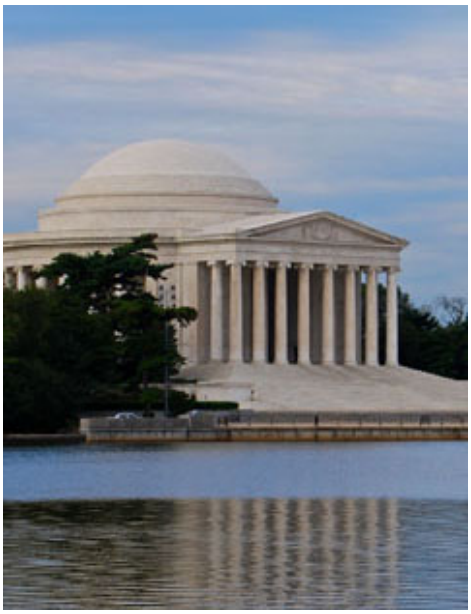

# Foreign Currency Options—Section 1256 Contracts or Not?

**A federal appellate court treated certain over-the-counter foreign currency options as section 1256 contracts. This article reviews the case and explains how the decision conflicts with earlier Tax Court decisions and IRS published guidance.**

In *Wright v. Commissioner*,[1] the Court of Appeals for the Sixth Circuit held that certain over-the-counter ("OTC") foreign currency options are subject to the rules of section 1256. The decision is based solely on the court's plain reading of the relevant statutory language; the court rejected consideration of relevant legislative history and tax policy.[2] Given that the court's decision is contrary to the holdings in several Tax Court decisions[3] and the published position of the IRS,[4] it creates uncertainty in an area that previously appeared to have been settled.

Professionals advising or assisting taxpayers holding or acquiring similar derivative financial instruments should consider the potential effect of the Sixth Circuit's decision in determining the proper tax accounting for such instruments. Specifically, the decision appears to offer some opportunity for taxpayer selectivity until the IRS and Treasury take steps to address the uncertainty created by the decision. Taxpayers outside of the Sixth Circuit may be able to choose between the two treatments depending on whether the taxpayer does or does not want the contract to be subject to section 1256 and its mark-to-market method of accounting.[5]

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1 809 F.3d 877 (6th Cir. 2016), *rev'g* T.C. Memo 102 T.C.M. (CCH) 597 (2011).

2 *Id.* at 882 ("The Tax Court's reasoning appears to be supported by sound tax policy, but nonetheless conflicts with the plain language of § 1256.").

3 *Wright*, 102 T.C.M. (CCH) 597; Garcia v. Commissioner, 101 T.C.M. (CCH) 1388 (2011); Summitt v. Commissioner, 134 T.C. 248 (2010).

4 Notice 2007-71, 2007-2 C.B. 472, modifying and supplementing Notice 2003-81, 2003-2 C.B. 1223.

5 Character is not at issue; all gain or loss will be ordinary in either case. Section 988.

Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

## Section 1256 and Foreign Currency Contracts

In general, a "section 1256 contract" is accounted for on a mark-to-market basis by treating the contract as if it were "sold" for its fair market value on the last business day of each tax year during which the taxpayer holds such a contract and recognizing the gain or loss.[6] "Foreign currency contracts" are one of several types of "section 1256 contracts."[7] In relevant part, a "foreign currency contract" is 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."[8] Currencies traded through regulated futures contracts are sometimes referred to as "major" currencies.[9]

## Notice 2007-71

The IRS has interpreted the term "foreign currency contracts" as limited to contracts to buy or sell currency ("foreign currency forward contracts"). In informal advice, it has concluded that neither foreign currency swaps (that is, notional principal contracts)[10] nor options on foreign currency are

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6 Mark-to-market gain or loss realized with regard to a section 1256 contract that is a capital asset is treated as 40 percent short-term capital gain or loss and 60 percent long-term capital gain or loss. Section 1256(a)(3). Section 1256 contracts on foreign currency and not traded on a qualified board or exchange, however, are subject to section 988 unless the taxpayer has made a section 988(a)(1)(B) election. An important exception to the application of section 1256 is to transactions that have been properly identified as hedging transactions. Section 1256(e)(1).

7 Section 1256(b)(1)(B). In addition, certain exchange-traded options on foreign currencies may qualify as "section 1256 contracts" subject to the rules of section 1256 under other prongs of the statute. *See generally* section 1256(g)(3) (defining "nonequity option"). The options entered into by the taxpayers in *Wright* were not exchange traded.

8 Section 1256(g)(2)(A)(i). In addition to these requirements, to be a foreign currency contract, the contract must be "traded in the interbank market" and entered into at "arm's length at a price determined by reference to the price in the interbank market." Section 1256(g)(2)(A)(ii)-(iii).

9 Unlike foreign currency derivatives referencing major currencies, a foreign currency derivative with regard to a currency that is not traded through regulated futures contracts (a so-called "minor" currency) cannot be a "foreign currency contract." Consequently, it is possible to execute economically similar derivatives on different currencies that will be accounted for in very different fashions for tax purposes (i.e., mark-to-market versus "open-transaction" or "realization" based accounting).

10 PLR 8818010 (Feb. 4, 1988) (ruling that currency swap contracts were not foreign currency contracts under section 1256(g)(2) and highlighting the economic dissimilarity between such contracts and the bank forward contracts described in the legislative history underlying section 1256(g)(2)). Swaps on foreign currency are now excluded

foreign currency contracts.[11] Informal advice became a published position in Notice 2007-71,[12] which states that the:

> Service and Treasury do not believe that foreign currency options, whether or not the underlying currency is one in which positions are traded through regulated futures contracts, are foreign currency contracts as defined in §1256(g)(2), and intend to challenge any such characterization by taxpayers.

The analysis in the notice is short and direct: The original definition of foreign currency contract applied to contracts that required actual delivery of foreign currency.[13] Because an option requires delivery only if the option is exercised, the statute does not apply to options. When Congress extended section 1256 to cash-settled contracts, there was no indication that Congress intended that amendment to apply to options. [14] Thus,

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under section 1256(b)(2)(B), enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (PL 111-203, §§ 1601(a)(1) – (3)).

11 FSA 200025020 (Mar. 17, 2000) (after stating that the statute may be read to include options on foreign currency, the author concluded that options are not foreign currency contracts because there was no indication that Congress intended to include such a result).

12 2007-2 C.B. 472, modifying and supplementing Notice 2003-81, 2003-2 C.B. 1223. Notice 2007-71 was issued to correct a statement in the "Facts" portion of Notice 2003-81 that had engendered confusion. The earlier notice had stated as a factual matter a legal conclusion that an option on a major foreign currency was a foreign currency contract. *See, e.g.*, Michael J. Feder, L.G. "Chip" Harter, and David H. Shapiro, *Notice 2003-81: Are OTC Currency Options Section 1256 Contracts?*, 101 Tax Notes 1470 (Dec. 22, 2003) (pointing out the confusion created by the earlier notice and asserting that both the legislative history was clear that Congress did not intend to treat OTC options on currency as foreign currency contracts and there was no overall tax principle to be achieved by applying section 1256 to such contracts).

13 "For purposes of this section, the term 'foreign currency contract' means a contract . . . which requires delivery of a foreign currency . . . ." Section 1256(g)(1) as amended by the Technical Corrections Act of 1982, PL 97-448, §105. The Technical Corrections Act of 1982 also amended the definition of regulated futures contract to include cash-settled contracts by removing the requirement that the contract provide for delivery of personal property or an interest in personal property.

14 The notice essentially adopted the analysis set forth in more detail in FSA 200025020. The House Ways and Means Committee report on the relevant provision of the 1984 Act states:

> 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.

options on foreign currency are not foreign currency contracts. Notice 2007-71 continues to represent the IRS's official position on the matter.

## The Tax Court

The U.S. Tax Court agrees with the IRS. In *Summitt v. Commissioner*,[15] the Tax Court not only wholeheartedly adopted the IRS's position outlined Notice 2007-71, but went on to conclude that nothing in the statute's plain language suggests that OTC options on currency are covered. The court read the relevant parts of the statute to require settlement at expiration, whether physical or cash-settled, and, because an option may expire unexercised (and thus with no settlement), it was not within the plain meaning of the statute. The court then considered legislative history to see if that outcome was inconsistent with legislative intent.

> It is clear that, as originally enacted in 1982, section 1256(g)(1) applied only to forward contracts. The statute referred to a contract which required delivery of the foreign currency, not to a contract in which delivery was left to the discretion of the holder.
>
> It is also clear that the 1984 amendment "or the settlement of which depends on the value of" was inserted to allow a cash-settled forward contract 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 statute's 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.[16]

## The *Wright* Case

The Sixth Circuit in *Wright* upset the apple cart. The court not only rejected the Tax Court's plain language view of the statute, but also refused to consider legislative history and whether the result was consistent with tax policy.

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*Summitt*, 134 T.C. at 263 (2010) *citing* H. Rept. 98-432 (Part 2), at 1646 (1984).

15 134 T.C. at 248. *Accord Garcia*, 101 T.C.M. (CCH) 1388; *Wright*, 102 T.C.M. (CCH) 597.

16 134 T.C. at 264-266 (internal citations omitted).

First, the court carefully parsed the words of the statute and concluded that settlement was not mandated by the statute.

> In order to interpret the statute to provide that "foreign currency contract" is a contract that requires a settlement, one would have to read the statute to state that a "foreign currency contract" is (1) "a contract . . . which requires . . . delivery of . . . a foreign currency" or (2) "a contract . . . which requires . . . the settlement of which depends on the value of, a foreign currency." Such a reading goes against the plain language of the statute because the phrase "a contract . . . which requires . . . the settlement of which depends on the value of, a foreign currency" is syntactically incoherent. Further, contrary to the Commissioner's assertion, the inclusion in § 1256 of a rule that applies to the cash settlement of a contract does not make it "implicit" that a settlement of the contract must actually occur. Instead, § 1256 provides that if a settlement of a "foreign currency contract" does occur, any such settlement must depend on the value of a foreign currency.[17]

Next, the court dispensed with any resort to the legislative history in interpreting the statutory language, stating that:

> Because the plain language of § 1256 clearly provides that the Wrights' euro put option meets the "settlement" prong of § 1256(g)(2)(A)(i), we need not resort to legislative history to interpret § 1256.[18]

Third, the court shrugged off any tax policy concerns.

> We see no conceivable tax policy that supports [our] interpretation of the plain language of § 1256, and none has been suggested to us by the parties. To the contrary, this interpretation of § 1256 seems to allow the Wrights to engineer a desired tax loss by paying only a minimal

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17 *Wright*, 809 F.3d at 883.

18 *Id.* at 884.

> cash outlay and by engaging in major-minor transactions that subject the Wrights to little economic risk.[19] . . .
>
> Congress may have wanted a contract that provides for settlement in cash to fall within the "foreign currency contract" definition only if that contract mandates settlement at maturity. If Congress had wanted to expand the definition of "foreign currency contract" to include only such contracts, Congress could have amended § 1256(g)(2)(A) to provide that a "foreign currency contract" is a contract "which requires delivery of, or *which requires* a settlement which depends on the value of, foreign currency." But Congress did not amend § 1256 in this way.[20]

Finally, the court rejected reforming the statutory language in the manner sought by the government for a variety of reasons. Doing so "might unintentionally permit other tax-avoidance schemes."[21] Treasury and the IRS could exercise the regulatory authority Congress expressly provided to exclude any type of contract that is inconsistent with the purposes of section 1256.[22] And Congress has provided the IRS with the means to prevent taxpayers from claiming tax losses from transactions lacking economic substance under the economic substance doctrine.[23]

## Observations about the Sixth Circuit's Holding

Was the case correctly decided? It is hard to argue with the construction the court gave the specific words, but only if the rest of the statute, its evolution across several amendments, and its legislative history are ignored. The U.S. Supreme Court has said that the job of the courts is to interpret a statute by determining its correct reading:

> If the statutory language is plain, we must enforce it according to its terms. But often times the meaning—or ambiguity—of certain words or phrases may only become evident when placed in

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19 *Id.*

20 *Id.* at 885.

21 *Id.*

22 *Id.*

23 *Id.*

> context. So when deciding whether the language used is plain, we must read the words in their context and with a view to their place in the overall statutory scheme. Our duty, after all, is to construe statutes, not isolated provisions.[24]

Although the *Wright* court asserted that the relevant part of the statute is unambiguous, the court got there by construing it in isolation, focusing myopically on the specific words used to define the term "foreign currency contract," without considering how other parts of the statute evolved contemporaneously with the term "foreign currency contract." In addition to the legislative history that the IRS and the Tax Court cited, the evolution of the definition of regulated futures contract and the gradual expansion of section 1256 to cover additional types of contracts suggests that the Sixth Circuit conclusion is not what Congress intended. The statute, as initially enacted, covered only physically settled exchange-traded futures.[25] The Technical Corrections Act of 1982 amended the statute to cover both cash-settled exchange traded futures and physically settled foreign currency forward contracts.[26] Congress's next step, as part of more substantial changes to section 1256 done by the Deficit Reduction Act of 1984, was to extend the scope of section 1256 by adding both the language at issue in *Wright*—"or the settlement of which depends on the value of"—and language covering nonequity options and dealer options, both of which are exchange-traded options.[27] Given that both changes occurred as part of the same act, if Congress intended to treat OTC foreign currency options as foreign currency contracts, why didn't it simply use the word "option," just as it did for exchange-traded options?[28] The *Wright* court thus, arguably, did not read the words at issue in their context and with a view to their place in the overall statutory scheme.

## Assessing the Effect of *Wright*

The *Wright* case agitates that which had seemed settled. As a practical matter, however, it probably matters little to most taxpayers that enter into derivatives on foreign currency. The class of taxpayers using OTC options on foreign currency that would be subject to section 1256 and mark-to-market accounting under the *Wright* analysis is likely a relatively small group; many taxpayers entering into these options do so for tax

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24 King v. Burwell, 135 S. Ct. 2480 (2015) (internal quotations omitted).

hedging purposes and likely would not be subject to mark-to-market accounting.[29]

Nevertheless, for those taxpayers that enter into OTC options on foreign currency for non-hedging purposes, the case does offer the potential for a certain amount of taxpayer electivity, although at a cost that may be unpalatable for most. Taxpayers within the Sixth Circuit have to decide whether they must follow *Wright* or whether Notice 2007-71 gives them a return position to ignore it. For taxpayers outside of the Sixth Circuit, the question is whether to continue to follow Notice 2007-71 and *Summitt*, or to rely on the *Wright* court's analysis to support a return position. Taxpayers that have already adopted a method of accounting for OTC options on foreign currency would have to seek the IRS's consent to apply the *Wright* treatment.[30] For taxpayers outside of the Sixth Circuit, it seems likely that for now the IRS would not grant that change. Of course, if the IRS and Treasury were to issue regulations, the matter would be put to

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25 Section 1256(b) as enacted by § 503 of the Economic Recovery Tax Act of 1981, P.L. 97-34.

26 Section 105(c)(5) of the Technical Corrections Act of 1982, PL 97-448. Notably, this paragraph, which made both changes, is titled "Foreign Currency and Cash Settlement Contracts Marked to Market."

27 Section 102 of the Deficit Reduction Act of 1984, PL 98-369. Nonequity options and dealer options are both limited to listed options, which are defined as any option (other than a right to acquire stock from the issuer) which is traded on (or subject to the rules of) a qualified board or exchange. Section 1256(g)(5).

28 Arguably, the then-existing definition of regulated futures contract (following the 1982 amendments) may have already picked up exchange-traded options because the statute defined such contracts as contracts "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 that was traded on a domestic board of trade. Section 1256(b) of the Internal Revenue Code of 1954 as amended by Section 105(c)(5) of the Technical Corrections Act of 1982, PL 97-448. Congress, however, did not think that exchange-traded options were covered by the broad definition of regulated futures contract given the 1984 amendments.

29 The mark-to-market method of accounting provided for in section 1256 does not apply if the transaction is a properly identified tax hedging transaction. Section 1256(e)(1). Instead, the method of accounting for such a hedging transaction is prescribed by the hedge timing rules of section 1.446-4.

30 *See* Rev. Proc. 2015-13, 2015-5 I.R.B. 419.

rest. Although it seems that as a practical matter the case has little impact for most taxpayers, ultimately it presents another tax outcome meriting consideration by those taxpayers using OTC options in the "right" fact pattern.