OFFICE OF
CHIEF COUNSEL

**DEPARTMENT OF THE TREASURY**
**INTERNAL REVENUE SERVICE**
**WASHINGTON, D.C. 20224**

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
INTERNAL REVENUE AGENT STOP: 4102-GRB

FROM: JEFFREY DORFMAN
CHIEF, BRANCH 5 CC: INTL: BR 5

SUBJECT:

This Field Service Advice responds to your memorandum dated September 8, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:
P =
S =
B =
Z =
FC =
a =
b =
c =
d =
e =
f =
Year 1 =

ISSUE(S):

Whether the taxpayer should recognize a taxable gain as a result of a debt for equity swap.

CONCLUSION:

Yes. The taxpayer should recognize a taxable gain from the debt for equity swap.

FACTS:

P, the taxpayer, is a U.S. corporation that uses the U.S. dollar as its functional currency. S is a Country Z subsidiary of P that uses the FC, country Z's currency, as its functional currency. Country Z had issued U.S. dollar-denominated debt that was trading on the secondary markets at steep discounts. Country Z implemented a debt for equity swap program that allowed it to retire this dollar-denominated debt in exchange for FCs that would be invested in Country Z. P, which was planning on investing in a plant in Country Z, participated in the program in an effort to obtain FCs at the lowest cost possible.

In Year 1, pursuant to the terms of its debt-equity swap agreement with Country Z, P purchased a participation in Country Z U.S. dollar-denominated debt (the "sovereign debt") with a face amount of $a from B, a U.S. commercial bank, for $b, the secondary market price of the sovereign debt. P then surrendered the sovereign debt to Country Z. From the information submitted, we do not have the ability to determine whether P transferred the sovereign debt to Country Z directly, or whether P contributed the debt to S, which then surrendered the sovereign debt to Country Z.

In exchange for the surrender of its dollar-denominated debt, Country Z credited S's account with FC in the amount of c. These FCs could be used only for the purposes specified under the agreement between P and Country Z. The c FC had a fair market value (had there been no restrictions on their use) equal to the face value of the sovereign debt, discounted by approximately f %, i.e., the FC proceeds which S received had a fair market value far greater than P's basis in the sovereign debt it purchased. S then issued all its capital stock to P. It is not clear whether there were any restrictions placed on the S capital stock or on the repatriation of S's earnings. Typically, such restrictions are imposed by Country Z.

In its Year 1 tax return as originally filed, P recognized gain on the debt-equity swap in the amount of $e, i.e., the difference between the amount realized on the exchange of the country Z sovereign debt, $d, and its basis in the sovereign debt, $b. P subsequently filed a claim for refund arguing that it should not have recognized any gains as a result of the debt-equity swap. You have requested guidance for purposes of considering the appropriate response to P's refund claim. The appellate venue for this taxpayer would be other than the Fifth Circuit. We respond first assuming that P surrendered the sovereign debt to Country Z directly, and then assuming that P contributed the sovereign debt to its subsidiary S, which surrendered it to Country Z.

## LAW AND ANALYSIS

### I. P directly exchanged the sovereign debt with Country Z

Under I.R.C. 1001, we believe P must recognize gain in the amount of the excess of the fair market value of the FC which was credited to S's account over P's basis in the sovereign debt. In this event, P did not receive the consideration for the sovereign debt directly. Nevertheless, since S received the FC payments as a result of P's transfer of the sovereign debt to Country Z, P is deemed to have constructively received the FC and contributed them to S. See Rev. Rul. 87-124, 87-2 C.B. 205.

#### A) Valuation

At issue is the amount of gain which P realized on the debt-equity swap. Taxpayers seeking to avoid the recognition of gains on this type of debt-equity swap argue that the restrictions imposed on the local currency and those imposed on the repatriation of earnings lower the value of the local currency received in the exchange. These arguments were rejected by the Tax Court in G.M. Trading Corp. v. Commissioner,103 T.C. 59 (1994) and 106 T.C. 257 (1996) (supplemental opinion), rev'd, 121 F.3d 977 (5th Cir. 1997). The Tax Court concluded that the local currency received by the taxpayer should not be reduced by the "restrictions" imposed on their use, which were similar to restrictions placed on loan disbursements by financial institutions when lending with respect to construction projects. We note, however, that, in reversing the Tax Court on another issue, the Fifth Circuit, in dicta, expressed some skepticism about the Tax Court's findings with respect to valuation. 121 F.3d 977 at 983 n.7 (5th Cir. 1997).

In a subsequent case, the Tax Court granted a taxpayer a 15% discount from the fair market value of the foreign currency due to some restrictions on the repatriation of the taxpayer's investment for twelve years. Norwest v. Commissioner, 108 T.C. 265 (1997). In that case, however, the Service's expert had conceded that, based on the facts of that case, a 10% discount might have been appropriate.

With respect to P's debt-equity swap, we have not been made aware of restrictions imposed on the local currency received or on the repatriation of earnings that would warrant a reduction in the amount of the taxable gain originally reported by the taxpayer.

B) Gain Recognition

The taxpayer's claim for refund, however, is based in large part on the Fifth Circuit's decision in G.M. Trading, which held that the foreign currency the taxpayer received in excess of its basis in the sovereign debt was in part a section 118 tax-free capital contribution by a non-shareholder. In G.M. Trading, the Service argued, and the Tax Court held, that the foreign currency received in excess of the taxpayer's basis in the sovereign debt did not fall under section 118 because the Mexican government received "direct, specific, and significant economic benefits that related . . . to its . . . foreign exchange position," namely, the surrender of dollar-denominated debt in exchange for local currency and the specific, contractual promise to employ Mexican workers and use Mexican contractors. G.M. Trading, 106 T.C. at 266.

The Fifth Circuit in G.M. Trading, however, reversed the Tax Court on this issue. The Fifth Circuit did not find that the total amount of foreign currency received in excess of the basis of the sovereign debt surrendered was necessarily a section 118 nontaxable capital contribution. Rather, the Fifth Circuit held that it could not determine the amount of foreign currency which constituted the capital contribution, and the amount of foreign currency, if any, which constituted gain, and therefore concluded that the values of both the debt and the Mexican pesos paid for its surrender were fixed by what the taxpayer had paid for the sovereign debt on the secondary market. The court concluded that any payment in excess of that amount constituted a tax-free capital contribution by a non-shareholder under section 118.

We do not agree with the Fifth Circuit's analysis. As the Tax Court had found, the taxpayer in G.M. Trading received specific, bargained-for benefits that rendered section 118 inapplicable. Similarly in this case, Country Z was able to retire dollar-denominated debt without using any of its hard currency reserves. This and other bargained-for benefits take P's debt-equity swap outside the intended scope of section 118.

Furthermore, even if the excess payment over P's basis were held to be a section 118 contribution to capital, P would still have to recognize gains under section 367(a). This argument was not made by the parties in G.M. Trading, and was not considered by either the Tax Court or the Fifth Circuit. Section 367(a), subject to various exceptions not relevant here, requires the taxpayer to recognize gain when it transfers appreciated property to a foreign subsidiary in exchange for that subsidiary's capital stock.

If tax free under section 118, the excess FC payment over P's basis in the Country Z debt would be treated as appreciated property for purposes of section 367(a). Since P uses the U.S. dollar as its functional currency, the FC constitutes property to P. Accordingly, the excess FC payment that would qualify as tax free under section 118 would have a zero basis under section 362(c)(1). Therefore, P's deemed contribution of the FC to S in return for S's capital stock constituted a contribution of appreciated property (i.e., with a market value in excess of basis) to a foreign subsidiary and is taxable under section 367(a).

II. P contributed the sovereign debt to S which S then surrendered to Country Z

If the facts show that, rather than surrendering the Country Z debt directly, P contributed the Country Z debt to S which in turn surrendered it to Country Z, then P cannot be said to have received FCs in exchange for the debt, and therefore cannot be taxable on the gains from that exchange under section 1001. However, P would still be taxable on the contribution of the sovereign debt to its foreign subsidiary under section 367(a).

As discussed above, section 367(a), subject to various exceptions not relevant here, requires the taxpayer to recognize gain when it transfers appreciated property to its foreign subsidiary in exchange for its subsidiary's capital stock. The sovereign debt it contributed to S had appreciated in value because P negotiated the debt-equity exchange agreement with Country Z prior to contributing it to S. The fair market value of the S capital stock which P received, which is a function of the fair market value of the FC paid to S, exceeded P's basis in the sovereign debt. Therefore, under this fact pattern, P should have recognized gain under section 367(a).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

If you have any further questions, please call (202) 622-3870.

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