OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR REID M. HUEY
DISTRICT COUNSEL, NORTH CENTRAL
CC:MSR:NCE:STP

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: I.R.C. § 265(a)(2) - Hedging Expenses and Loan Commitment Fees

This Field Service Advice responds to your memorandum dated April 10, 2000. 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

Taxpayer =
Subsidiary =
Bank 1 =
Bank 2 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
a =
b =
c =

d	=
e	=
f	=
g	=
h	=
i	=
j	=
k	=
l	=
m	=
n	=

ISSUES

1. Whether service fees should be treated as interest for purposes of I.R.C. § 265(a)(2).

2. Whether periodic and nonperiodic payments made pursuant to notional principal contracts should be treated as interest for purposes of section 265(a)(2).

3. Whether a commitment fee paid to obtain a line of credit should be treated as interest for purposes of section 265(a)(2).

CONCLUSIONS

1. No. Fees paid in exchange for services are not paid as a charge for the use or forbearance of money, and thus do not constitute interest for purposes of section 265(a)(2).

2. No. The periodic and nonperiodic payments at issue here do not qualify as interest for purposes of section 265(a)(2) because these payments were not made as compensation for the use or forbearance of money. Given the facts that we received, we have assumed for purposes of this field service advice that none of the payments constitute a "significant nonperiodic payment"' within the meaning of Treas. Reg. § 1.446-3(g)(4). Accordingly, we have not addressed the issue of whether some portion of the nonperiodic payments could be treated as a loan. Id.

3. No. A standby loan commitment fee is an expenditure that results in the acquisition of a property right, namely the right to the use of money. As a result, a commitment fee is similar to a premium paid to purchase an option contract. Because the commitment fee here is not paid as compensation for the use or forbearance of money, it is not treated as interest for purposes of section 265(a)(2).

FACTS

Taxpayer is the common parent corporation of an affiliated group of corporations that files a consolidated return. During the years in issue, which are the fiscal years ending on Date 4 through Date 6, Subsidiary, which is wholly owned by Taxpayer, entered into several notional principal contracts with Bank 1. Subsidiary also entered into loan commitment agreements with Bank 2. Subsidiary also incurred fees for services rendered.

Specifically, on Date 1, Subsidiary and Bank 1 entered into an interest rate swap and a collar agreement. On Date 2, the parties entered into a rate cap agreement. Under the terms of the interest rate swap agreement, Subsidiary agreed to pay Bank 1 a fixed rate of a percent and receive b-month LIBOR on a notional principal amount of $c for a term of d years. These payments, which were to be made n, were the only payments specified in the swap agreement. During the years in issue, it appears that Subsidiary made net periodic payments to Bank 1.

On Date 1 Subsidiary and Bank 1 also entered into a d year collar agreement on a notional principal amount of $e. Under the terms of this agreement Bank 1 paid Subsidiary the excess of b-month LIBOR over f percent, and Subsidiary paid Bank 1 the excess of g percent over b-month LIBOR. Subsidiary paid Bank 1 $h for the collar which Subsidiary amortized on a straight-line method over the term of the collar. During the years in issue, it appears that Subsidiary made periodic payments to Bank 1.

On Date 2, Subsidiary and Bank 1 entered into a d year cap agreement on a notional principal amount of $i. Under the terms of the cap, Bank 1 was obligated to pay Subsidiary the excess of LIBOR over j percent. Subsidiary paid Bank 1 $k for the cap, which Subsidiary amortized on a straight-line basis over the term of the cap. It does not appear that Subsidiary received any payments pursuant to the cap during the years in issue.

On Date 3, Subsidiary entered into a credit agreement with Bank 2. Pursuant to the agreement, Subsidiary paid Bank 2 a commitment fee in an amount equal to l percent of the daily average unused amounts of Bank 2's (1) revolving credit commitment and (2) term loan commitment. During the years in issue, Taxpayer's deductions for commitment fees totaled $m.

In addition, during the years in issue, Subsidiary deducted fees it incurred in exchange for services rendered. The nature of the services was not described in the request for field service advice.

The examining agent disallowed these deductions asserting that Taxpayer claimed the deductions for interest paid on indebtedness incurred or continued to purchase or carry tax-exempt securities which is proscribed by section 265(a)(2). Taxpayer contends that these amounts do not qualify as interest and thus should not be disallowed pursuant to section 265(a)(2).

LAW AND ANALYSIS

Whether the examining agent's adjustments discussed above can be sustained depends on whether the amounts in issue constitute interest. The Supreme Court has defined interest to mean "compensation for the use or forbearance of money." See Deputy v. DuPont, 308 U.S. 488, 498 (1940). For the reasons discussed more fully below, we conclude that no portion of the amount in issue constitutes interest. Accordingly, the deductions claimed by Taxpayer should not be disallowed under section 265(a)(2).

1. Service Fees

Taxpayer relies on Goodwin v. Commissioner, 75 T.C. 424 (1980), for the proposition that service fees paid in connection with tax-exempt interest loans are not interest for purposes of section 265(a)(2). Therefore, Taxpayer argues, the fees are deductible.

Section 265(a)(2) disallows any deductions for interest on indebtedness incurred or continued to purchase or carry obligations the interest of which is wholly exempt from the taxes imposed by Title 26. We conclude that Congress intended, generally, that the term "interest" under section 265(a)(2) should be given its usual meaning, i.e., the charge for the use or forbearance of money, not service fees that do not represent such a charge.

There are three reasons for our conclusion. First, neither the predecessors of section 265(a)(2) nor their legislative histories indicate that Congress intended the term "interest" to have any meaning other than its original meaning. See section 1201(1) of the Revenue Act of 1917 and S. Rep. No. 103, 65th Cong., 1st Sess. 20 (1917); section 234(a)(2) of the Revenue Act of 1918 and S. Rep. No. 617, 65th Cong., 3d. Sess. 6-7 (1918).

Second, when Congress wanted the term "interest" under section 265(a)(2) to apply to certain expenses that might not be interest under the usual meaning of that term it has done so explicitly. Thus, section 265(a)(5) provides that any amount paid or incurred by certain persons in connection with certain short sales is treated as interest under section 265(a)(2). In explaining this provision, H.R. Rep. No. 432 (Part II), 98th Cong., 2d Sess. 1195-1196 states:

> Present law also disallows a deduction for interest relating to tax-exempt interest but does not specifically extend the disallowance to costs to purchase or carry property used in a short sale...
>
> The provisions...disallowing interest relating to tax-exempt interest are extended to costs incurred to carry property used in a short-sale which are not required to be capitalized as described above.

See also H.R. Conf. Rep. No. 861, 98th Cong. 2d Sess. 824-8 (1984) 1984-3 (Volume 2) 78-82 and Staff of the Joint Committee of Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 156-159 (Jt. Comm. Print 1984).

Third, under section 265(a)(1), Congress specifically intended not to disallow deductions for non-interest expenses (other than section 212 expenses) related to such obligations. This is explained in S. Rep. No. 558, 73rd Cong., 2nd Sess. (1934), 1939-1 (Part 2) C.B. 586, 606:

> The House bill disallows amounts otherwise allowable as deductions which are allocable to one or more classes of tax-exempt income even though the income fails to materialize or is received in an amount less than the expenditures made or incurred. For instance, under the present law, salaries received by State employees, income from leases of State school lands, and the interest on State and some classes of Federal securities are exempt from the income tax. It is contended that under the existing law all expenses incurred in the production of such income are allowable as deductions. The House bill specifically disallows expenses of this character. While your committee is in general accord with the House provision, it is not believed that this disallowance should be made to apply to expenditures incurred in earning tax-exempt interest. To do so might seriously interfere with the sale of Federal and State securities, which would be unfortunate during the present emergency. Accordingly, your committee recommends that the disallowance be applied to all classes of tax-exempt income except interest. [Emphasis added]

Given the above, we conclude that amounts paid in exchange for services do not constitute interest on indebtedness. Accordingly, section 265(a)(2) would not apply to disallow a deduction for service fees. We note, however, that some so-called service fees are actually disguised interest. Blitzer v. United States, 684 F.2d 874, 881-882 (1982). Whether an amount represents a deductible fee or nondeductible interest depends on the facts of a particular case. In the instant case, given the limited facts that we received, we conclude that District Counsel is in a better posture to make this determination.

2. Notional Principal Contract Payments

Reg. § 1.446-3(c)(1)(i) defines a notional principal contract as a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. A "notional principal contract" includes interest rate swaps, and interest rate caps and floors. Id. A collar is not itself a notional principal contract, but a taxpayer may treat certain caps and floors that comprise a collar as a single notional principal contract under Reg. § 1.446-3(f)(2)(v)(C). Reg. § 1.446-3(c)(1)(i).

"Periodic payments" are payments made or received pursuant to a notional principal contract and are payable at some fixed periodic interval of one year or less during the entire term of the contract that are based on a specified index, and that are based on either a single notional principal amount or a notional principal amount that varies over the term of the contract in the same proportion as the notional principal amount that measures the other party's payments. Reg. § 1.446-3(e)(1).

A periodic payment is not treated as interest. Although a periodic payment made pursuant to an interest rate swap is made as a direct result of an increase or decrease in interest rates, this type of payment is not an interest expense because it is not "compensation for the use or forbearance of money." Deputy v. du Pont, 308 U.S. 488, 498 (1940). This is because under a typical on-market interest rate swap there is no loan of money. The principal or notional amount upon which the payments are calculated is not normally exchanged between the parties.

Similarly, a nonperiodic payment is not treated as interest. A nonperiodic payment is defined as any payment made or received with respect to a notional principal contract that is not a periodic payment or a termination payments. Reg. § 1.446-(3)(f)(1). A nonperiodic payment includes the premium for a cap or floor agreement, the payment for an off-market swap, and the payment for part or all of one leg of a swap. Id.

The nonperiodic payments at issue here do not constitute interest expense because the payments do not serve as compensation for the use or forbearance of money. Here, the upfront amounts were paid to purchase a cap and a collar. Accordingly, these amounts are similar to premiums paid to purchase options.

3. Commitment Fees

A loan commitment fee, which is described as a non-refundable fee charged solely for the availability of money on an as needed basis, does not constitute interest. In Rev. Rul. 81-160, 1981-1 C.B. 312, the Service ruled that a loan

commitment fee is an expenditure that results in the acquisition of a property right, that is, the right to the use of money. Such a loan commitment fee is similar to the cost of an option, which becomes part of the cost of the property acquired upon exercise of the option. Indeed, in Rev Rul. 70-540, 1970-2 C.B. 101 (Situation 3)[1], the Service ruled that a fee paid in consideration for a lender's agreement to make a loan at a specified date and at a specified rate of interest is not interest. Specifically, Rev. Rul. 70-540 provided that the commitment fee is a charge for agreeing to make funds available to the borrower rather than for the use or forbearance of money and, therefore, is not interest.

Based on the limited facts that we received, we have assumed for purposes of this field service advice that the loan commitment arrangement at issue here is similar to the arrangements discussed in the preceding paragraph. Given this assumption, we conclude that the commitment fee at issue here was not an amount paid as compensation for the use or forbearance of money, and thus cannot be construed as interest.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

Please call if you have any further questions.

By: _____
JOEL E. HELKE
Branch Chief
CC:DOM:FI&P:FS

cc:

[1] Declared obsolete on another issue by Rev. Proc. 94-29, 1994-1 C.B. 616, 621.