FEATURED PERSPECTIVES

U.S. Federal Income Tax Issues Arising From a Partial Disintegration of the Eurozone

by Robert H. Dilworth

Robert H. Dilworth is a partner with McDermott Will & Emery LLP in Washington.

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The eurozone may be on the verge of partial disintegration. For some investment managers and economists (and speculators),[1] departure in the next 12 months by at least one country from the euro seems likely. For European Central Bank (ECB) officials, in contrast, the notion seems absurd.[2] This article seeks to list some of the topics the U.S. Treasury Department and the Internal Revenue Service need to address, just in case businessmen George Soros and Mohamed El-Erian are correct and Jean-Claude Trichet, president of the ECB, is not.

In 1997-1998 U.S. taxpayers[3] and the IRS[4] pondered what should be done to ameliorate or avoid unwanted federal income tax consequences of the conversion of some legacy currencies of European Union countries to the euro during 1999-2002. The conversion was supposed to be permanent and ''irrevocable,'' and the resulting U.S. regulatory regime[5] did not address the possibility of a complete or partial departure of a member state from the European Monetary Union (EMU).[6]

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[1]Remarks attributed to Mohamed El-Erian, CEO of Pacific Investment Management Co., in Simon Kennedy, ''El-Erian Joins With Feldstein-Fels on Prospect of New Core Euro,'' Bloomberg News (Aug. 22, 2011), *available at* http://www.bloomberg.com/news/2011-08-21/el-erian-joining-feldstein-fels-on-prospect-of-euro-evolving-into-new-core.html; and remarks attributed to George Soros in Zoe Schneeweiss, ''Soros Says a Euro Exit Mechanism Is 'Probably Inevitable' Amid Debt Crisis,'' Bloomberg News (June 27, 2011), *available at* http://www.bloomberg.com/news/2011-06-26/soros-says-euro-member-exit-mechanism-is-probably-inevitable-amid-crisis.html.

[2]Remarks attributed to Jean-Claude Trichet, in Jack Ewing and Liz Alderman, ''Some in Germany Want Greece to Temporarily Exit the Eurozone,'' *N.Y. Times* (Aug. 10, 2011).

[3]Fred Murray, National Foreign Trade Council, ''Implications of European Economic and Monetary Union'' (Mar. 12, 1998), *Doc 98-10301*, *98 TNI 59-27*; Karla Johnsen, ''U.S. Tax Issues Raised by Conversion to the Euro'' (May 14, 1998), *Doc 98-9253*, *98 TNI 94-8*; Tax Executives Institute, ''Comments of Tax Executives Institute, Inc. on Announcement 98-18 Relating to the Conversion of Certain European Currencies to a Single Currency'' (May 5, 1998), *Doc 98-14277*, *98 TNI 94-30*.

[4]Announcement 98-18, 1998-1 C.B. 676 (Feb. 10, 1998).

[5]Treas. reg. sections 1.985-8 and 1001-5, issued per T.D. 8927 (Jan. 11, 2001), replacing Treas. reg. sections 1.985-8T and 1001-5T, issued per T.D. 8776 (July 29, 1998).

[6]The adoption of the euro was supposedly irrevocable under the applicable provisions of the Treaty on European Union signed at Maastricht, Netherlands, on February 7, 1992 (the Maastricht Treaty). There is no provision in the Maastricht Treaty for a member state to leave the EMU. The subsequent Treaty of Lisbon does provide, however, for the departure of a

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Even then, however, the absence of a common sovereign or a common fiscal control was identified as a serious challenge to economic and political stability in the EU.[7] Perhaps it is better to finally address the possibility, albeit later rather than never.

Turmoil

Will the Eurozone Deconstruct?

There is considerable and ongoing turmoil in the eurozone body politic about the prospects for Greek[8] sovereign debt default or for a continuing EU ''core country'' commitment to bail out Greece in satisfying Greek euro-denominated debt on a long-term basis. One outcome of that turmoil may be retention of the euro as the currency of all current members of the eurozone, and for the citizens of Greece (and later Ireland, Italy, Portugal, and Spain) to accept a relatively long period of ''austerity'' (consensual economic depression) that will eventually culminate in restored economic viability of, and domestic tranquility in, the consenting austerity state. In such an outcome, if the euro continues as it is constituted, as the sole legal tender in all members of the eurozone, there would be no occasion to fret about the U.S. tax treatment of a departure of a country from the EMU — a change that will never occur.

Another outcome, however, could resemble the one proposed by the demonstrators on the streets of Athens: Leave the eurozone (if the ECB and the IMF do not continue to fund an acceptable minimum lifestyle).[9] The demonstrators object to an unfair austerity, and to the euro as an instrument of that austerity, and not to the euro-derived low interest rates that may have helped to accommodate desired levels of consumption they have enjoyed since Greece joined the eurozone. Leaving the eurozone might not do much to preserve the pre-crisis lifestyles of the demonstrators, but at least leaving the eurozone would not require austerity that is explicitly linked to debt service payments to banks in core eurozone countries like Germany and France.

As noted above, various commenters and participants in the currency markets have speculated that an unnamed country (Greece) will leave the euro within the next year or so. Although that speculation has been rejected by the ECB, there is a legal working paper on that possibility available online at the ECB website.[10] The speculation about Greece leaving the EMU implicitly assumes that a politically more tolerable level of austerity could be achieved if a new national currency could be used by an unfettered sovereign Greece to effect productivity gains and to increase exports. The productivity gains and increased exports achieved by devaluing a currency relative to other national currencies are presumably only a politically acceptable way to reduce comparative domestic labor costs of producing exportable goods and services (including tourism in Greece), and to increase, by stealth, the costs of foreign goods and services. Comparative wage costs could be reduced by devaluing the new national currency's conversion rate: Greek wages could be reduced by currency devaluation without having to agree with the ECB or the IMF to reduce euro-denominated wages. Austerity would result from increasing the comparative costs of imports such as flatscreen televisions and iPads when the increased prices are expressed in local currency.[11]

Contours of a Post-EMU Greek Currency Regime

The contours of such a hypothetical new Greek currency regime after such a departure from the eurozone are at best unclear.

Reverse Convergence

Conceptually, a departing state such as Greece might simply do a ''reverse convergence'' and redesignate by legal fiat all euro-denominated obligations owed by Greek residents (or the Greek government) to foreigners as ''new drachma'' obligations, and provide that the new drachma will be the exclusive legal tender for all debts public and private.[12]

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member state from the European Union. Upon such a departure, the country would cease to be a member of the EMU. *See* Phoebus Athanassiou, ''Withdrawal and Expulsion From the EU and EMU, Some Reflections,'' European Central Bank Legal Working Paper Series, No. 10 (Dec. 2009), *available at* http://www.ecb.int/pub/pdf/scplps/ecblwp10.pdf.

[7]Martin Feldstein, ''Europe's New Challenge to America,'' *N.Y. Times,* May 7, 1998, *available at* http://www.nber.org/feldstein/ny050798.pdf.

[8]At the date this is being written, Ireland, Italy, Portugal, and Spain are also the topic of recurring speculation. *See, e.g.*, ''Euro Crisis in Uncharted Territory Menaces Eastern States, Bergloff Says,'' Bloomberg News (July 14, 2011). For the sake of simplicity, Greece will be referred to in this article in lieu of another more generic label for a eurozone member that might seek external debt adjustment, with one tool in any such adjustment being complete or partial withdrawal from the EMU.

[9]The possibility of Greece, or Germany, leaving the euro may also be an active topic around German dining room tables.

[10]''Soros: European Solution Needed for Greece; A Country May Have to Exit Euro,'' *Wall Street J.* (June 26, 2011); *but see* the statements attributed to Trichet in ''Interview With Jean-Claude Trichet, President of the ECB and The Times'' (Jun. 13, 2011), *available at* http://www.ecb.int/press/key/date/2011/html/sp110616_2.en.html (withdrawal of any eurozone country ''is not a working assumption anyone considers''). On the other hand, the European Central Bank Legal Working Paper Series has available online a paper by Athanassiou, *supra* note 6.

[11]There are some accidental correlations with the depreciation of the U.S. dollar against other currencies since 2009, but the U.S. monetary authorities insist this was merely an accidental byproduct of measures taken for other reasons.

[12]This approach would be similar in some respects to the U.S. actions in establishing legal tender unconstrained by grains of gold. *See Norman v. Baltimore & O.R.R.*, 294 U.S. 294 (1935).

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Two-Currency Approach

Alternatively, and perhaps more likely, Greece might adopt some variety of a two-currency approach. Under that approach, the euro would remain the Greek currency for all external transactions, while the new drachma would become legal tender for all internal transactions.[13] Greece's central bank could provide euros to Greek residents for approved external transactions and could provide to Greek residents new drachmas in exchange for the proceeds of all euro transactions by Greek residents. Under this alternative, exchange controls would require that all Greek residents surrender euros to the Central Bank. Presumably, governmental measures would also be taken to control foreign currency assets of all Greek residents and to control foreign debts to related parties that, if timely paid, could erode the government's ability to control scarce assets that it wishes to manage according to governmental rather than private citizens' priorities.

The two-currency approach has been adopted for limited periods of time to lesser or greater degrees by several countries over the years. For example, China, until recently, maintained two currencies as part of its exchange control systems — a yuan renminbi that could be used in only domestic transactions, including the purchase of domestically produced goods, and a "new" yuan renminbi that was required to be purchased at fixed exchange rates from the Bank of China with foreign currencies, but which could then be used to purchase imported products, as well as goods and services for non-Chinese tourists and long-term residents, and which was capable of being exchanged back into foreign currency at fixed exchange rates from the Bank of China. The fixed exchange rates of the Bank of China for the new yuan renminbi became the official exchange rate for China's currency, even though other mediums of exchange proliferated, which indicated varying degrees of buying power for the new yuan renminbi vis-à-vis the regular yuan renminbi.

Similarly, during the period of hyperinflation in Brazil, although the official exchange rate for the local currency (the cruzeiro) was permitted to float, payment obligations (both private and public) were indexed based on the value of the Brazilian readjustable national treasury bond (the *obrigaçoes reajustaveis do tesouro nacional*, or ORTN). The ORTN value was adjusted monthly to track the value of the purchasing power of the cruzeiro, which, in effect, reflected the devaluation resulting from inflation of the cruzeiro against the U.S. dollar.[14] One would expect that over time the euro would begin to look like the index for the value of the new drachma in a two-currency approach.

The practical advantages of, disadvantages of, or legal impediments associated with a reverse convergence or a two-currency approach are well beyond the scope of this article. Both alternatives (and variations) have been mentioned in public discourse.[15] The two-currency approach would seem to be only a temporary solution, while the reverse convergence alternative would likely be viewed as a permanent departure by Greece from the eurozone. The two-yuan-renminbi approach of China has fallen by the wayside as that country has enjoyed multiyear trade surpluses, while the ORTN indexation system became unnecessary as Brazil's inflation came under control.

The U.S. tax system also provides a bumpy ride for taxpayers who must deal with a country that has a two-currency regime, given the institutional IRS commitment to the belief that there is only one currency per country[16] and that that currency can only have one true exchange rate for a transaction,[17] regardless of which currency or value index can be used as a medium to settle transactions in the country or the often coexistent multitude of exchange rates (that is, "official exchange rates" and "market exchange rates") that may be available for a local currency depending on the source of the foreign currency and/or the use of the local currency.[18]

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[13]The continuation of the euro as the currency for purposes of external debt would perhaps finesse questions about the legal efficacy of outright re-denomination of euro-denominated obligations into new drachmas. For a general introduction to the topic, see *Braka v. Bancomer*, 762 F.2d 222 (2d. Cir. 1985) (re-denomination of U.S. dollar-denominated obligations into Mexican pesos sustained where obligations were payable in Mexico); *Allied Bank International v. Banco Credito Agricola de Cartago,* 757 F.2d 516 (2d. Cir. 1985) (acts by a foreign government that will be performed in the United States are not sheltered by the "act of state" doctrine); and *Case Concerning the Payment of Various Serbian Loans Issued in France,* Permanent Court of International Justice*,* File E.c. XV. Docket XVI, Judgment No. 14, July 12, 1929.

[14]*See AMP Incorporated v. United States*, 185 F.3d 1333 (Fed. Cir. 1999).

[15]Charles A.E. Goodheart and Dimitrios P. Tsomokos, "Financial Instability, Institutions and Regulations: The 2009-2010 Greek Crisis," Conference Proceedings of the International Conference on Financial and Economic Crisis, the Return to Stability, Alexander S. Onassis Public Benefit Foundation, Athens 2010, *available at* http://www.sbs.ox.ac.uk/research/people/Documents/Dimitri%20Tsomocos/Financial%20Instability.pdf. Interestingly, the two-currency approach is referred to in this paper as "the Californian Solution." Another topic for another article another day, ideally far in the future.

[16]*See AMP Incorporated*, 185 F.3d at 1338-39; Treas. reg. section 1.988-1(d)(4).

[17]*See Durovic v. Commissioner*, 542 F.2d 1328, 1334 (7th Cir. 1976) (the court determined the appropriate exchange rate, choosing between the four "official" exchange rates and the free market rate); and *G.M. Trading Corp. v. Commissioner,* 121 F3d 977, 984 (5th Cir. 1997) (court held that pesos obtained in a government-approved swap for a U.S.-dollar-denominated obligation should be based on the fair market value of that U.S.-dollar-denominated obligation, with "excess" peso value received (if any) being a deemed contribution to the capital of the exchanging entity).

[18]Multinational companies have long wrangled with the proper reporting of their business operations in Venezuela as the

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Federal Tax Issues

If the U.S. Treasury Department (including the IRS) were to commence public contingency planning for such an eventuality, the demise of the euro, at least in Greece, might be hastened. The IRS business plan is probably a suboptimal instrument to communicate the U.S. government's international financial policy and its expectations about foreign sovereign credibility. This short article is a modest placeholder in case the eurozone fractures for reasons that cannot be blamed on Treasury for having started prematurely to think publicly about the unthinkable.

The most basic federal income tax question will likely be whether a departure from the eurozone should be an occasion to mark debt instruments to market, and how to determine what components of market value to try to measure (or to imagine). The accrued value of the old obligation *at face* will be ascertainable for purposes of section 988, but what should be done to measure the value of any new obligation that might be deemed to have been received in an imaginary exchange? How should the impact of an unknown future history of the new currency and its sovereign be taken into account for U.S. tax purposes? Answering the question will require the IRS and Treasury to navigate both basic tax policy issues as well as the existing provisions of the subpart J regulations.

The better balance I expect will be to emulate the approach taken in 1998-2001[19] regarding convergence:

- exclude re-denomination from the euro into the new drachma from Treas. reg. section 1.1001-3 (as was done in Treas. reg. section 1.1001-5);
- translate newly nonfunctional currency creditor positions into section 988 transactions at the spot rate for euro to new drachma on the conversion date (that is, a euro functional currency creditor will now hold a nonfunctional currency new drachma debt obligation in place of a functional currency debt obligation);
- retain the creditor's functional currency basis in any substitute nonfunctional currency debt obligation (that is, a U.S. dollar creditor will now hold a nonfunctional currency new drachma debt in place of a nonfunctional currency euro debt);
- convert an obligor's adjusted issue price in euro functional currency to new drachma functional currency at the spot rate for euro to new drachma on the conversion date (that is, a euro functional currency obligor will now become the obligor of a new drachma functional currency obligation in an amount determined based on the conversion rate on the date of conversion); and
- convert a Greek obligor's adjusted issue price for its debt obligations in euro functional currency into a new drachma functional currency amount, if the obligation becomes a nonfunctional currency obligation, at the spot rate in effect on the date of a change in the obligor's functional currency (that is, the Greek sovereign decree effecting redenomination of euro into new drachma may be made inapplicable to some existing unrelated-party euro obligations).

A notice of proposed rulemaking (announcing future regulations that would be effective as of the date the notice is published) indicating that a re-denomination by a foreign sovereign fiat, without any action by a holder or obligor, would perhaps be the most direct way to achieve a limited and targeted exclusion from Treas. reg. section 1.1001-3, based on the approach taken in Rev. Rul. 63-107 (discussed below). Unless the IRS and Treasury act to recognize such a basis for deferring recognition until a creditor or obligor does something, however, the inertial operation of the existing regulatory apparatus might result in deemed exchanges resulting in current recognition of imaginary foreign currency gains and losses that may not be constrained by anticipated real diminution in the value of the expected amount eventually to be realized by the foreign creditor. Markets may not work at the relevant measuring moment to set useful values for the new debt in a new currency deemed to have been exchanged for old debt in the old currency.

Two examples may be helpful to illustrate the issues in the context of a single-currency re-denomination of both internal and external debt.[20]

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government imposed exchange controls to require local transactions to be transacted in either the local Bolivar fuerte currency (VEF) or the limited U.S. dollars issued by that government. As a result of the inability of companies to obtain a sufficient amount of U.S. dollars to conduct their normal operations, a black market for the exchange of Bolivar fuerte for U.S. dollars developed, whereby taxpayers could obtain U.S. dollars at a rate that was generally three times greater than the then-official exchange rate of VEF 2.15 to US $1. Another layer of complexity was added to this currency environment in January 2010 when the Venezuelan government instituted a new dual official exchange rate of (i) VEF 2.5 to US $1 for the import of specified goods (generally food and medicine) and (ii) VEF 4.3 to US $1 for most other goods. The fixed exchange rates for the Bolivar fuerte are maintained by the Central Bank of Venezuela. *See* http://www.bcv.org.ve/EnglishVersion/Index.asp. The author expresses no view on the appropriate exchange rate to use in translating earnings and profits of a Venezuelan affiliate, nor indeed on any other aspect of what to do about Venezuela.

[19]T.D. 8776, 1998-2 C.B. 200 (Jul. 28, 1998) and T.D. 8927, 2001-1 C.B. 807 (Jan. 11, 2001).

[20]The analysis would be similar in the case of a two-currency regime. The relevant variables will continue to depend on whether there are reliable markets for new drachma obligations on the deemed exchange date and whether there are reliable currency exchange rates on that date. By waiting until such markets develop, taxable income (or loss) can be measured more accurately and the risk of imaginary gain or loss can be minimized.

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Example 1

U.S. Bank holds euro-denominated obligations of a private-sector Greek borrower of €1 million.[21] The euro obligations were acquired by U.S. Bank when the exchange rate was US $1.25 to €1 (that is, the bank's basis is $1.25 million). The obligation by its terms is subject to the laws of Greece.[22] The Greek government exercises its authority as sovereign to require that all euro-denominated obligations that are subject to Greek law be forthwith payable solely in Greek new drachmas in an amount based on a fixed exchange rate of €1 to ND 1. On that date the exchange rate is US $1.40 to €1. Greece on the same date establishes an official exchange rate of €1 to ND 1. If the re-denomination is deemed a ''material change in the terms of the instrument,''[23] the bank may realize and recognize foreign currency gain in the amount of US $150,000 (US $1.4 million deemed received in exchange for property with a basis of US $1.25 million), unless U.S. Bank can establish that the market gain (or loss) places a cap on the amount of foreign currency gain that can be recognized.[24] However, the Greek central bank might establish a procedure for Greek residents to apply to purchase new drachma for external payments that requires a processing period of 60 days, and further assume that the stated interest rate is at or above the Greek equivalent of the AFR for the remaining maturity of the debt.[25] On the first trading day after the re-denomination, the debt obligations are no longer traded at euro-denominated prices on non-Greek exchanges, but instead trade on a Greek exchange at par in new drachma.[26] No parallel exchange market develops as of the first trading day after the date of re-denomination because potential participants in such a parallel market have not yet begun to trade.[27] Fifty-nine days after the date of re-denomination, the Greek Central Bank changes the official exchange rate to €1 to ND 2. The debt instrument continues to trade in the Greek market at par in new drachma. Although the instrument can be sold by foreign holders on the Greek exchange, the new drachma proceeds cannot be converted to euro or other currency until the Greek Central Bank determines that such conversion would be in the national interest. U.S. Bank decides to continue to hold the obligation to the earlier of maturity or until convertibility of new drachma into foreign currency is restored.

The example could be tweaked to assume a reliable market and a sensible exchange rate on the relevant measuring dates that might exist on the deemed conversion date. If such markets exist, it may make sense to build in such a possibility in the modification to reg. section 1.1001-5. In my view, however, the world on that date is likely to be even more chaotic than the examples assume.

Example 2

Next, consider the example of a U.S. parent that holds a euro-denominated obligation of a Greek subsidiary whose functional currency is the euro. Assume that the euro-denominated obligation in the amount of €1 million was acquired by original issuance when the U.S.-dollar-to-euro exchange rate was US $1.20 to €1, and that on the date that the Greek government re-denominates all related-party debt into new drachmas, the U.S. dollar to euro exchange rate is US $1.40 to €1. On the re-denomination date the official exchange rate is ND 1 to €1 to US $1.40. As in Example 1, on the date of the re-denomination there is no functioning parallel currency market and the great preponderance of exchange transactions on that date occur at the official exchange rate of ND 1 to €1.

If the re-denomination is treated as a tax recognition event, the U.S. parent will have foreign currency gain in the amount of US $150,000 under reg. section 1.988-2(b)(5), but limited to the overall gain on the deemed exchange for a new drachma obligation. Unlike a publicly traded obligation, the Greek affiliate's new drachma obligation will be property that is not publicly traded. If the exchange of the non-traded euro-denominated debt is treated as exchanged for a non-traded new drachma debt, the amount realized by the U.S. parent may be presumed to be its adjusted issue price.[28] The adjusted issue price, in turn, would be its stated principal amount in new drachma if the nominal (stated) interest rate is at or above the equivalent applicable federal rate for new drachmas. That stated principal amount would then be translated at the spot exchange rate into U.S. dollars on the date of the exchange. On that date the official exchange rate will be at parity with the euro. If that were to occur, the U.S. parent would have no offsetting loss on the

[21]International political or diplomatic obstacles to repudiation of euro-denominated government debt may preclude re-denomination of such debt even if private-sector obligors are subject to re-denomination.

[22]*See* Lee C. Buchheit and G. Mitu Gulati, ''How to Restructure Greek Debt,'' draft May 7, 2010, *available at* http:/ssrn.com/abstract=1603304, in which the authors state that about 90 percent of Greek external bonds are by their terms subject to Greek law.

[23]Reg. section 1.988-2(b)(5).

[24]Reg. section 1.988-2(b)(8).

[25]Reg. section 1.1274-4(d).

[26]Reg. section 1.273-2(c).

[27]Reg. section 1988-1(d)(4)(i) (there is no functioning alternative free market rate on the deemed exchange date). Potential market participants may be waiting to see what the Greek government and its central bank plan to do in the short run, even if devaluation in the long run is foreseeable. There may also be some concern about starting an alternative free market until the legality of doing so is clearer than on the date of initial re-denomination.

[28]Reg. sections 1.1274-2(b)(1) and 1.1274-4(d).

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deemed exchange of debt instruments because of deemed parity at the official exchange rate. Only upon repayment, or a subsequent realization event, would the foreseeable future devaluation be taken into account. The various deeming rules would find a gain when there is almost certainly a true economic loss in the creditor's functional currency.

Applying Various 'Deeming' Conventions

The two examples illustrate the federal tax problems that can result from mechanically applying various "deeming" conventions. First, there is the deeming of a "sale or other disposition"[29] by the holder or the obligor of the instrument on a date certain when neither party sold or disposed of any property. Second, there is the deeming of a single currency exchange rate when there may have been different exchange rates for different kinds of transactions. Third, there is the deeming of a market for new-drachma-denominated debt on the date of the Greek government's change in denomination currency rather than on some later date or range of dates when markets may have begun to function more efficiently. Fourth, there is the possible deeming of the amount realized to be the stated principal amount under section 1274(a)(1) rather than the fair market value mentioned in section 1001(b).

The simplest solution should be to defer recognizing gain or loss until the holder or the obligor actually does something that might constitute a significant modification (the author's first recommendation above). That is what the IRS and Treasury did in dealing with convergence to the euro.

Another approach to dealing with a problem in one or another of the deeming conventions could be to try to adjust one or another of those conventions. For example, something might be done to accommodate multiple exchange rates for distinct categories of transactions (for example, payment of government debt versus payment of private-sector obligations). This approach would require a fairly exhaustive review of the government's long-standing commitment to the one-rate principle, and could not be done carefully in a crisis environment.

A similar difficulty could attend trying to adjust the determination of what is the best market on which to base a measurement, or the date (or range of dates) on which a market value should be tested. It is one thing to posit that there is always a market, but something quite different to posit a reliable market when the associated economy is in temporary chaos.[30]

Re-Denomination: Realization/Recognition Event

Re-Denomination as a Material Change

Reg. section 1.988-2(b)(5) provides that a holder will realize exchange gain or loss regarding the principal amount of a debt obligation denominated in nonfunctional currency when payment is received "or the instrument is disposed of (including a deemed disposition under section 1001 that results from a material change in terms of the instrument)." Reg. section 1.1001-5 provides that a re-denomination from a legacy currency into a euro-denominated obligation does not constitute a modification within the meaning of reg. section 1.1001-3(c). By its terms, reg. section 1.1001-5 does not apply to a change from the euro to any other currency.

In the absence of specific regulatory guidance, how would a re-denomination into new drachma be treated? Plausible, even persuasive, arguments were made before promulgation of reg. section 1.1001-5 that a re-denomination should not be a "material change" or "significant modification" for purposes of section 1001.[31] In any event, however, establishing confidence in the outcome required explicit agreement by the IRS that the re-denomination was not a modification for purposes of reg. section 1.1001-3(c).

The case for treatment of a reverse convergence as a non-modification is somewhat more challenging under

[29]Section 1001(a) refers to gain "from the sale or other disposition of property" and to "the amount realized."

[30]A market can sometimes yield a "wrong" value if the wrong measuring date or reference market is selected. After the Supreme Court decision in *Comm. v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974), that the publicly traded debt price should be used to measure issue price when debt is issued

(Footnote continued in next column.)

to redeem non-traded stock, several courts had to wrestle with an exchange of publicly traded debt for publicly traded stock. If the relevant market occurred on the trading day *after* the redemption, referring to trading prices of the stock and the debt could yield very different values. For example, if in the context of a hostile tender a corporation were to agree to redeem its stock at a substantial premium over "normal" value, the situation could arise that before the exchange date the stock price would rise to the premium redemption price, but plummet to a "real" value after the exchange. If the issue price of the publicly traded debt were to be measured by reference to the stock received in the exchange (on the first stock trading date after the exchange), that issue price could be much lower than the stated redemption price. It would also be lower than the issue price determined by reference to the trading price of the debt on the first post-exchange trading date. *See Gulf, Mobile & Ohio R.R. Co. v. U.S.*, 579 F.2d 892 (5th Cir., 1978) (issue price of debt based on the trading price of stock), and *Cities Service Co. v. United States*, 522 F.2d 1281 (2d Cir., 1974), *cert. denied,* 423 U.S. 827 (1975), and 586 F.2d 967 (2d Cir. 967) (issue price of debt based on trading price of debt). The regulations issued under section 1232 directed the use of the public trading price of the debt (if any), as did the subsequent regulations under section 1273. Curiously, there was a regulatory lacuna from 1982 (after the regulations under section 1232 were limited to transactions before July 2, 1982) until the publication in 1994 of final regulations under section 1273. By looking at the post-exchange trading price of stock, remaining outstanding after a partial redemption of other stock at a premium, the government might have had some disquiet as to the reliability of the "market" price of the stock on that date to measure the values of the debt issued on the exchange date instead of looking at the trading price of the debt when it began to trade.

[31]*See supra* note 3.

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reg. section 1.988-2(b)(5) than the original convergence into the euro. The euro will continue as a currency somewhere, unlike the case when the legacy currencies that essentially disappeared when the euro convergence occurred and, before disappearance, had fixed and unmoving exchange rates among the legacy currencies. The new drachma might seem to be something more than just a new name for the old Greek version of the euro. The new drachma will be economically quite different from the euro. Obligations denominated in new drachma will likely have the prospects of a steeply eroded future value reflecting an expected steep yield curve for new-drachma-denominated Greek government obligations compared with the euro-denominated obligation superseded by the re-denomination. That difference will probably arise, even if the creditworthiness of the particular obligor is unaffected by the re-denomination, because the devaluation of the principal as a result of re-denomination would be the foreseeable and even intended effect of the reverse convergence re-denomination.

Re-Denomination Into New Drachma

Even with some significant economic differences between a new drachma obligation and a euro obligation, the IRS should consider treating the re-denomination as a ''non-modification.'' The re-denomination would occur as the result of a sovereign act beyond the control of the holder or the obligor. Neither the holder nor the obligor will take any action to ''sell'' or otherwise dispose of the obligation, and in analogous circumstances an involuntary change of status has been held to be outside section 1001.

The general rule in the federal income tax system is that income from the sale or other disposition of property is taxed when realized.[32] Realization, in turn, normally requires some act by the taxpayer. There are examples of exceptions to this general rule that deem realization to occur, notably the anti-straddle rules and the general mark-to-market provision for dealers and traders in financial or commodity-based instruments. Such regimes adopt a deeming convention that treats an instrument as sold when it is not sold or otherwise disposed of.

The underlying premise of the anti-straddle provisions, and of the dealer/trader mark-to-market provisions, is that there are functioning markets that can provide a reliable measurement of changes in wealth sufficient to include income or loss in the taxable income. It is entirely possible that there will be no market comparable to the reference markets under section 1256 on the date that reg. section 1.1001-3 might deem an exchange to occur by reason of the mere act of governmental re-denomination.

There have been other situations in which the IRS has concluded that the absence of any action by persons subject to a change in law was a reason to exclude application of deemed realization. For example, in Rev. Rul. 63-107,[33] organizations formerly treated as associations taxable as corporations were reclassified as partnerships by operation of new regulations promulgated under section 7701. The associations deemed to be partnerships rather than corporations had no control over the *ipso facto* consequence of applying new regulations. The revenue ruling stated that there was no deemed taxable liquidation as a result of the involuntary reclassification that occurred by operation of law.

If a U.S. taxpayer holds Greek debt denominated in euros, and if the involuntary re-denomination is treated as a deemed disposition for purposes of reg. section 1.988-2(b)(5), that taxpayer could recognize a gain on an obligation even if there is a significant risk of eventual diminished value or even worthlessness. Such gain would result from recognizing at the time of the deemed exchange (caused by re-denomination) the accrued appreciation of the euro against the dollar.[34]

Such gain recognized by a deemed realization exchange may not be offset by a mere expectation of loss on the new obligation after re-denomination. On that deemed exchange date (as distinguished from a day, week, or month in the future) there may be no market quantification of the expected loss. Subsequent fluctuations in either exchange rates or market values for new-drachma-denominated debt would not be deeming events, even when markets may have resumed functioning.

This might be particularly true of related-party debt for which there would be few or no market data points to provide a valuation based on political risk expectations (exchange controls, and so forth).[35] A sensible result could be to defer recognition until the final outcome can be determined (actual repayment, capitalization, confiscation, and so forth).

Two-Currency Regime: Not a Realization Event

If Greece were to leave undisturbed the denomination of external debt in euros but were to impose restrictions on payment, the imposition of such restrictions should not be treated as a recognition or

[32]The eurozone disintegration is the wrong occasion to sort out the general adequacy or suitability of using realization as a component in measuring taxable income. For the time being, realization can be fairly said to be the norm. *See, e.g.*, Staff of the Joint Committee on Taxation, ''Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates,'' JCX-15-11 (Feb. 28, 2011), at p. 6.

[33]1963-1 C.B. 71.

[34]Reg. section 1.988-2(b)(5), -(8).

[35]*Compare* sections 1001(b) and 1274(a)(1). Does section 1274(a)(1) prescribe the fair market value for purposes of applying section 1001(b)? An intriguing question perhaps best left for resolution in a non-emergency situation. *See* Harold L. Adrion, ''Reducing the Uncertainty Regarding the Amount Realized in Debt-for-Debt Exchanges,'' *Tax Notes*, May 30, 1994, p. 1169, or *94 TNT 107-23.*

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realization trigger. If, however, modifications are made to extend maturities, change interest rates, or convert the debt to equity, the normal rules for modification under reg. section 1.1001-3 should probably apply. It may be too slippery a slope to start special ''euro implosion'' exceptions to the rules generally applicable to *voluntary* modifications.

Change of Section 985 Functional Currency

If Greece issues the new drachma as a new internal currency but retains the euro for settlement of external transactions, will that internal currency become the functional currency of any qualified business unit (QBU) subject to mandatory use of that currency?

If the new drachma would be the functional currency of a QBU, should reg. section 1.985-8(c) be a model for new regulations to determine the new drachma basis of assets and amount of liabilities and other relevant items? Should, instead, the QBU be permitted to maintain two functional currencies reflecting separate internal and external functional currency environments for internal and external operations?

Hyperinflation Relief

Should the dollar approximate separate transactions method of accounting provisions of reg. section 1.985-3 be adjusted to anticipate high inflation in the first two years after the establishment of a national currency (but before passing the 100 percent threshold)?

Conversion Costs: *INDOPCO*

Should *INDOPCO*[36] guidance be provided to permit deduction or amortization of conversion costs associated with implementing a parallel national currency?

Blocked Exchange

If Greece prohibits or delays settlement of euro-denominated debt, particularly to related parties, should such prohibition qualify for blocked income relief under reg. section 1.482-1(h)(2)? If instead of outright blockage, Greece discourages but does not prohibit payment in euros, should financial penalties be treated as constituting a blockage?

Conversion to CFC Equity

If a U.S. taxpayer (or a controlled foreign corporation with a non-euro functional currency) converts outstanding Greek entity euro-denominated debt to equity of the obligor, how will gain or loss be measured for purposes of section 988 and section 367? Should already accrued section 988 gain attributable to the appreciation of the euro against the U.S. dollar be offset by the effect on current value *anticipated* deterioration in the value of the repayment currency at the time of conversion into equity? Should recognition instead be deferred by appropriate adjustment to the basis of the CFC equity expressed in the functional currency of the creditor?

Involuntary Conversions

If a U.S. taxpayer (with a dollar functional currency) has euro-denominated debt assets and obligations (that is, long and short positions), and if some of those assets include some euro-denominated claims on Greek obligors, will conversion of such claims to new drachma be treated as terminating a long position in euro? Should gains, but not losses, on such involuntary conversions be recognized for federal income tax purposes?

Final Remarks

The above questions and issues reflect just some of the guidance that the IRS and Treasury will need to provide to taxpayers. Moreover, given the state of the global economy, the international financial markets will almost certainly clamor for such guidance being rendered very shortly after (if not before) the permanence of the eurozone turns out to be only temporary. It would be a useful public service to eliminate at least the tax uncertainty from the myriad uncertainties that will roil the markets when the unthinkable happens. ◆

[36]*See INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992).

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