November–December 2012

Financing International Operations

By L.G. "Chip" Harter, Rebecca E. Lee and Jeffrey Maddrey*

Hedging the Foreign Currency Purchase Price of a Foreign Stock Acquisition

L.G. "Chip" Harter, **Rebecca Lee** and **Jeffrey Maddrey** are Principals in the Washington National Tax Practice of PricewaterhouseCoopers LLP.

I. Introduction

In recent years, IRS examiners have begun to focus on the tax treatment of hedges of the foreign currency purchase price in foreign stock acquisitions. Many U.S.-based multinationals enter into stock purchase agreements to acquire foreign target corporations. The purchase price in such acquisitions is often denominated in foreign currency, particularly where the selling shareholders are foreign persons. Given that a significant period of time often elapses between the date a stock purchase agreement (SPA) is signed and the date the transaction closes, a U.S. purchaser can be exposed to large foreign currency fluctuations when it has an obligation to pay at closing a purchase price denominated in foreign currency.

A purchaser may find it prudent to avoid this exposure by hedging the dollar value of the foreign currency denominated purchase price. If the purchaser is arranging financing for the acquisition in dollars, hedging the dollar value of the purchase price can assure that the dollar financing will be sufficient to fund the purchase of the foreign currency required to close the transaction. In addition, U.S. purchasers often agree to pay a foreign currency denominated purchase price even where the value of the target is more closely correlated to the value of the dollar than to the value of the foreign currency. Such is often the case in purchases of natural resource companies that produce commodities that trade in dollars on the global market, such as oil, coal or iron ore. A purchaser, for example, may agree to pay Australian dollars to acquire an Australian coal company, even though the revenue of the company from the sale of coal is primarily in U.S. dollars. If the Australian dollar were to appreciate between the date that the SPA is entered into and its closing date, the U.S. dollar costs of the purchase would increase without a corresponding increase in the U.S. dollar value of the company purchased. Entering into a hedge of the U.S. dollar value of the Australian dollar purchase price assures the purchaser that it is paying a U.S. dollar amount for the target that corresponds to the value of its U.S. dollar revenue streams.

As discussed below, Treasury regulations under Code Sec. 988 provide an important and useful regime that allows a taxpayer to treat the gain or loss on a foreign currency hedge of an SPA as an adjustment to the purchase price of the target. Any gain or loss on the currency hedge is not taxed currently and is instead capitalized into the purchaser's basis in the shares acquired. The hedge must be identified as an integrated hedge on the day it is entered into, to assure that the taxpayer cannot use hindsight to choose to integrate gains but not losses. Both the hedge and the SPA must satisfy detailed technical requirements to be eligible for integrated treatment.

> The stakes on this issue are high, however, because if the outbound transfers of the SPA and the hedges were analyzed separately, gain on the hedge would be recognized in an outbound transfer under Reg. §1.367(a)-5T, but loss would not be recognized.

One significant feature of the regulations is that they permit the IRS on audit to identify a hedge as an integrated hedge where the taxpayer has not done so. The IRS has discretion to integrate the hedge even where the hedge fails to satisfy the requirements of the regulations, such that the taxpayer would not have been permitted to make the identification for itself. In recent years, IRS agents have been identifying hedges for integrated treatment with increasing frequency, raising an issue about the proper exercise of the Commissioner's discretion under this provision. The regulations provide no guidance as to the circumstances under which it is appropriate for the IRS to exercise the Commissioner's discretion to integrate a hedge. We believe that the Commissioner's discretion is properly exercised in two situations. First, if a taxpayer originally identified a transaction but later, when it becomes clear that the hedge will produce a loss, asserts that the transaction failed to meet the regulation's requirements for integration, the IRS may appropriately hold the taxpayer to its original election to integrate. Second, if a taxpayer identifies a hedge as integrated, but inadvertently "foot faults" out of integrated treatment due to the rigidity of the rules, the IRS should use is discretion in a private letter ruling, in a pre-filing agreement, or on examination to allow the taxpayer the benefit of the intended integrated treatment.

For reasons discussed below, we believe that the IRS should not use its identification ability to override a taxpayer's up-front choice of whether or not to integrate, where the taxpayer is bound to the consequences of that up-front choice. We believe that it is especially inappropriate for the IRS to force integration in those instances where the taxpayer could not have chosen to integrate the hedge for itself. From a taxpayer's perspective, the best course generally is to structure hedges of SPAs so as to satisfy the requirements of the regulations and then to make the integrated hedging identification. Doing so provides appropriate and predictable tax treatment and avoids the possibility that the IRS will use its discretion to retroactively integrate a hedging loss. As discussed below, it is often difficult to satisfy the requirements of the regulations in an international acquisition context. In addition, there are ambiguities in the regulations that make it difficult to know whether a given purchase contract and hedge qualify for integration by the taxpayer.

II. Overview of Terms in Reg. §1.988-5(b)

Foreign currency hedges of SPAs potentially fall under Reg. §1.988-5(b), which applies to foreign currency hedges of executory contracts. The operative rule of Reg. §1.988-5(b) is straightforward: "If a taxpayer enters into a hedged executory contract ... the executory contract and the hedge shall be integrated."[1] The effect of "integrated" treatment is that the Code Sec. 988 gain or loss arising from the "hedge" is not tax accounted for under Code Sec. 988; instead, it is capitalized into the purchase or sale transaction.[2] Thus, for example, if a dollar taxpayer enters into an executory purchase contract where the taxpayer commits to deliver a fixed amount of Euros in exchange for property or services at a future date, any Code Sec. 988 gain or loss on a properly associated "hedge" is not accounted for under Code Sec. 988 and, instead, is reflected in the taxpayer's initial basis in the acquired property. Similarly, if a dollar taxpayer enters into an executory contract to sell property for a fixed amount of Euros, Code Sec. 988 gain or loss on the hedge is reflected in the taxpayer's amount realized.

The regulation has three critical elements: (1) the definition of an "executory contract," (2) the definition of a "hedge," and (3) the identification requirement. Each is discussed in turn below.

A. Executory Contract

An "executory contract" is defined as an agreement to purchase or sell property or services where the consideration for the purchase or sale is to be paid in (or determined by reference to) nonfunctional currency of the taxpayer.[3] When originally proposed, the definition was limited to property "used in the ordinary course of the taxpayer's trade or business" or "held for sale in the ordinary course of the taxpayer's trade or business." In response to comments, the final regulations expanded the "executory contract" definition to cover contracts for the purchase and sale of stock.

The definition's original inventory focus can be seen in its use of the term "accrual date." The accrual date is the date the taxpayer tax accounts for the underlying purchase or sale (typically, the time title passes to the property being purchased or sold). The contract is "executory" for the period between the time it is entered into and the accrual date.[4] If payment is not made on the accrual date, the payment right or obligation becomes a simple nonfunctional currency denominated receivable or payable; by definition, the "executory" phase of the contract ends on the accrual date.

B. Hedge

A "hedge" for this purpose is a foreign currency position that offsets the foreign currency payment or receipt component of the executory contract.[5] The foreign currency position must be: (1) a foreign currency forward or future, (2) a foreign currency option, or (3) a deposit of foreign currency in a specially designated "hedging account," or some combination of these.

There is no requirement that the hedge be a complete or perfect hedge of the embedded currency risk. Partial hedges are clearly contemplated. Partial hedges, such as options, may cover only some of the foreign currency exposure for the entire period of the executory contract. Hedges may also be partial because they naturally relate to less than all of the period of the executory contract. Finally, the regulations contemplate that a taxpayer can treat a series of hedges as a hedge for this purpose.[6] Thus, for example, a series of rolling forward contracts could constitute a good hedge.

There are a couple of additional requirements for a good hedge. First, the hedge must be entered into by the same taxpayer that entered into the executory contract.[7] If the executory contract was entered into by a QBU of a taxpayer, the hedge must be entered into by the QBU.[8] Second, the counterparty to the hedge must not be a related party within the meaning of Code Sec. 267(b) or Code Sec. 707(c)(1).[9] Third, the hedge must not be entered into *before* the executory contract is entered into.[10] The hedge can be entered into on the same day as the executory contract or on a date after the executory contract, just not before.

C. Identification

The third critical requirement is that the combination of the hedge and the executory contract be "identified" as a "hedged executory contract."[11] The regulations contain a two-part identification process. First, a taxpayer is allowed to identify the contract no later than the date the hedge is entered into (which must be on or after the date the executory contract is entered into) by documenting in its tax books and records its intention to treat the combination as a hedged executory contract.[12]

If a taxpayer fails to identify the hedged executory contract, the Commissioner may identify upon examination.[13] Significantly, the regulations do not place the same limitations on the Commissioner's ability to integrate a hedge that taxpayers must comply with. The Commissioner may integrate if it can be established that an "executory contract" exists and the executory contract is "in substance hedged." Those are the only two factual predicates to the application of the Commissioner's discretion under the regulation.

The Commissioner's ability to identify after the fact, and without regard to whether all of the substantive requirements of the regulations are satisfied, has the potential to make the hedged executory contract regime less elective than it first appears. Yes, the taxpayer has the theoretical right not to identify a foreign currency hedge to a foreign currency executory contract, but note what happens if the taxpayer exercises this "right." The hedge will either produce a current Code Sec. 988 gain or loss. If it produces a gain, the taxpayer will include current ordinary income and the Commissioner will be unlikely to alter this treatment on exam. If the hedge produces a loss, the taxpayer may initially report the loss as current and ordinary, but the taxpayer runs the risk that the Commissioner will exercise his discretion to integrate, capitalizing the loss into the basis of the acquired property (or proceeds from the sale of property). To avoid this character and timing whipsaw, a taxpayer would be effectively compelled to identify if the Commissioner has unlimited discretion to selectively identify losing hedging transactions. Only by identifying upfront could the taxpayer be assured it would get symmetrical treatment for hedging gains and losses. This of course assumes that the taxpayer is able to identify under the more stringent requirements that apply to taxpayers, which is frequently not the case.

III. Difficulties in Qualifying for Integrated Treatment

The integrated treatment rules work quite well in the case of hedges of inventory purchases and sales denominated in foreign currency, as well as purchases of big-ticket capital expenditures denominated in foreign currency. In these situations, the executory contract is, for lack of a better word, a "routine" business contract and the hedge is in many ways a "routine" business hedge. The tax analysis is usually straightforward—the contract is executory, the hedge is a good hedge, and the identification can be properly executed. In short, the rules work.

The rules are considerably more difficult to apply where a U.S. multinational is contemplating the purchase of a foreign corporation whose shares trade in a currency other than the dollar. The U.S. acquirer will typically enter into a SPA with the selling shareholder, or the foreign target in the case of a public tender offer, that typically sets a price denominated in the currency of the target. If the U.S. acquirer decides to hedge the foreign currency risk presented by the SPA, a number of significant interpretive issues typically arise. These are discussed immediately below.

A. When Does a SPA Constitute an "Executory Contract"?

The first issue is whether (and when) a stock purchase agreement constitutes an executory contract. As mentioned earlier, the executory contract definition was originally developed to deal with routine inventory purchases and sales where the determination of whether a contract exists is typically straightforward.[14]

In the case of a stock purchase agreement, the determination of whether and when an executory contract exists is considerably more difficult. Consider the life-cycle of the typical acquisition of a publicly traded target. It starts either with the acquirer's decision to seek a target, the identification of the target, and pre-SPA diligence around suitability of the acquisition. The acquirer and the target may enter into a letter of intent or memorandum of understanding that provides for confidential exchanges of information and limits the ability of the target to shop itself to others for a specific exclusivity period.

Continuing on (assuming the transaction continues—many do not), an "offer" is made to the target or the target's shareholders. There would subsequently be "acceptance" which thereby creates the executory contract, *i.e.,* the binding obligation to do something in the future. Who makes the offer and issues the acceptance, and how the offer and acceptance is communicated differs dramatically depending on whether the transaction is private or public, and whether the transaction is purely domestic or involves a non-U.S. target.

In the domestic private deal context, for example, the offer would typically be an offer communicated from the purchaser to the target shareholders. The shareholders would accept, and a contract would be executed between the purchaser and the selling shareholders. There may be conditions subsequent to execution of the agreement that have to be fulfilled prior to closing, but both parties are locked in at that time and cannot back out (assuming the subsequent conditions are satisfied) without providing the other with a cause of action for damages.

Things are not quite so simple if the deal involves a foreign target or if the deal is public. Even in a private deal with a foreign target in France, for example, works council approval may be required. Should the executory contract be considered to arise prior to works council approval? These definitional issues are particularly acute in the context of tenders for public corporations, where it is impractical to enter into a contract with each and every shareholder. That is why both domestic and foreign law typically provide for one or more "forcing" techniques whereby, if a sufficient number of shareholders agree to participate, corporate law ensures that all of the shares of the target (whether held by a participating shareholder or not) will be cancelled and exchanged for consideration (whether its cash or stock of the acquiring company). In these situations, the management of the target corporation typically enters into a contract with the potential buyer under which the parties agree to go through a process to attempt to (1) get the approval of the target's board of directors, (2) get the shareholders to vote to approve the tender offer, and may also need to (3) get approval of a court to review the transaction for fairness, effect the transfer of the shares, and to squeeze out dissenters. At the time the potential buyer enters into the contract with the management of the target, the current shareholders of the corporation are not parties to the agreement or yet under any obligation to sell. It is far from clear that such an agreement rises to the level of an executory contract to purchase shares when the sellers have not even had the offer communicated to them, have not voted in favor of the transaction, and are not yet bound to sell their shares under local law. It is not even clear that once the shareholders have voted in favor of the acquisition that an executory contract has arisen if a reviewing court still has to approve. In other words, the reviewing court's approval may not simply be a condition subsequent, the reviewing court's approval (in some jurisdictions) allows for shareholders to essentially have another bite at the apple and argue why the deal is unfair (underpriced) and urge the court to reject the transaction. In these situations, the court could almost be viewed as a third party to the transaction which has to also grant its acceptance before the contract is completely formed. Nevertheless, if a buyer seeks to enter into an integrated hedge of such a contract it would be helpful for the IRS to issue guidance specifically providing that such a contract can qualify for integrated hedging if the taxpayer chooses to identify the hedge.

B. The Same Person Must Be Party to Both Executory Contract and Hedge

A second difficult issue relates to the "single taxpayer" requirement. As mentioned earlier, the regulations limit hedged executory contract treatment to hedges that are entered into by the same taxpayer that enters into the executory contract. This rule is restrictive, even for inventory purchases, because (unlike the Code Sec. 1221 regulations) there is no exception for consolidated groups of corporations that allows one member of the group to enter into a hedge of the risk of another member of the group. For stock purchases, it is even more so. There are significant commercial and legal impediments to having both the stock purchase agreement and the corresponding hedge entered into the by the same legal entity, which we describe below.

There are a number of impediments to having any entity other than the top-tier U.S. parent enter into the SPA to purchase a target, even though that is not where the target is going to ultimately be owned by the U.S. multinational group. The seller typically prefers to contract directly with the U.S. parent as it is the entity in the acquiring group with the strongest credit. The contract typically provides the U.S. parent the right to designate a different lower-tier entity to be the ultimate acquiring corporation, because closing the purchase into a foreign acquisition company may be desirable for a variety of legal and tax reasons. Having the U.S. parent be the initial party to the SPA, with the ability to assign its rights prior to closing, is driven by both practical and legal considerations. Often, at the time of the SPA, the U.S. parent does not know which entity it wants to designate to close the transaction. In many cases, the entity that ultimately closes the transaction may not even exist at the time of the SPA—it may be formed after the SPA and in anticipation of the closing.

Even when it is possible to have the foreign entity in place and execute the SPA, problems arise because these legal and practical considerations also apply to entering into the hedge. Invariably, the hedge will need to be entered into by the entity in the U.S. acquirer's controlled group that has an existing relationship with a derivatives dealer. This is often the top-tier U.S. entity, but in some cases there may be one or more CFC's in the controlled group that have the requisite relationships in place. It is very unlikely, especially after the 2008 financial crises, that a counterparty will enter into a hedge directly with another entity without substantial additional due diligence and a parent guarantee of the subsidiary's ability to satisfy its obligations.

In short, both the executory contract and the hedge may be entered into at the U.S. parent level even though it is expected that the purchase will actually close into a lower-tier foreign acquisition company. Although the rights under the SPA may be assigned prior to closing, it is more typical that the U.S. parent remains the party to the hedge, as the creditworthy party with the banking relationships. Given these commercial realities, many acquirers find themselves in a position where they do not expect that the party entering into the hedges will be the same corporation that acquires the target. Under such circumstances, the U.S. parent may not be able to conclude that it is permitted to identify its hedges for integrated treatment.

IV. Structuring Acquisitions to Qualify for Integrated Hedging Treatment

There are a number of ways that a taxpayer can structure a foreign acquisition to attempt to satisfy the requirement that the same person be the party to both the SPA and the hedging transactions. As discussed below, however, it can be difficult finding a structure that satisfies both the tax requirements and the local legal and commercial requirements.

A. Have Foreign Acquisition Company Be Party to Both the SPA and Hedge

Having the foreign acquisition subsidiary in place at the time the SPA and hedges are entered into, and having that acquisition subsidiary be the party to both the SPA and the hedges clearly satisfies the requirements of the regulations. Such an approach is often not commercially practical, given that speed is of the essence in reaching an acquisition agreement, and the buyer may not even know where in its structure it wants the target to end up at the time the SPA is signed. It also can take time for a new acquisition subsidiary to get all of the financial documentation in place required to enter into the high value derivatives transactions required to effectively hedge the purchase price. Concerns about whether the acquisition subsidiary has the capitalization and credit quality to enter into the SPA and hedges can be addressed through parent guaranties of its contracts. Given enough lead time, it is therefore theoretically possible to comply with the regulations in this manner, but in many deals, where time is short, it will not be practical.

B. Have the U.S. Parent Close the Purchase Then Contribute Target into Foreign Holding Structure

An alternative that is sometimes feasible is to have the U.S. parent be the party to both the SPA and the hedges, to have it close the purchase, and then have it contribute the target down into a foreign ownership structure post-closing. As discussed above, the U.S. parent is often the entity best positioned to enter into the SPA and to hedge expeditiously. Post-closing, the shares of the target can be contributed into a foreign holding company structure through outbound Code Sec. 351 transfers without the recognition of gain, provided that Code Sec. 367(a) gain recognition agreements are entered into. The primary impediment to this approach is that in many jurisdictions it is necessary, or at least customary, to use a local acquisition company to close the purchase, especially in public tender offers.

Moreover, this approach may make it more difficult to introduce leverage at the foreign country level (which ultimately lowers foreign tax and redounds to the benefit of the U.S. tax authorities). This is because the interest deductibility limitations in many foreign countries are more stringent for debt incurred to acquire assets or property from a related party than they are for debt incurred to acquire assets or property from an unrelated party.

C. Have the U.S. Parent Be the Initial Party to Both the SPA and Hedges, Then Transfer Both Outbound Prior to Closing

A third alternative would be to have the U.S. parent be the initial party to both the SPA and the hedges, then assign its rights and obligations under both sets of contracts to the foreign acquisition subsidiary prior to closing. The parent could thus enter into the contracts expeditiously and make the integrated hedge identification on the date the hedges are entered into. An issue arises as to the treatment of the assignment of the SPA and the hedges, because the regulations do not directly address the treatment of an assignment of the components of a hedged executory contract. Once the U.S. parent has made an integrated hedge designation so that the executory contract is effectively treated as a synthetic dollar denominated contract, it seems entirely appropriate to treat the simultaneous assignments of the SPA and the hedges as an assignment of that dollar denominated contract for tax purposes. The assignee could then make its own integrated hedge designations to maintain the integrated treatment. Unfortunately, the regulations do not directly address this scenario, although arguments can be made that it should work under the existing regulations. The stakes on this issue are high, however, because if the outbound transfers of the SPA and the hedges were analyzed separately, gain on the hedge would be recognized in an outbound transfer under Reg. §1.367(a)-5T, but loss would not be recognized. It would be very helpful for the IRS to issue guidance specifically permitting the outbound transfer of the components of a hedge executory contract without the recognition of gain.

D. Have the SPA Be Entered into by a Foreign DE of the U.S. Parent That Is Not a QBU; Have Parent Hedge

An approach that sometimes works in cases where local law requires that a local entity be the party to the SPA is to use a disregarded entity organized under local law, but owned by the U.S. parent. If the U.S. parent then enters into the hedging transactions, the requirement that the same person be party to the SPA and hedges is satisfied if the DE does not constitute a qualified business unit (QBU).[15] Generally, a disregarded entity that has conducted no activities other than being a party to an SPA should not be a QBU.[16] After the acquisition closes, the U.S. parent can elect to regard the acquiring entity, with the effect that the shares of the target are transferred to the now regarded acquisition company in an outbound Code Sec. 351 transfer. Such a transfer should qualify for nonrecognition treatment provided that a Code Sec. 367(a) gain recognition agreement is entered into. This also assumes that the foreign DE does not have any debt obligations such that the election is not viewed as a transfer of a subsidiary subject to assumption of liabilities to which Code Sec. 304 could conceivably apply.[17]

V. Exercise of the Commissioner's Discretion to Indentify Hedges for Integrated Treatment

As noted above, the taxpayer may simply not be able to qualify for integration treatment even if the taxpayer wants to do so. Even if the taxpayer is able to satisfy the regulations, a taxpayer may choose to enter into an economic hedge of an SPA but not identify the hedge for integrated treatment for a number of reasons. In some cases, the taxpayer may be recognizing gains or losses on the hedge in its income statement and would prefer nonintegrated treatment for tax purposes to avoid a book-tax difference. In other cases, it will simply be unclear whether the hedge and the SPA qualify for integrated treatment under the regulations, because it is not clear whether the deal has progressed to the point that the taxpayer has an "executory contract." In still other cases, it will be clear that the taxpayer is not entitled to designate the hedge for integrated treatment, including cases in which different persons enter into the SPA and the hedges.

The regulations appear to give the Commissioner discretion to designate the hedge for integrated treatment in any of these cases, provided that he can establish the existence of an "executory contract" and that the executory contract "in substance is hedged."[18] How should the Commissioner exercise this discretion? One source of guidance is the legislative history of Code Sec. 988(d).

A. Legislative History of Code Sec. 988(d) on Prevention of Abuses

The legislative history to Code Sec. 988(d) directs the IRS and Treasury to issue anti-abuse rules and provides insight into the circumstances in which an exercise of discretion is appropriate. Specifically, the legislative history notes:

> The conferees intend that both sets of regulations relating to hedging transactions provide rules to *prevent taxpayers from selectively identifying only those transactions where the hedging rules are favorable to the taxpayer*. Rules applicable to partially hedged transactions may be necessary to achieve a hedging rule that is *not susceptible to abuse*. The Congress also intends that the regulations require a taxpayer to clearly identify a hedging transaction before the close of the day the transaction is entered into, in order to claim increased deductions attributable to the hedge.[19]

The Joint Committee on Taxation (JCT) report from the same year contains identical language. The report goes on to provide examples of the types of transactions that Congress was particularly concerned about. As noted from the JCT report:

> The Congress particularly is concerned about hedging transactions where a taxpayer borrows in a weak currency and eliminates virtually all risk of currency loss by establishing offsetting currency positions. If such a hedging transaction is not treated as an integrated transaction, the taxpayer may be able to defer tax on income and convert ordinary income to capital gain.[20]

Congress clearly intended to empower the IRS to prevent abuses of the foreign currency hedging rules. The legislative history specifically focuses on the need to prevent taxpayers from using hindsight to selectively integrate only hedges that produce gains while recognizing losses as realized. The legislative history also identifies specific instances where integrated treatment would produce an inappropriate tax result. There is no hint in the legislative history that all hedges should be integrated. Consistent with this legislative history, the integrated hedging regulations make integrated treatment elective to the taxpayer, requiring only that the taxpayer commit itself to integrated treatment on the day the hedge is entered into, when it does not know whether the hedge will produce a gain or a loss. The legislative history and the structure of the regulations thus suggest that the proper scope for the Commissioner's discretion is to prevent abuses, not to effectively force the integration of all hedged executory contracts.

The legislative history and the structure of the regulations therefore suggest that the proper role for the Commissioner's discretion to integrate is to hold the taxpayer to its choice made at the time the hedge is entered into. If the taxpayer identifies a hedge for integration, but tries to back out of that treatment by creating a technical foot fault under the regulations once it becomes clear that the hedge is producing a loss, the Commissioner should integrate the hedge notwithstanding the technical foot fault. Similarly, if the taxpayer attempts to structure the hedge to qualify for integration and identifies the hedge for integration, but inadvertently fails to satisfy all of the technical requirements of the regulation, the Commissioner should integrate the transaction notwithstanding the foot faults, to preserve the taxpayer's expectations. The Commissioner's discretion thus should be exercised to hold a taxpayer to its choice of whether to integrate a hedge, not to eliminate the ability of the taxpayer to choose.

B. Restraint Exercised by Commissioner in Analogous Circumstances

The IRS has considered the proper scope for exercising its discretion to integrate hedges in the context of the rules under Reg. §1.1275-6, which allow taxpayers to integrate certain interest rate hedges of debt instruments. As is the case under Reg. §1.988-5(b), the Commissioner may designate a hedge for integration in cases where the taxpayer has not done so.[21] The IRS has used restraint in exercising this discretion, concluding that it is appropriate to exercise its discretion only where necessary to prevent "abusive" transactions.

In GLAM 2007-14, the IRS declined to use its authority under Reg. §1.1275-6 or its authority under the OID anti-abuse rule to integrate a series of transactions. The transaction discussed in GLAM 2007-14 allowed a corporation to selectively integrate convertible notes it issued with purchased call options on its common stock ("hedges"), while not integrating written call options on its common stock ("warrants"). The IRS evaluated whether the OID anti-abuse rule in Reg. §1.1275-2(g) should be used to either disallow the integration of the notes with the hedges or to require the integration of the notes with the warrants as well as with the hedges. The IRS noted that the taxpayer's transaction allowed a corporation to convert its actual position as the issuer of convertible notes, the purchaser of hedges, and the writer of warrants into a synthetic position as the issuer of investment units consisting of nonconvertible, discount notes and warrants. After reviewing the rules of Reg. §1.1275-2(g) and, in particular, Example 3 of Reg. §1.1275-2(g)(3), the IRS determined that based on the particular facts of the case, the treatment of the note and hedge as integrated and the warrant as separate produced a reasonable tax result, even though the transaction increased the amount of the deduction permitted to be claimed by the taxpayer. Given that the favorable result was reasonable, it declined to exercise its discretion to integrate.

Rev. Rul. 2000-12[22] presents a contrasting situation, where the IRS found it necessary and appropriate to exercise its authority under Reg. §1.1275-6(c)(2) to integrate to prevent an abusive result arising under straddle transactions involving debt instruments with offsetting interest rate exposures. The contrast between GLAM 2007-14 and Rev. Rul. 2000-14 makes it clear that the IRS has used restraint in exercising its discretion to integrate interest rate hedges under Reg. §1.1275-6, and has forced integration only where necessary to prevent abusive outcomes. This experience suggests that the IRS should take a similar approach under the analogous integrated hedging regime for foreign currency hedges in Reg. §1.988-5(b).

C. Standards for Review of the Commissioner's Exercise of Discretion

Section 706(2) of the Administrative Procedures Act (the "APA") permits a reviewing court to set aside an agency's actions, findings and conclusions if they are "arbitrary, capricious, an abuse of discretion or otherwise not in accordance with the law."[23] The courts have held the Commissioner's actions to this "abuse of discretion" standard in circumstances where either the statute or the regulations grant the Commissioner the authority to make informal adjudications on audit adjusting the manner in which a taxpayer has reported an item of income on its return.[24] This standard of review is illustrated in a number of contexts.

For example, Code Sec. 482 grants the Commissioner wide discretion to make adjustments to a taxpayer's transfer pricing. The Commissioner's Code Sec. 482 allocations must be sustained absent a showing of an abuse of discretion.[25] Similarly, in interpreting whether, under Code Sec. 845(b), a reinsurance agreement has a "significant tax avoidance effect," the IRS has concluded that the "arbitrary, capricious and unreasonable or otherwise an abuse of discretion" standard applied to the exercise of the Commissioner's authority.[26] In this context, the IRS looked to the legislative history for the circumstances in which the Commissioner should exercise his discretion, but deferred to the standards in the APA to determine the standard of review once the IRS has exercised such discretion.[27] Collection due process cases also present issues (such as the abatement of failure to deposit penalties) that are adjudicated based on an "abuse of discretion" standard.[28]

The IRS has noted that the "abuse of discretion" standard is a "heavier than normal burden of proof."[29] The phrase "abuse of discretion" has been defined to include:

- a failure to exercise a sound, reasonable and legal discretion;
- a discretion exercised to an end or purpose not justified and clearly against reason and evidence; and
- any unreasonable, unconscionable and arbitrary action taken without proper consideration of facts and law pertaining to the matter submitted.[30]

In many of the cases cited above, the courts overturned a determination made by the Commissioner (or his delegate) where the taxpayer demonstrated that the IRS's determination abused the Commissioner's discretion.[31]

D. Proper Exercise of the Commissioner's Discretion to Integrate Under Reg. §1.988-5(b)

As discussed above, it is clearly appropriate for the Commissioner to exercise his discretion to integrate hedges under Reg. §1.988-5(b) where doing so is necessary to prevent abuses, such as where a taxpayer uses hindsight to cherry pick which hedges to integrate. This circumstance could arise where a taxpayer initially designates a hedge of an executory contract for integrated treatment, but then attempts to back out of that treatment by creating a technical foot fault under the regulations once it becomes clear that the hedge will produce a loss rather than a gain. In such a case, the Commissioner should affirmatively designate the hedge for integration, notwithstanding any technical foot fault under the regulations, to hold the taxpayer to its original hedging designation. Such an identification by the Commissioner prevents an abuse anticipated by the legislative history. Similarly, it is completely appropriate for the Commissioner to use his discretion to integrate to preserve the expectations of a taxpayer, which sought to integrate a hedge, and made a hedge identification, but committed a technical foot fault under the regulations.

It would not appear to be appropriate for the Commissioner to exercise his discretion to effectively deny a taxpayer's choice of whether to integrate a hedge where the taxpayer is bound to that choice. Where a taxpayer chooses not to identify a hedge for integrated treatment on the date the hedge is entered into, the taxpayer is bound to that choice. It cannot identify the hedge at a later date. Therefore, the taxpayer cannot use hindsight to cherry pick only winning hedges for integration. The taxpayer does not know whether the hedge will produce a gain or a loss, and the taxpayer will be currently taxed on any gain or currently will deduct any loss. As discussed above, there is nothing in the regulations or the legislative history of Code Sec. 988 to suggest that recognizing such gain or loss currently is an inappropriate tax result, or that integration is mandatory as the only appropriate treatment for a hedge of an executory contract. Under these circumstances, it is difficult to see how it would be an appropriate exercise of the Commissioner's discretion to force integration of the hedge. Unlike the taxpayer, the IRS can use hindsight on examination to choose to integrate hedges with losses to deny deductions that the taxpayer has claimed for those losses. It would appear to be unreasonable for the Commissioner to systematically review hedges of executory contracts on examination and identify for integration only those hedges that produced losses. Such a use of hindsight would be analogous to the abusive character games some taxpayers played during the years before hedge identifications were required, when they used hindsight to conclude that loss contracts were hedges but gain contracts were not.

An abuse of discretion would be clearest in cases where the taxpayer was not able to structure the hedge to qualify for integrated treatment, such as where commercial considerations necessitated placing the hedge in a different entity than the party to the SPA. In such a case, the taxpayer would not have been able to protect itself against the IRS's use of hindsight on audit by itself identifying the hedge for integrated treatment when the hedge is established. In such a case the taxpayer made a business decision to establish the hedge assuming that the gain or loss would be recognized currently. There is no policy justification for the IRS on audit to selectively force the capitalization of losses, but not gains, by identifying loss contracts for integration.

Endnotes

[*] The views expressed in this article are those of the authors, and do not necessarily reflect the positions of PwC. The authors wish to thank John McDonald for his comments.

[1] Reg. §1.988-5(b)(1).

[2] Reg. §1.988-5(b)(4). Note that the capitalization rule applies only to the Code Sec. 988 component of the gain or loss realized on the hedge. In most cases, the Code Sec. 988 component of the gain or loss is the entire gain or loss. The one exception is for a hedge that is a deposit in a hedging account. To the extent the depositor earns interest, the interest must be currently accounted for; it cannot be capitalized. *See* Reg. §1.988-5(b)(iii)(E).

[3] Reg. §1.988-5(b)(2)(ii)(A).

[4] Reg. §1.988-5(b)(2)(i)(B).

[5] Reg. §1.988-5(b)(2)(iii).

[6] Reg. §1.988-5(b)(2)(iii)(B).

[7] Reg. §1.988-5(b)(2)(i)(F).

[8] Reg. §1.988-5(b)(2)(i)(E).

[9] Reg. §1.988-5(b)(2)(i)(D).

[10] Reg. §1.988-5(b)(2)(i)(B).

[11] Reg. §1.988-5(b)(2)(i)(A).

[12] Reg. §1.988-5(b)(3)(i).

[13] Reg. §1.988-5(b)(3)(ii).

[14] It can be more complicated if there is a supply contract pursuant to which the buyer is required to issue orders from time to time but there are certain minimum quantities that have to be purchased *etc.* For an example of how the IRS has exercised its discretion under Reg. §1.988-5(e) in a more complex situation *see* LTR 200813026 (Dec. 20, 2007).

[15] Reg. §1.988-5(b)(2)(E).

[16] *See, e.g.,* Code Sec. 989(a); Proposed Reg. §1.987-1(b)(3).

[17] *But see* Code Sec. 304(b)(3)(B)(i) (excepting from the normal rule that liability assumptions are boot in the case of debt incurred to acquire the stock that is being transferred).

[18] Reg. §1.988-5(b)(3)(ii).

[19] H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. 549 (1986) [emphasis added]. Prior to conference, the House and Senate versions of this provision, as well as their respective explanations thereof, were substantially identical to the final version adopted in the Conference Agreement. *Compare* H.R. Rep. No. 426, 99th Cong., 1st Sess. 475 (Dec. 7, 1985) *with* S. Rep. No. 313, 99th Cong., 2d Sess. 465 (May 29, 1986).

[20] Joint Committee on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986 (JCS–10– 87, May 4, 1987), at 1103-1104.

[21] Reg. §1.1275-6(c)(2).

[22] 2000-1 CB 744.

[23] Section 706(2) of the Administrative Procedures Act, 5 U.S.C. § 706(2). Under this same provision, the reviewing court can also set aside a determination in an informal adjudication if the determination is "contrary to a constitutional right, power, privilege, or immunity," "in excess of statutory jurisdiction, authority, or limitations, or short of statutory right," or "without observance of procedure required by law."

[24] Note that IRS adjustments made during the course of the audit, similar to "[i]nterpretations such as those in opinion letters—like interpretations contained in policy statements, agency manuals, and enforcement guidelines, all of which lack the force of law—do not warrant Chevron-style deference." *See Christensen*, SCt, 529 US 576, 587 (2000).

[25] *See, e.g., Veritas Software Corporation & Subsidiaries, Symantec Corporation (Successor in Interest to Veritas Software Corpration & Subsidiaries),* 133 TC 297, 318, Dec. 58,016 (2009) (citing *Sundstrand Corp. & Subs*, 96 TC 226, 353, Dec. 47,172 (1991); *Bausch & Lomb, Inc.,* 92 TC 525, 582, Dec. 45,547 (1989), *aff'd,* CA-2, 91-1 USTC ¶50,244, 933 F2d 1084).

[26] *See* FSA 001398 (Sept. 9, 1994).

[27] *Id.*

[28] *Custom Stairs & Trim, Ltd.*, 102 TCM 1, Dec. 58,687(M), TC Memo. 2011-155 ("*Custom Stairs*") (Commissioner's imposition of failure to deposit penalties found to be an abuse of discretion). *See also S. Sego*, 114 TC 604, 609, Dec. 53,938 (2000) (application of abuse of discretion standard); *H. Goza,* 114 TC 176, 180, Dec. 53,803 (2000) (same).

[29] *Supra* note 26.

[30] Henry Campbell Black, Black's Law Dictionary, at 10-11 (6th ed. 1990).

[31] *See Custom Stairs, supra* 28.