Court Decision Spurs Foreign Currency Option Treatment Debate

By William R. Davis — william.davis@taxanalysts.org

A recent Sixth Circuit opinion was the subject of a March 9 debate regarding whether the court was correct in looking past years of prior guidance to determine that over-the-counter foreign currency options are subject to mark-to-market under section 1256.

In January the Sixth Circuit said in *Wright v. Commissioner*, No. 15-1071 (6th Cir. 2016), that based on the plain language of section 1256(g)(2)(A)(i), OTC foreign currency options are within the definition of foreign currency contract for purposes of section 1256, representing a turnaround from what was considered to be prior law. (Prior coverage: *Tax Notes*, Jan. 11, 2016, p. 183.)

Jeffrey L. Dorfman of PwC said at the District of Columbia Bar Taxation Section's Financial Products Committee luncheon in Washington that he thought the Tax Court had previously gotten the right answer and that the Sixth Circuit got it wrong in its January decision.

Viva Hammer, Joint Committee on Taxation legislation counsel, said, "Clearly we are defeating the intent of Congress if we are treating a contract on foreign currency that is economically equivalent to a forward [contract] in a different way from the way we treat the forward." A forward contract is the economic equivalent of two options, a put and a call, on the same underlying at the same strike price and other conditions being identical. "It's way too easy to arbitrage the difference between the two if we allow that," she said.

> ***Professionals have been disagreeing on this issue for 30 years, Hammer said.***

If a contract is subject to section 1256, gain or loss is calculated at the end of the year and is treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. In 1981 section 1256 was enacted, and regulated futures contracts were subject to mark-to-market accounting. In 1982 the term "foreign currency contract" was added to section 1256 to reflect the economic equivalency between foreign-currency forward contracts and forward-currency future contracts on the same underlying currencies. In 1984 Congress adjusted the definition of foreign currency contract to allow for contracts settled in cash based on the value of a foreign currency.

David H. Shapiro of PwC said he is mainly interested in having a consistent answer on the issue, to which Dorfman replied, "I think there is an answer: The Tax Court got it right, and the Sixth Circuit got *Wright* wrong." Hammer said that professionals have been disagreeing on this issue for 30 years.

Relying on the Definition

The court in *Wright* addressed whether taxpayers could use section 1256 to realize losses in a "major-minor foreign currency option transaction." In the transaction, the taxpayer entered into four OTC foreign currency options. The taxpayer purchased a euro call option and a euro put option on mirror-image terms. The taxpayer also sold to the same counterparty a Danish krone call option and a krone put option on mirror-image terms. The premiums paid by the taxpayer and counterparty for the options offset each other. The krone and euro are closely tied, so their values will rise and fall together. The calls and puts will also offset each other. After there was movement in the markets, the taxpayer assigned the rights to the depreciated euro option and the appreciated krone option to a charity.

This transaction works only if OTC foreign currency options are subject to section 1256, which requires taxpayers holding specific financial instruments to recognize gain and loss on the contract using a mark-to-market method of accounting. Exchange-traded foreign currency options are subject to mark-to-market treatment under section 1256(b)(1)(C) and (g)(3). Non-section 1256 options are generally taxed upon exercise or lapse.

When the taxpayer assigned the rights in the euro and krone options, it asserted that the assignment triggers a termination event under section 1256(c)(1). The taxpayer took the position that the krone option is not subject to section 1256 because it is a "minor" currency. Therefore, the taxpayer recognizes the loss under section 1256(a) on the assignment of the euro option and defers the gain on the krone option until the contract expires.

Over the objection of the government, the court looked only to the language of section 1256(g)(2), which defines a foreign currency contract. According to the statute, "the term 'foreign currency contract' means a contract 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 regulated futures contracts."

The court held that foreign currency options are contracts "the settlement of which depends on the value of a foreign currency" and therefore are within the meaning of section 1256 contracts under section 1256(b). This conclusion is in direct contrast to prior Tax Court opinions and IRS guidance.

Ignoring Prior Guidance

There are several forms of IRS guidance concluding that OTC foreign currency options are not section 1256 contracts, which bothers those that think the Sixth Circuit is wrong.

Three Tax Court cases say OTC foreign currency options are not section 1256 contracts: *Summitt v. Commissioner*, 134 T.C. 248 (2010); *Garcia v. Commissioner*, T.C. Memo. 2011-85; and *Wright v. Commissioner,* T.C. Memo. 2011-292.

LTR 8818010 concluded that foreign currency swaps are not section 1256 contracts, and FSA 200025020 concluded that given the legislative history, foreign currency options are not subject to section 1256.

Notice 2007-71, 2007-2 C.B. 472, clarified that foreign currency options are not subject to section 1256. The 2007 notice was issued in response to some unclear guidance in Notice 2003-81, 2003-2 C.B. 1223, in which the IRS described major-minor transactions as listed transactions. The 2003 notice also included an incorrect statement in the facts section that foreign currency options are section 1256 contracts.

''In 2010 the world seemed to be in order, and everybody was on the same page — these are not section 1256 contracts,'' Shapiro said.

The court in its analysis stopped at a ''textualist'' plain reading of the statute. Hammer said that if Congress truly intended not to include foreign currency options, it could have made the language narrower. By using the term ''contract,'' however, the statute must be read to include more than just forward contracts, she said. ''The word 'contract' has a very clear meaning in English, and it doesn't mean 'forward,''' she said. ''It means something more than any one or two types of agreements; it means any agreement that is meant to be binding.''

The other panelists did not agree with Hammer's interpretation that the statute should be read to include options.

John Kaufmann of Greenberg Traurig LLP said the different opinions reflect the ambiguity of the statute, necessitating a reading into the legislative history.

For the 1984 addition to section 1256, the legislative history says: ''Because certain contracts may call for a cash settlement by reference to the value of the foreign currency rather than actual delivery of the currency, the bill provides that *the delivery of a foreign currency requirement is met* where the contract provides for a settlement determined by reference to the value of the foreign currency'' (emphasis added).

Shapiro argued that the legislative history shows that delivery is a requirement under section 1256(g)(2), and therefore it doesn't cover options. He explained that the rationale behind not subjecting OTC options to mark-to-market was that in 1982 the pricing mechanisms were not available to administer a rule like that.

> ***'You don't see any language saying that they are expanding the definition to include options,' Dorfman said.***

On the 1984 addition, Dorfman said, ''The legislative history is really clear why [Congress] put it in. It is direct, and it is sparse.'' In the way Congress viewed the addition, the delivery requirement never changed, and it was not amended or withdrawn; a substitute for delivery is that it is cash settled, he said, adding, ''You don't see any language saying that they are expanding the definition to include options.''

Dorfman argued that the Sixth Circuit's opinion therefore was results oriented. The court ''never wanted to get past the language [of the statute] because the minute they did, they ran into the legislative history, which is absolutely clear,'' he said.

Hammer questioned the motive of the court's decision but suggested that it could have been results oriented because it wanted the IRS to be held to the statute and write regulations settling the issue. ''That's the result that I assume they wanted — not that they wanted the taxpayer to prevail, but they wanted the IRS to do their homework,'' she said. ■