Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: May 18, 2005

to:

from: Associate Chief Counsel (Corporate) CC:CORP:B03

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subject: Notice 2002-21: Whether Acquisition of the Foreign Currency in a Stock Subscription is a Substantially Similar Transaction to the Transaction Described in Notice 2002-21.

This Chief Counsel Advice responds to your request for advice dated October 13, 2004. Chief Counsel Advice is not binding on Examination or Appeals and is not a final Case determination. This Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

Taxpayer Subsidiary =

Foreign Affiliate =

Foreign Affiliate Foreign Currency Investment Program	=
LLC	=
Bank	=
Affiliate	=
Bond Issuer	=
Bank 2	=
Bank 3	=
Promoter	=
Manager	=
Year 1	=
Year 2	=
Month 1	=
Gain Company	=
Vice President of Taxes	=
FC	=
FC1	=
Country A	=
Country B	=
Floating Interest Rate	=
Fixed Interest Rate	=

Date 1	=
Date 2	=
Date 3	=
Custodian	=

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$a	=
$b	=
$c	=
d units	=
e units	=
f units	=
g units	=
h	=
i	=
$j	=
k	=
l	=
m	=
n units	=
$o	=
p	=
q	=

r units	=
s units	=
$t	=
Treasurer	=
Country C	=
Bank 4	=
Business x	=
u units	=
$v	=
$w	=
x units	=

ISSUES:

(1) Whether the transaction in the instant case falls within the scope of Notice 2002-21, 2002-1 C.B. 730.

(2) Should the Taxpayer's $b currency loss deduction for Year 2 be allowed as claimed and, if not, under what theory or theories should it be disallowed?

CONCLUSION:

(1) The transaction described below falls within the scope of Notice 2002-21.

(2) The Taxpayer's $b currency loss deduction for Year 2 should be disallowed in whole or in part for the following reasons:

(a) The deduction should be disallowed in its entirety on the grounds that LLC incurred no genuine indebtedness to Bank and, therefore, the purported assumption of such indebtedness by Taxpayer Subsidiary has no effect for federal income tax purposes. As a result, there is no § 357(c) gain on the purported § 351 exchange, no increase in the basis of the conveyed foreign currency (FCs) under § 362(a), and thus no loss on the subsequent sale of the "Conveyed FCs" (defined in the "Section 351 Transaction" section, below).

(b) Alternatively, if, upon further development of the facts, it appears that the parties did intend for Taxpayer Subsidiary to assume and pay some portion of the liability on the LLC Note, then Taxpayer Subsidiary's basis under § 362 in the Conveyed FCs should only be increased to the extent of the portion actually assumed.

(c) Taxpayer Subsidiary had no money or property at risk or, at most, it may include only d units (which ultimately was made available to Foreign Affiliate) in its amount at risk under § 465 of the Code. The result is that the loss deduction should be disallowed either in its entirety, or at most allowed only in the amount of the dollar equivalent of d units.

(d) The currency loss should be denied in its entirety until, if and when, Taxpayer can clearly demonstrate that with respect to the FCs which it could substantively use, exchange rate changes between the period it acquired and disposed of the FCs resulted in the loss. This is consistent with the intent of Congress and §1.988-2(f).

(e) Section 351 does not apply in the instant case because there was no bona fide, non-tax business purpose for the transaction. As a result, neither § 357(c) nor § 362(a) applies. Accordingly, the transaction should be treated as an exchange under § 1001, with the basis rules of § 1012 and the case law, both discussed in Notice 2002-21, controlling. The result is that the basis of the Conveyed FCs will be limited to the fair market value of such assets upon their acquisition by Taxpayer Subsidiary. Thus, the loss purportedly resulting from the transaction in the instant case is not allowable to the extent Taxpayer derives a tax benefit that is attributable to a basis in excess of the fair market value of the Conveyed FCs.

FACTS

Background

Taxpayer, a domestic corporation, is the common parent of an affiliated group of corporations that file a consolidated federal income tax return. Its primary business consists mainly of Business x. The taxable years under examination are return Year 1 through Year 2. In Month 1, Taxpayer sold its interest in Gain Company, realizing a capital gain of approximately $a. The transaction undertaken by Taxpayer described below created a non-economic $b foreign currency loss, intended to qualify under section 988 of the Internal Revenue Code, which it carried back to its Year 1 consolidated return. The carryback neutralized the gain recognized on the sale of Gain Company. While Taxpayer states that no promoter was involved in the transaction, it was billed $c dollars by Promoter, a recognized tax shelter promoter. Moreover, the transaction appears to have been brought to the attention of Taxpayer by its Vice President of Taxes, not by a business group. This was the only time a venture originating in the tax department was ever undertaken by Taxpayer. The transaction described below closely resembles the Custom Adjustable Rate Debt ("CARD") tax shelter described in Notice 2002-21.

Formation of LLC and Creation of Note

On Date 1, LLC,[1] a newly-formed domestic company owned by Country A nationals purportedly unrelated to the Taxpayer, entered into a contract with Bank. Under a Credit Agreement dated Date 1, between LLC, as borrower, and Bank, as both "Lender" and "Administrative Agent," LLC requested and Lender agreed to make a loan in the principal amount of e units pursuant to the terms and conditions under the Credit Agreement ("Loan").[2] Principal on the Loan was due in 30 years and interest was initially set at Floating Interest Rate due quarterly, and subject to reset after four years. Reset would occur annually thereafter, at which time the borrower would be free to find a new lender to assume the loan. Section 2.02 of the Credit Agreement requires Lender to make available to the Administrative Agent the amount of the loan proceeds, in immediately available funds, and the Administrative Agent is required to deposit such amount to a "Cash Collateral Account." The Cash Collateral Account is defined as a "segregated, interest-bearing deposit account established with the Custodian . . . in the name of the [LLC] but under the control of the Administrative Agent," which constitutes part of the collateral for the Loan and is required to be held until disbursed or invested in accordance with Section 7.02 of the Credit Agreement.

Under section 7.01 of the Credit Agreement, LLC was required to establish, on or before the loan date, a Cash Collateral Account (defined above) and a Securities Account. The "Securities Account" is defined as an account established by LLC at the Custodian . . . in the name of the LLC but under the control of the Administrative Agent which shall constitute part of the collateral provided for in the Company Pledge Agreement to hold the Eligible Investments and Other Investments made with the proceeds of the Loan. Section 7.02 of the Credit Agreement limits disbursements or releases from the Cash Collateral Account and the Securities Account to the following circumstances --

(i) Payments of principal and interest on the Loan in accordance with Section 4.01(b);
(ii) Transfers from the Cash Collateral Account to the Securities Account for the purpose of purchasing Eligible Investments and Other Investments;
(iii) Transfers from the Securities Account to the Cash Collateral Account representing the proceeds of the sale of any Eligible Investments or Other Investments; and
(iv) Transfers in accordance with the LLC's Pledge Agreement.

Eligible Investments are defined as investments that are reasonably acceptable to the Administrative Agent, having a maturity which is not more than one year, and which are (i) backed by the full faith and credit of the Country B government; (ii) commercial paper issued by a Country B Person and acceptable to Lender; (iii) time

[1] It is our understanding that this entity is classified as a partnership for US tax purposes.

[2] While the original loan amount was to be x units, the Promissory Note from LLC dated Date 1, as well as the Assumption Agreement and the Assumption Closing Agreement provide that the Loan between LLC and Lender was in the principal amount of e units.

deposits with banks acceptable to Lender in its sole discretion; or (iv) certificates of deposit or interests in money market funds reasonably acceptable to Lender.

Section 7.03 of the Credit Agreement requires that LLC maintain an aggregate Collateral Value in the Collateral Accounts equal to the sum of (i) the outstanding principal amount of the Loan plus (ii) all accrued and unpaid interest thereon and other amounts payable hereunder plus (minus) the termination cost (value) of the Hedge Agreements plus (iv) any other amount outstanding hereunder or under the other Financing Documents.

LLC entered a series of interest rate swaps with Affiliate (an affiliate of Bank), which converted its floating rate of interest on the Loan to a fixed rate of approximately Fixed Interest Rate. As further described below, earnings on the Collateral Account covered the first four year's interest, although Affiliate agreed to advance funds if the account earnings were insufficient.

Section 351 Transaction

Under a Subscription Agreement dated Date 2, among LLC, Taxpayer Subsidiary, and Manager (the manager of LLC), LLC agreed to transfer to Taxpayer Subsidiary g units (the "Conveyed FCs"), which represented h percent of the total e unit Loan amount, plus $i million[3] (or the FC equivalent thereof) in exchange for i thousand shares of non-voting preferred stock, par value $j per share, of Taxpayer Subsidiary and the assumption by Taxpayer Subsidiary of all the payment obligations of LLC under the Credit Agreement in a transaction intended to qualify under § 351 of the Internal Revenue Code. The h percent of the total e unit Loan amount contributed by LLC to Taxpayer Subsidiary equaled the present value of the principal amount of the e units Loan due in 30 years. As part of a side agreement between LLC and Taxpayer Subsidiary, Taxpayer Subsidiary agreed to be liable for the payment of the principal and LLC agreed to be liable for the interest payments on the Loan. Simultaneously, and as part of the same purported § 351 transaction, Taxpayer agreed to transfer assets with a fair market value of $k million and $l million for m shares of Taxpayer Subsidiary common stock and l thousand shares of Taxpayer Subsidiary preferred stock, respectively. The preferred stock paid an l percent dividend.

Under an Assumption Agreement dated Date 2, among Taxpayer Subsidiary, LLC, and Lender, in its capacity as both Lender and Administrative Agent, LLC proposed to transfer the Conveyed FCs to Taxpayer from the Collateral Account and Lender consented to the transfer, provided that Taxpayer supply substitute collateral to cover the partial withdrawal of the loan proceeds from the collateral account. In consideration for the transfer, Taxpayer Subsidiary agreed to assume, on a joint and

[3] According to the Daily Cash Management Report of Parent, the $i million appears initially to have been paid by Promoter on LLC's behalf. A few months later, LLC borrowed $o from Bank 3 for the purpose of making this purchase. LLC pledged the Taxpayer Subsidiary preferred stock as collateral for the loan and instructed Taxpayer Subsidiary to remit the l percent dividend directly to Bank 3 to pay off the loan. In granting the loan Bank 3 considered the true borrower to be Taxpayer.

several basis, all the obligations of LLC under the Credit Agreement and Note (without modifying, reducing, releasing or discharging the obligations of LLC under the Credit Agreement and the Note). In addition, Taxpayer Subsidiary provided for the issuance of letters of credit for the benefit of Lender in the aggregate stated amount of n units[4]. Taxpayer guaranteed Taxpayer Subsidiary's obligations under the letters of credit.

The Assumption Closing Agreement dated Date 2, among LLC, Taxpayer Subsidiary, and Lender, in its capacity as both Lender and Administrative Agent, provides that the proceeds of the Loan were deposited by LLC in time deposits with financial institutions other than Lender in an aggregate principal amount of e units.

In Section 1(a) of the Assumption Closing Agreement, the Administrative Agent agrees to instruct the Custodian to make the following transfers and releases from the Collateral Accounts on the Assumption Closing Date –

(i) purchase with funds on deposit in the Cash Collateral Account and for deposit in the Securities Account Country B government securities;

(ii) purchase with funds on deposit in the Cash Collateral Account and for deposit in the Securities Account short-term Country B government securities;

(iii) release f units from the Cash Collateral Account and prepay the Custodian in full for all custodial fees for the period between the closing date to the first re-set date; and

(iv) release the remaining funds in the Cash Collateral Account and pay such amount to Taxpayer Subsidiary's account.

The amount to be used to purchase Country B government securities was to be determined by oral agreement on the Assumption Closing Date between the Administrative Agent and Taxpayer Subsidiary.

Section 3 of the Assumption Closing Agreement provides that LLC has no right to request or agree to any amendment, modification, or supplement, waiver under, or termination of, any terms of the Financing Documents.

Under an Assignment and Cash Collateral Agreement dated Date 2, between Taxpayer Subsidiary and Lender, Taxpayer Subsidiary agreed to deposit an amount[5] of FCs in a "special cash collateral account" with Bank in the name of Taxpayer Subsidiary but under the sole control and dominion of Bank. The Assignment and Cash Collateral Agreement was a condition to the Assumption Agreement dated the same date.

Section 3 provides that Bank shall have the right, at any time in its discretion and without notice to Taxpayer Subsidiary, to transfer to or to register in the name of Bank or any of its nominees any or all of the collateral.

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[4] This total was sufficient to cover the g units withdrawal from the Collateral Account, plus the interest that would be due on that amount on Date 3.

[5] The amount deposited pursuant to the Assignment and Cash Collateral Agreement was left blank in the copy provided.

The Custodian Agreement between LLC and Custodian and Lender, as both Lender and Administrative Agent, authorized the Custodian to open and maintain one or more securities accounts(s) and a cash collateral account. Under Article 6 of the Custodian Agreement, the Administrative Agent was authorized to give instructions for and on behalf of LLC with respect to the Accounts and such instructions are conclusively binding on LLC. Article 10 provides that the Custodian Agreement could be terminated only with the consent of the Administrative Agent and, upon termination, the Custodian was required to act on all instructions from the Administrative Agent.

Sale of Foreign Currency

When Taxpayer Subsidiary received the Conveyed FCs in the purported § 351 exchange, it immediately sold them and purchased FC1s. Taxpayer Subsidiary sold the FC1s one week later, and purchased FCs with the proceeds from the sale. Taxpayer Subsidiary transferred the FCs to a new investment subsidiary, Foreign Affiliate, which placed the FCs into a money market account with Bank 2. Funds equal to approximately half of that amount were required to be placed in restricted accounts with Bank 2 as security for the Letters of Credit. Foreign Affiliate later invested a small portion of the funds in Bond Issuer and Country B Treasuries. Taxpayer alleges that the primary motive for entering into this transaction was to obtain funds for investing in its Foreign Affiliate Foreign Currency Investment Program.

Taxpayer's Tax Treatment of the Transaction

Taxpayer Subsidiary claimed a $b loss on the sale of the Conveyed FCs, which is equal to the excess of the stated principal amount of the Loan (e units) over the fair market value of the Conveyed FCs (g units). That is, Taxpayer Subsidiary claims basis in the Conveyed FCs equal to the sum of LLC's tax basis in the Conveyed FCs ($v) plus the amount of gain recognized by LLC under § 357(c) on the transfer ($b), for a total basis of $w.[6] See § 362(a). Taxpayer asserts that the entire principal amount of the Loan is included in its basis in the Conveyed FCs because of Taxpayer's purported assumption of joint and several liability on the entire amount of the Loan. As a result, Taxpayer's Year 2 consolidated return reflected a $b ordinary loss under § 988 from Taxpayer Subsidiary's sale of the Conveyed FCs.

LAW AND ANALYSIS

(1) Application of Notice 2002-21

Notice 2002-21 covers transactions involving the use of a loan assumption agreement to claim an inflated basis in assets acquired from another party. This inflated basis is claimed as a result of a transfer of assets in which a U.S. taxpayer (Taxpayer) becomes jointly and severely liable on indebtedness of the transferor of the

[6] The transactions described herein occurred prior to the effective date of §§ 357(d) and 362(d).

assets (Transferor), with the indebtedness having a stated principal amount substantially in excess of the fair market value of the assets transferred.

In the transaction discussed in the Notice, Transferor borrows money from a lender (Lender) on a long term basis such as 30 years (the "Loan"). The amount borrowed is frequently in a foreign currency. Interest is payable at regular intervals, and principal is due at maturity. The Loan is made with full recourse to Transferor.

Transferor uses the proceeds to purchase assets (the "Assets"), which may be denominated in a foreign currency. The Assets serve as collateral for the Loan pursuant to a loan agreement. As each interest payment becomes due, the collateral is used to satisfy such payments. Upon maturity or earlier payment, the Loan is satisfied, by its terms, first from the collateral, and only then against Transferor (or Transferor and any party that has assumed the liability as a joint and several obligor) to satisfy any shortfall.

Pursuant to a separate side-agreement between Transferor and Taxpayer, Transferor transfers a portion of the Assets to Taxpayer in consideration for Taxpayer's agreement to pay the principal only in 30 years. Under a separate side assumption agreement with the Lender, Taxpayer agrees to be jointly and severally liable on the entire Loan. The fair market value of the Assets transferred to Taxpayer (the "Conveyed Assets") equals the present value of the Loan's principal payment at maturity, determined by using a market rate of interest. Thus, the fair market value of the Conveyed Assets is substantially less than the Loan's stated principal amount. Taxpayer provides substitute collateral for the Loan, equal in value to the Conveyed Assets. The remainder of the Assets purportedly owned by Transferor continues to serve as collateral for the Loan.

Also pursuant to the side-agreement between Transferor and Taxpayer, Transferor agrees to make all interest payments on the Loan, and Taxpayer agrees to pay the principal due at maturity. The co-obligors and Lender anticipate that the collateral will be substantially (if not entirely) sufficient to repay the Loan.

Taxpayer subsequently disposes of the Conveyed Assets for their fair market value. Taxpayer claims that, as a result of its assumption of joint and several liability on the entire amount of the Loan, the entire principal amount of the Loan is included in Taxpayer's basis in the Conveyed Assets. As a result, Taxpayer claims a loss for federal income tax purposes in an amount equal to the excess of the stated principal amount of the Loan over the fair market value of the Conveyed Assets. If the Conveyed Assets are nonfunctional currency, Taxpayer claims an ordinary loss.

Application of Notice 2002-21 to the Instant Case

The instant transaction is substantially similar to the transaction described in Notice 2002-21 and, therefore, it falls within the scope of Notice 2002-21.

(2) The Taxpayer's $b currency loss deduction for Year 2 should be disallowed in whole or in part for the following reasons:

(a) There was no real liability and, therefore, no assumption of a liability in the purported § 351 exchange

A loss is allowable as a deduction for Federal income tax purposes only if it is bona fide and reflects actual economic consequences. See generally, Gregory v. Helvering, 293 U.S. 465 (1935); Freytag v. Commissioner, 904 F.2d 1011, 1015 (5th Cir. 1990). In certain circumstances, courts will recognize that even if a transaction actually does occur, that transaction may be lacking in economic substance. Lerman v. Commissioner, 939 F.2d 44, 49 n.6 (3d Cir. 1991). See also, Yosha v. Commissioner, 861 F.2d 494, 500 (7th Cir. 1988).

For instance, with respect to transactions involving loans, "[i]t is well settled that the mere fact that a note is given does not prove the existence of a loan if there was no indebtedness existing which the note evidenced." Leonard v. Commissioner, T.C. Memo. 1985-51, citing Elbert v. Commissioner, 45 B.T.A. 685 (1941), and Golsen v. Commissioner, 54 T.C. 742, 754 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971). In Knetsch v. Commissioner, 364 U.S. 361 (1960), the Supreme Court held that a loan transaction entered into by a taxpayer may be disregarded for tax purposes if there was no genuine indebtedness. The Supreme Court held that no valid indebtedness existed where the taxpayer never acquired a meaningful beneficial interest in the loan. In Bridges v. Commissioner, 39 T.C. 1064, aff'd, 325 F.2d 180 (4th Cir. 1963), a taxpayer purportedly borrowed funds from banks to buy Treasury notes and bonds which were pledged as collateral to secure the loans with the proceeds upon maturity or resale being applied to the repayment of the loans. The court described the transaction as merely providing the "facade" of a loan because the taxpayer never had control of the funds purportedly borrowed or the collateral (the Treasury notes and bonds), and the collateral amply secured the purported loan.

In the typical "Notice 2002-21" transaction, the facts and circumstances of the loan transaction support the conclusion that the credit arrangement lacks economic substance. On the original loan date, the lender purportedly transferred funds to the borrower. Contemporaneously with this "transfer," however, the entire loan proceeds were then deposited into a collateral account held by the lender. Per the loan agreement, the borrower assigned all its rights in the collateral account back to the lender. Therefore, borrower never obtained unfettered use of or control over the borrowed funds.

The facts of the instant case relating to the transfer of loan proceeds are substantially similar to the typical Notice 2002-21 transaction. In accordance with the Credit Agreement, upon issuance, the loan proceeds were immediately deposited in an account with Lender under the sole control of Lender. Transfers from the account were limited to transfers to Lender to make principal and interest payments on the Loan or purchases of Eligible Investments, which were limited to short-term investments in

Country B government bonds, certificates of deposit or time deposits with banks, or commercial paper, all of which were subject to the consent of Lender. Furthermore, the Credit Agreement requires that the Loan be fully collateralized. There was no provision for LLC acquiring the loan proceeds or the collateral for its own use. In light of these facts, it appears that LLC never obtained use of or control over the loan proceeds.

In addition, there is similar doubt as to whether there was a real transfer of any portion of the loan proceeds to Taxpayer Subsidiary under the Assumption Agreement. Under the Assignment and Cash Collateral Agreement between Taxpayer Subsidiary and Lender, Taxpayer Subsidiary agreed to deposit r units in a special collateral account with Lender in the name of Taxpayer Subsidiary but under the sole control and dominion of Lender.

Under these facts, it appears that, in substance, Lender never relinquished control of the "borrowed" funds and is protected from any credit risk because it holds sufficient funds in the collateral accounts to satisfy the Loan obligations. Lender simply made offsetting bookkeeping entries debiting the appropriate amount from the collateral accounts and applying these funds to pay the interest due on the Loan. At no time did LLC (or Taxpayer Subsidiary) obtain the unfettered use of any additional money as a result of the Credit Agreement. Since LLC incurred no genuine indebtedness, the purported assumption of such indebtedness by Taxpayer Subsidiary has no effect for federal income tax purposes. As a result, there is no § 357(c) gain on the purported § 351 exchange, no increase in the basis of the Conveyed FCs under § 362(a), and thus no loss on the subsequent sale of the Conveyed FCs.

(b) Taxpayer Subsidiary Assumption of Portion of LLC Loan in § 351 Exchange

Alternatively, if, upon further development of the facts, it appears that the parties did intend to make the Loan and for Taxpayer Subsidiary to assume and pay some portion of the liability on the LLC Note, then Taxpayer Subsidiary's basis under § 362 in the Conveyed FCs should only be increased to the extent of the portion actually assumed.

In this case, Taxpayer Subsidiary is responsible for the principal balance of the Loan only to the extent that it has not been satisfied from collateral. Thus, the collateral is the primary and expected source of repayment. At the inception of the transaction, Bank holds some p percent of the collateral, while Taxpayer Subsidiary holds the remaining h percent immediately after the § 351 transaction.

In some cases, courts have limited the portion of an assumed indebtedness that may be taken into account for federal income tax purposes. For example, where two or more persons are liable on the same indebtedness, or hold separate properties subject to the same indebtedness, the amount taken into account for federal income tax purposes by each person generally is based on all the facts and circumstances, including the economic realities of the situation and the parties' expectations as to how the liabilities will be paid. See Maher v. United States, No. 16253-1 (W.D. Mo. 1969)

(property was not in substance subject to liability where lender was not actually relying on property as collateral); Maher v. Commissioner, 469 F.2d 225 (8th Cir. 1972) (corporation's assumption of primary liability on shareholder's indebtedness becomes taxable dividend only as corporation makes payments as promised).

In appropriate cases, courts have rejected attempts to assign an inflated basis to property and have limited the basis of property to its fair market value. For example, the basis of property acquired with the issuance or assumption of recourse indebtedness has been limited to the acquired property's fair market value where a transaction is not conducted at arm's-length by two economically self-interested parties or where a transaction is based upon "peculiar circumstances" which influence the purchaser to agree to a price in excess of the property's fair market value. Lemmen v. Commissioner, 77 T.C. 1326, 1348 (1981) (citing Bixby v. Commissioner, 58 T.C. 757, 776 (1972)); Webber v. Commissioner, T.C. Memo. 1983-633, aff'd, 790 F.2d 1463 (9th Cir. 1986). See also Majestic Securities Corp. v. Commissioner, 42 B.T.A. 698, 701 (1940), aff'd, 120 F.2d 12 (8th Cir. 1941) (The general rule that the price paid is the basis for determining gain or loss on future disposition presupposes a normal business transaction.)

The concept of limiting basis from debt to the fair market value of the property acquired also is found in case law concerning nonrecourse debt. The effect of nonrecourse debt on basis was considered by United States Supreme Court in Crane v. Commissioner, 331 U.S. 1 (1947), where the Court held that a taxpayer's basis in inherited property was its fair market value on the date of decedent's death and was not reduced by the amount of nonrecourse debt that encumbered the property. The Court also held that upon disposition of the property, the amount realized included the amount of the debt.

In Commissioner v. Tufts, 461 U.S. 300 (1983), the taxpayer challenged the second Crane holding, which treated the nonrecourse debt as part of the amount realized upon disposition of the encumbered property. The taxpayer argued that this rule should not apply when the amount of debt exceeds the fair market value of the property. The Court rejected this argument and noted that the taxpayer had included the debt in basis for depreciation purposes and had (based upon a repayment expectation) failed to include the loan proceeds in income upon receipt: "[A] taxpayer must account for the proceeds of obligations he has received tax-free and included in basis." Id. at 313.

Tufts, however, does not foreclose an inquiry into whether the amount of nonrecourse debt so unreasonably exceeds the fair market value of encumbered property that repayment is unlikely. This is explained in Odend'hal v. Commissioner, 748 F.2d 908, 913 (4th Cir. 1984):

> We see nothing in Tufts to alter the well-established rules that a taxpayer may not inflate his depreciation deductions, as did taxpayers here, by including in his basis for depreciation nonrecourse debt when that debt so

> far exceeds actual value at the time that it is incurred that there is no economic incentive to pay it . . . . In reaching these conclusions, we note that while Tufts did state that "Crane also stands for the broader proposition . . . that a nonrecourse loan should be treated as a true loan," 461 U.S. at 313, it emphasized that Crane was "predicated on the assumption that the mortgage will be repaid in full," id. at 308, and that "the original inclusion of the amount of the mortgage in basis rested on the assumption that the mortgagor incurred an obligation to repay." Id.

In Regents Park Partners v. Commissioner, 1992 RIA TC Memo ¶92,336, the court limited a partnership's basis in property to the property's fair market value. The court noted that one rationale for disregarding the nonrecourse debt in its entirety from basis is the theory that a taxpayer in such circumstances lacks incentive to pay the debt::

> [T]he purported purchaser had no incentive to pay off the nonrecourse note because by abandoning the transaction the taxpayer can lose no more than a mere chance to acquire an equity in the future should the value of the acquired property increase. Estate of Franklin v. Commissioner, supra at 1048.

1992 RIA TC Memo ¶92,336 at 1742-92. The court also cites Pleasant Summit Land Corp. v. Commissioner, 863 F.2d 263 (3d Cir. 1988), as authority for a more limited approach that, in lieu of disregarding debt in its entirety, limits basis to the fair market value of the encumbered property. Without resolving the issue of whether excessive debt should be disregarded in its entirety or only in part, the court in Regents Park did find that under the circumstances of that case (the debt was to be renegotiated, bore below-market interest, etc.), a partnership did have an incentive to continue to make payments so that it was appropriate to grant basis, but only to the extent of the encumbered property's fair market value. Id. at 92-1743.

The underlying rationale of these cases, that a taxpayer acquires basis as the result of debt only when the circumstances indicate that the taxpayer will pay the debt, is very relevant to this transaction. The amount that Taxpayer Subsidiary was likely to pay is much less than the full amount of the Loan, and its claim to basis premised on payment of the full amount of the Loan is unreasonable.

Based in large part on many of the above authorities, the Service in Notice 2002-21 announced its position with respect to the basis of property acquired by taxpayers in transactions similar to the transaction at issue here. Notice 2002-21 concludes that the basis in certain assets conveyed to the taxpayer, which, in certain circumstances, include the use of a loan assumption agreement to claim an inflated basis in assets acquired from another party, is equal to the fair market value of such assets upon their acquisition by the taxpayer. Consequently, losses purportedly resulting from such transactions are not allowable to the extent the taxpayer derives a tax benefit that is attributable to a basis in excess of the fair market value of the assets that were the

subject of the conveyance. In addition, the Service announced that it may impose penalties, including the accuracy-related penalty under § 6662, on participants in such transactions.

In sum, Taxpayer Subsidiary's basis in the Conveyed FCs should be limited to their fair market value when acquired by Taxpayer Subsidiary. Because of the manner in which the Loan was collateralized, the amount of the Loan that Taxpayer Subsidiary can be considered to have assumed does not exceed this amount. Accordingly, the claimed loss should be disallowed.

(c) Section 465 – Deductions Limited to Amount at Risk

For any particular taxable year, § 465(a) limits losses from the activities listed in § 465(c) to individuals and C corporations, with respect to which the stock ownership requirements of § 542(a)(2) are met. Under that section losses are limited to the aggregate amount with respect to which the taxpayer is at risk for the activity at the close of the taxable year. Under § 465(c)(3)(A), for taxable years beginning after December 31, 1978, § 465 applies to each activity engaged in by the taxpayer in carrying on a trade or business or for the production of income. An affiliated group is treated as a single taxpayer under § 465(c)(7)(B). In addition, under § 1.1502-45(a)(2) Taxpayer is entitled to include a loss from one of its subsidiary's activities on its consolidated return only to the extent that the loss does not exceed Taxpayer's amount at risk in the subsidiary activity at the close of the subsidiary's taxable year, and does not exceed the amount for which the Taxpayer is at risk in the subsidiary at the close of the subsidiary's year.

Because Taxpayer wholly owns Taxpayer Subsidiary, Taxpayer Subsidiary meets the ownership requirements of § 542(a)(2). Because Taxpayer Subsidiary is an entity to which § 465 applies and because Taxpayer Subsidiary claims to have engaged in this transaction to earn a profit, § 465(a) limits Taxpayer Subsidiary's losses from the activity to its amount at risk in the activity. Section 465(c)(7)(A) may still exclude Taxpayer Subsidiary from § 465 if Taxpayer Subsidiary's Foreign Affiliate Foreign Currency investment Program activity is a "qualified business" under § 465(c)(7)(B) and if Taxpayer Subsidiary is a "qualified C corporation" under § 465(c)(7)(C). The field's submission indicates that this exception does not apply. That submission indicates that although Taxpayer Subsidiary is a qualified C corporation, Taxpayer Subsidiary is a qualified C corporation because, although it meets the personal holding company ownership test in § 542(a), it does not meet the personal holding company income test in that section. The field's submission indicates that Taxpayer Subsidiary's Foreign Affiliate Foreign Currency Investment Program activity was not a qualified activity because neither of the direct participants, Taxpayer Subsidiary and Foreign Affiliate, had any employees.

Because § 465 applies to Taxpayer Subsidiary, its amount at risk in the activity is determined under § 465(b)(1). That section includes in the amount at risk, money, the adjusted basis of other property that the taxpayer contributes to the activity, and

amounts that the taxpayer borrows with respect to such activity that are included in § 465(b)(2). Section 465(b)(2) includes amounts borrowed for use in the activity to the extent that the taxpayer is personally liable for the repayment of the borrowed amounts and to the extent of the fair market value of the taxpayer's interest in property, not used in the activity, pledged as security for the borrowed amounts. Property that is directly or indirectly financed by indebtedness which is secured by the property described in § 465(b)(1) is not considered at risk.

It is questionable whether Taxpayer Subsidiary was the payor of last resort for the entire e units. The terms of the Assumption Agreement provided that Taxpayer Subsidiary and LLC were jointly liable for the entire e units liability, with no right of contribution or indemnification. However, those terms also provided that LLC would make current interest payments and Taxpayer Subsidiary would make the principal payment in 30 years. The Assumption Agreement permitted Taxpayer Subsidiary to trigger prepayment at any time, which obligated LLC, under the Subscription Agreement, to make a capital contribution to Taxpayer Subsidiary in the amount by which the principal payment due under the Loan exceeded Taxpayer Subsidiary's accreted principal amount. The accreted principal amount was the g units with a q percent yield compounded annually. Viewed as a whole, the formalities of the financing arrangement appear to cause Taxpayer Subsidiary to be the payor of last resort with regard to only the g units, unless Taxpayer Subsidiary failed to trigger repayment before the expiration of the 30-year term. Any indication that the parties intended to terminate the arrangement before the close of the 30-year term would strengthen the argument that Taxpayer Subsidiary was the payor of last resort with regard to only g units.

Assuming that Taxpayer Subsidiary can establish that under the financing documents it was the payor of last resort with regard to the entire e units, it is questionable whether that entire amount can be considered as having been "borrowed with respect to the activity," which was the Foreign Affiliate Foreign Currency Investment Program, under § 465(b)(2). Arguably, Taxpayer Subsidiary should be treated as having borrowed, with respect to the Foreign Affiliate Foreign Currency Investment Program activity, only that amount over which Taxpayer Subsidiary had sufficient control to invest it in the activity. The only portion of the assets that Bank was to release under the documents was g units. There may be an argument that Taxpayer Subsidiary should be treated as having borrowed only d units with respect to the Foreign Affiliate Foreign Currency Investment Program. When Bank released g units from the Collateral Account to Taxpayer Subsidiary, it required Taxpayer Subsidiary to simultaneously substitute that amount with letters of credit from Bank 2 and Bank 3 and agree to the terms of the Credit Facility. The Credit Facility between Bank, Bank 2, Bank 3, and Taxpayer Subsidiary required Taxpayer Subsidiary to maintain a balance of at least s units on deposit with Bank 2 at all times. Therefore, Taxpayer Subsidiary may have only had sufficient control over approximately d units (g units – s units) for investment in the Foreign Affiliate Foreign Currency Investment Program.

Section 465(b)(4) excludes from amounts-at-risk any amount protected against loss through non-recourse financing, guarantees, stop loss agreements, or other similar

arrangements. The case law construing § 465(b)(4) to borrowed amounts is not in complete accord. The Second, Eighth, Ninth, and Eleventh Circuits look to the underlying substance of the borrowing arrangement to determine whether an amount is protected against loss under § 465(b)(4). Waters v. Commissioner, 978 F.2d 1310, 1316 (2nd Cir. 1992) (citing American Principals Leasing Corp. v. United States, 904 F.2d 477, 483 (9th Cir. 1990)); Young v. Commissioner, 926 F.2d 1083, 1089 (11th Cir. 1991); Moser v. Commissioner, 914 F.2d 1040, 1048-49 (8th Cir. 1990). Other circuits will not find that a borrowed amount is protected against loss under § 465(b)(4) if the formal arrangements reflect that in a "worst-case" scenario the taxpayer is liable for repayment. See Emershaw v. Commissioner, 949 F.2d 841, 845 (6th Cir. 1991) (stating that the issue of whether a taxpayer is at risk for purposes of § 465(b)(4) "must be resolved on the basis of who realistically will be the payor of last resort if the transaction goes sour and the secured property associated with the transaction is not adequate to pay off the debt") (quoting Levy v. Commissioner, 91 T.C. 838, 869 (1988)).

We believe the better analysis, as adopted by the Second, Eighth, Ninth, and Eleventh Circuits, and the Tax Court is that in determining who bears the ultimate liability for an obligation, the economic substance and the commercial realities of the transaction control. See Waters, 978 F.2d at 1316; Levien, 103 T.C. 120 (1994); Thornock v. Commissioner, 94 T.C. 439 (1990), Bussing v. Commissioner, 89 T.C. 1050 (1987). A court applying this approach first examines under § 465(b)(2) who, if anyone, will ultimately be obligated to pay the recourse obligations if the borrower is unable to do so and, second, whether that ultimately liability is limited by an arrangement described in § 465(b)(4). To determine whether such an arrangement exists, "the substance and commercial realities of the financing arrangements presented . . . by each transaction" are taken into account. Thornock, 94 T.C. at 449. To avoid the application of § 465(b)(4), there must be more than "a theoretical possibility that the taxpayer will suffer economic loss." American Principals, 904 F.2d at 483. Interpreting § 465(b)(4) in this way, any part of a formal obligation, the risk of which is practically eliminated by some other arrangement, is disregarded from the amount at risk.

The terms of the financing arrangement insulated Taxpayer Subsidiary from the risk that it would be liable for any loss or diminution of the entire e units. Because all of the loan proceeds, apart from the g units that Bank released to Taxpayer Subsidiary, were required to remain on deposit with Bank or in Bank selected investments, at all times; and Bank indemnified Taxpayer Subsidiary for any diminution or loss of collateral value resulting from failure of any of Bank to perform its obligations under any of the Agreements, it seems like there are minimal circumstances under which Taxpayer Subsidiary could be liable to repay the e units from its own funds.

Taxpayer Subsidiary may argue that Bank's possession of the bulk of the loan proceeds should be viewed as a pledge, includable in their amount at risk under § 465(b)(2)(B). That section excludes from the amount at risk pledged property that is used in the activity. Taxpayer Subsidiary cannot likely justify including e units in its amount at risk by arguing that it pledged that amount as security for the Loan, because the e units is the property that Taxpayer Subsidiary purportedly borrowed for use in the

Foreign Affiliate Foreign Currency Investment Program activity. Section 465(b)(2)(B) does not include in a taxpayer's amount at risk borrowed amounts, secured by pledged property that is used in the activity.

(d) Section 988 – Treatment of Certain Foreign Currency Transactions

Sections 985-989, which were enacted as part of the Tax Reform Act of 1986, set forth a comprehensive set of rules for the treatment of foreign currency transactions. Section 988(a)(1)(A) provides that foreign currency gain or loss attributable to a § 988 transaction is computed separately and treated as ordinary income or loss. Foreign currency gain on a § 988 transaction is generally defined as the gain on the transaction to the extent such gain does not exceed gain realized by reasons of changes in exchange rates on or after the booking date and before the payment date. § 988(b)(1). Foreign currency loss is similarly defined in § 988(b)(2). In this manner, Congress intended that only gain or loss to the extent it is realized by reason of a change in exchange rates between the date the asset or liability is taken into account for tax purposes and the date it is paid or otherwise disposed of, will be treated as foreign currency gain or loss. S. Rep. No. 313., 99th Cong., 2d Sess. 461 (1986). In addition, any gain or loss from the disposition of nonfunctional currency is treated as foreign currency gain or loss under the assumption that any gain or loss realized on the disposition of nonfunctional currency must be attributable to the fluctuation in the foreign exchange rates between the purchase and sale of the currency. § 988(c)(1)(C)(i). This is confirmed by committee reports describing the principles of § 988 prior to its amendment. The House Ways and Means Committee Report to the Miscellaneous Revenue Act of 1988 stated that "[i]n the case of any disposition of nonfunctional currency, the relevant period for measuring rate changes is the time between acquisition and disposition of the currency." H.R. Rep. No. 795, 100th Cong., 2d Sess. 296 (1988).

The legislative history of §§ 985-989 suggests a consistent concern about tax motivated transactions. The Senate Finance Committee Report accompanying the Tax Reform Act of 1986 stated that one of the two reasons §§ 985-989 were enacted was prior law provided opportunities for tax motivated transactions. S. Rep. No. 313., 99th Cong., 2d Sess. 450 (1986). Accordingly, in enacting §§ 985-989, Congress granted broad authority for the Service to promulgate regulations "as may be necessary or appropriate to carry out the purposes of [§§ 985-989]. . ." § 989(c). The legislative history to the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"), in discussing the law prior to the enactment of TAMRA, stated that "[t]he Secretary has general authority to provide the regulations necessary or appropriate to carry out the purposes of new subpart J. For example, the Secretary may prescribe regulations appropriately recharacterizing transactions to harmonize the general realization and recognition provisions of the Code with the policies of § 988." H.R. Rep. No. 795, 100th Cong., 2d Sess. 296 (1988); S. Rep. No. 445, 100th Cong., 2d Sess. 311 (1988) (containing identical language).

In response to Congress's concern about tax motivated transactions, the Service, under the authority of § 989(c), promulgated Treasury regulation §§ 1.988-2(f) and 1.988-1(a)(11). Section 1.988-2(f) states that if the substance of a transaction differs from its form, the Commissioner may recharacterize the timing, source, and character of gains or losses with respect to the transaction in accordance with the substance of the transaction. Section 1.988-1(a)(11) states in part that the Commissioner may exclude a transaction or series of transactions which in form is a § 988 transaction from the provisions of § 988 if the substance of the transaction, or series of transactions indicates that it is not properly considered a § 988 transaction.

Under § 988(c)(1)(C)(i), any gain or loss from the disposition of nonfunctional currency is treated as foreign currency gain or loss. As indicated previously, Congress adopted this rule under an assumption that any gain or loss realized on the disposition of nonfunctional currency must be attributable to the fluctuation in the foreign exchange rates between the purchase and sale of the currency. This assumption is confirmed by the House Ways and Means Committee Report to the Miscellaneous Revenue Act of 1988 stating that "[i]n the case of any disposition of nonfunctional currency, the relevant period for measuring rate changes is the time between acquisition and disposition of the currency." H.R. Rep. No. 795, 100th Cong., 2d Sess. 296 (1988).

Section 1.988-2(f) states that "[I]f the substance of a transaction described in § 1.988-1(a)(1) differs from its form, the timing, source, and character of gains or losses with respect to such transaction may be recharacterized by the Commissioner in accordance with its substance." In this case, the currency loss should be denied in its entirety until, if and when, the Taxpayer can clearly demonstrate that with respect to FCs which it could substantively use, exchange rate changes between the period it acquired and disposed of the FCs resulted in the loss. This is consistent with the intent of Congress and §1.988-2(f).

It is clear that Taxpayer Subsidiary did not have substantive use of the full <u>e</u> units borrowed from Bank even though it was jointly liable with LLC to repay such amount. <u>R</u> units were required to be deposited with Bank in the Collateral Accounts as collateral on the Loan and was beyond Taxpayer Subsidiary's reach. Taxpayer Subsidiary did have access to <u>g</u> units which it used to generate the claimed foreign currency loss. However, its use of these funds was also restricted since a balance equal to <u>s</u> units was required to be maintained as collateral for the letters of credit issued to Bank that guaranteed payment of <u>n</u> units.

At best, the taxpayer can argue that it was substantively exposed to currency fluctuation on the <u>g</u> units of borrowed funds to which it had access. (As noted in the previous paragraph, it is not clear that the taxpayer had economic use of the full <u>g</u> units because of the collateral arrangements which were an integral part of the transaction.) Whatever the proper amount, under §1.988-2(f), any foreign currency loss should be limited to loss <u>resulting from changes in exchange rates</u> with respect to funds that the taxpayer economically had access to.

(e) Section 351 -- Lack of Bona Fide Business Purpose

A transaction meeting the statutory provisions of § 351 will not qualify for nonrecognition treatment if it lacks a bona fide, non-tax business purpose. See Caruth v. United States, 688 F. Supp. 1129, 1138-1141 (N.D. Tex. 1987), aff'd on other issues, 865 F.2d 644 (5th Cir. 1989); Stewart v. Commissioner, 714 F.2d 977, 992 (9th Cir. 1983). Opinions discussing other § 351 issues often point out that the taxpayer had a valid business purpose for the transaction in question. See Hempt Bros., Inc. v. United States, 490 F.2d 1172, 1178 (3d Cir. 1974), cert. denied, 419 U.S. 826 (1974); Rev. Rul. 55-36, 1955-1 C. B. 340.

In the instant case, there was no bona fide business purpose to the Transaction, but merely the creation of tax benefits. The linchpin of the scheme was Taxpayer Subsidiary's disposition of the high-basis Conveyed FCs. That disposition created a tax loss that offset the tax liability Taxpayer otherwise would have had to pay on its gain from the sale of its interest in Gain Company. The only remotely constructive result of the scheme was the Foreign Affiliate Foreign Currency Investment Program, which, after taking fees, expenses, and other commitments into account, wound up with only $t (this was the approximate value of d units converted into dollars at that time) for investment purposes, and never engaged in many of the activities purportedly planned for it anyway. In fact, Foreign Affiliate lent u units back to Taxpayer within two months. Clearly, the tax loss was Taxpayer's primary goal; the Foreign Affiliate Foreign Currency Investment Program merely lent a cloak of legitimacy to the scheme, and the other complexities set up conditions, such as co-obligation on a foreign bank loan, to generate the tax loss from the sale of the Conveyed FCs.

The Transaction was contrived to create a foreign currency loss for Taxpayer Subsidiary. Taxpayer's capital contribution to Taxpayer Subsidiary was merely to meet the control requirements of § 351; Taxpayer Subsidiary assumed joint and several liability on the Loan simply to generate § 357(c) gain for LLC, which would never be taxed in the U.S. (neither LLC nor the LLC owners are considered to be engaged in a trade or business in the United States); and, last, the gain generated by LLC could be added to the tax basis of the Conveyed FCs received by Taxpayer Subsidiary thereby artificially creating an ordinary loss under § 988 when the Conveyed FCs were disposed of.

Furthermore, Taxpayer's stated reason for changing the FCs into FC1s conflicts with sound professional judgment in this area. Taxpayer's Treasurer testified that upcoming elections in Country B made him and his colleagues "nervous" and "jumpy" about the stability of the FC when they received them from Bank. To protect their investment, according to Taxpayer's Treasurer, they decided to convert the FCs into FC1s for a short period of time, because that made them more comfortable. In fact, since 1983, the monetary policy of the central bank of Country C, Bank 4, had been to maintain the FC1/FC exchange rate as absolutely stable, and since 1994, the two currencies had fluctuated within a margin of no more than ± 1 percent. Thus, anyone who viewed the FC as a risky currency, for whatever reason, would not logically have

chosen FC1s as an alternative, a fact with which a person of Taxpayer Treasurer's expertise would undoubtedly have been well-acquainted.

Since the Transaction was engineered to create a high basis-low value asset that upon disposition would generate a tax loss in excess of $a for Taxpayer, an amount grossly disproportionate to any non-tax consequences realized by the parties, a bona fide business purpose is lacking. Consequently, the requirements for a valid § 351 exchange are not satisfied. As a result, neither § 357(c) nor § 362(a) apply in this case. Accordingly, the transaction should be treated as an exchange under § 1001, with the basis rules of § 1012 and the case law, both discussed in Notice 2002-21, controlling. The result is that the basis of the Conveyed FCs will be limited to the fair market value of such assets upon their acquisition by Taxpayer Subsidiary. Thus, the loss purportedly resulting from the transaction in the instant case is not allowable to the extent Taxpayer derives a tax benefit that is attributable to a basis in excess of the fair market value of the Conveyed FCs.

CONCLUSION AND SUMMARY

Based on all of the arguments set forth above, we conclude that the claimed currency loss either should be disallowed in its entirety or disallowed in part, as the case may be. Moreover, it is our view that the transaction in this case is substantially similar to the transaction described in Notice 2002-21 and, therefore, it falls within the scope of the Notice.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call John Tarrant at (202) 622-3497 if you have any questions.

By ________________________________

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