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I. INTRODUCTION

Since 1982, when Mexico came close to defaulting on its foreign loans, American banks have been struggling to cope with the Latin American debt crisis. It is estimated that Latin American debtor nations owe 450 billion dollars to banks worldwide. One hundred and ten billion dollars of this debt is owed to United States commercial banks, and the top fifteen United States commercial banks have lent seventy billion dollars to the fifteen most indebted countries.

These banks have adopted a number of strategies for coping with these debts including debt rescheduling, increasing loan loss reserves, and debt-for-equity swaps. For example, in May 1987, Citicorp Chairman John Reed announced that Citicorp would set aside three billion dollars in additional reserves to cover loan losses on its foreign debt exposure. Most money center banks have followed Citicorp's lead and increased their loss reserves.

Debt-for-equity swaps are an alternative that some Latin American countries[1] have adopted to reduce their foreign currency denominated debt. Debt-for-equity swaps permit banks with Latin American debt exposure to convert the foreign denominated debt into equity holdings[2] in

* The assistance of Bradley Schmarak, Esq. is gratefully acknowledged.

1. Countries that have established debt-for-equity swap programs include Argentina, Bolivia, Brazil, Chile, Costa Rica, Ecuador, Jamaica, Mexico, Nigeria, Uruguay, and Venezuela.

2. *See No Easy Path For Debt/Equity Swaps*, EUROMONEY, Sept. 1988, at 2 [hereinafter

the debtor country. Although the long-term utility of debt-for-equity swaps is unclear, they have played a role in reducing Latin American debt.[3]

Countries that wish to use debt-for-equity swaps to reduce their foreign currency denominated debt usually establish a formal program, although some debt-for-equity swaps are conducted informally.[4] Formal debt-for-equity programs require foreign banks or companies to make a formal proposal for a debt-for-equity swap to the debtor country's central bank. If the proposal is accepted, the foreign bank or multinational company is allowed to present the debtor country's foreign denominated debt at the country's central bank where the debt is paid either in full or at a discount. The bank or company is subsequently required to invest the proceeds in the debtor country in accordance with its previously submitted proposal. This investment is subject to various restrictions. Such restrictions include limitations on the repatriation of dividends or capital from the investment and restrictions on the sale of the stock acquired in the swap.

These programs benefit the foreign banks which are able to reduce their Lesser Developed Country (LDC) debt exposure, although in many cases they are required to take on the unfamiliar role of managing a business. The debtor nations benefit by reducing their foreign currency denominated debt and the increased investment creates jobs that will eventually help the country to repay its remaining debt. However, many countries periodically suspend, discontinue, and subsequently reinstitute their debt-for-equity swap programs, depending on the prevailing political and economic climate. Also, the terms of these programs frequently change, often with little or no advance notice. For example, Chile, Mexico, and Brazil have periodically suspended their programs on the grounds that the local currency generated by the swaps fuels inflation.[5] Nigeria discontinued its program because it believed that the funds generated by debt-for-equity swaps were leaving the country via the black market.

The future of debt-for-equity swap programs is unclear. Since United States banks have survived the worst stage of the LDC debt crisis,

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No Easy Path]. Investments made through debt equity swap programs have included hotels, pulp plants and automobile factories.

3. *See generally* Weinert, *Swapping Third World Debt*, 65 FOREIGN POLICY 85 (1987); Rubin, *Guide to Debt Equity Swaps: Special Report No. 1104*, ECONOMIST, 1987.

4. *No Easy Path*, *supra* note 2, at 2.

5. Paisley, *Political Maneuvering May Spell The End of Brazil's Debt-For-Equity Swap Program*, AMERICAN BANKER, Nov. 28, 1988, at 14.

their incentive to swap debt for equity may be diminished. Also, the perceived disadvantages of debt-for-equity swaps may discourage LDCs from instituting or continuing debt-for-equity swap programs. Finally, indications of a "kinder and gentler" approach by the Bush administration to LDC debt may signal a return to forgiveness and a move away from unconventional approaches to solving the debt crisis.[6]

Regardless of the future of debt equity swaps, there are substantial tax implications for the billions of dollars that have been invested in LDCs through debt-for-equity swap programs. This Article will examine the tax implications of debt-for-equity swap programs.

II. TAX IMPLICATIONS

A. Revenue Ruling 87-124

The Internal Revenue Service (IRS) did not examine the United States tax consequences of debt-for-equity swaps until late 1987, long after conversion programs had become fashionable. Unfortunately for United States companies that have already swapped debt for equity or who are considering swaps, the IRS has taken a troublesome position on the potential income realization which stems from these transactions. In Revenue Ruling 87-124,[7] the IRS considered three different scenarios, all based on the following underlying facts:

X, a United States commercial bank, holds debt of the Central Bank of foreign country (*FC*). The debt obligation evidences a loan of one hundred dollars that *X* made to the Central Bank. *X*'s adjusted basis in the obligation is one hundred dollars. Under the laws of *FC*, the obligation cannot be held by an *FC* entity. *Y* is a domestic corporation in the United States. *FX* is a corporation organized in *FC* and engaged in business in *FC*, but not in the United States. The local currency of *FC* is LC. The exchange rate is one dollar to ten LCs.

FC has a program whereby a holder of the foreign debt can negotiate with the Central Bank to deliver the *FC* debt to the Central Bank for LCs if the holder agrees to invest the LCs in stock of a *FC* corporation or otherwise use the LCs in *FC* in a manner approved in advance by the government of *FC*. The program contains other restrictions and limitations. The Ruling considered the following three situations:

Situation l.

Y purchases the obligation from *X* for sixty dollars, its fair market

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6. *See* N.Y. Times, April 13, 1981, at D1, col. 6; Wall St. J., Mar. 9, 1989, at 1, col. 6.
7. Rev. Rul. 87-124, 1987-2 C.B. 205.

value in the secondary market. The Central Bank redeems the note with 900 LCs and credits that amount in *FX*'s account. *FX* then issues all of its capital stock to *Y*.

Holding 1.

The IRS held that *X*, the United States commercial bank, recognizes a loss of forty dollars ($100 — $60) on the sale of the obligation to *Y*. *Y* takes an initial basis in the obligation of sixty dollars, its cost. The transaction is then viewed as a transfer by *Y* of the obligation to the Central Bank for 900 LCs, which in turn is invested by *Y* in *FX* for stock in *FX*. *Y*, the United States corporation, is required to recognize a gain on the exchange of the obligation for the 900 LCs, to the extent that the fair market value of 900 LCs exceeds *Y*'s basis in the obligation, sixty dollars. The fair market value of the 900 LCs is determined by taking into account all the facts and circumstances of the exchange. The IRS has not elaborated on what facts or circumstances are significant. The IRS has stated, however, that the limitation of *Y*'s use of the 900 LCs under the swap program will generally reduce their fair market value below ninety dollars (the value of 900 LCs converted at the free market exchange rate), and thereby reduce both the amount of the immediately recognized gain and the basis in the *FX* stock. The Ruling does not, however, suggest that these limitations reduce the value of the LCs to sixty dollars, the price *Y* paid for the obligation. *Y* recognizes no gain on the exchange of 900 LCs for *FX* stock because its basis in the LCs equals the stock's fair market value.

Situation 2.

The facts are the same as in Situation 1, except that instead of selling the obligation to *Y* for sixty dollars *X* delivers the obligation to the Central Bank, which credits *FX*'s account at the Central Bank with 900 LCs. *FX* then issues all of its capital stock to *X*.

Holding 2.

The IRS held that *X* recognizes a loss on the exchange of the obligation for the 900 LCs to the extent of the excess of the adjusted basis in the obligation ($100) over the fair market value of the 900 LCs. *X* recognizes no gain on the exchange of the 900 LCs for *FX* stock because its basis in the LCs equals the stock's fair market value.

Situation 3.

The facts are the same as in Situation 2, except that instead of crediting *FX*'s account, the Central Bank credits the 900 LCs to an account of *Z*, a United States charitable organization. Under the terms of the program, *Z* can only use the 900 LCs in *FC* for charitable purposes meeting the requirements of Section 170 of the Internal Revenue Code.

Holding 3.

The IRS held that *X* will be treated as realizing the 900 LCs in exchange for the obligation and then contributing them to *Z*. *X* therefore recognizes a loss on the exchange of the obligation for the 900 LCs to the extent the adjusted basis in the obligation ($100) exceeds the fair market value of the 900 LCs. If *X* and *Z* otherwise have satisfied all requirements of the Internal Revenue Code relating to charitable contributions, *X* is entitled to a charitable contribution deduction equal to the fair market value of the 900 LCs at the time of the contribution.

The immediate gain recognition required by Revenue Ruling 87-124 could be an unwelcome consequence for companies considering participation in debt-for-equity swaps. Under the restrictions of most foreign debt-for-equity swap programs, gain will be recognized and tax will be due even though cash to pay the tax on the gain cannot be distributed from the subsidiary.[8] This detracts from the economic attractiveness of this method of investment.

B. Minimizing The Effect of Revenue Ruling 87-124

1. Discounting the Value of the Local Currency

There are various ways to minimize or eliminate the negative tax consequences of Revenue Ruling 87-124 in debt-for-equity swaps. First, for tax purposes, a company could significantly discount the fair market value of the local currency it receives and invests through the transaction.[9] Given the extensive limitations and restriction imposed by most

8. Although the specific terms of each country's debt-for-equity swap program are different and frequently change, most countries impose restrictions on the repatriation of income and capital from the investment purchased through the swap. Most countries prohibit capital repatriation before the end of a specified period ranging from five years in the case of Bolivia and Venezuela to twelve years in the case of Mexico, Ecuador and Brazil. Chile and Costa Rica do not permit capital to be repatriated at terms more favorable than the terms of the original debt. Restrictions on the repatriation of profits are also usually imposed. This may be an absolute prohibition against repatriating profits for a certain period, a prohibition against remitting more than a certain percentage of profits for a certain period or restricting the amount of repatriated profits to the interest that would have been paid on the debt. Finally, some countries limit the debt to equity investment to some percentage of the project cost. *See* Rubin, *supra* note 3, at 100-01.

9. A taxpayer's gain on a sale or exchange is calculated by subtracting his adjusted basis in the asset from the amount realized on the transaction. I.R.C. § 1001 (1986 as amended). The amount realized from the sale or other disposition of property is the sum of any money received plus the fair value of the property (other than money) received. *Id.* § 1001(b). As foreign currency, LCs are treated as personal property, instead of money under the Code. *See*

swap programs, a strong argument can be made that a significant discount will apply.[10] The pronouncements of the Financial Accounting Standards Board (FASB) suggest that this is the position of the accounting profession for financial statement purposes.[11] This alternative, how-

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generally McGarry, *The Taxation of Exchange Gains and Losses: A Road Map*, 14 INT'L TAX J. 25, 25-26 (1988). Fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell. Commissioner v. Marshman, 279 F.2d 27 (6th Cir. 1960), 60-2 USTC ¶ 9484, *cert. denied*, 364 U.S. 918 (1960). Fair market value is always a question of fact. Treas. Reg. § 1.1001-1(a) (as amended in 1972).

10. Restrictions on the use of property decrease its value. Barlow v. Commissioner, 34 T.C.M. (CCH) 1373 (1975).

11. The American Institute of Certified Public Accountants, in conjunction with Deloitte, Haskin & Sells, first focused on this question in April, 1987, when it released an Emerging Issues Task Force Issue Summary (Issue Summary). The Issue Summary considered the accounting implications of the following scenerio.

Facts

A United States company (Company) with operations in Mexico purchases a United States dollar-denominated loan from a financial institution for $5 million. The loan, owed by a Mexican debtor, is in the principal amount of $10 million. Pursuant to the rules and regulations of Mexico's official debt-for-equity swap program, the Mexican government purchases the loan from Company for $8.5 million worth of Mexican *pesos*, computed at current exchange rates. Upon its purchase of the loan, the Mexican government remits the *pesos* to the Mexican subsidiary of Company (Subsidiary) and Subsidiary subsequently issues capital stock to Company. There is an agreement with the Mexican government which restricts the redemption of the stock, dividend payments and sales of the stock to Mexicans for a stated period of time. Additionally, the *pesos* obtained on the conversion are required to be used for a specified purchase in the Mexican operation (such as to make a capital expenditure). These provisions are designed to retain the *pesos* in the Mexican economy.

Company theoretically receives new stock in Subsidiary worth $8.5 million in exchange for only a $5 million investment. The Issue Summary examines five alternatives for accounting for this $3.5 million credit (Credit).

1. *Alternative 1 — No Recognition of the Credit As Income*

Under this alternative, Subsidiary does not recognize any income because the fair market value of the Credit must be discounted to properly reflect the effects of the restrictions imposed by the Mexican government. The fair market value of the *pesos* is determined by and equal to the amount the Company paid for the Mexican loan in the secondary market. Thus, the exchange rate of the $8.5 million in *pesos* received would be discounted down to $5 million and, as a result, the recorded value of Subsidiary's net assets would equal the Company's investment in Subsidiary. This alternative, however, would conflict with FASB Statement 52 because it would have required discounting of the current exchange rate.

2. *Alternative 2 — No Recognition of the Credit as Current Income. Classify the Credit as a Deferred Credit or as a Component of Stockholder's Equity (Similar to Translation Adjustment) in the Balance Sheet.*

Under this alternative, Subsidiary does not recognize income currently because the restrictions on Subsidiary's capital stock and the instability of the Mexican economy make ultimate distribution of the Credit to the Company unlikely. Recognition of the Credit is instead deferred until there has been some true event of a realization, such as when Subsidiary distributes the Credit to the Company. Until such an event occurs, the Credit would be classified on ever, retains the risk that on audit the IRS will challenge the discount applied, thereby increasing the likelihood that some gain will result.

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the balance sheet as a deferred Credit or, alternatively, as a component of stockholder's equity, similar to the classification for translation adjustments.

3. *Alternative 3 — Treat the Credit in the Same Manner As a Credit Excess Associated With A Consolidated Subsidiary Or an Equity Method Investee*

Under this alternative, the Credit is not recognized as a current income because it stems from the capital contribution made to Subsidiary by the Company. Since a capital contribution is not the culmination of the earnings process required for triggering income recognition, the Company must record its investment in Subsidiary at cost. The Credit, which represents the difference between the Company's $5 million investment in Subsidiary and Subsidiary's equity of $8.5 million, would be accounted for according to its nature in the Company's consolidated financial statements. For example, if the Credit could be identified to specific accounts within the financial statements, such as assets acquired by the Subsidiary, the Credit should be allocated as a component of such accounts. If the Credit could not be specifically identified, it is accounted for in a manner similar to an unallocated Credit excess that arises in a purchase business combination, i.e. negative goodwill.

4. *Alternative 4 — Recognize the Credit Currently in Income.*

Under this alternative, the Credit is considered realized by the consolidated entity because the *pesos* contributed by the Mexican government to Subsidiary results in an increase in Subsidiary's net worth and cash flow. This realization is deemed sufficient for recognition of income.

5. *Alternative 5 — Recognize the Credit in Income Based on the Way the Debt-For-Equity Swap Program Requires the Pesos to be Used*

Under this alternative, the Credit is recognized in accordance with the way the *pesos* are required to be used by Subsidiary. Thus, for example, if as part of the swap agreement the Mexican government required Subsidiary to use the *pesos* to purchase equipment, the Credit derived from the swap would be amortized to income of the expected useful life of the asset acquired with the *pesos*. Alternatively, if the *pesos* were used to pay a portion of the subsidiary's *peso* debt, Company would recognize the Credit as a gain from extinguishment of debt in its consolidated financial statements.

The Issue Summary suggested alternatives for consideration, but did not provide guidance as to an acceptable practice for companies to follow. The FASB Emerging Issues Task Force (Task Force) has established the following generally accepted accounting principles for dealing with swaps. The excess credit in local currency realized in a swap should be used to reduce the basis of the long-lived asset acquired or constructed by the foreign subsidiary pursuant to the swap agreement. The basis for allocation to long-lived assets appeared to be based on the view that the underlying motivation to foreign governments in permitting swaps is the lock-up of long term investment in local assets.

This credit is allocated as follows. First, the United States company should reduce or eliminate the basis of the long-lived fixed assets it acquired or constructed with the swap proceeds. The excess should be applied next to reduce or eliminate the basis of existing fixed assets. In both instances the assets are selected in the order of their remaining useful life, with the longest one used first. Any remaining excess should be reported as excess of fair market value of risk that on audit the IRS will challenge the discount applied, thereby increasing the likelihood that some gain will result in assets acquired over cost—negative goodwill. Thus, for accounting purposes, the debt-for-equity swap will result in no immediate gain recognition. Pursuant to Accounting Principles Board Opinion 16, this negative goodwill is amortized systematically to income over the period estimated to be benefited, but not to exceed 40 years.

The following example illustrates the Task Force findings:

Assume Company *X*, a Delaware corporation, purchases $10 million of face value debt owed by a Mexican debtor for $5 million. *X* delivers this debt to the Mexican government,

2. Blocked Income

Alternatively, the company which swaps debt could treat the gain as "blocked income" which is not recognized for United States tax purposes until it becomes unblocked.[12] Generally, a United States parent corporation does not include the earnings and profits of a controlled foreign corporation (CFC) when those earnings and profits are subject to a foreign country's currency restriction throughout the 150 day period begining 90 days before the close of the taxable year and ending 60 days after the close of the taxable year.[13] Since debt-for-equity swap programs generally impose restrictions on the repatriation of dividends or capital, it is possible to argue that any gain on the swap should be deferred until the currency becomes unblocked. However, the IRS requires taxpayers to report blocked income in order to have the benefit of the deferral.[14] This forces the corporation to make a difficult decision between admitting the receipt of income but claiming it is deferred or arguing that no gain at all was recognized in the transaction.[15] Although a preliminary draft of Revenue Ruling 87-124 indicated that under certain circumstances the gain on a swap might be deferred under the blocked income rules, that is not the Treasury's current position.[16]

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which pays $8.5 million in *pesos* to *X*'s Mexican subsidiary, *Y*. *Y* issues $8.5 million (in *pesos*) of capital stock to *X*. *Y* uses the proceeds to buy $1 million (in *pesos*) worth of Machines. The remainder is left in cash. *Y*'s existing fixed assets consist of $2 million (in *pesos*) worth of Cranes. For purposes of *X*'s consolidated financial statements, *Y*'s Machine and Cranes would have 0 value and *X* would have a $500,000 amount shown as excess of fair market value of assets acquired over cost ($3,500,000 excess – $3,000,000 elimination of basis).

12. I.R.C. § 964(b) (1988). *See generally* Dionne, *Revenue Ruling on Debt/Equity Swaps Leaves Unanswered Questions—To the Delight of the Tax Bar*, 39 TAX NOTES 166, 169 (1988).

13. The regulations define blocked currency as "earnings and profits of a controlled foreign corporation . . . [that are] subject to a currency or other restriction or limitation. . . ." Treas. Reg. § 1.964-2(a) (1988). The restriction must prevent the ready conversion into United States dollars, conversion into currency convertible into dollars, or conversion into property of a type normally owned by the CFC or prevent the CFC from distributing a dividend to its United States shareholders.

14. Rev. Rul. 74-351, 1974-2 C.B. 144 as modified by Rev. Rul. 81-290, 1981-2 C.B. 108. A taxpayer treating income as blocked income must report the amount of blocked income in foreign currency.

15. *See* Dionne, *supra* note 12, at 171.

16. The preliminary draft of Rev. Rul. 87-124 is available from TAX NOTES as document 88-3911. This document was not officially released. That draft ruling held that the United States parent corporation may elect to defer reporting any gain resulting from the sale because the income is blocked. Rev. Rul. 74-351, 1974-2 C.B. 144. The sole difference between the draft and final ruling was that in the draft ruling limitations on dispositions of stock and dividend payments were imposed on the foreign investor. The foreign investor could not sell or otherwise dispose of the stock it is required to invest for a ten year period, and no distributions with respect to the stock could be made for a five year period.

The Service does not currently recognize that the blocked income rules will apply. Robert

3. Philadelphia Park Amusement Co.

One could also take the position that as a matter of law, the restrictions placed on the foreign investment require that the market value of the currency equal the United States company's investment. Consequently, the transaction does not result in a gain. This doctrine has its origins in *Philadelphia Park Amusement Co. v. United States,*[17] in which the Court of Claims held that when the fair market value of property received is unascertainable, the fair market value of the property received is equal to the fair market value of the property surrendered. However, IRS officials have stated that this interpretation is incorrect because the court's statements on that issue are only dicta. Consequently, *Philadelphia Park Amusement Co.* has no precedential value.[18] In dictum in *United States v. Davis,*[19] the Court stated that "absent a readily ascertainable value it is accepted practice to hold, as did the Court of Claims in *Philadelphia Park Amusement Co. v. United States,* that the values 'of the two properties exchanged in an arms length transaction are either equal in fact, or are presumed to be equal.' "[20] Therefore, the IRS's analysis of *Philadelphia Park Amusement Co.* represents a very narrow reading of the case which would probably not withstand challenge.

4. Contribution to Capital

It is also possible to argue that the excess of the value of local currency, if any, over the United States company's investment is a contribution to the capital of the foreign subsidiary. Non-shareholder contributions to capital are excluded from a corporation's taxable income

Katcher, Chief of Branch 5 in the IRS Office of Chief Counsel (International) who was responsible for preparing Rev. Rul. 87-124 posited a situation where the restricted LCs obtained in the debt-for-equity swap freed up other LCs for unrestricted use, conversion, or repatriation as a situation where the blocked income rules would not apply. Dionne, *supra* note 12, at 171.

17. 126 F. Supp. 184 (Ct. Cl. 1954), 54-2 USTC ¶ 9697. In *Philadelphia Park Amusement Co.,* the taxpayer had constructed a bridge in connection with a 50 year franchise granted by the City of Philadelphia to construct and operate a passenger railway. When the taxpayer's financial condition prevented him from making necessary repairs to the bridge, the taxpayer transferred the bridge to the city in exchange for a 10-year extension of its franchise. When the taxpayer abandoned the franchise it claimed a loss deduction for the undepreciated cost of the bridge as the value of the franchise to be amortized over its remaining term. The court held that the cost of the franchise was equal to the value of the bridge stating that "the fair market value of the 10 year extension of the franchise should be established but, if that value cannot be determined with reasonable certainty, the fair market value of [the bridge] should be established and that will be presumed to be the value of the extended franchise." *Id.* at 187.

18. Dionne, *supra* note 12, at 168. IRS Officials stated that because the case was remanded to determine the value of the franchise, it had no precedential value. *Id.*

19. 370 U.S. 65 (1962).

20. *Id.* at 72.

by Internal Revenue Code section 118.[21] Section 118 is a codification of the Supreme Court's decision in *Edwards v. Cuba R.R.*[22] which stated that non-shareholder contributions to capital were not income subject to taxation by the sixteenth amendment.

Governments frequently make contributions to corporations, in which they have no ownership interest and without receiving any goods or services, in order to obtain indirect benefits from the corporation's operations. The exclusion for contributions to capital specifically includes contributions made for the purpose of inducing the corporation to locate its business in a particular community or for the purpose of enabling the corporation to expand its existing business.[23] If the restricted local currency has a value in excess of the United States corporation's investment, that excess should be considered a contribution to capital by the foreign government made for the purpose of encouraging the United States corporation to invest there. The value of the United States corporation's investment should not be considered to be in excess of its cash investment since the restrictions on repatriations of capital and dividends cause the excess value of the local investment, if any, to be unlike the corporation's ordinary income.[24]

D. The New York State Bar Association Report

Revenue Ruling 87-124 was criticized in a report recently published by the New York State Bar Association (Report).[25] The Report concluded that the ultimate commercial result in each of the three transactions discussed in Revenue Ruling 87-124 is essentially the same. Consequently, the three transactions should be analyzed in a consistent fashion. The Report agreed with the IRS's conclusion that *X* recognized a loss of forty dollars as a result of the swap. The forty dollars represents the difference between its one hundred dollar basis in the obligation and the sixty dollars it received in the transaction. However, the Report disagreed with the conclusion that *Y* has a gain to the extent that the value of 900 restricted LCs is greater than sixty dollars. This gain realization is a result of the transaction being characterized as *Y* purchasing the debt

21. I.R.C. § 118 (1986). *See generally* Note, *Taxation of Nonshareholder Contributions to Corporate Capital*, 82 HARV. L. REV. 619 (1969); Landis, *Contributions to Capital of Corporations*, 24 TAX L. REV. 241 (1969).

22. 268 U.S. 628 (1925).

23. Treas. Reg. § 1.118-1 (1960).

24. *See supra* note 8 and accompanying text.

25. *Report on Developing Country Debt-Equity Swaps*, Dec. 1, 1988, *reprinted in* TAX NOTES TODAY, Dec. 6, 1988 at 244-319.

from *X* and redeeming the debt for the 900 LCs. The 900 LCs are subsequently contributed to *FX*.

The Report concludes that a better characterization of the transaction is *X* redeeming the debt for 900 LCs, and *Y* contributing sixty dollars to *FX*, which uses these funds to purchase the 900 LCs from *X*. Consequently, although *X* realizes a forty dollar loss, *Y* does not recognize any gain. *Y* did not have any interest in acquiring the *FC* debt as an investment but acquired it solely to participate in the debt-for-equity swap program. The entire series of transactions that comprise the swap were required by the terms of the debt-for-equity swap program and are carried out pursuant to signed agreements that obligate the parties to carry out all the steps of the swap. Consequently, as a matter of both form and substance, *Y* never acquired the debt, nor any of the LCs. Therefore, it is not appropriate to characterize the transaction in any way that treats *Y* as directly owning either the debt or the LCs, which is an integral component of the Revenue Ruling's analysis of *Y*'s role in the swap. Instead, the transaction's effect is as though *Y* had invested sixty dollars in exchange for all the stock of *FX* and consequently *Y* does not recognize any gain.

Even if the transaction is characterized in some form that treats *Y* as directly acquiring the debt or the LCs, the Report concluded that the rule of *Philadelphia Park Amusement Co.* requires that the value of either the debt or the LCs surrendered by *Y* be fixed at sixty dollars, with the result that *Y* does not recognize a gain.

The Report's analysis of Situation 2 in the Revenue Ruling agrees with the analysis adopted by the IRS. *X* recognizes a loss on the swap to the extent that the fair market value of the LCs is less than its basis in the debt. Although the swap could alternatively be characterized as a contribution of the debt to *FX* which redeems it for 900 LCs, this characterization is inappropriate because most countries do not allow their foreign debt to be held by domestic entities. Furthermore, if the obligation were deemed to have been transferred to *FX*, that step should be disregarded because of *FX*'s transitory ownership of the obligation.

III. ALTERNATIVE STRUCTURES

A safer route would be to let the creditor bank initially make the conversion and realize the difference between the secondary market price and the redemption price paid by the Central Bank (gain spread). Since the bank has credits in its portfolio, it does not need to go to the secondary market to purchase it. There will, as a result, be no gain spread.

Instead, the bank will simply reduce its loss on the credit, which will now be limited to the difference between its basis and the value of the local equity received. The value of the local equity received should be immediately determinable because the investing United States corporation will pay a specified sum of United States dollars for it. That amount would represent the cost basis to the United States corporation.

If the bank contemplated selling its foreign credit in the secondary market at a significant discount, it should be willing to sell the shares to the United States corporation at approximately the same rate (after adjustment for additional expenses and possibly a small premium). Thus, each party will come out in approximately the same economic position as with the direct swap without the negative United States tax consequences.

Although previous banking regulations would have made this alternative difficult to achieve, recent changes in Regulation K should permit this to occur.[26] Some risk remains that the IRS would assert the step

26. Before August of 1987, Regulation K of the Federal Reserve Board, 12 C.F.R. § 211 (1986), and the Bank Holding Company Act, 12 U.S.C. § 1841 *et seq.* (1982), prevented banks from holding equity interests greater than 20% in foreign corporations. Money center banks were thus relegated to selling their Latin American debt at deep discounts in the secondary market. This was their only realistic participation in the debt-for-equity swap. However, intensive lobbying by various banking groups put pressure on the regulators to permit banks or bank holding companies to acquire greater equity interests in foreign corporations. The new liberalization of Regulation K has now permitted banks to directly swap their debt for equity in Latin American corporations.

Regulation K permits bank holding companies to purchase and hold one hundred percent of the shares in foreign financial companies. On August 12, 1987 Regulation K was liberalized so that bank holding companies could swap their Latin American debt for a one hundred percent equity stake in a public-sector, non-financial Latin American company which was being privatized by the debtor nationals. However, the liberalization was not broad enough because the bank holding companies were required to sell the stock within five years of the acquisition date, and bank holding companies still could not own an equity interest in non-financial, private sector companies. But nevertheless, this liberalization of Regulation K was a major stepping stone for banks to be able to directly participate in debt-for-equity swaps.

Regulation K was amended for the second time in February of 1988. The amendment made sweeping changes in the manner in which a bank holding company could participate in debt-for-equity swaps. Most significantly, the amendment now permits bank holding companies to acquire up to forty percent of the shares of a foreign non-financial private company when the sovereign debt obligations are swapped for an ownership interest in private companies. Second, the amended Regulation K also permits United States banking firms to invest in foreign companies based in heavily indebted nations for a longer period of time than was currently permissible under the previous Regulation K. A bank holding company can now keep an equity interest in an overseas corporation for up to fifteen years. However, the bank must report to the Fed on its plans for divestiture on the tenth anniversary of the acquisition and two years before the end of the holding period. Third, Board approval is only required when: (a) the amount to be invested is greater than fifteen million dollars ($15.0 M) or one percent of the bank holding company's equity capital after goodwill is deducted; (b) the country's debt-transaction doctrine and try to impose the result of Situation 1 in Revenue Ruling 87-124. However, a closer analysis of the step transaction doctrine indicates that the two transactions should be treated differently.

A. The Step Transaction Doctrine

The step transaction doctrine is a judicially created doctrine which permits a series of separate transactions to be recharacterized and treated as a single integrated transaction if the steps are closely related and focused toward a particular end result.[27] This general principal has been the subject of various judicial interpretations. The most common interpretation of this doctrine is the "mutual interdependence" test which allows separate transactions to be stepped together if they are so interdependent that the legal relations created by each transaction would be fruitless without the others.[28] Another common interpretation of the doctrine is the "end result" test under which if a taxpayer intends a series of transactions to reach a particular result, the transactions may be recharacterized in ways that reach the same result.[29] Although the step transaction doctrine has never been applied to a foreign debt-for-equity swap, several private rulings have considered whether the doctrine applies to domestic debt-for-equity swaps.[30] These transactions are generally not considered to fall within the step transaction doctrine.

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for-equity swap program requires the investor to invest new money in addition to swapping the debt obligation; and then only if the new money portion of the investment is greater than fifteen million dollars; or (c) the investment is made through an insured bank or its subsidiary. Fourth, the bank holding company can provide loans or financing up to fifty percent of the total loans and extensions of credit to their affiliate company. The fifty percent requirement was instituted to insure that the company would have to obtain fifty percent of its credit outside of the bank and thus prove its credit worthiness. Fifth, if the bank holding company acquires greater than twenty-five percent of the control of the private sector, non-financial, foreign company, another shareholder must own a larger block of shares. This provision insures that the bank will not be the controlling shareholder in the corporation. Finally, the Regulation permits the bank holding company to have membership on the firm's board of directors or management committees.

The liberalization of Regulation K has had a significant impact on the bank's role in debt-for-equity swaps. No longer are banks required to sell their debt at a high discount in the secondary markets. Now, banks can directly swap their debt-for-equity in Latin American companies.

27. *See generally* Chirelstein & Lopata, *Recent Developments in the Step Transaction Doctrine*, 60 TAXES 970 (1982); Mintz & Plumb, *Step-Transactions in Corporate Reorganizations*, 12 N.Y.U. ANN. INST. OF FED. TAX'N 247 (1954).

28. *See, e.g.*, McDonald's Restaurants of Illinois v. Commissioner, 688 F.2d 520 (7th Cir. 1982), 82-2 USTC ¶ 9581.

29. King Enterprises v. United States, 418 F.2d 511 (Ct. Cl. 1969), 69-2 USTC ¶ 9720.

30. Tech. Adv. Mem. 87-35-007 (May 28, 1987); Tech. Adv. Mem. 87-08-003 (May 22, 1987); Tech. Adv. Mem. 87-35-006 (May 18, 1987).

Recharacterizing this proposed transaction as Situation 1 in Revenue Ruling 87-124 would require a reversal of the order of the transactions, because in the proposed transaction the conversion of the debt into equity is the first step in the transaction instead of the last.[31] Courts are usually reluctant to reverse the order of steps when applying the step transaction doctrine.[32] Furthermore, recharacterizing the transaction would not be a better portrayal of the substance of these transactions.[33] So long as the bank was not acting as the United States company's agent, the bank bears a risk that the purchaser would not purchase the stock. In Situation 1, there is no risk that the bank will be left holding stock because it sells its debt for cash. If a bank were anxious enough to sell its foreign debt that it was willing to assume the risk that the transaction would not go through and it would be left holding the stock, the transaction would likely withstand scrutiny under the step transaction doctrine. Of course, this additional risk may deter banks from engaging in a transaction of this type. If the transaction were structured in such a way that the bank bore little or no risk that it would not be able to sell the stock, then the bank's purchase of the stock might be seen as lacking legal significance and the transaction might be recharacterized as Situation 1 under the step transaction doctrine.

It may be possible for the bank to bear a greater risk on paper than actually exists. The bank would almost certainly not acquire the stock unless it was certain to be able to immediately resell it.[34] There is no doubt that if the United States company wishes to have cordial relations with its banks in the future, it will in no case fail to purchase the stock.

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31. In addition to the New York State Bar Association Report, at least one other commentator has argued that the step transaction doctrine requires that the transactions described in Rev. Rul. 87-124 be recharacterized as simply a $60 investment in the stock of *FX*. Terry, *Debt Equity Swaps; Analysis of Rev. Rul. 87-124*, 17 TAX MGMT. INT'L 151 (1988). *Y*'s participation in the debt equity swap program is for the purpose of investing in *FX*, without a motivation to invest in the obligations of *FC* in the hope of realizing a gain thereon. The steps must therefore be combined under the end result test. The debt equity swap program only creates another exchange rate for investments in the stock of country *C*. The same result can be reached under the "mutual interdependence" test since "[i]t is evident from the facts that it would not have taken the first two steps of buying the obligation and of exchanging it for foreign currency if it could not have taken the final step of making foreign currency available to its foreign subsidiary." *Id.* at 154.

32. *See, e.g.*, Palmer v. Commissioner, 62 T.C. 684 (1974), *acq.*, 1978-1 C.B. 2, *aff'd on other grounds*, 523 F.2d 1308 (8th Cir. 1975); Grove v. Commissioner, 490 F.2d 241 (2d Cir. 1973); Rev. Rul. 78-192, 78-1 C.B. 83; Chamberlin v. Commissioner, 207 F.2d 462 (6th Cir. 1953), *rev'd*, 18 T.C. 164 (1952), *cert. denied.*, 347 U.S. 918 (1954).

33. *See* Priv. Ltr. Rul. 87-35-007 (May 28, 1987).

34. *See* Priv. Ltr. Rul. 87-38-003 (May 22, 1987); *see also* Chirelstein & Lopata, *supra* note 27, at 972.

Therefore, it is possible for the transactions to be independently recognized for tax purposes with little additional economic risk to the bank.

IV. CONCLUSION

The proper tax characterization of debt-for-equity swaps remains unsettled. Although the IRS has attempted to provide guidance in Revenue Ruling 87-124, that guidance is flawed. The IRS's result-oriented analysis ignores the commercial reality of debt-for-equity swaps. Although it is evident that a multinational bank that participates in the swap should recognize a loss, the IRS has incorrectly concluded that the multinational company recognizes a gain as a result of the swap. There are a number of arguments that indicate that no gain should be recognized. The principles underlying the concepts of income, realization, and form over substance, require that the gain, if any, go untaxed at the time of the swap. The IRS's conclusion to the contrary in Revenue Ruling 87-124 ignores these fundamental principles and is unlikely to withstand a court challenge.