Part I

Section 1275.–-Other definitions and special rules

26 CFR 1.1275-2: Special rules relating to debt instruments.
(Also §§ 165; 1.165-1, 1.1275-6.)

Rev. Rul. 2000-12

ISSUE

Under the circumstances described below, if a taxpayer acquires two debt instruments that are structured so that it is expected that the value of one will increase significantly at the same time that the value of the other one decreases significantly, can the taxpayer recognize a current loss on the sale of the debt instrument that decreases in value while not recognizing the gain on the other debt instrument?

FACTS

Situation 1

X is a corporation that files returns on a calendar-year basis. On September 1, 1993, X purchases two privately-placed debt instruments, Note 1 and Note 2, from unrelated issuers for $1,000,000 each.

Note 1 has a 10-year term and a stated principal amount of $1,000,000. It provides for quarterly interest payments, beginning on December 1, 1993. The interest rate for the first quarter is 5.9 percent, compounded quarterly. Note 1 provides for contingent payments based on an event that will occur (or not occur) with a probability of 50 percent on December 1, 1993 (the reset event). The reset event does not

depend on actively traded personal property. If the reset event occurs, the interest rate doubles to 11.8 percent, compounded quarterly. If the reset event does not occur, the interest rate is reset at zero.

Note 2 has the same terms as Note 1 except that the consequences of the contingency are reversed. Thus, if the reset event occurs, the interest rate is reset at zero. If the reset event does not occur, the interest rate doubles to 11.8 percent, compounded quarterly.

At the time the notes are purchased, based upon the structure of the notes, it can be expected that, as a result of the reset, one note will increase significantly in value and the other note will decrease in value by the same amount. The expected tax loss on the note that decreases in value significantly exceeds any reasonably expected economic loss on the two notes.

On December 1, 1993, the reset event does not occur. Thus, on that date, the interest rate on Note 1 is reset at zero, and the interest rate on Note 2 doubles to 11.8 percent, compounded quarterly. As a result of the reset, the fair market value of Note 2 increases significantly because of the doubling of its interest rate, and the fair market value of Note 1 decreases by the same amount. On December 2, 1993, X sells Note 1 for its fair market value and claims a loss.

Situation 2

Y is a corporation that files returns on a calendar-year basis. On September 1, 1998, Y purchases two privately-placed debt instruments, Note 3 and Note 4, from unrelated issuers for $1,000,000 each.

Note 3 has a 10-year term and a stated principal amount of $1,000,000. It provides for quarterly interest payments, beginning on December 1, 1998. The interest rate for the first quarter is 5.7 percent, compounded quarterly. Note 3 provides for contingent payments based on an event that will occur (or not occur) with a probability of 50 percent on December 1, 1998 (the reset event). The reset event does not depend on actively traded personal property. If the reset event occurs, the interest rate doubles to 11.4 percent, compounded quarterly. If the reset event does not occur, the interest rate is reset at zero.

Note 4 has the same terms as Note 3 except that the consequences of the contingency are reversed. Thus, if the reset event occurs, the interest rate is reset at zero. If the reset event does not occur, the interest rate doubles to 11.4 percent, compounded quarterly.

At the time the notes are purchased, based upon the structure of the notes, it can be expected that, as a result of the reset, one note will increase significantly in value and the other note will decrease in value by the same amount. The expected tax loss on the note that decreases in value significantly exceeds any reasonably expected economic loss on the two notes.

On December 1, 1998, the reset event does not occur. Thus, on that date, the interest rate on Note 3 is reset at zero, and the interest rate on Note 4 doubles to 11.4 percent, compounded quarterly. As a result of the reset, the fair market value of Note 4 increases significantly because of the doubling of its interest rate, and the fair market

value of Note 3 decreases by the same amount. On December 2, 1998, Y sells Note 3 for its fair market value and claims a loss.

Situation 3

Z is a corporation that files returns on a calendar-year basis. On September 1, 1998, Z purchases two privately-placed debt instruments, Note 5 and Note 6, from unrelated issuers.

Note 5 is purchased for $1,000,000. Note 5 has a 10-year term and a stated principal amount of $1,000,000. It provides for quarterly interest payments, beginning on December 1, 1998. The interest rate for the first quarter is 5.7 percent, compounded quarterly. Note 5 provides for contingent payments based on an event that will occur (or not occur) with a probability of 50 percent on December 1, 1998 (the reset event). The reset event does not depend on actively traded personal property. If the reset event occurs, the interest rate doubles to 11.4 percent, compounded quarterly. If the reset event does not occur, the interest rate is reset at zero.

Note 6 is purchased for $615,000. Note 6 has a 20-year term and a stated principal amount of $615,000. It provides for quarterly interest payments beginning on December 1, 1998. The interest rate on Note 6 for the first quarter is set at 3-month LIBOR. If the reset event occurs, the interest rate is reset at zero. If the reset event does not occur, the interest rate doubles to 200 percent of 3-month LIBOR, adjusted quarterly.

At the time the notes are purchased, based upon the structure of the notes, it can be expected that, as a result of the reset, the value of one note will increase

significantly and the value of the other note will decrease significantly. The expected tax loss on the note that decreases in value significantly exceeds any reasonably expected economic loss on the two notes.

On December 1, 1998, the reset event does not occur. Thus, on that date, the interest rate on Note 5 is reset at zero, and the interest rate on Note 6 doubles to 200 percent of 3-month LIBOR, adjusted quarterly. As a result, the fair market value of Note 6 increases significantly because of the doubling of its interest rate, and the fair market value of Note 5 decreases significantly. On December 2, 1998, Z sells Note 5 for its fair market value and claims a loss.

LAW AND ANALYSIS

Situation 1

Section 165(a) of the Internal Revenue Code provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. Section 1.165-1(b) of the Income Tax Regulations provides, in addition, that for a loss to be allowable as a deduction under § 165(a), it must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. Section 1.165-1(b) also provides that only a bona fide loss is allowable and that substance and not mere form shall govern in determining a deductible loss.

The courts have held that a loss is allowable as a deduction for federal income tax purposes only if it is bona fide and reflects actual economic consequences. An artificial loss lacking economic substance is not allowable. See ACM Partnership v.

Commissioner, 157 F.3d 231, 252 (3d Cir. 1998) ("Tax losses such as these ... which do not correspond to any actual economic losses, do not constitute the type of 'bona fide' losses that are deductible under the Internal Revenue Code and regulations."), cert. denied, 526 U.S. 1017 (1999); Scully v. United States, 840 F.2d 478, 486 (7th Cir. 1988) (to be deductible, a loss must be a "genuine economic loss"); Shoenberg v. Commissioner, 77 F.2d 446, 448 (8th Cir. 1935) (to be deductible, a loss must be "actual and real"), cert. denied, 296 U.S. 586 (1935).

The courts similarly have disallowed losses from option-straddle transactions that were found to be devoid of economic substance. The option-straddle transactions were prearranged to generate a loss for tax purposes while deferring an offsetting gain. Even though the relevant trades may have taken place, the loss deduction claimed was not allowed because no true loss had occurred. Lerman v. Commissioner, 939 F.2d 44, 52 (3d Cir. 1991), cert. denied, 502 U.S. 984 (1991), and Keane v. Commissioner, 865 F.2d 1088, 1092 (9th Cir. 1989), aff'g Glass v. Commissioner, 87 T.C. 1087 (1986).

The sale of Note 1 in Situation 1 does not produce an allowable loss under § 165. When X sells Note 1 before its maturity date but retains Note 2, X does not realize an actual economic loss because the purported loss on the sale of Note 1 is substantially offset by the unrealized gain in Note 2. Such an artificial loss is not allowable for federal income tax purposes.

Situation 2

Sections 1271 through 1275, and the regulations thereunder, provide rules for the taxation of holders of debt instruments, including debt instruments that provide for

one or more contingent payments. These rules generally require holders of debt instruments to accrue original issue discount (OID) using the constant-yield method. Note 3 and Note 4 are subject to the OID rules because the notes provide for contingent payments.

Section 1.1275-6 generally provides for the integration of a “qualifying debt instrument” with a “§ 1.1275-6 hedge” if the combined cash flows of the components are substantially equivalent to the cash flows on a fixed rate debt instrument or a variable rate debt instrument that pays interest at a qualified floating rate. When § 1.1275-6 applies, the combined cash flows of the qualifying debt instrument and the § 1.1275-6 hedge generally are treated as a synthetic debt instrument for all federal income tax purposes. The purpose of § 1.1275-6 is to permit a more appropriate determination of the character and timing of income, deductions, gains, or losses than would be achieved by separate treatment of the components. Section 1.1275-6 generally applies to qualifying debt instruments issued on or after August 13, 1996.

Under § 1.1275-6(b)(1), a contingent payment debt instrument (CPDI) that is issued for cash is a qualifying debt instrument. Under § 1.1275-6(b)(2)(i), a § 1.1275-6 hedge is any financial instrument (including a debt instrument) if the combined cash flows of the financial instrument and the qualifying debt instrument permit the calculation of a yield to maturity (under the principles of § 1272) or the right to the combined cash flows would qualify under § 1.1275-5 as a variable rate debt instrument that pays interest at a qualified floating rate or rates (except for the requirement that the interest payments be stated as interest)(fixed-or-floating requirement).

Section 1.1275-6(b)(2)(ii)(B) provides that a debt instrument can be a § 1.1275-6 hedge only if it is issued substantially contemporaneously with, and has the same maturity (including rights to accelerate or delay payments) as, the qualifying debt instrument.

Section 1.1275-6(c)(2) grants the Commissioner authority to integrate a qualifying debt instrument that is a CPDI with a § 1.1275-6 hedge if the combined cash flows are substantially the same as either of the cash flows necessary to satisfy the fixed-or-floating requirement of § 1.1275-6(b)(2)(i). This rule allows the Commissioner to prevent the potential timing and character mismatches that arise if the CPDI and its hedge are treated separately.

Section 1.1275-6(d)(2) provides rules for legging out of an integrated transaction. Section 1.1275-6(d)(2)(i)(B) sets out the rules for determining when a legging out occurs if the Commissioner has integrated a qualifying debt instrument and a financial instrument under § 1.1275-6(c)(2). Under those rules, the taxpayer legs out of the integrated transaction if, prior to the maturity of the synthetic debt instrument, the requirements for Commissioner integration under § 1.1275-6(c)(2) are no longer met. Section 1.1275-6(d)(2)(ii) provides that if the taxpayer legs out of an integrated transaction, then the taxpayer is treated as selling or otherwise terminating the synthetic debt instrument, immediately before legging out, for its fair market value and realizing and recognizing at that time any resulting income, deduction, gain, or loss.

In Situation 2, unlike Situation 1, the notes are issued after the effective date of the integration rules of § 1.1275-6 and qualify for integration by the Commissioner

under § 1.1275-6(c)(2). In this case, the Commissioner integrates the notes under § 1.1275-6(c)(2) as of the issue date. Upon the sale of Note 3, the requirements for Commissioner integration under § 1.1275-6(c)(2) are no longer met. Therefore, Y is treated as legging out of the integrated transaction under § 1.1275-6(d)(2)(ii).

Under the legging out rules of § 1.1275-6(d)(2)(ii), immediately before Note 3 is sold, Y is treated as disposing of the synthetic debt instrument for its fair market value, and Y must realize and recognize at that time any gain or loss on the deemed disposition. As a result, Y cannot recognize the claimed loss on the sale of Note 3 while not recognizing the gain on Note 4.

Situation 3

Under § 1.1275-2(g), 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 §§ 163(e), 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. Section 1.1275-2(g) applies to debt instruments issued on or after August 13, 1996.

Section 1.1275-2(g)(2) provides that whether a result is unreasonable is determined based on all the facts and circumstances. A significant fact is whether the treatment of the debt instrument is expected to have a substantial effect on the issuer's or a holder's U.S. tax liability. A result is unreasonable only if there is an expected substantial effect on the present value of a taxpayer's tax liability.

A principal purpose of §§ 1271 through 1275 and related sections of the Code is to tax holders of debt instruments according to economic income as determined by the constant-yield method. These provisions ensure that the holder of a debt instrument cannot artificially avoid, defer, or offset timely recognition of the economic income from the debt instrument.

In Situation 3, the notes are issued after the effective dates of the integration rules of § 1.1275-6 and the anti-abuse rule of § 1.1275-2(g). But for the anti-abuse rule, there are two reasons why the integration rules would not apply. First, it cannot be determined at the time of issuance whether the combined cash flows will be substantially the same as either of the cash flows necessary to satisfy the fixed-or-floating requirement of § 1.1275-6(b)(2)(i). Second, the notes have different maturities and, thus, they do not meet the same-maturity limitation of § 1.1275-6(b)(2)(ii)(B).

If the structure of the transaction were respected for federal income tax purposes, Z would be able to recognize the claimed loss upon the sale of Note 5 even though it could be expected, when Z purchased the two notes, that, as a result of the reset, one note would increase significantly in value and the other note would decrease significantly in value. The expected tax loss on the note that decreases in value significantly exceeds any reasonably expected economic loss on the two notes. Essentially, Z purchased a series of cash flows that, absent the application of the anti-abuse rule of § 1.1275-2(g) (or § 165 principles), would produce an artificial loss immediately after the reset.

This result is unreasonable in light of the purposes of the OID rules. The OID rules were intended, in part, to ensure that the holder of a debt instrument cannot artificially avoid, defer, or offset timely recognition of the economic income from the debt instrument. In this case, the transaction is structured to defeat this purpose by creating an artificial loss immediately after the reset. Section 1.1275-2(g) authorizes the Commissioner to apply or depart from the OID regulations as necessary or appropriate to prevent this unreasonable result.

In this case, the Commissioner departs from the literal requirements of the integration rules by integrating the two notes before Note 5 is sold. Upon the sale of Note 5, Z is treated as legging out of an integrated transaction under § 1.1275-6(d)(2)(ii). Under the legging out rules of § 1.1275-6(d)(2)(ii), immediately before Note 5 is sold, Z is treated as disposing of the synthetic debt instrument for its fair market value, and Z must realize and recognize at that time any gain or loss on the deemed disposition. As a result, Z cannot recognize the claimed loss on the sale of Note 5 while not recognizing the gain on Note 6.

HOLDING

In each situation the taxpayer cannot recognize the claimed loss on the sale of the debt instrument that decreases in value while not recognizing the gain on the other debt instrument.

In Situation 1, the loss on the sale of Note 1 is not allowed under § 165.

In Situation 2, the integration rule of § 1.1275-6(c)(2) applies. The Commissioner integrates the notes as of the issue date. Upon the sale of Note 3, Y is

treated as legging out of the integrated transaction. Accordingly, Y is treated as disposing of the synthetic debt instrument at its fair market value immediately before the sale.

In Situation 3, the anti-abuse rule of § 1.1275-2(g) applies. The Commissioner integrates the notes before Note 5 is sold. Upon the sale of Note 5, Z is treated as legging out of the integrated transaction. Accordingly, Z is treated as disposing of the synthetic debt instrument at its fair market value immediately before the sale.

DRAFTING INFORMATION

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