Section 1256 and Foreign Currency Derivatives

Viva Hammer[1]

Mark-to-market taxation was considered "a fundamental departure from the concept of income realization in the U.S. tax law"[2] when it was introduced in 1981. Congress was only game to propose the concept because of rampant "straddle" shelters that were undermining the U.S. tax system and commodities derivatives markets. Early in tax history, the Supreme Court articulated the realization principle as a Constitutional limitation on Congress' taxing power. But in 1981, lawmakers makers felt confident imposing mark-to-market on exchange traded futures contracts because of the exchanges' system of variation margin. However, when in 1982 non-exchange foreign currency traders asked to come within the ambit of mark-to-market taxation, Congress acceded to their demands even though this market had no equivalent to variation margin. This opportunistic rather than policy-driven history has spawned a great debate amongst tax practitioners as to the scope of the mark-to-market rule governing foreign currency contracts. Several recent cases have added fuel to the debate.

The Straddle Shelters of the 1970s

Straddle shelters were developed to exploit several structural flaws in the U.S. tax system: (1) the vast gulf between ordinary income tax rate (maximum 70%) and long term capital gain rate (28%), (2) the arbitrary distinction between capital gain and ordinary income, making it relatively easy to convert one to the other, and (3) the non-economic tax treatment of derivative contracts. Straddle shelters were so pervasive that in 1978 it was estimated that more than 75% of the open interest in silver futures were entered into to accommodate tax straddles and demand for U.S. Treasury Bills severely impacted the U.S. Treasury's ability to manage America's debt.[3]

[1] vhammer@brandeis.edu

[2] Commodity Tax Straddles: Hearing before the Subcomm. on Taxation and Debt Mgmt. and the Subcomm. on Energy and Agric. Taxation of the S. Comm. on Fin., 97th Cong. 67 (1981) (oral statement of Panel of Robert K. Wilmouth, President, The Chicago Board of Trade, Chicago, Ill.).

[3] Commodity "Tax Straddles": Hearing before the H. Comm. on Ways & Means, 97th Cong. 59 (1981) (Statement of Hon. Benjamin S. Rosenthal (N.Y.)).

Straddle shelters came in several forms[4]:

Commodity Straddles

Commodity (such as silver) straddles were used to defer capital gains and convert short-term capital gains into long-term capital gains.

In a typical commodity straddle, a taxpayer entered into two futures contracts on a commodity with very similar characteristics except that one was a contract to buy the commodity and one was a contract to sell the commodity, and the contracts had different delivery months. In time, one of the contracts decreased and the other increased in value, in virtually equal amounts. The taxpayer sold the futures contract that was in a loss position and entered into an identical futures contract but with a different delivery date. The taxpayer deducted the loss on the contract sold in the year it was sold. The next year, the taxpayer sold both futures contracts.

The combination of transactions resulted in a short-term capital loss (used to offset against short term capital gain) in the first year and a long term capital gain (taxed at low rates) in the second year.

Treasury Bill Straddles

In a Treasury bill straddle, a taxpayer entered into long and short futures contracts on Treasury bills with delivery months at the end of the taxable year. The futures contracts were characterized as capital assets, but the Treasury bills were ordinary property. At the end of the year, the taxpayer closed the futures contract that was in a loss position by taking or making delivery of the Treasury bills rather than closing out the derivative, and took an ordinary loss from a disposition of the Treasury bills. Then the taxpayer replaced the futures contract with an identical one that had a later delivery date. The following year, the taxpayer recognized long term capital gain on the futures contract that has been held for the long term holding period.

Treasury bill straddles were used to shelter ordinary income.

Mark-to-Market Taxation

[4] The examples are based on the written testimony of Representative Brodhead found at Commodity "Tax Straddles": Hearing before the H. Comm. on Ways & Means, 97th Cong. 7 (1981) (Statement of Hon. William M. Brodhead (Mich.)).

The idea of mark-to-market taxation was introduced in the Congressional debates of 1981. It was offered as an alternative to the principal solution to the straddle abuses, the "balanced position" rule, which to denied a taxpayer a loss on a transaction to the extent that there was an unrealized gain in an offsetting position. Offsetting positions were defined as positions in which there was a substantial diminution of risk of loss from holding one position as result of holding another. John Chapoton, Assistant Secretary for Tax Policy at the U.S. Treasury Department, said that the balanced position rule could not apply for taxpayers with a significant volume of commodities transactions because it required "the identification of particular positions, [and would be] cumbersome to apply. There is also the risk that such a rule could be avoided by these market participants."[5] Instead, Treasury proposed that a "special rule" would apply for these persons.

> In lieu of the balanced position rule, we propose that these persons be subject to a mandatory mark to market rule for their positions in futures contracts traded on an organized futures exchange. Because futures positions are marked to market on a daily basis under the normal operating rules of the exchange, with actual cash settlements on a daily basis, this rule does no more than make the tax laws reflective of the underlying market transactions.[6]

Treasury proposed to tax mark-to-market gains and losses as ordinary in character. This had the advantage of making the losses offsetable against other income of a taxpayer, and also allowed taxpayers to carry losses back to other years, allowing "income smoothing." But it had the disadvantage of the very high tax rates at which ordinary income was taxed as compared to long term capital gain.

Taxpayers targeted by the mark-to-market rule objected strongly. A few examples of the disadvantages were listed by Donald Schapiro, representing the New York State Bar Association Tax Section: (1) there would be no benefit of step up in basis on death; (2) the taxpayer could not make gifts in a tax-advantaged fashion; and (3) taxpayers could not skip the tax in a corporate liquidation.[7]

Schapiro, and the New York State Bar, thought that only if the gain and loss resulting from the mark were taxed at long term capital rates would taxpayers acquiesce to the new system. They argued that gains and losses were a "zero sum" in the public

---

[5] Commodity "Tax Straddles": Hearing before the H. Comm. on Ways & Means, 97th Cong. 71 (1981) (statement of John E. Chapoton, Assistant Sec'y for Tax Policy).
[6] Id. at 63.
[7] Commodity Tax Straddles: Hearing before the Subcomm. on Taxation and Debt Mgmt. and the Subcomm. on Energy and Agric. Taxation of the S. Comm. on Fin., 97th Cong. 116 (1981) (statement of Donald Schapiro, Tax Section, N.Y. State Bar Association).

futures markets - when one taxpayer made money, her counterparty lost an equal and opposite amount – and so the U.S. Treasury should be indifferent to character. It was expected that taxpayers, eternally optimistic and sure of their gains in their derivatives trades, would consider long term capital character a great attraction and would cooperate with mark-to-market if coupled with a long term capital rate.

Michael L. Maduff, of Maduff & Sons Inc., a commodities brokerage firm in Chicago, testified before the Committee on Finance of the U.S. Senate on the proposed straddle rules. He protested vociferously against mark-to-market, dubbing it a "very bad scheme" and a "radical departure from our system of taxation."[8] But he did confess that "if the committee or the Congress were to pass a bill which incorporated mark-to-market at a very favorable tax rate, I would be delighted to conduct my business under such a bill, under such a law…"[9], but maintained "that would not make it right."

Congress and Treasury were aware that taxing futures contracts under a mark-to-market system was indeed a "radical departure" from the U.S. system of taxation. In order to survive constitutional challenge, it would have to be viewed as consistent with the realization principle of income taxation, as articulated by the U.S. Supreme Court in Eisner v. Macomber.[10] The Court there stated that income was "… a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in,* being "derived," that is, *received* or *drawn* by the recipient (the taxpayer) for his separate use, benefit and disposal…".[11] Further, in Comm'r v. Glenshaw Glass Co.,[12] the Supreme Court defined income as "... undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[13]

Operation of Commodities Futures Exchanges

Anticipating a Constitutional challenge to mark-to-market taxation, Congressional committees conducted substantial research on the operation of the commodities exchanges to justify the imposition of this novel form of tax accounting.

The report of the Joint Committee on Taxation (JCT) published in anticipation of the Hearing on straddles organized by the Senate Committee on Finance[14] describes the

[8] Id. at 202 (statement of Michael L. Maduff, Maduff & Sons, Inc.).
[9] Id.
[10] 252 U.S. 189 (1920)
[11] Id. at 207 (emphasis in original).
[12] 348 U.S. 426 (1955).
[13] Id. at 431.
[14] "Background on Commodity Tax Straddles and Explanation of S.626," Joint Committee on Finance, June 12, 1981.

commodities futures markets. The report defines a commodities futures contract as a "standardized agreement either to buy or to sell a fixed quantity of a commodity to be delivered at a particular location in a specified month in the future."[15] The JCT describes several distinguishing features of an exchange traded contract – as compared to an over the counter contract: (1) all trading in futures contracts must be transacted through an exchange by exchange members; (2) a clearing association guarantees performance on all contracts traded through an exchange by interposing itself as counterparty to every contract after the trade is made; (3) all futures contracts are standardized as to size, location of delivery, dates of delivery.[16]

The JCT describes a unique feature of the futures markets: the use of margin deposits. In order for a clearing association to be able to guarantee all contracts, it must minimize risk in any of the open positions. It accomplishes this by demanding a deposit upfront for every contract entered into.[17] In turn, the clearing association requirements are cascaded down to apply to the ultimate customers/taxpayers. The initial deposit is usually a percentage of the value of the contract, depending on the riskiness of the contract and other positions held by the exchange member. The most important aspect of the margining system is that the amount of margin changes daily. If the value of a taxpayer's position declines (because the market has moved against her), the taxpayer must make an additional deposit; if the value of the taxpayer's position increases (because the market has moved in her favor), the taxpayer is entitled to withdraw money from her account. The daily margin adjustments are called "marking to market."[18]

Congress and Treasury reasoned that tax could imitate the system by which the futures exchanges conducted business – the mark-to-market margining system. And since there was true cash movement, the Constitutional requirement of "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion"[19] would be met. And so in 1981, exchange-traded commodities futures contracts began to be taxed under a mark-to-market accounting system with a 60% long term and 40% short term rate on gains and losses under section 1256 of the Internal Revenue Code.[20] Although initially opposed to marking to market their positions, with

---

[15] Id. at 3.
[16] Id.
[17] Here and elsewhere, the presentation is reflects the 1981 Congressional Hearings. However, a key point is that the variation margin deposit with the clearing corporation is mirrored between the Futures Commission Merchant and the customer. The Constitutional analysis depends on the treatment at the customer level.
[18] Id. at 7-8.
[19] Comm'r v. Glenshaw Glass Co. at 431.
[20] Unless otherwise indicated all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

the long-term character advantage (which was particularly marked for individual taxpayers facing an upper marginal rate of 70%), the industry accepted the compromise.

One of the private sector concerns was that if Congress forced the exchange members to mark-to-market and off-exchange traders had no such requirement, off-exchange contracts would have an unfair pricing advantage.[21] The New York State Bar, speaking through Donald Schapiro, thought "executory contracts, other than regulated futures contracts, that is puts, calls, forward contracts, and futures transactions on foreign exchanges should not be taxed on a mark to market basis, because they don't involve daily transfers of cash. They are not a sum zero system."[22]

They missed the mark. At the time, the 60/40 rate advantage was so attractive that as soon as mark-to-market was imposed on futures contracts, those trading in off-exchange derivatives requested mark-to-market for their contracts too.[23] In response to the lobbying, Congress enacted mark-to-market for "foreign currency contracts" in 1982. The legislative history explicitly recognizes that there is no equivalent to the margining mechanism in the over-the-counter market, but Congress was not troubled by that. The policy Congress favored in that year appears to have been efficiency – to tax foreign currency contracts off exchanges equivalent to those on exchanges.[24] Congress provided for mark-to-market for foreign currency contracts as follows:

> Section 1256(g)(2) FOREIGN CURRENCY CONTRACT DEFINED. – The term "foreign currency contract" means a contract--
>
> - 1256(g)(2)(A)(i) which requires the 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,
> - 1256(g)(2)(A)(ii) which is traded on the inter-bank market, and
> - 1256(g)(2)(A)(iii) which is entered into at arm's length at a price determined by reference to the price in the inter-bank market.

The law clearly covers "foreign currency contracts," but confusion has arisen over the explanation in the legislative history which discusses only "Bank Forward Contracts." It is unclear why the law and history use different terminology. Some tax advisers believe "foreign currency contracts" means only currency forwards, following the

---

[21] Commodity Tax Straddles: Hearing before the Subcomm. on Taxation and Debt Mgmt. and the Subcomm. on Energy and Agric. Taxation of the S. Comm. on Fin., 97th Cong. 90 (1981) (statement of Lee H. Berendt, President, Commodity Exchange, Inc.).

[22] Id. at 111-12 (statement of Donald Schapiro, Tax Section, N.Y. State Bar Association).

[23] See, Letter from Frank V. Battle, Jr. to Thomas Gallagher, Department of the Treasury (12-8-1981), Tax Notes Documents No. 81-12076 and Letter from Donald C. Lubick to Robert Woodward, Department of the Treasury (7-12-1982), Tax Notes Documents No. 82-7832.

[24] S. Rep. No. 97-592 at 4172.

legislative history. But those who put primacy on the language of the law, which appears to be clear, consider "foreign currency contracts" to include swaps, options and related derivatives as well.

Subsequently, the enactment of foreign currency rules under section 988 of the Code in 1986[25] presented another wrinkle in the taxation of foreign currency contracts. Under the default rule of section 988(a)(1), foreign currency gain or loss is treated as ordinary in nature. In a rare tax irony, those who bowed to mark-to-mark in order to get a rate advantage in section 1256, are now saddled with annual marking coupled with ordinary income tax rates.[26] As commentators have noted, the application of a mark-to-market method for derivative contracts can lead to material distortions in taxable income on a year-by-year basis inconsistent with the economics of the transactions.[27]

Despite the importance of providing certainty to taxpayers with respect to this issue, no published guidance was offered by the Government on the interpretation of section 1256(g)(2) for more than 20 years. However, taxpayers seized upon two private pieces of guidance as giving comfort to those who rely on the legislative history as being the correct interpretation of "foreign currency contract."

1. <u>Private Letter Ruling 8818010 – (February 4, 1988)</u>

PLR 8818010 involved a corporate taxpayer requesting a ruling on whether certain currency swap agreements were foreign currency contracts within the meaning of section 1256(g)(2). The contracts were in a currency in which positions were traded through regulated futures contracts. As a result, they fulfilled section 1256(g)(2)(i), however the PLR held that the swaps were not foreign currency contracts because they failed to meet the requirements of sections 1256(g)(2)(ii) and (iii).

The reasoning of the Internal Revenue Service ("Service") is worth examining in its entirety:

> "A review of the legislative history underlying section 1256(g)(2)(A) indicates that Congress intended to include within the definition of foreign currency contract bank forward contracts in currencies traded through

[25] <u>See</u> P.L. 99-514, Section 1261(a) (adding section 988 and other related provisions to the Code).
[26] Exchange traded foreign currency contracts come within the normal character rule of section 1256 unless the taxpayer makes an election otherwise. <u>See</u> section 988(c)(1)(D).
[27] <u>See, e.g.</u>, <u>Comments of Alan Fu of Prudential Financial Inc.</u> (Apr. 23, 2010), Doc 2010-9908, 2010 TNT 86-22 (Noting several objections to the potential application of the mark-to-market method of section 1256 to swap contracts as a result of Dodd-Frank including (i) "a mismatch in recognizing taxable gain/loss on . . . derivatives and the economic reality" and (ii) difficulties in "forecasting taxable income, which in turn hinders rational business decision-making that depends on such forecasts.").

> regulated futures contracts because they are economically comparable and used interchangeably with regulated futures contracts."

The Ruling goes on to say:

> "Currency swap contracts are significantly different than bank forward contracts in the way the interest rate differentials in the currencies which are the subject of the contracts are accounted for. Currency swaps typically account for interest rate differentials through a present and continuing exchange of notional interest payments over the life of the contracts while bank forward contracts account for such difference upon maturity. Given this significant difference between bank forward contracts and currency swap contracts and the failure by Congress in the legislative history of the Technical Corrections Act of 1982 and the Tax Reform Act of 1986 (the 1986 Act) to indicate its intention to include currency swaps within the definition of a foreign currency contract, we conclude that the currency swap agreements fail to satisfy the requirements of section 1256(g)92)(A)(ii) and (iii). Accordingly we hold that the currency swap agreements are not section 1256 contracts."

As an initial matter, it is important to recognize that this private letter ruling (like all PLR's) is directed only to the taxpayer who requested it, and that section 6110(j)(3) provides that it may not be used or cited as precedent. Despite the fact that a PLR represents one of the lowest levels of authority for taxpayers, this PLR was widely adopted by taxpayers to establish the position that swaps are not section 1256 contracts.

Furthermore, it is unclear that the legislative history cited by the ruling necessarily results in the conclusions presented. For example, the ruling states that foreign currency swaps and forwards are significantly different because of the different ways in which they account for interest rate differentials. The ruling indicates that swaps account for these differences over the life of the loan while forwards account for these differences at maturity. While accurate, it is also true that sophisticated counterparties take this difference into account when structuring their transactions and price their contracts accordingly. Contrary to the reasoning of the PLR, the difference in payment of interest differentials between the two types of contracts is not fatal. As explicitly stated in the legislative history, significant differences existed between futures and forwards. The absence of an exchange regulated daily mark-to-market margin requirement and a central clearing house being the most significant ones enumerated. Despite these differences, which are far more significant than timing differences with respect to the

payment of exchange rate differentials, bank forwards were deemed similar enough to futures contracts to be considered section 1256 contracts.

As discussed previously, the reason Congress set aside these differences was the economic interchangeability of futures and forwards. It was recognized that the forward market was significantly larger and more liquid than the futures market. Congress wanted to equalize the tax treatment of these contracts to prevent tax motivated market distortions.[28] The same realism and flexibility that drove the inclusion of forwards into section 1256 supports the conclusion that swaps and other contracts used for the same purpose should be covered by section 1256 as well.

2. <u>Field Service Advice 200025020 – (June 23, 2000)</u>

Non-regulated foreign currency option contracts are not foreign currency contracts as defined by section 1256(g)(2).

The FSA purports to rest its conclusion on its view of the legislative history of the statute:

> "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 Sec. 1256 to include foreign currency contracts, indicates that the Congress intended to extend Sec 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. 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 Sec. 1256(g)(2)(A)."

The FSA goes on to elaborate on the potential inclusion of foreign currency option contracts within section 1256(g)(2)(A):

> "Sections 1256(b)(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)93) 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. (FN left out). The legislative

[28] S.R. 97-592 at 4172.

> 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 Sec. 1256(g)(2)(A).
>
> The legislative history to section 722(a)(2) of the TRA, however, which amended Sec. 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 Sec.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 Sec. 1256(g)(2)."

While acknowledging that foreign currency options could technically fit the section 1256(g)(2) definition, the FSA declines to do so. Its primary reasons can be summed up as follows: 1) foreign currency options are not specifically mentioned in the legislative history, therefore we must conclude they were not meant to be included and, 2) including foreign currency options as foreign currency contracts effectively overrides the limitations of sections 1256(b)(3) and (b)(4).

This reasoning puts the FSA's authors in the awkward position of interpreting what was *not* said in the legislative history rather than looking to the language expressly laid out in the Code. This language of section 1256(g)(2)(B) bears repeating here: "The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of subparagraph (A), including regulations excluding from the application of subparagraph (A) any contract (or type of contract) if its application thereto would be inconsistent with such purposes." Thus, if certain foreign currency contracts are to be excluded section 1256 foreign currency contracts, they are to be explicitly identified in regulations. To date no regulations a have been issued, therefore, there are no statutory exclusions from the definition of section 1256 foreign currency contract. Exclusions from the definition of "foreign currency contract" that have been imputed by Service guidance have been misguided.

In addition, with respect to the assertion that including options from section 1256 foreign currency contracts "effectively overrides the limitations of sections 1256(b)(3) and (4)", this assertion does not take into account the historical context in when these sections were added, namely to equalize the treatment of commodity traders and options

market makers. The addition of non-equity options and dealer equity options were a product of industry lobbying and had no relation to foreign currency options.

Much has been made of this FSA which is yet another taxpayer specific ruling which may not be cited as precedent pursuant to section 6110(k)(3). However, since no explanatory regulations exist under section 1256, this FSA and PLR 8818010 have endured as importance pieces of authority available for practitioners regarding the meaning of foreign currency contracts.

IRS Issues Binding Guidance Notice 2003-81[29]

Notice 2003-81 involves a highly structured foreign currency shelter. The Notice designates it a "listed transaction" for purposes of tax shelter regulations sections 1.6011-4(b)(2), 301.6111-2(b)(2) and 301.6112-1(b)(2). The mechanics are as follows: a taxpayer purchases a put and a call on a foreign currency in which positions are traded through regulated futures contracts which are foreign currency contracts within the meaning of section 1256(g)(2)(a) . The purchased options are expected to move inversely in value to one another. As the value of the foreign currency changes, one of those option contracts is certain to be in a loss position. The taxpayer also receives premiums for writing a call option and a put option on a different foreign currency in which positions are not traded through regulated futures contracts. The written contracts are not foreign currency contracts within the meaning of section 1256(g)(2)(A) nor are they section 1256 contracts within the meaning of section 1256(b). The written options are also expected to move inversely in value to one another, ensuring that, as the value of the foreign currency changes, the taxpayer will hold a gain position in one of the two written options.

The values of the two currencies underlying the purchased and written options (i) historically have demonstrated a very high positive correlation with one another or (2) officially have been linked to one another. Therefore as the currency changes in value the taxpayer expects to have the following gains and losses in substantially offsetting positions: (1) a loss in a purchased option and a gain in a written option; and (2) a gain in a purchased option and a loss in a written option. The taxpayer assigns to a charity the purchased option that has a loss, the charity also assumes the taxpayer's obligation under the offsetting written option that has a gain.

The taxpayer treats the purchased option assigned to the charity as a section 1256 contract and relies on section 1256(c) to mark the purchased option to market when it is assigned to charity and to recognize a loss at that time. Because the assumed option is

[29] 2003-51 I.R.B. 1223, 2003-2 C.B. 1223.

not a section 1256 contract the taxpayer claims not to recognize gain attributable to the option premium. Therefore the taxpayer claims that she does not recognize gain when the charity assumes the obligation, or upon expiration or termination of the option.

The Service determined that when the option writer's obligation terminates, the transaction closes and the option writer must recognize any income or gain attributable to the prior receipt of the option premium. It further classified this type of transaction as a listed transaction that requires disclosure under the tax shelter disclosure requirements.

While interesting, the mechanics of this particular transaction are secondary to the current discussion. Uncertainty and confusion arose after the release of Notice 2003-81 because of the following assumption which was included in the facts section. "*The currency is one in which positions are traded through regulated futures contracts, and the purchased options, therefore, are foreign currency contracts within the meaning of 1256(g)(2)(A) of the Internal Revenue Code and section 1256 contracts within the meaning of sections 1256(b).*"

This statement, seemingly an aside, surprised many and was criticized by commentators.[30] The Service was accused of reversing established course on foreign currency contracts and disregarding legislative history. In 2007, at least partially in response to these comments, the Service revised its position and issued Notice 2007-71 modifying Notice 2003-81.

Notice 2007-71[31]

The correcting notice states: "Although, as a general matter, the "Facts" portion of Notice 2003-81 correctly describes the transaction at issue, it includes an erroneous conclusion of law. The second sentence states: "The currency is one in which positions are traded through regulated futures contracts, and the purchased options, therefore, are foreign currency contracts within the meaning of section 1256(g)(2)(A) of the Internal Revenue Code and section 1256 contracts within the meaning of 1256(b)." The Notice goes on to say that "This sentence should have stated "*the taxpayer takes the position* that the purchased contracts are…." The modifying Notice briefly refers to the legislative history of sections 1256 and 988 and concludes that a foreign currency option is not a foreign currency contract under section 1256(g)(2).

---

[30] See Michael Feder, Chip Harter, David Shapiro: "Notice 2003-81: Are OTC Currency Options Section 1256 Contracts?", 2003 TNT 246-33, (Dec. 22, 2003); Lee Sheppard: "Foreign Currency Contracts and the Unintended Consequences of Informal Guidance", 2004 TNT 32-5, (Feb. 16, 2004).

[31] 2007-35 I.R.B. 472, 2007 WL 2285349

An error was admitted by the Service, which was subsequently corrected in Notice 2007-71, almost four years after the publication of the original Notice. What remains puzzling then, is the timing. Did it really require four years to produce a simple correction which involved changing a statement of the Service to an assertion by the taxpayer? At minimum, the delay in the issuance of the correction highlights uncertainty and disagreement over the status of such options and the true definition of "foreign currency contract" for purposes of section 1256.

Tax Court Endorses Narrow View of "Foreign Currency Contract"

In two recent cases, the U.S. Tax Court confirmed the position taken in Notice 2007-71 and sided with the Service in holding that foreign currency option contracts are not "foreign currency contracts" under section 1256(g)(2). Although the ultimate disposition of the cases is perhaps unsurprising in light of Notice 2003-81 and Notice 2007-71, the Court's reasoning in reaching these results merits discussion.

Summitt v. Comm'r (134 T.C. 248, May 20, 2010)

The first of these cases, Summitt v. Comm'r, involved the very tax shelter that was the subject of Notice 2003-8. The shelter is commonly referred to as a major-minor transaction given the use of foreign currency options with respect to both major currency (i.e., traded through regulated futures contracts) and minor currency (i.e., not traded through regulated futures contracts).

Facts

Mr. Summitt, through an S corporation (Summitt, Inc.) in which he owned a 10% stake, arranged to purchase a series of foreign currency options in September, 2002 as follows. First, the "major" prong of the transaction consisted of Summitt purchasing exactly offsetting puts and calls pegged to the Euro and the U.S. Dollar. These options carried the same strike price and entitled Summitt to purchase Euros (call option) and sell Euros (put option) at the same U.S. dollar-denominated conversion rate on the same date in 2003. Second, on the same day in 2002, Summitt wrote and sold reciprocal puts and calls with respect to the U.S. dollar and the Danish krone, a minor currency with respect to which positions were at that time *not* traded through regulated futures contracts. These options obligated Summitt to purchase Danish krone (written put option) and sell Danish krone (written call option) at the same U.S. dollar-denominated conversion rate on the

same date in 2003 (which was also the same date on which the Euro-denominated options purchased by Summitt were subject to exercise).[32]

As discussed above, taking into account the historically high positive correlation between the Euro and the Danish krone, this combination of options was likely to result in the following gains and losses in substantially offsetting positions as the currencies fluctuated in value: (1) a loss in a purchased major (Euro) option and a gain in a written minor option; and (2) a gain in a purchased major option and a loss in a written minor option. Just as with the transaction described in Notice 2003-81, Summitt assigned to a charity the purchased major (Euro) call option and the written minor (Danish krone) call option only days after acquiring and writing the various options. At the time of this assignment the major (Euro) call option carried with it an unrealized loss of approximately $1.75 million while the minor (Danish krone) call option carried an unrealized gain of approximately $1.74 million. A few months after the assignment of the options to the charity, Summitt closed out the other options (Euro put option and written Danish krone put option) by agreeing with the counterparty to offset those positions against each other.

On his 2003 return, Mr. Summitt claimed a loss resulting from flow-through of the mark-to-market loss claimed by the S corporation under section 1256(c) on the assigned Euro call option. Mr. Summitt however did not recognize as income the unrealized gain inherent in the assigned option with respect to the Danish krone. The Service issued a notice of deficiency to Mr. Summitt disallowing the claimed mark-to-market loss on the grounds that the Euro call option was not a contract subject to section 1256.[33]

Analysis

The taxpayer's principal argument was that under a "plain reading" of section 1256(g)(2)(A), the foreign currency option with respect to the major currency (Euro) was a "foreign currency contract" subject to the mark-to-market rules of section 1256. The taxpayer highlighted for the Court that foreign currency forwards, futures and options are in most meaningful respects economically equivalent:

---

[32] Summitt paid premiums of $19,967,500 million in order to purchase the Euro-denominated put and call options and received premiums of $19,950,000 million as a result of writing the Danish krone-denominated put and call options. Thus, Summitt paid a net premium of only $17,500 in order to enter into these various transactions.

[33] The Service also disputed the nonrecognition by Summitt of the gain on the Danish krone call option assigned to the charity. This issue was not resolved in the Court's opinion as the Court was issuing a ruling in respect of a motion for summary judgment filed by the Service's attorneys and the Court concluded that further factual development was necessary in order to resolve this issue.

> "All of these derivatives accomplish the same economic access to currency risk. They reproduce the economic risks and rewards of holding a particular foreign currency over time. These derivatives only differ in their pricing, timing and payment structure, and thus, can be modified or transformed into one another by entering into other derivatives. For example, an option writer fearing a movement in the underlying security adverse to his position can purchase a future on that security to effectively offset this risk, or he could write a contraindicated option as Petitioners did here."

On the other hand, the Commissioner advocated a more restrictive interpretation of the statute, arguing that the "plain language" of the statute compelled the contrary conclusion. Essentially conceding that the Euro option satisfied the last two prongs of the definition of "foreign currency contract" in section 1256(g)(2)(A) (i.e., the contract was traded on an interbank market and was entered into at arm's length at a price determined by reference to the price in the interbank market), the Government focused on the first requirement relating to delivery under the contract. The Government's view proceeded in two steps. First, as originally enacted, section 1256(g)(2)(A) only covered foreign currency contracts that required delivery of the underlying foreign currency. Given their unilateral nature, options clearly did not require such delivery. Second, the addition of the phrase "or the settlement of which depends upon the value of" to the statute in 1984 was merely intended to deal with uncertainty as to whether cash-settled forward contracts were included in the definition of foreign currency contracts. According to this "two-step" interpretation of the statute espoused by the Government, the "settlement" concept in section 1256(g)(2)(A)(i), (which the taxpayer clearly relied on to argue that foreign currency options fell within the statute), was a deliberate and well-reasoned expansion of the statute to capture certain contracts (foreign currency forwards) but Congress had not contemplated or intended to do anything more.

Faced with two conflicting interpretations of the same statute (both purporting to be based on the "plain language" of the statute), the Court engaged in a rather confusing exercise of statutory interpretation peppered by liberal reference to legislative history that effectively embraced the Government's two-step view. Focusing on the delivery/settlement prong of section 1256(g)(2)(A)(i), the Court stated that:

> "[it] is also clear that the 1984 amendment "or the settlement of which depends on the value of" was inserted to allow settled forward contracts to come within the term "foreign currency contract". Foreign currency contracts can be physically settled or cash-settled, but they still must require, by their terms at inception, settlement at expiration. The statutes

plain language is dispositive. There is no evidence in the legislative history that a literal reading of the statute will defeat Congress' purpose in enacting it."

The Court also rejected out-of-hand the taxpayer's arguments that (a) if the Government had intended to exclude foreign currency option contracts from section 1256(g)(2)(A) it would have done so via regulatory action and (b) that Congress' decision to expressly include other option contracts within the sphere of "section 1256 contracts" (e.g., nonequity options, dealer equity options) was evidence of Congressional intent to include foreign currency options within section 1256. Finally, the Court dismissed the taxpayer's policy argument regarding equivalency between forward, futures and options relating to foreign currency contracts by noting that these various types of contracts differ in pricing, timing and payment structures and stating that "[i]t is precisely these economic and legal distinctions that give rise to disparate treatment under the tax laws." The Court makes no mention of the fact that forwards and futures themselves are clearly different in numerous ways (not least due to the margining requirement present in exchange-traded futures but lacking in forward contracts) but that Congress deemed it prudent to disregard these differences in drafting the statute and extending mark-to-market treatment for non-exchange traded foreign currency forward contracts.

Garcia v. Comm'r (T.C. Memo 2011-85)

Facts

Garcia involved essentially the same transaction at issue in Summitt and raised the same issues. A taxpayer purchased major currency options and wrote minor currency options and subsequently assigned certain of these options to a charity, claiming a mark-to-market loss on the major currency options but no gain recognition on the minor currency options. Perhaps the sole difference was the presence of a "barrier" feature in the option contracts at issue in Garcia. As explained in the Court's opinion, a "barrier" feature provides that exercise of an option is dependent on the option's reaching, or failing to reach, a certain price. As noted below, this factual difference was deemed of no consequence to the analysis under section 1256(g)(2)(A).

Analysis

With the benefit of the Tax Court's analysis of the issue in Summitt, the Court in Garcia did not engage in detailed reconsideration of the sole legal issue. Indeed, the opinion in Garcia quotes extensively from the Court's opinion in Summitt. Apparently

only one theory for distinguishing Garcia from Summitt was advanced by the taxpayer – that Summitt was decided on an "incomplete factual base" due to the fact that the case was decided without the benefit of testimony from a foreign currency options expert.[34] The Garcia Court rejected this argument, noting that Summit "was decided on summary judgment and, therefore, the facts were viewed in a light most favorable to the taxpayer. Under those circumstances Summitt held that foreign currency options were economically distinguishable from contracts covered by section 1256. The testimony suggested by petitioner is nothing more than the legal conclusions of a supposed industry expert. We made our legal determination of the section 1256 issue in Summitt."

Discussion

Neither Notice 2003-81 nor Notice 2007-71 are mentioned in the Court's opinions in Summitt or Garcia. The transactions at issue occurred in 2002 and pre-dated the issuance of these Notices and so the transactions were not subject to the disclosure and related requirements specified in the Notices. However, it is curious that the Court did not choose to discuss the Service's views as set forth in the Notices.

Most tax practitioners and commentators agree that the result reached in Summitt and Garcia (i.e., denial of the loss deduction claimed by the taxpayers on assignment of the major currency options to the charities) was correct.[35] But was the route taken by the Court to reach its conclusion optimal? In the Court's view, the legislative history of section 1256(g)(2)(A) did not explicitly refer to foreign currency options as within the province of the statute, and this was evidence of Congress' intent to exclude them. While this rule of interpretation is certainly not without precedent, it rests on the assumption that Congress operated with prophetic foresight in drafting the statute. Most of the derivatives markets active today did not exist in 1982. To require Congress to modify a statute to keep abreast of every innovation in the financial markets is unrealistic. In fact, Congress did use broad and clear language of general application to the evolving markets, but the Court chose the narrow road of interpretation.

---

[34] The Court did address the apparently sole factual difference between the transactions in Summitt and Garcia – the presence of the "barrier" feature in the options at issue in Garcia. It is not clear from the Court's opinion whether the taxpayer advanced any theory as to why the "barrier" feature should cause the contracts to fall within Section 1256(g)(2)(A) but in any event, the Court summarily concluded that the contracts were options and that the "barrier" feature did not alter the Court's conclusion that the options were not "foreign currency contracts" subject to Section 1256.

[35] See e.g., Erika W. Nijenhuis, "New Tax Issues Arising From the Dodd-Frank Act and Related Changes to Market Practice for Derivatives", The Corporate Tax Practice Series (PLI 2010), "News Analysis: Garbled Reasoning in Garcia", 2011 TNT 79-1 (April 22, 2011), "Tax Court Rules Against Application of Mark-to-Market Rules to Foreign Currency Options", 2010 TNT 98-4 (May 20, 2010)

Moreover, the Court's heavy leaning on legislative history in interpreting the statute is curious. As the Court in Summitt noted, "[w]here a statute is silent or ambiguous, we may look to legislative history in an effort to ascertain congressional intent" but generally, "where a statute appears to be clear on its face, we require unequivocal evidence of legislative purpose before construing the statute so as to override the plain meaning of the words used therein." Was the statute at issue truly "ambiguous" or "silent" as to whether foreign currency options were within the type of contracts covered by section 1256(g)(2)(A)? Indeed, there is a very reasonable reading of the language of section 1256(g)(2)(A) that would lead a reader to conclude that foreign currency options are unambiguously covered by the statute. Is an option not a "contract"? Is it possible the Government pressed a conflicting interpretation of the statute on the Court? Or that a series of tax motivated transactions did so?

Further Evolution in Statutory and Regulatory Framework

The most recent path in this journey comes from the package of laws referred to as the Dodd-Frank Act.[36] As the new clearing and trading requirements related to formerly over-the-counter derivatives began to evolve under Dodd-Frank, practitioners became increasingly concerned that certain contracts would become subject to section 1256. Would the new clearing and trading requirements cause OTC derivative contracts to be "traded on or subject to the rules of a qualified board or exchange" and therefore within the definition of a "regulated futures contract" subject to section 1256? This concern caused Congress to add, in the sole page of the Act devoted to taxes, a list of exclusions from the definition of section 1256 contracts. The amendment to section 1256 provides that "Any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement" is not a section 1256 contract.[37]

In the wake of Dodd-Frank, the Treasury Department issued proposed regulations under section 1256.[38] They exclude notional principal contracts (as defined in Treas. Reg. section 1.446-3(c)) from the definition of section 1256 contracts, thus tying a contract's exclusion from section 1256 under new section 1256(B)(2)(B) to a determination of whether the contracts meets the tax definition of "notional principal contract."

---

[36] Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203, H.R. 4173. For further discussion of the various component parts of Dodd-Frank and their potential tax consequences see Viva Hammer and John Bush, "The Taxation of Dodd-Frank, Part I", TNT July 11, 2011 and Viva Hammer, John Bush and Paul Kunkel, "The Taxation of Dodd-Frank, Part II", TNT July 25, 2011.

[37] Section 1601(a)(3) of Dodd-Frank Act, adding section 1256(b)(2)(B) to the Code.

[38] See REG-111283-11 (Sept. 15, 2011), 76 Fed. Reg. 57684 (Sept. 16, 2011).

What do these developments mean for foreign currency contracts? As a general matter, it would seem that the holding of PLR 8818010 stands and foreign currency swap contracts (whether exchange-traded or not) are not "foreign currency contracts" subject to section 1256. However, taxpayers will continue to monitor developments as the regulations are finalized.

Conclusion

It is not uncommon to hear a professor in a first-year law school class explain away confusing or counterintuitive legal holdings under the principle that "bad facts make bad law." The evolution in the interpretation of section 1256(g)(2)(A), capped by the Tax Court's decisions in Summitt and Garcia, arguably provides another example of this principle. The Government did win the battle against the tax shelters in these cases, but it may have lost the war against tax irrationality. Whenever economically equivalent transactions are taxed differently, it is always the Government and unwitting taxpayers who stand to lose.

As every infant learns in its cradle, a pair of options can be designed to provide identical economic results to a forward contract. After the decisions in Summitt and Garcia, a taxpayer that enters into a forward contract on foreign currency and wants realization treatment, will use a pair of options. A taxpayer that wants mark-to-market treatment will use a regular forward contract. The economic consequences are the same, but the tax accounting results are radically different.

This article represents the views of the author only, and does not necessarily represent the views or professional advice of KPMG LLP.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

©2012 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. [This is optional and may not be allowed by the publisher.]