

TAX SECTION

New York State Bar Association

NYSBA Tax Section Committee on Financial Instruments  
Report on Final and Proposed Section 988 Regulations

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**TAX SECTION****New York State Bar Association****OFFICERS****JOHN A. CORRY**

Chair  
450 Lexington Avenue  
New York City 10005  
212/530-4608

**PETER C. CANELLOS**

First Vice-Chair  
299 Park Avenue  
New York City 10171  
212/371-9200

**MICHAEL L. SCHLER**

Second Vice-Chair  
Worldwide Plaza  
825 Eighth Avenue  
New York City 10019  
212/474-1588

**CAROLYN JOY LEE ICHEL**

Secretary  
30 Rockefeller Plaza  
New York City 10112  
212/903-8761

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David E. Watts  
Philip R. West

October 21, 1992

The Honorable Shirley D. Peterson  
Commissioner  
Room 3000  
1111 Constitution Avenue, N. W.  
Washington, D.C. 20224

Dear Commissioner Peterson:

I enclose a Report analyzing the final and proposed Treasury Regulations under Section 988 of the Internal Revenue Code. The Report was prepared by a Subcommittee of the Committee on Financial Instruments of the Tax Section, chaired by Esta E. Stecher and Jodi J. Schwartz. The principal author of the Report was David Hariton.

The Report reflects the Committee's view that the final Section 988 regulations addressed many of the concerns about the previous temporary regulations that this Tax Section raised in its previous report. The Report principally examines the treatment of debt instruments which provide for payments in multiple currencies, the scope of the - integration rules under Section 988, and the application of the integration rules to consolidated group hedging. The conclusions of the Report are summarized on pages 1 to 3 of the Report.

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James M. Peaslee

We would be pleased to meet with your staff at their convenience to discuss this report and related matters.

Very truly yours,

John A. Corry

Identical Letter Sent to  
The Honorable Fred T. Goldberg, Jr.

CC: Abraham N. M. Sashy, Jr., Esq.  
Chief Counsel  
Internal Revenue Service  
Room 3026  
1111 Constitution Avenue, N. W.  
Washington, D.C. 20224

James R. Mogle, Esq.  
Acting International Tax Counsel  
Department of the Treasury  
Room 3064, Main Treasury  
1500 Pennsylvania Avenue, N.W.  
Washington, D.C. 20220

Robert E. Culbertson, Esq.  
Associate Chief Counsel (International)  
Internal Revenue Service  
Room 3052, IR  
1111 Constitution Avenue, N.W.  
Washington, D.C. 20224

Jeffrey L. Dorfman, Esq.  
Branch Chief, Branch 5  
Associate Chief Counsel (International)  
Internal Revenue Service  
CC: INTL, Room 4562, IR  
1111 Constitution Avenue, N.W.  
Washington, D.C. 20224

NYSBA Tax Section Committee on Financial Instruments  
Report on Final and Proposed Section 988 Regulations<sup>1</sup>

This Report analyzes the final Treasury Regulations (the "Final Regulations")<sup>2</sup> promulgated under Section 988 of the Internal Revenue Code of 1986, as amended (the "Code") and proposed Treasury Regulations under Section 988 of the Code (the "Proposed Regulations")<sup>3</sup>.

The Committee believes that the Final Regulations adequately address many of the concerns about the prior temporary regulations raised in its previous report.<sup>4</sup>

This Report sets forth certain specific comments on the Final and Proposed Regulations. The Report recommends that all debt instruments denominated in, or determined by reference to, foreign currency should be subject to the regime of Section 988, including debt instruments which provide for payments in multiple currencies, which payments cannot be determined by reference to the positive value of one currency.

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<sup>1</sup> This Report was prepared by a subcommittee of the Committee on Financial Instruments of the New York State Bar Association Tax Section (the "Committee") composed of Esta E. Stecher, Jodi J. Schwartz, David Hariton, Micah Bloomfield, Adrienne S. Browning, Linda Carlisle, Toby Cozart, James Finkel, Darren Fortunato, Neil Feinstein, Andrew Feldstein, Denise Hintzke, Robert Kantowitz, Robert M. Kreitman, David B. Newman, Erika Nijenhuis, Michael Peller, Jeffrey S. Sion and Mary Sue Teplitz. David Hariton was the principal draftsman of the Report. Helpful comments were received from John Corry, Peter C. Canellos and Michael Schler.

<sup>2</sup> Treasury Decision 8400, IRB 1992-15, page 4.

<sup>3</sup> Notice of Proposed Rulemaking, INTL 15-91, IRB 1992-15, page 47.

<sup>4</sup> New York State Bar Association Tax Section Committee on Financial Instruments, Report on Section 988 Regulations, May 8, 1990 (published in Tax Notes Today, May 18, 1990).

The Report further recommends that mixed currency debt instruments not be bifurcated into components but instead should be treated in a manner similar to the current treatment of original issue discount securities under Section 988.

The Report analyzes the scope of the integration rules under Section 988 and recommends that the Final Regulations be amended to clarify that the integration rules do not apply in circumstances not contemplated by Section 988(d) of the Code. The Committee recommends that the present requirements for an integrated economic transaction be expanded to also require that there be both a 988 transaction and a transaction entered into primarily to reduce the risk of currency fluctuation. Finally, the Report discusses the application of the integration rules to consolidated group hedging and recommends that, particularly in situations where the benefits and burdens of a hedge acquired by one member of a consolidated group are economically borne by the member with the foreign currency position or where the taxpayer whose tax consequences would be impacted controls the decision to put the hedge and to leg out, the regulations should permit integration of positions held by members of a consolidated group.

#### I. Mixed Currency Debt Instruments

This section discusses the treatment of debt instruments providing for payments determined by reference to the value of more than one currency ("mixed currency debt instruments"). These instruments have been issued and acquired with increasing frequency over the past decade, and it is likely that they will be issued and acquired in increasing volume over the coming

decade<sup>5</sup>. The Committee believes that the treatment of mixed currency debt instruments proposed in the Proposed Regulations and reflected in parts of the Final Regulations should be revised. The fundamental premise underlying the Proposed Regulations appears to be that the rules of Section 988 should apply only to non-contingent instruments, and that contingent instruments should be subject to the rules of Section 1275, whether or not the contingency relates to foreign currency. The Committee believes that the better approach is to provide for the taxation of all instruments denominated in, or determined by reference to, foreign currency only (as opposed to instruments linked to, e.g., a stock index) within Section 988. Failure to include all instruments linked solely to currency within Section 988 will lead to disparate treatment for similar instruments, substantially increase the complexity of determining the taxation of currency-linked instruments and provide ongoing opportunities for taxpayers to whipsaw the government.

The discussion below begins with some descriptive and analytic background. It then analyzes the treatment of mixed currency debt instruments under law prior to the Final and Proposed Regulations, under both Sections 988 and 1275(d) of the Code, and considers how this treatment has been, or may be altered, by the Final and Proposed Regulations. Finally, it makes specific recommendations for prompt amendment of the Final and Proposed Regulations to deal with mixed currency debt instruments.

A. Background. The simplest foreign currency debt instrument is one which is actually denominated in a single

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<sup>5</sup> According to the Securities Data Company, Inc., in 1990 domestic corporations issued foreign currency denominated instruments with an aggregate principal amount of US \$8.4 billion, and in 1991, with an aggregate principal amount of US \$12 billion.

foreign currency. For example, assuming that the U.S. dollar is worth 130 Yen at current rates of exchange, and that the market rate of interest on five-year Yen denominated obligations is 3.67% (whereas the market rate of interest on five-year U.S. dollar obligations is 7%), a U.S. investor might acquire, for 130,000 Yen, a 5-year debt obligation promising 4,770 Yen per annum and, at maturity, 130,000 Yen.

As a practical matter, such instruments are rarely issued into the U.S. market, partly because U.S. investors do not have Yen to invest (i.e., they would have to acquire the Yen in a separate transaction) and partly because U.S. investors are not interested in receiving Yen-denominated payments of interest. A U.S. investor would more likely acquire an instrument that is denominated in U.S. dollars but provides for a payment at maturity determined by reference to the value of 130,000 Yen. For example, the instrument might be issued for \$1,000, promise \$40 of interest per annum and, at the end of five years, the U.S. dollar value of 130,000 Yen, based on rates of exchange in effect on the date of maturity.

The low rate of interest paid on this instrument is consistent with the fact that the payment of principal is, in effect, measured in Yen, a "strong" foreign currency. One way to view this is that investors are willing to accept a lower rate of interest than the market rate on U.S. dollars because, based on "forward" rates of exchange in effect on the date of issuance, it is anticipated that 130,000 Yen will be worth more than \$1,000 at the end of five years. Under the principles of foreign currency arbitrage, the market rate of interest on foreign currency A is always lower than the market rate of interest on foreign currency B if, based on forward rates of exchange, foreign currency A is expected to appreciate in relation to foreign currency B.

On the other hand, the rate of interest is 4%, rather than 3.67% (the market rate of interest on Yen), because interest on the instrument is paid in U.S. dollars. By contrast, interest payments of 4,770 Yen per annum would be worth only \$36.70 (as compared with \$40) based on rates of exchange in effect on the date of issuance, but it is anticipated that they will be worth more over time as the Yen appreciates in relation to the dollar.

Instruments similar to the one described above were the first kind of mixed currency debt instrument marketed to U.S. investors. As the appetite of U.S. investors for mixed currency debt instruments increased, however, the instruments themselves grew more complex. One kind of instrument that was frequently issued to U.S. investors during the late 1980s provided for a payment at maturity that varied inversely with the value of specified foreign currency. For example, a domestic corporation might issue, for \$1,000, a 5-year debt instrument promising \$100 of interest per annum and, at maturity, \$2,000 minus the U.S. dollar value of 130,000 Yen, based on rates of exchange in effect on the date of maturity.

The "above-market" rate of interest on this instrument is consistent with the anticipated payment at maturity, based on forward rates of exchange in effect on the date of issuance. Investors require more interest over the life of the instrument because it is anticipated that 130,000 Yen will be worth more than \$1,000 on the date of maturity, and that \$2,000 minus the U.S. dollar value of 130,000 Yen will therefore be less than \$1,000.

More recently, mixed currency debt instruments issued to U.S. investors have provided for payments at maturity determined

by reference to increasingly complex foreign currency formulas. For example, a debt instrument issued for \$1,000 and promising \$60 per annum of interest might provide for a payment at maturity equal to the U.S. dollar value of 1,500 Swiss francs, minus the U.S. dollar value of 130,000 Yen, plus the U.S. dollar value of 800 British pounds. The payment at maturity might be determined by reference to the values of five or ten foreign currencies, moreover, and involve a variety of multiples and numerical relationships.

Most mixed currency debt instruments are issued "at par," based on spot rates of exchange in effect on the date of issuance. In other words, assuming that the instrument is issued for \$1,000, the instrument will also pay \$1,000 at maturity under the formula which determines the payment at maturity if rates of exchange in effect on the date of maturity are precisely the same as those in effect on the date of issuance (i.e., if the formula which determines the amount of the payment at maturity is "plugged in" using spot rates of exchange in effect on the date of issuance). As described above, however, the anticipated payment at maturity will be more or less than \$1,000, based on forward rates of exchange in effect on the date of issuance. Likewise, the rate of interest on the instrument will be determined by (and will vary inversely with) the anticipated value of the payment of principal, based on forward rates of exchange, rather than by the market rate of interest on U.S. dollars.

In some, until now, relatively infrequent cases, mixed currency debt instruments have been issued to U.S. investors providing for a "par" payment at maturity based on forward rates of exchange. For example, such an instrument might be issued for \$1,000, provide for \$70 of interest per annum and, at maturity,

the U.S. dollar value of 108,333 Yen. Based on spot rates of exchange in effect on the date of issuance, the U.S. dollar value of 108,333 Yen is only \$833, and the instrument is issued at a substantial "premium". Based on forward rates of exchange in effect on the date of issuance, however, the U.S. dollar value of 108,333 Yen is anticipated to be \$1,000 on the date of maturity, and the instrument is issued at par. Since, based on the principles of financial arbitrage, U.S. investors require a rate of interest consistent with the anticipated payment of principal based on forward rates of exchange, the instrument provides for interest at the market rate of interest on U.S. dollars.

In other, and until now, relatively infrequent cases, U.S. investors have acquired instruments providing for a payment at maturity determined by reference to the value of one foreign currency and denominated in a second foreign currency. For example, the instrument described immediately above might be issued for 600 British pounds, rather than for \$1,000, providing for 66 British pounds of interest per annum (assuming that 11% is the market rate of interest on British pounds) and, at maturity, the British pound value of 108,333 Yen. Likewise, a U.S. investor might acquire an instrument that is issued for 600 British pounds, provides for 40 British pounds of interest per annum and, at maturity, the British pound value of 130,000 Yen.

Mixed currency debt instruments have until now rarely provided for complex payments of interest. The relevant "foreign currency play" has generally been written into the payment at maturity, and the instrument has simply provided for fixed payments of interest, in the currency in which the instrument is denominated. There is no reason, however, why instruments issued in the future could not provide for payments of interest based on currency formulas.

B. Prior Law Under The Temporary Regulations. The temporary regulations<sup>6</sup> under Section 988 (the "Temporary Regulations") took a relatively simple approach to the taxation of currency-linked obligations. First, the Temporary Regulations addressed only obligations with payments that could be determined by reference to the value of one currency, and as to which the total amounts payable were determinable in a single currency on the issue date. Thus, the Temporary Regulations excluded from the scope of Section 988 an instrument linked to a foreign stock index and provided no rules for the taxation of a debt obligation denominated in one nonfunctional currency with payments determined by reference to a second non-functional currency.<sup>7</sup>

Second, the Temporary Regulations provided that exchange gain or loss on an obligation governed by Section 988 is determined by reference to rates of exchange in effect at the time the obligation is issued, rather than by reference to forward rates of currency exchange or other indices of anticipated value.<sup>8</sup> This has, in some respects, been a policy decision, based on the belief that interim realization of foreign currency gains or losses which might subsequently be reversed was inconsistent with the "all-events test" for the realization of income.<sup>9</sup> In addition, there is no ready means of determining

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<sup>6</sup> Temp. Reg. Sec. 1.988-0T - 1.988-5T, T.D. 8265, 1989-2 C.B. 160.

<sup>7</sup> Temp. Reg. Sec. 1.988-2T(b)(2)(i).

<sup>8</sup> See, e.g., Temp. Reg. § 1.988-2T(b)(9), Example (1).

<sup>9</sup> See Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (the "1986 Bluebook"), at 1088 ("The Congress was not persuaded that exchange gain or loss should be currently accrued in most cases. Because a right to receive (or an obligation to pay) foreign currency is not a right (or obligation) to receive (or pay) a fixed number of dollars, it would be problematical to require income inclusion (or permit deductions) due to exchange gain or loss that could be lost through subsequent exchange rate fluctuations.")

forward rates of exchange in many cases, and any proposed method of providing for U.S. tax consequences based on forward rates of exchange would be complex.

For example, if a U.S. person acquires, for 130,000 Yen (i.e., for \$1,000), a 5-year Yen denominated debt instrument promising 130,000 Yen at maturity and bearing interest at the market rate of interest on Yen (e.g., 3.67%, or 4,770 Yen, per annum), neither Section 988 nor any other provision of the Code requires the holder (or permits the issuer) to accrue original issue discount on the obligation in respect of the anticipated appreciation of the Yen in relation to the U.S. dollar. Section 988 could have required the holder to determine the five-year forward U.S. dollar value of 130,000 Yen and, assuming that such a five-year forward value was determined to be \$1,200, accrue \$200 of original issue discount over the life of the obligation. Under the current principles of Section 988, however, original issue discount on the obligation is measured in Yen,<sup>10</sup> and since there is no difference between the Yen issue price and the Yen stated redemption price, the obligation does not have any original issue discount.

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<sup>10</sup> See 1986 Bluebook, at 1099, Example (7).

While the simplicity offered by providing rules only for non-contingent instruments and by determining tax consequences by reference to current rates of exchange provided a rational and workable framework for most currency-linked obligations, the Temporary Regulations did not, as a result, provide explicit rules for all aspects of the taxation of currency-linked obligations.

For example, if the obligation described above was issued for \$900, the U.S. dollar value of 117,000 Yen, however (because, for example, the obligation provided for \$18, rather than \$40, of interest per annum), the obligation would presumably have some amount of original issue discount. Because the Temporary Regulations reserved on the treatment of mixed currency debt instruments,<sup>11</sup> however, there was no clear authority for determining the amount of this original issue discount. One way to account for original issue discount on the instrument described above would have been to translate the issue price of the instrument into Yen and treat the obligation as having 13,000 Yen of original issue discount (130,000 Yen - 117,000 Yen). Original issue discount accruing in Yen over the life of the obligation would then have been translated into U.S. dollars at the average rate of exchange in effect during the relevant accrual period.<sup>12</sup>

In the absence of any other authority, however, we understand that taxpayers generally translated the stated redemption price at maturity into U.S. dollars based on spot rates of exchange in effect on the date of issuance. Thus, in the case of the instrument described above, they translated the

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<sup>11</sup> Temp. Reg. § 1.988-2T(b)(16).

<sup>12</sup> S. Finance Comm. Rep. at 461, 1986 Bluebook at 1099.

130,000 Yen stated redemption price into \$1,000 and treated the obligation as having \$100 of original issue discount.

Taxpayers generally adopted this latter approach, and rejected the former approach, for several practical reasons. First, determining original issue discount in a foreign currency (by translating the issue price into foreign currency), and then translating the foreign currency original issue discount back into U.S. dollars at rates of exchange in effect over the life of the instrument, seemed to be an unnecessarily complex approach. If an instrument was denominated in U.S. dollars, issued for U.S. dollars, and provided for payments of interest determined by reference to U.S. dollars, it seemed appropriate to account for original issue discount in U.S. dollars.

Second, the former approach was of little use in dealing with instruments which provided for a payment determined by reference to the value of more than one currency, such as a payment at maturity equal to \$2,000 minus the U.S. dollar value of 130,000 Yen, or a payment at maturity based on a foreign currency formula. The issue prices of these instruments could not be translated into the multi-currency formula which determined the amount of the stated redemption price at maturity. Original issue discount therefore had to be accounted for by translating their stated redemption prices into U.S. dollars at the spot rate of exchange in effect on the date of issuance (i.e., by plugging in the foreign currency formulae which determined the amount payable at maturity using spot rates of exchange in effect on the

date of issuance) and measuring original issue discount in U.S. dollars.<sup>13</sup>

Moreover, the approach adopted by taxpayers in mixed currency debt instruments is consistent with the principles of Section 988 as applied to non-contingent currency obligations. Applying these principles means that taxpayers in effect treat a mixed currency debt instrument as providing for fixed payments, based on spot rates of exchange in effect on the date of issuance, and then account for any difference between these provisionally fixed payments and the amount ultimately received (i.e., any gain or loss arising from changes in the value of foreign currency between the relevant "booking date" and the relevant "payment date") as foreign currency gain or loss<sup>14</sup>. The

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<sup>13</sup> We understand that some taxpayers took the view, however, that no original issue discount accrues over the life of the instrument described above, because the original issue discount is not fixed and determinable on the date of issuance. There is arguably some legal support for this position -- at least by negative inference -- in United States v. Midland Ross, 381 U.S. 54 (1965), and its progeny, and in the all-events test under which accrual basis taxpayers are not required to include amounts in income which have not yet become fixed. Midland Ross, in which the Supreme Court denied capital gain treatment for gain from the sale of a debt obligation attributable to accrued discount, stood for the proposition that when all of the payments under a debt obligation are fixed, any difference between the issue price and the stated redemption price of the obligation should be treated as interest. Taxpayers have an argument, therefore, that since the U.S. dollar value of the promised payment at maturity cannot be determined until such time, no income is recognized until payments are under the obligation in excess of the issue price are fixed. See also Utility Trailer Manufacturing Co. v. United States, 212 F. Supp. 773 (S.D. Cal. 1962) (issuer could not accrue over the life of an obligation a contingent payment on the obligation payable at maturity and based on the increase in the consumer price index at maturity).

The argument is that the original issue discount rules of Sections 1271 through 1275 of the Code merely place cash-basis taxpayers on the accrual basis with respect to the inclusion in income of an anticipated receipt of original issue discount, and so long as the original issue discount is contingent, it need not be included in income. This argument, however, is inconsistent with the principles of Section 988, as discussed below. Moreover, the legislative history of Section 988 implies that original issue discount is to accrued. See supra note 12.

<sup>14</sup> See Section 988(b)(1) and (2) of the Code.

principles of Section 988 over ride the "all events" test in this regard. There is no doubt, for example, that under Section 988, a zero-coupon debt obligation denominated in Yen has Yen denominated original issue discount, and that the holder of the obligation must accrue the original issue discount (translated into U.S. dollars at the applicable rates of exchange for the relevant accrual periods) over the life of the obligation.<sup>15</sup> The fact that the U.S. dollar value of what the holder ultimately receives may be less than the U.S. dollar value of the original issue price does not negate the accrual of original issue discount.

Based on the above, the treatment of mixed currency debt instruments under the Temporary Regulations, while largely unstated, was relatively simple and straightforward, even in the case of complex instruments. Under the principles of Section 988, any difference between the \$1,000 issue price and the amount ultimately received by the holder on the date of maturity was foreign currency gain or loss to be accounted for, as ordinary income or loss, on the date of maturity.<sup>16</sup> This was true notwithstanding that it was generally anticipated, based on forward rates of exchange, that holders of an instrument providing for payment at maturity determined by reference to an appreciating foreign currency would have a foreign currency gain, and issuers would have a foreign currency loss. Likewise, under the principles of Section 988, interest accrued on the obligation at the coupon rate (without original issue discount or bond issuance premium) if the instrument was issued at par based on spot rates of exchange. In other words, interest accrued on the instrument at the market rate of interest in the foreign currency

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<sup>15</sup> Treas. Reg. § 1.988-2(b)(9), Example (7).

<sup>16</sup> Temp. Reg. § 1.988-2T(b)(5) and § 1.988-3T,

which took account of the anticipated value (based on forward rates of exchange) of the principal payment rather than at the market rate of interest on U.S. dollars.

C. Prior Law Under Section 1275(d). Shortly after the issuance of the proposed original issue discount regulations in 1986,<sup>17</sup> practitioners pointed out to the Internal Revenue Service an apparent conflict in the treatment of foreign currency debt instruments between the newly proposed rules under Section 1275(d) of the Code and the rules of Section 988 of the Code. Prop. Reg. Sec. 1.1275-4(f) provides, in the case of any debt instrument providing for one or more "contingent payments" which does not guarantee fixed payments equal to or greater than its issue price, for the re characterization of all fixed payments under the instrument, including payments of interest, as payments of principal. Any excess of the amount paid over the issue price of the instrument (as reduced by prior deemed payments of principal) is characterized as a payment of interest and includible in income at the time of payment (or when the right to such payment becomes fixed). Any excess of the issue price (as reduced by prior deemed payments of principal) over the amount paid at maturity is characterized as a capital loss.

Prop. Reg. Sec. 1.1275-4 contains no specific definition of a contingent payment (a section entitled "definition of a contingent payment" merely describes certain payments which may not be treated as contingent),<sup>18</sup> but it did not seem unreasonable to view mixed currency debt instruments as providing for one or more contingent payments. The proposed treatment of such instruments under Section 1275(d) was radically different,

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<sup>17</sup> Notice of Proposed Rulemaking, LR 189-84, 1986-1 C.B. 820.

<sup>18</sup> Prop. Reg. § 1.1275-4(b).

however, from the treatment set out under Section 988. As described above, under Section 988, stated payments of interest under the instrument were respected, and any difference between the issue price of the instrument and the amount ultimately received at maturity was foreign currency gain or loss (i.e., ordinary income or loss with residence-based sourcing).

The Internal Revenue Service presumably saw no reason at that time to subject mixed currency debt instruments to the proposed rules under Section 1275(d) for the treatment of contingent payment debt obligations. For one thing, if applied to mixed currency debt instruments, the proposed rules would have exposed the fisc to a substantial whipsaw: Holders would have treated payments of interest on mixed-currency debt instruments as tax-free returns of principal. The resulting deferral of interest income to maturity of the instrument would have conferred a substantial timing benefit. Issuers, on the other hand, would have integrated the issuance of the instrument with one or more appropriate hedges under the authority of Section 988(d) of the Code. The resulting synthetic instrument would not be a contingent debt instrument, and there would therefore be no deferral of interest deductions. (No such integration was available, of course, for issuances of contingent debt instruments not relating to the values of foreign currency.)

Equally important, the proposed rules under Section 1275(d) seemed counter-intuitive, and were even then the subject of substantial criticism. They had been drafted to deal with a broad range of contingent instruments, and with a view to concerns which did not relate to mixed currency debt instruments. The treatment set out under Section 988, on the other hand, seemed simple, adequate and intuitively logical.

In light of the above, the Internal Revenue Service issued a single-sentence announcement, Announcement 86-92,<sup>19</sup> stating that "it was not intended that the rules contained in proposed Treas. Reg. § 1.1275-4 be applied to lending transactions merely because some or all of the payments are denominated in or determined by reference to the value of one or more foreign currencies." The announcement was admittedly cryptic and it was interpreted, by some taxpayers, practitioners, commentators<sup>20</sup> and scholars, to mean that a debt instrument would be governed by the rules of Section 988, rather than by the newly proposed rules under Section 1275(d), so long as the "contingencies" which determined the amount of the payments under the instrument related solely to the values of one or more foreign currencies, rather than, for example, to the values of a stock or commodity index. Others believed that the announcement applied only to instruments as to which the amounts of all payments to be made were determinable in a single currency at the time of issuance.<sup>21</sup> Under either view, the announcement was generally thought to apply to most or all of the mixed currency debt instruments described above.

D. The Proposed Regulations. The Final Regulations make certain references to the treatment of mixed currency debt obligations. Those references are best understood in light of the proposed treatment of mixed currency debt obligations in the

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<sup>19</sup> 1986-32 I.R.B. 46.

<sup>20</sup> See, e.g., Benjamin B. Lopata, "Current Issues in Foreign Currency Transactions," 51 Tax Notes 895, 896 (May 20, 1991).

<sup>21</sup> For example, an instrument that provided for payment at maturity of the cash value of \$2000 minus 130,000 Yen would not, under this interpretation, have been subject to the announcement, because the amount of the payment could not be determined at the time of issuance in either U.S. dollars or Yen.

Proposed Regulations. Accordingly, we discuss the Proposed Regulations first.

The Proposed Regulations would provide for the first time explicit rules for the taxation of some mixed currency debt instruments determined by reference to multiple currencies.<sup>22</sup> The rules generally would apply to any instrument that provides for some payments determined by reference to the positive values of one currency and other payments determined by reference to the positive values of another currency.<sup>23</sup> The rules would include, for example, the 5-year debt instrument described above that is (a) issued for \$1,000, (b) provides for \$40 of interest per annum, and (c) at maturity, the U.S. dollar value of 130,000 Yen. The rules do not include, however, the debt instrument described above which provides for a payment at maturity equal to \$2,000 minus the U.S. dollar value of 130,000 Yen.

The Proposed Regulations would provide that Prop. Reg. Sec. 1.1275-(4)(g) applies before Section 988. The Proposed Regulations then expand on the bifurcation rules provided in Prop. Reg. Sec. 1.1275-4(g), which apply only to obligations

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<sup>22</sup> The Proposed Regulations do not affect the treatment of instruments all of the payments on which are determined by reference to the value of a single foreign currency, e.g., a conventional debt instrument that is actually denominated in a foreign currency. Thus, a cash-basis U.S. holder of a debt instrument providing for the payment of 5,200 Yen of interest per annum and 130,000 Yen at maturity would continue to include the U.S. dollar value of the interest payments in income as the interest was received, and (assuming that the instrument had been issued for \$1,000, the U.S. dollar value of 130,000 Yen on the date of issuance) would recognize any difference between \$1,000 and the amount received at maturity as foreign currency gain or loss on the date of maturity. Treas. Reg. § 1.988-2(b)(9), Example (1).

<sup>23</sup> The Proposed Regulations divide such instruments into "dual currency" and "multi-currency" debt instruments. The distinctions between these definitions are discussed in more detail in section I.C. below. Both definitions provide, however, that the "amount of all payments in each currency is fixed on the issue date." Prop. Reg. § 1.988-1(c)(4)(i) and (5)(i).

where repayment of an amount at least equal to the issue price is guaranteed, by bifurcating instruments to which they apply into several different instruments, one for each group of payments determined by a single currency. For example, the first instrument described in the paragraph immediately above would be bifurcated into (a) a U.S. dollar denominated installment obligation providing for annual payments of \$40 per annum, which would not be subject to Section 988, and (b) a Yen denominated zero coupon instrument promising 130,000 Yen on the date of maturity, which would be subject to Section 988.

The practical execution of this treatment is fairly complex. First, a Yen denominated issue price must be determined for the deemed zero-coupon 130,000 Yen obligation by discounting the right to receive 130,000 Yen in five years to its present value on the date of issuance at an appropriate arm's length rate of interest for Yen obligations issued by issuer with an equivalent credit and having a similar term to maturity. This rate must be agreed to by the issuer and the holder, on the basis of the yields of similar debt instruments previously issued by the issuer of comparable debt instruments issued by other issuers, taking into account all of the relevant facts and circumstances.<sup>24</sup> Over the life of the deemed zero-coupon Yen obligation, Yen denominated original issue discount (equal to the excess of 130,000 Yen over the agreed upon Yen issue price) must be translated into U.S. dollars at the rate of exchange prevailing during the relevant accrual period.

Second, an issue price must be determined for the deemed U.S. dollar denominated installment obligation by translating the Yen denominated issue price of the deemed zero-coupon Yen

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<sup>24</sup> Prop. Reg. § 1.988-2 (a)(4)(ii)(A) and Prop. Reg. § 1.1273-2(d)(2)(iv).

obligation into U.S. dollars at the applicable rate of exchange in effect on the date of issuance and subtracting this amount from the overall issue price of the mixed currency instrument. Original issue discount then accrues on the deemed U.S. dollar denominated installment obligation over the life of the obligation under rules set out in regulations proposed under Section 1272 of the Code which in effect characterize each payment under the installment obligation partly as a payment of interest, and partly as a payment of principal, on a yield to maturity basis.<sup>25</sup>

Interestingly, this relatively complex methodology does not produce tax results which differ substantially from those which prevail in the absence of bifurcation under current law. For example, suppose that the market rate of interest for Yen denominated obligations is 3.67% per annum, the market rate of interest for U.S. dollar denominated obligations is 7% per annum, and the market rate of interest for 5-year mixed currency instruments paying U.S. dollar interest and Yen denominated principal is 4% per annum. The deemed zero-coupon 130,000 Yen obligation will be discounted to present value at 3.67%, and original issue discount will therefore accrue, on an initial deemed issue price of approximately 108,000 Yen, at a rate of 3.67%. Original issue discount will accrue in respect of the deemed U.S. dollar denominated installment obligation at a rate of 7% per annum, on an initial issue price of approximately 22,000 Yen, or \$170. The combined average rate of interest accrual on the aggregate \$1,000 issue price of the mixed currency debt instrument will be approximately 4%, the rate of return which investors require to invest in the mixed currency instrument. This is of course precisely the rate at which stated

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<sup>25</sup> Prop. Reg. § 1.988-2(a)(4)(ii)(B) and Prop. Reg. § 1.1273-1(b)(2).

interest accrues on the mixed currency debt instrument without bifurcation under current law.

There are some technical differences worth noting. First, as principal is paid down on the deemed U.S. dollar denominated installment obligation, and as there is a corresponding increase in the accreted issue price of the deemed zero-coupon Yen obligation in respect of accrued original issue discount (i.e., as principal shifts from the deemed U.S. dollar denominated installment obligation to the deemed Yen denominated zero-coupon obligation), the combined rate of interest accrual on the overall mixed currency instrument slowly drops. A drop in overall rate of interest accrual, from for example 4.1% per annum at issuance to 3.9% per annum immediately prior to maturity, may more accurately reflect the pay down of the U.S. dollar component of the instrument over time.

Second, because original issue discount accruing on the deemed zero-coupon Yen obligation is translated into U.S. dollars at the rate of exchange in effect during the relevant accrual period, rather than at the rate of exchange in effect at maturity, holders realize gains and losses attributable to changes in the value of foreign currency on accrued original issue discount over the life of the obligation, rather than at maturity. These gains and losses are reflected, moreover, as changes in the amount of original issue discount (i.e., interest) earned on the instrument, rather than as foreign currency gains or losses on the receipt of previously accrued interest income.

For example, suppose in the case of the instrument described above that the U.S. dollar value of the Yen increases by 20% immediately after issuance and then remains constant over the next four years. With bifurcation, the holder includes

approximately \$12 of interest in income in year one in respect of the deemed U.S. dollar denominated installment obligation, and accrues approximately 4,000 of Yen denominated original issue discount in year one in respect of the deemed zero-coupon Yen denominated obligation. The Yen denominated original issue discount equals \$37, rather than \$31, then translated into U.S. dollars at the 20% higher rate of exchange. The holder therefore recognizes \$49, rather than \$43, of interest income in year one, and has no additional foreign currency gain at maturity. Without bifurcation, the holder simply includes \$43 of interest in income in year one and, at maturity, recognizes \$6 of foreign currency gain in respect of the increase in value of 4,000 of the 130,000 Yen payable at maturity.

Of course, this distinction has nothing to do with anticipated changes in the values of strong and weak currencies, based on forward rates of exchange. If the U.S. dollar value of the Yen decreases by 20% in year one, the holder of a bifurcated instrument accrues only \$37 of interest and original issue discount in year one.

The effect of the Proposed Regulations is that the universe of non-contingent instruments to which the Final Regulations apply has been expanded by treating each separate currency component of a mixed currency debt instrument providing for payments by reference to the positive value of multiple currencies as a separate non-contingent debt instrument. Since a payment equal to \$2,000 less 130,000 Yen cannot be separated into two separate debt obligations, instruments with payments linked to such amounts remain outside the scope of the Proposed Regulations.

As a technical matter, the Proposed Regulations have nothing to say about the treatment of such instruments, other than to clarify that the rules of the Proposed Regulations do not apply to them, and that they therefore are not bifurcated into more than one instrument. Consistent with the concept that contingent instruments should be taxed under the rules of Section 1275, however, the Proposed Regulations appear to imply that mixed currency debt instruments outside the scope of the Proposed Regulations are subject to the rules of Prop. Reg. Sec. 1.1275-4, concerning the treatment of contingent debt obligations. For example, the Proposed Regulations point out that the instruments to which the Proposed Regulations apply are not "contingent debt instruments under Section 1275(d)," <sup>26</sup> implying that instruments outside the scope of the Proposed Regulations are subject to Section 1275(d).

E. Contingent Debt Instruments and the Final Regulations. While the Final Regulations reserve on the treatment of mixed currency debt instruments providing for payments determined by reference to the positive value of multiple currencies (referring taxpayers to the Proposed Regulations), they have more to say about the treatment of mixed currency debt instruments not covered by the Proposed Regulations.

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<sup>26</sup> Prop. Reg. § 1.988-2(4)(i) and (a)(5)(i).

The preamble to the Final Regulations, for example, contains the following language:

"The term contingent payment debt obligation does not include dual currency or multi-currency debt instruments which were within the definition of qualifying debt instrument in § 1.988-5T(a)(3) and hence eligible for integration under the Temporary Regulations. The term contingent payment debt obligation does include reverse principal exchange rate linked securities such as the one described in Example 6 of § 1.988-5(a)(9)(iv) because the amount of principal paid upon maturity of the instrument is not determinable in any currency on the issue date (assuming, of course, that the instrument is unhedged)"<sup>27</sup>

The instrument described in Example 6 provides for a payment at maturity equal to \$2,000 less the U.S. dollar value of 150,000 Yen.)

As a technical matter, this language in the preamble does not speak to whether instruments of this type are subject to the rules of Prop. Reg. Sec. 1.1275-4. The purpose of this portion of the preamble is to clarify that these instruments may now be integrated with an appropriate hedge under Section 988(d) into a synthetic fixed U.S. dollar denominated obligation.

This language implies, however, that instruments of this type cannot be integrated under Section 988(d) if they were issued prior to March 17, 1992, the effective date of the new rule in the Final Regulations permitting the integration under Section 988(d) of "contingent debt instruments." This is an unfortunate development. The Temporary Regulations clarified that an instrument providing for a payment determined by reference to the value of a stock index was a "contingent debt instrument"

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<sup>27</sup> TD 8400, IRB 1992-15 at p. 7.

falling outside the purview of Section 988, and therefore could not be integrated under Section 988(d).<sup>28</sup> The Temporary Regulations, provided, however, that integration under Section 988(d) was available for debt instruments under which the payments are determined by reference to multiple currencies.<sup>29</sup> As described earlier, one view of Announcement 86-92 was that all mixed currency debt instruments were subject to Section 988 and were not subject to Section 1275. Accordingly, many taxpayers assumed that a mixed currency debt instrument could be integrated with an appropriate hedge under Section 988(d) so long as it did not provide for contingent payments determined by reference to factors other than the value of foreign currencies, such as the value of a stock or commodity index.

A sentence contained in the body of the Final Regulations, moreover, seems to imply that mixed currency debt instruments falling outside the scope of the Proposed Regulations are subject to the rules of Prop. Reg. Sec. 1.1275-4. Reg. Sec. 1.988-2(b)(2)(iii)(B)(2) contains the following sentence:

"For purposes of Section 1275(d), a debt instrument denominated in, or all payments of which are determined with reference to, a single nonfunctional currency (with no contingencies) is not a contingent payment debt instrument.

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<sup>28</sup> Under § 1.988-5T(a)(3) and § 1.988-2T(b)(2)(i) of the Temporary Regulations, the definition of a "qualified debt instrument" that was eligible for integration did not include a "contingent payment debt instrument". Compare Treas. Reg. § 1.988-5(a)(9)(iv), Example (7) (a British pound borrowing with a principal payment at maturity linked to the value of a stock index is integrated with a swap under which the borrower pays fixed U.S. dollar amounts and receives periodic British pound amounts and a final payment of pounds in an amount that is needed to meet the borrower's contingent obligation at the maturity of the borrowing. The borrowing and the swap are integrated and treated as a U.S. dollar borrowing providing for fixed U.S. dollar interest and principal payments).

<sup>29</sup> Temp. Reg. 1.988-5T(a)(3).

See Section 1.988-1(a)(4) and (5) for the treatment of dual currency and multi-currency debt instruments."

The implication that such instruments are contingent debt instruments for purposes of Section 1275(d).

If mixed currency debt instruments outside the scope of the Proposed Regulations are subject to the rules of Prop. Reg. Sec. 1.1275-4, then they are subject to a treatment which differs remarkably from the treatment of instruments falling within the Final and Proposed Regulations. As noted above, under Prop. Reg. Sec. 1.1275-4 (unless the instrument provides for U.S. dollar denominated payments of interest which in the aggregate equal the issue price of the instrument, i.e., unless the term of the instrument is very long), stated payments of interest are recharacterized as payments of principal. In other words, no interest accrues on the instrument until the date of maturity. At that time, any excess of the amount paid over the issue price of the instrument (less previous deemed returns of principal) is characterized as a payment of interest, even though it relates solely to increases in the value of foreign currency rather than to the time value of money.

As a technical matter, the Committee notes that a basis still exists for concluding that the instruments not covered by the Proposed Regulations are not now subject to the rules of Prop. Reg. Sec. 1.1275-4. First, the Final Regulations do not make any affirmative statement concerning the treatment under Section 1275(d) of such instruments. Second, regulations under Section 988 arguably should not determine the operation of regulations under Section 1275(d). Third, while the Proposed Regulations clearly contemplate that the rules of Prop. Reg. Sec. 1.1275-4 will apply to mixed currency debt instruments covered by the Proposed Regulations, based on informal conversations with

members of the staff of the Internal Revenue Service, the Committee believes that the implication in the preamble to the Final Regulations that the rules of Prop. Reg. Sec. 1.1275-4 currently apply to mixed currency debt instruments may have been unintentional. Fourth, such a conclusion would reverse a widely held interpretation of Announcement 86-92, and there does not appear to have been any intention on the part of the Internal Revenue Service to reverse the announcement, prospectively or otherwise. Finally, such a conclusion would, expose the fisc to a whipsaw on the accrual of interest, as described more fully below.

F. General Recommendations. The Committee bases its recommendations on the following observations, in light of the discussion set out above.

First, the distinctions among the mixed currency debt instruments which, under the Proposed Regulations, would cause these instruments to fall within or outside the scope of the Proposed Regulations are relatively minor, and do not warrant radical differences in treatment. The Committee concedes that there are cases in which the formula determining the amount of a payment at maturity may be so variable, and the term of the instrument may so short, as to warrant the conclusion that the instrument itself is not a debt instrument, but rather a foreign currency warrant or other property right. The regulations under Sections 988 and 1275 do not purport to determine, however, whether, based on all of the relevant facts and circumstances,

an instrument is a debt instrument for Federal income tax purposes.<sup>30</sup> Given the assumption that an instrument is a debt instrument, however, the Committee, for example, sees no reason for providing for one treatment if all of the payments are determined by reference to Yen, a second treatment if the interest payments are determined by reference to U.S. dollars and the principal payment is determined by reference to Yen, and a third treatment if the interest payments are determined by reference to U.S. dollars and the principal payment is determined by reference to U.S. dollars and Yen.

The Committee is particularly concerned to the extent that these treatments produce substantially different results. Providing three different treatments for similar instruments is not only unnecessarily complex, but it creates needless opportunities for whipsawing the government as well as creating traps for the unwary.

Second, the Committee does not see any reason to bifurcate a mixed currency debt instrument into component parts. As described above, administration of the treatment of dual and multi-currency obligations, as set out in the Proposed Regulations, would be exceedingly complex, both in theory and in practice, and would not produce results which differ substantially from the non-bifurcated treatment under current law.

Third, for the reasons set out above, the Committee sees no reason to subject mixed currency debt instruments not providing for payments determined solely by reference to the positive value of multiple currencies, or any other debt

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<sup>30</sup> See Prop. Reg. § 1.1275-4.

instruments providing for payments determined solely by reference to the values of one or more foreign currencies, to the rules of Prop. Reg. Sec. 1.1275-4. The rules of Prop. Reg. Sec. 1.1275-4 are (a) in direct conflict with the general principles of Section 988,<sup>31</sup> (b) not designed to deal with mixed currency debt instruments, and (c) themselves the subject of substantial criticism. Moreover, application of the rules of Prop. Reg. Sec. 1.1275-4 to mixed currency debt instruments would arguably reverse an announcement which has been relied on by many taxpayers and which has until now produced equitable and reasonable tax results in a substantial and orderly market. The Committee sees no reason to surprise taxpayers by providing that mixed currency debt instruments not covered by the Proposed Regulations cannot be integrated with an appropriate hedge if they were issued prior to March 17, 1992. The Committee is not aware of any abuse which has occurred, or could have occurred, in connection with the issuance of these instruments.

Finally, in view of the fact that the Final Regulations now permit issuers to integrate a contingent debt instrument with an appropriate hedge under Section 988(d), application of the rules of Prop. Reg. Sec. 1.1275-4 to mixed currency debt instruments could only whipsaw the government. Holders will have complete deferral of interest income (as a result of the recharacterization of interest payments under the instrument as principal), while issuers will be able to integrate the instrument with an appropriate hedge into a fixed U.S. dollar denominated obligation and deduct interest currently.

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<sup>31</sup> There is no reason to treat a payment determined by reference to two or more currencies as "contingent" when the principle of Section 988 is that payments determined by reference to a nonfunctional currency is not contingent.

We recognize that, under these proposals, the contingent payment rules of proposed Treas. Reg. Sec. 1.1275-4 would have a narrower scope when a payment formula was expressed in terms of foreign currency than when it was expressed in terms of other variable factors. For example, a debt instrument would clearly be subject to the contingent payment rules if its payment at maturity was equal to \$1,000 minus X times the prime rate (or \$1,000 minus Y times some stock index), but not if the payment was \$1,000 minus Z times the value of a specified amount of Japanese yen. The resulting difference between the treatment of foreign currency contingencies and other contingencies appears to be somewhat arbitrary. Moreover, taxpayers would have the option of coming under the Section 1275 regime or the Section 988 regime, and this may result in whipsaw to the government. However, the non-application of the contingent payment rules to foreign currency debt can be justified as a statutory matter because of the more specific regime for foreign currency debt set out in Section 988 of the Code. Further, as the Tax Section stated in a letter dated April 30, 1991 to then Commissioner Goldberg<sup>32</sup>, the contingent payment rules of the proposed regulations raise important tax policy issues, as well as presenting a host of technical problems. Thus, to the extent consistency in the treatment of different types of contingent obligations is deemed appropriate, serious consideration should be given to amending the proposed Section 1.1275-4 regulations to reflect the results we suggest under Section 988.

In light of the above, the Committee makes the following recommendations.

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<sup>32</sup> See 51 Tax Notes 573 (May 5, 1991).

First, the language of Announcement 86-92 should be clarified. The Final Regulations should clearly state, retroactive to the date on which the announcement was published, that a debt instrument is not a contingent debt instrument, for purposes of Section 1275(d) and for purposes of Section 988, if all of its contingent payments are determined solely by reference to the values of one or more foreign currencies. Any language in the Proposed or Final Regulations that is inconsistent with this clarification should be deleted.

Second, the proposal to bifurcate certain mixed currency debt instruments into component parts should be dropped.

Third, the Final Regulations should contain some elaboration on how original issue discount and premium should be accounted for on mixed currency debt instruments (i.e., debt instruments providing for payments in different currencies). Specifically, the Committee suggests that the Final Regulations provide that original issue discount, or bond issuance premium, on mixed currency debt instruments should be measured in the currency in which the majority of the interest payments are denominated or determined by reference to. The amount of original issue discount or bond issuance premium should then be determined by translating the anticipated payment at maturity (and any interest payments denominated in a currency other than the currency in which the majority of the interest payments are denominated or determined by reference to) into the currency in which the majority of the interest payments are denominated or determined by reference to at the rate of exchange in effect on the date of issuance. The discount or premium would be amortized in that currency. Any difference between the anticipated payment of principal (or interest) thus provisionally determined and the amount of the payment ultimately received should be recognized as

foreign currency gain or loss on the date the payment is accrued or received, in accordance with the holder's method of accounting.

G. Technical Recommendations. In addition to the general recommendations made above, the Committee offers the following- more technical suggestions. These suggestions should be adopted only if the Service does not adopt the Committee's general recommendations.

1. The Committee sees no reason for the existence of rules both for "dual currency" and for "multi-currency" debt instruments. Because a dual currency instrument is by definition (subject to section I.G.2. below) a multi-currency debt instrument, the Committee recommends that Prop. Reg. Sec. 1.988-1(c)(4) be dropped and that Prop. Reg. Sec. 1.988-1(c)(5) be amended to delete the references to dual currency obligations.

2. While the definition of a dual currency debt instrument includes the standard reference to payments "denominated by reference to" a currency, the definition of multi-currency debt instruments includes only instruments with payments "made in" more than one currency. There does not appear to be any reason for this narrower definition of multi-currency debt instruments, and the Committee recommends that the definition be broadened.

3. Both Prop. Reg. Sec. 1.988-1(a)(4)(i)(C) and 1.988-1(a)(5)(i)(B) require that the "amount of all payments in each currency [be] fixed." The reference to "fixed" amounts could be understood not to include payments determined by a standard floating rate, such as sterling LIBOR. The Committee recommends that the provisions cited be revised to include objective

interest rates as defined for purposes of the original issue discount regulations.

4. Because Prop. Reg. Sec. 1.988-1(c)(3) provides that Prop. Reg. Sec. 1.1275-4(g) applies before Section 988, it appears that a sterling obligation with interest linked to the FTSE-100 would not be eligible as a whole for integration under Section 988(d). According to Example 7 of Reg. Sec. 1.988-5(a)(9)(iv), however, such obligations currently are eligible for integration. The Committee recommends that Prop. Reg. Sec. 1.988-1(a)(3) be revised to clarify that no change is intended to the availability of integration for such instruments when the Proposed Regulations are adopted in final form.

## II. 988 Hedging Transactions

The Final Regulations expand the universe of debt instruments and hedges that may be integrated and treated as synthetic debt instruments. In general the Committee approves of the extension of the regulations under Section 988(d) to permit the integration of certain contingent debt instruments that could not be integrated under the Temporary Regulations. The Service should make it clear, however, that the integration rules do not apply in instances not contemplated by Section 988(d) of the Code. Specifically, integration should only apply if there is a "section 988 transaction" that is a part of a transaction entered into primarily to reduce the risk of currency fluctuation.

A. Statutory authority. Section 988(d) of the Code provides that, "[to] the extent provided in regulations, if any section 988 transaction is part of a 988 hedging transaction, all transactions which are part of the 988 hedging transaction shall be integrated and treated as a single transaction or otherwise

treated consistently. . .” Thus, there are two statutory requirements for integration: there must be a “988 transaction” and the 988 transaction must be part of a “988 hedging transaction.” A “988 transaction” is a transaction described in Section 988(c)(1)(B) of the Code,<sup>33</sup> but only if the amount which the taxpayer is required to pay or receive by reason of such transactions is (i) denominated in terms of a nonfunctional currency or (ii) determined by reference to the value of a nonfunctional currency.<sup>34</sup> A “988 hedging transaction” is any transaction which is (1) entered into by a taxpayer primarily to reduce the risk of currency fluctuation with respect to assets or liabilities of the taxpayer and (ii) identified by the taxpayer or the Secretary as a 988 hedging transaction.<sup>35</sup>

B. Integration under the Final Regulations. Similar to the Temporary Regulations, the Final Regulations permit the integration of a “qualifying debt instrument” and a “Section 1.988-5(a) hedge” if, in addition to the satisfaction of certain other requirements, all payments to be received under the qualifying debt instrument are fully hedged such that a yield to maturity can be calculated in the currency in which the synthetic

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<sup>33</sup> Transactions described in Code Section 988(c)(1)(B) include: (i) the acquisition of a debt instrument or becoming the obligor under a debt instrument, (ii) accruing or otherwise taking into account any item of expense or gross income or receipts which is to be paid or received after the date so accrued or taken into account and (iii) entering into or acquiring any forward contract, futures contract, option or similar financial instrument.

<sup>34</sup> Code Section 988(c)(1)(A).

<sup>35</sup> Code Section 988(d)(2).

debt instrument is denominated.<sup>36</sup>

The Temporary Regulations limited the definition of qualifying debt instrument to include only debt instruments which provide for the payment of amounts denominated in (or determined by reference to the value of) a nonfunctional currency. The Temporary Regulations also excluded contingent debt instruments from the definition of qualifying debt instrument. The Final Regulations retroactively expand the definition of qualifying debt instrument to include functional currency debt instruments and prospectively expand the definition to include contingent debt instruments.<sup>37</sup> The Final Regulations define a Section 1.988-5(a) hedge (a "hedge") as a spot contract, futures contract, forward contract, option contract, notional principal contract, currency swap contract, similar financial instrument, or series or combination thereof, that when integrated with a qualifying debt instrument permits the calculation of a yield to maturity in the currency in which the synthetic debt instrument is

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<sup>36</sup> Under both the Temporary and the Final Regulations, integration results in a single synthetic debt instrument for tax purposes. If the qualifying debt instrument is a borrowing, the synthetic debt instrument is denominated in the currency paid under the hedge to acquire the currency used to make payments on the qualifying debt instrument. If the qualifying debt instrument is a lending, the synthetic debt instrument is denominated in the currency received under the terms of the hedge in exchange for the amounts received under the qualifying debt instrument. The synthetic debt instrument is subject to the original issue discount provisions of Code Sections 1272 through 1298 and Section 163(e). No exchange gain or loss is recognized on the qualifying debt instrument or the hedge so long as either is part of the integrated transaction, but, if the synthetic debt instrument is denominated in a nonfunctional currency, the rules of Temp. Reg. § 1.988-2T(b) or Reg. § 1.988-2(b) apply.

<sup>37</sup> Reg. § 1.988-5(a)(3). The preamble to the Final Regulations indicates that the prior exclusion of debt instruments denominated in a functional currency from the definition of qualifying debt instrument was unintentional. There is some confusing language in Prop. Reg. § 1.988-1(a)(3) which might be read to imply that the bifurcation rule of Prop. Reg. § 1.1275-4(g) should apply to contingent debt instruments prior to the application of S 1.988-5. Example 7 in § 1.9885(a)(9)(iv) makes it clear, however, that the integration rule is intended to trump the bifurcation rule.

denominated.<sup>38</sup> The Final Regulations include no requirement that there be a 988 transaction or that there be a transaction entered into primarily to reduce the risk of currency fluctuation.

Under a literal reading of the Final Regulations, therefore, integration is now available for transactions that contain neither a Section 988 transaction nor a transaction entered into primarily to reduce the risk of currency fluctuation and, thus, do not meet the requirements of Section 988(d) of the Code. For example, a stock-index linked note denominated in a taxpayer's functional currency now satisfies the definition of qualified debt instrument and, therefore, can be integrated with an option on the stock index which permits the computation of a yield to maturity in the taxpayer's functional currency.<sup>39</sup> The Final Regulations were obviously not meant to apply to transactions, such as this one, with no foreign currency element. The Committee does not, in general, disagree with the concept of integrating such transactions but merely believes that integration pursuant to Section 988 is appropriate only where the requirements of that section are met. It would be more appropriate, perhaps, to address integration of transactions without foreign currency elements in the context of the contingent debt regulations under Section 1275(d) of the Code or under regulations promulgated pursuant to Section 1092(b) of the Code.

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<sup>38</sup> Reg. § 1.988-5(a)(4).

<sup>39</sup> E.g., an issuer with the dollar as its functional currency can integrate (i) a note issued for \$100X which pays no periodic interest and provides for a payment at maturity equal to \$100X plus \$100X multiplied by the rate of appreciation of a stock index with (ii) the purchase of an option pursuant to which the issuer is entitled to receive the contingent payment owed on the note.

A more complicated issue is raised by integration in the case of a contingent debt instrument denominated in a nonfunctional currency which is hedged into a noncontingent debt instrument denominated in a functional currency. For example, suppose an issuer with the dollar as its functional currency issues a debt instrument for L50X which pays no periodic interest and provides for a payment at maturity equal to L50X plus L50X multiplied by the rate of appreciation on the Financial Times 100 Stock Exchange ("FTSE"). Under the Final Regulations, the issuer can hedge into synthetic U.S. dollar denominated borrowing by purchasing for \$20X an option contract which gives the issuer the right at maturity to exchange \$100X for the amount owed on the debt instrument. In this case, there is clearly a section 988 transaction because the FTSE-Linked debt instrument is denominated in nonfunctional currency. It is less clear, however, that the issuer entered into the option contract primarily to reduce the risk of currency fluctuation, i.e., the primary purpose for the option contract may be to reduce the risks that are incident to an obligation to make payments based on movements in a stock exchange index. There may not be, therefore, a transaction entered into primarily to reduce the risk of currency fluctuation (i.e., there may not be a section 988 hedging transaction). Suppose, for example, that at the date of issuance (i) the pound interest rate and the dollar interest rate are equivalent and (ii) there is very little expected volatility in the pound/dollar exchange rate over the term of the debt instrument. In this case, it is extremely likely that the issuer entered into the hedge primarily to eliminate the FTSE risk and not to reduce the risk of currency fluctuations. However, under different circumstances (e.g., very little expected FTSE volatility and wildly fluctuating exchange rates), it might be clear that the issuer entered the hedge primarily to reduce the risk of currency fluctuation. Indeed, given the volatility of

both the foreign exchange and stock markets it may be difficult to determine which purpose is primary.

C. Recommendation. The Committee believes that the Final Regulations should be amended to ensure that there is integration under Section 988 only if there is a 988 transaction that is part of a 988 hedging transaction. This would be accomplished most effectively by adding requirements to the definition of "integrated economic transaction" rather than by amending the definition of either "qualifying debt instrument" or "§ 1.988-5(a) hedge". Thus, in addition to the present requirements for an integrated economic transaction there would also be requirements that there be (i) a 988 transaction (not necessarily a nonfunctional currency debt instrument) and (ii) a transaction entered into primarily to reduce the risk of currency fluctuation (not necessarily the hedge).<sup>40</sup>

### III. Treasury Regulation Section 1.988-5 As Applied to Consolidated Group Hedging

In the preamble to the Final Regulations, the Service has stated that it is considering whether to permit the rules of Treas. Reg. Sec. 1.988-5 to be applied by treating consolidated group members as a single corporation. Adoption of such a consolidated group rule would be a very useful step in helping to conform the tax law to common business practice.

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<sup>40</sup> It should be made clear that the synthetic debt instrument itself could be a 988 hedging transaction that satisfies the requirements of Section 988(d). For example, suppose an issuer with the U.S. dollar as its functional currency issues a British pound denominated FTSE-linked bond and hedges it into a pound denominated noncontingent debt instrument for the purpose of hedging noncontingent pound denominated assets. The synthetic pound denominated debt instrument, not the FTSE hedge, is the 988 hedging transaction. The FTSE hedge could not be the 988 hedging transaction because it merely eliminates the FTSE risk and does nothing to reduce the risk of currency fluctuations.

Consolidated group hedging, commonly referred to as "split hedging", is used by affiliated corporations for nontax reasons: to reduce costs and administrative inefficiencies on a consolidated group basis by locating the purchasing, selling, and processing activities related to hedging foreign currency exposure in an affiliate better able to manage the activity through allocated personnel or business acumen. For example, a dealer in foreign currency that is a member of a consolidated group that enters into transactions to hedge the foreign currency exposure of an affiliated financing company that issues debt to fund the operations of the group, or to hedge the foreign currency exposure of an operating company that is a dealer of foreign currency denominated debt, will be in a better position to obtain the best market price for the hedge, and to process administratively the purchases and sales.

The simplest case for allowing positions held by different members of a consolidated group to be integrated is where the benefits and burdens of the hedge would economically be borne by the taxpayer issuing or holding, for example, a qualifying debt instrument. In such a case, that taxpayer would control the decision to hedge and to leg out and would reap the economic benefits or detriments of the hedge. The entity entering into the hedge is, in effect, acting as an agent for the taxpayer.

The Committee also believes that consolidated group integration is appropriate where the borrower and hedging entity each bear the economic benefits and burdens of their respective positions, as long as the taxpayer whose tax consequences would be impacted (or an entity which controls such taxpayer) controls the decision to put on the hedge and to leg out. In such a circumstance, correlative adjustments will need to be made to the

tax basis and earnings and profits of the companies involved to reflect the fact that the positions are in fact held by different taxpayers.