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

MEMORANDUM FOR

FROM: Jeffrey Dorfman
Chief, Branch 5 CC:INTL:BR 5

SUBJECT:
This Field Service Advice responds to your memorandum dated March 29, 2000. 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.

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LEGEND

FP	=
USP	=
USS	=
A Corp.	=
B	=
Country Y	=
Country Z	=
FC	=
a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=
i	=
j	=
k	=
l	=
m	=
n	=
o	=
p	=
q	=
r	=
s	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Year 1	=
Year 2	=

ISSUE:

Whether, under the facts described below, the taxpayer should recognize a taxable gain as a result of a debt-equity swap transaction.

CONCLUSION:

Yes. The taxpayer should recognize a taxable gain from the debt-equity swap transaction described below.

FACTS:

USP ("Taxpayer") is a subsidiary of FP, the country Y parent of the group, and is the group's U.S. holding company. USP uses the U.S. dollar as its functional currency. Country Z had issued U.S. dollar-denominated debt ("sovereign debt") that was trading on the secondary markets at steep discounts. Country Z implemented a debt-equity swap program that allowed it to retire this dollar-denominated debt in exchange for its currency, the FC, that would be invested in Country Z.

On Date 1, A Corp., a country Z corporation was formed, with USP, FP, and USS, a domestic subsidiary of USP, receiving 50%, 40% and 10% respectively, of A Corp.'s stock. A Corp. was formed to engage in the same general business as FP, albeit in Country Z. A Corp.'s functional currency was the FC.

On Date 2 in Year 1, pursuant to the terms of a debt-equity swap agreement, parties to which were USP, A Corp., Country Z and B, a U.S. commercial bank, the following actions occurred simultaneously:

> USP paid B the market value of the sovereign debt subject to the swap (approximately j% of the face amount), plus commissions.
>
> B agreed that the debt shall be canceled.
>
> Country Z transferred FCs into an account held by the Country Z Treasury in favor of A Corp. equal to c% of the face value of the dollar denominated sovereign debt.
>
> In exchange for the FCs, A Corp issued shares of a special series of restricted common stock to USP.

The amount of FCs which Country Z transferred to A Corp. equaled c% of the face amount of the debt, based on the market exchange rate (of U.S. dollars for FC). The use of these FCs by A Corp. was restricted by Country Z to funding certain capital and operating expenses within Country Z. In addition, the capital stock that A Corp. issued could not be transferred to a Country Z person or entity prior to Date 4, and bore a legend so stating. The capital stock also had limited redemption and dividend rights and was not convertible into any other type of security.

In Year 2, USP and FP entered into a debt-equity swap which was identical in all respects to the debt-equity swap which occurred in Year 1, except for the following:

1. Unlike the Year 1 debt-equity swap, FP also participated in the debt-equity swap which occurred in Year 2, i.e., FP paid a portion of the payment to B, and received a proportionate amount of A Corp.'s capital stock.[1]

2. The amounts of sovereign debt subject to the swap varied from the amounts of sovereign debt subject to the Year 1 swap. In both debt-equity swaps USP (and in the Year 2 debt-equity swap FP) paid B the secondary market price for the sovereign debt, and in both debt-equity swaps Country Z deposited FCs with spot value equal to c% of the face value of the dollar denominated sovereign debt. In addition, the secondary market value of the sovereign debt had fluctuated slightly, so that the amounts paid by USP and FP constituted k% of the face value of the sovereign debt.

In its Year 1 and Year 2 tax returns as originally filed, USP did not recognize any gain on the debt-equity swaps. The District Director issued to USP a Notice of Proposed Adjustments in which it claimed that USP should have recognized gain on the Year 1 debt-equity swap in the amount of $e, i.e., the difference between $a, [2] the amount realized on the exchange of the country Z sovereign debt (the spot value of the FCs transferred by Country Z), less $d, its basis in the sovereign debt. USP's basis in the debt consists of $b, the secondary market value of the sovereign debt, and commissions in the amount of $g paid to B in respect to the debt equity swap. Similarly, the District Director claimed that USP should have recognized gain on the Year 2 debt-equity swap in the amount of $p, i.e., the difference between the amount realized on the exchange of the country Z sovereign debt, $l, less its basis in the sovereign debt, $m, which includes $n, the secondary market value of the sovereign debt, and commissions in the amount of $o [3] paid to B in respect to the debt-equity swap. USP paid the tax asserted based on recognizing gain on the debt-equity swaps. Subsequently USP filed claims for refund arguing that it should not have recognized any gains as a result of the debt-equity swaps. You have requested guidance for purposes of considering the appropriate response to USP's

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[1] This FSA only discusses USP's tax treatment of the debt-equity swaps. Accordingly, we ignore FP's participation in the second debt-equity swap, except to the extent it is relevant to USP's tax treatment, i.e., whether the second debt-equity swap includes an exchange described in section 351(a).

[2] District Counsel suggests that a mathematical error may exist in this amount.

[3] District Counsel suggests that a mathematical error may exist in this amount.

refund claims. The appellate venue for this taxpayer would be other than the Fifth Circuit.

LAW AND ANALYSIS

I Characterization of the Debt-Equity Swaps

For Federal tax purposes, the above described debt-equity swap transactions should be characterized as USP (and in the second transaction, USP and FP) purchasing the sovereign debt (or a participation interest therein) from B for cash and surrendering the sovereign debt to Country Z, which then canceled the debt. In exchange for USP surrendering the sovereign debt, Country Z transferred FCs to USP, which then contributed the FCs to A Corp. in exchange for its capital stock.

Support for this characterization is derived from 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 on other grounds, 121 F.3d 977 (5th Cir. 1997) which characterized a similar debt-equity swap in this manner. In G.M. Trading the taxpayer argued that the transaction should be characterized as a contribution of dollars to its Mexican subsidiary (Procesos), the purchase of the Mexican debt by Procesos, and the exchange of that debt by Procesos with the Mexican government for restricted pesos. 103 T.C. at 68. The Tax Court rejected the taxpayer's characterization of the transaction, stating that the U.S. parent, not the Mexican subsidiary, must be viewed as purchasing and exchanging the debt with the Mexican government in exchange for pesos.[4] The U.S. parent then transferred the pesos to its Mexican subsidiary for stock. 103 T.C. at 68-69. The Fifth Circuit similarly held that the U.S. parent, rather than the Mexican subsidiary, surrendered the Mexican debt, stating that "[t]he record unambiguously shows that [G.M. Trading Corp.] paid [the dollars] to the bank, and Procesos never had possession of that money." 121 F.3d 977, at 979 n.2.

II Gain Recognition

As set forth above, both the Tax Court and the Fifth Circuit characterized the debt-equity swap transaction in G.M. Trading as having two essential steps: (1) The purchase of the Mexican debt by G.M Trading and its transfer to the Mexican

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[4] In CMI International v. Commissioner, 113 T.C. 1 (1999), the Tax Court found that the sovereign debt was contributed by the U.S. parent, CMI Texas, to the Mexican subsidiary, Industrias Fronterizas CMI, S.A. de C.V. ("Industrias"). In CMI, however, the Purchase and Capitalization Agreement specifically stated that the sovereign debt was to be transferred from CMI Texas to Industrias as a capital contribution.

government in exchange for restricted pesos; and (2) a contribution of those pesos to Procesos. Under the Tax Court's view, G.M. Trading must recognize gain on step one of the transaction to the extent the fair market value of the pesos exceeds its basis in the debt. However, no gain (or loss) would be recognized on step two of the transaction since G.M. Trading's basis in the pesos would equal the fair market value of the stock received. Moreover, 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 also focused on step one of the transaction. It held that the restricted pesos received by G.M Trading were in part in exchange for inducing investment in Mexico (qualifying as a non-shareholder contribution to capital under section 118) and in part in exchange for extinguishment of dollar denominated debt (a specific service that would not qualify as a non-shareholder contribution to capital under section 118). The Fifth Circuit further held that the restricted pesos received for debt extinguishment had no readily ascertainable value and under U.S. v. Davis, 370 U.S. 65 (1962), the basis of the pesos was equal to G.M Trading's basis in the debt exchanged. Accordingly, no gain was realized on such exchange. The court further held that the value of any other restricted pesos received was a non-taxable contribution to capital.

The Fifth Circuit did not focus on step two of the transaction other than in footnote 10 of the opinion. In that footnote, the court noted that G.M. Trading's basis in the pesos acquired as a contribution to capital is zero under section 362(c)(1). "Therefore it presumably will pay taxes on the contribution when it sells or liquidates the factory." 121 F.3d 977, at 984 n.10. It is hard to reconcile the court's characterization of the debt-equity swap transaction with footnote 10. If G.M. Trading was considered to have acquired pesos with a zero basis and to have transferred them to Procesos, it should have been taxable at the time of the transfer on any gain inherent in the pesos under section 367(a) (not at the time the factory is sold).[5]

We do not agree with the Fifth Circuit's analysis in G.M. Trading. As the Tax Court has found, the taxpayer in G.M. Trading received specific, bargained-for

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[5] It should be noted that G.M. Trading did not own the factory at issue, its Mexican subsidiary, Procesos, did. Thus, even at the time the factory is sold, G.M. Trading would recognize no gain (except indirectly if a section 1504(d) election is in place.)

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 USP's debt-equity swaps outside the intended scope of section 118. We believe the position set forth in Rev. Rul. 87-124, 1987-1 C.B. 205, as supported by the Tax Court opinions in G.M. Trading is correct. Thus, USP should recognize gain with respect to the Year 1 and 2 debt-equity swaps at the time the Country Z debt is exchanged for the restricted pesos, respectively.

As set forth below, even if we were to accept the analysis of the Fifth Circuit in G.M. Trading, USP will recognize gain with respect to the Year 1 and 2 swaps.

1. The Year 1 Debt-Equity Swap

Generally, section 351 provides that investors do not recognize gain or loss if they transfer property to a corporation solely in exchange for its stock and if the transferors, as a group, are in control of the transferee corporation immediately after the exchange. "Property" includes foreign currency. Rev. Rul. 74-7, 1974-1 C.B. 198. For purposes of section 351, control is defined as ownership of 80 percent of the total combined voting power of all classes entitled to vote and 80 percent of the total number of shares of all other classes of stock of the transferee corporation. §§ 351(a) and 368(c). The ownership interests of all transferors participating in a single transaction are aggregated to determine whether the control test is met. Rev. Rul. 73-473, 1973-2 C.B. 115. Generally, to determine control, a group of transferors may include all of the transferee stock owned by each transferor participating in the transaction, not just the shares the transferors receive in the current transaction. Id.

We note that, before the Year 1 swap, USP, the transferor, owned 50% of the voting common stock of A Corp., the transferee. As noted above, FP and USS owned the remainder of such stock of A Corp. Further, there were no other classes of stock of A Corp. outstanding.

As part of the Year 1 swap, USP was deemed to have transferred FCs to A Corp. in exchange for shares of A Corp.'s voting common stock. We do not have any information as to how many shares of such stock USP received in the exchange. However, based on the information we do have, it does not appear that USP's ownership of A Corp. increased significantly beyond the 50% it already owned. In that case, USP's transfer does not qualify under section 351(a) because USP was not in control of A Corp. within the meaning of section 368(c). In other words, USP did not own at least 80% of the voting common stock of A Corp. after the Year 1 exchange. In determining whether the control requirement of section 368(c) is satisfied, USP may not take into account stock of A Corp. owned by related parties. Rev. Rul. 56-613, 1956-2 C.B. 212 ("Section 368(c) specifically defines control in terms of direct ownership of stock and not in terms of practical control. There is no basis for disregarding the separate legal entities of the parent and its subsidiary and for attributing the subsidiary's ownership of the [target] corporation stock to the parent.") Since section 351(a) does not apply on the transfer of the restricted pesos by USP in exchange for A Corp. stock any gain would be recognized under section 1001.

Under the Fifth Circuit's approach, the restricted FCs received by USP are in part in exchange for inducing investment in Country Z (which qualify as a non-shareholder contribution to capital under section 118) and in part in exchange for extinguishment of dollar denominated debt (a specific service that would not qualify as a non-shareholder contribution to capital under section 118). The restricted FCs that qualify as a non-shareholder contribution to capital by Country Z to USP under section 118 have a zero basis under section 362(c) and gain is recognized under section 1001 on the transfer of the FCs by USP to A Corp. to the extent the value of A Corp. stock received in the exchange exceeds the zero basis in the FCs.[6]

2. The Year 2 swap

Before the Year 2 swap, USP owned approximately 50% of the voting common stock of A Corp. and FP owned 40%. As part of the Year 2 swap, USP and FP were deemed to have transferred FCs to A Corp. in exchange for A Corp.'s common stock. Since USP and FP were collectively in control of A Corp. after this exchange, and the other elements of section 351(a) are satisfied, but for the application of section 367(a), the Year 2 swap qualifies for nonrecognition treatment under section 351(a).

Section 367(a), subject to various exceptions not relevant here, requires the taxpayer to recognize gain when it transfers appreciated property to a foreign corporation in exchange for that corporation's capital stock, in an exchange which would otherwise qualify for nonrecognition treatment under section 351(a).

As set forth above, under the Fifth Circuit's approach, the restricted FCs received by USP are in part in exchange for inducing investment in Country Z (which qualify as a non-shareholder contribution to capital under section 118) and in part in exchange for extinguishment of dollar denominated debt (a specific service that would not qualify as a non-shareholder contribution to capital under

[6] To the extent that the basis of the FCs originally given in exchange for debt extinguishment is exceeded by the value of A Corp. stock received in the exchange, gain should be recognized on that exchange as well.

section 118). The restricted FCs that qualify as a non-shareholder contribution to capital by Country Z to USP under section 118 have a zero basis under section 362(c) and gain is recognized under section 367(a) on the transfer of the FCs by USP to A Corp.[7]

III Valuation

At issue is the amount of gain which USP realized on the debt-equity swaps. Taxpayer argues that the restrictions imposed on the use of the local currency lower the value of the local currency received in the exchange. This argument was 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.[8]

The restrictions on the FCs in the case at hand are very similar to those imposed on the pesos in the G.M. Trading case. We agree with the Tax Court's analysis of the value of the restricted pesos in G.M. Trading (see 103 T.C. 69-71 and 106 T.C. 258-264), and based on the information in our possession, believe

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[7] Similarly, section 367(a) will apply to any gain inherent in the restricted FCs given in exchange for debt extinguishment.

[8] In CMI International, Inc. v. Commissioner, 113 T.C. 1 (1999), a case involving a Mexican debt-equity swap in which the US parent contributed a participation interest in Mexican U.S. dollar denominated debt to its Mexican subsidiary, which then transferred the participation interest to the Mexican government in exchange for Mexican pesos, the Tax Court did not reach the issue as to whether the value of the pesos received by the Mexican subsidiary should be discounted due to the restrictions on use of the pesos or restrictions on repatriation of the earnings. Id. at 10.

that the restrictions imposed with respect to the FCs in this case do not materially affect their value.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

As discussed above, a threshold issue in this case exists as to the characterization of the debt-equity swaps. We concluded that the debt-equity swaps should be characterized as USP purchasing the sovereign debt from B, exchanging it with Country Z for FCs, and contributing those FCs to A Corp. in exchange for its common stock. We based this conclusion on the similarity between the debt-equity swap agreement in this case, and the Debt Participation and Capitalization Agreement in G.M. Trading. We do note, however, that differences in the agreements exist, so that the agreement between USP, FP, A Corp., B, and Country Z is somewhat less clear than the G.M. Trading agreement. In the G.M. Trading agreement, the bank was deemed to sell to G.M. Trading Corp. the Mexican sovereign debt upon receipt of payment from G.M. Trading Corp. In addition, on the closing date of the swap, "the participation shall be terminated and [G.M. Trading Corp.] shall not be entitled to receive any amount with respect to the Mexican debt," i.e., G.M. Trading Corp. must be viewed as surrendering the debt to the Mexican government.

We do not have all the exhibits to the Satisfaction and Purchase Agreement in this case. In particular, exhibit G referred to in the definition of "Quotation Acceptance Notice" may have a bearing on the similarity of the two agreements. Accordingly, we cannot fully assess the risk that a court may not characterize the transaction in this case in the same manner as the G.M. Trading agreement. We note that the agreement (exclusive of the exhibits) in this case nowhere states that USP is deemed to have acquired the sovereign debt. Furthermore, the agreement in this case states that it is being entered into "[w]hereas, [USP and FP] desire, through their payment of U.S. Dollars for the benefit of [Country Z], to acquire Qualified Capital Stock of [A. Corp.] reflecting the payment of [FCs] to [A. Corp.] by [Country Z]." In addition the agreement states that USP and FP grant B an exclusive mandate "to arrange for [USP and FP] to invest . . . an amount of U.S. Dollars (based on the amount of credits [i.e., sovereign debt] to be cancelled (sic.) hereunder) in shares of Qualified Capital Stock . . . ." Finally, you should note that subsequent to the Tax Court's decision in G.M. Trading, the Tax Court held in CMI International, Inc. v. Commissioner, 113 T.C. 1 (1999), that the taxpayer did not recognize gain when pursuant to the Purchase and Capitalization Agreement the taxpayer contributed the debt to its Mexican subsidiary, which then effected the exchange.

The second issue in this case is the value of the FCs received by USP. In light of the conclusions reached by the Tax Court in Norwest, supra, which was decided after the Tax Court's decision in G.M. Trading, the restrictions imposed on the FCs and on the A Corp. stock should be examined carefully. [redacted]

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

JEFFREY DORFMAN
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