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CHIEF COUNSEL

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

MEMORANDUM FOR

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

SUBJECT: Debt Straddles (Bear/Bull Notes)

This Field Service Advice responds to your memorandum dated September 20, 1999. 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	=
Broker	=
Bank	=
Year 1	=
Year 2	=
Month 1	=
Month 2	=
Month 3	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
A	=
B	=
C	=

<u>D</u> =
<u>E</u> =
<u>F</u> =
<u>G</u> =
<u>H</u> =
<u>I</u> =
<u>J</u> =
<u>K</u> =
<u>L</u> =
<u>M</u> =
<u>N</u> =
<u>O</u> =
<u>P</u> =

<u>ISSUE</u>:

Whether the capital loss recognized by <u>Taxpayer</u> upon the sale of Note B (the Bull notes) should be disallowed.

<u>CONCLUSION</u>:

Note A (the Bear notes) and Note B (the Bull notes) represent a single investment that has been structured as two debt instruments so that one will increase significantly in value at the same time that the other decreases in value by substantially the same amount. The treatment of Note A and Note B as separate debt instruments lacks economic substance. Separate treatment of Note A (the Bear notes) and Note B (the Bull notes) results in a significant artificial loss that can be recognized in one taxable year and a matching gain that can be deferred until a later taxable year. Such artificial losses are not allowable for federal income tax purposes. Therefore, the capital loss recognized by <u>Taxpayer</u> upon the sale of Note B (the Bull notes) should be disallowed.

<u>FACTS</u>:

On <u>Taxpayer</u>'s <u>Year 1</u> tax return, net capital gain was reported in the amount of $<u>A</u>. This amount was the net of $<u>B</u> of long-term capital gain and $<u>C</u> of short-term capital loss. Most of the long-term gain was from <u>Taxpayer</u>'s sale of stock. Most of the short-term loss consisted of a loss on the transaction described below.

The transaction involves the purchase and sale of notes and the generation of short-term capital losses which are used to offset other capital gains. The vehicles used to accomplish this goal were a series of bonds. This type of deal is commonly referred to as a Bear/Bull note. Broker was the calculation agent in the transactions. Essentially this means that Broker structured and brokered the deal.

The deal was described in an offering as involving two obligations which a taxpayer would purchase. The obligations had a term of D-years. In the example outlined in the prospectus, each note carried a coupon rate of E percent through the “reset date.” On that date, the coupon rates were reset based on the level of the three-month LIBOR at the time. The coupon payments on the first note (“Note A”) were to be linked to the bearish movements in the short-term US interest rates. If LIBOR were greater than F percent on the reset date, the coupon rate on Note A was to reset to two times LIBOR for the remaining term of the note. If LIBOR were to be less than F percent, the coupon rate on Note A reset to zero.

The interest rate on Note B was linked to the bullish movements in the short-term US rates. If LIBOR were to be less than F percent on the reset date, the coupon rate on Note B reset to two times LIBOR for the remaining term of the note. If LIBOR exceeded F percent on the reset date, the coupon rate for Note B reset to zero.

The prospectus describes the notes using the terms “super floater” and “zero note.” The descriptions vary depending on the manner in which the coupon rates were reset. The zero note, having no return on investment, is worth the face amount at maturity, and has a value of considerably less than par during the term of the note. The super floater carried substantial built-in gain if held to maturity. Thus, the sale of the zero note during Year 1 would generate a large capital loss, while no gain would be recognized on the super floater until its sale. The problem of finding a buyer for the zero note was solved by the Broker’s assurance in the prospectus that they:

> ... stand ready to purchase the Zero Note from the Investor at a price to be determined at the time on the basis of prevailing interest rates and other market conditions on the sale date .... [Broker] will determine the price at which it is willing to purchase the Zero Note only upon the request of the Investor and, in order to quote a price, [Broker] will perform a new analysis of the terms of the Note.

The prospectus included an attachment in the form of a legal opinion letter. Among other things, this opinion included the assurance that the deal would not constitute a straddle within the meaning of I.R.C. § 1092 because the notes are not listed on a securities exchange or quoted in an inter-dealer price quotation system. Moreover, neither Broker nor any other potential purchaser is expected to prepare and retain price quotations on the notes on an ongoing basis.

Taxpayer entered into the transaction. During Month 1, Taxpayer purchased eight bonds with maturity dates in Year 2 from eight different issuers. Broker acted as agent for all of these offerings. These bonds were all issued electronically, i.e., no paper bonds were issued and the transactions were merely recorded electronically. Four of the bonds represented what has been described above as "Note A." These bonds will be referred to as "Bear bonds." The other four bonds purchased represent what was referred to above as "Note B." These bonds will be referred to as the "Bull bonds."

All eight of the bonds were new issue LIBOR reset notes, offering a fixed coupon rate from settlement to Date 6 fluctuating around G percent. The coupon rate from Date 6 to maturity was based on the three month USD LIBOR rate on the "Trigger Date" as compared to the "3M Libor Trigger Level." The "Trigger Date" was a specified number of business days prior to Date 6. The "3M Libor Trigger Level" was H percent.

The total value (cost) of the eight bonds was $I ($J for each of the groups of bonds representing Notes A and B). These amounts were debited to the Taxpayer's general account at Bank. This account was a custodian account and was debited on Date 1 for the amount of $K and for the amount of $L on Date 4. (The latter date corresponds to the date of a $L loan from Broker to Taxpayer (see below).)

The Bear bonds' coupon rate to maturity was to be two times LIBOR if, on the "Trigger Date," the level of "Trigger 3M Libor" was greater than or equal to the "3M Trigger Level" (H percent). If on the "Trigger Date" the level of "Trigger 3M Libor" was less than the "3M Libor Trigger Level" (H percent), the note would pay a coupon of zero from Date 6 to maturity.

The Bull bonds' terms of coupon rates from Date 6 to maturity are the opposite of the Bear bonds. If, on the "Trigger Date," the level of "Trigger 3M Libor" was less than the "3M Trigger Level," the coupon rate was to be two times LIBOR for the remainder of the note term. If the rate was greater than the "3M Trigger Level" (H percent), the coupon would reset to zero.

On Date 3, Taxpayer and Broker entered into a Master Repurchase Agreement (the "Agreement"). The Agreement was to be effective as of Date 2 and was to govern the purchase of notes by Taxpayer and the repurchase of notes by Broker. The Agreement was entered into in contemplation of Taxpayer borrowing $L from Broker, which loan was made on Date 4, with a maturity date of Date 7. The interest rate was listed at M percent and secured by twelve bonds held by

Taxpayer which had an aggregate face value of $N.[1] The funds from this borrowing were deposited into Taxpayer's general account at Bank. The borrowing was renewed in Month 2 and held until Month 3, at which time the loan was paid.

On Date 5, the Bull bonds were disposed of when the coupon rate reset to zero. The total cost of these bonds was $J. Taxpayer requested the "analysis of the terms of the Note in light of prevailing interest rates and other market conditions" referred to in the opinion letter. The total value of the four bonds, as calculated by Broker as of Date 5, was determined to be $O. The Bull bonds were purchased by Broker as previously agreed, resulting in a "loss" in the amount of $P (the difference between the cost and the proceeds).

The Bear/Bull note transaction typically concludes with the "investor" holding the note bearing interest at (in this case) two times LIBOR for at least a year beyond the settlement, reporting interest income and ultimately recognizing long-term gain/loss upon disposition of the note(s). In this case, Taxpayer still holds the super floater note (the Bear bonds) as of the date of the FSA request.

LAW AND ANALYSIS:

In this case, Note A (the Bear notes) and Note B (the Bull notes) represent a single investment that has been structured as two debt instruments so that one will increase significantly in value at the same time that the other decreases in value by substantially the same amount. For the reasons set forth below, the treatment of Note A (the Bear notes) and Note B (the Bull notes) as separate debt instruments lacks economic substance. Therefore, the Commissioner may disregard the separate treatment of the two notes under the doctrine of economic substance.

In determining whether a transaction has economic substance, the net economic effect of the transaction is compared to the expected tax benefits. A transaction is lacking in economic substance if the transaction has no material effect on a taxpayer's economic position other than the creation of tax benefits. ACM Partnership v. Commissioner, 157 F.3d 231, 248 n.31 (3rd Cir. 1998), cert. denied, 119 S. Ct. 1251 (1999). See also Compaq Computer Corp. v. Commissioner, 113 T.C. No. 17 (September 21, 1999); Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. No. 21 (October 19, 1999); United Parcel Service of America, Inc. v. Commissioner, T.C. Memo. 1999-268. See also Cook v. Commissioner, 941 F.2d 734, 738 (9th Cir. 1991), aff'g 90 T.C. 975 (1988); Sheldon v. Commissioner, 94 T.C. 738, 759 (1990). A transaction that has only a small or incidental effect on a taxpayer's net economic position is not sufficient to impute

[1] These bonds did not include any of the Bear bonds or Bull bonds.

substance to a transaction having no other economic effect. ACM Partnership, 157 F.3d at 250.

The courts have applied the economic substance doctrine to disregard or to recast dispositions of property in cases where offsetting legal positions or circular cash flows eliminate any material economic effect other than the recognition of tax benefits. Id. at 248. In general, a transaction contains offsetting positions where the combined positions have the effect of substantially reducing the holder's risk of loss as well as limiting the holder's potential for gain with respect to each individual position.

Note A (the Bear notes) and Note B (the Bull notes) represent offsetting positions because as the value of one note increases the value of the offsetting note decreases by substantially the same amount. For example, when Taxpayer sells Note B (the Bull notes) prior to its maturity date, but retains Note A (the Bear notes), any loss recognized on the transfer of Note B is economically offset by the embedded gain in Note A. Thus, the disposition will have no material economic consequences to Taxpayer, but will produce a significant tax loss if respected by the Commissioner.

The facts show that the expected tax benefits far outweigh any potential effect on the economic position of Taxpayer. Therefore, separate treatment of Note A (the Bear notes) and Note B (the Bull notes) lacks economic substance.

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, 157 F.3d at 252 ("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.");Treas. Reg. § 1.165-1(b) ("Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.").

The debt straddle transaction described above does not produce an allowable loss. Separate treatment of Note A (the Bear notes) and Note B (the Bull notes) results in a significant artificial loss that can be recognized in one taxable year and a matching gain that can be deferred until a later taxable year. Such artificial losses are not allowable for federal income tax purposes.

Accordingly, the capital loss recognized by Taxpayer upon the sale of Note B (the Bull notes) should be disallowed.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

In your FSA request, you note that you considered the applicability of the anti-abuse rules under Temp. Treas. Reg. § 1.1275-2T(g). Under Temp. Treas. Reg. § 1.1275-2T(g), if a principal purpose in structuring a debt instrument, engaging in a transaction, or applying the regulations under sections 163(e) or sections 1271 through 1275 is to achieve a result that is unreasonable in light of the purposes of the applicable statutes, then the Commissioner can apply or depart from the regulations as necessary or appropriate to achieve a reasonable result.

However, the integration regulations under Treas. Reg. § 1.1275-6 apply to a qualifying debt instrument issued on or after August 13, 1996. The debt instruments involved in the instant transactions were all issued prior to August 13, 1996.

Due to the effective date of Treas. Reg. § 1.1275-6, the integration regulations cannot be applied to the facts of the instant case. This conclusion is the same regardless of the authority granted to the Commissioner under the anti-abuse provision found in Temp. Treas. Reg. § 1.1275-2T(g) because the Commissioner cannot "apply or depart from" a regulation that is not otherwise in effect for the taxable year in issue.

In addition, the Commissioner may require that the debt instruments be treated in combination for reporting purposes without need for the integration regulations of Treas. Reg. § 1.1275-6. Under the doctrine of economic substance, the form of a transaction may be disregarded and recast according to its substance. Therefore, the doctrine of economic substance may be relied upon to disallow the loss without the need to go through the steps for application of the anti-abuse rule in Temp. Treas. Reg. § 1.1275-2T(g) or the requirements for integration under Treas. Reg. § 1.1275-6.

Taxpayer may argue that its subsequent transactions with respect to the super floater note provide substance to the sale of the zero note. For purposes of applying the doctrine of economic substance, Taxpayer's subsequent transactions with respect to the super floater note should be treated as separate transactions and therefore will not provide substance to the sale.

The Service recently issued guidance on certain types of transactions that are being marketed to taxpayers for the purpose of generating tax losses. See Notice 99-59, 1999-52 I.R.B. __, dated December 27, 1999. We note that the debt straddle issue is on the Business Plan, and further guidance may be forthcoming on these types of transactions.

Please call if you have any further questions.

By: ____________________________

JOEL E. HELKE
Branch Chief
Financial Institutions & Products Branch

William F. Hammack
CC:MSR
Rebecca W. Wolfe
CC:MSR