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March 5, 2007

Ms. Clarissa Potter
Office of the Deputy Chief Counsel
Room 3034
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on the Reportable Transaction Regulations
and their Application to Section 988 Transactions

Dear Ms. Potter:

The Clearing House Association L.L.C. (“The Clearing House”), an association of major commercial banks,¹ is writing to comment on the application of regulations governing required filings for reportable transactions contained in Treasury regulations § 1.6011-4 (the “Reportable Transaction Regulations”) to certain transactions defined as “section 988 transactions” under Section 988(c)(1) of the Internal Revenue Code of 1986, as amended (the “Code”). In particular, The Clearing House proposes that the Internal Revenue Service issue a revenue ruling, a revenue procedure or other guidance pursuant to its authority under Treasury regulations § 1.6011-4(b)(8)(i) excluding certain nonabusive section 988 transactions from the category of “loss transactions” as defined in Treasury regulations § 1.6011-4(b)(5). If the Internal Revenue Service disagrees with The Clearing House’s proposal, The Clearing House suggests that, at a minimum, the Internal Revenue Service issue guidance (i) authorizing protective disclosures for nonabusive section 988 transactions with less information than currently required on Internal Revenue Service Form 8886, and (ii) relieving taxpayers of

¹ The members of The Clearing House are Bank of America, National Association; The Bank of New York; Citibank, N.A.; Deutsche Bank Trust Company Americas; HSBC Bank USA, National Association; JPMorgan Chase Bank, National Association; LaSalle Bank, National Association; UBS AG; U.S. Bank National Association; Wachovia Bank, National Association; and Wells Fargo Bank, National Association.

reporting obligations on section 988 transactions where the taxpayer engaged in such transaction only by virtue of attribution from a pass-through entity and where the pass-through entity acknowledges that it has complied with its own reporting obligations for the section 988 transactions.

BACKGROUND TO THE REPORTABLE TRANSACTION REGULATIONS AND LOSS TRANSACTIONS

Under the Reportable Transaction Regulations, a taxpayer must attach to its return a disclosure statement with details related to each reportable transaction if, during the taxable year of the return, the taxpayer engaged in one or more reportable transactions.² A reportable transaction is a transaction of a type falling within one or more of five distinct categories: listed transactions, confidential transactions, transactions with contractual protection, loss transactions, or transactions involving a brief asset holding period.³

A loss transaction is a transaction resulting in a taxpayer's claiming of a significant loss (for corporations, a loss of \$10 million in any one single taxable year or \$20 million in any combination of taxable years) under Code Section 165.⁴ For purposes of this definition, a loss under Code Section 165 includes "an amount deductible pursuant to a provision that treats a transaction as a sale or other disposition, or otherwise results in a deduction under section 165."⁵ Of most relevance in this case, a loss under Code Section 165 includes any "loss resulting from a section 988 transaction."⁶

Despite the breadth of the definition of a "loss transaction," the Internal Revenue Service has authority to exempt certain transactions from any category of reportable transactions

² See Treasury regulations § 1.6011-4(a).

³ See Treasury regulations § 1.6011-4(b)(2)-(7). The current final regulations include a category titled "transactions with a significant book-tax difference," but the Internal Revenue Service has announced that it will no longer require filings with respect to such transactions. See Notice 2006-6, I.R.B. 2006-5. Proposed regulations under Code Section 6011 which would amend Treasury regulations § 1.6011-4 would add a new, sixth category of reportable transactions, "transactions of interest." See Proposed Treasury regulations § 1.6011-4(b)(6). This sixth category of reportable transactions is not relevant to the discussion in this letter.

⁴ See Treasury regulations § 1.6011-4(b)(5)(i).

⁵ See Treasury regulations § 1.6011-4(b)(5)(iii)(B).

⁶ Id.

defined under the Reportable Transaction Regulations.⁷ The Internal Revenue Service has exercised this authority in issuing Revenue Procedure 2004-66, which contains a list of transactions exempted from the category of “loss transactions” (the “Loss Transaction Angel List”).⁸ Included in the Loss Transaction Angel List are transactions where an asset with a “qualifying basis” is sold or exchanged (where a “qualifying basis” is a basis determined by reference to an amount of cash paid by the taxpayer, or a basis determined under Code Section 358 where the basis in the hands of the transferor was otherwise a qualifying basis, or a basis adjusted from an otherwise qualifying basis through certain Code provisions, or other similar situations),⁹ losses arising from certain casualties,¹⁰ losses arising from a properly identified hedging transaction,¹¹ losses equal to and determined solely by reference to a payment of cash by the taxpayer,¹² and similar other transactions.¹³

The particular categories of transactions appearing on the Loss Transaction Angel List appear to be selected to identify transactions where any concern as to tax avoidance or evasion is minimal. For instance, a loss arising from the sale of assets with a qualifying basis is likely of little concern to the Internal Revenue Service, as such a loss arises from an economic loss on the part of the taxpayer. Similarly, any loss equal to and determined solely by reference to a payment of cash by the taxpayer is a real and indisputable economic loss to such taxpayer.

Notably absent from the Loss Transaction Angel List, with one exception, is an exclusion for section 988 transactions. First, any sale or exchange of an asset where the loss from the sale or exchange is treated as ordinary under Code Section 988 is excluded from qualifying as a sale or exchange of an asset with a qualifying basis.¹⁴ This exclusion will apply to most section 988 transactions, carving them out of the most significant category of transactions identified on the Loss Transaction Angel List. Second, no other exclusion in the Loss Transaction Angel List (other than an exclusion for certain mark-to-market losses found in

⁷ See Treasury regulations § 1.6011-4(b)(8)(i).

⁸ Revenue Procedure 2004-66, I.R.B. 2004-50.

⁹ See Loss Transaction Angel List § 4.02(1), (2).

¹⁰ See Loss Transaction Angel List § 4.03(1).

¹¹ See Loss Transaction Angel List § 4.03(5).

¹² See Loss Transaction Angel List § 4.03(9).

¹³ See generally Loss Transaction Angel List § 4.03.

¹⁴ See Loss Transaction Angel List § 4.02(1)(c).

Treasury regulations § 1.988-5(a), involving integrated nonfunctional currency debt instruments and certain currency hedging transactions) covers section 988 transactions generally.

The failure to exclude section 988 transactions of any kind from the definition of loss transactions under the Reportable Transaction Regulations potentially imposes substantial reporting obligations on financial institutions with substantial international operations, such as the members of The Clearing House.

SECTION 988 TRANSACTIONS AND FINANCIAL INSTITUTIONS

A section 988 transaction is defined to include “any transaction described in subparagraph (B) [of Code Section 988(c)(1)] if the amount which the taxpayer is entitled to receive (or is required to pay) by reason of such transaction” is either denominated in a nonfunctional currency of the taxpayer’s or is determined by reference to the value of one or more nonfunctional currencies.¹⁵ The transactions described in subparagraph (B) of Code Section 988(c)(1) include the “acquisition of a debt instrument or becoming the obligor on a debt instrument,”¹⁶ as well as “[a]ccruing . . . any item of expense or gross income or receipts which is to be paid or received after the date on which so accrued or taken into account.”¹⁷

Thus, if a financial institution with the U.S. dollar as its functional currency issues debt denominated in nonfunctional currency, the financial institution will generally engage in at least four different distinct section 988 transactions. First, the financial institution’s becoming of an obligor is a section 988 transaction. Second, any accrual of interest expense on the debt occurring before payment of the interest is a section 988 transaction. Third, the acquisition of the nonfunctional currency necessary to make payments on the debt is a section 988 transaction. Finally, the disposition of the nonfunctional currency to make the payments due on the debt is a section 988 transaction.

Financial institutions with significant international operations, such as the members of The Clearing House, routinely engage in transactions such as the one described above (including similar transactions, such as acquiring debt obligations denominated in nonfunctional currency) in the ordinary course of their business. For any single financial institution, these transactions could number in the thousands or tens of thousands. These transactions are part of the day-to-day business of most financial institution, and are not entered into with a principal or substantial purpose of tax avoidance or evasion.

¹⁵ Code Section 988(c)(1)(A).

¹⁶ Code Section 988(c)(1)(B)(i).

¹⁷ Code Section 988(c)(1)(B)(ii).

Because financial institutions enter into transactions such as the above with great frequency, it is possible that the \$10 million (or \$20 million over five years) loss transaction threshold will be met with some regularity. Forcing a financial institution to identify and report each and every transaction where the thresholds are met would be extremely burdensome on its operations. Also, many financial institutions maintain a single general ledger account for all foreign exchange positions, where income is accrued on a monthly basis. The fact that multiple transactions are combined into a single general ledger account makes it difficult, if not practically impossible, to identify when any individual section 988 transaction meets the \$10 million (or \$20 million over five years) threshold. For these reasons, the internal information systems of the members of The Clearing House are generally not able to keep track of all the information required to be included on the Internal Revenue Service Form 8886 for every routine section 988 transaction that potentially falls under the definition of a loss transaction.

Further, because this category of section 988 transactions is not abusive, there is no need to burden the Internal Revenue Service with multiple filings specifically identifying these transactions. It would be counterproductive to the Internal Revenue Service's legitimate goal of identifying truly abusive transactions to flood the Internal Revenue Service with multiple disclosures of clearly nonabusive transactions.

RECOMMENDATIONS

The Clearing House recommends that the Internal Revenue Service expand the Loss Transaction Angel List to include, as a new category, section 988 transactions entered into in the ordinary course of a financial institution's trade or business, whether by the financial institution itself or through one of its affiliated entities. Such transactions present no risk of tax evasion or avoidance, and thus there exists no need for such transactions to be identified under the Reportable Transaction Regulations. The Clearing House recognizes that the Internal Revenue Service is concerned with highly engineered and replicable transactions taking advantage of Code Section 988's treatment of certain foreign currency losses as ordinary losses. The Clearing House thus recommends that any transaction where one or more partnerships, hybrid entities, trusts, or similar entities are formed solely for the purposes of completing such transaction would be expressly excluded from the new category on the Loss Transaction Angel List, as would transactions involving the issuance or acquisition of hybrid instruments (*e.g.*, instruments treated as debt for U.S. federal income tax purposes and equity for non-U.S. tax purposes).

If the Internal Revenue Service disagrees with The Clearing House's recommendation on the Loss Transaction Angel List, The Clearing House also suggests an alternative to relieve at least some of the burdens imposed by the Reportable Transaction Regulations with respect to section 988 transactions.

First, The Clearing House suggests that the Internal Revenue Service issue guidance stating that any protective disclosure filed pursuant to Treasury regulations § 1.6011-4(f)(2) regarding section 988 transactions entered into in the ordinary course of a financial institution's trade or business would be considered in compliance with the Reportable Transaction Regulations even if the protective disclosure does not contain all the information required on Internal Revenue Service Form 8886. As noted above, the internal information systems of the members of The Clearing House are generally not able to keep track of all the information required to be included on the Internal Revenue Service Form 8886, and the members of The Clearing House would not be able to take advantage of the protective disclosure option available under the current Reportable Transaction Regulations without such an assurance.

Second, The Clearing House suggests that the Internal Revenue Service issue guidance providing that a taxpayer need not file a disclosure statement pursuant to the Reportable Transaction Regulations if (i) the sole reason the taxpayer is deemed under Treasury regulations § 1.6011-4(c)(3)(i)(D) to have participated in a section 988 transaction that is a loss transaction is by reason of the taxpayer's direct or indirect interest in a pass-through entity, and (ii) the taxpayer has received acknowledgment from the pass-through entity that it has or will comply with its separate disclosure obligation under the Reportable Transaction Regulations with respect to such section 988 transaction. This suggestion mirrors the language in Notice 2006-16, creating such an exception to a taxpayer's reporting obligation for certain notional principal contracts.¹⁸ This suggestion would reduce the number of unnecessary protective disclosures made to the Internal Revenue Service and would reduce the administrative burdens imposed on financial institutions.¹⁹

¹⁸ Notice 2006-16, I.R.B. 2006-9, discussing reporting obligations for notional principal contracts described in Notice 2002-35, 2002-1 C.B. 992.

¹⁹ Given the multiple categories of section 988 transactions that have little or no potential for tax avoidance or evasion, and the fact that the particular transactions about which the Internal Revenue Service should have the most concern are generally highly engineered and replicable transactions, The Clearing House suggests as a further alternative that the regulations be amended to exclude all section 988 transactions with losses from the category of "loss transactions." The particular types of section 988 transactions about which the Internal Revenue Service is concerned could be identified instead as "transactions of interest" once Proposed Treasury regulations § 1.6011-4(b)(6) is finalized.

The Clearing House appreciates your consideration of these comments. If you have any questions or if the members of The Clearing House can assist you in considering these important issues, please contact Norman R. Nelson, General Counsel of The Clearing House, at (212) 612-9205.

Very truly yours,

A handwritten signature in dark ink, appearing to read "N. Nelson", with a horizontal line underneath.

JPN:kp

cc: Mr. Donald Korb
Office of the Chief Counsel
Internal Revenue Service

Mr. Steven Musher
Office of the Associate Chief Counsel (International)
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Mr. William O'Shea
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