TAX SHELTERS: A MAJOR-MINOR MISHAP

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The federal government has committed significant resources to battling tax shelters and has enjoyed some significant successes. Last week, however, the government stumbled in a foreign currency shelter case, *Wright v. Comm'r*, 2016 U.S. App. LEXIS 126 (6th Cir. Jan. 7, 2016). Wright involved a "major-minor" arrangement, which uses offsetting foreign currency options in conjunction with the mark-to-market rules of Section 1256 of the Internal Revenue Code to create tax losses. These transactions are labeled "major-minor" because one of the options involves a "major" currency, meaning there is regulated futures trading for that currency, while the other involves a "minor" currency that is not the subject of regulated futures trading.

The transaction works like this: the taxpayer arranges a series of OTC options with a counterparty, buying a Euro call option and a Euro put option with identical terms, and selling the counterparty a Danish Krone put and a Danish Krone call with identical terms. *Wright*, 2016 U.S. App. LEXIS 126, *6. The premiums are similar and largely offset one another. Because the put and call options have mirror terms, one will rise and the other will fall, and because the Danish Krone and the Euro follow very similar trading patterns, the two puts and the two calls will largely offset each other. *Id.*

Next, the taxpayer assigns his rights under the depreciated Euro option and the offsetting Krone option to a charity. In the taxpayer's view this assignment has two consequences: *first*, the assignment of the Euro option is a recognition event under Section 1256(c) of the Code; *second*, the Krone denominated option does not fall within Section 1256 of the Code, so his recognition of the gain embedded in that contract is deferred. *Id.* at *6-*7. After the assignment to the charity, the taxpayer and the counterparty then terminate the remaining options, triggering offsetting gains and losses. *Id.* at *7.

To understand how the shelter was intended to work, some background on Section 1256 of the Code is in order. Section 1256 directs that certain types of contracts be marked to market at year

end and that income be recognized at that time. Specifically, a contract that is governed by Section 1256 “shall be treated as sold for its fair market value on the last business day of such taxable year (and any gain or loss shall be taken into account for the taxable year).” I.R.C. § 1256(a)(1). Gains or losses are characterized under a set formula: 40 percent of the gain or loss is short term, while the remaining 60 percent is long term. I.R.C. § 1256(a)(3). The same rules apply if a contract subject to Section 1256 is terminated during a taxable year. I.R.C. § 1256(c)(1). Thus, if the Euro-denominated options employed in the major-minor shelter at issue in Wright fell within the scope of Section 1256, then the transaction with the charity triggers recognition of loss.

Not all contracts fit within the scope of Section 1256. The statute provides that a variety of types of contracts are covered, including “any regulated futures contract,” and “any foreign currency contract.” I.R.C. § 1256(b)(1), (2). *Wright* turned on whether the Euro-denominated option was a “foreign currency contract,” which is itself a defined term:

The term “foreign currency contract” means a contract—
(i) 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,
(ii) which is traded in the interbank market, and
(iii) which is entered into at arm’s length at a price determined by reference to the price in the interbank market.

I.R.C. § 1256(g)(2)(A). A Euro-denominated option potentially fits within this definition since the Euro is a major currency subject to regulated futures trading, while a Krone-denominated option would not as the Krone is not the subject of regulated futures trading.

The fact that the major-minor transaction employed options created an issue. In *Summit v. Commissioner*, 134 T.C. 248 (2010), the Tax Court addressed a major-minor transaction, holding that a Euro-denominated foreign currency option was not a foreign currency contract within the meaning of Section 1256(g)(2)(A). 134 T.C. at 264-66. Consequently, when the taxpayer in *Wright* filed a petition with the Tax Court, it followed that holding, disallowing the loss and imposing a penalty. 2016 U.S. App. LEXIS 126 at *10-*11. The Tax Court’s basic rationale was that an option contract did not fall within Section 1256(g)(2)(A) because it did not *require* delivery or settlement at a fixed point in time; instead settlement or delivery were deferred until the option was exercised, which might not occur. *Id.* at *11. This disposition was consistent with the IRS’s administrative position. *See* Notice 2007-71 2007-35 I.R.B. 472 (2007) (correcting prior notice and indicating that foreign currency options were not intended to fall within Section 1256).

On appeal, the Sixth Circuit reversed. In the Sixth Circuit’s view, the Tax Court’s insistence that a contract require settlement to fit within the definition of a foreign currency contract was wrong. 2016 U.S. App. LEXIS 126 at *13. Specifically, the Court focused upon first part of the definition of a foreign currency contract:

the statute provides that a “foreign currency contract” is (1) “a contract . . . which requires delivery of . . . a foreign currency” or (2) “a contract . . . the settlement of which depends on the value of . . . a foreign currency.” The use of the word “or” between the “delivery” and “settlement” phrases indicates that these phrases describe two ways in which a contract may qualify as a “foreign

currency contract." Further, the use of a comma after "delivery of" establishes that the word "requires" does not apply to the settlement prong.

Id. at *14. The Court then explained that the Euro-denominated option met the "settlement prong" because any settlement that would occur under the contract would depend on the value of the Euro as of the settlement date. *Id.* at *15-*16. While acknowledging that the option contract structure did not assure that a settlement would occur, the Sixth Circuit concluded that the plain language of the statute did not make settlement mandatory; instead it was sufficient that if settlement under the contract did occur, it would be depend on the value of the Euro. *Id.* at *16-*17.

The Court acknowledged that its reading of the statute had no support in tax policy, noting that its interpretation "seems to allow the Wrights to engineer a desired tax loss by paying only minimum cash outlay and engaging in major-minor transactions that subject the Wrights to little actual economic risk." *Id.* at *18.

Nonetheless, the Court refused to deviate from the plain language of Section 1256 for three reasons:

- *First*, it expressed concern that in attempting to recast Section 1256, it might simply create new tax-avoidance alternatives inadvertently.
- *Second*, the Court observed that the Commissioner had authority to exclude particular contracts from Section 1256 by regulation but had failed to do so.
- *Third*, it noted that the government remained free to attack similar arrangements as lacking economic substance. *Id.* at *20-*22.

This is an unusual disposition, as courts rarely acknowledge that they have construed a statute in a fashion that creates absurd results. Consequently, it will be interesting to see how other courts react to this construction of Section 1256. In addition, the Sixth Circuit remanded, which may permit the government to proceed on alternative theories, such as lack of economic substance. So while *Wright* represents a set-back for the government, participants in major-minor transactions should not assume that they will achieve similar results.

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