

INTERNAL REVENUE SERVICE

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR District Counsel

FROM: Carol P. Nachman, Special Counsel
Field Service Division, Financial Institutions and Products
Branch

SUBJECT:

This Field Service Advice responds to your memorandum

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:

A =
B =
C =
D =
E =

\$F =
\$G =
\$H =
\$I =
\$J =

%K =
%L =
%M =

%N =

DATE 1 =

DATE 2 =

DATE 3 =

DATE 4 =

DATE 5 =

DATE 6 =

DATE 7 =

DATE 8 =

DATE 9 =

YEAR 1 =

YEAR 2 =

MONTH 1 =

MONTH 2 =

ISSUE:

Whether the taxpayer's loss on the termination of an interest rate swap agreement is ordinary or capital.

CONCLUSION:

We conclude that the taxpayer incurred an ordinary loss.

FACTS:

A, the taxpayer, is a U.S. corporation and a subsidiary of B. A borrowed \$J from C, D Branch, at an interest rate of LIBOR plus L% on DATE 1, pursuant to a subordinated loan agreement ("the loan"). Interest payments were payable on MONTH 1 and MONTH 2 of each year until repayment in DATE 9. A did not pay most of the interest on the loan until DATE 6.

A and C entered into a second agreement, an Interest Rate Swap Agreement ("Swap Agreement" or "the swap"), on DATE 2, which was effective as of DATE 3. The details of the swap were set forth in a separate letter from C, E Branch, to A dated DATE 5. In this letter, the parties agreed that the notional principal amount of the swap was \$J; A was to make "one payment on DATE 8, of \$I"; and A's rate of interest was "a rate which, when compounded semi-annually using the Fixed Rate Day Count Fraction, will result in one payment on DATE 8 of \$I" (approximately N%). C was to make semi-annual periodic payments on the swap on MONTH 1 and MONTH 2 of each year at an interest rate of adjusted LIBOR plus K%. C failed to make these periodic payments on the swap until DATE 6. The

effect of the swap was to change the interest rate on the loan from a variable rate (LIBOR plus L%) to a fixed interest rate (approximately N%).

A terminated both the loan and the swap on DATE 6. A paid C the \$J principal amount outstanding on the loan and the accrued interest on the loan. A agreed to pay C a swap termination payment of \$H. A's payment of \$H was offset by \$G, which represented the accrued periodic payments on the notional principal amount that C was to have paid A from DATE 4 through DATE 7, for a net payment to C of \$F. The parties had previously agreed that A was to pay C \$I for the swap on DATE 8; it is not clear how they derived the \$H amount.

A characterized this net payment as an ordinary expense and deducted the entire payment as interest under I.R.C. § 163 and Treas. Reg. § 1.163-4(c) in YEAR 2. A stated in its response to the Information Document Request number 16 that the loan and the swap were an integrated financial transaction which constituted one fixed rate loan.

A asserted that a purpose of the swap was to amend the terms of the loan with C so as to fix the interest rate and defer interest payments until DATE 8. During YEAR 1, A believed that interest rates would rise and that it was best to lock in a favorable interest rate for a portion of the loan term. In addition, deferral of interest payable on the loan was beneficial to A from a cash flow perspective. A represented that the use of the swap to amend the loan and incorporate the new terms (i.e., fixed rate of interest of N% and deferral of interest payments until DATE 8) was less administratively burdensome than rewriting the loan documents. A also entered into the interest rate swap to reduce the risk of interest rate fluctuations inherent in the LIBOR borrowing.

Prevailing interest rates fell during the two years after the swap was entered into; LIBOR declined by approximately M%. In order to prevent losses from continuing, A terminated the swap on DATE 6.

It is Examination's position that the swap payments fall within the definition of personal property under section 1092, and therefore, pursuant to section 1234A, the gain or loss attributable to the termination payments with respect to the personal property (as defined in section 1092) should be treated as a capital loss. Section 1234A provides that gain or loss attributable to the cancellation or other termination of a right or obligation with respect to personal property (as defined in section 1092) which is a capital asset in the hands of the taxpayer should be treated as gain or loss from the sale of a capital asset.

It is District Counsel's position that this swap transaction was a hedging transaction, and, therefore, District Counsel does not disagree with the taxpayer's argument that the loss on the termination was properly characterized as ordinary.

LAW AND ANALYSIS:

Whether the loss incurred upon the termination of the swap is properly characterized as ordinary or capital depends on whether the swap was a capital asset pursuant to section 1221.

A capital asset is defined under section 1221 as property held by the taxpayer. Certain assets are excluded from capital treatment, such as stock in trade of the taxpayer, property held for sale to customers in the course of business, and accounts or notes receivable. Pursuant to Treas. Reg. § 1.1221-2, a hedge is excepted from capital treatment.

A hedging transaction is defined under Treas. Reg. § 1.1221-2(b) as:

a transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily -

* * *

(2) To reduce risk of interest rate or price changes or currency fluctuations with respect to borrowing made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer.

Whether a transaction reduces risk is determined based on all of the facts and circumstances surrounding the taxpayer's business and the transaction. Treas. Reg. § 1.1221-2(c)(1). These regulations were finalized on July 13, 1994, but the final regulations generally apply to all open tax years. 1994-2 C.B. 180.

A entered into an interest rate swap in YEAR 1 so as to reduce the risk of interest rate fluctuations on the DATE 1 loan. A's copy of the Swap Agreement apparently included a statement under the signatures that the swap was being identified as a hedge of A's variable interest rate liability arising from the loan. Thus, the facts that are available to us indicate that the swap was entered into to hedge interest rate risk in the underlying loan. Accordingly, the swap is excepted from capital asset treatment pursuant to Treas. Reg. § 1.1221-2(a)(1).¹ Consequently, the swap is properly characterized as ordinary and the loss arising from its termination is characterized as ordinary.

We further note that the swap should not be integrated with the loan. Given the facts of this case, there is no authority to integrate the hedge with the underlying hedged transaction. See, Federal National Mortgage Association v. Commissioner,

¹ Because this swap is excepted from capital asset treatment, we do not address Examination's concerns under sections 1234A and 1092.

100 T.C. 541, 583-84 (1993).

The loss arising from A's net termination payment is properly characterized as ordinary.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

The conclusion that the loss incurred upon the termination of the swap is ordinary depends on a factual determination that the swap is a hedge. If it is later determined that this swap does not qualify as a hedge, we request that you contact us for further analysis.