Offsetting foreign currency option transaction had no economic substance

The U.S. Court of Appeals for the Fifth Circuit recently handed down a decision in *Tucker v. Comm.*, a case involving foreign currency options. In it, the appellate court affirmed the U.S. Tax Court's position that a complex offsetting foreign currency option transaction had no economic substance and, thus, didn't justify the losses taken by the taxpayer.

More specifically, the Fifth Circuit held that: 1) it was appropriate for the Tax Court to apply the economic substance doctrine to the transaction, and 2) the Tax Court had applied the economic substance doctrine correctly.

Economic substance doctrine

To determine whether a transaction has economic substance, courts usually make a two-pronged factual inquiry:

1. The subjective test: Was the taxpayer motivated by no business purpose (other than getting tax benefits) in entering into the transaction?
2. The objective test: Did the transaction have objective economic substance; in other words, was there a reasonable possibility of a profit?

The economic substance doctrine allows the government to look beyond technical compliance with the Internal Revenue Code to ascertain the real nature of the transaction at issue.

Courts have differed in their application of the two-prong test. Some require that a transaction have both a subjective business purpose and objective economic substance to be respected (the conjunctive test). Other courts require only that a transaction have either a subjective business purpose or objective economic substance (the disjunctive test).

Various corporation and foreign income rules

A controlled foreign corporation (CFC) is any foreign corporation of which more than 50% of the vote or value is owned by U.S. shareholders. Under the "30-day rule" that existed during the years at issue in this case — before it was amended by the Tax Cuts and Jobs Act — a CFC's income was "taxable to a U.S. shareholder only if the U.S. shareholder owned the CFC for 30 or more days in a tax year." An election allows taxpayers to elect to include in income either the CFC's earnings and profits amount or the amount of gain realized in the liquidation.

The tax code imposes a tax of 30% on foreign corporations on amounts of "fixed or determinable annual or periodical gains" income from sources within the United States. Foreign corporations are taxed on income "effectively connected with the conduct of a trade or business within the United States."

Facts of the case

In late December 2000, the taxpayer in this case organized three new entities — Sligo LLC, Sligo and Epsolon — to execute a transaction recommended to him by financial advisors (the FX transaction).

Sligo LLC was, as its name indicates, a limited liability company. The taxpayer was its sole member. Sligo was an S Corporation wholly owned by the taxpayer. Sligo was also a U.S. shareholder of Epsolon, an Irish company, and Sligo owned 99% of Epsolon from December 18 to 31, 2000. Sligo's 99% ownership

of Epsolon resulted in Epsolon initially being classified as a CFC for federal tax purposes. Effective December 27, 2000, however, Epsolon elected partnership classification and was no longer considered a CFC.

On December 20, 2000, Epsolon bought roughly $157 million in Eurocurrency options and sold a similar dollar amount of unrelated Eurocurrency options. The potential return on the investment was based on the volatility of the U.S. dollars/euro exchange rate. The taxpayer understood that the options had a 40% chance of profitability.

On December 21, Epsolon disposed of the gain legs of its positions while it was a CFC and realized a $50 million gain. Epsolon didn't recognize the $50 million gain for U.S. tax purposes because:

- Epsolon was a foreign corporation not subject to tax under the tax code at the time of the gain, and
- Sligo wasn't required to include its share of Epsolon's gain because Epsolon had been a CFC for less than 30 days when it elected partnership status.

Epsolon and Sligo weren't required to recognize gain or loss when Epsolon elected partnership status because it made an election that allowed it to recognize gain equal to Sligo's basis in its Epsolon stock. Furthermore, Sligo had a zero basis in its Epsolon stock.

After Epsolon became a U.S. partnership, it disposed of the other four foreign currency options for a net loss of $39.5 million. Sligo considered its distributive share of Epsolon's net loss, which passed through to the taxpayer, as Sligo's S corporation shareholder, and the loss was deductible.

Appellate court on the doctrine

As mentioned, the Tax Court held that the FX transaction didn't have economic substance and disallowed the taxpayer's loss deduction.

When his case reached the Fifth Circuit, the taxpayer argued that:

- It was inappropriate for the Tax Court to apply the economic substance doctrine to the transaction, and
- The Tax Court had applied the doctrine incorrectly.

The Fifth Circuit rejected both arguments. First, it found that the economic substance doctrine was applicable to the FX transaction. The taxpayer argued that the economic substance doctrine was inapplicable because the transaction complied with the literal reading of the tax code.

The court noted that the U.S. Supreme Court and the Fifth Circuit itself have applied the economic substance doctrine to transactions that technically complied with tax laws. For example, in *Gregory v. Helvering*, the Supreme Court said that it's appropriate for a court to apply the economic substance doctrine to a transaction to determine whether what was done, apart from the tax motive, was what the statute intended.

In response, the taxpayer argued that *Summa Holdings, Inc. v. Comm*. supported his position that the Tax Court had erred in applying the economic substance doctrine to the FX transaction. In *Summa Holdings*, the Sixth Circuit reviewed the Tax Court's decision denying relief to a family who sought to lower their taxes by using a domestic international sales corporation to transfer money from their family-owned company to their sons' Roth IRAs.

The Sixth Circuit didn't apply the economic substance doctrine to the transactions because, that court said, it was "not a case where the taxpayers followed a devious path to a certain result in order to avoid the tax consequences of the straight path." The Sixth Circuit found the doctrine was inapplicable because none of the transactions "was a labeling-game sham or defied economic reality," and the tax provisions used were designed for tax-reduction purposes.

But, in *Tucker,* the Fifth Circuit said the taxpayer's "manipulation of the rules" was different in that it was contrary to Congress's intent. It looked to a 1962 Senate Report that said Subpart F, which includes the 30-day rule, was "designed to end tax deferral on 'tax haven' operations by U.S. controlled corporations."

Lack of economic substance

The appellate court said that, to have economic substance, both prongs of the economic substance test must be met, and the FX transaction failed the objective prong. The test, the Fifth Circuit explained, is an objective inquiry into whether the transaction either caused real dollars to meaningfully change hands or created a realistic possibility that they would do so.

The taxpayer argued that the FX transaction created the realistic probability that real dollars would change hands because he had a 40% chance to generate a net profit of $487,707 for the investments. But the court found that the transaction defied objective economic reality because the "$487,707 potential profit is de minimis as compared to the expected $20 million tax benefit" and the "$52.9 million in tax losses over two years."

Moreover, after considering both parties' expert reports, the Fifth Circuit found that there was a low likelihood — between 16% and 40% — that the FX transaction would be profitable because the options were "egregiously" mispriced against the taxpayer.

Complex by nature

Foreign currency option transactions are complex by nature. They often draw IRS challenges and, as this case shows, the outcome isn't always in the taxpayer's favor. Work closely with your CPA when executing any such transaction. •