Part III – Administrative, Procedural, and Miscellaneous

Modification of Notice 2003-81

Notice 2007-71

This Notice modifies and supplements Notice 2003-81, 2003-2 C.B. 1223, by correcting a statement in the "Facts" portion of Notice 2003-81.

BACKGROUND

On December 4, 2003, the Internal Revenue Service ("Service") and the Treasury Department ("Treasury") published Notice 2003-81, which described a tax avoidance transaction involving offsetting foreign currency options and identified such transaction and those substantially similar to it 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.

In the transaction described in Notice 2003-81, a taxpayer pays premiums to purchase a call option and a put option (the purchased options) on a foreign currency in which positions are traded through regulated futures contracts. 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 purchased options. 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. The taxpayer takes the position that the written options are neither foreign currency contracts within the meaning of § 1256(g)(2)(A) nor §1256 contracts within the meaning of §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 written options.

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. The premium received on that written option is not assigned but is retained by the taxpayer. 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 taxpayer takes the position that the purchased option assigned to the charity is a § 1256 contract, the taxpayer relies on § 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 taxpayer takes the position that the assumed written option is not a § 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

Although as a general matter the “Facts” portion of Notice 2003-81 correctly describes the transaction at issue, it includes an erroneous conclusion of law. The second sentence in the “Facts” portion of Notice 2003-81 states: “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 § 1256(g)(2)(A) of the Internal Revenue Code and §1256 contracts within the meaning of §1256(b).”

This sentence should have stated “The taxpayer takes the position that the purchased options are foreign currency contracts within the meaning of §1256(g)(2)(A) of the Internal Revenue Code and §1256 contracts within the meaning of §1256(b).” The Service and Treasury do not believe that foreign currency options, whether or not the underlying currency is one in which positions are traded through regulated futures contracts, are foreign currency contracts as defined in §1256(g)(2), and intend to challenge any such characterization by taxpayers.

Section 1256(g)(2)(A) defines a foreign currency contract, in part, as a contract that requires delivery of, *or the settlement of which depends on the value of*, certain foreign currencies. The original statutory definition, however, did not allow for cash settlement and required actual delivery of the underlying foreign currency in all circumstances. Options, by their nature, only require delivery if the option is exercised. Section 102 of the Tax Reform Act of 1984, P.L. 98-369, 1984-3 (Vol. 1) C.B. 128, added the clause “or the settlement of which depends on the value of.” There is no indication, however, that Congress intended by this addition to extend the definition of “foreign currency contract” to foreign currency options. That conclusion is confirmed by the legislative history to § 988(c)(1)(E), enacted by the Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647, 1988-3 C.B. 377-380, which indicates that a foreign currency option is not a foreign currency contract as defined in §1256(g)(2).

Subject to the following, §7805(b) relief is granted to taxpayers that adopted an accounting method in reasonable reliance on Notice 2003-81 to treat over-the-counter foreign currency options as foreign currency contracts as defined in §1256(g)(2). Section 7805(b) relief is not granted with respect to options entered into in transactions that are the same or substantially the same as those described in Notice 2003-81.

Further, §7805(b) relief is not granted with respect to options entered into in any transaction identified as a listed transaction for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2) and 301.6112-1(b)(2).

The principal authors of this notice are Mark E. Erwin of the Office of Associate Chief Counsel (International) and Patrick E. White of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this notice contact Mark E. Erwin at (202) 622-3870 or Patrick E. White at (202) 622-3920 (not a toll free call).