting gross income from the allowable income tax deductions and applying the relevant modifications of § 172(d). See Treas. Reg. § 1.172-3(a). Among these modifications, under § 172(d)(2)(A), the deduction of any nonbusiness capital loss is limited to the amount of capital gain; consequently, any excess of capital losses over capital gains cannot, by definition, create or

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[4] A listed option is traded on or subject to the rules of a qualified board or exchange under § 1256(g)(5) and (g)(7) to the same extent that an RFC is traded on or subject to the rules of a qualified board or exchange. See discussion, infra, at 5-6.

increase an NOL. In this context, it should also be remembered that capital losses and capital gains remain such irrespective of whether these amounts are long-term or short-term (i.e., taxation rates are distinguished from the character of the income).

Section 172(d)(4) limits the use of nonbusiness deductions in the computation and deems any gain or loss on the sale of a business property (i.e., real property or other property used in the trade or business and subject to the depreciation allowance of § 167) as attributable to that trade or business.

Under the § 172(d) modifications, each taxpayer is considered to have two general categories of income: business income and nonbusiness income. Similarly, there are two corresponding categories of deductions: business deductions and nonbusiness deductions. To apply the modifications correctly, therefore, a taxpayer's income items and deductions must be appropriately characterized as either attributable or not attributable to a trade or business. Nonbusiness deductions, like capital losses, have no effect on an NOL, except to the extent they absorb nonbusiness income that would otherwise be applied against an NOL. The restrictions on nonbusiness deductions in making the modifications in computing an NOL often lead to the statement that such nonbusiness deductions end up "wasted." See, e.g., Malchin v. Commissioner, T.C. Memo. 1981-460.

Notwithstanding its critical nature for purposes of many other provisions, as well as § 172 here, the phrase "trade or business" has never been expressly defined by the Internal Revenue Code. In determining whether deductions and income are attributable to a taxpayer's trade or business for the purpose of the NOL rules of § 172, the term trade or business has been given the same meaning as it has under § 162. See Commissioner v. Polk, 276 F.2d 601 (10th Cir. 1960), aff'g 31 T.C. 412 (1958); Roberts v. Commissioner, 258 F.2d 634 (5th Cir. 1958), aff'g T.C. Memo. 1957-145; Todd v. Commissioner, 682 F.2d 207 (9th Cir. 1982), aff'g 77 T.C. 246 (1981); Wood v. Commissioner, 37 T.C. 70 (1961), acq. 1969-2 C.B. xxv.

The resolution of whether a taxpayer is engaged in a trade or business is always a highly factual determination. There are many cases setting out the general factors to be weighed in making that call in a variety of circumstances; yet, in the context of the specific choice presented here–the trader vs. investor dichotomy–there are numerous decided cases that should aptly guide that analysis.

The Supreme Court case of Higgins v. Commissioner, 312 U.S. 212 (1941), interpreting the predecessor provision to § 162 ("carrying on any business") and stressing that it was a case-by-case decision, did indeed find that the investment activity there, irrespective of how involved and continuous it was, should not be treated as a trade or business. It noted that the Commissioner had not, as yet, made any allowance for the "continuity, constant repetition, regularity, and extent" with which a particular activity was pursued so as to rise to a business. Id. at 215.

No such allowance on his part could be inferred. Id. At the same time, however, the Court did recognize that decisions of the lower courts in other cases had found such facts distinguishable and had ruled against the Commissioner in those cases, i.e., that the activity did rise to the level of carrying on a business. Id. at 216. The Court did not question the results in those case. See, e.g., Kales v. Commissioner, 101 F.2d 35, 39 (6th Cir. 1939) (holding its taxpayer within the scope, court said "there are cases where the activities of taxpayers are such that though they invest but their own capital they are none the less carrying on a business"). While the Court has since repeated its earlier statement that "investing is not a trade or business," Whipple v. Commissioner, 373 U.S. 193 (1963), in reality, that does not provide us a standard informing when trading activity, in itself, becomes a trade or business.

In a case quoted with approval by the Ninth Circuit in Purvis v. Commissioner, 530 F.2d 1332 (9th Cir. 1976), the Tax Court set forth this standard in attempting to distinguish between investing and trading:

> [I]n [investing], securities are purchased to be held for capital appreciation and income, usually without regard to short-term developments that would influence the price of securities on the daily market. In a trading account, securities are bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis.

Chang Hsiao Liang v. Commissioner, 23 T.C. 1040, 1043 (1955), acq. 1955-2 C.B. 4. See also Estate of Yaeger v. Commissioner, 889 F.2d 29, 33 (2d Cir. 1989).

Applying that Liang paragraph as the sole standard, A here may seem to meet the test for a trader, given the short term nature of his various security positions taken. In addition, no dividends are paid and long-term capital appreciation is usually unattainable with respect to foreign currency futures, forwards and options contracts.

To the extent that the Liang "holding" considerations are viewed as merely factors, rather than as a standard or test, to be weighed along with other factors noted in the other cases (e.g., the time, resources, and regularity dedicated to the purported trading activity), then labeling A here as a "trader" probably becomes much less compelling. Thus, in the same way, a finding that any losses are attributable to a business rather than "merely" capital losses for purposes of making the § 172(d) modifications is also less likely. Therefore, to the extent that A was in the trade or business of engaging in § 988 transactions, any losses incurred would affect the taxpayers' NOL. However, even if A were in the trade or business of trading § 1256 contracts, any gain or loss realized on these contracts would not reduce their NOL under § 172(d)(2)(A) because § 1256(f)(3)(A) specifically states that gain or loss

from trading in § 1256 contracts shall be treated as gain or loss from the sale or exchange of a capital asset.

Issue 5

Unless C is viewed as acting as an agent of A with respect to a trade, it will be viewed as a separate entity and its trading activity must be analyzed independently of the taxpayer. The determination must then be made whether either C or the A are traders or investors. If C is viewed as an agent of the taxpayer, its trading activity may be aggregated with A's trading activity in determining whether A is a trader or investor.

Thus, in determining whether A's trading activity was sufficiently regular and continuous so that the taxpayer would be considered a trader rather than an investor, those trades conducted through C will not be considered unless C is found to be an agent of the taxpayer. If C is not found to be the agent of A, its trading activity must be independently analyzed to determine whether it was sufficiently regular and continuous so that C would be considered a trader rather than investor.

Issue 6

Tax Court Rule 41(a) requires a party to obtain the leave of the court or the written consent of the opposing party before amending a pleading using the standard of whether "justice so requires." Unless the other party can show surprise, disadvantage, or prejudice, the court will generally allow a pleading to be amended at any time before a decision is filed. To avoid such surprise or disadvantage, the court is more likely to allow a pleading to be amended early in the trial process than after a case has been tried. Kroh v. Commissioner, 98 T.C. 383 (1992); Kramer v. Commissioner, 89 T.C. 1081 (1987).

The taxpayers were allowed to raise the new issue in this case when the court allowed them to file the First Amendment. Since then, the Service and the taxpayers have had the opportunity to develop that issue through informal and formal discovery. In the course of that development, taxpayers have apparently found records of additional transactions (the L trades) not reported on their return and were reminded that some trades had been made, not by A, but by D and C.

We are not aware of how many transactions must be examined in connection with the L trades, the D trades, or the C trades, but we understand that these transactions are of the same nature as the other trades undertaken by A directly. In fact, they may have been considered as A's trades in computing the overpayment claimed in the First Amendment to the petition. Since no trial date has been set and the taxpayers have provided access to the trade documentation, we can see no reason for objecting to the Second Amendment to clarify the legal issues before the court.

Under the doctrine of res judicata, the pending Tax Court case is the taxpayers' last opportunity for raising these issues with respect to the Year 3 tax year. A judgment on the merits for a particular tax year bars any subsequent proceedings for the same tax year. Commissioner v. Sunnen, 333 U.S. 591 (1948). If a party does not raise a claim or a defense in the first suit, the party is deemed to waive the right to raise that claim in a later suit. United States v. Shanbaum, 10 F.3d 305 (5th Cir. 1994). The doctrine applies whenever a decision is entered on the merits of a case, regardless of whether the case is settled or tried. Baptiste v. Commissioner, 29 F.3d 1533, 1539 (11th Cir. 1994), quoting United States v. International Building Co., 345 U.S. 502 (1953). Thus, if the taxpayers did not raise a claim to carry forward the losses to Year 3 in this case before filing a stipulated decision in settlement of the charitable deduction issue, they could not raise the losses in a later proceeding.

The court can consider the taxpayers' losses from Year 1 through Year 2 even though those years are not before the court and even though the limitations periods for assessing tax or claiming refunds for those years have expired. In determining the taxpayers' Year 3 tax liability, including overpayments, the court clearly has jurisdiction to consider transactions in other years that affect the Year 3 taxes.

Section 6214(b) gives the Tax Court jurisdiction —

> to consider such facts with relation to other years and other quarters as may be necessary correctly to redetermine the amount of [the deficiency for the year before the court], but in so doing shall have no jurisdiction to determine whether or not the tax for any other year has been overpaid or underpaid.

Thus, for example, when a taxpayer claims the benefits of the carryforward or carryback of an NOL or an investment credit to the year before the court, the court may consider whether the taxpayer actually incurred a loss or was entitled to an investment credit in the claimed amount in an unopen tax year and may consider the proper allocation of the NOL in other tax years before determining how much of the loss or credit is available in the year before the court. Leitgen v. Commissioner, 82-2 U.S.T.C. (CCH) ¶ 9553 (8th Cir. 1982), aff'g T.C. Memo. 1981-525; Phoenix Coal Co. Inc. v. Commissioner, 231 F.2d 420 (2d Cir. 1956), aff'g. T.C. Memo. 1955-28; Hill v. Commissioner, 95 T.C. 437 (1990); Lone Manor Farms, Inc. v. Commissioner, 61 T.C. 436, 440 (1974), aff'd without published opinion 510 F.2d 970 (3d Cir. 1975); ABKCO Industries, Inc. v. Commissioner, 56 T.C. 1083 (1971), aff'd on other grounds, 482 F.2d 150 (3d. Cir. 1973).

The court cannot determine taxes for a tax year not before the court, but it can consider adjustments to the tax for the year not before the court in determining the tax for the year over which it does have jurisdiction. Thus, in Leitgen, the Eighth Circuit upheld the Tax Court in allowing the Service to challenge the validity and the

amount of a loss claimed on the taxpayers' 1972 return in the process of determining the tax liability for 1973, even though the statute of limitations had run for the 1972 tax year.

In this case, the Tax Court can consider the losses claimed by the taxpayers for their Year 1 through Year 2 tax years in determining how much of such losses were available to be carried forward to the Year 3 tax year. The taxpayers will have the burden of convincing the court:

1) that they incurred losses from trading activities during Year 1 through Year 2;

2) that the losses were ordinary losses or § 988 losses rather than capital losses as initially reported on the taxpayers' returns;

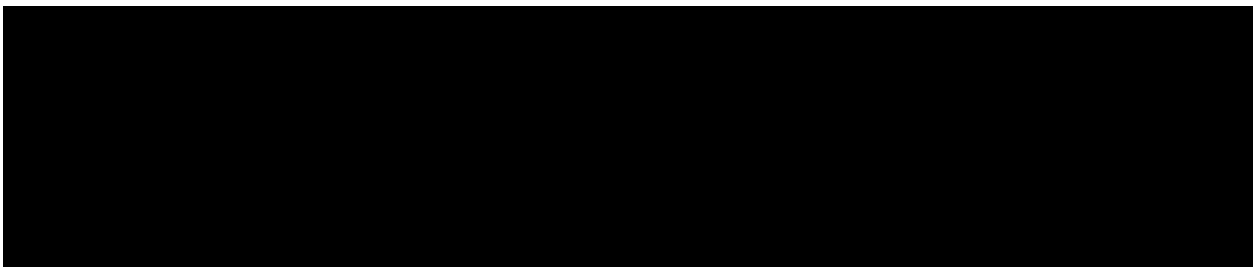
3) that they actually incurred losses in the amounts they now claim;

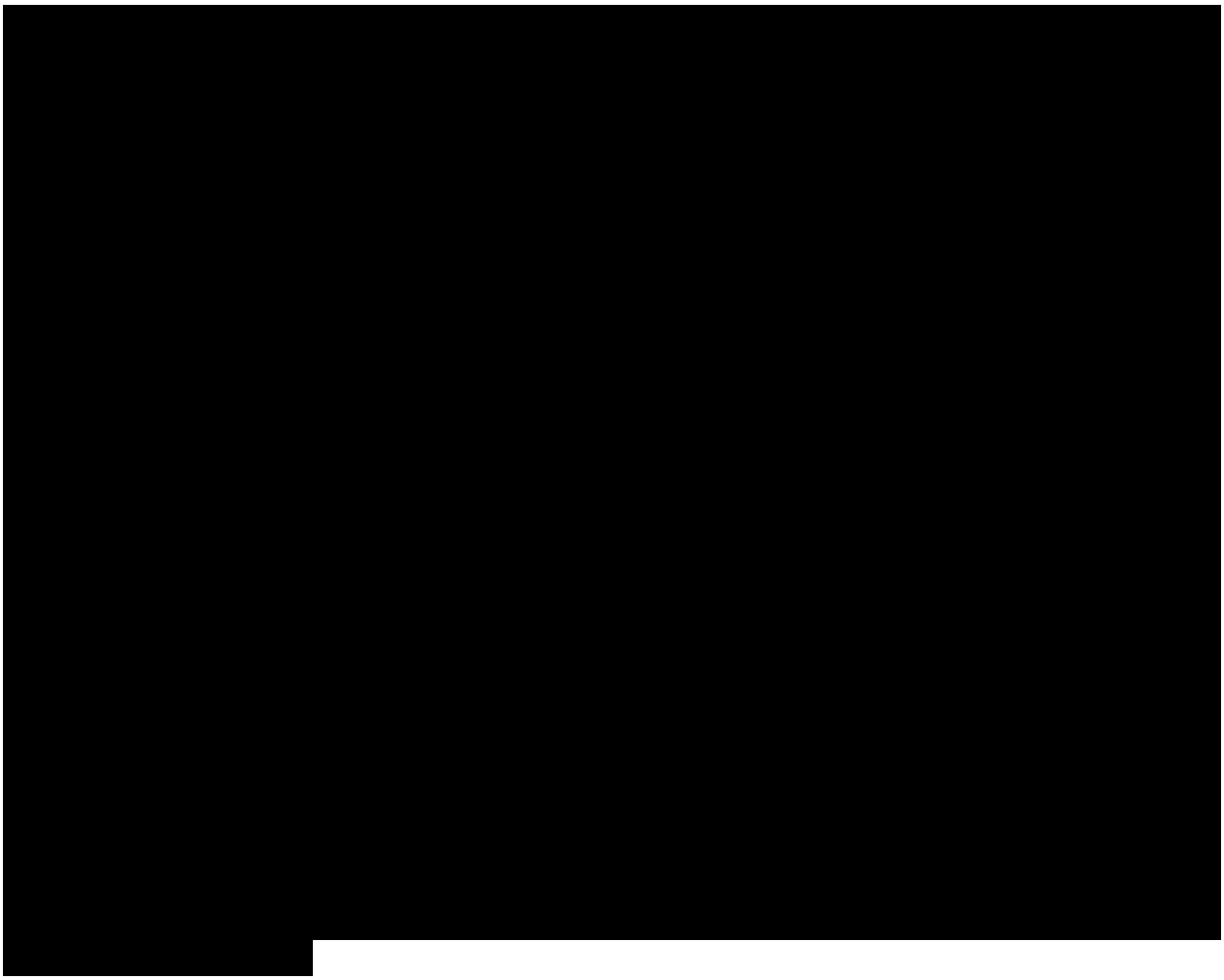
4) that the losses would not have been exhausted in determining the correct tax liabilities in the years in which they were incurred or in other years to which they could have first been carried back or carried forward, but for which refunds are now barred by the statutory limitations periods; and

5) that the claimed losses were available for use in determining the taxpayers' Year 3 tax liability.

Realistically, because the Tax Court allowed the taxpayers to file the Amended Petition over the Service's objection on Date 4, we see no reason to object to the filing of the Second Amendment to the petition. The characterization of the taxpayers' trading losses is now before the court. We anticipate, once the Second Amendment to the petition is filed, that the Service will file the appropriate motion on the issue of whether the Tax Court has jurisdiction to consider the taxpayers' claimed recharacterization of the losses incurred, and reported as capital losses, by D and C. In the interim, Counsel will need to address the amount and characterization of the losses incurred directly by A.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS





Please call if you have any further questions.

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