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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM:

, BRANCH 5 CC:INTL:Br5

SUBJECT:

This Field Service Advice responds to your memorandum dated June 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:

X	=
Y	=
A	=
B	=
vv	=
ww	=
xx	=
yy	=
zz	=
k	=
m	=
Date 1	=
Date 2	=

Date 3 =
Date 4 =
Year 1 =

ISSUES:

1. Whether the loss incurred on the assignment of a swap and the up-front payment received for a new, subsequent swap are subject to Treas. Reg. §1.446-4.

2. Whether the loss incurred on the assignment of a swap can be integrated with the up-front payment received on a subsequent swap under the anti-abuse and substance-over-form rules of Treas. Reg. §1.446-3(i) and §1.988-2(f).

3. Whether the loss incurred on the assignment of a swap and the up-front payment received for a new, subsequent swap can be integrated under Treas. Reg. §1.988-5.

4. Whether the loss incurred on the assignment of a swap and the up-front payment received for a new, subsequent swap can be integrated under I.R.C. §1092.

CONCLUSIONS:

1. The effective date of Treas. Reg. §1.446-4 prevents its application to this transaction.

2. The effective date of Treas. Reg. §1.446-3 prevents its application to this transaction. Moreover, the transactions at issue do not warrant the application of the anti-abuse rules or the substance-over-form rules of Treas. Reg. §1.988-2.

3. The integration rules of Treas. Reg. §1.988-5 are not applicable to the transactions at issue.

4. I.R.C. §1092 is not applicable to the transactions at issue.

FACTS:

The following facts have been presented for consideration. Y is a wholly-owned domestic subsidiary of X, a U.S. entity. Y uses the U.S. dollar as its functional currency for federal income tax purposes but uses the Swiss Franc ("CF") for financial reporting purposes. On Date 1, Y issued a seven-year vv European Currency Unit ("ECU") bond bearing interest at the fixed rate of k%. On Date 2, two years prior to the maturity of this ECU bond, Y entered into a seven-year currency swap with A (the "A Swap"). Under the terms of the swap, Y received periodic payments based on the fixed rate of k% on vv ECU for two years, and at LIBOR for the remaining five-year term. In exchange, Y agreed to make periodic payments based on the fixed rate of m% on the principal amount of CF xx. The principal amounts of the swap were to be exchanged at the swap's maturity. Y entered into the swap in part to economically convert the last two years of its fixed rate ECU borrowing into a fixed rate Swiss Franc borrowing. It is unclear, however, why Y entered into a seven-year swap rather than a two-year swap that would have terminated at the same time as its ECU borrowing.

On Date 3, Y borrowed $ww at a floating rate from its parent, X, and converted that amount into ECU at the spot rate in order to repay its vv ECU loan. Concurrently, Y entered into a five-year ECU/U.S. Dollar currency swap with B (the "B Swap"). Under this swap, Y was to receive periodic payments based on a floating rate on $ww and was to make periodic payments based on LIBOR less 2.1 basis points on vv ECU. The B Swap economically converted the U.S. Dollar floating rate borrowing into a ECU floating rate borrowing, which the existing A Swap effectively converted into a fixed rate Swiss Francs borrowing.

Finally, on Date 4, Y decided to economically convert its fixed rate CF obligation under the A Swap to a floating rate CF obligation. To achieve that goal, Y assigned the A Swap to B and entered into a new four-year swap with B under which Y received LIBOR on vv ECU (as in the A Swap) but paid LIBOR plus 4.1 basis points (instead of a fixed rate) on xx Swiss Francs (the "New Swap").

The assignment of the A Swap to B was costly to Y. Because of changes in interest rates and currency values, Y was obligated to make to B an assignment payment of $yy. However, the New Swap was an off-market swap that was structured in such a way as to require B to make an up-front payment of $yy to Y in exchange for higher periodic payments and principal to be paid by Y. Thus, no cash actually changed hands when these transactions were consummated.

Y claimed the assignment payment as a loss in Year 1, but amortized the up-front payment. Because it attributed $zz to the principal of the New Swap, it did not report that amount until the fourth year. The remainder of the up-front payment was amortized over the four-year term of the swap. The Service proposes to treat the up-front payment on the New Swap as taxable gain in the same year Y deducted the loss on the assignment payment.

LAW AND ANALYSIS

Treas. Reg. §1.988-2(e)(2)(i) provides in part, subject to exceptions not relevant here, that:

> any income or loss realized with respect to a currency swap contract shall be characterized as exchange gain or loss (and not as interest income or expense). Any exchange gain or loss realized ... shall be recognized unless otherwise provided in an applicable section of the Code.

Treas. Reg. §1.988-2(e)(2)(v) provides in part that:

> If the taxpayer's method of accounting for income, expense, gain or loss attributable to a currency swap does not clearly reflect income ... the Commissioner may apply principles analogous to those of section 1274 or such other rules as the Commissioner deems appropriate to clearly reflect income.

Treas. Reg. §1.988-2(e)(3)(ii) provides in part that

> If a taxpayer that enters into ... a currency swap ... receives a payment (that is, the taxpayer enters into ... the currency swap at a discount, "swap discount") in order to make the present value of the amounts to be paid equal the amounts to be received, such payment shall be amortized in a manner which places the taxpayer in the same position it would have been in had the taxpayer entered into a currency swap contract under which the present values of the amount to be paid equal the amounts to be received ... Thus, swap ... discount shall be amortized as follows –
>
>> (A) The amount of swap ... discount that is attributable to the difference between the swap exchange rate ... and the spot rate on the date the contract is entered into or acquired shall be taken into account as income ... on the date the swap principal amounts are taken into account; and

> (B) The amount of swap ... discount attributable to the difference in values of the periodic interim payments shall be amortized in a manner consistent with the principles of economic accrual. ...
>
> Any amount taken into account pursuant to this paragraph (e)(3)(ii) shall be treated as exchange gain ...

Treas. Reg. §1.988-2(e)(4) provides that:

> Any gain or loss realized on the disposition or the termination of a currency swap is exchange gain or loss.

Treas. Reg. §1.988-2(f)(1) provides in part that:

> If the substance of a transaction described in §1.988-1(a)(1) differs from its form, the timing, source, and character of gains or losses with respect to such transaction may be recharacterized by the Commissioner in accordance with its substance. For example, if the taxpayer enters into a transaction that it designates a "currency swap contract" that requires the prepayment of all payments to be make or to be received (but not both), the Commissioner may recharacterize the contract as a loan. In applying the substance over form principle, separate transactions may be integrated where appropriate.

Treas. Reg. §1.988-5 provides rules for the integration of debt instruments and related hedges resulting in the treatment of the combined transactions as a single, synthetic debt instrument. Treas. Reg. §1.988-5(a)(4)(i) provides that:

> A §1.988-5(a) hedge ... is a ... currency swap ..., or series or combination thereof, that when integrated with a qualifying debt instrument permits the calculation of a yield to maturity (under principles of section 1272) in the currency in which the synthetic debt instrument is denominated...

I.R.C. §1092 provides rules limiting the recognition of losses in the case of straddles. I.R.C. §1092(c)(2)(A) provides that:

> A taxpayer holds offsetting positions with respect to personal property if there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of his holding 1 or more other positions with respect to personal property (whether or not of the same kind).

Treas. Reg. §1.446-3, which provides accounting methods to ensure the clear reflection of income and deductions from notional principal contracts, applies to contracts entered on or after December 13, 1993. Furthermore, Treas. Reg. §1.446-4, which provides rules to ensure that the method of accounting used for hedging transactions clearly reflects income is applicable to hedging transactions entered into on or after October 1, 1994.

Inapplicable provisions

The A Swap was entered into on Date 2, and is not subject to Treas. Regs. §§1.446-3 and 1.446-4. The assignment of the A Swap to B on Date 5 does not affect the fact that the A swap was entered into prior to these regulations' effective dates.

The hedging rules of Treas. Reg. §1.988-5 are inapplicable because the term of the A Swap does not match that of taxpayer's borrowing, making the computation of a yield to maturity on a synthetic instrument comprising of the underlying debt and the A Swap impossible. Furthermore, even if applicable, these rules would allow the Commissioner to integrate the qualified borrowing with one or more hedges. They would not allow the Commissioner to integrate the assignment payment incurred in disposing of the A Swap with the up-front payment due to the taxpayer on a the New Swap.

I.R.C. §1092 is also inapplicable because the taxpayer did not hold the A Swap and the New Swap simultaneously. The A Swap and the New Swap, therefore, cannot be treated as offsetting positions, as would have been required under §1092. I.R.C. §1092(c)(2).

Treas. Reg. §§1.988-2 anti-abuse rules

The taxpayer's treatment of the up-front payment and of the assignment payment, when analyzed separately, are generally in accord with the rules of the §988 regulations. Under Treas. Reg. §1.988-2(e)(3)(ii), the portion of the up-front payment relating to the periodic payment should be amortized in a manner consistent with the principles of economic accrual, and the amount attributable to the principal of the swap should be taken into account on the date the swap principal amounts are taken into account. This methodology was followed by the taxpayer. As to the assignment payment, the taxpayer is entitled to its immediate realization under Treas. Reg. §1.988-2(e)(4), and to its recognition under Treas. Reg. §1.988-2(e)(2)(i). The issue, therefore, is whether the particular circumstances surrounding these transactions call for the application of the anti-abuse rules of the §988 regulations. The assignment payment on the A Swap, to the extent it reflects its value, could not have been avoided. We consider, therefore, the structure of the New Swap which was designed by the parties to require the up-front payment.

Y had decided to replace a combination of instruments which economically replicated a fixed rate CF liability with a similar combination which replicated a floating rate CF liability. As a result of movements in interest rates and in the currency markets, Y had to make a substantial payment in order to assign its fixed rate CF liability to B. To avoid having to make a cash payment, Y entered into an off-market swap with B that required B to make an up-front payment to Y. B agreed to make this up-front payment because the periodic payments that Y agreed to make to B, and the amount of principal that Y agreed to pay to B at the termination of the swap were higher than what the market called for. The present value of these payments in excess of market were represented by the up-front payment that B agreed to make to Y. The New Swap was the equivalent of an on-market swap (where the present values of the payments to be made by each parties equal on the date the contract is entered into) and a loan from B to Y. In essence, Y entered into a new, on-market swap and, in addition, borrowed the cash it needed to make the required payment so that it could dispose of the fixed rate Swiss Franc Swap it no longer wanted.

We believe that the funding of the assignment payment through a loan does not create the type of distortion in income that would allow the successful invocation of the anti-abuse rule of Treas. Reg. §1.988-2(e)(3)(v). *See, generally,* Crane v. Commissioner, 67 S. Ct. 1047 (1945) (depreciation deductions were computed based on the basis of property that included its mortgage). Similarly, the substance over form provision of Treas. Reg. §1.988-2(f)(1) is not applicable here, because, as discussed above, the recharacterization of the transactions does not affect their tax consequences.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Finally, we stated above that §1092 did not apply because the A Swap and the New Swap were not offsetting positions. However, unrealized gains on a position offsetting the A Swap held by a member of the consolidated group of which Y is a member could be used to deny the loss on the assignment of the A Swap. *See* §1092(d)(4). [redacted]

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

JEFFREY L. DORFMAN
Branch Chief, Branch 5
Associate Chief Counsel
(International)