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

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OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: LON B. SMITH
ACTING ASSOCIATE CHIEF COUNSEL (FINANCIAL INSTITUTIONS AND PRODUCTS) CC:FIP

SUBJECT:
This Chief Counsel Advice responds to your memorandum dated May 2, 2001. In accordance with Section 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =
Counterparty A =
Counterparty B =
Date 1 =

x =

a% =

b% =

c% =
d% =

Date 2 =
Date 3 =

$a =

$b =

$c =
$d =
$e =
e% =

f% =

g% =

$f =
y =

$g =

ISSUE:

The sole issue set forth in your Field Service Advice (FSA) request is whether Taxpayer is permitted to deduct the built-in loss on the Old Swaps where they are closed out by entering into off-market New Swaps with excess fixed rate payments to cover the built-in loss.

CONCLUSION:

No. The built-in loss is not allowed absent a termination payment equal to the built-in loss.

FACTS:

The facts, as set forth in your FSA request, and the materials submitted therewith, are as follows: Taxpayer entered into a notional principal contract (Swap A) with Counterparty A on Date 1 (the trade date) with a notional amount of x. Taxpayer paid the fixed rate of a%, and Counterparty A paid the floating rate, which was b% for the initial calculation period. On the same day, Taxpayer entered into an interest rate swap with Counterparty B (Swap B). As with Swap A, the notional amount was x. Taxpayer paid the fixed rate of c%, and Counterparty B paid the floating rate, which was d% for the initial calculation period. The FSA request states that neither Swap A nor Swap B are hedges under section 1.1221-2(b) of the Income Tax Regulations.

Taxpayer asserts that it effectively made termination payments to Counterparty A and Counterparty B to terminate Swap A and Swap B (the Old Swaps). On Date 2, Taxpayer received, from Counterparty A, a document that stated Taxpayer had agreed to pay a termination fee of $a, with respect to Swap A. The next day, Taxpayer received a letter from Counterparty A explaining that the fair market value of Swap A at the time of termination was a loss of $b, an amount substantially greater than $a. On Date 3, Taxpayer received an unwind confirmation from Counterparty B confirming that Taxpayer would pay $c to terminate Swap B. On the same day, Counterparty B sent a letter to Taxpayer stating that the cost of Swap B, $d (an amount substantially greater than $c), was rolled into a new swap.

At the same time Taxpayer terminated the Old Swaps, Taxpayer entered into two new swaps, each with a trade date of Date 2. Both swaps had a notional amount of x. The swap entered into with Counterparty A (Swap C) required Taxpayer to pay the fixed rate of e%, with Counterparty A paying the floating rate, which was f% for the initial calculation period. The swap entered into with Counterparty B (Swap D) required Taxpayer to pay the fixed rate of g%, with Counterparty B paying the floating rate, which was f% for the initial calculation period. Neither Swap C nor Swap D provided for an up-front payment to Taxpayer.

Taxpayer asserts that the Old Swaps were entered into in connection with a variable rate borrowing, and terminated in connection with the termination of that variable rate borrowing. Likewise, Taxpayer asserts the New Swaps related to the resumption of a variable rate borrowing.

Swap C and Swap D (the New Swaps) were off-market swaps. The FSA request states that the New Swaps had an aggregate embedded economic loss of approximately $e. Taxpayer appears to have terminated the Old Swaps and structured the New Swaps to ensure Taxpayer would be obligated to pay amounts over the life of the New Swaps to compensate each counterparty for the termination of the Old Swaps. Taxpayer acknowledges that the cost of terminating Swap B was rolled into the cost of Swap D. The paperwork terminating Swap A does not state that the cost was rolled into Swap C, but the FSA request states that the financial worksheets presented by Taxpayer reflect the same book treatment for Swap A and Swap B.[1] Furthermore, Taxpayer has not claimed deductions in the amounts that were specified as termination fees, but instead has claimed deductions for the amount of loss on the Old Swaps. Taxpayer did, however, make a payment of $g.

Taxpayer claimed deductions for termination payments in the amount of $b and $d. The total claimed deduction was $f. The Revenue Agent disallowed those deductions.

LAW AND ANALYSIS

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[1] It appears that for book purposes Taxpayer amortized the built-in loss on the Old Swaps over the life of the New Swaps.

A termination payment is defined as a payment made to extinguish or assign the remaining rights and obligations of a party under a notional principal contract. Section 1.446-3(h)(1). Any economic benefit given or received in lieu of a termination payment is a termination payment. Section 1.446-3(h)(4)(ii). A termination payment includes a payment made between the original parties to the contract. Section 1.446-3(h)(1). A party to a notional principal contract recognizes the termination payment in the year the contract is extinguished. Section 1.446-3(h)(2).

The Commissioner may depart from the rules of section 1.446-3 as necessary to reflect the appropriate timing of income and deductions if a taxpayer enters into a notional principal contract with a principal purpose of creating a material distortion of income. Section 1.446-3(i).

Taxpayer relies on FSA199905002 in support of its position.[2] FSA 199905002 involved a taxpayer that assigned a swap to a third party. The assignment obligated the taxpayer to make an assignment payment to the third party. The taxpayer then entered into an off-market swap with the third party. The off-market swap obligated the third party to make an up-front payment which was equal to the assignment payment. Since the up-front payment and assignment payment were equal, no cash actually exchanged hands. The FSA held that the taxpayer was entitled to deduct the assignment payment and that the funding of the assignment payment through the loan (up-front payment) did not create the type of distortion in income that should be remedied through the anti-abuse rule of section 1.988-2(e)(3)(v).

Because the Old Swaps have been extinguished, at least in form, Taxpayer may argue that the built-in loss may be deducted because it effectively paid an amount equal to the loss by entering into an off-market swap. Section 1.446-3(h)(2). However, a termination payment is specifically defined as a payment made to extinguish a notional principal contract. Section 1.446-3(h)(1). In this case, Taxpayer has not made a termination payment on either of the Old Swaps because it did not make an actual payment to either Counterparty A or Counterparty B.

Taxpayer's reliance on FSA 199905002 is misplaced. That FSA was decided before the effective date of section 1.446-3, so the notional principal contract regulations were not considered. Furthermore, the prior FSA involved three different parties. The taxpayer had entered into a swap with a counterparty, but the taxpayer then assigned that swap to a third party and entered into a new swap with the third party. In short, the old swap and the new swap were entered into with

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[2] As you know, FSAs may not be relied on as authority.

different counterparties. In this case, Taxpayer has terminated the Old Swaps and entered into the New Swaps with the same counterparties.

Taxpayer argues that the economic benefit is a payment in lieu of a termination payment under section 1.446-3(h)(4)(ii). In particular, Taxpayer argues that it indirectly gave an economic benefit to the Counterparties because the New Swaps did not require that the Counterparties make an up-front payment to compensate for the above market fixed rate payment being paid by Taxpayer. While it may be true that an up-front payment might be expected in an off-market swap, an up-front payment would not have been made here because the excess payments made by Taxpayer were designed to compensate for the built-in loss on the Old Swaps. As such, there seems to be little justification for deeming a payment.

Moreover, the regulations define a termination payment in terms of a payment made or received, implying that an actual payment must occur. Section 1.446-3(h)(1). The economic benefit rule of section 1.446-3(h)(4)(ii) should be read consistently with the general definition of termination payment. It is a well-settled principle of statutory interpretation that provisions of law should be interpreted consistently with each other. <u>See</u> <u>United Transp. Union-Illinois Legislative Bd. v. Surface Transportation Bd.</u>, 169 F.3d 474, 480 (1999). No additional economic benefit has been provided that approximated or was equivalent to a payment.[3] Since the Counterparties were in the same position they were before the Old Swaps were terminated, they were not provided and did not receive any benefit from entering into the New Swaps.

The above analysis is consistent with the use of the term payment in other regulations. The economic performance regulations define a payment as the furnishing of cash or cash equivalents or the netting of offsetting accounts, and not the furnishing of a note or other evidence of indebtedness. Section 1.461-4(g)(1)(ii)(A). Although not specifically applicable to notional principal contracts, those regulations suggest that there must be an outlay of cash for there to be a termination payment.

If this matter were to advance to litigation, we would recommend consideration and further development of two other arguments. An argument might

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[3] Generally, a taxpayer is treated as receiving income, under the economic benefit theory, where the taxpayer has the absolute right to income set aside for the taxpayer, or where a payment has been made on the taxpayer's behalf. <u>See</u> <u>Pulsifer v. Commissioner</u>, 64 T.C. 245, 246 (1975); <u>Old Colony Trust Co.</u>, 279 U.S. at 729 (1929). Taxpayer has not set aside funds for either Counterparty A or Counterparty B, nor has Taxpayer made any payments on behalf of either Counterparty.

be made that the anti-abuse rules of section 1.446-3(i) apply to the New Swaps. As explained above, it appears that Taxpayer terminated the Old Swaps and entered into the New Swaps with a principal purpose of materially distorting income and deductions. It can be argued that Taxpayer's income would be distorted if it could deduct the asserted termination payment currently since the payments will actually be made over the term of the New Swaps.

It also might be argued, based on the overall economics of the transaction, that terminating the Old Swaps and entering into the New Swaps does not result in a deductible loss. A loss is allowable as a deduction for federal income tax purposes only if it is bona fide and reflects actual economic consequences. An artificial loss lacking economic substance is not allowable. See ACM Partnership v. Commissioner, 157 F.3d 231, 252 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999) ("Tax losses such as these . . . which do not correspond to any actual economic losses, do not constitute the type of 'bona fide' losses that are deductible under the Internal Revenue Code and regulations."); Scully v. United States, 840 F.2d 478, 486 (7th Cir. 1988) (to be deductible, a loss must be a "genuine economic loss"); Shoenberg v. Commissioner, 77 F.2d 446, 448 (8th Cir. 1935) (to be deductible, a loss must be "actual and real"); Section 1.165-1(b) ("Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.").

Taxpayer has structured the New Swaps in order to pay the termination payment due over the life of the New Swaps, instead of currently. By rolling the losses on the Old Swaps into the New Swaps, Taxpayer will pay the amount of the embedded loss over the life of the New Swaps. Thus, in substance, it can be argued that a loss should not be permitted. Indeed, for book purposes, the loss was only taken over the life of the New Swaps.

With respect to transactions that occurred prior to the effective date of section 1092, courts have held that losses incurred in certain straddle transactions were not deductible because the transactions lacked economic substance. See Demartino v. Commissioner, 862 F.2d 400, 406 (1988); Keane v. Commissioner, 865 F.2d 1088, 1092 (9th Cir. 1989), aff'g Glass v. Commissioner, 87 T.C. 1087 (1986). The straddle transactions were prearranged to generate a loss for tax purposes while deferring the offsetting unrealized gains. Somewhat similarly, the termination of the Old Swaps and the establishment of the New Swaps were prearranged to recognize a current loss upon the termination of the Old Swaps while deferring the payment of that loss over the terms of the New Swaps.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS.

[redacted]

[redacted]

Although we believe that FSA 199905002 is not a relevant statement of the IRS litigation position for the reasons stated above, we also believe that it would be appropriate, if Taxpayer relies on it, to point out that it simply does not address the economic substance precedents discussed above.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

We would be pleased to provide ongoing assistance as this case develops. Please call Kate Sleeth at 202-622-3097 if you have any further questions.

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