Sixth Circuit holds over-the-counter foreign currency option contracts are Section 1256 contracts

On January 7, 2016, the Sixth Circuit Court of Appeals, in *Wright v. Commissioner*,[1] held that over-the-counter (OTC) currency option contracts constitute "foreign currency contracts" under section 1256(g)(2)(A) and thus are subject to the mark-to-market rules of section 1256. The *Wright* case involves a listed transaction, commonly referred to as a "major-minor trade," which is premised on the position that OTC currency options in major currencies are properly treated as section 1256 contracts.[2] While the facts of *Wright* are somewhat narrow, its holding and rationale are broad and may significantly impact the tax treatment of OTC currency options.

Background

Whether an OTC currency option is a section 1256 contract has been an issue of uncertainty for a couple of decades. The IRS view is that OTC currency options are not section 1256 contracts, based largely on the legislative history of section 1256. In 2003, the Service published Notice 2003-81,[3] which concluded that OTC currency options denominated in currencies in which positions are traded through regulated futures contracts (RFCs) are "foreign currency contracts," but the Service reversed its position in Notice 2007-71,[4] concluding that OTC currency options are not subject to section 1256, regardless of whether the underlying currency is so traded. Notice 2007-71 states that the Service and Treasury intend to challenge any contrary position taken by taxpayers.

The Tax Court has also considered the issue on multiple occasions, and has agreed with the IRS that OTC currency options are not subject to section 1256. The conclusion reached in Notice 2007-71 was the government's litigating position in *Summit v. Commissioner*.[5] In that case, the Tax Court dealt with a major-minor trade that is substantially identical to the one at issue in *Wright*, and held that OTC currency options used there did not constitute foreign currency contracts based on, among other things, the legislative history of section 1256. The Tax Court reached the same conclusion in *Garcia v. Commissioner*,[6] holding that an OTC currency option is not a section 1256 contract based on the plain language of the statute.

Therefore, before *Wright*, it appeared to be settled law that OTC currency options did not constitute section 1256 contracts. Thus, such options have generally been subject to open transaction treatment (whereby gain or loss is only realized when the option is exercised, lapsed, terminated, or sold). Taxpayers and tax professionals have relied on the legislative history of section 1256, the tax court's holding in *Summit* and *Garcia*, and the government's position in Notice 2007-71 to treat OTC currency options as non-section 1256 contracts.

Observation: The Sixth Circuit's ruling in *Wright* came as a surprise to most taxpayers and tax practitioners because it appears to be inconsistent with the legislative history of section 1256, prior informal and formal IRS guidance on this subject, and prior tax court decisions.

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[1] No. 15-1071 (6th Cir. 2016).
[2] Note that the conclusion of this ruling only affects the timing of gain or loss on an OTC currency option. It does not change the character of such gain or loss, which is ordinary under section 988.
[3] 2003-2 C.B. 1223 (Dec. 22, 2003).
[4] 2007-35 I.R.B. 472 (Aug. 27, 2007).
[5] 134 T.C. 248 (2010).
[6] T.C. Memo. 2011-85 (Apr. 13, 2011).

The statute at issue

Section 1256(g)(2)(A) provides that the term "foreign currency contract" means, among other things, 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...."

Interpreting the above language, the court in *Wright* held that OTC currency options denominated in Euros are treated as section 1256 contracts based on the plain meaning of the statute. It should be noted that the case centered around the timing provisions of section 1256, that is, the mark-to-market provisions, and was silent as to any character issues.

Why the legislative history is inconsistent with *Wright*

The legislative history of the Technical Corrections Act (TCA) of 1982,[7] which amended section 1256 to include foreign currency contracts, clearly indicates that Congress intended to extend section 1256 treatment only to foreign currency forward contracts that are traded in the interbank market.[8] There was simply no indication that foreign currency option contracts were contemplated for inclusion in the statutory definition of a foreign currency contract in section 1256(g)(2)(A).[9] Congress intended to include bank forward contracts in currencies that are traded through RFCs within the definition of a foreign currency contract because bank forward contracts are economically comparable to, and used interchangeably with, RFCs.[10] OTC currency options, on the other hand, simply do not share the same economics with RFCs or forward contracts (i.e., they differ in their pricing, timing, and payment structures).[11]

The "settlement of which depends on the value of" prong of the statute was added by section 102 of the Tax Reform Act (TRA) of 1984.[12] The legislative history indicates that this language was added to deal with uncertainty as to whether cash-settled forward contracts were included in the definition of "foreign currency contracts."[13] (In other words, the 1984 revision to the definition of "foreign currency contract" appears to be a clarification.) The House Report explains that Congress amended section 1256 to allow a contract that provides for settlement in an amount determined by the value of the foreign currency, rather than actual delivery of the currency, to meet the "delivery" requirement of the "foreign currency contract" definition.[14] There is no indication that Congress intended by this addition to extend the definition of "foreign currency contract" to OTC currency options, although there would appear to be no policy reason why a listed and an OTC option in the same currency should not be afforded the same tax treatment. Such a conclusion is further supported by the fact that the TRA also added sections 1256(g)(3) and (4) to the Code, which extended section 1256 to specifically include exchange-traded currency options. Thus, if Congress had intended to subject OTC currency options to section 1256, it presumably would have chosen to do so directly rather than through the inclusion of ambiguous language that even the court in *Wright* conceded would have no application in the event an option ultimately lapses unexercised.[15] This conclusion is also consistent with the legislative history to section 988(a)(1)(E), enacted by the Technical and Miscellaneous Revenue Act of 1988, which indicates that a foreign currency option is not a foreign currency contract as defined in section 1256(g)(2).[16]

The Sixth Circuit read the 1984 amendment to vastly expand the scope of the definition of foreign currency contracts. Specifically, the Sixth Circuit concluded that the plain language of section 1256(g)(2)(A) should be

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[7] Pub. L. No. 97-448, 1983-1 C.B. 451.
[8] See S. Rep. No. 592, 97th Cong., 2d Sess.; H.R. Rep. No. 986, 97th Cong., 2d Sess.
[9] See also FSA 200025020 (June 23, 2000).
[10] In the Committee Report, H. Rept. 97-794, 97th Cong., 2d Sess., 23 (1982), Congress stated the following:
Although bank forward contracts differ from regulated futures contracts, the volume of trading through forward contracts in foreign currency in the interbank market is substantially greater than foreign currency trading on futures exchanges, and prices are readily available. Such contracts are economically comparable to regulated futures contracts in the same currencies and are used interchangeably with regulated futures contracts by traders.
[11] In PLR 8818010 (Feb. 4, 1988), the Service considered whether a cross-currency swap contract was a foreign currency contract under section 1256(g)(2)(A). After reviewing the legislative history to section 1256(g)(2), it concluded that, because currency swap contracts are economically very different from bank forward contracts, they should not constitute section 1256 contracts.
[12] P.L. 98-369, 1984-3 (Vol. 1) C.B. 128.
[13] See H. Rept. 98-432 (Part 2), at 1646 (1984).
[14] Id. ("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.")
[15] As such, the holding in Wright can be viewed as effectively overriding the limitations of sections 1256(g)(3) and (4).
[16] P.L. 98-369, 1984-3 (Vol. 1) C.B. 128.

read to provide that a contract the settlement of which depends on the value of a foreign currency is a foreign currency contract, regardless of whether that contract mandates that any such settlement occur. Therefore, even though (i) an OTC currency option does not require delivery or settlement unless and until the option is exercised by the holder and (ii) an obligation to settle will never arise if the option lapses unexercised, the Sixth Circuit concluded that such an option is a "foreign currency contract" because any settlement that does occur will necessarily depend on the value of the foreign currency in which the option is denominated.

The Sixth Circuit acknowledged that its reading of the statute is inconsistent with the legislative history. However, it reasoned that the plain language of the statute clearly provides the conclusion it reached and, therefore, it did not need to resort to the legislative history to interpret the meaning of section 1256.

Observation: The introduction of ambiguity on this issue by *Wright* is as troublesome as it is confusing. First, there is now a question as to whether taxpayers can continue to take the position under previously-settled law that OTC currency options are not section 1256 contracts. Second, this ruling creates a potential "whipsaw" of the IRS by taxpayers – taxpayers seeking section 1256 treatment may rely on *Wright* as substantial authority, while taxpayers seeking to avoid section 1256 treatment could continue to rely on the legislative history, the tax court cases, and IRS guidance. Interestingly, taxpayers who take the position that OTC currency options are section 1256 contracts can elect to treat the resulting gain or loss as 60%/40% long-term/short-term capital gain or loss by making a section 988(a)(1)(B) election. Finally, for taxpayers in the Sixth Circuit, there is now a question as to whether they are required to (i) file an accounting method change request to mark their OTC currency options to market or (ii) disclose their current position that OTC currency options are not section 1256 contracts on their tax returns. Even if a taxpayer files such a method change request, it is unclear whether the Service will grant it. We hope that the government will clarify this matter sooner rather than later by issuing public guidance or regulations.

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