

Sixth Circuit Follows Plain Meaning; Tax Bar Up in Arms

By John Kaufmann

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John Kaufmann is of counsel at Greenberg Traurig LLP. He would like to thank John F. Prusiecki and Barbara T. Kaplan for comments on an earlier draft of this article.

In this article, Kaufmann discusses the Sixth Circuit's controversial decision in *Wright v. Commissioner*, which is inconsistent with long-held beliefs of many practitioners.

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A recent decision by the Sixth Circuit¹ reminds one of the old joke in which a lawyer calls his client and says, "Justice has prevailed!" The taxpayer in *Wright v. Commissioner* entered into a tax shelter transaction, whereby he entered into a long position in an at-the-money put and an at-the-money call on a notional amount of euros, and simultaneously entered into short positions in an at-the-money put and an at-the-money call with the same expiration date on a principal amount of Danish krone equivalent in value to the notional amount underlying the euro options. There was little expectation of economic profit; the euro and the krone are tightly correlated, and the premiums paid to purchase the euro options were offset by premiums received in exchange for writing the krone options. After a few days, the taxpayer contributed the euro option, which had decreased in value, and the krone option, which had increased in value, to a charity. Because the taxpayer took the position that under the plain meaning of section 1256(g)(2)(A), the euro option (but not the krone option) was a foreign currency contract for purposes of section 1256(b)(1)(B), he also took the position that the contribution of the euro option (but not that of the krone option) to the charity should be a recognition event under section 1256(c)(1). The IRS argued that given the policy and legislative history of section 1256, an option on a major currency should not be

treated as a foreign currency contract for these purposes. The Sixth Circuit sided with the taxpayer, holding that in this case, the plain meaning of the statute should control.

Many members of the financial instruments tax bar are perplexed and angered by the decision. In the joke, the client tells the lawyer, "Appeal!"

Section 1256

Section 1256(a) requires that so-called section 1256 contracts be treated as if they were sold for their fair market value at the end of each tax year. Section 1256(c) requires that gain or loss from a section 1256 contract be taken into account in the year in which the contract is terminated, transferred, or assigned. Therefore, to the extent that an option on foreign currency is a section 1256 contract, gain or loss should be recognized therefrom upon termination, transfer, or assignment thereof.

Under section 1256(b), a section 1256 contract includes, *inter alia*, any regulated futures contract or any foreign currency contract. For these purposes, a regulated futures contract is a futures contract that is traded on a qualified board or exchange, for which a margin account is required to be marked to market.² A foreign currency contract is defined as a contract that:

- i. requires delivery of, or the settlement of which depends on the value of, a foreign currency that is a currency in which positions are also traded through regulated futures contracts;
- ii. is traded on the interbank market; and
- iii. is entered into at arm's length at a price determined by reference to the price in the interbank market.³

Regulated futures contracts that reference the euro are traded on the Chicago Mercantile Exchange (that is, the euro is a major currency); however, there are no regulated futures contracts that reference the Danish krone. Because the taxpayer's krone options did not reference a major currency, the krone options were clearly not foreign

¹*Wright v. Commissioner*, No. 15-1071 (6th Cir. 2016).

²Section 1256(g)(1).

³Section 1256(g)(2).

currency contracts. The question at issue in the case was whether the euro options were foreign currency contracts.

Policy

The history of section 1256 indicates that Congress did not intend for options on major currencies to be foreign currency contracts. Section 1256 was passed in 1981 as part of the straddle rules, which were intended to combat tax abuse through the use of financial instruments.⁴ The statute was expanded to cover foreign currency contracts in 1982.⁵ Under section 1256(g), as enacted in 1982, a foreign currency contract was defined as a contract that:

- i. requires delivery of a foreign currency that is a currency in which positions are also traded through regulated futures contracts;
- ii. is traded on the interbank market; and
- iii. is entered into at arm's length at a price determined by reference to the price in the interbank market.

The 1982 act granted the IRS the authority to publish regulations interpreting the definition of foreign currency contract.⁶ These regulations have never been published.

The legislative history of the 1982 act made it clear that the definition of section 1256 was expanded to include foreign currency contracts because failure to do so would cause currency *forward* contracts traded on the interbank market — which are economically identical to regulated futures contracts that reference foreign currencies — to be taxed differently from foreign currency regulated futures contracts.⁷ This reflected a policy goal that economically similar contracts should be taxed in a similar manner, both to promote fairness and to prevent arbitrage. Foreign currency options, which are economically quite different from foreign currency futures or forwards, were not mentioned in the legislative history.⁸

The definition of foreign currency contract was expanded to include a contract that “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” in 1984 (emphasis added).⁹ The phrase was added to include cash-settled forward contracts within the relevant definition.

⁴Economic Recovery Tax Act of 1981, P.L. 97-34 (1981).

⁵Technical Corrections Act of 1982, P.L. 97-448 (1982).

⁶*Id.*; section 1256(g)(2)(B).

⁷H.R. Rep. No. 97-794, 97th Cong., 2d Sess., 23 (1982).

⁸*Id.*

⁹Deficit Reduction Act of 1984, P.L. 98-369.

The IRS has generally taken the position that foreign currency options are not section 1256 contracts for the reasons discussed above.¹⁰ However, regulations have not been issued under section 1256(g)(2)(B). Commentators have expressed the belief that foreign currency options should not be treated as foreign currency contracts.¹¹ When the Tax Court has addressed this issue, it has sided with the IRS.¹²

Plain Meaning

The taxpayer in the instant case argued that, notwithstanding the policy behind section 1256(g)(2)(A), an option that references a major currency is a section 1256 contract within the plain meaning of the statute. To recapitulate, under current law, a foreign currency contract is a contract that, *inter alia*:

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.

The court held that a foreign currency option fits within the four corners of the definition because a foreign currency option's settlement depends on the value of a foreign currency. The is because, to the extent that an option expires or is terminated when it is in the money, the amount to be paid under settlement is calculated with reference to the value of the underlying currency, while to the extent that the option expires out of the money, settlement generally does not happen.

The IRS argued that the definition should not apply to foreign currency options because Congress's intent was for it to include only forward contracts. As support for this, the IRS argued that under the 1982 act, the definition of a foreign currency contract did not include a contract the settlement of which depends on the value of a foreign currency. Recall that under the 1982 act, a foreign currency contract was any contract that, *inter alia*:

requires delivery of a foreign currency which is a currency in which positions are also traded through regulated futures contracts.

¹⁰*See, e.g.*, LTR 8818010; FSA 200025020, Notice 2003-81, 2003-2 C.B. 1223; Notice 2007-71, 2007-2 C.B. 472. However, see Lee A. Sheppard, “Foreign Currency Contract Shelters and the Unintended Consequences of Informal Guidance,” *Tax Notes*, Feb. 16, 2004, p. 827 (discussing contemporary government employee's interpretation of the statute).

¹¹*See, e.g.*, Michael J. Feder, L.G. “Chip” Harter, and David H. Shapiro, “Are OTC Currency Options Section 1256 Contracts?” *Tax Notes*, Dec. 22, 2003, p. 1470.

¹²*Summitt v. Commissioner*, 134 T.C. 248 (2010); *Garcia v. Commissioner*, T.C. Memo. 2011-85; *Wright v. Commissioner*, T.C. Memo. 2014-175.

A foreign currency option does not fall into this category because a physically settled option does not *require* delivery of the underlying; it only grants the holder the *right* to delivery, and this right is rarely, if ever, exercised when the option is out of the money. The IRS argued further that the expansion of the definition was added by the 1984 act only to include cash-settled contracts that were economically equivalent to contracts treated as foreign currency contracts under section 1256(g) as it existed pre-1984, that is cash-settled forward contracts. Therefore, cash-settled foreign currency options should not be treated as section 1256 contracts.

The court did not buy it. It held that under general principles of statutory construction, legislative history and congressional intent are examined only if the plain meaning of a statute itself is ambiguous. Section 1256(g)(2)(A)(i) states clearly that a contract whose settlement depends on the value of a foreign currency is a foreign currency contract. Because the settlement of a cash-settled foreign currency contract depends on the value of its underlier, a cash-settled foreign currency option is a foreign currency contract. If you strip away the jargon, the following lines could have been written by the court:

There are the Alps. What is there to say about them?
 They don't make sense. Fatal glaciers, crags
 cranks climb,
 jumbled boulder and weed, pasture and boulder,
 scree
 et l'on entend, maybe, le refrain joyeux et léger.
 Who knows what the ice will have scraped on
 the rock it is smoothing?
 There they are, you will have to go a long way
 round
 if you want to avoid them.
 It takes some getting used to. There are the
 Alps,
 fools! Sit down and wait for them to
 crumble!¹³

In addition, the court stated that the IRS should have no standing to challenge the plain meaning of the text because it has had the authority to issue regulations interpreting the statute since 1982. It also suggested that the IRS could have used other avenues of attack, such as the economic substance doctrine.

Is It the Correct Result?

The issue of whether a foreign currency option is a section 1256 contract is a subject that engenders strong emotion among a select few.¹⁴ When the case was reported, the Twitterverse (or what the Twitterverse would be, if financial instruments tax experts tweeted) lit up.¹⁵ The decision is inconsistent with long-held beliefs of many practitioners. But is it right?

The Wrights are not sympathetic litigants. The transaction that they entered into was a classic tax shelter that had no business purpose beyond the creation of tax benefits. It is clear that the policy behind section 1256(g)(2) is to ensure that foreign currency forwards, which are economically identical to foreign currency regulated futures contracts, are taxed in the same manner as foreign currency regulated futures contracts. Because foreign currency options are not economically similar to foreign currency regulated futures contracts, there is no policy reason for treating them similarly. The language inserted into the statute in 1984 was intended to clarify that contracts already classified as foreign currency contracts (that is, foreign currency forward contracts) should not be excluded from the definition of foreign currency contract merely because they are cash settled. The Wrights used a literal reading of the text to recognize a tax loss that did not reflect economic income.

But — the statute means what it means, right?

A full discussion of the plain meaning doctrine could be the subject of a separate, much longer article. That said, discussions about the plain meaning doctrine generally come down to what the word “means” means. Strict textualists prefer a statute to be read with reference to nothing but a dictionary. By contrast, purposivists read a statute in light of its history and legislative intent. If you were to ask a purposivist whether she seeks to make a statute mean what it does not mean, she would deny that allegation and say that, on the contrary, she seeks to clarify what the statute really means in light of its context. If one were to make a purposivist argument in the instant case, one would argue that section 1256(g)(2)(A) *is* ambiguous. We know that it is ambiguous because reasonable people have been arguing about its meaning since 1982. Given the statute’s ambiguity, it is appropriate to look to the historical and policy context of the law to interpret it. Although this may not be the winning argument, it should not be dismissed lightly.

¹³Basil Bunting, *On the Flyleaf of Pound's Cantos*, *Collected Poems* (2000).

¹⁴See, e.g., Sheppard, *supra* note 10.

¹⁵William R. Davis, “Sixth Circuit Subjects Foreign Currency Option to Mark-to-Market,” *Tax Notes*, Jan. 11, 2016, p. 183.

Regardless of the merits of the “plain meaning” argument, the estoppel argument made by the court near the end of the opinion seems to be a winner. When Congress passed the 1982 act, it granted the IRS the authority to issue regulations interpreting the meaning of the term “foreign currency contract.” The IRS knew that there was a difference of opinion regarding the interpretation of the term, and it had the power to clarify that foreign currency options do not constitute foreign currency contracts simply by declaring so in a regulation. The IRS can hardly complain that it lost a case because it sat on the right to settle the issue in its favor for 34 years.

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