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# U.S. Tax Court: Loss under section 1256(c) on foreign currency option transaction disallowed under section 165(c) for lack of profit motive

The U.S. Tax Court yesterday held that the taxpayers were prevented under section 165(c) from recognizing a loss under section 1256(c) on an alleged assignment of a foreign currency put option because there was no profit motive for entering into the original foreign currency option transactions.

The case is: *Wright v. Commissioner*, T.C. Memo 2024-100 (October 30, 2024). Read the Tax Court's opinion

**Summary**

During 2002, a partnership owned by the taxpayer and his wife realized long-term capital gains of $3,456,988 on sales of stock that the partnership had acquired from the taxpayer. Subsequently, the taxpayers' estate planning attorney and accountant recommended that the taxpayers engage in foreign currency option transactions to generate losses that could offset the capital gains.

To that end, during December 2002, the partnership purchased both a euro put option (for a nominal premium of $36,177,750) and offsetting euro call option (for a nominal premium of $36,177,750), and a Danish krone put option (for a nominal premium of $36,162,000) and offsetting Danish krone call option (for a nominal premium of $36,162,000). The puts and calls were European-exercise options, meaning that they could be exercised only at a specified time on their expiration date (not at just any time), and they each contained a digital kicker, requiring a fixed payment if the exchange rate between the U.S. dollar and the Danish krone was below a certain amount at a specified time on the options' expiration date. The options were all with the same counterparty, and the partnership paid only the net premium of the four options ($31,500) to the counterparty and received no payment from the counterparty. The counterparty also did not require the partnership to post any margin collateral in respect of the Danish krone straddle it sold despite the partnership's potentially unlimited nominal obligations as the Danish krone straddle's writer.

Later in December 2002, the partnership and the counterparty allegedly assigned both put options to a charity. At the time of their alleged assignment, the euro put option was valued at $33,018,574, and the Danish krone put option was valued at $33,012,274. The net value of the allegedly assigned put options was $6,300. The partnership did not, however, assign the euro or Danish krone call options to the charity. Instead, the partnership and the counterparty closed out those positions by offsetting them. To close out the euro call option, the partnership sold an offsetting call option to the counterparty for a nominal premium of $39,318,026. To close out the Danish krone call option, the partnership purchased an offsetting call option

from the counterparty for a nominal premium of $39,311,726. Thus, by the close of the option transactions, the partnership had paid only $25,200 ($31,500 previously paid plus $39,311,726 nominally paid minus $39,318,026 nominally received) to engage in the option transactions, excluding transaction costs including $25,000 paid for a tax opinion letter and $27,500 for purported management fees.

The partnership took the position that the purported assignment of the euro put option to the charity resulted in a termination as defined in section 1256(c) and reported a short-term capital loss of $3,159,176, which flowed through to the taxpayer and his wife. The partnership did not report any gain or loss in respect of the Danish krone put option's alleged assignment, but reported a $3,140,276 gain from the termination of the euro call option and a $3,149,276 loss from the termination of the Danish krone call option.

The IRS disallowed the partnership's short-term capital loss claimed as a result of the purported assignment of the euro put option to the charity, and the Tax Court in an earlier decision upheld the IRS' disallowance on the grounds that the euro put option was not a "foreign currency contract" as defined in section 1256(g)(2) subject to mark-to-market recognition of gain or loss under section 1256(c). The taxpayers appealed that earlier decision, and the U.S. Court of Appeals for the Sixth Circuit reversed and remanded for further proceedings (*Wright v. Commissioner*, 809 F.3d 877 (6th Cir. 2016)).

In the further proceedings before the Tax Court, the IRS argued that the partnership did not actually assign the euro option to the charity. The IRS further argued that even if such an assignment occurred and caused the partnership to recognize a loss under section 1256, the taxpayers could not recognize the loss under section 165(c), which prevents individuals from deducting losses unless incurred in a trade or business or in a transaction entered into for profit (other than certain casualty or theft losses).

After reviewing the facts in the record, the Tax Court held that the partnership did not establish any profit motive for entering into the foreign currency option transactions. The court stated, "[e]ven though the positions offset nearly perfectly, however, [the partnership] could expect that it would always have a loss in one component option of the euro straddle that it purchased, which it could terminate (along with the offsetting sold position in a minor currency) at its discretion to generate an artificial capital loss." The court emphasized that it did not hold that transactions on the same terms as the partnership's foreign currency option transactions could never be attended by profit motive (such as a motive to speculate on the possibility that two currencies will decouple from each other or for other bona fide business or investment reasons), but only that the record did not support such a motive on the partnership's part.

The court also rejected the taxpayers' argument that sections 1211(b) and 1256(a) somehow override the application of section 165 with respect to losses arising from the sale or exchange of capital assets.