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:

FROM:

SUBJECT:

This Field Service Advice responds to your memorandum dated March 19, 1999 and additional information submitted on May 18th and June 3rd, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

Petitioner =
DC1 =
DC2 =
FC1 =
FC2 =
Country C =
Country D =
Year 1 =
Year 2 =
$ U =
$ V =

Y =
Z =

ISSUE:

1. Whether the proposed adjustment, which relates to the deferred swap income in Year 1, constitutes income equivalent to interest under section 954(c)(1)(E) for purposes of determining FC1's subpart F income?

2. Whether the proposed adjustment, which relates to the deferred swap income in Year 1, would reduce the ratio of FC1's actual subpart F gross income to total gross income below 70%, and thereby decrease the total amount of FC1's subpart F income inclusion under section 954(b)(3)(B)?

CONCLUSION:

The proposed adjustment related to FC1's deferred swap income in Year 1 does not constitute income equivalent to interest under section 954(c)(1)(E). Income earned from swap agreements by a nondealer does not constitute income equivalent to interest when that income is not part of an integrated transaction. Therefore, the proposed adjustment would effectively reduce the ratio of FC1's actual subpart F gross income to total gross income below 70%, and thereby reduce the total amount of FC1's subpart F income inclusion under section 954(b)(3)(B).

FACTS:

The petitioner is a domestic corporation and operates its business through subsidiaries and branches. For the taxable year at issue, December 31, Year 1, the petitioner owned DC1, a domestic subsidiary, that was in the business of providing Z services. DC1 owned a domestic subsidiary, DC2, which in turn owned two foreign corporations, FC1 (incorporated in Country C) and FC2 (incorporated in Country D). Both FC1 and FC2 are controlled foreign corporations ("CFC") under section 957(a).

In Year 1, FC1 maintained an office in Country C and had approximately thirty to fifty employees. FC1's business included entering into swap arrangements, and maintaining swap positions generated from activities prior to Year 1. In addition, FC1 also represents that it engaged in activities involving global custody accounts, corporate trust services, transfer/clearing agent services, lending in the Y market, and mutual fund administration.

FC1 claims that it regularly offered to enter into interest rate swap transactions depending upon the needs of its customers. However, because the individuals responsible for the origination of the swaps were primarily located in Country D, where most swap activity for the Y market took place during this time period, FC1 was not the preferred entity for the initiation of new swaps. Such swap transactions could have been easily executed by DC1's branch office located in Country D. Furthermore, since Country D's tax authority changed its rules regarding withholding taxes related to payments arising from swap transactions, there was less of an incentive for DC1 and its affiliates to be aggressively promoting FC1 as a swap dealer. Thus, the volume of FC1's new swaps declined in Years 1 and 2.

In Year 1, FC1 entered into four new swaps, and in Year 2, it entered into one additional swap. During these years, FC1 entered into and held swap positions that it had acquired by taking the opposite side of the transaction from its customers. FC1 hedged its position by taking offsetting positions with DC1's "swap warehouse" or by matching swap positions.

During Year 1, FC1 earned total swap income of $ U. Income from intercompany swap positions was generally less than 50% of the swap income realized by FC1. However, FC1 also realized interest income from funds on deposit with DC1 and its affiliates. When the intercompany swap and interest income are taken into account in the aggregate, more than 50% of FC1's income is derived from related parties.

According to section 954(c)(1)(A), FC1's interest income is foreign personal holding company income ("FPHCI"), and is therefore part of foreign base company income ("FBCI") under section 954(a). If the sum of the FBCI for the taxable year exceeds 70% of gross income, then section 954(b)(3)(B) requires the entire gross income to be treated as FBCI (hereinafter referred to as the "70% rule"). FC1's FPHCI for Year 1 exceeded 70% of its gross income, therefore FC1 reported its entire gross income as FBCI.

For Year 1, the Service raised a deferred swap income adjustment. The specific details of that adjustment have not been presented. If there is an adjustment for Year 1 related to deferred swap income of $ V, then such income recognition will increase FC1's gross income, and alter the percentage of subpart F income to total gross income. Hence, the petitioner argues that if the adjustment is recognized in Year 1, the 70% rule under section 954(b)(3)(B) will no longer operate to treat FC1's entire gross income as FBCI because the deferred swap income is not FPHCI. If the 70% rule does not operate to capture FC1's entire gross income as FBCI, then the only income that is treated as FBCI is the actual income that falls within the definition of FBCI under section 954(a). Thus, by accepting the proposed adjustment for Year 1, the total amount of FC1's FBCI would decrease.

LAW AND ANALYSIS:

The petitioner's argument is predicated on the conclusion that swap income is not FBCI for purposes of determining whether the 70% rule under section 954(b)(3)(B) operates to include FC1's entire gross income as FBCI. Section 954(b)(3)(B) is a provision that prescribes how to treat the CFC's gross income once the threshold limitation of FBCI exceeds 70% of total gross income. Therefore, the key issue is whether the deferred swap income falls within the definition of FBCI under section 954(a). If the deferred swap income is determined to be FBCI, then FC1 will satisfy the 70% threshold requirement for Year 1. However, if the deferred swap income is not FBCI, and such income is taken into account in Year 1, then the adjustment would decrease FC1's total subpart F income, and the 70% threshold requirement will not be met.

As a general rule, section 951(a) requires the U.S. shareholder of a CFC to include in gross income its pro rata share of the CFC's subpart F income. Section 952(a) defined subpart F income to include, inter alia, FBCI as determined under section 954(a). Section 954(a)(1) defines five categories of FBCI, one of which is FPHCI as defined in section 954(c). Section 954(c) defines FPHCI to include income equivalent to interest.

Section 954(c)(1)(E) defines income equivalent to interest as "any income equivalent to interest, including income from commitment fees (or similar amounts) for loans actually made. Petitioner claims that prior to Notice 89-90, 1989-2 C.B. 407, income from interest rate swaps of nondealers was not FPHCI. The rules set forth in Notice 89-90 were intended to apply when incorporated in the final regulations for all items of income received or accrued on or after the date of publication of the Notice. Thus, for the taxable year at issue, the determination of whether swap income constitutes income equivalent to interest is governed by Treas. Reg. § 1.954-2T(h)(1). Treas. Reg. § 1.954-2T(h)(1) states in pertinent part:

> Income equivalent to interest does not include income attributable to notional principal contracts such as interest rate swaps, currency swaps, interest rate floor agreements, or similar contracts except to the extent that such contracts are part of an integrated transaction that gives rise to income equivalent to interest. Income derived from notional contracts by a person acting in its capacity as a regular dealer in such contracts will be presumed not to be integrated with an investment.

Treas. Reg. § 1.954-2T(a)(4)(iii) defines the term "regular dealer" to include:

> a merchant with an established place of business that makes a market in derivative financial products of property (such as forward contracts to buy or sell property, interest rate and currency swap contracts or other notional principal contracts) by regularly and actively offering to enter into positions in such products to the public in the ordinary course of business.

> Purchasing and selling property through a regulated exchange or established off-exchange market (for example, engaging in futures transactions) is not actively engaging as a merchant for purposes of this section.

Whether certain income constitutes FBCI is determined based on the facts and circumstances when the income is earned. Similarly, any exceptions to FBCI, such as the status of FC1 as a dealer, must also be determined when the income is earned. In light of the facts presented, we conclude that FC1 was not a dealer in interest swaps during Year 1. To be considered a dealer, FC1 had to regularly and actively offer to enter into swap positions to the public in the ordinary course of its business. FC1's affiliates were no longer using FC1 to enter into interest rate swaps with its customers. DC1's swap business remained in its office located in Country D. In Year 1, FC1 only entered into four interest rate swaps, and a majority (greater than 50%) of FC1's combined interest and swap income was earned from transactions with related entities. Because no evidence has been presented that FC1 regularly and actively offered to enter into swap transactions with the public, and the fact that it only entered into four swap transactions in Year 1, we conclude that FC1 was not actively engaging in transactions with the public.

The swap income will be treated as "income equivalent to interest" only if the underlying contract that gave rise to FC1's swap income was part of an integrated transaction. Treas. Reg. § 1.954-2T(h)(2) sets forth an example that illustrates an integrated transaction.

> *Example (3).* (i) At the beginning of its 1988 taxable year, CFC, a controlled foreign corporation, purchases at face value a one-year debt instrument issued by A having a $100 principal amount and bearing a floating rate of interest set at the London Interbank Offered Rate ("LIBOR") plus one percentage point payable on the last day of CFC's current taxable year. CFC subsequently determines that it would prefer receiving interest at a fixed rate, and, on January 1, 1989, enters into an agreement with B, an unrelated person, whereby B promises to pay CFC on the last day of CFC's 1989 taxable year an amount equal to 10 percent on a notional principal amount of $100. In exchange, CFC promises to pay B on the last day of CFC's 1989 taxable year an amount equal to LIBOR plus one percentage point on the notional principal amount.
>
> (ii) CFC receives a total of $10 from B, and pays $9 to B. CFC also receives $9 from A. The $9 paid to B is directly allocated to, or is otherwise an adjustment to, the $10 received from B. The transactions are considered an integrated transaction giving rise to $9 of interest income (paid by A) and, under paragraph (h)(1)(i), $1 of income equivalent to interest (paid by B).

For Year 1, pursuant to Treas. Reg. § 1.954-2T(h)(1), income equivalent to interest includes interest rate swaps, currency swaps or similar contracts that are part of an integrated transaction that gives rise to income equivalent to interest. Example 3 under Treas. Reg. § 1.954-2T(h)(2) illustrates a swap agreement that was integrated with an underlying debt obligation having a principal amount. Based upon the general information presented, and the specific information with respect to the swaps entered into in Year 1, it appears that the only type of notional principal contract entered into by FC1 was interest rate swaps. There is no definition of an integrated transaction in the temporary regulation. Under the temporary regulations, the only illustration of an integrated transaction is "Example 3" described above, which involves the use of a notional principal contract to hedge a debt security.

These interest rate swaps do not appear to be entered into to hedge a debt instrument, nor do we have any information that would indicate that any of the notional principal contracts in substance may be recast as debt instruments, including contracts giving rise to the deferred swap payment. This appears to be solely a notional principal contract used solely to offset another notional principal contract. Accordingly, based upon the information provided, the only hedging transactions the swaps may be part of is another notional principal contract that is not treated as a debt instrument, and thus, the income is not income equivalent to interest under Treas. Reg. § 1.954-2T(h)(1). Therefore, the recognition of the deferred swap income of $V in Year 1 will reduce FC1's total subpart F income because the 70% threshold requirement will not be met.

However, if it is subsequently determined that the deferred swap adjustment is made with respect to a notional principal contract that in substance is recast as a loan, any other swap used to hedge this transaction may be integrated, and thus the transaction may produce income equivalent to interest under Treas. Reg. § 1.954-2T(h)(1). If a recast occurs, then the adjustment, in whole or in part, may also be interest that is FPHCI, without regard to whether another swap is treated as integrated with the transaction that gives rise to the deferred payment. We do not have sufficient information to answer this issue presently.

No opinion is expressed as to whether these swap agreements are integrated transactions for any other provision of the Code.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

If you have any further questions, please call (202) 622-3840.

By: ~~/s/ Phyllis E. Marcus~~

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Office of Associate Chief Counsel
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