

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Date:
July 09, 2024

LEGEND

Amount A =
Amount B =
Amount C =
Amount D =
Amount E =
Amount F =
Amount G =
Amount H =
Amount I =
Bank =
Currency A =
Date A =
Date B =
Date C =
Date D =
Date E =
Date F =
Method =

Offer =

Parent =

Subsidiary =

Target =

Dear :

This letter responds to a letter dated Date A, requesting a ruling pursuant to Treas. Reg. §1.988-5(e) regarding the U.S. federal income tax treatment of a hedge of Subsidiary's foreign currency exposure with respect to the acquisition of all issued and outstanding equity interests in Target pursuant to Method (the "Target Share Acquisition").

The rulings contained in this letter are based on information and representations submitted by you and your representatives and accompanied by a penalties of perjury statement executed by the appropriate party. While this office has not verified any of the materials submitted in support of the ruling request, it is subject to verification on examination.

FACTS

Parent represents the following facts:

Parent is the common parent of an affiliated group of corporations that files a consolidated Form 1120, U.S. Corporation Income Tax Return (the "Consolidated Group"). Subsidiary is wholly owned by Parent through members of the Consolidated Group. Each of Parent and Subsidiary's functional currency (as defined in section 985(b) of the Internal Revenue Code ("Code")) is the United States dollar ("USD"). Parent and Subsidiary are calendar year taxpayers that use the accrual method of accounting.

Subsidiary was formed on Date B to acquire Target. Before Date C, Subsidiary did not have any assets or activities unrelated to the Target Share Acquisition, did not have any Currency A hedges (including Currency A deposits) other than the Option (as defined below), and did not engage in speculative trading with respect to any foreign currency.

On Date D, Subsidiary issued an Offer to acquire Target shares pursuant to the Target Share Acquisition (the "Offer Announcement"). Under the terms of the Offer Announcement, Subsidiary would acquire all outstanding Target shares in exchange for a cash payment of Amount A per Target share. Employees holding options that would become exercisable upon the Target Share Acquisition could either gross settle the options (paying the strike price and receiving a gross payment of Amount A per optionable Target share) or "cash cancel" the options (receiving a net payment, per optionable Target share, of Amount A less the strike price). The Offer Announcement valued the issued and to be issued equity interests of Target at Amount B, but the precise amount of Subsidiary's total Currency A exposure from the Target Share

Acquisition could not be determined in advance due to the remote possibility that the Target Share Acquisition would not occur and (if the Target Share Acquisition did occur) uncertainty as to the manner in which employees would elect to settle their options. The Offer was binding on Subsidiary to the extent accepted, ratified, and approved by Target shareholders and applicable courts, but the Target Share Acquisition would not occur unless it was approved by a vote of the Target shareholders.

On Date D, Subsidiary acquired an option (the "Option") from Bank to hedge against the anticipated Currency A exposure resulting from the Offer Announcement made earlier that day. Under the terms of the Option, Subsidiary had the option to receive Amount C of Currency A from Bank in exchange for Amount D of USD. The premium paid for the Option was Amount E, and the Option had an expiration date of Date C.

The Target Share Acquisition became effective on Date E; pursuant to the Target Share Acquisition, Subsidiary paid total cash consideration of Amount F on Date F. The Option was terminated on Date F for a payment of Amount G. If, on Date D, Parent had purchased an option to acquire Amount F with a settlement date of Date F, the arm's length premium paid for the option would have been Amount H.

Parent has determined that the Target Share Acquisition and the Option are not eligible for hedge accounting treatment. Parent represents that, if the Target Share Acquisition were an executory contract entered on the date of the Offer Announcement and the Option had an expiration date ending on the accrual date of the Target Share Acquisition, then the Option would satisfy the requirements of Treas. Reg. §1.988-5(b) to be a hedge of the Target Share Acquisition, including:

1. The Option is an option described in Treas. Reg. §1.988-1(a)(1)(ii) and (a)(2)(iii) that is a "section 988 transaction" within the meaning of section 988(c)(1) of the Code;
2. The Option was timely identified in accordance with Treas. Reg. §1.988-5(b)(3) as a hedge for integration with the anticipated Target Share Acquisition;
3. The Option was entered into after the Offer Announcement and before the accrual date as defined in Treas. Reg. §1.988-5(b)(2)(iv) (the "Accrual Date") in accordance with Treas. Reg. §1.988-5(b)(2)(i)(B);
4. The Target Share Acquisition was hedged in whole or in part with the Option throughout the period beginning with the date the Option was identified in accordance with Treas. Reg. §1.988-5(b)(3) and ending on or after the Accrual Date; and
5. Bank is not related to Subsidiary or to any member of Consolidated Group within the meaning of section 267(b) or 707(c)(1) of the Code.

Parent represents that it has not made and will not make an election pursuant to section 988(a)(1)(B) of the Code with respect to the Option and that the Option did not hedge any transaction other than the Target Share Acquisition.

LAW AND ANALYSIS

Section 988(d)(1) of the Code provides that, to the extent provided in regulations, if any section 988 transaction is part of a 988 hedging transaction, all transactions which are part of such 988 hedging transaction shall be integrated and treated as a single transaction or otherwise treated consistently for purpose of Subtitle A of the Code.

Section 988(d)(2) of the Code provides that the term “988 hedging transaction” means any transaction that is entered into by the taxpayer primarily to manage risk of currency fluctuations with respect to property which is held or to be held by the taxpayer or to manage risk of currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred, by the taxpayer and is identified by the Secretary or the taxpayer as being a 988 hedging transaction.

Treas. Reg. §1.988-5(b)(2)(i) provides that a hedged executory contract is an executory contract (as defined in Treas. Reg. §1.988-5(b)(2)(ii)) that is the subject of a hedge (as defined in Treas. Reg. §1.988-5(b)(2)(iii)), provided that the following requirements are satisfied: (A) The executory contract and the hedge are identified as a hedged executory contract as provided in Treas. Reg. §1.988-5(b)(3); (B) The hedge is entered into on or after the date the executory contract is entered into and before the accrual date as defined in Treas. Reg. §1.988-5(b)(2)(iv); (C) The executory contract is hedged in whole or in part throughout the period beginning with the date the hedge is identified in accordance with paragraph Treas. Reg. §1.988-5(b)(3) and ending on or after the accrual date; and (D) None of the parties to the hedge are related (within the meaning of section 267(b) and section 707(c)(1)). Both the executory contract and the hedge must be entered into by the same individual, partnership, trust, estate, or corporation. Treas. Reg. §1.988-5(b)(2)(i)(F). Additional requirements apply in the case of a qualified business unit with a residence outside of the United States or a foreign person engaged in a U.S. trade or business. Treas. Reg. §1.988-5(b)(2)(i)(E) and (G).

Treas. Reg. §1.988-5(b)(2)(ii) provides generally that an “executory contract” is an agreement entered into before the accrual date to pay nonfunctional currency (or an amount determined with reference thereto) in the future with respect to the purchase of property used in the ordinary course of the taxpayer's business, or the acquisition of a service (or services), in the future, or to receive nonfunctional currency (or an amount determined with reference thereto) in the future with respect to the sale of property used or held for sale in the ordinary course of the taxpayer's business, or the performance of a service (or services), in the future. A contract to buy or sell stock is also considered to be an executory contract. On the accrual date, the agreement ceases to be considered an executory contract and is treated as an account payable or receivable. The accrual date is defined as the date when the item of income or expense (including a capital expenditure) that relates to an executory contract is required to be accrued under the taxpayer's method of accounting. Treas. Reg. §1.988-5(b)(2)(iv).

Treas. Reg. §1.988-5(b)(2)(iii)(A) provides that the term “hedge” includes an option contract described in Treas. Reg. §1.988-1(a)(1)(ii) and (2)(iii), but only if the option’s expiration date is on or before the accrual date. The premium paid for an option that lapses is integrated with the executory contract.

Treas. Reg. §1.988-5(b)(3)(i) provides that a taxpayer must establish a record and, before the close of the date the hedge is entered into, the taxpayer must enter into the record a clear description of the executory contract and the hedge and indicate that the transaction is being identified in accordance with Treas. Reg. §1.988-5(b)(3).

Treas. Reg. §1.988-5(b)(4)(i) provides that if a taxpayer enters into a hedged executory contract, amounts paid or received under the hedge by the taxpayer are treated as paid or received by the taxpayer under the executory contract, or any subsequent account payable or receivable, or that portion to which the hedge relates. Also, the taxpayer recognizes no exchange gain or loss on the hedge. If an executory contract, on the accrual date, becomes an account payable or receivable, the taxpayer recognizes no exchange gain or loss on the payable or receivable for the period covered by the hedge.

Treas. Reg. §1.988-5(e) provides that in his sole discretion, the Commissioner may issue an advance ruling addressing the income tax consequences of a taxpayer's system of hedging either its net nonfunctional currency exposure or anticipated nonfunctional currency exposure. The ruling may address the character, source, and timing of both the section 988 transaction(s) making up the hedge and the underlying transactions being hedged. The procedures for obtaining a ruling are governed by such pertinent revenue procedures and revenue rulings as the Commissioner may provide. The Commissioner will not issue a ruling regarding hedges of a taxpayer's investment in a foreign subsidiary.

Absent an advance ruling to the contrary under Treas. Reg. §1.988-5(e), Subsidiary is required to treat the Option as a separate section 988 transaction that is not integrated with the Target Share Acquisition. The Option is not eligible for integration with the Target Share Acquisition under §1.988-5(b) for two reasons. First, at the time the Option was acquired, there was no executory contract within the meaning of Treas. Reg. §1.988-5(b)(2)(ii) because the Offer Announcement was not binding on the Target shareholders; if the Target shareholders had rejected the Offer, the Target Share Acquisition would not have occurred. In addition, the Option is not a hedge within the meaning of Treas. Reg. §1.988-5(b)(2)(iii) because the expiration date of the Option was after the accrual date of the Target Share Acquisition.

Under the authority provided in Treas. Reg. §1.988-5(e), we have determined that Subsidiary should be allowed to generally apply the principles of Treas. Reg. §1.988-5(b) (with the modifications set forth below) to integrate the Option and the Target Share Acquisition. Integration is appropriate because (i) Subsidiary’s exposure to the risk of exchange rate fluctuations with respect to Currency A payments under the Target Share Acquisition was substantially similar to that of a party to an executory contract; (ii) the

Option reduced this risk; and (iii) the Option was timely identified as a hedge of the Target Share Acquisition.

RULINGS

Based solely on the information provided and the facts set forth above, and under the authority provided in Treas. Reg. §1.988-5(e), we rule as follows:

1. The Option is treated as though it were two distinct transactions:
 - a. An option (the “Hedge”) to acquire Amount F (the amount paid for the Target Share Acquisition), exercisable on Date F (the date payment was made for the Target Share Acquisition), which was purchased for a premium equal to Amount H (the arms’ length premium for such an option); and
 - b. A separate option (the “Excess Hedge”) which was purchased for Amount I (the remainder of the premium paid for the Option) and was terminated in exchange for Amount G (the amount received upon termination of the Option).
2. The Target Share Acquisition is integrated with the Hedge and the principles of Treas. Reg. §1.988-5(b) apply to the integrated transaction (treating the Target Share Acquisition as an executory contract under Treas. Reg. §1.988-5(b)(2)(ii) and the Hedge as a hedge under Treas. Reg. §1.988-5(b)(2)(iii)). Accordingly, Amount H is added to the basis of the stock acquired by Subsidiary in the Target Share Acquisition.
3. Section 988 gain or loss with respect to the Excess Hedge is subject to the general rules of section 988.

CLOSING AGREEMENT

We have approved a closing agreement with Parent with respect to those issues affecting its tax liability on the basis set forth above. In pursuance of our practice with respect to such agreements, the agreement contains a stipulation to the effect that any change or modification of applicable statutes enacted subsequent to the date of the agreement and made applicable to the taxable period involved will render the agreement ineffective to the extent that it is dependent upon such statutes.

CAVEATS

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter or the method for computing exchange gain or loss for any item not addressed

by these rulings. In particular, other than as provided above, no opinion is expressed or implied about the U.S. federal income tax consequences of the Target Share Acquisition or any related hedges, including what the accrual date is for any item.

PROCEDURAL INFORMATION

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

Pursuant to a power of attorney on file in this office, a copy of this ruling is being furnished to your authorized representatives.

Sincerely,

Raphael Cohen
Senior Counsel, Branch 5
Office of Associate Chief Counsel (International)

cc: