

1-1-1989

## Revenue Ruling 87-124: Treasury's Flawed Interpretation of Debt-for-Nature Swaps

Ronny Jay Halperin

Follow this and additional works at: <https://repository.law.miami.edu/umlr>



Part of the [Environmental Law Commons](#)

---

### Recommended Citation

Ronny Jay Halperin, *Revenue Ruling 87-124: Treasury's Flawed Interpretation of Debt-for-Nature Swaps*, 43 U. Miami L. Rev. 721 (2015)

Available at: <https://repository.law.miami.edu/umlr/vol43/iss3/6>

This Comment is brought to you for free and open access by the Journals at University of Miami School of Law Institutional Repository. It has been accepted for inclusion in University of Miami Law Review by an authorized editor of University of Miami School of Law Institutional Repository. For more information, please contact [library@law.miami.edu](mailto:library@law.miami.edu).

# Revenue Ruling 87-124: Treasury's Flawed Interpretation of Debt-for-Nature Swaps

I. INTRODUCTION .....	721
A. <i>Third World Debt and Environmental Crises</i> .....	721
B. <i>Debt-for-Nature Swaps</i> .....	723
C. <i>Tax Considerations: A Deterrent to Contributing Debt to Charity</i> .....	723
D. <i>Treasury to the Rescue</i> .....	724
II. THE RULING .....	726
A. <i>Contemplated Fact Situation</i> .....	726
B. <i>Reversal of Tradition</i> .....	728
III. PROPERTY LOSS VERSUS BAD DEBT .....	728
A. <i>Worthlessness</i> .....	729
B. <i>Recharacterization Strategies</i> .....	731
C. <i>The Charitable Contribution Valuation</i> .....	731
D. <i>Withers v. Commissioner: The Flip-Flop of Revenue Ruling 87-124</i> .....	733
IV. QUALIFYING ORGANIZATION? .....	734
A. <i>The Control Test</i> .....	734
B. <i>The Legislative Solution</i> .....	736
V. CONCLUSION .....	737

## I. INTRODUCTION

### A. *Third World Debt and Environmental Crises*

The macroeconomic relationship between the rich, industrialized nations of the world and the middle-income developing countries began to reverse in 1982. Economic resources began to flow from the developing countries to the developed ones,<sup>1</sup> mainly because developing countries paid more in interest on their foreign loans than they received in net new borrowing and direct investment.<sup>2</sup> Belt-tightening, necessary to service their outstanding foreign debt, stifled the economic growth of these developing countries and frustrated their return as viable markets for exports from the United States and other industrialized nations.<sup>3</sup> The continual drain of resources and the

---

1. Orr, *Third-world Debt: New Fixes Needed*, ABA BANKING J., Apr. 1987, at 79. The decade from 1982 to 1992 will witness the transfer from the developing countries to the developed countries of 314 billion dollars. *Id.*

2. *Id.*

3. *Foreign Debt: Listen to Bill Bradley*, BUSINESS WEEK, July 28, 1986, at 92. Developing countries, for the most part, are commodity exporters. Price declines of oil and other commodities have led to more production and less earnings for commodities sold by exporters in world markets. To make matters worse, prices of imported manufactured goods have not dropped to compensate for export price declines. See Orr, *supra* note 1, at 80. The United States and Europe have directly contributed to the problem:

European nations have thwarted imports from developing countries to bring

resultant shrinking of national economies has left many of these nations on the verge of bankruptcy and has threatened their political stability.<sup>4</sup>

Under pressure to pay their external debt, many countries employ quick-fix solutions that exhaust their natural resources and therefore undercut their economic potential as a nation.<sup>5</sup> One such solution serves only to create an ecological crisis with global ramifications: the rapid destruction of rain forests together with their plant and animal species.<sup>6</sup> The ominous consequences were described in a recent article:

In 20 years the forests of the tropics will be largely stripped bare unless Third World countries slow their ravenous logging and mining. Countless species of plants and animals will die in "the greatest extinction since the end of the age of the dinosaurs". . . . But biology lectures carry little clout with poor countries desperate for cash to pay huge foreign debts.<sup>7</sup>

This trend toward ecological disaster is most evident in the developing countries of the Central and South American tropics.<sup>8</sup> Ironically, the trend is a product of a well-intentioned effort to repay the debt owed to developed nations.

---

down their own stubbornly high unemployment. The U.S. also inhibits the flow of imports to "protect" domestic jobs. But this country's main uses of the inflowing resources are to help finance its budget deficit. In effect, the U.S. is asking poorer nations to tighten their belts—consume less and export more of the wealth they produce—so we can loosen our belts, continuing to consume more and save less of the wealth we produce.

*Id.* See also *7 Latin Leaders Agree to Seek Joint Debt Reduction Strategy*, Miami Herald, Oct. 29, 1988, at 7A, col. 4 (Brazilian Foreign Minister Mailson Ferreira da Nobrega remarked: "There is a broad consensus that there is no possibility of development in our countries without a reduction of the debt.").

4. Moreover, as one United States Senator has recognized, "[T]he existence of these huge debts also has ramifications for our balance of trade, the soundness of our financial institutions, and the general political stability of these developing countries." *Charitable Deduction for Donors of Debt of Developing Nations: Introduction of S. 1781 Before the Senate Comm. on Finance*, 100th Cong., 1st Sess., 133 CONG. REC. S14,063-64 (1987) [hereinafter *S. 1781*] (statement of Sen. John Chafee, R-R.I.); see, e.g., *Brazil Lunges Nearer to Out-of-Control Inflation*, Miami Herald, Oct. 22, 1988, at 7D, col. 1. Due to runaway inflation, blamed on the debt crises, angry, underpaid workers have engaged in strikes that have paralyzed more than a dozen government ministries and agencies. *Id.* at col. 6.

5. Shabecoff, *Bolivia to Protect Lands in Swap for Lower Debt*, N.Y. Times, July 14, 1987, at C2, col. 3.

6. *Id.*

7. Copeland, *Buying Debt, Saving Nature*, NEWSWEEK, Aug. 31, 1987, at 46 (quoting Harvard biologist E.O. Wilson).

8. See Shabecoff, *supra* note 5, at C2, col. 3.

### B. *Debt-for-Nature Swaps*

It is very difficult for developing nations to expend financial resources on the environment when there are many other competing human needs that first must be satisfied. International environmental groups, well aware of this dilemma, have developed an imaginative way to help developing nations implement and maintain conservation programs. Taking a cue from increasingly popular debt/equity swaps,<sup>9</sup> these environmental groups have offered, essentially, to pay Third World government debts in exchange for conservation concessions within the countries.

Through these so-called "debt-for-nature swaps," conservation organizations acquire Third World debt from U.S. banks as a charitable contribution.<sup>10</sup> Subsequently, they negotiate with the debtor country to redeem the debt for local currency and then use these funds to finance environmental conservation in that country. Because debt is redeemed in local currency<sup>11</sup> and the funds are dedicated for use in local conservation programs, debt redemption commands a substantial premium in excess of the prices at which debt is traded in world markets.<sup>12</sup>

### C. *Tax Considerations: A Deterrent to Contributing Debt to Charity*

Tax law limits the charitable deduction to the market value of

---

9. A debt/equity swap involving national debt is a complex multi-party transaction. Typically, it involves the transfer of a debt instrument back to a debtor country in exchange for an equity position in a new or existing entity in the country. A multinational corporation, desiring to make a new investment or increase investment in a foreign country, purchases that country's debt from a bank at a deep discount. The corporation then presents the debt instrument to the Finance Minister of the debtor country, who cancels it for the face amount in local currency. The local currency is then used to make the desired investment. When the investor is a United States bank, the debt is directly swapped with the debtor country. For a detailed description of debt/equity swaps, see paper by W. Alexander & J. Ross, *Consequences of Debt/Equity Schemes* (unpublished manuscript) in Letter from John B. Ross to Ellen April, Tax Legislative Counsel, United States Treasury (Feb. 17, 1988) (available on Westlaw, Tax Analyst database) [hereinafter *Consequences of Debt/Equity Schemes*].

10. The charitable organization can acquire the debt either by outright purchase from a United States bank or by contribution from the bank to the charitable organization. This Comment deals only with the latter situation as anticipated by Revenue Ruling 87-124. See *infra* notes 19-21 and accompanying text.

11. Payment in local currency does not impact adversely the debtor nation's balance of payments as would payments of United States dollars in the ordinary course of the debt instrument's maturity. The charitable organization, though rewarded by an increase in the value of its donation is, however, also saddled with the prospect of decreased purchasing power due to local inflation. See Lamp, *A Tax Blueprint for LDC Debt Swaps*, 1988 TAX NOTES 1215, 1218.

12. See S. 1781, *supra* note 4, at S14,064.

the property donated.<sup>13</sup> Thus, if a lender donates Third World debt with a market value below its cost basis<sup>14</sup> to a charitable organization, the lender will be unable to recover its entire cost basis in the debt through the charitable deduction.<sup>15</sup> Alternatively, if the lender sells the debt to the charitable organization at the discounted market price, the lender will be entitled to a deduction for only the amount of the loss realized on the sale.<sup>16</sup> Either scenario places the lender in a worse position than if it had simply sold the debt, taking a deduction for the loss, and donated the proceeds of the sale to charity, taking an additional deduction for a charitable donation.<sup>17</sup>

#### D. *Treasury to the Rescue*

In order to encourage United States banks to donate their lesser-developed-country (LDC) debt for charitable purposes in foreign countries, the United States Department of the Treasury intends to construe liberally<sup>18</sup> the debt-for-charity section of Revenue Ruling 87-124.<sup>19</sup> Revenue Ruling 87-124 permits banks to transfer directly their

13. Treas. Reg. § 1.170A-1(c) (as amended in 1984) (The amount of the contribution is the fair market value of the property at the time of the contribution.).

14. Basis generally equals the taxpayer's cost of the property. See I.R.C. § 1012 (1986).

15. The deduction would be limited to the fair market value of the property. See *supra* note 13.

16. I.R.C. §§ 165, 1001 (1986).

17. This two-step transaction allows for a deduction of the taxpayer's total basis in the property. See, e.g., *Federal Income Taxation of Banks and Financial Institutions*, BANKING L.J. ¶ 9.14, at 9-27 (E. Krader 5th ed. 1978) [hereinafter *Taxation of Banks*].

18. See Letter from C. Eugene Steuerle, Treasury Deputy Assistant Secretary for Tax Analysis, to Sen. John H. Chafee, R-R.I., Senate Finance Committee member (Mar. 29, 1988), reprinted in 1988 TAX NOTES 402.

19. Rev. Rul. 87-124, 1987-2 C.B. 205. Revenue Rulings are opinions, issued by the IRS, concerning matters of law arising in particular fact settings. They often advise taxpayers about specific legal issues. Rulings are somewhat less authoritative than Treasury Regulations, but they are significant in the day-to-day administration of tax laws and are persuasive to the courts. See W. KLEIN, B. BITTKER & L. STONE, *FEDERAL INCOME TAXATION* (7th ed. 1987).

Revenue Ruling 87-124 deals with three debt swap situations. The first two concern typical debt/equity swaps, and the third concerns debt-for-charity swaps. This Comment discusses only the third situation. The transaction is described as follows:

##### FACTS

*X*, a United States commercial bank, holds a United States dollar denominated debt (the Obligation) of the central bank (the Central Bank) of foreign country *FC*. The Obligation evidences a loan of \$100 that *X* made to the Central Bank. *X*'s adjusted basis in the Obligation, as determined under section 1011 of the Internal Revenue Code of 1986, is \$100. Under the laws of *FC*, the Obligation cannot be held by an *FC* entity.

The local currency of *FC* is the LC. On July 1, 1987, the free market exchange rate was \$1 = 10 LCs.

*FC* has a program (the Program) whereby a holder of United States dollar denominated debt of *FC* can negotiate with the Central Bank to deliver the *FC*

LDC debt to the debtor country, for a charitable purpose in that country, and allows the bank a deduction for its full cost basis in the debt.<sup>20</sup> This seemingly straightforward interpretation has been the cause of considerable bewilderment in the tax and banking community<sup>21</sup> because it constitutes a complete reversal of the Internal Revenue Service's (IRS) traditional interpretations<sup>22</sup> of tax codes dealing with losses,<sup>23</sup> bad debts,<sup>24</sup> and charitable contributions.<sup>25</sup>

---

debt to the Central Bank for LCs if the holder agrees to . . . use the LCs in *FC* in a manner approved in advance by the government of *FC*. The Program controls the LCs by . . . channeling the LCs to their designated use in *FC*. . . . The amount of LCs the Central Bank will give the holder in exchange for the debt varies according to how the LCs are used.

In accordance with a prearranged plan pursuant to the Program, the following transaction[] occurred on July 1, 1987:

*Situation 3*

[X delivered the Obligation to the Central Bank.] . . . [T]he Central Bank credited an account of Z, a United States corporation that is a charitable organization described in section 170(c)(2) of the Code, with 900 LCs. Under the terms of the Program, Z can use the 900 LCs only in *FC* for charitable purposes meeting the requirements of section 170 . . . .

LAW AND ANALYSIS

*Situation 3*

X will be treated as if it received the 900 LCs from the Central Bank in exchange for the Obligation and then contributed the 900 LCs to Z. X recognizes a loss on the exchange of the Obligation . . . (\$100) over the fair market value of the 900 LCs. In addition, assuming X and Z satisfy all requirements of the Code relating to charitable contributions, X is entitled to a charitable contribution deduction under section 170 of the Code equal to the fair market value of the 900 LCs at the time of the contribution . . . .

Rev. Rul. 87-124, 1987-2 C.B. 205, 205-06.

20. Rev. Rul. 87-124, 1987-2 C.B. 205, 206 (HOLDINGS section, Situation 3).

21. See Dionne, *Revenue Ruling on Debt/Equity Swaps Leaves Unanswered Questions—To the Delight of the Tax Bar*, 1988 TAX NOTES 166 [hereinafter Dionne, *Revenue Ruling*] ("Despite this ruling, the tax treatment of the debt/equity swaps is still unclear."); Dionne, *Treasury Agrees to Construe Revenue Ruling on Debt-for-Nature Swaps Liberally*, 1988 TAX NOTES 307 [hereinafter Dionne, *Treasury Agrees*] ("[T]he ruling thus far has done little to achieve its goal because of bank concerns over deduction consequences.") "[A]mbiguities in Rev. Rul. 87-124 created a disincentive to claim a charitable contribution deduction . . . ." *Id.* at 308.

John B. Ross, Banking Advisor to the Institute of International Finance, Inc., Washington, D.C., has suggested that Revenue Ruling 87-124 be clarified. Letter from John B. Ross to Ellen April, Tax Legislative Counsel, United States Treasury (Feb. 17, 1988). Ross wrote: "I understand perfect certainty—beyond death and taxes in general—is not envisioned, but I think it is necessary to reduce significantly the level of uncertainty surrounding Revenue Ruling 87-124." *Id.*; see also TAX NOTES INT'L, Mar. 2, 1988, at 28 (David Kline, President of the Fund for Private Assistance in International Development, has submitted to Treasury a proposed revenue ruling to clarify Revenue Ruling 87-124).

22. But see Lamp, *supra* note 11, at 1220 ("The U.S. Treasury has done much to make debt for charity swaps possible without violating traditional tax rules.").

23. I.R.C. § 165 (1986).

24. I.R.C. § 166 (1986).

This Comment analyzes the contradictions presented by Revenue Ruling 87-124. In Section II, this Comment discusses the transaction envisioned by the IRS in Revenue Ruling 87-124 and the two-step analysis applied to it. Section III examines the motivation for banks to undertake this transaction and argues that the transaction should be considered for its ultimate result—allowing a deduction for a bad debt. Section IV then examines ambiguities raised by allowing the deduction for a charitable contribution to a foreign country. Finally, in Section V, this Comment concludes that definitive legislation is necessary in order to avoid abuse and to quiet confusion over the intended tax treatment of debt-for-nature swaps.

## II. THE RULING

### A. *Contemplated Fact Situation*

Revenue Ruling 87-124 describes the federal income tax consequences to a lender resulting from various transactions that are part of a foreign country's program to reduce the amount of its outstanding United States dollar-denominated debt.<sup>26</sup> Under a prearranged program, a United States commercial bank delivers a debt instrument to the Central Bank of the debtor country. The Central Bank then credits the account of a United States charitable organization that meets the requirements of Section 170(c)(2) of the Internal Revenue Code (the Code).<sup>27</sup> The amount of this credit is a predetermined per-

---

25. I.R.C. § 170 (1986).

26. Rev. Rul. 87-124, 1987-2 C.B. 205.

27. Section 170 of the Code provides in part:

§ 170. Charitable, etc., contributions and gifts

(a) Allowance of Deduction.—

(1) General Rule.—There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary or his delegate.

(c) Charitable Contribution Defined.—For purposes of this section, the term "charitable contribution" means a contribution or gift to or for the use of—

(2) A corporation, trust, or community chest, fund, or foundation—

(A) created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States;

(B) organized and operated exclusively for religious, charitable,

centage of the original debt<sup>28</sup> and is payable to the charitable organization in the local currency of the foreign country.<sup>29</sup> In addition, the local currency deriving from this credit is to be used solely in the foreign country for purposes meeting the requirements of Section 170.<sup>30</sup>

In the factual scenario just described, the IRS treats the United States bank as having received the local currency from the Central Bank and then having contributed the local currency to the charitable organization.<sup>31</sup> As a result of this treatment, United States banks may recognize a loss on the exchange of the obligation for the local currency<sup>32</sup> and are entitled to a charitable contribution deduction under Section 170 of the Code, equal to the fair market value of the local

---

scientific, literary, or educational purposes, . . . or for the prevention of cruelty to children or animals;

(C) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and

(D) no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation.

A contribution or gift by a corporation to a trust, chest, fund, or foundation shall be deductible by reason of this paragraph only if it is to be used within the United States or any of its possessions exclusively for purposes specified in subparagraph (B).

28. The amount is predicated on how the funds are to be used within the foreign country. See Alexander & Ross, *supra* note 9. This presents the issue of how the market value of the donated debt is to be determined. *Id.* The market value of the amount of foreign currency deposited by the central bank to the account of the charitable organization may bear no relation to the actual market value of the debt. *Id.* For instance, a debt obligation of a foreign country might sell on the open market for 60% of its United States dollar face value, but because the debt is being redeemed in local currency, the foreign country might be willing to deposit an amount equal to 90% of the face value. *Id.* Other valuation issues have been raised, such as determining the adjustment in market value if the foreign currency is restricted to use in the foreign country. *Id.*

29. Rev. Rul. 87-124, 1987-2 C.B. 205, 205-06.

30. Prior revenue rulings have carved out exceptions to the apparent proscriptions against use of the donated funds outside the United States or its possessions. Rev. Rul. 66-79, 1966-1 C.B. 48; Rev. Rul. 63-252, 1963-2 C.B. 101. Funds donated to an otherwise qualified domestic organization can be excepted, even though the domestic organization grants funds to charitable groups organized in a foreign country. If the purposes of the domestic organization are furthered by granting funds to the foreign group, and no special funds are solicited on behalf of the foreign group, then donations made to the domestic organization are deductible. Rev. Rul. 63-252, 1963-2 C.B. 101. Similarly, a domestic organization that forms a foreign subsidiary to facilitate its charitable work in the foreign country and solicits funds for its foreign activities is considered to be the true beneficiary of funds donated to it, rendering those funds deductible. *Id.* "The test in each case is whether the organization has full control of the donated funds, and discretion as to their use, so as to insure that they will be used to carry out its functions and purposes." Rev. Rul. 66-79, 1966-1 C.B. 48, 51.

31. Rev. Rul. 87-124, 1987-2 C.B. 205, 206 (LAW AND ANALYSIS, Situation 3).

32. The loss is equal to the excess of the bank's adjusted basis in the obligation over the fair market value of the local currency. *Id.*; see *supra* note 16 and accompanying text.



currency at the time of the donation.<sup>33</sup> Thus, under this interpretation, United States banks may recognize a loss equal to their total adjusted basis in the debt.<sup>34</sup>

### B. *Reversal of Tradition*

Much of the confusion surrounding Revenue Ruling 87-124 stems from the Treasury's bifurcation of the debt-swap transaction. Taken separately, each transaction routinely gives rise to distinct, generally sanctioned tax consequences. Ordinarily, the exchange or sale of United States dollar debt obligations for a lesser amount of foreign local currency, although not devoid of interpretive problems, would give rise to a deductible loss under Section 165 of the Code.<sup>35</sup> One asset, the loan receivable, would be exchanged for another asset of lesser value, the LDC's currency, and the difference would be the allowable loss.<sup>36</sup> The problem with the Treasury's example—theoretically and in actual practice—is that the exchange is inextricably tied to the subsequent contribution. The original debt holder actually receives nothing for its exchange; its only benefit is the ability to ultimately deduct its entire basis in the debt.<sup>37</sup> In effect, the bank has been allowed a deduction for a loss on a bad debt, characterizing a portion of the transaction as an allowable deduction for a loss incurred on an exchange of property under Section 165, and characterizing the remainder as a deduction for a charitable contribution under Section 170.

## III. PROPERTY LOSS VERSUS BAD DEBT

A deduction for a bad debt is only permitted if the debt becomes worthless within the taxable year.<sup>38</sup> The statutory provision for the deduction for bad debt losses is made, not under Section 165, but under Section 166. The courts have found that these two Sections are mutually exclusive.<sup>39</sup> In *Spring City Foundry Co. v. Commissioner*,<sup>40</sup> the taxpayer claimed a deduction for a loss under Section 234(a)(4) of

---

33. Rev. Rul. 87-124, 1987-2 C.B. 205, 206 (LAW AND ANALYSIS, Situation 3); see *supra* note 13 and accompanying text.

34. Rev. Rul. 87-124, 1987-2 C.B. 205, 206 (HOLDINGS, Situation 3); see *supra* note 17 and accompanying text.

35. Treas. Reg. § 1.165-1(c)(3) (as amended in 1977).

36. *Id.*

37. See *supra* note 17 and accompanying text.

38. Note, *Coping with the Specific Charge-off Method: Developing Standards to Determine When an Outstanding Obligation is Worthless*, 7 VA. TAX REV. 365, 375 (1987). "The ultimate issue in determining whether a bad debt deduction will be allowed is if, in fact, the outstanding obligation is worthless." *Id.* at 375.

39. See *Putnam v. Commissioner*, 352 U.S. 82 (1956); *Spring City Foundry Co., v.*

the Act of 1918 (the predecessor of the current Section 165), arising from a debt that was not then ascertained to be worthless.<sup>41</sup> The Supreme Court of the United States disallowed the deduction stating:

The making of the specific provision as to debts indicates that these were to be considered as a special class and that losses on debts were not to be regarded as falling under the preceding general provision. What was excluded from deduction under [the predecessor of Section 166] cannot be regarded as allowed under [the predecessor of Section 165].<sup>42</sup>

Normally the IRS is quick to recognize the distinction and advise taxpayers to correctly categorize their losses. Revenue Ruling 87-124, however, indulges a less stringent standard, as it must, to validate the IRS's interpretation.<sup>43</sup> If the IRS were to deem the loss as one arising from a debt, it would have to concede that the indebtedness had become worthless during the taxable year.<sup>44</sup>

### A. Worthlessness

The Code, which painstakingly defines key words, has failed to define "worthlessness,"<sup>45</sup> leaving its definition to the courts.<sup>46</sup> The

---

Commissioner, 292 U.S. 182 (1934); *Lewellyn v. Electric Reduction Co.*, 275 U.S. 243 (1929); *accord* *Porter v. United States*, 27 F.2d 882 (9th Cir. 1928).

40. 292 U.S. 182 (1934).

41. *Id.* at 185-86. The debtor had become bankrupt, leaving the debt in suspense. What amount might be recovered was uncertain. There was, however, an expectation of some recovery. *Id.* The Court was of the opinion that Congress "did not authorize the deduction of a debt which was not then ascertained to be worthless but was recoverable in part, the amount that was not recoverable being still uncertain." *Id.* at 189.

42. *Id.*

43. Moreover, the IRS has been reluctant to classify foreign debt as property in order to allow a Section 165 deduction. In the Treasury's own opinion, "[t]he fact that the debtor [is] a foreign country does not preclude classification of the obligation as a debt for the purposes of section 166 of the Code." Rev. Rul. 72-1, 1972-1 C.B. 52, 55; *see* Priv. Ltr. Rul. 84-33-008 (Apr. 27, 1984). A corporate taxpayer's receivables from a foreign government were characterized as debts, precluding any consideration of their deductibility under Section 165. *Id.*; *see also* Gen. Couns. Mem. 39,265 (Aug. 1, 1984). Amounts owing but not paid by the Iranian government on contracts between the taxpayer and that government, if and when deductible, would be deductible as bad debts under Section 166 and not as losses under Section 165. *Id.*

44. *See supra* note 38 and accompanying text.

45. *See Note, supra* note 38, at 381. The IRS offers only subjective guidance in determining whether a debt is worthless, instructing its district director to "consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor." Treas. Reg. § 1.166-2(a) (as amended in 1973).

The Tax Court considers a debt wholly worthless when there are reasonable grounds for abandoning any hope of repayment in the future. But this definition only lays a foundation for determining worthlessness and provides no guidance as to when hope of repayment should be abandoned and what the extent of the taxpayer's efforts to collect the outstanding obligation should be.

Supreme Court has posited an objective standard, holding that "[a] loss, to be deductible, must have been sustained *in fact* during the taxable year."<sup>47</sup> Proving that the loss "in fact" occurred is the burden of the taxpayer<sup>48</sup> and depends upon all the facts and circumstances of the case.<sup>49</sup> This burden on a bank, in the case of an LDC debt, could be a heavy one indeed.

By March 31, 1988, United States banks reported total claims on foreign public borrowers<sup>50</sup> in Latin America and the Caribbean to be in excess of 108 billion dollars.<sup>51</sup> Despite the perceived hopelessness of the problem, one noted economist pointed out that "[t]he frequently predicted crisis, in which debtor countries repudiate their debts and big banks are no longer able to attract deposits, has not occurred."<sup>52</sup> Financial disaster had been averted by extensive renegotiation of Third World debt, involving rescheduling of payments and additional financing.<sup>53</sup> As a result, in 1987, when Revenue Ruling 87-124 was announced, no major debtor country had defaulted.<sup>54</sup>

The success of the debt management strategy militates against a finding that the LDC debts are worthless. Moreover, the very techniques employed in managing the debt—continued negotiation and further extensions of credit—and the fact that the debtor has not defaulted, are held by the courts to contradict claims by the taxpayer that the debts are uncollectable.<sup>55</sup>

---

Note, *supra* note 38, at 381.

46. The Code speaks only of "evidence of worthlessness." I.R.C. § 166 (1986).

47. *Boehm v. Commissioner*, 326 U.S. 287, 292 (1945) (emphasis in original).

48. See *Sollitt Const. Co. v. United States*, 1 Cl. Ct. 333 (1983); *accord* *Riss v. Comm'r*, 478 F.2d. 1160 (8th Cir. 1973).

49. See, e.g., *Sollitt Const. Co.*, 1 Cl. Ct. at 345.

50. The term "foreign public borrower" encompasses foreign central governments and their departments and possessions, foreign central banks, corporations and other agencies of central governments, and any international or regional organization or subordinate or affiliated agency, created by treaty or convention between sovereign states. OFFICE OF THE SECRETARY, DEP'T OF THE TREASURY, TREASURY BULLETIN, CAPITAL MOVEMENTS 66 (Sept. 1988).

51. *Id.* at 76 (Table CM-11-3, entitled - Total Claims on Foreigners by Type and Country Reported by Banks in the United States, as of Mar. 31, 1988).

52. Feldstein, *Latin America's Debt: Muddling Through Can be Just Fine*, THE ECONOMIST, June 27, 1987, at 21.

53. See, e.g., Orr, *supra* note 1.

54. See *id.* at 79.

55. See *Riss v. Commissioner*, 478 F.2d. 1160 (8th Cir. 1973) (The granting of additional credit after failing to receive proper payment from a prior debt indicated that the debt was not worthless.); *Dustin v. Commissioner*, 467 F.2d. 47 (9th Cir. 1972) (The fact that the debtor had never defaulted on any of its obligations supported the Tax Court's determination that the taxpayer did not establish that the debt was worthless.).

### B. *Recharacterization Strategies*

It seems ironic for the IRS to split the debt-for-nature swap, thus circumventing the issue of worthlessness, so that it inures to the benefit of the taxpayer. In litigation both prior and subsequent to Revenue Ruling 87-124, the IRS has advocated an examination of the total effect of multi-part transactions, especially when the motivation behind the transaction is the resultant tax savings.<sup>56</sup>

In *Cottage Savings Association v. Commissioner*,<sup>57</sup> a savings and loan institution and four other thrift institutions engaged in a series of purchases and sales of loan participations in order to recognize a loss deduction under Section 165.<sup>58</sup> The IRS argued that the "reciprocal sales" were merely exchanges, resulting in no recognizable loss or gain.<sup>59</sup> The only practical interpretation of the transaction under Section 165, the IRS claimed, was that the simultaneous purchases and sales were interdependent, and that the separate agreements should be regarded as one transaction, rather than as separate sales between the parties.<sup>60</sup> The IRS further contended that "[a] transaction involving legally enforceable arrangements . . . may lack substance and fail to achieve the desired tax effect because it is purposeless apart from tax motivations."<sup>61</sup>

According to the debt-for-nature swap outlined by Revenue Ruling 87-124, the exchange of the debt for local currency is accompanied by the simultaneous donation of the local currency to a charitable organization. Query what else but tax considerations would motivate a bank in this situation, and why the IRS has chosen to separate rather than consolidate this transaction.

### C. *The Charitable Contribution Valuation*

The IRS's bifurcation of the debt-for-charity swap also implicates the charitable contribution portion of the transaction. Even accepting, for the sake of argument, the IRS's characterization of the debt as "property," the deduction allowed by the Revenue Ruling must fail under traditional tax treatments of donated property. The fair market value of the property, at the time of the contribution, is the amount allowed as a deduction when property is contributed to a

---

56. See *Johnson v. Commissioner*, 495 F.2d 1079 (6th Cir. 1974); *Cottage Savings Ass'n v. Commissioner*, 90 T.C. 372 (1988).

57. 90 T.C. 372 (1988).

58. *Id.* at 377-85.

59. *Id.* at 386.

60. *Id.* at 386-87.

61. *Id.* at 401 (citing *Gregory v. Helverling*, 293 U.S. 465 (1935)). The court disagreed, concluding that the S & L had realized recognizable losses. *Id.*

charitable organization, without any recognition of gain or loss in the value of the property.<sup>62</sup> In the case of appreciated property, in which the allowable deduction may exceed the taxpayer's cost basis in the property, this method of donation is highly desirable.<sup>63</sup> When property has declined in value, however, the established method for disposal is to sell the property, recognize the loss for tax purposes, and then donate the proceeds, thereby obtaining a charitable contribution deduction for the gift of cash.<sup>64</sup>

Nothing prevents banks holding LDC debt from undertaking this well-established method that allows them to achieve, without the perplexity, the same tax benefit provided by Revenue Ruling 87-124.<sup>65</sup> It must be noted, however, that after disposal of the property for cash, nothing guarantees that the bank will follow through and make the charitable contribution, except the possibility that by making the contribution, the bank receives an even greater benefit.<sup>66</sup> To be sure, banks will not be clamoring to make these contributions of Third World debt.<sup>67</sup> When they do, however, their motivation could preclude deduction as a charitable contribution.

Although the receipt of benefits by the donor does not necessarily preclude a charitable deduction, courts are likely to deny a deduction when the donor receives benefits that are substantial. For example, in *Ottawa Silica Co. v. United States*,<sup>68</sup> a corporation was denied a charitable deduction for contributing a portion of real property for a high school sight.<sup>69</sup> Even though the school district had solicited the dona-

---

62. Treas. Reg. § 1.170A-1(c) (as amended in 1984).

63. In such a case, the contribution is deductible in an amount measured by the fair market value of the property, even though the taxpayer does not have to recognize gain on the appreciation in value. See *Taxation of Banks*, *supra* note 17, ¶ 9.14[3] at 9-28.

64. *Id.* at 9-29.

65. The real benefit inures to the charitable organization because the value of the gift in the foreign country may exceed substantially the debt's fair market value. See *supra* note 28 and accompanying text.

66. See Copeland, *Buying Debt, Saving Nature*, NEWSWEEK, Aug. 31, 1987, at 46. Gary Caesar, head of international asset sales at BankAmerica Corp., remarked that debt for nature swaps "will work only where the banks have written the debt down to next to nothing and can claim some real benefits from a tax or political perspective." *Id.*

67. The Director of the National Wildlife Federation noted that her organization had been unable to obtain donations of LDC debt from banks. Dionne, *Treasury Agrees*, *supra* note 21, at 309. A bank would rather engage in a typical debt/equity swap, gaining at least some prospect of enhancing its chances for recovery of its investment. As a New York investment banker remarked, "Clearly, a bank would prefer an interest in a profitable fish farm to a nonperforming loan." Dionne, *Revenue Ruling*, *supra* note 21, at 167; see Copeland, *supra* note 7, at 46 ("Bankers are increasingly willing to trade their bad loans for investments in developing nations, but hotels and factories are more what they have in mind.")

68. 699 F.2d 1124 (Fed. Cir. 1983).

69. *Id.* at 1131.

tion from the corporation,<sup>70</sup> a deduction for a charitable contribution was denied primarily because the corporation acted more out of its own self interest.<sup>71</sup> The court concluded that "the benefits to be derived by [the corporation] from the transfer were substantial enough to provide [the corporation] with a *quid pro quo* for the transfer and thus effectively destroyed the charitable nature of the transfer."<sup>72</sup>

As in *Ottawa*, the banks are being solicited by the conservation organizations for donations of LDC debt. The banks, however, are only willing to make the donation if they are able to gain a "substantial benefit" from the transaction.<sup>73</sup> Ironically, it is the special tax treatment itself that motivates the bank, destroying the charitable nature of the transfer. This is especially so in the case of an LDC debt, where its market price has been discounted so low that its sale would yield less than the tax savings provided by Revenue Ruling 87-124.

D. Withers v. Commissioner: *The Flip-Flop of  
Revenue Ruling 87-124*

Another instance exists in which the IRS's position in Revenue Ruling 87-124 is irreconcilable with its previous posture under very similar circumstances. In *Withers v. Commissioner*,<sup>74</sup> the IRS opposed the identical deduction it now specifically endorses in Revenue Ruling 87-124. In *Withers*, taxpayers contributed corporate stocks that had bases exceeding their fair market value to a qualified charity.<sup>75</sup> The taxpayers argued that they were entitled to deductions equal to their cost basis in the property contributed,<sup>76</sup> effectively arguing for a two-stage deduction. The taxpayers claimed that if under Section 107 they were entitled to a charitable contribution deduction equal only to the fair market value of the property when contributed, then they were also entitled under Section 165 to a loss deduction equal to the difference between the property basis and fair market value.<sup>77</sup> The IRS, on the other hand, contended that the deduction was limited to the fair market value of the property transferred, and

---

70. *Id.* at 1132.

71. *Id.* at 1135 (The corporation expected that the construction of access roads to service the high school would greatly enhance development of the remainder of the corporation's land.).

72. *Id.* at 1132.

73. See Copeland, *supra* note 66, at 46.

74. 69 T.C. 900 (1978).

75. *Id.* at 901.

76. *Id.*

77. *Id.* at 903.

that no deductible loss was created by the contribution.<sup>78</sup> The court relied on the IRS's own unchallenged regulations<sup>79</sup> and held that the charitable contribution deduction was limited to the fair market value of the property contributed.<sup>80</sup> It further held that although the taxpayers "realized" a loss on the difference between the value and the basis of the shares contributed, the loss was not "sustained" under Section 165(a), nor recognized under Section 165(c). Aside from the mutual exclusivity conflict between Sections 165 and 166, Revenue Ruling 87-124 completely ignores the rule of *Withers*, thus compounding the confusion.<sup>81</sup>

#### IV. QUALIFYING ORGANIZATION?

The most obvious issue is whether or not the organization in the foreign country is qualified to receive a charitable contribution under Section 170 as stipulated by Revenue Ruling 87-124. The Code allows a deduction only for contributions to be used within the United States.<sup>82</sup> The IRS, however, does not foreclose deductions for contributions to foreign charities. Contributions to a domestic charity described in Section 170(c)(2) that are channeled to a foreign charitable organization for furtherance of the domestic charity's purposes may be deductible.<sup>83</sup> Likewise, when a domestic charity is formed for foreign wildlife purposes and makes grants to foreign charities, contributions to the domestic charity are deductible.<sup>84</sup> Contributions ultimately committed to go to a foreign organization, however, are not deductible simply because they come to rest momentarily in a qualifying domestic organization.<sup>85</sup>

##### A. *The Control Test*

The overriding consideration in both situations is control and discretion over the use of the funds by the domestic organization to insure that they will be used to carry out its functions and purposes. When this criterion is applied, the conflict with Revenue Ruling 87-124 is apparent. As described in the Ruling, the terms of the program provide that the funds can be used only in the foreign country. This

---

78. *Id.* at 901.

79. *Id.* at 905 (citing Treas. Reg. § 1.1001-1(a) (as amended in 1972)).

80. *Id.* at 902-03 ("The general rule . . . allows taxpayers a deduction equal to the fair market value of the property contributed. . . . We will not change that result here.").

81. See *supra* note 21 and accompanying text.

82. I.R.C. § 170(c)(2) (1986). For the text of Section 170(c)(2), see *supra* note 27.

83. Rev. Rul. 66-79, 1966-1 C.B. 48.

84. Rev. Rul. 75-65, 1975-1 C.B. 79.

85. Rev. Rul. 63-252, 1963-2 C.B. 101, 104.

restriction alone could be held to strip control effectively from the domestic charity.<sup>86</sup> Moreover, one actual debt-for-nature swap—viewed as typical of the Revenue Ruling 87-124 formulation—describes the foreign government as the administrator of the conservation areas, and the domestic organization as a mere advisor.<sup>87</sup>

Simply handing over the funds to the foreign country for administration does not further the purposes of the United States based charitable organization. Many of these Latin American countries lack the bureaucratic personnel to effectively administer United States programs, in particular those dealing with the use of aid monies for development projects.<sup>88</sup> Most of the difficulty with the administration of United States programs in Latin America lies in ensuring that the aid is properly delivered and that it performs the stated task. Some Latin American countries have reputations for administrative corruption and misuse of aid funds. Although such corruption exists in almost every nation, the funneling off of development aid by government officials in lesser developed countries could vitiate the effectiveness of these conservation programs.<sup>89</sup>

Even so, any attempt by a charitable organization to force compliance with the control requirement would most likely be an affront to foreign sovereignty. Debt-for-nature swaps do not involve typical charitable activities, such as hospitals or missionaries, but rather involve efforts by United States organizations to exert actual control over a foreign country's land. Even if an organization has obtained an agreement with the state extending over a considerable time, the state still may exercise its power of eminent domain over its own resources by nationalizing the enterprise.<sup>90</sup> This power is well-recognized in

---

86. In Revenue Ruling 66-79, 1966-1 C.B. 48, the IRS found it significant, in approving a donation to a foreign organization, that the directors of the domestic organization administering the funds had the right to withdraw approval of the grant and use the funds for other charitable purposes.

87. See *Beautiful Barter in Bolivia*, THE ECONOMIST, July 16, 1987, at 26 ("The Bolivian government remains in control of its land, with the American organisation acting as an advisor only."); Shabecoff, *supra* note 5, at C2, col. 3. But see *Old Colony Trust Co. v. United States*, 438 F.2d 684, 687 (1st Cir. 1971) (upholding the deductibility of a donation to a foreign hospital, and noting that at no time had the foreign government exercised any control over the management and operation of the hospital).

88. M. KRYZANEK, U.S.-LATIN AMERICAN RELATIONS 146 (1985).

89. *Id.* at 147.

90. I. DELUPIS, FINANCE AND PROTECTION OF INVESTMENTS IN DEVELOPING COUNTRIES 53 (1973). Nationalism in the LDC is a major consideration. Some argue that the increased ownership and control of domestic entities by foreigners that typically follows debt/equity swaps is intolerable to the LDC. See Alexander & Ross, *supra* note 9. Evidence is emerging that this argument has considerable merit. Increased foreign pressure aimed at influencing the environmental policies of the Amazon Forest countries has brought strong negative reactions. Speaking on Amazon issues recently, a powerful Brazilian Army Minister



international law. According to the United Nations General Assembly, a state always retains its sovereignty over natural resources; natural resources cannot validly be transferred to the sovereignty of another state.<sup>91</sup>

### B. *The Legislative Solution*

International conservation groups are cognizant of the inherent problems in the Revenue Ruling and, in 1987, advocated legislation to accomplish their objectives.<sup>92</sup> In response, a bill was introduced to the Senate Committee on Finance to amend the Internal Revenue Code of 1986. It permitted taxpayers who donated debt of developing countries to charitable organizations to obtain a charitable deduction equal to the taxpayer's basis in the debt.<sup>93</sup> The bill specifically allowed a full basis deduction for contributions of LDC debt to quali-

---

said, "Any foreign influence is unwelcome." *World Concern for Rain Forest Rankles Brazil*, Miami Herald, Mar. 13, 1989, at 1A, col. 5. He added, however, that "[f]oreign funds are fine as long as they are turned over to the government to use as it wishes." *Id.* A government scientist, recognizing the emotional issues, stated, "This business of the dangers to our national sovereignty is very sensitive and it will continue to be." *Id.* Nationalistic fervor is spreading to other Amazon countries. At a meeting in Quito, Ecuador, representatives from Bolivia, Ecuador, Guyana, Peru, Suriname, and Venezuela joined Brazil in repudiating "any foreign interference in the policies that the Amazon countries carry out in the region." *Id.* When a group of United States government officials suggested that Brazil implement debt reduction programs in conjunction with rain forest preservation, "[t]he answer they received was a succinct 'no.'" *Id.*

91. See G.A. Res. 1803 (1962), reprinted in 9 UNITED NATIONS RESOLUTIONS 107 (D. Djonovich ed. 1974).

92. See Letter from Terrill Hyde (counsel to the World Wildlife Fund) to Sen. Baucus (Dec. 10, 1987) (available from office of Sen. Chafee) (urging passage of S. 1781 to foster debt-for-nature swaps).

93. See S. 1781, *supra* note 4, at S14,064. The amendment provides in part:

#### SECTION 1. CHARITABLE DEDUCTION FOR CONTRIBUTION OF DEBT OF DEVELOPING NATIONS TO CONSERVATION GROUPS.

"(m) CONTRIBUTIONS OF QUALIFIED DEBT INSTRUMENTS FOR INTERNATIONAL CONSERVATION PURPOSES.—

"(1) IN GENERAL.— In the case of a qualified debt contribution, the amount of the deduction otherwise allowable under this section shall not be less than the donor's basis in the debt instrument being contributed.

"(2) QUALIFIED DEBT CONTRIBUTION.— For purposes of this subsection, the term 'qualified debt contribution' means a contribution—

"(A) of a debt instrument . . . evidencing a loan to foreign state . . . eligible for World Bank or International Development Association financing,

"(B) to a qualified organization . . . and

"(C) with respect to which the taxpayer receives from the donee a written statement that such debt instrument (or the proceeds therefrom) will be used for an international conservation purpose.

fyng organizations for international conservation purposes.<sup>94</sup> The liberal interpretation of Revenue Ruling 87-124, offered by the Treasury, however, has quieted the concerns of conservation groups, who now no longer feel the need for legislation.<sup>95</sup>

## V. CONCLUSION

The goal of Revenue Ruling 87-124—to assist in saving the world's forests and the animals that inhabit them—is an admirable one. The legal contortions required to justify the interpretation given by the Treasury, however, may severely strain future IRS positions in which taxpayers argue for similar tax treatment of losses, bad debts, and charitable contributions, outside the context of debt-for-nature swaps.<sup>96</sup> Since deductions are a matter of legislative grace,<sup>97</sup> a concise, narrowly drafted amendment could achieve the desired result and relieve the Treasury from inevitably having to rule on each transaction. The satisfaction achieved for the international conservation groups could be short-lived should the Treasury be forced to abandon its ruling in the face of widespread abuse of the inherent contradictions between precedential tax law and Revenue Ruling 87-124.

RONNY JAY HALPERIN

---

94. The bill defines "international conservation purpose" as:

[T]he expenditure of funds in or with respect to the foreign country that is the obligor (or the guarantor) of the qualified debt instrument for one or more of the following purposes—

"(A) a purpose described in clause (i) [preservation of land areas for recreation and education] or (ii) [protection of natural habitats of fish, wildlife, or plants] of subsection (h)(4)(A);

"(B) the support of museum, park, conservation, and nature and conservation education personnel and programs;

"(C) the facilitation of cohabitation between inhabitants of a particular area and fish, wildlife, plant, or similar ecosystems in the area;

"(D) research and experimentation in connection with any of the purposes described in subparagraphs (A) through (C); and

"(E) the support of international, national, and local governmental programs to accomplish any of the purposes described in subparagraphs (A) through (D).

S. 1780, 100th Cong., 1st Sess. (1987).

95. See Letter from William Reilly (President of World Wildlife Fund) to Rep. Pease (Apr. 28, 1988) (available from office of Sen. Chafee) (expressing satisfaction with Treasury's interpretation of Revenue Ruling 87-124).

96. A Peruvian economist has proposed that a fund be established, using a variation of debt-for-nature swaps, to help fight the war on drugs. *Plan Would Fight Drugs and Debt*, The Miami Herald, Dec. 19, 1988, (Business Monday), at 17, col. 1. The donated funds would be used for economic development programs in areas where drugs are produced and for projects that encourage farmers to grow alternative crops. *Id.*

97. *Withers v. Commissioner*, 69 T.C. 900, 905 (1978).