Office of Chief Counsel
Internal Revenue Service
memorandum

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subject: . ("Taxpayer") – Termination of Forward Rate Agreements

Disclosure Statement

This advice may not be used or cited as precedent. This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

LEGEND:
N1 =
Date1 =
RFA1 =
Date2 =

RFA2 =
Date3 =
N2 =
N3 =
Date4 =
Bank =

ISSUES

Whether Taxpayer may recognize any loss pursuant to section 165(a) of the Code[1] in connection with the termination of its forward rate agreements.[2]

CONCLUSIONS

No, Taxpayer may not recognize any loss pursuant to section 165(a) in connection with the termination of its forward rate agreements because its adjusted basis in these forward rate agreements was $0.

FACTS

Taxpayer is a company with its headquarters in .

Between , and , Taxpayer executed forward rate agreements with a total notional principal amount of $N1, which included forward rate agreements with a Date1, maturity date (collectively, the "RFA1 Agreements"), and forward rate agreements with a Date2, maturity date (collectively, the "RFA2 Agreements"). See The tables below include the general details of the RFA1 and RFA2 Agreements.

[1] Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended and in effect during the taxable year at issue, and to the Treasury Regulations promulgated thereunder.

[2] A forward rate agreement is a type of notional principal contract that, at a specified future date, will settle in cash based on the difference between a set fixed interest rate and a specified marked interest rate. Bittker & Lokken, Federal Taxation of Income, Estates and Gifts ¶ 57.4 Notional Principal Contracts (2021) (quoting Bank One Corp. v. Commissioner, 120 T.C. 174, 186 (2003), aff'd in part, vacated in part, and remanded on other grounds, JP Morgan Chase & Co v. Commissioner, 458 F.3d 564 (7th Cir. 2006)); see Treas. Reg. § 1.446-3(c)(1)(i) (defining a notional principal contract).

On , Taxpayer "de-designated" the RFA1 Agreements as hedges for book purposes,[3] and using a Bloomberg terminal, Taxpayer priced the RFA1 Agreements as of this date. Id. at According to Taxpayer, the RFA1 Agreements had a negative fair market value of $ on . The RFA1 Agreements "

" Id. at

On , Taxpayer issued the anticipated debt against which the RFA1 Agreements no longer served as hedges.

at

On Date3, Taxpayer and each of the relevant counterparties terminated the RFA1 and RFA2 Agreements, and using a Bloomberg terminal, Taxpayer priced the RFA1 and RFA2 Agreements as of this date.

at According to Taxpayer, the RFA1 Agreements had a negative fair market value of $N2 on Date3, and the RFA2 Agreements had a negative fair market value of $N3 on Date3. Id. at Taxpayer did not cash settle the RFA1 and RFA2 Agreements. See id. at

On Date4, Taxpayer and Bank executed a new forward rate agreement with a notional principal amount of $N1. Id. at Bank subsequently syndicated a portion of the new forward rate agreement among separate counterparties. Id. at As a result, Taxpayer was a party to new forward rate agreements with a total notional principal amount of $N1 (collectively, the "RFA3 Agreements"). Id. at The table below includes the general details of the RFA3 Agreements.

[3] For tax purposes, the RFA1 Agreements remained hedges of issued and to-be-issued debt.

According to Taxpayer, the RFA3 Agreements had the "same negative value" as the RFA1 and RFA2 Agreements on Date3. Id. at ; see at

On , Taxpayer presented the IRS Exam Team with its proposed tax position regarding the termination of the RFA1 and RFA2 Agreements and execution of the RFA3 Agreements. See generally

With respect to the RFA1 Agreements, Taxpayer stated that "

" Id. at Taxpayer explained that

" Id. at

With respect to the RFA2 Agreements, Taxpayer stated that "

" Id. at Taxpayer explained that the basis for this position was section 1.446-4(e)(8) of the Income Tax Regulations. See id. at

The IRS Exam Team requested that Taxpayer provide a detailed computation of its adjusted basis, as defined under section 1.1011-1 of the Income Tax Regulations, for the RFA1 Agreements and the RFA2 Agreements.

On , Taxpayer informed the IRS Exam Team that its adjusted basis in the RFA1 Agreements and the RFA2 Agreements was $0. at

LAW

Section 165(a) provides that, as a general rule, "[t]here shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise."

Section 165(b) provides that, for purposes of section 165(a), "the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property."

Section 1.165-1(c)(1) of the Income Tax Regulations provides in part that "[t]he amount of loss allowable as a deduction under section 165(a) shall not exceed the amount prescribed by § 1.1011-1 as the adjusted basis for determining the loss from the sale or other disposition of the property involved." See also, e.g., Helvering v. Owens, 305 U.S. 468, 471 (1939) ("[W]e think section 113(b)(1)(B)[4] must be read as a limitation upon the amount of the deduction so that it may not exceed cost, and in the case of depreciable non-business property may not exceed the amount of the loss actually sustained in the taxable year, measured by the then depreciated value of the property."); Barry v. United States, 501 F.2d 578, 585 (6th Cir. 1974) ("Even under the construction of the law urged by taxpayers, there would be no loss to deduct since the adjusted basis of the building was found to be zero.") (internal citations omitted).

[4] The section 113 that was in effect during 1939, which was analyzed in Helvering v. Owens, was the predecessor to the current section 1011 and was entitled "Adjusted Basis for Determining Gain or Loss," which is the same title used for current section 1011. Section 113 was renumbered to section 1011 in the Internal Revenue Code of 1954.

ANALYSIS

In conjunction with the execution of the RFA3 Agreements, Taxpayer terminated the RFA1 Agreements and RFA2 Agreements. Taxpayer contends that these transactions constituted a sale or disposition for purposes of section 1001, whereby Taxpayer realized a loss pursuant to section 165(a) in the amount of the fair market value of the RFA1 Agreements and RFA2 Agreements.[5] See I.R.C. § 165(a) (allowing a deduction for any loss sustain during the taxable year and not compensated by insurance or otherwise); see also I.R.C. § 165(b) (providing that the basis used to determine any deduction under section 165(a) shall be adjusted basis under section 1011). Taxpayer further contends that, of the purported loss, the portion attributable to the RFA1 Agreements is recognized over the -year term of Taxpayer's debt and the portion attributable to the RFA2 Agreements is recognized immediately. However, Taxpayer's adjusted basis, as defined by section 1.1011-1, in the RFA1 Agreements and the RFA2 Agreements was $0. Section 1.165-1(c) provides that "[t]he amount of loss allowable as a deduction under section 165(a) shall not exceed the amount prescribed by § 1.1011-1 as the adjusted basis for determining the loss from the sale or other disposition of the property involved." Thus, Taxpayer may not deduct any amount pursuant to section 165(a) as a loss sustained in connection with the termination of the RFA1 Agreements and the RFA2 Agreements.

Please call Tyler J. Rippon at (202) 803-9482 if you have any further questions.

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[5] This memorandum does not express any opinion as to whether these transactions constituted a sale or other disposition under section 1001.