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With IRS, Courts at Odds Over Foreign Currency Options, Taxpayers Win

Conflicting court decisions and IRS notices in the past 15 years about whether over-the-counter foreign currency options and swaps are foreign currency contracts under the mark-to-market provisions of the tax code give taxpayers the latitude to take the position that best suits them.

The government has been ''bouncing back and forth'' about whether foreign currency options are contracts under tax code Section 1256, which can be attributed to differing views in interpreting the meaning of the statute that defines the options as contracts that require either delivery or a cash settlement, David Shapiro, a principal at PricewaterhouseCoopers LLP, said March 9.

Wright v. Commissioner, a case decided Jan. 7 in the U.S. Court of Appeals for the Sixth Circuit, overruled a U.S. Tax Court decision and said the options do qualify as Section 1256 contracts. The Tax Court has ruled in three cases that the options don't qualify. The Internal Revenue Service said in Notice 2003-81 that the options are contracts, but the position was reversed in Notice 2007-71 (05 DTR K-3, 1/8/16).

Limitless Options. This decision matters greatly to a narrow swath of corporations that aren't subject to the mark-to-market accounting election under Section 475, and for individuals or organizations that pass character and timing attributes on to individuals, Viva Hammer, legislation counsel for the Joint Committee on Taxation, said at a District of Columbia Bar Association event. They now have ''every option under the sun to choose their outcome with plenty to rely on,'' she said.

The Sixth Circuit cut the legislative history ''off at the knees'' and only looked at the statute with little regard for additional context, said John Kaufmann, of counsel at Greenberg Traurig, LLP.

''What does this say about the next time this comes up?'' Shapiro said. ''The words say what the words say, but we know that's not what they mean. Can we point to *Wright* for that? You could write almost anything you want in the legislative history, because it doesn't matter.''

The *Wright* decision was a results-oriented outcome, because the Sixth Circuit was worried about the penalties, said Jeffrey Dorfman, a managing director at PwC. Dorfman said the court couldn't have looked beyond the statute to the legislative history, because the congressional intent is clear.

Federal Homework. ''You could say it was results-oriented because they wanted the IRS to be held to the statute and they should've written regulations if they didn't like the statute. They wanted the IRS to do their homework,'' Hammer said, adding she doesn't believe the government wanted the taxpayer to prevail in a case involving at ''major-minor'' tax shelter.

The *Wright* and Tax Court cases have all centered around a similar tax shelter structure intended to engineer tax losses through offsetting option transactions involving a ''major'' currency—the euro—and a ''minor'' currency closely tied to the euro—the Danish krone.

The IRS and the Treasury Department have had discussions in the past about the need to issue regulations to state the government's position to provide clarity and to save money on litigating these cases, Hammer said. The project was drafted, but never went through, she said.

''Taxpayers have the best of both possible worlds right now,'' Hammer said. ''Taxpayers can do whatever they please and rely on all kinds of arguments. It behooves the government, of which I am a member, to do something about it. It's not good for taxpayers to be able to choose the outcome, when economically you can achieve the same thing with options as you can with forwards.''

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