Tax Avoidance Using Offsetting Foreign Currency Option Contracts

Notice 2003–81

The Internal Revenue Service and the Treasury Department are aware of a type of transaction, described below, in which a taxpayer claims a loss upon the assignment of a section 1256 contract to a charity but fails to report the recognition of gain when the taxpayer's obligation under an offsetting non-section 1256 contract terminates. This notice alerts taxpayers and their representatives that these transactions are tax avoidance transactions and identifies these transactions, and those that are substantially similar to these transactions, as listed transactions for purposes of § 1.6011–4(b)(2) of the Income Tax Regulations and §§ 301.6111–2(b)(2) and 301.6112–1(b)(2) of the Procedure and Administration Regulations. This notice also alerts parties involved with these transactions of certain responsibilities that may arise from their involvement with these transactions.

FACTS

A taxpayer pays premiums to purchase a call option and a put option (the purchased options) on a foreign currency. The currency is one in which positions are traded through regulated futures contracts, and the purchased options, therefore, are foreign currency contracts within the meaning of section 1256(g)(2)(A) of the Internal Revenue Code and section 1256 contracts within the meaning of section 1256(b). The purchased options are reasonably expected to move inversely in value to one another over a relevant range, thus ensuring that, as the value of the underlying foreign currency changes, the taxpayer will hold a loss position in one of the two section 1256 contracts. The taxpayer also receives premiums for writing a call option and a put option (the written options) on a different foreign currency in which positions are not traded through regulated futures contracts. Thus, the written options are not foreign currency contracts within the meaning of section 1256(g)(2)(A), nor are they section 1256 contracts within the meaning of section 1256(b). The written options are reasonably expected to move inversely in value to one another over a relevant range, thus ensuring that, as the value of the underlying foreign currency changes, the taxpayer will hold a gain position in one of the two non-section 1256 contracts.

The values of the two currencies underlying the purchased and written options (i) historically have demonstrated a very high positive correlation with one another, or (ii) officially have been linked to one another, such as through the European Exchange Rate Mechanism (ERM II). Thus,

as the currencies change in value, the taxpayer reasonably expects to have the following potential gains and losses in substantially offsetting positions: (1) a loss in a purchased option and a gain in a written option; and (2) a gain in a purchased option and a loss in a written option. At any time, the taxpayer's loss in the purchased option position that has declined in value may be more or less than the taxpayer's gain in the offsetting written option position that has appreciated in value. Similarly, the taxpayer's gain in the remaining purchased option position may be more or less than the taxpayer's loss in the remaining written option position. A material pre-tax profit or rate of return, or both, on the transaction is possible but unlikely.

The taxpayer assigns to a charity the purchased option that has a loss. The charity also assumes the taxpayer's obligation under the offsetting written option that has a gain. As with all written options, the amount of gain on the option is limited to the premium received for the option. In the same tax year, the taxpayer may dispose of the remaining purchased option and offsetting written option.

Because the purchased option assigned to the charity is a section 1256 contract, the taxpayer relies on section 1256(c) and *Greene v. United States*, 79 F.3d 1348 (2d Cir. 1996), to mark to market the purchased option when the option is assigned to the charity and to recognize a loss at that time. In contrast, because the assumed written option is not a section 1256 contract, the taxpayer claims not to recognize gain attributable to the option premium. Specifically, the taxpayer claims that the charity's assumption of the option obligation does not cause the taxpayer to recognize gain and that the taxpayer also does not recognize gain either at the time the option expires or terminates or at any other time.

ANALYSIS

Rev. Rul. 58–234, 1958–1 C.B. 279, *clarified by* Rev. Rul. 68–151, 1968–1 C.B. 363, holds that an option writer does not recognize income or gain with respect to a premium received for writing an option until the option is terminated, without exercise, or otherwise. *Accord* Rev. Rul. 78–182, 1978–1 C.B. 265; *Koch v. Commissioner*, 67 T.C. 71 (1976), *acq.* 1980–2 C.B. 1. Rev. Rul. 58–234 explains that this is the treatment for the option writer because the option writer assumes a burdensome and continuing obligation, and the transaction therefore stays open without any ascertainable income or gain until the writer's obligation is finally terminated. When the option writer's obligation terminates, the transaction closes, and the option writer must recognize any income or gain attributable to the prior receipt of the option premium.

In some cases, the option writer's obligation under the option contract may terminate on the charity's assumption of the written option obligation. In other cases, the writer will have a continuing obligation because the writer may be called upon to perform if the charity fails to perform or to reimburse the charity for any losses or expenses it may incur if called upon to perform. If an assumption terminates the option writer's obligation under the option contract, the option writer must recognize gain when the option obligation is assumed. If the assumption does not terminate the option writer's obligation under the option contract, the option writer must recognize the premium when the option writer's obligation under the option contract terminates (other than through an exercise of the option against, and performance by, the option writer).

These general principles remain applicable even if the assumption of the option writer's obligation is part of what the taxpayer claims is a donative transaction. *Cf. Diedrich v. Commissioner*, 457 U.S. 191 (1982) (noting that if a donee pays a gift tax obligation arising from a donative transfer, the donative nature of the transaction does not preclude income recognition by the donor on the obligation assumed). Here, the taxpayer has made a transfer to the charity of the purchased option, and the charity has assumed the burden of the written option. No aspect of the taxpayer's transfer or the charity's assumption (or their combination) relieves the taxpayer from its duty under the Code to account for the gain attributable to the premium originally received by the taxpayer for assuming the burden of writing the option. *See Lucas v. Earl*, 281 U.S. 111 (1930) (holding that a taxpayer may not avoid inclusion of future earned income by making a gratuitous transfer of the right to receive the income).

Finally, if the taxpayer has any unrecognized gain on the written option at the end of the year in which the assumption occurs (*e.g.*, the assumption did not terminate the option writer's obligation under the option contract), the mark-to-market loss on the offsetting contributed section 1256 contract will be deferred under section 1092.

Transactions that are the same as, or substantially similar to, the transactions described in this notice are identified as "listed transactions" for purposes of §§ 1.6011–4(b)(2), 301.6111–2(b)(2) and 301.6112–1(b)(2) effective December 4, 2003, the date this notice was released to the public. Variations on these transactions may include positions in other section 1256 and non-section 1256 contracts. Independent of their classification as "listed transactions" for purposes of §§ 1.6011–4(b)(2), 301.6111–2(b)(2), and 301.6112–1(b)(2), transactions that are the same as, or substantially similar to, the transaction described in this notice may already be subject to the disclosure requirements of section 6011 (§ 1.6011–4), the tax shelter registration requirements of section 6111 (§§ 301.6111–1T, 301.6111–2), or the list maintenance requirements of section 6112 (§ 301.6112–1). Persons who are required to register these tax shelters under section 6111 but have failed to do so may be subject to the penalty under section 6707(a). Persons who are required to maintain lists of investors under section 6112 but have failed to do so (or who fail to provide those lists when requested by the Service) may be subject to the penalty under section 6708(a). In addition, the Service may impose penalties on parties involved in these transactions or substantially similar transactions, including the accuracy-related penalty under § 6662.

The Service and the Treasury recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this notice. These taxpayers should consult with a tax advisor to ensure that their transactions are disclosed properly and to take appropriate corrective action.

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