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News Analysis: Garbled Reasoning in Garcia

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Summary by taxanalysts

A pair of recent Tax Court cases that reach the right result through weak legal reasoning suggest that the time is ripe for the IRS to formulate regulations that provide a cohesive framework for dealing with economically similar financial products.

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Over-the-counter foreign currency options and swaps have long been excluded from mark-to-market treatment on the basis of legislative history. A pair of recent Tax Court cases that reach the right result through weak legal reasoning suggest that the time is ripe for the IRS to formulate regulations that provide a cohesive framework for dealing with economically similar financial products.

In *Garcia*, the Tax Court reached an unsurprising result in holding that the taxpayer could not get mark-to-market treatment on a long position in a transaction involving offsetting positions in OTC foreign currency options. However, the logic that the court followed in reaching its conclusion points to a broader problem in taxing financial products: Legislative history has become an integral part of the statutory interpretation in this area. (For *Garcia v. Commissioner*, T.C. Memo. 2011-85 (Apr. 13, 2011), see *Doc 2011-7986* or *2011 TNT 72-11*.)

The Tax Court first embraced the IRS's argument that a foreign currency option cannot be a foreign currency contract in *Summitt*, which involved a tax shelter substantially similar to the one in *Garcia*. (For prior coverage, see *Doc 2010-11302* or *2010 TNT 98-4*. For *Summitt v. Commissioner*, 134 T.C. No. 12 (May 20, 2010), see *Doc 2010-11286*.)

Although the foreign currency option was premised on a plain reading of section 1256, the *Summitt* court resorted to legislative history to reach its conclusion. In effect, the court declined to do violence to what it deemed to be Congress's purpose by reading the statutory language the legislature enacted.

Section 1256(g)(2) requires a contract to have three features to be a foreign currency contract subject to mark-to-market treatment. First, the contract must require delivery of a foreign currency in which positions are traded through regulated futures contracts, or the contract's settlement must depend upon the value of such a currency. Second, the contract must be traded in the interbank market. Third, it must be entered into at arm's length at a price determined by reference to the price in the interbank market. This definition does not literally exclude foreign currency options or swaps.

According to Mark Leeds of Greenberg Traurig LLP, "The court's reading of the statute is strained and, for foreign currency transactions that are not tax-motivated, it would have been much more preferable if the court had come out the other way and held that [foreign exchange] options are within the ambit of code section 1256(g)(2)."

The *Summitt* opinion accepted that "as originally enacted in 1982 . . . [the statute] applied only to forward contracts." Indeed, the legislative history referred specifically only to "bank forward contracts" in its discussion of foreign currency contracts. The court in *Garcia* followed *Summitt*. (See H.R. Rep. No. 97-794, 97th Cong., 2d Sess., 23 (1982).)

"I think the IRS is fairly interpreting and administering the will of Congress," said David Shapiro of PricewaterhouseCoopers LLP. "The Tax Court decisions in *Summitt* and *Garcia* are simply confirming this."

The outcomes in the cases were clearly correct. The Tax Court was presented with an abusive shelter and shut it down. But the path it took to get there is troubling.

Leeds suggested that the court could have reached the same conclusion under a theory of lack of business purpose or lack of profit motive, but he said that "no one has a business reason for a charitable deduction," so this argument could have been more difficult for the IRS to make.

"My guess is that the court did not desire to discuss this avenue of foreclosing the strategy because to mix up business purpose/profit motive with a charitable donation could put a chill on donations of appreciated securities, hurting charities," he said. "So it found a path to the right answer that is inconsistent with a better reading of 1256."

The conclusion the court reached does provide certainty regarding whether foreign currency options and swaps are subject to section 1256 treatment, and certainty is generally desirable in tax law. It is also possible that the technical solution (as opposed to, say, an economic substance argument) was consistent with congressional intent. Perhaps Congress did intend to have section 1256 apply only to the types of exchange-traded forwards that it knew about in 1982, when the definition of "foreign currency contract" was enacted.

Still, the decision makes for thoroughly unsatisfying jurisprudence. Reliance on legislative history puts courts and administrators on shaky ground, especially when, as in the Dodd-Frank Act's recent addition to section 1256, the legislative history amounts to one sentence. (For prior news analysis, see *Doc 2010-17962* or *2010 TNT 157-4*.)

Compounding the interpretive problem, the Tax Court's decisions highlight the different tax treatments accorded economically similar financial products. Viva Hammer of KPMG LLP's Washington National Tax practice said *Garcia* is an example of the IRS drawing a line in the sand to eliminate a particular tax shelter. "But when you draw that line, you should not be creating the maximum amount of arbitrage opportunities," she said.

Regarding different tax treatment for similar financial instruments, Leeds said: "The code presents this problem in myriad situations today. It is inherent in the nature of our tax system. We have different buckets, and once a position falls into that bucket, it will be taxed in a certain way."

Hammer said that as a policy matter, "there is no reason not to read section 1256(g)(2) as broadly as possible." Because the character of OTC foreign currency derivatives is determined under section 988, 60/40 treatment does not apply to those derivatives. ("60/40" refers to the code's treatment of marked-to-market financial products as 60 percent long-term capital gains and 40 percent short-term.) "The IRS's narrow reading of section 1256(g)(2), applying the section to forwards but not to options or swaps, means taxpayers can combine their foreign currency derivatives to produce the tax result they want," she said.

Narrow Reading of Section 1256(g)(2)

For almost two decades the IRS has generally read section 1256(g)(2) narrowly to exclude foreign currency swaps and options. The lone exception came in 2003, when the IRS released Notice 2003-81, which stated in the factual recitation that the taxpayer's foreign currency options were foreign currency contracts. Practitioners were caught off guard, having relied on the legislative history to find substantial authority for the position that OTC foreign currency options or swaps were not foreign currency contracts under section 1256(g)(2). (For Notice 2003-81, 2003-2 C.B. 1223, see *Doc 2003-25811* or *2003 TNT 234-4*. For prior commentary, see *Doc 2003-26876* or *2003 TNT 246-33*.)

Four years later, in Notice 2007-71, the IRS revised its position by amending Notice 2003-81 to frame as an assertion of the taxpayer that the foreign currency option is a foreign currency contract. Ever since, the IRS has consistently taken the position that options and swaps are not foreign currency contracts. (For Notice 2007-71, 2007-35 IRB 472, see *Doc 2007-18700* or *2007 TNT 156-2*.)

The Argument for a More Inclusive Reading

There is a counterpoint to the IRS's argument that section 1256(g)(2) does not, on its face, apply only to forward contracts and that there is no need to look to legislative history to shut out other types of instruments.

Hammer explained that "Congress had significant foresight in drafting section 1256(g)(2) relatively comprehensively. The IRS and the courts have chosen to read it only to apply to the instruments that Congress had before it at that moment."

By adopting a narrow approach to interpreting section 1256, the IRS has created unnecessary inefficiencies because derivatives with similar economics receive differing tax treatment. There is no policy reason for this construction, said Hammer. "Section 1256(g)(2) is clear. When looking at a well-drafted law, there is no need to examine Congress's understanding of the embryonic derivatives markets when the law was enacted," she said.

This sort of rationale puzzles other practitioners. "Section 1256 is a political creation that was all about creating different tax treatment for transactions with similar economics; one need only compare a corn or Treasury futures contract to a forward contract on the same asset," Shapiro said.

"A policy that tries to tax transactions as section 1256 contracts simply because they are economically similar to section 1256 contracts proves too much," he said. "It would extend 1256 treatment where it was not designed or intended to go. The IRS and the courts are simply calling balls and strikes; they're enforcing and applying the rules as written. That's exactly what they're supposed to do."

The IRS has tools at its disposal to take down shelters like those at issue in *Summitt* and *Garcia*. With the codification of economic substance, the advent of Schedule UTP, and listed transaction disclosure requirements, the IRS has an expanded arsenal targeting abuses, so the Service's technical argument under section 1256(g)(2) was probably not necessary.

What to Do Next

"The government needs to look to long-term policy goals. It is a mystery why you would interpret 1256(g)(2) contracts narrowly, if there is no concern about 60/40 character issues," Hammer said.

But Shapiro believes he's solved Hammer's mystery. "First, if the courts had held that OTC currency options are 1256 contracts, they would be creating a new class of instrument that would be entitled, with proper elections, to 60/40 treatment," he said. "If I were in government, I would not be in a rush to extend this sort of opportunity to taxpayers. My suspicion is that if it were a legislative change, it would lose revenue in the economists' scoring room."

"Second, a broad interpretation of one category of 1256 contracts might lead to a broad interpretation of other categories, with a similar revenue effect," Shapiro continued. "Last, in my experience the real users of OTC currency options are using them to hedge ordinary business transactions. There's no doubt they want ordinary treatment in respect of these transactions, and there's no doubt they can get it. The real question is how much attention they need to pay upfront to ensure that hedge timing principles apply, and not a mark-to-market regime that bears no relation to the risk that's being hedged."

Shapiro explained that "a default mark-to-market timing regime is not always great tax policy, especially when it doesn't clearly reflect income."

The IRS seems to know that its current position on section 1256 contributes to tax arbitrage and creates certainty only at the expense of legal purity, but the agency is apparently unable to fix the problem because of disagreement about its ultimate policy goal. (For prior coverage, see *Doc 2010-20934* or *2010 TNT 186-2*.)

Comprehensive regulations under section 1256 would focus the development of tax law in the financial products area and put the legal analysis in this area on surer footing. This approach would eliminate the specter of another decades-long debate over basic questions of the statute's applicability.

A serious attempt to draft regulations would also have the happy consequence of requiring the government to establish a policy framework that is less dependent on the whims of legislative history writers.

Alan Fu of Prudential Financial Inc., speaking on his own behalf, said that he "would like to see more coherent guidance dealing with timing and character issues of all financial products." He noted that the current rules "lag behind financial product innovations and still leave significant uncertainty for taxpayers and the government."

Drafting guidance will not be easy. The IRS will need to address complicated policy questions if it is to undertake comprehensive regulations on financial products.

For example, Michael Farber of Davis Polk & Wardwell LLP suggested that section 1256 is an inappropriate regime to deal with instruments that involve periodic payments or significant upfront payments. He explained that if such instruments were to be included within the ambit of section 1256, "in the case of periodic payments, there would need to be rules matching out marked-to-market tax items with the future periodic payments to which they economically relate, and allowing recapture. In the case of significant upfront payments, mark-to-market of these 'prepaid' instruments will tend to treat the implicit time value component of returns as capital gain."

Despite, or perhaps because of, the obstacles, the IRS should begin to chart out a path toward publishing regulations under section 1256.

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