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Sixth Circuit Reverses Tax Court on Mark to Market/Foreign Currency Option can be a Foreign Currency Contract

The Court of Appeals for the Sixth Circuit recently held that over-the-counter (OTC) foreign currency options on major currencies are subject to section 1256. *Wright v. Commissioner*, No. 15-1071 (6th Circuit January 7, 2016) rev'g T.C. Memo 2011-292 and T.C. Memo 2014-175. The court's holding is contrary to the Internal Revenue Service's official position that section 1256 does not apply to OTC options on foreign currency. Notice 2007-71, 2007-2 C.B. 472.

A foreign currency contract that is subject to section 1256 must be marked to market if held at the close of the tax year. Absent an election, gains and losses on OTC foreign currency contracts are ordinary under section 988.

Section 1256 applies to section 1256 contracts, which include "foreign currency contracts." In general, a foreign currency contract is an OTC contract on a foreign currency, positions in which are also traded through regulated futures contracts (e.g., a "major currency"), entered into with a bank or someone else that deals in the interbank market. The IRS has interpreted the term "foreign currency contract" to be limited to forward contracts; thus, the IRS has not treated OTC foreign currency options as foreign currency contracts.

What the government does in response to the opinion will dictate the practical consequences of the case. The government has 45 days from the decision date to petition the court for a rehearing. Assuming a rehearing is not granted, Taxpayers may continue to rely on Notice 2007-71 (unless withdrawn by the IRS) to not treat OTC foreign currency options as section 1256 contracts. Taxpayers that have not been treating OTC foreign currency options as section 1256 contracts but would like to start doing so would have to request permission from the IRS to change their

method of accounting for such contracts; currently, it is unlikely that the IRS would grant such permission. Taxpayers that have not established a method of accounting for OTC foreign currency options may do so without seeking the IRS's permission, but for taxpayers outside of the Sixth Circuit, it is likely that the IRS would challenge subjecting such contracts to section 1256, and it is unclear whether another appellate court would reach the same conclusion as the Sixth Circuit. Finally, the IRS could promulgate regulations that exclude OTC options on foreign currency from section 1256.

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