Summitt v. Comm'r, 134 T. C. 248 (U. S. Tax Ct. 2010)

In Summitt v. Comm'r, the U. S. Tax Court ruled that a major foreign currency option assigned to a charity was not a 'foreign currency contract' under Section 1256 of the Internal Revenue Code, thus no loss could be recognized upon its assignment. The decision hinged on the statutory requirement for delivery or settlement at inception, which an option does not fulfill. This case sets a precedent for interpreting the scope of Section 1256 contracts and has significant implications for tax treatment of foreign currency derivatives.

Parties

Mark D. and Jennifer L. Summitt, as petitioners, were the taxpayers challenging the Commissioner of Internal Revenue's determination. The Commissioner of Internal Revenue, as respondent, sought partial summary judgment on the tax treatment of foreign currency options assigned by Summitt, Inc. , an S corporation in which Mark D. Summitt held a 10% share.

Facts

Summitt, Inc. engaged in foreign currency option transactions in 2002. On September 23, 2002, Summitt purchased two major foreign currency options (a EUR call and a EUR put) from Beckenham Trading Co. , Inc. and sold two minor foreign currency options (a DKK call and a DKK put) to Beckenham. These options were structured as reciprocal put and call pairs, offsetting each other. Two days later, on September 25, 2002, Summitt assigned the EUR call and the DKK call options to the Foundation for Educated America, Inc. , a charity. The potential loss on the EUR call option was $1,750,535, and the potential gain on the DKK call option was $1,745,285 at the time of assignment. Summitt later closed out the EUR put and DKK put options on December 12, 2002.

Procedural History

The Commissioner of Internal Revenue issued a notice of deficiency on March 15, 2007, disallowing a $1,767 flow-through loss from Summitt's foreign currency option transactions. The Summitts filed a petition with the U. S. Tax Court on June 12, 2007. On February 9, 2009, the Commissioner filed a motion for partial summary judgment, seeking a determination that the EUR call option assigned to charity was not a 'foreign currency contract' under Section 1256, thus no loss could be recognized, and that gain should be recognized on the assignment of the DKK call option. The Tax Court granted the motion on the EUR call option issue but denied it on the DKK call option issue, citing remaining material facts that required trial.

Issue(s)

Whether, under Section 1256 of the Internal Revenue Code, a major foreign currency call option assigned to a charity qualifies as a 'foreign currency contract'

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such that loss, if any, on the assignment of that option is recognized by the assignor in the year of assignment under the marked-to-market rules?

Rule(s) of Law

Section 1256 of the Internal Revenue Code defines a 'section 1256 contract' to include, among others, any 'foreign currency contract. ' A 'foreign currency contract' is defined in Section 1256(g)(2)(A) as a contract: (i) which requires delivery of, or the settlement of which depends on the value of, a foreign currency which is 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 interbank market price.

Holding

The U. S. Tax Court held that the major foreign currency call option assigned by Summitt to the charity was not a 'foreign currency contract' as defined in Section 1256(b)(2) and (g)(2) of the Internal Revenue Code. Consequently, the marked-to-market provisions of Section 1256 did not apply, and no loss was recognized by Summitt in 2002 on the assignment of the EUR call option to the charity.

Reasoning

The Court's reasoning focused on the statutory language and legislative intent behind Section 1256. The Court emphasized that the plain meaning of the statute requires that a 'foreign currency contract' must, at inception, obligate the parties to either deliver the currency or settle based on its value. A foreign currency option, however, does not impose such an obligation until it is exercised, if ever. The Court rejected the petitioners' argument that the addition of 'or the settlement of which depends on the value of' in 1984 amendments was intended to include options, finding instead that it was aimed at including cash-settled forward contracts. The Court also noted the absence of regulations from the Secretary that would include options within the definition of foreign currency contracts. The Court further distinguished between the economic and legal differences among futures, forwards, and options, which justified their different tax treatments. The Court concluded that Congress's specific inclusion of other types of options in Section 1256 suggested an intentional exclusion of foreign currency options.

Disposition

The Court granted the Commissioner's motion for partial summary judgment on the issue of the EUR call option, holding that no loss was recognized on its assignment to charity. The motion was denied on the issue of the DKK call option, with the Court finding genuine issues of material fact that required trial.

Significance/Impact

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This case is significant for clarifying the scope of ‘foreign currency contracts’ under Section 1256, particularly in the context of options. It establishes that foreign currency options do not qualify as ‘foreign currency contracts’ for purposes of applying the marked-to-market rules, impacting how taxpayers must account for gains and losses from such transactions. The decision also underscores the importance of statutory language in tax law interpretation and the role of legislative history and intent. Subsequent cases and tax practitioners will need to consider this ruling when structuring foreign currency transactions and assessing their tax implications.

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