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A Tax Blueprint for LDC Debt-for-Development Swaps

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LDC debt for development/charity swaps can materially increase the amount of spendable funds available to U.S. charities with activities abroad. The charity either purchases some outstanding obligations of these less developed countries ("LDC debt") with its own funds or finds some LDC debtholder to make a contribution of the LDC debt. In a negotiated deal with the foreign government, the debt is then swapped for local currency to be devoted to the charitable purpose in the foreign country. The amount of local currency obtained this way in a purchased debt situation is generally much more than the charity could have gotten had it purchased the foreign currency directly. If the charity didn't use any of its funds because the LDC debt was contributed, so much the better -- but such a contribution is not a necessary ingredient for the charity to benefit handsomely from an LDC debt for charity swap. This paper addresses only tax issues, and not any economic or legal issues.

Misconception that donors benefit

There is misconception that an LDC debtholder obtains a tax advantage out of an debt for charity swap. Some people even believe that the nonexistent tax advantage can turn a loss on the LDC debt into a profit.

The facts are that a bank, or other LDC debtholder, gets no special tax advantage from this swap. Receiving a tax deduction for an incurred loss is normal in a business context. The government treats income as taxable, losses as deductible. There is nothing special about this, there is no hand-out nor any special benefit being given.

For example, if a bank made a $1,000 LDC loan and sells the loan for $750, there is a tax deductible loss of $250. At best, the $250 loss will reduce the bank's Federal tax by $85 (34%). It's difficult to view the loss as a tax advantage. The result is exactly the same as paying $250 in wages, and yet nobody would say that a business achieves a tax advantage from paying wages. Whether there is a $250 wage cost or LDC loss, the after-tax cost is $165 and there is no way to apply tax magic to change this at all to say nothing of turning it into a profit.

75

The LDC debt for charity swap does not provide an LDC debtholder with anything more than can otherwise be obtained. To the contrary, the swap has the potential of actually hurting the LDC debtholder. In fact, the U.S. Treasury has done a good job of reducing the potentially negative tax aspects of LDC debt for charity swaps to bring it back to a more normal tax situation at no cost to the Treasury. Had Treasury not done this, the same tax deductions would still be available to the LDC debtholders through sale, and the charities wouldn't be in a position to even pursue donations of LDC debt. It is the charities and not the LDC debtholders who are pursuing these issues with Treasury.

Purchase transactions

Let's take the simplest situation, and probably the one which will ultimately yield the most benefit for U.S. charities, where the charity purchases LDC debt at a discount in the open market for cash received through its normal contribution stream. The LDC debt might be purchased through the larger banks, like Chase, which maintain trading desks, or from any other source. Generally speaking, the U.S. charity then arranges the debt for charity swap with responsible officials of the foreign government or central bank which is obligated to pay that debt. This may be done through or with the assistance of U.S. banks or others who have a presence in the foreign country and have experience in handling commercial swaps. If agreement is reached, the foreign government will make local currency available for use in the specified project in the foreign country.

The advantage to the U.S. charity is in the numbers. Assume that the U.S. charity has $100 which it intends to spend on its charitable projects in the foreign country. It could merely convert the U.S. dollars into foreign currency and proceed to spend the foreign currency. Let's call the foreign currency a Peso and let's assume for illustrative purposes that the Peso is freely exchangeable for U.S. dollars on a one to one basis -- that is, $100 would yield P100.

Instead, the U.S. charity goes out into the open market and buys some of that country's outstanding debt using its $100. The purchased debt is denominated in U.S. dollars -- that is, the foreign country had borrowed U.S. dollars and had agreed to repay U.S. dollars. If the LDC debt is selling at a 20% discount, the charity could buy $125 of LDC debt for its $100. If the LDC debt is selling at a 50% discount, it would get $200 of LDC debt. As 50% is an easier number to work with, let's assume that the U.S. charity spent its $100 for $200 face value of LDC debt.

In accepting the debt for charity proposal, the foreign government will agree on the amount of Pesos it will exchange to reacquire the $200 of its debt held by the charity. Even though

76

the assumed open market exchange rate is $1 = P1, the foreign government would not necessarily make P200 available. The actual amount depends on many factors, but it's basically a negotiated amount. Let's assume that P180 (or 90%) is the agreed sum.

Thus, instead of having P100 to spend locally if the U.S. charity exchanged its $100 in the open market, the U.S. charity winds up with P180 or 80% more. By going into the debt for charity swap, the U.S. charity increased its actual spending power by a material amount. Although an 80% increase is on the high side, the salient point is that the U.S. charity can expect a material increase in the funds already available to it -- something worth going after.

This result is not dependent on getting a bank or other LDC debtholder to make a donation of its LDC debt. To be sure, a donation makes more funds available to the charity, but basic analysis would indicate that the LDC debt swap transaction and the donation are two independent transactions.

Donations of LDC debt

A donation of LDC debt must be viewed as being independent of the swap, both in tax terms and economic reality. To explain this, we must switch our focus to the donor's (LDC debtholder's) viewpoint.

On the tax level, we all know that a tax deduction for the contribution of property is measured by the fair market value of that property, with a number of exceptions not relevant here. The fact that the donor's cost, or tax basis, differs from the fair market value is irrelevant. Thus, if the LDC debt originated from a loan of $100 made by a bank, the bank's cost or tax basis would be $100. Staying with our example, if the fair market value of the debt is 50%, a donation of that debt would yield only a tax deduction of $50. The other $50 of tax basis disappears; no tax deduction is ever obtained for it.

Instead, if the donor were to sell the debt for $50 and then contribute the $50 cash to the U.S. charity, it would obtain a tax deduction for the $50 loss on the sale and the $50 contribution making for a total of $100, the full original cost. This is a normal tax situation; there is nothing nefarious about it. A business asset normally yields tax deductions equal to its cost, whether the asset is sold or is depreciated over time. It is the charitable contribution situation which creates a tax hazard, because one must look at fair market value rather than cost. And the situation is particularly troublesome with respect to LDC debt because the fair market values are today lower than cost.

Many banks have established reserves on their accounting books against their LDC debt portfolios to reflect the problems relating to that debt. Colloquially, this is viewed as having taken an accounting loss on this debt. But this "hit" to the financial statements is not a tax recognized event -- that is, the accounting loss does not represent a tax deductible item. Thus, a bank establishing a reserve against its LDC debt, would not get a tax deduction for the book loss. For tax purposes, the cost or tax basis for the $100 of LDC debt remains at $100.

A charitable contribution of that debt would still result in tax basis "wastage" measured by the difference between the $100 and the fair market value of that debt, just as though the book loss not been taken. (The foregoing does not apply, and a tax deduction is obtained where there has been a mandated charge-off; which was not the case with the large special reserve additions.)

Also, many charities have assumed that the accounting losses already taken on LDC debt portfolios make donations of that debt easier to obtain. As long as the debt remains on the books, donation would entail a charge to the special reserves or expense and the normal charitable contribution budget hurdles must be faced. And, as we've seen, there are no tax benefits to offset the budgetary impact.

Because of the tax "wastage" inherent in the charitable contribution of LDC debt, direct contributions of LDC debt to charities shouldn`t be expected. But the U.S. Treasury has approved a mechanism in Revenue Ruling 87-124 which makes possible indirect contributions of LDC debt in three party debt for charity swaps.

<u>Revenue Ruling 87-124</u>

In an LDC debt for charity swap, the bank or other holder of the debt, the issuer of the debt (the foreign government or its central bank) and the U.S. charity effectively enter into a contract on a swap proposal. The donor gives up the debt, the issuer provides local currency and the U.S. charity has the currency available for spending in the foreign country for an agreed purpose.

Revenue Ruling 87-124 separates this transaction into two parts and concludes that the donor first disposed of the LDC debt in exchange for the local currency and, second, the local currency was contributed by the donor to the U.S. charity.

With this construction, two separate tax recognized events take place. In the first, a tax deductible loss is realized measured by the difference between the donor's tax basis in the LDC debt and the fair market value of the local currency. Using the numbers we have assumed in our example, the $100 of LDC debt would have been converted into P90, which we assumed was worth $90 based on the assumed exchange rate of $1 = P1 (more as to valuation later).

Thus, the donor would have a tax deductible loss of $10 on the first transaction and have a $90 tax cost or basis in the local currency, which gives rise to a $90 tax deductible charitable donation on the second transaction. In total, the donor gets $100 in tax deductions for its $100 of LDC debt, which is what it would have obtained if it sold the debt in the open market and contributed the proceeds to the charity.

In addition to separating the swap into two transactions, Revenue Ruling 87-124 also specifies the sequence. The swap for the local currency is deemed to have taken place before the contribution. Had the contribution been deemed to have taken place first, followed by the swap, the donor would have been in the tax wastage situation -- that is, getting a $50 fair market value tax deduction for a $100 asset, the difference being disappearing tax basis. Hereinafter, all references to a "donation" of LDC debt or "donor" contemplates the indirect swaps and not direct contributions of the LDC debt to the charity.

The Eugene Steuerle letter

The foregoing was the situation on November 23, 1987, when Revenue Ruling 87-124 was issued. Since that time, a number of Senators became interested in the matter and had proposed legislation to clarify some open items. Since these matters were largely interpretative, the U.S. Treasury decided to handle them in an unusual fashion.

On March 29, 1988, Mr. C. Eugene Steuerle, Deputy Assistant Secretary (Tax Analysis), U.S. Treasury Department, wrote to Senator John H. Chafee, Senate Finance Committee member, clarifying the scope of Revenue Ruling 87-124. A tax attorney might advise, on a technical level, that that letter has no official status (like the Revenue Ruling it interprets) and that one relies on it at one's peril. However, it's a good bet that everyone will accept the letter as authoritative, especially since the rationale advanced seems sound.

Mr. Steuerle's letter addresses the issues directly. He points out that the swap transaction may possibly be viewed as either an exchange of the debt followed by a contribution or as a contribution followed by the exchange. He supports the former view, as specified in Revenue Ruling 87-124. By pointing out that this type of analysis does not depend on the identity of the issuer of the debt nor the type of consideration received on the disposition of the debt, the scope of Revenue Ruling 87-124 is effectively expanded.

Revenue Ruling 87-124 referred only to the debt of the foreign sovereign being swapped at its central bank, while Mr. Steuerle's letter says that the debt of other entities might be the subject of the exchange. While the terms foreign government and central bank may have been used interchangeably, it is clear that the letter would cover private sector debt and government agency debt as well as sovereign debt. Actually, it would not seem to matter what was exchanged, since it is the bifucation of the transaction and the ordering sequence thereof which are the important elements.

Similarly, the nature of the consideration received is not important. It doesn't matter whether local currency or newly issued bonds are given. On the same token, it would not seem to matter if something else were given - you name it. The only condition specified is that the item received must be sufficiently different from the debt given up.

This would restrict potential problem areas to those situations where new debt is issued in exchange for the LDC debt. This potential problem arises where the foreign government doesn't want to make the local currency available immediately, and the mechanism of issuing new debt is used to delay and spread the payments.

Newly issued debt for the swapped debt

The Steuerle letter notes that no loss will be recognized on the swap unless the newly issued debt differs sufficiently from the old debt. Traditionally, the exchange of one property interest for another is a taxable event if the properties are different. If the property interests are essentially the same, the tax laws would not impose a tax on a gain nor allow deduction of a loss.

This represents a tax hazard area for the donor of the LDC debt. Upon the exchange, the donor is treated as the owner of the newly issued bond which it is deemed to have contributed to the charity. The tax issue is whether the donor realized a tax deductible loss on the exchange of the LDC debt for the newly issued bond.

If the two instruments are essentially the same, no loss is recognized and the donors $100 cost or tax basis for the old LDC debt is ascribed to the newly issued debt. If this happens, the donor is right back in the tax "wastage" situation; the contribution for the newly issued debt on the second transaction produces a tax deduction based on the fair market value of the newly issued debt, a value which is presumably the same $50 as the essentially similar LDC debt.

The tax risk here clearly belongs to the donor. The charity, while it does not have the tax risk, risks losing the charitable donation if the issue cannot be readily resolved.

Normally, it's not sufficient to say that the donor can rely on the opinion of counsel. That rarely provides absolute certainty especially since many options are available. Nor is it usually sufficient to say that a tax ruling could be obtained from the Internal Revenue Service. This takes time (3 to 4 months at best) and keeps the donor involved. Since the donor doesn't achieve a tax advantage, the donor might not like the time and effort required to give property away when it's easier to sell it and make a cash contribution. Further, the donor might not want to get involved in negotiating the terms of the bond with the foreign government.

There are no clear statutory or regulatory rules or standards regarding when instruments are significantly different. A body of precedent exists, and that makes some people comfortable. Others shy away from issues relying on case law interpretation, seeing it as a situation that just promises more litigation. The determination is based on the various elements involved. The obligor on the new and the old debt may be the same, which is not a favorable factor. The interest rates and maturity of the two instruments may differ sufficiently, or not. As the old LDC debt is invariably payable in U.S. dollars, denomination of the new debt in local currency (not U.S. dollars) would seem to be a very significant difference. But denomination of the new instrument in local currency might not be desired economically since it does not protect purchasing power from local inflation. If the newly issued local currency instrument is indexed to the U.S. dollar, the difference isn't as clear cut. Over time, the issuance of IRS rulings on specific transactions may clarify matters and establish acceptable models.

This substantial difference reservation in the Steuerle letter, which is technically sound and warranted, does not represent a death knell for LDC debt for newly issued debt swaps. Rather, it suggests only that donors may be reluctant to participate in these transactions because of the potential uncertainties or the required involvement, time and effort.

But there is no reason why the U.S. charities shouldn't pursue these LDC debt for newly issued debt swaps where they have purchased the LDC debt in the open market. As indicated previously, it is believed that these open market purchases will be the mainstay in this area since they maximize the funds already available to the charity by such material amounts. The U.S. charity need not be concerned that the newly issued debt is essentially the same as the old, since in that case there would be no difference -- $50 cost for the old debt, $50 value for the new. On the other hand, should the new debt be deemed to be worth more, say $90, one would hardly expect the IRS to attempt to tax the U.S. charity.

The reasons for a swap into newly issued debt fall outside the tax area. No special tax benefit is conferred. Economic, budgetary and legal reasons may exist either on the part of the charities or the foreign government.

<u>The valuation issue</u>
Revenue Ruling 87-124 specifically points out that the LDC debtholder in a bifucated swap transaction must value the foreign currency received to compute the tax deductible loss on that leg of the transaction, and then use that value for the or charitable contribution on the second leg. We made that easy by assuming a given value for the local currency -- $100 LDC debt swapped for P90, worth $90 ($1 = P1).

That ruling provides that the restrictions the use of the local currency, as agreed to in the swap itself, will generally reduce the fair market value below the free market exchange rate. Thus, even though the free market exchange rate may be 1 to 1 ($1 = P1) as we assumed, the Pesos obtained in the swap transaction cannot be freely converted back into U.S. dollars as an unrestricted Peso might, and is therefore worth less.

The restrictions in a commercial swap might be along the lines that a specific commercial asset must be purchased with the foreign currency and that asset cannot be sold, converted back into U.S. dollars or remitted for 12 years. For illustrative purposes, let us assume then that the fair market value of the P90 is only $80 because of the restrictions. In that case, the $100 LDC debtholder would have a $20 tax deductible loss on the swap and have an $80 cost or tax basis for the commercial asset acquired.

One encounters difficulty in applying this rationale in the debt for charity situation. It would seem that the restrictions have no meaning in the charity situation. The U.S. charity is not purchasing an asset which has a restricted value because it can't be sold and remitted back to the United States for a long period of time.

Rather, the U.S. charity is spending the money concurrently. It is fulfilling its purpose in exactly the same way and amount as if instead it went out and purchased local currency at the free rate. It could take $90 and buy P90 in the free exchange market and that P90 would be spent, presumably getting a full $90 of "charitable value". Obtaining P90 through a swap would seem to place it in the same position, the local currency still being worth $90 in terms of spendable "charitable value". The fact that the local currency is restricted for use in the agreed to project, which is the U.S. charity's purpose and desire, should not reduce the Peso value.

417

Nor should the fact that the donor is deemed to receive the P90 on the swap make a difference. The donor is restricted in using that P90 and cannot convert and remit it back to the United States like a free P90. However, the salient point remains that the P90 is being contributed to the U.S. charity concurrently and no restrictions inhibit remittance because the funds are for spending, not investing in a commercial sense. The Internal Revenue Service might not agree with this view.

This valuation matter does not have tax deduction significance to the donor because the sum of the two parts - the loss and the donation - must equal the $100 LDC debt cost or tax basis. If the P90 is worth $90, there is a $10 loss and a $90 donation. If the P90 is worth $80, there is a $20 loss and an $80 donation. Either way, it equals $100 of tax deductions; and baring limitation problems, the valuation issue is not likely to be of tax deductibility concern.

However, there could be other tax or accounting significance to this. The financial and tax accounts could reflect a $10 or $20 LDC loss, and a $90 or $80 donation respectively, and there could be some significance to these differences.

U.S. vs. foreign charities

The U.S. tax laws do not permit a deduction for a charitable contribution to a foreign charity. Nor can a U.S. charity collect earmarked contributions as a conduit for a foreign charity. However, a U.S. charity may spend funds abroad in furtherance of its charitable purposes and may solicit funds for such a specific purpose, and funnel the funds through a foreign charity, as long as certain conditions are met.

Obviously, a fine line has to be drawn as to whether an impermissible earmarking or conduit situation exists. In a swap transaction, a specific proposal must be presented to the foreign government and, if approved, a contractual type situation arises. While the contribution is being made to the U.S. charity, the "deal" may well have the funds wind up in a foreign charity. At the point the contribution is considered made, the destination of the funds is clear and fixed.

Both Revenue Ruling 87-124 and the Steuerle letter recognize this and specifically condone the four party transactions (now including the foreign charity) if the funds are to be expended in furtherance of the U.S. charities charitable purposes and adequate approvals and controls exist. This does not represent a change in existing law.

Thus, the mere fact that a foreign charity winds up with the funds does not necessarily destroy U.S. tax deductions. However, the requirements delineated in Revenue Ruling 87-124 and the Steuerle letter must be met. Both of these refer to other Revenue Rulings and judicial cases which might be viewed

47

as being incorporated by reference, and may be interpreted as specifying still more requirements to be satisfied. For example, both a 1966 ruling and a 1975 ruling indicated that the board of directors of the charities involved had the authority to cancel their previous approval of a grant and use the funds for other purposes, a matter which is difficult to square with these swaps.

At this point, a potential donor might become concerned as to whether these conditions will be met. Donors normally do not deal with such matters. Ultimately, these matters are under the control of the U.S. charity, and a donor might be reluctant to take on the role of an auditor. Unless the IRS clarifies the situation, one could hardly expect donors to enter into four party swaps where a foreign charity winds up with the funds.

But again, all is not lost for the charities. These concerns largely disappear in the mainstay situation where the U.S. charity purchases LDC debt for charity swaps so as to increase purchasing power. A cash contributor to a U.S. charity which undertakes activities outside the United States does not get involved in issues concerning foreign grants as long as the charity has its qualifying ruling. If the contributors even thought about it, they would assume that the charity is handling its affairs correctly. Disqualification of the charity, by itself or coupled with disallowances of contributor tax deductions, is hardly to be considered under normal circumstances.

In the purchased debt situations, there is no specific taxpayer at risk as there would be in the contributed debt situation, and earmarking and conduct concerns should disappear. The U.S. charity is using its unfettered cash contributions, exercising its powers, and approving transactions as it normally would. The swap transaction with the foreign government is strictly between the U.S. charity and the foreign government and shouldn't add any significant new elements not previously encountered by U.S. charities making grants abroad. All this makes the purchased debt swap a much easier transaction to pursue and probably much more viable, than the donated debt swaps where foreign charities are involved.

Timing of the charitable donation

Swap programs will necessarily differ in detail from country to country. They may have different features and controls as to how the local currency funds are actually distributed. If the foreign currency is actually expended, or credited to an account of the U.S. charity, or credited to an account of a foreign charity through which the U.S. charity is working, a distribution of the funds has taken place. As the charitable donation is deemed to take place upon the transfer of the foreign currency, that event has clearly taken place.

However, if the foreign currency remains in an "open account" with the foreign government to be drawn down when invoices, payrolls or other operating documentation is provided over the course of the project, there may be an issue as to when the charitable donation is deemed to have been made. Delayed deductions would also necessitate revaluations on the delayed dates, and generally add to the uncertainties and complexities.

It is hoped that the swap procedures and documentation as they develop in practice would eliminate this timing problem, but that is at best likely to vary by country. The IRS might clarify this issue, hopefully treating it as a closed transaction for the donor when the swap is approved, the LDC debt yielded, and the swap contract is finalized. At that point, it's reasonable to conclude that the donor is out of the picture and the contribution has been made.

<u>In conclusion</u>
The U.S. Treasury has done much to make debt for charity swaps possible without violating traditional tax rules. The remaining tax uncertainties may deter some donations of LDC debt for charity swaps. Purchased debt swaps are very viable as a means of materially increasing the purchasing power of the funds available to U.S. charities.

National Association
of State Universities
and Land-Grant Colleges

Robert L. Clodius, President

U.S. UNIVERSITIES ON DEBT FOR DEVELOPMENT

U.S. universities have a long history of commitment and leadership in the broad area of international education and international development. They have played a crucial role in education, training, institutional development and scientific and technical assistance to developing countries--programs which promote economic growth and well-being at all levels.

The National Association of State Universities and Land Grant Colleges (NASULGC), the nation's oldest higher education association, has offered strong leadership to the university community in this international area. Among the first national groups to respond to President Harry S. Truman's famous "Point Four" program in 1949, NASULGC universities have been involved in foreign assistance programs for almost four decades. These land-grant universities have been in the forefront in bringing modern methods of agricultural research and technology to help other nations help themselves in the fight against hunger and malnutrition. NASULGC represents 149 state and land-grant universities which enroll more than 2.6 million students; annually invest more than $13 billion in teaching, research, and public service programs, and award about 468,000 degrees annually, including: 33.5 percent of all bachelor's, 33.3 percent of all master's, 27.6 percent of all first professional, and 60 percent of all doctoral degrees.

As the lead association, NASULGC is now working closely with other higher education associations in representing the total university community interested in continuing their linkages and collaborative programs in developing countries. For this purpose, an ad hoc committee on Debt for Development has been established which is chaired by Dr. Elwin Svenson, University of California, Los Angles. Vice Chair is Dr. Cecil Mackey, former president of Texas Tech and Michigan State Universities. Represented on the Committee are the American Council on Education, the umbrella organization for some 1,400 higher education institutions in the U.S., and the Association of American Universities, whose members include 56 of the leading private and public research institutions in America (54 U.S. and two Canadian) with strong programs of graduate and professional education and research.

While a list of specific linkages and collaboration with other countries and institutions would be too lengthy and difficult to attach, a few examples may be illustrative of the types of programs in which U.S. universities are involved and which have contributed to the economic growth and resources of those countries at that time.

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They should include such programs as:

- University of Wisconsin cooperating with the Federal University of Rio Grade do Sul, Brazil, in improving the training of agriculturalists, encouraging improved soil and crop management practises, laying the foundation for rapid expansion of agricultural production.

- Six midwest universities (Illinois, Missouri, Ohio state, Penn state, Tennessee, and Kansas State) in building agricultural institutions in India, which led to the Green Revolution.

- Cornell University and the University of Phillipines which have cooperated formally in agricultural education and research for more than three decades

- University of Rhode Island in collaboration with the National Health Service of Chile on the problems of high-protein food for low-income families.

- Michigan State University, Oregon State University and other university programs working on agricultural and forestry development in Venezuela

- University of California, Los Angles language-learning and research programs in Mexico, China, Egypt, as well as other countries.

- In Costa Rica, university programs in natural resource managment, agricultural and environmental planning, marine and coastal resources development, assistance in developing tourism, professional training in health, marine biology and coastal zone planning.

- In Brazil, cooperative research in veterinary sciences, in the storage and marketing of fruits and vegetables; research on the soils of the tropics; on-site teacher training; and in developing primary health care programs.

- In the Phillipines, health research; watershed management; assistance in food science research, handling of fruits; provide assistance in rural education, teacher training, development of farming systems.

- In Mexico, scientific and technical cooperation in many fields of agriculture, rangeland management, border control of diseases, collaborative reserach on vegetable, fruit and pecan production; research in new and traditional arid and semi-arid crops.

Through their graduates and successful development programs in almost all Third World countries, universities have been effective development partners. Universities offer effective and long term relationships with research and education institutions in the developing countries which can provide effective tools for economic growth and development.

BREAKFAST

May 23, 1988

8:15 a.m. - 9:30 a.m.

8th Floor Dining Room

State Department

M. Peter McPherson, Host
Deputy Secretary
U.S. Department of Treasury (Host)

Richard E. Bissell
Assistant Administrator for Program
and Policy Coordination, A.I.D.

Jack Ross
Banking Advisor
Institute for International Finance

Horst Schulmann
Managing Director
Institute for International Finance

Andrew Bartels
Director, Chairman's Office
American Express

Eugene R. Mason
Vice President
First Bank System

David Barcellos
Vice President
Bank of America

Bill Hoar
Managing Director
Bankers Trust

Gilbert Pierce
Vice President
Bank of Boston

Walter Lamp
Senior Vice President
Chase Manhattan Bank

INTERNAL REVENUE SERVICE ADVANCE REVENUE RULING 87-124, ON DEBT-EQUITY SWAPS, RELEASED NOV. 12, 1987 (TEXT)

(Note: Rev. Rul. 87-124 will appear in Internal Revenue Bulletin No. 1987-14, dated Nov. 23, 1987.)

Part I

Section 1001. — Determination of Amount of and Recognition of Gain or Loss

26 CFR 1.1001-1: Computation of Gain or Loss. (Also Section 170; 1.170A-1.)

Rev. Rul. 87-124

ISSUE

What are the federal income tax consequences resulting from various transactions, described below, that are part of a foreign country's program to reduce the amount of its outstanding United States dollar denominated debt?

FACTS

X, a United States commercial bank, holds a United States dollar denominated debt (the Obligation) of the central bank (the Central Bank) of foreign country *FC*. The Obligation evidences a loan of $100 that *X* made to the Central Bank. *X's* adjusted basis in the Obligation, as determined under section 1011 of the Internal Revenue Code of 1986, is $100. Under the laws of *FC*, the Obligation cannot be held by an *FC* entity.

Y is a domestic corporation. *FX* is a corporation organized in *FC* and engaged in business in *FC* but not in the United States. Prior to the transactions described below, there was no cross-ownership among *X*, *Y*, *FX*, and the Central Bank. The functional currency, as defined in section 985 of the Code, of *X* and *Y* is the United States dollar.

The local currency of *FC* is the LC. On July 1, 1987, the free market exchange rate was $1=10 LCs.

FC has a program (the Program) whereby a holder of United States dollar denominated debt of *FC* can negotiate with the Central Bank to deliver the *FC* debt to the Central Bank for LCs if the holder agrees to invest the LCs in stock of an *FC* corporation or otherwise use the LCs in *FC* in a manner approved in advance by the government of *FC*. The Program controls the LCs by either (1) remitting the LCs to, or crediting them to the account of, an *FC* corporation that issues capital stock to the holder, or (2) otherwise channeling the LCs to their designated use in *FC*. In the case of a stock investment in an *FC* corporation, the stock cannot be sold or otherwise transferred to *FC* entities. The amount of LCs the Central Bank will give the holder in exchange for the debt varies according to how the LCs are used.

In accordance with a prearranged plan persuant to the Program, the following transactions occurred on July 1, 1987:

Situation 1

Y purchased the Obligation from *X* for $60, which was the fair market value of similar *FC* debt in the secondary markets outside of *FC*. *X*, on behalf of *Y*, delivered the Obligation to the Central Bank, which credited an account of *FX* at the Central Bank with 900 LCs. *FX* then issued all its capital stock to Y.

Situation 2

The facts are the same as in *Situation 1*, except that instead of selling the Obligation to Y for $60, *X* delivered the Obligation to the Central Bank, which credited an account of *FX* at the Central Bank with 900 LCs. *FX* then issued all its capital stock to *X*.

Situation 3

The facts are the same as in *Situation 2*, except that instead of crediting an account of *FX*, the Central bank credited an account of *Z*, a United States corporation that is a charitable organization described in section 170(c)(2) of the Code, with 900 LCs. Under the terms of the Program, *Z* can use the 900 LCs only in *FC* for charitable purposes meeting the requirements of section 170 (including those described in Rev. Rul. 63-252, 1963-2 C.B. 101, and Rev. Rul. 66-79, 1966-1 C.B. 48).

LAW AND ANALYSIS

Situation 1

Under section 1001(a) of the Code, the amount of loss from a sale of property is the excess of the property's adjusted basis over the amount realized by the seller. *X's* sale of the Obligation to Y produces a loss of $40 ($100 - $60). Y's adjusted basis in the Obligation is $60; *see* section 1011. The remainder of the transaction will be treated for federal income tax purposes as if Y received 900 LCs from the Central Bank in exchange for the Obligation, and then contributed the 900 LCs to *FX* in exchange for *FX* stock. *See* section 1271(a)(1); *Lucas v. Earl*, 281 U.S. 111 (1930).

With respect to Y, LCs are considered property; *see* Rev. Rul. 74-7, 1974-1 C.B. 198. Thus, Y has a gain on the exchange of the Obligation for 900 LCs with the Central Bank to the extent the fair market value of the 900 LCs exceeds $60, Y's adjusted basis in the Obligation. The fair market value of the 900 LCs is determined by taking into account all the facts and circumstances of the exchange. The limitation on Y's use of the 900 LCs under the Program will generally reduce their fair market value below $90 (the value of 900 LCs convertible at the free market exchange rate).

Y's basis in the 900 LCs is $60 plus the gain, if any, recognized on the exchange. The fair market value of the *FX* stock is presumed to equal the fair market value of the 900 LCs. Y's basis in the *FX* stock received in exchange for the 900 LCs equals the fair market value of the 900 LCs.

Situation 2

The analysis is the same as in *Situation 1*, except that *X* will be treated as if it received 900 LCs from the Central Bank in exchange for the Obligation and then contributed the 900 LCs to *FX* in exchange for *FX* stock. *X* recognizes a loss on the exchange of the Obligation for 900 LCs equal to the excess of *X's* adjusted basis in the Obligation ($100) over the fair market value of the 900 LCs.

Situation 3

The analysis is the same as in *Situation 2*, except that *X* will be treated as if it received the 900 LCs from the Central Bank in exchange for the Obligation and then contributed the 900 LCs to *Z*. *X* recognizes a loss on the exchange of the Obligation for 900 LCs equal to the excess of *X*'s adjusted basis in the Obligation ($100) over the fair market value of the 900 LCs. In addition, assuming *X* and *Z* satisfy all requirements of the Code relating to charitable contributions, *X* is entitled to a charitable contribution deduction under section 170 of the Code equal to the fair market value of the 900 LCs at the time of the contribution; *see* section 1.170A-1(c)(1) of the Income Tax Regulations.

HOLDINGS

Under the facts described above, the federal income tax consequences to *X* and *Y* are as follows:

Situation 1

(1) *X* recognizes a loss of $40 on the sale of the Obligation to *Y*.

(2) *Y* recognizes a gain on the exchange of the Obligation for the 900 LCs to the extent the fair market value of the 900 LCs exceeds $60.

(3) *Y* recognizes no gain on the exchange of the 900 LCs for *FX* stock because its basis in the LCs equals the stock's fair market value.

Situation 2

(1) *X* recognizes a loss on the exchange of the Obligation for the 900 LCs to the extent of the excess of its adjusted basis in the Obligation ($100) over the fair market value of the 900 LCs.

(2) *X* recognizes no gain on the exchange of the 900 LCs for *FX* stock because its basis in the LCs equals the stock's fair market value.

Situation 3

(1) *X* recognizes a loss on the exchange of the Obligation for the 900 LCs to the extent of the excess of its adjusted basis in the Obligation ($100) over the fair market value of the 900 LCs.

(2) If *X* and *Z* otherwise satisfy all requirements of the Code relating to charitable contributions, *X* is entitled to a charitable contribution deduction equal to the fair market value of the 900 LCs at the time of the contribution.

(End of Text)

-- End of Section J --