Office of Chief Counsel
Internal Revenue Service
Memorandum

Release Number: ***20131701F***

Release Date: 4/26/2013
CC:LB&I:F:MAN:1:MSCoravos
POSTF-114291-12

date: January 31, 2013

to: Peter Toporowski, Revenue Agent
Large Business & International

from: Michael S. Coravos
Attorney (Manhattan, Group 1)
(Large Business & International)

---

subject: The SPV Financing Transaction

LEGEND:

Domestic Holdings =

Domestic Parent =

Domestic Subsidiary = .

Euro International = .

Euro Finance = .

SPV = .

BANK =

Foreign Country =

Amount 1 =

Amount 2 =

Amount 3 =

Amount 4 =

Amount 5	=	
Amount 6	=	
Amount 7	=	
Amount 8	=	
Amount 9	=	
Amount 10	=	
Amount 11	=	
Amount 12	=	
Date 1	=	
Date 2	=	
Date 3	=	
Date 4	=	
Rate 1	=	
Rate 2	=	
Rate 3	=	
Rate 4	=	
Rate 5	=	
Rate 6	=	

This memorandum responds to your request for our assistance in reviewing the Bank and Domestic Holdings structured finance transaction known as "the SPV Financing Transaction" (hereafter "**the transaction**"). Attached hereto as Exhibit A is a copy of the power point presentation that you provided to our office. For a step-by-step, detailed description of the transaction, refer to the attached power point presentation.

The advice rendered in this memorandum is conditioned on the accuracy of the facts presented. If the facts are different from the facts as set forth below and in the attached power point presentation, you should immediately advise this office.

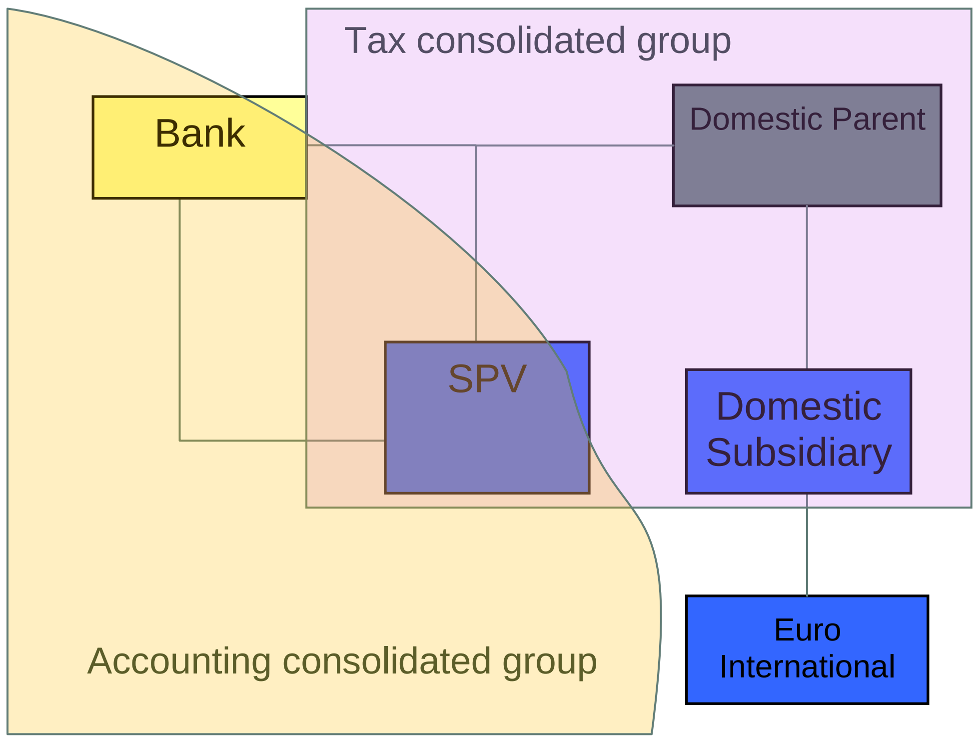
This writing contains privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client and attorney work product privileges. Accordingly, this memorandum is not to be distributed to the taxpayer. If disclosure becomes necessary, please contact this office for our views on the matter.

Facts

Bank and Domestic Holdings entered into a structured finance transaction that was designed to utilize Domestic Holdings' losses to shelter income that economically belonged to Bank. Domestic Holdings and Bank shared these tax savings in a manner that allowed Domestic Holdings to borrow at a tax advantaged rate and earn a spread on LIBOR based assets over 5 years. To accomplish this purpose, Bank and Domestic Holdings' wholly owned domestic subsidiary, Domestic Parent, established a special purpose vehicle named SPV. During the Date 1 and Date 2 taxable years, Bank contributed an aggregated Amount 1 to SPV in exchange for preferred stock and Amount 2 in exchange for common stock. In contrast, during this same time period, Domestic Parent contributed an aggregated Amount 3 to SPV in exchange for purely common stock. After the initial capitalization, Domestic Parent held 80% of the SPV common stock and Bank held 20% of the SPV common stock. In connection with the formation of SPV, Bank also received a call option that entitled Bank to purchase all of the SPV common stock owned by Domestic Parent.

The taxpayer claims that SPV is part of Domestic Holdings' consolidated group because Domestic Parent owns 80% of the vote and value of SPV common stock. The taxpayer further claims that although Bank owned all of the preferred stock, that preferred stock qualifies as "I.R.C. § 1504(a)(4) stock" and thus, is not considered when determining whether the 80% vote and value test is met for purposes of consolidation.

By claiming SPV as part of Domestic Holdings' consolidated group for tax purposes, SPV was able to utilize Domestic Holdings' losses to shelter any income that accrued within SPV. SPV is not part of Domestic Holdings' consolidated group for financial accounting purposes, however. In contrast, SPV is part of Bank's consolidated group under FIN 46R because SPV is a "variable interest entity" and Bank is exposed to the majority of the risks and rewards of ownership by virtue of its preferred stock investment. The following graph depicts the consolidated relationships between the parties for both tax and accounting purposes. The entities labeled Domestic Parent, Domestic Subsidiary, and Euro International will be described in more detail below.



Exam has argued that because it was reasonably certain at the time of issuance that Bank would exercise its call option, that option is treated as exercised under Treas. Reg. § 1.1504-4 for purposes of the consolidation rules and, as a result, SPV cannot be consolidated into either Bank or Domestic Holdings. Because CC:CORP has already approved of Exam's argument with respect to this issue, this memorandum does not discuss it further.

The Credit Linked Note[1]

Of the Amount 1 that SPV raised from Bank, SPV lent Amount 4 to a Domestic Holdings' subsidiary named Domestic Subsidiary in exchange for a credit-linked note ("CLN"). The CLN had a maturity date of five years and paid a floating interest rate, which Domestic Subsidiary deducted annually. In fact, SPV lent Amount 4 to Domestic Subsidiary in two tranches. During the Date 1 taxable year, SPV lent Amount 5 to Domestic Subsidiary in exchange for a CLN that paid an interest rate of USD-LIBOR-BBA (three month rate) minus Rate 1, determined utilizing the actual number of days divided by 360. During the Date 2 taxable year, SPV lent Amount 6 to Domestic Subsidiary in exchange for a CLN that paid an interest rate of USD-LIBOR-BBA (three month rate) minus Rate 2, determined utilizing the actual number of days divided by 360.

Under the terms of the CLNs, Domestic Subsidiary could satisfy its obligations at maturity by either repaying the Amount 4 principal amount in cash or by delivering to SPV a portfolio of "Specified Assets," which could include any security listed on Appendix A of the CLN or any security that met the "Portfolio Criteria." According to the Portfolio Criteria, the specified assets consisted of highly liquid, investment grade asset-backed securities, including AAA rated bonds and A-1 rated commercial paper. The Portfolio Criteria also specified that the assets had to be denominated in U.S. dollars only and that, "No fixed rate coupon assets allowed. Floating rate coupons only." Attached hereto as Exhibit B is a copy of the CLNs and their appendices describing the Portfolio Criteria in more detail.

The Prepaid Forward Contract[2]

Domestic Subsidiary used the Amount 4 that it borrowed from SPV and some nominal funding that it received from Domestic Parent to purchase an Amount 1 prepaid forward contract (hereafter the "PPF") from Euro International, a Foreign Country subsidiary of Domestic Holdings' foreign parent corporation. In fact, Domestic Subsidiary purchased two PPFs. During the Date 1 taxable year, Domestic Subsidiary purchased a five year PPF with a prepayment amount of Amount 7. Similarly, during the Date 2 taxable year Domestic Subsidiary purchased a five year PPF with a prepayment amount of Amount 8.

Generally, a PPF requires the forward buyer to pay the forward seller the forward price (discounted to present value on the date of the payment) at the time the parties enter into the transaction. In contrast with a traditional postpaid forward contract, the seller of a PPF has use of the buyer's money during the term of the PPF. The amount paid to the buyer at settlement thus includes compensation to the buyer for the

[1] This memorandum does not address whether the credit linked note should be respected as debt for federal tax purposes.
[2] This memorandum does not address whether the prepaid forward contract should be respected as a forward contract for federal tax purposes.

time value of money. See Staff Report of the Joint Committee on Taxation, *Present Law and Issues Related to the Taxation of Financial Instruments and Products* (JCX-56-11).

The PPFs at issue in this case had a settlement date that matched the maturity date of the CLNs (i.e., five years). Under the terms of the PPFs, Euro International had to deliver to Domestic Subsidiary on the settlement date the “reference portfolio.” The reference portfolio had to meet certain “investment guidelines” including that the underlying securities had to be “liquid” and offer a return that was at least equal to USD LIBOR[3]. The guidelines required that all securities originally designated as the reference portfolio must either mature or be deemed to have been sold by the settlement date. Thus, changes to the reference portfolio required by the guidelines would result in a complete turnover of the securities in the reference portfolio.

Interest or other income on all securities, and the principal proceeds of all securities that mature or are deemed sold during the term of the PPFs, are deemed reinvested in securities in accordance with the guidelines. The amount of the deemed reinvestment is determined after making an adjustment for the net payments that would be deemed to have been made or received on an interest rate swap pursuant to which the reference portfolio is deemed to pay 3-month LIBOR quarterly on a notional principal amount equal to the prepayment amount (i.e., Amount 1), in exchange for a fixed rate of Rate 3 on the same notional principal amount.

Moreover, the investment guidelines provided that proceeds from the underlying securities were deemed to be reinvested in securities that offered a return that was at least equal to USD LIBOR (or in the case of securities not carrying interest at floating rates, the fixed swap rate equivalent thereof) less Rate 4 for the prevailing term from the time of designation. Attached to the PPFs was a list of securities that were designated as the “initial reference portfolio.” These securities were substantially similar to the “Specified Assets” listed in the appendices to the CLNs. In fact, some of the underlying securities were identical. Attached as Exhibit C is a copy of the PPFs and the appendices describing the investment guidelines of the reference portfolio in more detail.

The Interest Rate Swaps

Because the PPFs did not produce current cash flows (i.e., Domestic Subsidiary wasn’t entitled to any payments until the settlement date), Domestic Subsidiary entered into interest rate swaps with Domestic Parent to ensure that it had sufficient cash flows to service the interest payments due on the CLNs. First, Domestic Subsidiary entered into a fixed-floating interest rate swap with Domestic Parent with respect to a notional amount equal to the principal amount on the CLNs (Amount 4), whereby Domestic Parent made periodic payments to Domestic Subsidiary equal to three-month LIBOR and Domestic Subsidiary was required to make a single payment to Domestic Parent

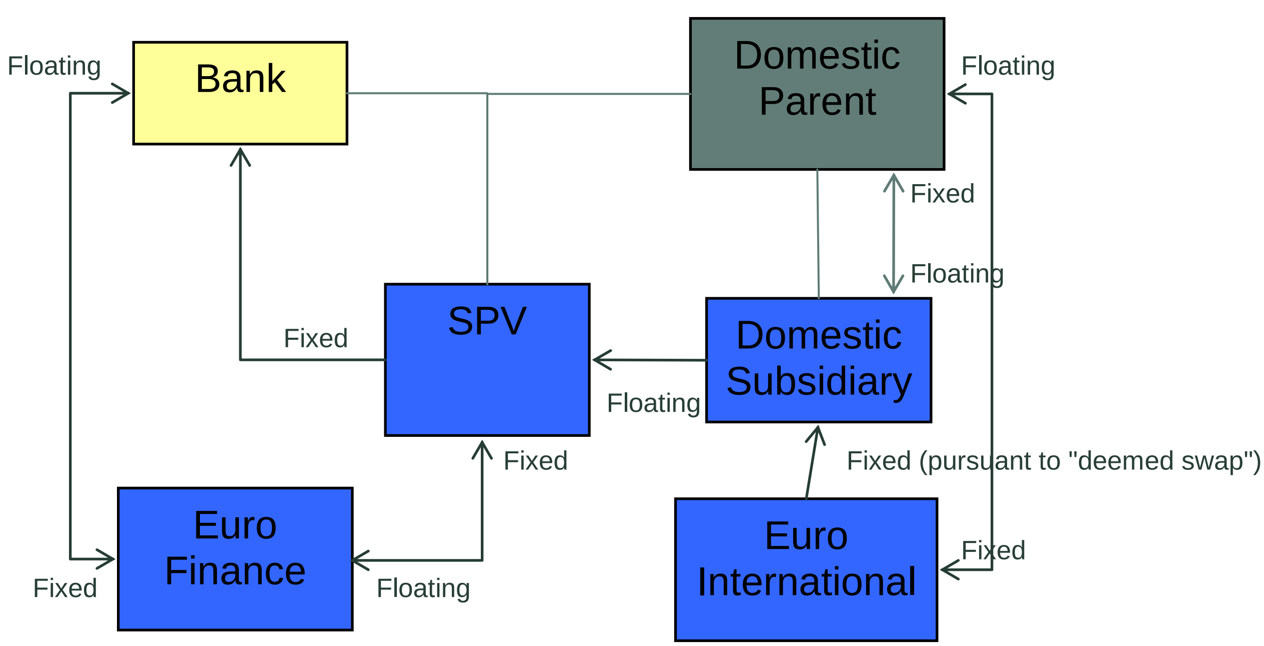
[3] It is worth noting that while the CLNs provide for an interest rate at three month USD LIBOR, the PPFs simply provide for a return “at least equal to USD LIBOR” without specifying whether its three month USD LIBOR, one month USD LIBOR, etc. Furthermore, the PPFs do not define the term “USD LIBOR.”

equal to 5.28195 % per annum, compounding quarterly at three-month LIBOR, at termination of the swap.

Next, Domestic Parent entered into a fixed-floating interest rate swap with Euro International with respect to a notional amount equal to the principal amount on the CLNs (Amount 4), whereby Domestic Parent paid a fixed amount of Rate 5 to Euro International in exchange for a floating interest rate of 3-month LIBOR. Similarly, SPV entered into a fixed-floating interest rate swap with Euro Finance, a Foreign Country subsidiary of Domestic Holdings' foreign parent corporation, with respect to a notional amount equal to the principal amount on the CLNs (Amount 4), whereby SPV received a fixed Rate 5 and paid a floating rate equal to U.S. dollar monthly LIBOR. Lastly, Euro Finance entered into a fixed-floating interest rate swap with Bank with respect to a notional amount equal to the principal amount on the CLNs (Amount 4), whereby Euro Finance received a fixed Rate 5 and paid a floating rate equal to U.S. dollar monthly LIBOR. The interest rate swaps provided for the payment of a breakage fee in the event that the swap terminated prior to the expiration of the 5-year period.

It is worth noting that the interest rate swaps were with respect to a notional principal amount that matched the principal amount of the CLNs (Amount 4), rather than the principal amount of the PPFs (Amount 1). Apparently, this was done because Domestic Subsidiary only needed to generate enough cash flow to make interest payments under the CLNs. Additionally, it is likely that the timing of the fixed and floating payments due under all the swaps were matched.

The cash flows generated by the transaction are depicted below.



The Taxpayer's Return Position

During the years the CLNs and PPFs remained outstanding, Domestic Subsidiary annually deducted interest payments made to SPV under the CLNs. For example, Domestic Subsidiary deducted Amount 9 in connection with the CLNs as an "other deduction" on Line 26 of its Date 2 Form 1120, U.S. Corporation Income Tax Return. Similarly, Domestic Subsidiary deducted Amount 10 in connection with the interest rate swaps as an "other deduction" on Line 26 of its Date 2 Form 1120, U.S. Corporation Income Tax return. In contrast, Domestic Subsidiary did not include in income annually any appreciation from the forward portfolio. Rather, Domestic Subsidiary determined that it was not liable for any tax under the PPFs until it became a "closed transaction," which would not be until the forward contract's settlement date.

At the time the transaction was entered into, Domestic Subsidiary anticipated that it would either: (1) sell the PPFs to a related Domestic Holdings entity prior to the settlement date, realize a capital gain, and use the cash proceeds to repay the CLNs; or (2) take physical possession of the securities on the settlement date and recognize a capital gain when Domestic Subsidiary transferred the securities to SPV to repay the CLNs. The transaction was designed so that Domestic Subsidiary would recognize a capital gain because Domestic Holdings had to utilize its expiring capital losses.

Under the terms of the interest rate swap between Domestic Subsidiary and Domestic Parent, Domestic Subsidiary was required to make a single payment to Domestic Parent equal to Rate 5 per annum, compounding quarterly at three-month LIBOR on the termination of the swap. It is likely that Domestic Subsidiary treated this swap as a notional principal contract under Treas. Reg. § 1.446-3, treated the single interest payment due on settlement as a "periodic payment" under Treas. Reg. § 1.446-3(e), and deducted its "ratable daily portion" of that net swap payment on an annual basis. While the taxpayer submitted a power point to Exam indicating that it treated the interest rate swaps as a loan for tax purposes, this claim was not supported by the return. For example, Domestic Subsidiary deducted Amount 10 in connection with the interest rate swaps as an "other deduction" on Line 26 of its Date 2 Form 1120, U.S. Corporation Income Tax return; rather than deducting the amount as "interest" on Line 18. Moreover, the Schedule L, Balance Sheets per Books, did not list the interest rate swaps as liabilities. Rather, the only liabilities listed are the CLNs.

The Winding Up of SPV

On Date 3, Bank notified Domestic Holdings that it was exercising its call option on the common stock of SPV and thus, effectively unwound the transaction. The common stock of SPV was delivered to Bank on or about Date 4. Prior to exercising the call option, Domestic Subsidiary repaid the CLNs in full with cash. SPV then took the cash and lent Amount 11 to Bank with interest accruing at one month LIBOR, payable monthly. As a result of the transaction being unwound, Domestic Subsidiary terminated the PPFs and recognized Amount 12 of capital gain, which was offset with Domestic Holdings' existing capital losses.

Issue

1. Whether Domestic Subsidiary's Amount 9 deduction for annual interest payments to SPV under the CLNs should be capitalized under I.R.C. § 263(g) as "carrying costs" properly allocable to straddle property.

2. Whether Domestic Subsidiary's Amount 10 deduction for payments to Domestic Parent in connection with the interest rate swap should be capitalized under I.R.C. § 263(g) as "carrying costs" properly allocable to straddle property.

3. Whether the Amount 12 that Domestic Subsidiary recognized as capital gain upon the termination of the PPFs should be recharacterized as ordinary income because the forward contract is a "conversion transaction" under I.R.C. § 1258.

Law and Analysis

Generally, the Code does not impose any tax consequences when parties enter into a forward contract. Similar to an option, a standard forward contract is an executory contract that is treated as an "open transaction" until the contract is settled. See Lucas v. North Texas Lumber, 281 U.S. 11, 13 (1930) (purchase and sales agreement for a house entered into in December of year 1 but not closed until January of year 2 treated as an open transaction that did not settle until year 2).[4] If the forward contract is settled by delivery of the underlying property, the forward seller (i.e., the party delivering the property) recognizes gain or loss based on the difference between the price received at settlement and the taxpayer's basis in the property delivered. In contrast, the forward buyer (i.e., the party receiving the property) takes a cost basis in the assets equal to the forward contract price, and gain or loss is deferred until the subsequent disposition of the assets. The character of the gain or loss that is realized with respect to the forward contract is generally the same as the character of the underlying property. Alternatively, if a forward contract is not physically settled at the settlement date, but rather the forward contract is settled for a cash payment, cancelled, terminated, or sold prior to its settlement date, then the gain or loss is generally capital if the forward contract is a capital asset in the hands of the taxpayer. See Staff Report of the Joint Committee on Taxation, *Present Law and Issues Related to the Taxation of Financial Instruments and Products* (JCX-56-11).

[4] As noted, we are not addressing whether the PPF should be respected as a forward contract for federal tax purposes and subject to "open transaction" treatment. In some instances, parties to prepaid contracts should be required to accrue income or expense during the term of the transaction. See Rev. Rul. 2008-1, 2008-1 C.B. 248; Notice 2008-2, 2008-2 IRB 252.

Section 1092 Straddles

The standard tax consequences flowing from a forward contract can be altered, however, if the forward contract makes up part of a straddle in personal property. Section 263(g) provides that no deduction shall be allowed for interest and carrying charges[5] properly allocable to personal property that is part of a straddle (as defined in I.R.C. § 1092(c)). See I.R.C. § 263(g). Section 1092(c) defines a straddle as "offsetting positions with respect to personal property." In general, 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[6] with respect to personal property[7] by reason of his holding one or more other positions with respect to personal property." I.R.C. § 1092(c)(2). Moreover, under I.R.C. § 1092(c)(3)(A)(ii) and (iii), two or more positions shall be presumed to be offsetting if the positions are in the same personal property (even though such property may be in a substantially altered form) or the positions are in debt instruments of a similar maturity.

In this case, Domestic Subsidiary entered into PPFs that gave Domestic Subsidiary the right to receive a portfolio of highly liquid, investment grade securities. These PPFs qualify as positions in personal property under I.R.C. § 1092(d). In order for these positions in personal property to be a straddle, however, Domestic Subsidiary must have entered into offsetting positions with respect to the PPFs. Domestic Subsidiary entered into two offsetting positions – the interest rate swap with Domestic Parent and the rights under the CLNs.

Domestic Subsidiary's Right Under the CLN to Deliver "Specified Assets"

Domestic Subsidiary's rights under the CLNs constitute an offsetting position with respect to the PPFs because Domestic Subsidiary rights under the CLNs substantially diminished Domestic Subsidiary's risk of loss with respect to the PPFs. The CLNs provided Domestic Subsidiary with the choice of repaying the Amount 4 that Domestic Subsidiary borrowed from SPV by physically delivering to SPV either cash or a reference portfolio of securities called "Specified Assets." The Specified Assets under the CLNs had specific characteristics, including that they be highly liquid, investment grade asset-backed securities such as AAA rated bonds and A-1 rated commercial paper. The investment profile (i.e., interest rate risk, average length to maturity, credit rating, etc.) associated with the Specified Assets is substantially similar to the investment profile of the securities underlying the PPFs (the "reference portfolio"). In

---

[5] As relevant here, "interest and carrying charges" is defined as the amount of interest on indebtedness incurred or continued to purchase or carry the personal property over the amount of interest includible in gross income with respect to the personal property.

[6] The Code defines a "position" as any interest in personal property (including an interest in a futures or forward contract). See I.R.C. § 1092(d)(2).

[7] The Code defines "personal property" as any personal property of a type which is actively traded. See I.R.C. 1092(d)(1); See also Treas. Reg. § 1.1092(d)-1(c). If a taxpayer is an obligor under a debt instrument and debt payments are linked to the value of personal property, the debt instrument may be part of a straddle. See Prop. Reg. § 1.1092(d)-1(d).

fact, some of the underlying securities listed in the appendices to the CLNs as "Specified Assets" are identical to the underlying securities listed in the reference portfolio of the PPFs.

If the PPFs had diminished in value because the securities underlying the PPFs diminished in value, then Domestic Subsidiary could wait until it received the securities in settlement of the PPFs and then deliver them to SPV in satisfaction of the CLNs. As a result, Domestic Subsidiary's risk of loss in the PPFs was substantially diminished by its rights under the CLNs. While the Specified Assets did not make up 100% of the PPFs' reference portfolio, there was a sufficient amount of overlap that Domestic Subsidiary's risk of loss with respect to the PPFs was substantially diminished by Domestic Subsidiary's ability to repay the CLNs with those securities or securities with a substantially similar investment profile. Thus, Domestic Subsidiary investment in the PPFs and its rights under the CLNs represent offsetting positions in personal property and constitute a straddle under I.R.C. § 1092.

Moreover, under I.R.C. § 1092(c)(3)(A)(ii) and (iii), two or more positions shall be presumed to be offsetting if the positions are in the same personal property (even though such property may be in a substantially altered form) or the positions are in debt instruments of a similar maturity. The PPFs and CLNs were offsetting positions in the same personal property because the "Specified Assets" under the CLNs and the "reference portfolio" under the PPFs were substantially similar and in some cases involved identical securities. Additionally, the PPFs and CLNs had five year lengths to maturity, and thus, should be presumed to be offsetting positions under I.R.C. § 1092(c)(3).

Because Domestic Subsidiary's investment in the PPFs and its borrowing under the CLNs constitute a straddle under I.R.C. § 1092, Domestic Subsidiary cannot deduct the Amount 9 in annual interest payments under the CLNs that it claimed on its tax return. Pursuant to I.R.C. § 263(g), that amount must be capitalized. Those payments cannot be deducted until the 2011 taxable year, when the PPFs were terminated and Domestic Subsidiary recognized a capital gain.

The Interest Rate Swaps

As mentioned above, I.R.C. § 263(g) provides that no deduction shall be allowed for interest and carrying charges properly allocable to personal property which is part of a straddle. Section 1092(c) defines a straddle as "offsetting positions with respect to personal property," and a taxpayer holds offsetting positions if there is a substantial diminution of the taxpayer's risk of loss from holding any position by reason of his holding one or more other positions. I.R.C. § 1092(c)(2).

Domestic Subsidiary's investment in the PPFs and Domestic Subsidiary's rights and obligations under the interest rate swap with Domestic Parent represent a straddle because Domestic Subsidiary's risk of loss in the PPFs was substantially diminished by Domestic Subsidiary's interest rate swap with Domestic Parent. Domestic Subsidiary received a fixed rate of return from the PPFs and paid SPV a floating interest rate under the CLNs. Domestic Subsidiary was exposed to interest rate risk on the PPFs because if interest rates went up, the PPFs underlying portfolio of securities would become less valuable relatively (i.e., they would be producing interest at a rate less than the prevailing market rate). Moreover, Domestic Subsidiary's interest payments to SPV under the CLNs would also increase. Domestic Subsidiary was able to hedge against this risk by entering into an interest rate swap with Domestic Parent, whereby Domestic Parent was required to make annual payments to Domestic Subsidiary to the extent interest payments rose above Rate 6 (the rate the forward securities were accruing value) and where Domestic Subsidiary was only required to make a lump sum payment to Domestic Parent at termination at a fixed interest rate if interest rates fell below Rate 6. In other words, if interest rates went up, then Domestic Subsidiary would receive a net increase in payments from Domestic Parent to offset the decreased value of the PPFs. Thus, by entering into an interest rate swap with Domestic Parent, Domestic Subsidiary was able to substantially diminish its risk of loss on the PPFs by eliminating its exposure to rising interest rates.

Because Domestic Subsidiary's investment in the PPFs and Domestic Subsidiary's rights and obligations under the interest rate swap with Domestic Parent constitute a straddle under I.R.C. § 1092, Domestic Subsidiary cannot deduct the Amount 10 in accrued payments due under the interest rate swap with Domestic Parent that it claimed on its tax return. Rather, those amounts must be capitalized pursuant to I.R.C. § 263(g). Those amounts cannot be deducted until the 2011 taxable year, when the PPFs were terminated and Domestic Holdings recognized a capital gain.

Section 1258 Conversion Transaction

As mentioned previously, during Date 4, Domestic Subsidiary terminated the PPFs with Euro International and recognized Amount 12 of capital gain. Generally, when a forward contract is not physically settled at the settlement date, but rather is sold prior to its settlement date, then the gain or loss is capital in nature if the forward contract is a capital asset in the hands of the taxpayer. "Conversion transactions," as defined in I.R.C. § 1258, provide an exception to the general rule that gains and losses resulting from forward contacts are capital in nature. Conversion transactions are transactions in which a taxpayer holds two (or more) opposing positions with respect to a security, and substantially all of the return from the combined positions is generated by the time value of money (i.e., the return resembles interest on a loan). See I.R.C. § 1258(c). If a transaction is determined to be a "conversion transaction," then I.R.C. § 1258 recharacterizes the capital gain as ordinary income (to the extent it does not exceed the applicable imputed income amount as defined in I.R.C. § 1258(d)).

Congress enacted I.R.C. § 1258 because of perceived abuses by taxpayers that entered into economically identical transactions but that had widely disparate tax treatment. See Joint Committee on Taxation, *Ways and Means Committee Markup of the Administration's Revenue Proposals* (JCX-1-93). For example, a taxpayer that invests in a zero-coupon bond is generally taxed at ordinary income rates and on an annual basis under the original issue discount rules of I.R.C. § 1272. In contrast, if a taxpayer purchases a forward contract where the underlying security is a zero coupon bond, then the taxpayer could get capital gain treatment even though the economic return is based purely on the time value of money (i.e., interest) rather than any actual appreciation in the security due to, for example, falling interest rates. See James H. Combs, *Section 1258 Conversion Transactions*, The Michigan Tax Lawyer (Fall 2010).

In this case, Domestic Subsidiary's investment in the PPFs and its rights under the CLNs represent a conversion transaction because substantially all of the capital gain Domestic Subsidiary recognized from the PPFs is attributable to the time value of money. Under the PPFs, Domestic Subsidiary was entitled to receive a portfolio of "reference securities" that accrued value at a fixed rate of return. Domestic Subsidiary protected itself from any downside risk in the PPFs by (1) having the option under the PPFs to take physical possession of the underlying securities and (2) having the option under the CLNs to put those securities to SPV. Domestic Subsidiary's return on the PPFs was derived from the "reference portfolio" of securities, and that return was economically linked to the interest earned on those securities. In other words, substantially all of Domestic Subsidiary's return on the PPFs was generated by the time value of money and thus, is a conversion transaction within the meaning of I.R.C. § 1258.

Additionally, sections 1258(c)(2)(B) and (d)(1) specifically define a conversion transaction as including an applicable straddle (within the meaning of I.R.C. § 1092(c)). As discussed in the previous section, Domestic Subsidiary's position in the PPFs is part of a straddle and, as a result, section 1258 should apply to convert Domestic Subsidiary's capital gain into ordinary income (to the extent it does not exceed the applicable imputed income amount as defined in I.R.C. § 1258(d)).

Furthermore, this transaction is precisely the type of abuse that Congress had in mind when it enacted I.R.C. § 1258. Domestic Subsidiary was able to convert income attributable to interest accruing on debt instruments (i.e., the reference portfolio of securities) that should be taxed at ordinary income rates into capital gains, which could be offset with Domestic Holdings' expiring capital losses. Economically, the CLNs and the PPFs are nearly identical transactions. Under the PPFs, Domestic Subsidiary gave money to Euro International at the opening of the transaction in exchange for a fixed interest rate based return and a portfolio of highly liquid, investment grade securities due at the settlement date. Similarly, under the CLNs, SPV gave money to Domestic Subsidiary at the opening of the transaction in exchange for annual payments of interest and repayment of principal at maturity, which Domestic Subsidiary could repay by delivering a portfolio of highly liquid, investment grade securities. In both cases, the long party transferred money to the short party at the opening of the transaction and in exchange received the right to receive an annual rate of return that represented the time value of money and the right to receive a portfolio of highly liquid, investment grade securities five years in the future that was equal in value to the amount of money initially transferred at the opening of the transaction. This is precisely the type of abuse that

Congress had in mind when it enacted I.R.C. § 1258. Based on the foregoing analysis of the statutory language and policy considerations, this is a “conversion transaction” within the meaning of I.R.C. § 1258 and Domestic Subsidiary’s capital gain will be converted into ordinary income (to the extent it does not exceed the applicable imputed income amount as defined in I.R.C. § 1258(d)).

Conclusions

1. Domestic Subsidiary’s investment in the PPFs and its rights and obligations under the CLNs constitute a straddle under I.R.C. § 1092. Thus, Domestic Subsidiary must capitalize the Amount 9 it deducted for annual interest payments to SPV under the CLNs. Pursuant to I.R.C. § 263(g), those amounts must be capitalized and cannot be recognized until the 2011 taxable year when the PPFs were terminated and Domestic Holdings recognized a capital gain.

2. Domestic Subsidiary’s investment in the PPFs and its rights and obligations under the interest rate swap with Domestic Parent constitute a straddle under I.R.C. § 1092. Thus, Domestic Subsidiary must capitalize the Amount 10 it deducted for accrued payments to Domestic Parent in connection with the interest rate swap. Pursuant to I.R.C. § 263(g), those amounts must be capitalized and cannot be recognized until the 2011 taxable year when the PPFs were terminated and Domestic Holdings recognized a capital gain.

3. Domestic Subsidiary’s investment in the PPFs is a “conversion transaction” within the meaning of I.R.C. § 1258 because substantially all of the capital gain Domestic Subsidiary recognized from the PPFs was attributable to the time value of money and because Domestic Subsidiary’s position in the PPFs was part of a straddle. As a result, section 1258 should apply to convert Domestic Subsidiary’s capital gain into ordinary income (to the extent it does not exceed the applicable imputed income amount as defined in I.R.C. § 1258(d)).

If you have any questions about the advice rendered in this memorandum, please contact the undersigned attorney at .

Sincerely,

ROLAND BARRAL
Area Counsel
(Financial Services)

By: ______________________________
Michael S. Coravos
Attorney (Manhattan, Group 1)
(Large Business & International)