OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Swaption Issue

This Field Service Advice responds to your memorandum dated February 16, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer	=
Year 1	=
Year 2	=
Date 1	=
X	=
Y	=

ISSUES:

1. Whether Taxpayer's method of accounting for the upfront payments received under the swap agreements and the premiums received for the swaptions clearly reflects income under Notice 89-21, 1989-1 C.B. 651, and I.R.C. § 446.

2. With respect to the callable corporate debentures in issue, whether the clear reflection of income requirement of section 446(b) requires Taxpayer to amortize certain call premium and accrued interest expenses (which would otherwise be deductible in full in the year incurred) in the same fashion as, and over the same time period that, the related up front payments from the swaps and premiums for the swaptions are taken into income.

3. Whether the transactions in issue lacked economic substance and should be disregarded for tax purposes.

CONCLUSIONS:

1. Even though Treas. Reg. § 1.446-3 is not controlling, since Taxpayer has satisfied the specific rules contained in Treas. Reg. § 1.446-3, we conclude that Taxpayer has met the standard set forth in Notice 89-21. Thus, Taxpayer's amortization method is reasonable, and, therefore, its method of accounting for the upfront payments received under the swap agreements and the premiums received for the swaptions clearly reflects income for purposes of Notice 89-21 and section 446. This conclusion assumes the transactions have economic substance.

2. With respect to the callable corporate debentures, an argument could be made that the clear reflection of income requirement of section 446(b) requires Taxpayer to amortize certain call premium and accrued interest expenses in the same fashion as, and over the same time period that, the related up front payments from the swaps are taken into income. However, an argument under section 446(b) presupposes that the transactions have some business purpose or economic effect outside the creation of tax benefits. For the reasons set forth herein, we agree with your conclusion that under the facts of this case, an "economic substance" argument appears to provide a better basis for challenging the transactions.

3. Further factual development is necessary before conclusive advice can be provided on whether an argument should be pursued that the transactions in issue lacked economic substance and should be disregarded for tax purposes.

FACTS:

The facts that follow are taken from your Field Service Advice ("FSA") request and the materials submitted by the Financial Product Specialist ("FPS"). The materials submitted by the FPS include an excerpt of the Revenue Agent's Report ("RAR") and Taxpayer's rebuttal.

In Year 1, Taxpayer decided to retire various of its outstanding U.S. dollar-denominated callable corporate debentures by exercising a call provision included in the debentures' terms. For each debenture in question, that provision allowed Taxpayer to retire the debenture in advance of its stated maturity date by paying to the holders thereof, in addition to interest and principal otherwise due them, a specified call premium. The amount of the call premium required to retire a particular debenture varied, depending on the point in time that Taxpayer elected to exercise the call provision. The closer the call was to the original maturity date, the smaller was the call premium.

In connection with the contemplated call of each of the debentures in issue, Taxpayer granted an unrelated third party (the "counterparty") a swaption for which Taxpayer received a premium. The swaption entitled the counterparty, as grantee thereof, an option which, upon exercise, required Taxpayer to enter into an interest rate swap with the counterparty. In each instance, the terms of the interest rate swap relating to a particular debenture, which ranged in term from X to Y years, required Taxpayer to make periodic fixed interest rate-based payments based on a notional principal amount. The interest rate swap required the counterparty to make periodic floating interest rate-based payments based on the same notional principal amount. Although the notional principal amount declined over the term of the swap, in every case the initial notional principal amount specified by the swap equaled, or was within a few hundred thousand dollars of, the outstanding face amount of the associated debenture as of the exercise date of the underlying swaption.

In addition, the interest rate swap arising from the exercise of each swaption called for the counterparty to make two upfront payments (the "Upfront Payments") to Taxpayer. One payment (the "Interest Amount") was structured to equal the accrued interest, if any, on the associated debenture as of the effective date of the swap. The other Upfront Payment (the "Additional Fee") was structured to equal the call premium required to call the associated debenture as of the effective date of the swap.

The swaption associated with each of the debentures at issue was exercised by the holder thereof. In each instance, immediately following exercise, Taxpayer elected to call the related debenture on the effective date of the swap.

Taxpayer amortized the Upfront Payments received under the swap agreements in Year 1, and the premiums received with respect to the swaptions in Year 1, over the term of the corresponding swap agreements. Therefore, Taxpayer reported only a ratable portion of this income on its Year 1 return. Taxpayer cites Notice 89-21, 1989-1 C.B. 651, as authority for this treatment.

With respect to each debenture, Taxpayer claimed a deduction in Year 1, the year the debentures were called, for the full amount of the accrued interest and call premium paid that year in connection with the call of the debentures. Taxpayer cites as authority for its deduction, inter alia, section 163 and the regulations thereunder.

On Date 1, the FPS issued a revised Form 5701 challenging Taxpayer's treatment of the accrued interest expense and call premium. Specifically, the FPS asserts that Taxpayer's treatment of those amounts does not achieve a clear reflection of income and proposes, under the authority of section 446(b), to require Taxpayer, in the case of each debenture, to amortize those amounts in the same fashion as, and over the same time period that, the Upfront Payments are taken into income.

LAW AND ANALYSIS

Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

Section 446(b) provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

Section 446(c) provides that subject to subsections 446(a) and 446(b), a taxpayer may compute taxable income under any of the following methods of accounting: 1) the cash receipts and disbursements method; 2) an accrual method; 3) any other method permitted by Subtitle A, Chapter 1E; or 4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

Treas. Reg. § 1.446-1(a)(1) provides, in part, that the term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item.

Upfront Payments received under the swap agreements; premiums received for the swaptions.

Taxpayer amortized the Upfront Payments received under the swap agreements in Year 1, and the premiums received with respect to the swaptions in Year 1, over the term of the corresponding swap agreements. As authority for this treatment, Taxpayer cites Notice 89-21, 1989-1 C.B. 651.

Notice 89-21, published on February 21, 1989, provides guidance with respect to the federal income tax treatment of lump-sum payments received in connection with interest rate and currency swap contracts, interest rate cap contracts, and similar financial products ("notional principal contracts").

Notice 89-21 provides that in the case of a payment received during one taxable year with respect to a notional principal contract where such payment relates to the obligation to make a payment or payments in other taxable years under the contract, a method of accounting that properly recognizes such payment over the life of the contract clearly reflects income. Notice 89-21 provides further that including the entire amount of such payment in income when it is received or deferring the entire amount of such payment to the termination of the contract does not clearly reflect income and is an impermissible method of accounting.

Notice 89-21 provides that regulations will be issued under sections 61, 446(b), 451, 461, and 988 providing specific rules regarding the manner in which a taxpayer must amortize or take into account over the life of a notional principal contract payments made or received with respect to the contract.

Notice 89-21 provides that in the case of lump-sum payments made or received with respect to notional principal contracts entered into, or assignments made, prior to the effective date of the regulations (including contracts entered into prior to the publication date of Notice 89-21), a method of accounting used by a taxpayer is a method that clearly reflects income only if the payments are taken into account over the life of the contract using a reasonable method of amortization. Notice 89-21 provides further that for contracts entered into prior to the effective date of the regulations, the Commissioner will generally treat a method of accounting as clearly reflecting income if it takes such payments into account over the life of the contract under a reasonable amortization method, whether or not the method satisfies the specific rules in the forthcoming regulations.

On June 10, 1991, the Service published proposed regulations under sections 446(b) and 1092(d). See 1991-2 C.B. 951. The proposed regulations, as revised by T.D. 8491, 1993-2 C.B. 215, were subsequently adopted as final regulations.[1] The final regulations are effective for notional principal contracts entered into on or after December 13, 1993. Treas. Reg. § 1.446-3(j).

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[1] The final regulations were amended by T.D. 8554, 1994-2 C.B. 76.

Treas. Reg. § 1.446-3(c)(1)(i) provides, in part, that a notional principal contract is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. Notional principal contracts governed by Treas. Reg. § 1.446-3 include interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity index swaps, and similar agreements. Treas. Reg. § 1.446-3(c)(1)(i).

In the instant case, the terms of the interest rate swap relating to a particular debenture, which ranged in term from X to Y years, required Taxpayer to make periodic fixed interest rate-based payments based on a notional principal amount. The terms required the counterparty to make periodic floating interest rate-based payments based on the same notional principal amount. Thus, each swap falls within the definition of a "notional principal contract" under Treas. Reg. § 1.446-3(c)(1)(i).

However, since the swap agreements were entered into before December 13, 1993, Treas. Reg. § 1.446-3 does not apply. Notice 89-21, as cited above, includes interest rate swaps in the definition of notional principal contract. Under Notice 89-21, in the case of notional principal contracts entered into before the effective date of the final regulations, the Commissioner will generally treat a method of accounting as clearly reflecting income if it takes lump-sum payments made or received with respect to the notional principal contract into account over the life of the contract under a reasonable amortization method, whether or not the method satisfies the specific rules contained in Treas. Reg. § 1.446-3.

With respect to the swaptions, the terms of the swaption agreement entitled the counterparty, as grantee of the swaption, an option which, upon exercise, required Taxpayer to enter into an interest rate swap with the counterparty. Treas. Reg. § 1.446-3(c)(1)(ii) provides that an option or forward contract that entitles or obligates a person to enter into a notional principal contract is not a notional principal contract but payments made under such an option or forward contract may be governed by Treas. Reg. § 1.446-3(g)(3). However, as with the swaps in issue, since the swaptions were entered into before December 13, 1993, Treas. Reg. § 1.446-3 does not apply.

Even though Treas. Reg. § 1.446-3 is not controlling, if Taxpayer demonstrates that it has satisfied the specific rules contained in Treas. Reg. § 1.446-3[2], a strong argument could be made that under the standard set forth in Notice 89-21, Taxpayer's amortization method is reasonable, and, therefore, its method of accounting clearly reflects income for purposes of Notice 89-21 and section 446.

Treas. Reg. § 1.446-3(g)(3), which provides special rules for options and forwards to enter into notional principal contracts, provides as follows:

> An option or forward contract that entitles or obligates a person to enter into a notional principal contract is subject to the general rules of taxation for options or forward contracts. Any payment with respect to the option or forward contract is treated as a nonperiodic payment for the underlying notional principal contract under the rules of paragraphs (f) and (g)(4) or (g)(5)[3] of this section if and when the underlying notional principal contract is entered into.

Treas. Reg. § 1.446-3(f)(1) defines a "nonperiodic payment" as follows:

> [A]ny payment made or received with respect to a notional principal contract that is not a periodic payment ... [as defined in Treas. Reg. § 1.446-3(e)(1)] or a termination payment ... [as defined in Treas. Reg. § 1.446-3(h)]. Examples of nonperiodic payments are the premium for a cap or floor agreement (even if it is paid in installments), the payment for an off market swap agreement, the prepayment of part or all of one leg of a swap, and the premium for an option to enter into a swap if and when the option is exercised.

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[2] The purpose of the final regulations is to enable the clear reflection of the income and deductions from notional principal contracts by prescribing accounting methods that reflect the economic substance of such contracts. Treas. Reg. § 1.446-3(b).

[3] Under Treas. Reg. § 1.446-3(g)(4), significant nonperiodic payments on a swap contract may be recharacterized as embedded loans; however, there is no definition of "significant" for these purposes. For purposes of our response, we assume, without concluding, that even if Treas. Reg. § 1.446-3 were to apply, Treas. Reg. § 1.446-3(g)(4) would not apply to the instant swaps. Treas. Reg. § 1.446-3(g)(5), concerning caps and floors that are significantly in-the-money, is reserved.

Thus, the payment received by Taxpayer with respect to the swaption--that is, the premium for an option to enter into a swap if and when the option is exercised--falls within the definition of a "nonperiodic payment" under Treas. Reg. § 1.446-3(f)(1). Similarly, each Upfront Payment received by Taxpayer with respect to the swap--that is, the payment for an off market swap agreement--falls within the definition of a "nonperiodic payment" under Treas. Reg. § 1.446-3(f)(1).

The recognition rules with respect to nonperiodic payments are set forth in Treas. Reg. § 1.446-3(f)(2). Treas. Reg. § 1.446-3(f)(2)(i) provides that, in general:

> All taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of a nonperiodic payment for the taxable year to which that portion relates. Generally, a nonperiodic payment must be recognized over the term of a notional principal contract in a manner that reflects the economic substance of the contract.

The general rule for swaps is contained in Treas. Reg. § 1.446-3(f)(2)(ii):

> A nonperiodic payment that relates to a swap must be recognized over the term of the contract by allocating it in accordance with the forward rates ... of a series of cash-settled forward contracts that reflect the specified index and the notional principal amount. For purposes of this allocation, the forward rates or prices used to determine the amount of the nonperiodic payment will be respected, if reasonable.

In the instant case, Taxpayer amortized the Upfront Payments received under the swap agreements in Year 1, and the premiums received with respect to the swaptions in Year 1, over the term of the corresponding swap agreements. Therefore, Taxpayer reported only a ratable portion of this income on its Year 1 return. As demonstrated above, this treatment is consistent with Treas. Reg. § 1.446-3 and, more specifically, with the recognition rules set forth in Treas. Reg. § 1.446-3(f)(2).

Accordingly, even though Treas. Reg. § 1.446-3 is not controlling, since Taxpayer has satisfied the specific rules contained in Treas. Reg. § 1.446-3, we conclude that Taxpayer has met the standard set forth in Notice 89-21. Thus, Taxpayer's amortization method is reasonable, and, therefore, its method of accounting for the Upfront Payments received under the swap agreements and the premiums received for the swaption clearly reflects income for purposes of Notice 89-21 and section 446. The foregoing discussion assumes the transactions have economic substance, an issue we discuss below.

Call premiums and accrued interest for callable corporate debentures.

With respect to the callable corporate debentures, Taxpayer deducted the call premium and accrued interest in accordance with section 163. Section 163(a) provides that there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

Section 163(e) provides that in the case of any debt instrument issued after July 1, 1982, the portion of the original issue discount with respect to such debt instrument which is allowable as a deduction to the issuer for any taxable year shall be equal to the aggregate daily portions of the original issue discount for days during such taxable year.

Treas. Reg. § 1.163-4(c)(1) provides generally that if bonds are issued by a corporation and are subsequently repurchased by the corporation at a price in excess of the issue price plus any amount of original issue discount deducted prior to repurchase, or minus any amount of premium returned as income prior to repurchase, the excess of the repurchase price over the issue price adjusted for amortized premium or deducted discount is deductible as interest for the taxable year.

Thus, with respect to the call of the debentures, Taxpayer's method of accounting conforms with a permissible method of accounting. Nevertheless, the FPS argues that the clear reflection of income requirement of section 446(b) requires Taxpayer to amortize the call premium and accrued interest expenses (which would otherwise be deductible in full in the year incurred) in the same fashion as, and over the same time period that, the related Up front Payments from the swaps are taken into income.

As discussed above, section 446(b) allows the Commissioner to recompute taxable income under a method of accounting that clearly reflects income if the method of accounting used by a taxpayer fails to clearly reflect income. The Commissioner may even challenge a taxpayer's use of a method of accounting specifically authorized by the Code or the regulations if the method results in a material distortion in taxable income, and therefore does not clearly reflect income. Ford Motor Co. v. Commissioner, 71 F.3d 209 (6th Cir. 1995), aff'g 102 T.C. 87 (1994)(Court reviewed).

Income is clearly reflected by deducting from gross income for the taxable year the costs and expenses attributable to the production of that income during the year. U.S. v. Anderson, 269 U.S. 422, 440 (1926). The concept of matching income and related expenditures, however, is not absolute. U.S. v. Hughes

Properties, Inc., 476 U.S. 593, 603-604 (1986). Nevertheless, under section 446(b), the Commissioner has the authority to require that a taxpayer's reporting of a transaction conform to the "economic reality" of that transaction. See Prabel v. Commissioner, 882 F.2d 820, 826-827 (3rd Cir. 1989).

Thus, an argument could be made that the clear reflection of income requirement of section 446(b) requires Taxpayer to amortize certain call premium and accrued interest expenses in the same fashion as, and over the same time period that, the related up front payments from the swaps are taken into income. However, an argument under section 446(b) presupposes that the transactions have some business purpose or economic effect outside the creation of tax benefits. For the reasons set forth herein, we agree with your conclusion that under the facts of this case, an "economic substance" argument appears to provide a better basis for challenging the transactions.

Economic substance.

In addition to the Commissioner's authority under section 446(b), the Commissioner also may disregard a transaction for federal tax purposes where the transaction lacks "economic substance." A transaction that is devoid of economic substance is not recognized for federal tax purposes, even where the form of a transaction satisfies the literal requirements of the statutes or regulations. ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff'd, 157 F.3d 231 (3rd Cir. 1998), cert. denied, 119 S. Ct. 1251.

Since its recognition in the case of Gregory v. Helvering, 293 U.S. 465 (1935), the economic substance theory has generally been construed to mean that a transaction may be completely disregarded for federal tax purposes if it serves no business purpose and lacks any significant economic effect other than the creation of tax benefits. See also ACM Partnership v. Commissioner, supra.

The test for determining whether a transaction or series of transactions lack economic substance was recently set forth by the Third Circuit in ACM Partnership v. Commissioner, supra, as including inquiries into the "objective economic substance of the transactions" and the "subjective business motivation" behind them. 157 F.3d at 247. In assessing the objective economic substance of certain transactions, the courts have examined dispositions "in their broader economic context and refused to recognize them for tax purposes where other aspects of a taxpayers' transactions offset the consequences of the disposition, resulting in no net change in the taxpayer's economic position." Id. at 249. In assessing the

subjective business motivation behind the transactions, the courts have considered whether, subjectively, the transactions were intended to serve any business purpose or were reasonably expected to generate a pre-tax profit. Id. at 252-253.

However, a transaction will not be disregarded merely because it was motivated by tax considerations. Id. at 248. Therefore, even if Taxpayer structured the transactions in order to reduce its current tax bill, if there are other real, non-tax-related changes in Taxpayer's economic position as a result of the transactions, the transactions generally will not be disregarded for federal income tax purposes. Id. at 248 n.31.

In the instant case, further factual development is necessary before conclusive advice can be provided on whether an argument should be pursued that the transactions in issue lacked economic substance and should be disregarded for tax purposes.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

As discussed above, an argument could be made that the clear reflection of income requirement of section 446(b) requires Taxpayer to amortize certain call premium and accrued interest expenses (which would otherwise be deductible in full in the year incurred) in the same fashion as, and over the same time period that, the related up front payments from the swaps are taken into income. [redacted]

Although the courts have not delineated the degree to which a distortion between economic income and taxable income constitutes a "material" distortion, arguably a deliberate manipulation of the timing rules (that is, entering a transaction only to take advantage of timing rules) that results in a pure tax loss (i.e., absent any economic substance) constitutes a material distortion. See ACM Partnership v. Commissioner, 157 F.3d 231, 249 (3rd Cir. 1998). Even without a deliberate manipulation, a method may give rise to a material distortion of income. See Ford Motor Co., Inc. v. Commissioner, supra.

However, an argument under section 446(b) presupposes that the transaction has some business purpose or economic effect outside the creation of tax benefits. Accordingly, section 446(b) should not be asserted if the transactions are determined to have lacked economic substance. Even if the transactions are not determined to have lacked economic substance, based upon current case law, it appears as if the mismatch that results from the amortization of the Upfront Payments received on the swaps and the immediate deduction of the call premium

and accrued interest expenses incurred with respect to the call of the debentures may not rise to the level of a material distortion that allows the Commissioner to prohibit the use of specifically authorized methods of accounting.

For the reasons discussed above, and because the cases have not uniformly required adherence to the matching principle under section 446(b), we agree with your conclusion that under the facts of this case, an "economic substance" argument appears to provide a better basis for challenging the transactions--provided that the evidence supports such a challenge. Absent a material distortion in taxable income, it is uncertain whether a court would disallow Taxpayer's use of a permissible method of accounting.

The circumstances surrounding the sale of the swaptions raise concerns about the economic substance of the swaptions, the underlying swap transactions, and, in light of the timing, the refinancing as a whole. The willingness of the counterparty to the swap to make the Upfront Payments suggests that market interest rates had fallen at the time the refinancing transactions were entered into. [redacted]

The fact that, in each case, the swaption was exercised on the date of purchase suggests that the swaptions were illusory. The Commissioner's ability to disregard the swaption alone, however, may be of little benefit for purposes of matching the related income and deductions. Under the final regulations, the Upfront Payments on the swap and the option premium are treated as nonperiodic payments on the swap transaction under Treas. Reg. § 1.446-3(f)(1). Under Treas. Reg. §1.446-3(f)(2), a nonperiodic payment usually is allocated over the term of the swap contract based upon prices for analogous forward contracts. This allocation of upfront payments is similar to the reporting method used by Taxpayer and still results in the mismatching with which the Service is concerned. Thus, we must look behind the swap transaction itself to determine if, and to what extent, it might lack economic substance.

Generally, an upfront payment on a swap compensates the recipient for the difference between the contract rate the recipient is paying or receiving and the current market rate. If the facts indicate that interest rates declined substantially between the original issuance of the debentures and the date of the related swaption, then the option premium and other Upfront Payments on the swap transaction may represent the present value, at the time the swap terms were set, of the excess of the fixed rate paid on the swap over an arms length fixed rate. If

the LIBOR rate and fixed interest rate that were part of the swap transaction did not represent going market rates, but rather were agreed to in order to pull the value of the decline in interest rates into current cash flow, it would appear that the transaction had a non-tax economic benefit to Taxpayer.

On the other hand, if market interest rates had not declined, and if the amounts that the swap counterparty paid up front to Taxpayer represented only the fair market value of the option privilege (i.e., the legal right of the counterparty to not enter into the swap) then there would have been no reason for Taxpayer to enter those transactions other than to obtain tax benefits.

[redacted]

With respect to the "economic substance argument," based on the available facts, it appears that the Upfront Payments received by Taxpayer represent an embedded value in the swap transaction due to the decline in market interest rates. [redacted].

For the forgoing reasons, we conclude that further factual development is necessary before conclusive advice can be provided on whether an argument should be pursued that the transactions in issue lacked economic substance and should be disregarded for tax purposes.

Please call if you have any further questions.

By: _____
CAROL P. NACHMAN
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cc: Joseph F. Maselli
CC:NER