

**NEW YORK STATE BAR ASSOCIATION
TAX SECTION**

REPORT ON PROPOSED REGULATIONS SECTION 1.988-6

FEBRUARY 19, 2004

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Introduction

This report comments on the proposed regulations under Treasury Regulations Section 1.988-6 that were issued on August 28, 2003 (the “Proposed Regulations”). The Proposed Regulations address the tax treatment of (i) debt instruments that provide for payments that are denominated in or determined by reference to the performance of a single foreign currency and that also include one or more non-currency contingencies, (ii) debt instruments that provide for payments that are denominated in or determined by reference to the performance of at least two currencies (“Multicurrency Debt Instruments”) and that do not include any non-currency contingencies and (iii) Multicurrency Debt Instruments that also include one or more non-currency contingencies (collectively, “Foreign Currency Contingent Debt Instruments”).²

We believe that the Proposed Regulations provide much needed guidance regarding the taxation of Foreign Currency Contingent Debt Instruments. We commend the Service and the Treasury for their efforts in this area and we endorse the basic approach of the Proposed Regulations. Specifically, we commend the Service and the Treasury for issuing detailed and specific rules regarding the complex interaction of the “comparable yield” accrual rules set forth in Treasury Regulations Section 1.1275-4 and the foreign currency accounting rules set forth in Treasury Regulations Section 1.988-2. However, as discussed more fully below, there are a number of changes and clarifications

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² For purposes of this report, the term “foreign currency” refers to a currency that is a nonfunctional currency with respect to the taxpayer.

to the Proposed Regulations that we believe should be included when the Proposed Regulations are finalized (the “Final Regulations”).

This report is divided into six parts. Part I contains a general summary of the recommendations set forth in this report. Part II contains a general summary of the rules in the Proposed Regulations. Part III contains our views regarding the general approach of the Proposed Regulations. Part IV contains three changes to the Proposed Regulations that we believe should be included in the Final Regulations. Part V contains certain clarifications and technical comments that we believe should be included in the Final Regulations. Finally, Part VI responds to specific requests for comments that were included in the preamble to the Proposed Regulations.

I. Summary of Recommendations

A. Recommended Changes to the Proposed Regulations

- We recommend that the Final Regulations include a provision under which the rules set forth in Treasury Regulations Section 1.1275-5 with respect to the taxation of “variable rate debt instruments” would generally apply to a Foreign Currency Contingent Debt Instrument if the Foreign Currency Contingent Debt Instrument is not a Multicurrency Debt Instrument and it otherwise satisfies all of the requirements necessary to qualify as a variable rate debt instrument.
- We recommend that the Final Regulations include an anti-abuse rule that would prevent a taxpayer from structuring a Multicurrency Debt Instrument and a related hedge in a manner so as to enable the taxpayer to inappropriately defer the inclusion of original issue discount (“OID”) with respect to the instrument.
- We recommend that the Final Regulations provide that a currency shall only be treated as the predominant currency of a Multicurrency Debt Instrument if the present value of the

payments that are denominated in, or determined by reference to such currency, exceeds 50% of the present value of all of the payments with respect to the Multicurrency Debt Instrument.

B. Clarifications and Technical Comments

- We recommend that the Final Regulations clarify that the exceptions in Treasury Regulations Section 1.1275-4(a)(2) (other than the exception for debt instruments that are subject to Section 988) shall also apply for purposes of determining whether a Foreign Currency Contingent Debt Instrument is subject to the Final Regulations.
- We recommend that the Final Regulations clarify that the Final Regulations shall not apply to a Foreign Currency Contingent Debt Instrument that is subject to the integration rules set forth in Treasury Regulations Section 1.988-5.
- We recommend that the Final Regulations clarify that for purposes of applying the alternative payment schedule rules of Treasury Regulations Section 1.1272-1(c) and the “fixed yield test” of Treasury Regulations Section 1.1272-1(d) to a Foreign Currency Contingent Debt Instrument, the yield of the instrument should be determined in the instrument’s functional currency and not in the functional currency of the taxpayer.
- We recommend that the Final Regulations clarify that the rules of Section 988 will not apply to a Multicurrency Debt Instrument if the predominant currency of the debt instrument is the functional currency of the taxpayer.
- We recommend that the Final Regulations clarify that Foreign Currency Contingent Debt Instruments that are subject to the

“comparable yield” accrual rules in the Final Regulations should be treated as if they were subject to Treasury Regulations Section 1.1275-4 for purposes of applying other regulatory provisions that reference Treasury Regulations Section 1.1275-4.

C. Responses to Requests for Comments

- We recommend that a “netting rule” be included in the Final Regulations notwithstanding that such a rule has the potential to eliminate the recognition of foreign currency gain or loss that otherwise would appropriately be recognized by the taxpayer.
- We recommend that the Final Regulations provide rules governing tax-exempt Foreign Currency Contingent Debt Instruments that would be consistent with the rules set forth in Treasury Regulations Section 1.1275-4(d)(3) regarding tax-exempt contingent debt instruments and the rules set forth in Treasury Regulations Section 1.988-3(c) regarding noncontingent tax-exempt foreign currency denominated debt instruments.
- We recommend that the Final Regulations provide that all gain or loss recognized on the sale of a Multicurrency Debt Instrument with no non-currency contingencies should be treated as foreign currency gain or loss.

II. The Proposed Regulations

The Proposed Regulations address four different types of Foreign Currency Contingent Debt Instruments: (a) Foreign Currency Contingent Debt Instruments that are issued for money or publicly-traded property and that have one or more non-currency contingencies and that are not Multicurrency Debt Instruments, (b) Multicurrency Debt Instruments that have no non-currency contingencies, (c) Multicurrency Debt Instruments that also have one or more non-currency contingencies, and (d) Foreign Currency Contingent Debt Instruments which otherwise would fall into

one of the three foregoing categories but for the fact that the instruments are not issued for money or publicly-traded property.³

In the case of the first three types of debt instruments (i.e., Foreign Currency Contingent Debt Instruments that are issued for money or publicly traded property), the Proposed Regulations generally apply the noncontingent bond method set forth in Treasury regulations Section 1.1275-4 in the currency in which the instrument is predominantly denominated. More specifically, a taxpayer would generally be required to (a) accrue interest in the debt instrument's denomination currency at a yield at which the issuer would issue a fixed rate debt instrument denominated in such currency with terms and conditions similar to those of the debt instrument, (b) account for gain or loss arising from contingencies in a manner consistent with the rules of Treasury Regulations Section 1.1275-4 and (c) translate the interest accrued from the denomination currency into the taxpayer's functional currency (and account for foreign currency gain or loss on payments of interest and principal) under the principles of Treasury Regulations Section 1.988-2(b).

In the case of a Multicurrency Debt Instrument, the Proposed Regulations provide that the issuer must first determine the instrument's predominant currency, which will be used as the instrument's denomination currency for purposes of applying the rules described above. The predominant currency of the instrument is determined on the issue date by comparing the present value in functional currency of the noncontingent and projected payments denominated in, or determined by reference to, each currency. After the denomination currency has been determined, all payments on the instrument that are denominated in, or determined by reference to, a currency other than the denomination currency are treated as non-currency related contingent payments for purposes of applying the rules of the Proposed Regulations. Thus, if the predominant currency of the

³ The rules in the Proposed Regulations are generally consistent with the rules that the IRS announced that it was considering with respect to foreign currency contingent debt instruments in Announcement 99-76 (1999-2 C.B. 233).

debt instrument is the functional currency of the taxpayer, the taxpayer will not be subject to the rules set forth in the Proposed Regulations but would rather account for the debt instrument under the rules set forth in Treasury Regulations Section 1.1275-4.

Finally, in the case of a Foreign Currency Contingent Debt Instrument that is issued for non-publicly traded property, the instrument is not accounted for under the rules described above but rather is accounted for in a manner that is similar to the rules set forth in Treasury regulations Section 1.1275-4(c) with respect to contingent debt instruments that are issued for non-publicly traded property. Specifically, the debt instrument is separated into its components based on the currency in which the payments are denominated and whether the payments are contingent or noncontingent. The noncontingent components in each currency are treated as a separate debt instrument denominated in the currency in which the payment (or payments) is denominated. A component consisting of a contingent payment is generally accounted for in the manner described in Treasury Regulations Section 1.1275-4(c)(4).

III. Interaction of Section 988 Rules and Contingent Debt Rules

Treasury Regulations Section 1.988-2 requires taxpayers to accrue interest on a foreign currency denominated note in the currency in which the note is denominated rather than requiring taxpayers to convert the note into an equivalent functional currency note based on the forward prices for the foreign currency payments on the note. In proposing rules governing Foreign Currency Contingent Debt Instruments, the IRS could have chosen one of two approaches. First, the IRS could have proposed that while the general rules in Treasury Regulations Section 1.988-2 may be appropriate for a straightforward noncontingent foreign currency note, it would be more appropriate to account for a Foreign Currency Contingent Debt Instrument by treating all foreign currency payments as contingent payments and then applying the general rules of Treasury Regulations Section 1.1275-4 to the note (in which case the taxpayer would be required to accrue interest based on the functional currency comparable yield for the note). Alternatively, the IRS could have proposed that it would be more appropriate to

account for a Foreign Currency Contingent Debt Instrument by applying the general rules of Treasury Regulations Section 1.988-2 while incorporating the “comparable yield” and “positive and negative adjustment” provisions of Treasury Regulations Section 1.1275-4 in the currency in which the debt instrument is denominated. As noted above, the Proposed Regulations adopt the latter approach. We think that, on balance, this is the correct approach, particularly in light of the general Section 988 statutory and regulatory framework under which notes that are denominated in a foreign currency (or notes that have payments that are determined by reference to a foreign currency) are generally subject to the rules of Section 988. However, as discussed below under Section IV, the interaction of the Section 988 rules and the general rules governing contingent debt instruments may in certain cases lead to certain anomalies which could enable taxpayers to inappropriately engage in certain abusive transactions. We therefore think that although we agree with the general approach of the Proposed Regulations, the Final Regulations should include the additional rules described in Section IV below in order to prevent taxpayers from exploiting the interaction between the general rules governing contingent debt instruments and the Section 988 rules in order to achieve an inappropriate tax result.

IV. Recommended Changes to the Proposed Regulations

A. Variable Rate Debt Instruments

Although it is not entirely clear, it is likely that under the Proposed Regulations a foreign currency denominated debt instrument that provides for floating rate interest payments (e.g., LIBOR) would be subject to the “comparable yield” accrual rules set forth in the Proposed Regulations. The instrument would likely be subject to these rules because under current law a foreign currency denominated debt instrument is unlikely to qualify as a “variable rate debt instrument” (“VRDI”) under Treasury Regulations Section 1.1275-5.⁴ While we agree that the “comparable yield” accrual rules

⁴ Although there is no rule that specifically provides that a foreign currency denominated debt instrument cannot qualify as a VRDI, that appears to be the

set forth in the Proposed Regulations should generally apply to Foreign Currency Contingent Debt Instruments notwithstanding their formidable complexity, we do not think that is appropriate to apply such rules to debt instruments that could be more appropriately accounted for under the general rules governing noncontingent foreign currency denominated debt instruments. We therefore recommend that the Final Regulations include a provision under which the rules set forth in Treasury Regulations Section 1.1275-5 with respect to the taxation of VRDIs would apply to a Foreign Currency Contingent Debt Instrument if (a) the Foreign Currency Contingent Debt Instrument otherwise satisfies all of the rules in Treasury Regulations Section 1.1275-5 regarding the requirements necessary to qualify as a VRDI and (b) the Foreign Currency Contingent Debt Instrument is not a Multicurrency Debt Instrument. The amount of gain or loss recognized with respect to a Foreign Currency Contingent Debt Instrument that is subject to the VRDI rules would then be adjusted to take into account foreign currency gain or loss recognized with respect to the instrument under the rules set forth in Treasury Regulations Section 1.988-2.

We believe that such a rule would enable taxpayers to appropriately avoid the complexity of the “comparable yield” accrual rules in the case of straightforward

result of the interaction of Treasury Regulations Section 1.988-2(b)(2)(i)(B)(2) and Treasury Regulations Section 1.1275-5(a)(5). More specifically, Treasury Regulations Section 1.1275-5(a)(5) provides that a debt instrument will generally not qualify as a VRDI if the debt instrument has any contingent principal payments. Treasury Regulations Section 1.988-2(b)(2)(i)(B)(2) provides that a foreign currency debt instrument will not be treated as a contingent payment debt instrument for purposes of Section 1275 (notwithstanding that the US dollar value of the foreign currency payments are contingent) as long as (a) all payments on the debt instrument are denominated in, or determined by reference to, a single foreign currency and (b) the debt instrument does not provide for any non-currency contingencies. The implication of this rule is that foreign currency payments on a debt instrument that provides for non-currency contingencies should be treated as contingent for purposes of Section 1275. Accordingly, if this implication is correct, a foreign currency debt instrument that provides for floating rate payments would not qualify as a VRDI.

floating rate debt instruments that do not create opportunities for abuse. Moreover, such a rule would be consistent with the rules governing non-foreign currency contingent debt instruments which are not subject to the “comparable yield” accrual rules if they qualify as VRDIs under Treasury Regulations Section 1.1275-5.

B. Multicurrency Debt Instruments with Related Hedges

As described above, in the case of a Multicurrency Debt Instrument, the Proposed Regulations provide that the issuer must first determine the instrument’s predominant currency, which will be used as the instrument’s denomination currency for purposes of applying the accrual rules set forth in the Proposed Regulations. After the denomination currency has been determined, all payments on the instrument that are denominated in, or determined by reference to, a currency other than the denomination currency are treated as non-currency related contingent payments for purposes of applying the rules of the Proposed Regulations.

While we generally agree with this approach, we believe that an anti-abuse rule should be included in the Final Regulations to address certain transactions that would inappropriately enable a taxpayer to defer the inclusion of OID with respect to certain Multicurrency Debt Instruments. The need for such a rule can best be illustrated by the following example.

Suppose an investor would like to purchase a 30-year US dollar denominated note issued by a specific issuer that would (a) be issued for \$100, (b) provide for a \$150 payment of maturity and (c) provide for annual interest payments of \$5 per annum. Assume that (a) the comparable yield for a Euro denominated instrument issued by the issuer is 4%, (b) the Euro/US dollar exchange rate at the time of the issuance of the note is 1:1 and (c) the forward price for \$150 upon the maturity of the note is 100 Euro. In order to enable the holder to avoid the accrual of \$50 of OID over the term of the note, the taxpayer and the issuer could alternatively structure the note in the same manner as described above except that the note would provide for annual

interest payments of 4 Euro per annum instead of \$5 per annum.⁵ Furthermore, the taxpayer could then enter into a swap with an unrelated third party pursuant to which the taxpayer would hedge out most, but not all, of its Euro risk under the note.⁶

The predominant currency of the note in this example would be Euro. Accordingly, under the rules set forth in Proposed Treasury Regulations Section 1.988-6(d), the taxpayer would be required to account for the note in the same manner that it would account for a Euro denominated debt instrument that provides for a non-currency contingent payment upon the maturity of the note. Because the comparable yield for a Euro denominated instrument issued by the issuer is 4%, the projected payment at maturity would be 100 Euro. Accordingly, the taxpayer would not be required to accrue any OID under the note even though the taxpayer (a) paid \$100 for a note that has a principal amount of \$150 and (b) hedged out most of its Euro risk under the note.⁷

⁵ This assumes that the present value of a series of 4 Euro per annum payments over 30 years is the same as the present value of a series of \$5 per annum payments over 30 years. Although the US dollar/Euro exchange rate upon the issuance of the note is 1:1, the present value of the future payments in each currency will differ in the example because the forward price for US dollars in the example differs from the forward price for an equivalent amount of Euros.

⁶ The taxpayer would not hedge out all of its Euro risk under the note because the Commissioner could then force the taxpayer to integrate the note and the swap under Treasury Regulations Section 1.988-5, in which the case the integrated instrument would be a US dollar denominated note. See Treasury Regulations Section 1.988-5(a)(5).

⁷ Furthermore, we note that a non-US person that holds a note with respect to which it is not eligible for the portfolio interest exception could also structure a Foreign Currency Contingent Debt Instrument and a related hedge (under facts that are different than in the example set forth above) in order to convert interest income that would be subject to withholding into foreign currency income that would not be subject to withholding.

Moreover, the Service would not be permitted to force the taxpayer to integrate the note and its position under the swap.⁸

We note that a similar abuse could potentially be achieved under current law by a taxpayer that purchases a noncontingent foreign currency note and that enters into a related hedge that is not subject to the integration rules of Treasury Regulations Section 1.988-5. This could be illustrated by an example that assumes the same facts as the example in the second preceding paragraph except that (a) the note has a principal amount of 100 Euro and is issued for 100 Euro (and thus is not a Multicurrency Debt Instrument) and (b) the swap also provides that the holder will pay 100 Euro to the counterparty, and the counterparty will pay \$150 to the holder, upon the maturity of the note. The swap would be an on-market swap because the forward price as of the issue date of the note for a 100 Euro payment upon the maturity of the note is \$150. Thus, the taxpayer would effectively be able to defer OID on an investment that, after taking into account the swap, is effectively the same as US dollar denominated note that is issued with \$50 of OID.

We think that most appropriate way to address the potentially abusive transactions described above would be for the Final Regulations to clarify that the OID anti-abuse rule set forth in Treasury Regulations Section 1.1275-2(g) also applies to debt instruments described in Treasury Regulations Section 1.988-2 and Treasury Regulations Section 1.988-6. More specifically, Treasury Regulations Section 1.1275-2(g) provides that “if a principal purpose in structuring a debt instrument or engaging in a transaction is to achieve a result that is unreasonable in light of the purposes of section 163(e), sections 1271 through 1275, or any related section of the Code, the Commissioner can apply or depart from the regulations under the applicable sections as necessary or appropriate to achieve a reasonable result.” It is not entirely clear whether Section 988 should be

⁸ See note 6 above as to why the Commissioner could not force the taxpayer to integrate the note and its position under the swap.

treated as a “related section of the Code” for this purpose. We therefore recommend that the Final Regulations either (a) include an anti-abuse rule that has the same effect as the OID anti-abuse rule and that would specifically apply to debt instruments that are subject to Section 988 or (b) clarify that Section 988 is treated as a “related section of the Code” for purposes of the OID anti-abuse rule.⁹

If our recommendation in the prior paragraph is accepted, the IRS would be able to challenge the abusive transactions described above in the same way that it challenged a similar abusive transaction that is described in Rev. Rul. 2000-12, 2000-1 C.B. 744. More specifically, Rev. Rul. 2000-12 addressed a case in which a taxpayer purchased two debt instruments that were expected to vary inversely in value and the taxpayer then sold one of the debt instruments at a loss. The debt instruments were structured in a manner such that they technically did not satisfy the requirements for integration under Treasury Regulations Section 1.1275-6. The IRS ruled that the Commissioner could use the OID anti-abuse rule to force the taxpayer to integrate the two instruments notwithstanding the fact that they technically did not satisfy the regulatory requirements for integration. We therefore think that our recommendation described above would enable the IRS to similarly force the taxpayer in the two examples described above to integrate the swap with the debt instrument under Treasury Regulations Section 1.988-5 or to otherwise account for the debt instrument and the swap in a more reasonable manner.

⁹ We note that Treasury Regulations Section 1.988-2(f) provides for an anti-abuse rule that governs Section 988 transactions. The Section 988 anti-abuse rule, however, is drafted quite narrowly and is limited to Section 988 transactions in which the substance of the transaction differs from its form. It is therefore unlikely that this rule could be used to challenge the tax treatment of the two examples described above.

C. Multicurrency Debt Instruments – Determination of Predominant Currency

As discussed above, in the case of a Multicurrency Debt Instrument, the Proposed Regulations provide that the issuer must first determine the instrument's predominant currency, which will be used as the instrument's denomination currency for purposes of applying the general rules governing Foreign Currency Contingent Debt Instruments . The predominant currency of the instrument is determined on the issue date by comparing the present value in functional currency of the noncontingent and projected payments denominated in, or determined by reference to, each currency. After the denomination currency has been determined, all payments on the instrument that are denominated in, or determined by reference to, a currency other than the denomination currency are treated as non-currency related contingent payments for purposes of applying the rules of the Proposed Regulations. Thus, if the predominant currency of the debt instrument is the functional currency of the taxpayer, the taxpayer will not be subject to the rules set forth in the Proposed Regulations but would rather account for the debt instrument under the rules set forth in Treasury Regulations Section 1.1275-4.

Under these rules, a currency can be the predominant currency of a Multicurrency Debt Instrument even if the payments that are denominated in or determined by reference to such currency represent a small percentage of the total payments with respect to the instrument. As illustrated by the following two examples, this rule would enable taxpayers to inappropriately (i) defer OID with respect to certain Multicurrency Debt Instruments and (ii) convert U.S. source foreign currency income into foreign source interest income with respect to certain Multicurrency Debt Instruments.

The ability to inappropriately defer OID with respect to certain Multicurrency Debt Instruments can be illustrated by an example in which a taxpayer purchases a ten-year note that pays no interest and that has a principal payment 89% of which is equally linked to ten inflationary (but not hyperinflationary) currencies and 11% of which is linked to a currency that has a comparable yield of 1% (the "11% Currency").

Under the Proposed Regulations, the 11% Currency would be the predominant currency of the note and the taxpayer would accrue income at a yield of 1% per annum over the term of the note even though (i) the taxpayer obviously expects to receive a principal payment at maturity that substantially exceeds its initial investment and (ii) the 11% Currency only represents a small portion of the total return with respect to the note.

The ability to inappropriately convert U.S. source foreign currency income into foreign source interest income with respect to certain Multicurrency Debt Instruments can be illustrated by an example that has the same facts as in the example in the preceding paragraph except that the 11% Currency is US dollars (which is the functional currency of the holder of the note) and the issuer of the note is a non-U.S. corporation. Under the Proposed Regulations, the predominant currency of the note would be US dollars and thus the taxpayer would not be subject to Section 988 with respect to the note even though 89% of its return with respect to the note is denominated in or determined by reference to nonfunctional currencies. Consequently, the taxpayer could potentially convert income that would otherwise be U.S. source foreign currency gain (if the note was subject to Section 988) into foreign source interest income, which is likely to improve the taxpayer's foreign tax credit limitation position.

In order to avoid the potential abuses described above, we recommend that the Final Regulations provide that a currency shall only be treated as the predominant currency of a Multicurrency Debt Instrument if the present value of the payments that are denominated in, or determined by reference to such currency, exceeds 50% of the present value of all of the payments with respect to the Multicurrency Debt Instrument. If the debt instrument has no such currency (as in the examples in the prior two paragraphs), then the comparable yield for the instrument would be equal to the weighted average (i.e., after taking into account the present value of the payments that are denominated in, or determined by reference to, each currency) of the comparable yield of all the currencies in which the instrument is denominated. The debt instrument would then be treated as having a notional denomination currency with such comparable yield for purposes of applying the general rules governing Foreign Currency Contingent Debt Instruments.

While this may seem overly complex, we think that this will not be overly burdensome to taxpayers because (i) the issuer will have to determine the appropriate comparable yield and send the information to holders, (ii) it is probably extremely rare that any such instruments are issued and (iii) if such notes are issued, they probably are only purchased by very sophisticated investors who can handle the complexity. In any case, we cannot think of a simpler approach that would effectively prevent taxpayers from engaging in the abusive transactions described above.

V. Clarifications and Technical Comments

A. Exceptions to the Final Regulations

Section 1.988-6(a) of the Proposed Regulations provides that the rules in Treasury Regulation Section 1.1275-4 (subject to the modifications set forth in the Proposed Regulations) shall apply to Foreign Currency Contingent Debt Instruments that are described in Treasury Regulations Section 1.1275-4(b)(1). The Proposed Regulations do not, however, specifically incorporate the exceptions to Treasury Regulations Section 1.1275-4(b)(1) that are set forth in Treasury Regulations Section 1.1275-4(a)(2) (e.g., short-term notes, notes with a fixed yield, notes subject to the alternative payments schedule rules, notes with remote contingencies, convertible notes, etc.).¹⁰ We do not think that it is appropriate for the Proposed Regulations to apply (nor do we think that the drafters of the Proposed Regulations intended for them to apply) to contingent debt instruments that would not have been subject to Treasury Regulations Section 1.1275-4 had they not been subject to Section 988. We therefore recommend that the Final Regulations clarify that the exceptions in Treasury Regulations Section 1.1275-4(a)(2) (other than the exception for debt instruments that are subject to Section 988) shall also

¹⁰ It may be possible to interpret the reference in the Proposed Regulations to debt instruments that are described in Treasury Regulations Section 1.1275-4(b) as indirectly incorporating the exceptions set forth in Treasury Regulations Section 1.1275-4(a)(2). We think, however, that even if that was the intent of the Proposed Regulations, the language is somewhat ambiguous and thus should be clarified in the Final Regulations.

apply for purposes of determining whether a Foreign Currency Contingent Debt Instrument is subject to the Final Regulations.¹¹

B. Integrated Debt Instruments

Treasury Regulations Section 1.988-5 provides that a foreign currency debt instrument may be integrated with certain foreign currency hedges in order to produce a synthetic debt instrument that is required to be accounted for on a separate basis. Similarly, Treasury Regulations Section 1.1275-6 provides that a contingent payment debt instrument that would otherwise be subject to the special rules governing contingent payment debt instruments may be integrated with certain hedges in order to produce a noncontingent synthetic debt instrument that is required to be accounted for on a separate basis. We recommend that the Final Regulations clarify that the Final Regulations shall not apply to a Foreign Currency Contingent Debt Instrument that is subject to the integration rules set forth in Treasury Regulations Section 1.988-5. This rule would be consistent with the rule in Treasury Regulations Section 1.1275-4(a)(1) which clarifies that the contingent debt rules set forth in Treasury Regulations Section

¹¹ As discussed above, we think that the exception from the contingent debt rules for short-term notes should also apply to Foreign Currency Contingent Debt Instruments. We are concerned, however, that the absence of rules regarding contingent short-term notes may be enabling issuers and holders to “whipsaw” the Internal Revenue Service by taking inconsistent positions with respect to such notes. More specifically, we are concerned that holders of contingent short-term notes may be taking a “wait and see” approach with respect to such notes (both for purposes of the rules governing accruals of interest and the rules governing deferral of interest deductions) while issuers may be accruing deductions with respect to such notes based on a “reasonable basis” approach (such as deducting the contingent payment that would be payable if the note hypothetically matured at the end of the issuer’s taxable year). We therefore recommend that the Internal Revenue Service provide guidance regarding the taxation of contingent short-term notes (which would also apply with respect to Foreign Currency Contingent Debt Instruments) in order to eliminate the potential “whipsaw” effect illustrated above.

1.1275-4 do not apply to a debt instrument that is subject to the integration rules set forth in Treasury Regulations Section 1.1275-6.

C. **Fixed Yield and Alternative Payment Schedule Rules**

One of the exceptions in Treasury Regulations Section 1.1275-4(a)(2) is for debt instruments that provide for a fixed yield under Treasury Regulations Section 1.1272-1(d). Under this rule, a debt instrument that provides for contingent payments would not be subject to the special rules governing contingent debt obligations as long as the debt instrument would have the same yield irrespective of the outcome of the contingencies. As discussed above, we believe that this exception should also apply for purposes of determining whether a Foreign Currency Contingent Debt Instrument should be subject to the Final Regulations. We recommend, however, that the Final Regulations clarify that for purposes of applying the fixed yield test to a Foreign Currency Contingent Debt Instrument, the yield of the instrument should be determined in the instrument's functional currency and not in the functional currency of the taxpayer.

The application of this rule may be illustrated by the following example. Assume that (a) an issuer issues a note with a principal amount of 100 Euro that pays a fixed rate of interest and (b) the issuer has the right under certain circumstances to defer the interest payments on the note except that any such deferred interest payments will accrue interest at the stated interest rate for the note.¹² If the fixed yield rule is applied in the currency in which the note is denominated, then the note would be treated as having a fixed yield and thus would not be subject to the special rules governing contingent debt instruments. If, however, the fixed yield rule is applied in the functional currency of the taxpayer (assuming the functional currency of the taxpayer is US dollars), then the debt instrument would not have a fixed yield (because the yield would change depending on

¹² This is a typical term in the case of subordinated debt issued in a trust preferred securities transaction.

the US dollar/Euro exchange rate in effect at the time of the interest payment) and thus would be subject to the special rules governing contingent debt instruments.

For the following reasons, we think that the fixed yield determination should be made in the functional currency in which the note is denominated. First, such a rule would be consistent with the general rule under Treasury Regulations Section 1.988-2 that requires a taxpayer to account for a nonfunctional currency debt instrument in the currency in which the debt instrument is denominated. Second, an alternative result would mean that investors with different functional currencies would have a different amount of original issue discount with respect to their notes. Consequently, the notes issued to taxpayers with different nonfunctional currencies would be non-fungible with each other.

Similarly, one of the exceptions in Treasury Regulations Section 1.1275-4(a) is for debt instruments that provide for alternative payment schedules (such as a put or call option) under Treasury Regulations Section 1.1272-1(c). Under this rule, a debt instrument that provides for alternative payment schedules will generally not be subject to the special rules governing contingent debt obligations as long as there is one payment schedule that is more likely than not to occur. In the case of a call option, an issuer of a debt instrument is presumed to exercise or not exercise the option in a manner that would minimize the overall yield with respect to the debt instrument. Conversely, in the case of a put option, a holder is presumed to exercise or not exercise the option in a manner that would maximize its yield with respect to the debt instrument.

As discussed above, we believe that this exception should also apply for purposes of determining whether a Foreign Currency Contingent Debt Instrument should be subject to the Final Regulations. We recommend, however, that the Final Regulations clarify that for purposes of applying the alternative payment schedule rules to a Foreign Currency Contingent Debt Instrument, the yield of the instrument should be determined in the instrument's functional currency and not in the functional currency of the taxpayer.

The application of this rule may be illustrated by the following example. Assume that (a) an issuer issues a fixed rate ten-year note with a principal amount of 100 Euro, (b) the holder of the note has the right to put the note to the issuer for 102 Euro after five years and (c) based on the current US dollar/Euro forward prices, the holder would maximize its US dollar yield with respect to the note if it elects to hold the note until its maturity. If the alternative payment schedule rules are applied in Euro, Treasury Regulations 1.1272-1(c)(5) would presume that the holder would exercise its put right (because doing so would maximize its yield) and thus the note would be treated as issued with original issue discount of two Euro. By contrast, if the alternative payment schedule rules are applied in the functional currency of the taxpayer (assuming the functional currency of the taxpayer is US dollars), Treasury Regulations 1.1272-1(c)(5) would presume that the holder of the note would not exercise its put right (in which case the note would be treated as issued without original issue discount). We believe that the alternative payment schedule rule should be applied in the functional currency in which the debt instrument is denominated because, as described in the second preceding paragraph, that would be consistent with the approach set forth in Treasury Regulations 1.988-2 and it would enable debt instruments that are issued with alternative payment schedules to have the same amount of original issue discount and thus be fully fungible with each other.

D. Multicurrency Debt Instruments

As described above, the Proposed Regulations provide that if the predominant currency of a Multicurrency Debt Instrument is the functional currency of the taxpayer, the taxpayer will not be subject to the rules set forth in the Proposed Regulations but would rather be subject to the rules set forth in Treasury Regulations Section 1.1275-4. Announcement 99-76 also included the same rule but with additional language that explicitly provided that such a debt instrument would not be subject to Section 988. We think that the Proposed Regulations effectively includes the same rule because Treasury Regulations Section 1.1275-4(b) provides for specific rules that govern the accruals of interest, source and character with respect to debt instruments that are

subject to the regulation. We are concerned, however, that the aforementioned difference in language between Announcement 99-76 and the Proposed Regulations may lead to some confusion as to whether the source and character rules of Section 988 should apply to a Multicurrency Debt Instrument that under the Proposed Regulations is subject to Treasury Regulations Section 1.1275-4. We therefore recommend that the Final Regulations clarify that the rules of Section 988 will not apply to a Multicurrency Debt Instrument if the predominant currency of the debt instrument is the functional currency of the taxpayer (subject to the recommended anti-abuse rule described above).

E. Other Regulatory Provisions

The Final Regulations should clarify that Foreign Currency Contingent Debt Instruments that are subject to the “comparable yield” accrual rules in the Final Regulations should be treated as if they were subject to Treasury Regulations Section 1.1275-4 for purposes of applying other regulatory provisions that reference Treasury Regulations Section 1.1275-4. It would be helpful if the preamble to the Final Regulations provided some examples illustrating the application of this rule. Thus, for example, the preamble to the Final Regulations could provide that under this rule (a) a reopening of a Foreign Currency Contingent Debt Instrument will generally not be treated as a “qualified reopening” under Treasury Regulations Section 1.1275-2(k)¹³ and (b) a Foreign Currency Contingent Debt Instrument will generally be subject to the information reporting rules set forth in Treasury Regulations Section 1.1275-3 with respect to contingent payment debt obligations. Furthermore, we also recommend that the preamble to the Final Regulations clarify that the purchase of a Foreign Currency Contingent Debt Instrument will not be treated as a “reportable transaction” for purposes of Treasury Regulations Section 1.6011-4 solely as a result of a “book-tax difference”

¹³ This would be consistent with the rule in Treasury Regulations Section 1.1275-2(k)(3)(iv) that provides that the “qualified reopening” rules do not apply to reopenings of contingent debt instruments that are subject to Treasury Regulations Section 1.1275-4.

arising from the use of the “comparable yield” method of accounting with respect to the debt instrument.¹⁴

VI. Responses to Requests for Comments

A. Application of Netting Rule

The Proposed Regulations do not provide for the netting of market gain or loss with currency gain or loss upon the disposition of a Foreign Currency Contingent Debt Instrument. Thus, under the Proposed Regulations, a holder could dispose of a Foreign Currency Contingent Debt Instrument and simultaneously recognize foreign currency income and a capital loss (to the extent that such loss exceeds the taxpayer’s prior interest inclusions with respect to the instrument).¹⁵ The preamble to the Proposed Regulations requests comments as to whether a “netting rule” should be incorporated in the Final Regulations.

As noted in the preamble, different character and source rules generally apply to market gain or loss and currency gain or loss, and netting such items may under certain circumstances create distortions and/or produce results that are inconsistent with the tax treatment of other types of instruments. On the other hand, where market gain or loss and currency gain or loss offset each other, requiring separate recognition of such gain and loss may not accurately reflect the economic benefits and burdens associated with the instrument.

For the following reasons we think that a “netting rule” should be included in the Final Regulations notwithstanding that such a rule has the potential to eliminate the

¹⁴ This would be consistent with Rev. Proc. 2003-25 which provides that book-tax differences arising from the use of the “comparable yield” method of accounting for tax purposes will not cause a transaction to be treated as reportable transaction for tax purposes.

¹⁵ This possibility is illustrated by Examples 2 and 4 in Proposed Regulations Section 1.988-6(c).

recognition of foreign currency gain or loss that otherwise would appropriately be recognized by the taxpayer. First, we think that a “netting rule” would substantially simplify the complex rules regarding the computation of foreign currency gain or loss upon the disposition of a Foreign Currency Contingent Debt Instrument. Second, Treasury Regulations Section 1.988-2(b)(8) specifically includes a “netting rule” with respect to debt instruments that are not subject to the special rules governing Foreign Currency Contingent Debt Instruments. We do not think that it would be appropriate to apply the “netting rule” in the case of noncontingent foreign currency denominated debt instruments and to not apply a similar rule in the case of a Foreign Currency Contingent Debt Instrument (nor can we think of a policy reason to differentiate between the two cases). Finally, we note that the application of the “netting rule” to a Foreign Currency Contingent Debt Instrument is unlikely to be subject to abuse because gain or loss recognized upon the disposition of a Foreign Currency Contingent Debt Instrument will generally be ordinary in any case (except in the case of losses that exceed prior interest inclusions).

B. Tax-Exempt Foreign Currency Contingent Debt Instruments

The Proposed Regulations do not address the treatment of contingent tax-exempt obligations the payments on which are denominated in or determined by reference to one or more nonfunctional currencies. The preamble to the Proposed Regulations requests comments as to the proper treatment of such instruments.

Treasury Regulations Section 1.1275-4(d)(3) provides for rules governing contingent tax-exempt obligations (other than obligations with “interest based” or “revenue based” payments for which special rules are provided). Under the regulations, the comparable yield for a contingent tax-exempt obligation is the greater of the obligation’s yield (determined without regard to the contingent payments) and the tax-exempt applicable federal rate that applies to the obligation. The regulations further provide that although positive and negative adjustments are generally treated as adjustments to interest income, positive and negative adjustments with respect to

contingent tax-exempt obligations are treated as gain or loss from the sale of the debt instrument and thus such adjustments are not treated as tax-exempt income (or as a reduction in tax-exempt income).

Treasury Regulations Section 1.988-3(c) provides that although foreign currency gain recognized by a taxpayer with respect to a tax-exempt obligation is not treated as interest income (and thus is taxable), any foreign currency loss recognized by a taxpayer with respect to such an instrument shall be treated as an offset to, and shall therefore reduce, the total interest income received or accrued with respect to the instrument. Thus, a taxpayer that holds a noncontingent foreign currency tax-exempt instrument is effectively “whipsawed” in that any gain it recognizes on the sale of the instrument is taxable while any loss that it recognizes on the sale of the instrument reduces the tax-exempt income that it otherwise would recognize with respect to the instrument.

We think that the rules in the Final Regulations governing tax-exempt Foreign Currency Contingent Debt Instruments should to the extent possible be consistent with the rules set forth in Treasury Regulations Section 1.1275-4(d)(3) and Treasury Regulations Section 1.988-3(c). We therefore recommend that the Final Regulations include the following three rules with respect to tax-exempt obligations. First, the Final Regulations should provide that the comparable yield for a tax-exempt Foreign Currency Contingent Debt Instrument shall be equal to the greater of the obligation’s yield (determined without regard to the contingent payments) and the tax-exempt applicable federal rate that applies to the obligation. Second, the Final Regulation should provide that positive and negative adjustments with respect to a tax-exempt Foreign Currency Contingent Debt Instrument that are normally treated as adjustments to interest should be treated as gain or loss from the sale of the instrument and thus should not be treated as an adjustment to the tax-exempt income recognized with respect to the instrument. Third, the Final Regulations should provide that foreign currency gain recognized with respect to a tax-exempt Foreign Currency Contingent Debt Instrument shall not be treated as additional tax-exempt interest income and that foreign

currency loss recognized with respect to such an instrument shall reduce the tax-exempt interest income recognized by the taxpayer with respect to the instrument. Although we think that the rule in the preceding sentence is unfair to taxpayers in light of the “whipsaw” effect described above, we think that in the absence of a change to the rule in Treasury Regulations Section 1.988-3(c), the rules regarding foreign currency gain or loss in Treasury Regulations Section 1.988-6 should be consistent with the rules governing noncontingent debt instruments that are set forth in Treasury Regulations Section 1.988-3(c).

C. Multicurrency Debt Instruments with no Non-Currency Contingencies

The preamble to the Proposed Regulations requests comments regarding whether all gain or loss recognized upon a sale of a Multicurrency Debt Instrument with no non-currency contingencies should be treated as foreign currency gain or loss. We assume that the only other alternative contemplated by the preamble would be to isolate the portion of the gain or loss that is attributable to changes in the value of nonfunctional currencies and then treat the remainder of the gain or loss as interest income or as a reduction of interest income (or as capital loss to the extent in excess of prior interest inclusions).¹⁶ While we acknowledge that the latter approach represents the more technically and conceptually accurate approach, we think that such an approach would be unnecessarily burdensome for taxpayers and would as a practical matter be difficult to administer. Although taxpayers are generally required to separately compute foreign currency gain or loss upon the sale of a noncontingent foreign currency denominated debt instrument, it is generally easy to compute such amount by reference to changes in exchange rates during the taxpayer’s holding period for the debt instrument. By contrast, in the case of a Multicurrency Debt Instrument (which often incorporates a number of

¹⁶ We do not think that the alternative contemplated by the preamble is to treat gain or loss in excess of currency gain or loss as capital gain or loss because that would be inconsistent with the principles of the Proposed Regulations and Treasury Regulations Section 1.1275-4.

foreign currency derivative positions within a single debt instrument), we think that it would often be difficult, if not impossible, to isolate the portion of the gain or loss that is recognized upon the sale of the instrument that is attributable to changes in exchange rates. Furthermore, the treatment of all such gain or loss as foreign currency gain or loss (as opposed to interest income or a reduction in interest income) will generally have little consequence as the character of the income and loss will generally be the same in either case (although the source could differ in certain circumstances).

Finally, we note that the Proposed Regulations provides that a holder of a Multicurrency Debt Instrument is not subject to the Section 988 rules if the predominant currency of the instrument is the functional currency of the holder. We think that this rule appropriately sacrifices a small measure of technical and conceptual accuracy (which would have required the holder to recognize foreign currency gain or loss with respect to the nonfunctional currency component of the instrument) for the sake of simplicity. We therefore think that the Final Regulations should similarly sacrifice a modicum of technical and conceptual accuracy in favor of simplicity by providing that all gain or loss recognized on the sale of a Multicurrency Debt Instrument should be treated as foreign currency gain or loss.