



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Jeffrey L. Dorfman  
Branch Chief CC:INTL:BR5

SUBJECT: FSA - Foreign Exchange Loss

This Field Service Advice responds to your memorandum dated March 2, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

Taxpayer	=
Corporation A	=
Corporation B	=
Corporation C	=
Corporation D	=
Corporation E	=
Corporation F	=
Country A	=
Year a	=
Year b	=
Currency A	=
X	=
Y	=
Z	=

ISSUE(S):

- (1) Whether debt instruments issued by Taxpayer denominated in currency A were “paid” within the meaning of §1.988-2(b)(6) when such instruments were refinanced with new debt having the same terms as the original debt thus entitling the taxpayer to claim a foreign exchange loss under section 988.
- (2) If it is determined that the loans were in fact “paid” under §1.988-2(b)(6), what is the character of the loss?

CONCLUSION:

- (1) Under the standard set forth in §1.1001-3, the instruments were “paid” for purposes of §1.988-2(b)(6) giving rise to an exchange loss.
- (2) Pursuant to section 988(a)(1)(A), the loss is ordinary in character.

FACTS:

During the taxable Year b, Taxpayer reported a foreign exchange loss in the amount of \$Z. The loss represents exchange loss recognized by Taxpayer with respect to the principal repaid, on 13 currency A denominated loans.

Taxpayer is a U.S. corporation which is owned by five Country A corporations (Corporations A, B, C, D, and E). Corporations A and B own 19.1% and 15.9%, of Taxpayer, respectively. Although Taxpayer intended on forming a manufacturing business in the United States, Taxpayer’s sole business activity was holding stock in Corporation F, a publically held Country A corporation. Together with its affiliated corporations, Taxpayer owns approximately 20% of Corporation F.

Beginning in Year a, Taxpayer borrowed fixed rate, currency A funds from Corporations A, C and F. At the end of taxable year b, there were 19 loans with a currency A balance of X (equal to \$Y). With regard to most of the loans in question, the interest rates on the loans were periodically adjusted pursuant to an index set forth in the instrument. During the period, interest rates on the loan went from 8.5% in Year a to 2.125% in Year b.

During taxable Year a, the loans came due. Taxpayer paid off the loans with proceeds from new loans entered into with the same lenders having the same terms as the old loans.

## LAW AND ANALYSIS

Regulation §1.988-2(b)(6) provides that the obligor under a nonfunctional currency debt instrument shall realize exchange gain or loss with respect to the principal amount of such instrument on the date principal is paid or the obligation to make payments is transferred or extinguished (including a deemed disposition under section 1001 that results from a material change in terms of the instrument).

Generally, in determining the meaning of “paid” in the context of a currency loss, the appropriate standard is the standard set forth under §1.165-1. Under §1.165-1(a), losses are allowed in the year they are “sustained.” Pursuant to §1.165-1(b), losses are allowed only if evidenced by a “closed and completed transaction, fixed by identifiable events and actually sustained. Substance and not mere form shall govern in determining a deductible loss.

In the context of the facts of this case, regulations issued under section 1001 of the Code are also relevant with respect to whether the currency loss claimed by Taxpayer was actually sustained. Under § 1.1001-1(a), the exchange of property for other property that differs materially either in kind or in extent is a realization event. Reg. § 1.1001-3 prescribes the tax treatment for modification of debt instruments and is effective for alterations of the terms of a debt instrument on or after September 24, 1996. Taxpayers, however, may rely on §1.1001-3 for alterations of the terms of a debt instrument after December 2, 1992, and before September 24, 1996. See, §1.1001-3(h). The modification to all the loans at issue in this case occurred before March 31, 1996--i.e., prior to the effective date of the §1.1001-3 regulations. However, we assume that the taxpayer will apply the regulation to the pertinent years since it is in its interest to do so.

The economic effect of paying the old loans with proceeds from the new loans (that have identical terms and conditions) was to extend the maturity date of the original loans. Thus, the issue is whether this was a material modification that would give rise to a realization event. Under §1.1001-3,(e)(3) a modification that changes the timing of payments due under a debt instrument is a significant modification if it results in the material deferral of scheduled payments. Under a safe-harbor rule in the regulations, the deferral of one or more scheduled payments within the safe-harbor period is not a material deferral if the deferred payments are unconditionally payable no later than at the end of the safe-harbor period. The safe-harbor period is the lesser of five years or 50 percent of the original term of the instrument. The old loans had a 5 year term and were replaced with new loans with the same term. Accordingly, these new loans would fall outside the safe harbor and must be treated as significant modifications to the old loans. Since the debt refinancing results in a realization event under §1.1001-3, Taxpayer has realized and may deduct the currency losses at issue.

Under section 988(a)(1)(A), the currency losses are characterized as ordinary losses.

While not raised in your request for field service advice, you may want to consider the effect of the change in interest rates for the small number of loans which did not have interest reset features in the terms of the instrument. In those instruments, the change in rates may give rise to a realization event in years that may be closed. See, §1.1001-3(e)(2) and Rev. Rul. 81-169, 1981-1 C.B. 429.

If you have any further questions, please feel free to call me 202-622-3870.

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JEFFREY L. DORFMAN  
Branch Chief