
HOW MUCH IS COMMON SENSE WORTH? WHAT YOU PAID IS WHAT IT'S WORTH, EXCEPT WHEN IT COMES TO DEBT-EQUITY SWAPS

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Cite as: Elisabeth S. Shellan, *How Much Is Common Sense Worth? What You Paid Is What It's Worth, Except When It Comes to Debt-Equity Swaps*, 2 SEVENTH CIRCUIT REV. 844 (2007), at <http://www.kentlaw.edu/7cr/v2-2/shellan.pdf>.

INTRODUCTION

This Note discusses how the gain resulting from a foreign debt-equity swap should be valued for tax purposes. Usually, gain equals the amount realized from the transaction minus the basis in the property disposed of in the transaction (taxable gain = amount realized – basis).¹ This seems very simple. For example, what is the gain from an exchange of pesos worth \$19 million for dollar-denominated debt worth \$11 million? Easy? Yes; $\$19 - \$11 = \$8$ million.

But what if the pesos you received in the exchange came with restrictions? You could only use the pesos in Mexico; to buy land in Mexico; to build a factory in Mexico, using only Mexican labor and supplies; and your factory had to export goods from Mexico. Maybe you would no longer think your pesos were worth \$19 million? And maybe you no longer believe that your taxable gain from the exchange should be \$8 million? So what are your pesos worth?

You think your pesos are worth \$11 million—that is after all, what you traded them for! But the Internal Revenue Service (“IRS”) thinks

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¹ 26 U.S.C. § 1001 (2000).

your pesos are worth \$19 million (the face value of the bills is, after all, \$19 million), and determines that you have \$8 million in taxable gain! So how should your restricted pesos be valued? That is the question this Note will attempt to answer.

This Note will first explain how gain is typically calculated and will then describe an alternative method of calculating gain. Then, it will summarize and critique *Kohler Co. v. United States*,² the Seventh Circuit's decision discussing how gain from debt-equity swaps should be calculated. Finally, this Note will conclude that *United States v. Davis*³ supplies a superior method for easily and correctly valuing the gain from debt-equity swaps.

I. BACKGROUND

A. Mexico's Debt-Equity Swap Program

Mexico⁴ developed a debt-equity swap program during the 1980's,⁵ while the country was in the depths of an economic crisis⁶

² *Kohler Co. v. United States* ("Kohler IV"), 468 F.3d 1032 (7th Cir. 2006), *reh'g denied and reh'g en banc denied*, No. 05-4472, 2007 U.S. App. LEXIS 3929 (7th Cir. Feb. 12, 2007).

³ *United States v. Davis*, 370 U.S. 65 (1962).

⁴ Argentina, Brazil, Chile, Ecuador, the Philippines, and Venezuela had similar programs as well. Leslie A. Sowle, Comment, *International Debt for Equity Swaps: Does Revenue Ruling 87-124 Make Sense?*, 83 NW. U. L. REV. 1079, 1079 n.1 (1989); Ridgeley A. Scott, *Taxation of Maquiladora Exchanges: The Taming of the Shrew*, 5 TUL. J. INT'L & COMP. L. 201, 203 (1997) (citing Bruce Cohen, *Tax Implications of Debt-for-Equity Swaps*, 12 HASTINGS INT'L & COMP. L. REV. 575, 576 (1989); Thomas Reiter, *The Feasibility of Debt-Equity Swaps in Russia*, 15 MICH. J. INT'L L. 909, 943-50 (1994); *see generally* Jon H. Sylvester, *Impracticability, Mutual Mistake and Related Contractual Bases for Equitably Adjusting the External Debt of Sub-Saharan Africa*, 13 NW. J. INT'L L. & BUS. 258 (1992)). New programs, for example, in the Philippines, may emerge in the future. *ASEAN asks int'l creditors to consider debt swap scheme*, http://business.inquirer.net/money/breakingnews/view_article.php?article_id=43254 (last visited April 29, 2007); *Debt-for-equity swap plan gets big boost*, <http://www.manilatimes.net/national/2007/jan/14/yehey/metro/20070114met3.html> (last visited April 29, 2007).

and could no longer service its foreign debt.⁷ The goal of Mexico's swap program was to reduce the outstanding balance of the Mexican government's foreign-currency-denominated debt while encouraging foreign investment in Mexico.⁸ Under the program, non-Mexican corporations that wanted to invest in Mexico, and therefore needed pesos, were able to purchase defaulted Mexican debt on the open market and then swap it with the Mexican government for pesos that could be spent only in Mexico.⁹ Mexico designed its program to ensure that 1) its debt would be canceled without requiring it to use foreign currency; 2) the non-Mexican corporation's payment (made in exchange for the debt cancellation) would remain in Mexico; and 3) foreign currency would enter Mexico through the export of goods manufactured by the Mexican subsidiary of the non-Mexico corporation.¹⁰

For United States tax purposes, the sale of Mexico's debt for the restricted pesos is treated as a taxable sale.¹¹

⁵ *Kohler Co. v. United States* ("Kohler I"), 247 F. Supp. 2d 1083, 1085 (E.D. Wis. 2003).

⁶ *Id.*

⁷ Leslie A. Sowle, Comment, *International Debt for Equity Swaps: Does Revenue Ruling 87-124 Make Sense?*, 83 Nw. U. L. REV. 1079, 1079 (1989).

⁸ *Kohler I*, 247 F. Supp. 2d at 1085; see generally Christopher Gottscho, Note, *Debt-Equity Swap Financing of Third World Investments—Will the I.R.S. Hinder U.S. Swappers?*, 8 VA. TAX REV. 143, 153 (1988) ("Viewed optimistically, debt-equity swaps may ultimately provide [less developed countries] with a second chance to develop the productive capacity that the huge amounts of external debt incurred was intended to finance").

⁹ *Kohler Co. v. United States* ("Kohler IV"), 468 F.3d 1032, 1033 (7th Cir. 2006), *reh'g denied and reh'g en banc denied*, No. 05-4472, 2007 U.S. App. LEXIS 3929 (7th Cir. Feb. 12, 2007).

¹⁰ *Kohler I*, 247 F. Supp. 2d at 1085.

¹¹ *Kohler IV*, 468 F.3d at 1035.

B. How Gain is Typically Calculated

First, it is important to understand that there is a difference between gain and taxable gain. The word “gain” means “sources or advantage acquired or increased.”¹² This dictionary definition of “gain” is not the same as the way the Internal Revenue Code¹³ computes “gain.”

In the Internal Revenue Code, the amount of gain from a sale or exchange is determined according to 26 U.S.C. § 1001.¹⁴ Gain is equal to, “the excess of the amount realized therefrom over the adjusted basis.”¹⁵ The “amount realized” from a sale or exchange is “the sum of any money received plus the fair market value of the property (other than money) received.”¹⁶ Generally speaking, a property’s “basis” is the cost of the property.¹⁷

If you apply these definitions to the situation described in the introduction to this Note, your taxable gain from \$19 million worth of pesos exchanged for debt costing \$11 million, would be \$8 million (\$19 million (amount realized) - \$11 million (cost/basis)).¹⁸

Recall that if you did not receive any money in a transaction, your “amount realized” is equal to the fair market value of the property

¹² WEBSTER’S NINTH NEW COLLEGIATE DICTIONARY (Frederick C. Mish, ed. 1987).

¹³ “Internal Revenue Code” refers to Title 26 of the United States Code.

¹⁴ 26 U.S.C. § 1001(a) (2000) (“Computation of gain or loss. The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized). In general, the gain realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income. 26 C.F.R. § 1.1001-1(a) (2006).

¹⁵ 26 U.S.C. § 1001(a). Gain = amount realized - basis

¹⁶ 26 U.S.C. § 1001(b).

¹⁷ 26 U.S.C. § 1012.

¹⁸ 26 U.S.C. § 1001.

received in the transaction;¹⁹ and remember that you, the taxpayer, and the IRS disagree as to the value of the pesos. What is the taxable gain if the fair market value of the property received in the transaction is unknown?

C. How to Determine Fair Market Value When There is No “Market?”

Sometimes the fair market value of property, like the restricted pesos described above, is not easily determinable because there is “little or no” market for the property.²⁰ The fair market value of the pesos, or any property, matters because it is one component of calculating taxable gain.²¹

The idea that the fair market value of property might be equal to the fair market value of the property that it was exchanged for, was first recognized by the courts in 1954, with the decision in *Philadelphia Park Amusement Co. v. United States*.²² The Court of Claims²³ held that “the value of the two properties exchanged in an arms-length transaction are either equal in fact, or are presumed to be equal.”²⁴ In the case, the Court of Claims needed to determine the taxpayer’s basis in an extension of a railway franchise (for construction, maintenance, and operation of a passenger railway), the fair market value of which was difficult to determine.²⁵ The court held that the fair market value of the franchise could be presumed to be equal to the fair market value of the bridge for which the franchise had

¹⁹ 26 U.S.C. § 1001(b).

²⁰ Christopher Gottscho, Note, *Debt-Equity Swap Financing of Third World Investments—Will the I.R.S. Hinder U.S. Swappers?*, 8 VA. TAX REV. 143, 172-73 (1988).

²¹ 26 U.S.C. § 1001.

²² 126 F. Supp. 184 (Ct. Cl. 1954).

²³ The Court of Claims is now known as the United States Court of Federal Claims. For information on the history of the court visit: <http://www.uscfc.uscourts.gov/USCFChistory.htm> (last visited April 29, 2007).

²⁴ *Philadelphia Park Amusement Co.*, 126 F. Supp. at 189.

²⁵ *Id.* at 184-90.

been exchanged for, if the bridge's value was *more readily ascertainable than* the franchise's value.²⁶

In 1962, the *Philadelphia Park* rule was accepted by the Supreme Court in *United States v. Davis*.²⁷ The *Davis* cases²⁸ involved the tax consequences of Mr. Davis' transfer of stock to his former wife as part of a property settlement executed prior to the Davis' divorce.²⁹

The Court looked at the income tax consequences of Mr. Davis' transfer of stock to his wife in two steps.³⁰ First, the Court decided whether the transaction was a taxable event.³¹ Then, the Court determined what gain resulted from the transaction.³² The Court determined that Mr. Davis' transfer of stock was a taxable transaction;³³ however, this result has since been superseded by statute.³⁴ Returning to the second issue, the Court held that absent a readily ascertainable value, the value of Mrs. Davis' marital rights had a value equal to the stock she had traded for those rights.³⁵ The Court

²⁶ *Id.* at 167, 190 (emphasis added).

²⁷ 370 U.S. 65 (1962).

²⁸ *United States v. Davis*, 370 U.S. 65 (1962) together with, *Davis v. United States*, also on certiorari to the same Court.

²⁹ *Davis*, 370 U.S. at 66. Specifically, Mr. Davis agreed to transfer to his wife, 1,000 shares of stock in exchange for the then Mrs. Davis' acceptance of the stock "in full settlement and satisfaction of any and all claims and rights against [her] husband whatsoever." *Id.* at 67.

³⁰ *Id.*

³¹ *Id.*

³² *Id.*

³³ *Id.* at 71.

³⁴ Congress intended to overrule the result in *Davis* with the passage of the Tax Reform Act of 1984, P.L. 98-369. H.R. REP. 98-432 (1984). The provision was later codified as 26 U.S.C. § 1041, which states: "General rule. No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of)-- (1) a spouse, or (2) a former spouse, but only if the transfer is incident to the divorce." 26 U.S.C. § 1041(a) (2000).

³⁵ *Davis*, 370 U.S. at 72 ("Absent a readily ascertainable value it is accepted practice where property is exchanged to hold, as did the Court of Claims in *Philadelphia Park Amusement Co. v. United States* that the values 'of the two

disagreed with lower courts,³⁶ which had found that there was no way to compute the fair market value of Mrs. Davis' marital rights and that it was therefore impossible to determine the taxable gain realized by Mr. Davis.³⁷ The Supreme Court reasoned that it must be assumed, as there was no evidence to the contrary, that the parties acted at arms-length and that they judged their marital rights to be equal in value to the property for which their rights were exchanged.³⁸ The Court concluded that once it had recognized that the transfer between husband and wife was a taxable event, it was "more consistent with the general purpose and scheme of the taxing statutes to make a rough approximation of the gain realized thereby than to ignore altogether its tax consequences."³⁹

In summary, the Supreme Court held in *Davis* that absent a readily ascertainable value, the values of two properties exchanged in an arms-length transaction are equal or are presumed to be equal to each other.⁴⁰ In the forty-five years since the *Davis* decision, neither the Supreme Court nor Congress has overruled or superseded this holding.

properties exchanged in an arms-length transaction are either equal in fact, or are presumed to be equal") (internal citations omitted).

³⁶ The Court of Claims, from which *Davis* had been appealed, *United States v. Davis*, 370 U.S. 65, 66 (1962), had followed the precedent of the Sixth Circuit, *United States v. Davis*, 370 U.S. 65, 68 (1962) ("The matter was considered settled until the Court of Appeals for the Sixth Circuit, in reversing the Tax Court, ruled that, although such a transfer might be a taxable event, the gain realized thereby could not be determined because the impossibility of evaluating the fair market value of the wife's marital rights. *Comm'r v. Marsham*, 279 F.2d 27 (1960)").

³⁷ *Davis*, 370 U.S. at 72.

³⁸ *Id.* (The Court acknowledged, but was not persuaded, that, "there is much to be said of the argument that such an assumption is weakened by the emotion, tension and practical necessities involved in divorce negotiations and the property settlements arising therefrom").

³⁹ *Id.* at 72-73.

⁴⁰ *Id.* at 72.

D. Different Approaches: Valuing Debt-Equity Swaps

Since the beginning of Mexico's debt-equity swap program in the early 1980's,⁴¹ there have been few judicial decisions considering the valuation of the amount realized, and hence the taxable gain, stemming from debt-equity swaps with Mexico. This section will first discuss IRS Revenue Ruling 87-124, which covers debt-equity swaps with foreign governments.⁴² Then, this section will review the Court of Appeals for the Fifth Circuit's decision in *G.M. Trading Corp. v. Commissioner*⁴³ and the United States Tax Court's decision in *CMI International, Inc. v. Commissioner*.⁴⁴ The Court of Appeals for the Seventh Circuit's decision in *Kohler Co. v. United States*⁴⁵ will be discussed in Section II. As only three cases been decided, it is premature to say there is a trend in the decisions. However, the decisions of the Tax Court, Fifth Circuit, and Seventh Circuit have all been in favor of the taxpayer.⁴⁶

Revenue Ruling 87-124 (the "Ruling") was promulgated by the IRS, in 1987, to govern debt-equity swaps with foreign governments.⁴⁷ The Ruling describes three situations, with Situations 2 and 3 being variations on Situation 1.⁴⁸ Situation 1 describes a debt-equity swap similar to the program described in Section I.A. above. First, a U.S. corporation purchases debt obligations from a U.S. bank for \$60; second, the bank delivers the debt obligation to the foreign country's central bank; third, the central bank credits 900 LCs (local currency) to the U.S. corporation's foreign subsidiary's central bank account; and

⁴¹ *Kohler Co. v. United States* ("*Kohler I*"), 247 F. Supp. 2d 1083, 1085 (E.D. Wis. 2003).

⁴² Rev. Rul. 87-124.

⁴³ 121 F.3d 977 (5th Cir. 1997).

⁴⁴ 113 T.C. 1 (T.C. 1999).

⁴⁵ ("*Kohler IV*"), 468 F.3d 1032 (7th Cir. 2006), *reh'g denied and reh'g en banc denied*, No. 05-4472, 2007 U.S. App. LEXIS 3929 (7th Cir. Feb. 12, 2007).

⁴⁶ *G.M. Trading Corp.*, 121 F.3d at 981; *CMI Int'l, Inc.*, 113 T.C. at 5; *Kohler IV*, 468 F.3d at 1037.

⁴⁷ Rev. Rul. 87-124.

⁴⁸ *Id.*

fourth, the foreign subsidiary issues all its capital stock to its U.S. parent.⁴⁹ The Ruling acknowledged that the restrictive character of the local currency received in the swap would “generally reduce” the fair market value of the currency below the value of currency “convertible at the free market exchange rate.”⁵⁰ However, no further guidance for establishing the value of the restricted currency was provided.⁵¹ The Ruling concluded that the U.S. corporation has a gain on the exchange of the debt obligations for the local currency “to the extent the fair market value of the 900 LCs [local currency] exceeds \$60 [the price paid for the debt obligation].”⁵²

Revenue rulings are not binding upon the courts.⁵³ Since its publication, no court has chosen to apply this Ruling. When the Fifth Circuit examined debt-equity swaps, it described the Ruling as erroneous as a matter of law.⁵⁴ And, when the Seventh Circuit addressed the issue, it did not even mention the Ruling in its opinion.⁵⁵

In 1994, the Tax Court ruled on the first debt-equity swap case,⁵⁶ which was later appealed to the Fifth Circuit in 1997.⁵⁷ In *G.M. Trading Corp. v. Commissioner*, G.M. had surrendered \$600,000 worth of Mexican national debt to the Mexican government in exchange for approximately 1.7 billion pesos, whose use was restricted to the construction of a G.M. plant in Mexico.⁵⁸ The Fifth Circuit rejected

⁴⁹ *Id.* (“Y purchased the Obligation from X for \$60, which was the fair market value of similar FC debt in the secondary markets outside of FC. X, on behalf of Y, delivered the Obligation to the Central Bank, which credited an account of FX at the Central Bank with 900 LCs. FX then issued all its capital stock to Y”).

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Broadview Lumber Co. v. United States*, 561 F.2d 698, 704 (7th Cir. 1977).

⁵⁴ *G.M. Trading Corp. v. Comm’r*, 121 F.3d 977, 980 (5th Cir. 1997).

⁵⁵ *Kohler Co. v. United States (“Kohler IV”)*, 468 F.3d 1032 (7th Cir. 2006), *reh’g denied and reh’g en banc denied*, No. 05-4472, 2007 U.S. App. LEXIS 3929 (7th Cir. Feb. 12, 2007).

⁵⁶ *G.M. Trading Corp. v. Comm’r*, 103 T.C. 59 (T.C. 1994).

⁵⁷ *G.M. Trading Corp. v. Comm’r*, 121 F.3d 977 (5th Cir. 1997).

⁵⁸ 121 F.3d at 978.

Revenue Ruling 87-124,⁵⁹ because the court found that this Ruling implicitly held that no portion of a debt-equity swap would qualify as a nontaxable contribution to capital under 26 U.S.C. § 118.⁶⁰

The court found that there were two parts to the restricted peso payment G.M. had received.⁶¹ The first part of the peso payment by the Mexican government to G.M. was for extinguishing part of Mexico's national debt.⁶² The second part of the payment was a contribution to capital because the payment was to persuade G.M. to invest in Mexico's economy.⁶³ The test for determining whether a particular payment is a contribution to capital under section 118 is "the intent or motive of [Mexico]."⁶⁴ "[T]he contribution 1) must become a part of the recipient's capital structure; 2) may not be compensation for a 'specific, quantifiable service'; 3) must be bargained for; 4) must result in a benefit to the recipient; and 5) ordinarily will contribute to the production of additional income."⁶⁵

The court concluded that the solution to the valuation problem was to bifurcate the payment.⁶⁶ G.M. would be taxed on the value of the restricted pesos received in exchange for extinguishing the debt.⁶⁷

⁵⁹ Rev. Rul. 87-124.

⁶⁰ *G.M. Trading Corp.*, 121 F.3d at 980.

⁶¹ *Id.* at 981. Total = Payment to G.M. for extinguishing debt (*Davis* rule) + Contribution to G.M.'s capital (section 118).

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.* at 980 (citing *United States v. Chicago, Burlington & Quincy R.R. Co.*, 412 U.S. 401, 411 (1973)).

⁶⁵ *G.M. Trading Corp.*, 121 F.3d 977, 980-81 (5th Cir. 1997) (citing *Chicago, Burlington & Quincy R.R. Co.*, 412 U.S. at 413).

⁶⁶ *G.M. Trading Corp.*, 121 F.3d at 980-81 (Bifurcation of a section 118 contribution to capital is allowed, according to the Fifth Circuit, because "according to the plain terms of the statute, anything that qualifies as a contribution to capital is nontaxable . . . the statute mandates bifurcation by requiring that any, rather than some, contributions to capital be excluded from income").

⁶⁷ *Id.*

The balance of the payment would be excluded from taxation as a contribution to capital under 26 U.S.C. § 118.⁶⁸

Returning to the first part of the payment (the taxable portion, not exempt under section 118), the court found that, “when property with a readily ascertainable value is exchanged for property without one, the latter property is presumed to be equal in value to the former.”⁶⁹ The court emphasized that this principle reflects the common sense notion that an asset’s value is the price persons are willing to pay for it.⁷⁰ The court concluded that since the transaction was at arms-length, and since there was not a readily ascertainable value for the amount and worth of the pesos exchanged for the debt extinguishment, the court had to follow *Davis* and assume that value received for \$600,000 of debt was, in fact, \$600,000.⁷¹

The next court to tackle the debt-equity swap valuation issue was the United States Tax Court.⁷² In 1999, the United States Tax Court issued its decision in *CMI International, Inc. v. Commissioner*.⁷³ In *CMI*, CMI-Texas (a wholly owned subsidiary of CMI International) acquired a Mexican debt interest, which it transferred to Industries (CMI-Texas’ Mexican subsidiary).⁷⁴ The court articulated that while “section 351(a) allows the tax-free exchange of property from a shareholder to its wholly owned subsidiary, section 367(a) may deny such treatment if the transfer is from a domestic to a foreign corporation.”⁷⁵ The court stated that the transfer described above fell within the scope of section 367(a).⁷⁶ Assuming *arguendo* that CMI-Texas realized gain on the transaction, the court held that the amount of recognized gain was limited to zero under temporary income tax

⁶⁸ *Id.*

⁶⁹ *Id.* at 983 (citing *United States v. Davis*, 370 U.S. 65, 72 (1962)).

⁷⁰ *G.M. Trading Corp.*, 121 F.3d at 983.

⁷¹ *Id.*

⁷² *CMI Int’l, Inc. v. Comm’r*, 113 T.C. 1 (T.C. 1999).

⁷³ *Id.*

⁷⁴ *Id.* at 4-5.

⁷⁵ *Id.* at 5.

⁷⁶ *Id.*

regulations pursuant to section 1.367(a), because the debt interest was not appreciated property.⁷⁷

CMI is inapplicable to *Kohler Co. v. United States*,⁷⁸ which is discussed fully in Section II., because Kohler had not transferred its interest in the debt obligations to its subsidiary as *CMI* had done.⁷⁹

II. KOHLER CO. V. UNITED STATES

A. Description of the Kohler Transaction

Kohler, the Wisconsin manufacturer of plumbing products, decided to build a plant, to be owned and operated by its Mexican subsidiary, Sanimex, in Monterrey, Mexico.⁸⁰ Kohler's motivation for locating its plant outside the United States was two-fold: 1) significantly lower labor costs, and 2) an increase in its production capacity for lower cost plumbing products in a location close to the United States, the intended market for its products.⁸¹

Kohler became aware of the Mexican debt equity swap program, which Kohler recognized as an opportunity to realize even greater savings on its planned investment in Mexico.⁸² In May 1987, Kohler applied to the Mexican government for approval to participate in

⁷⁷ *Id.*

⁷⁸ *Kohler Co. v. United States* (“*Kohler IV*”), 468 F.3d 1032 (7th Cir. 2006), *reh'g denied and reh'g en banc denied*, No. 05-4472, 2007 U.S. App. LEXIS 3929 (7th Cir. Feb. 12, 2007).

⁷⁹ *Kohler Co. v. United States* (“*Kohler I*”), 247 F. Supp. 2d 1083, 1096 (E.D. Wis. 2003). The court in *Kohler I* did not believe that *CMI* was applicable to the Kohler transaction. *Id.* The lawyers that argued Kohler, Miller & Chevalier, thought that the Kohler and *CMI* transactions were similar. Miller & Chevalier, Chartered Tax Controversy Alert, <http://www.millerchevalier.com/files/Publication/f13a97d0-7906-461d-8978-7b966825e8ba/Presentation/PublicationAttachment/4d5cadea-4fc9-4993-a44f-92acadb7d1ce/2005-09-28%20MC%20Tax%20Controversy%20Alert.pdf> (last visited April 29, 2007).

⁸⁰ *Kohler I*, 247 F. Supp. 2d at 1084.

⁸¹ *Id.* at 1084-85.

⁸² *Id.* at 1085.

Mexico's debt equity swap program.⁸³ Kohler's application was approved in September 1987.⁸⁴

Kohler purchased from Bankers Trust Company an interest in publicly traded debt obligations owed by the Mexican government.⁸⁵ The face value of the debt interest Kohler acquired was \$22,439,000, but Kohler paid only \$11,114,267 for the debt.⁸⁶ The transaction between Kohler and Bankers Trust was negotiated at arms-length, with the price paid for the debt obligations being the fair market value of the debt at the time of the transaction.⁸⁷ Put another way, the amount Bankers Trust received for the debt was the best price at which the debt obligations could be sold.⁸⁸

The debt equity swap transaction was finalized on December 28, 1987.⁸⁹ Under the terms of the party's agreement, four prearranged and interrelated steps occurred.⁹⁰

⁸³ *Id.* at 1086.

⁸⁴ *Id.*

⁸⁵ *Id.*

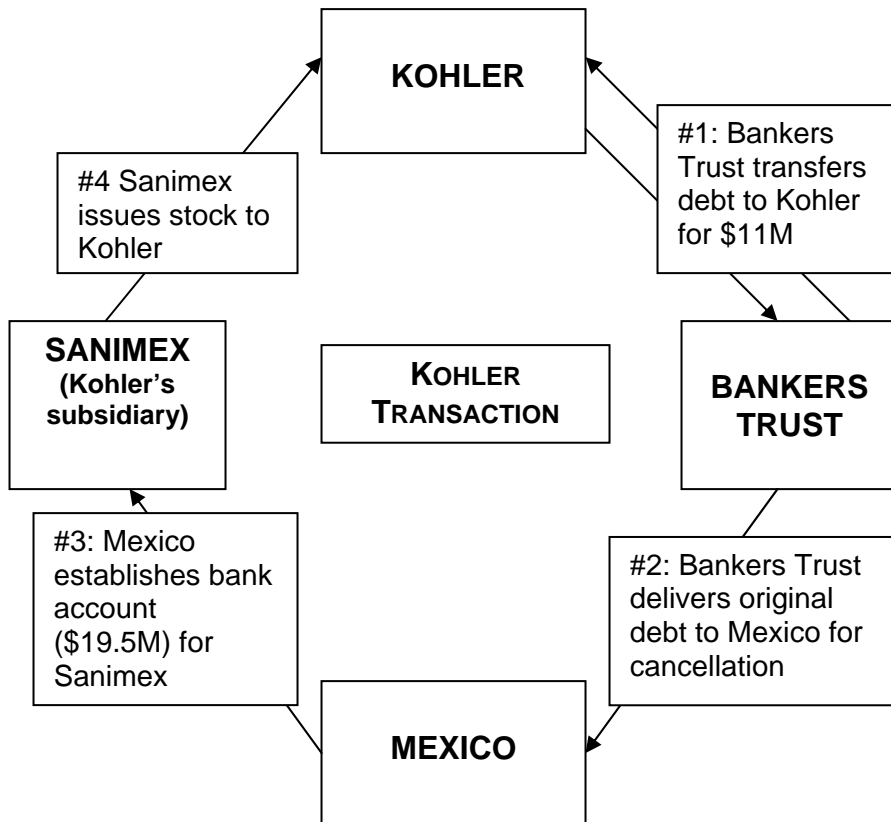
⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.* at 1087.

⁹⁰ *Id.*



First, Bankers Trust transferred⁹¹ its interest in the Mexican debt obligations to Kohler for \$11,114,267.⁹² Second, Bankers Trust delivered the original debt obligations to a ministry of the Mexican government for cancellation.⁹³ Third, the Mexican Central Bank established a bank account, into which it deposited 43,778,766,018 Mexican pesos, for Sanimex, Kohler's Mexican subsidiary.⁹⁴ The

⁹¹ The acquisition of the debt obligations occurred in stages prior to as well as on the actual date of the closing. *Id.*

⁹² *Id.*

⁹³ *Id.*

⁹⁴ *Id.*

pesos were nominally equivalent to \$19,500,564 or 87% of the face value of the original debt obligations.⁹⁵ Finally, Sanimex issued qualified capital stock, in the name of Kohler, for 43,778,766,018 Mexican pesos.⁹⁶

B. Procedural Background

Kohler treated the purchase of the debt and its sale to the Mexican government as yielding no taxable income.⁹⁷ Essentially, it was as if the Mexican government had paid Kohler \$11.1 million in dollars rather than paying it in pesos.⁹⁸ The IRS disagreed with this treatment of the transaction and added \$8.4 million to Kohler's taxable income, the difference between the price that Kohler had paid Bankers Trust for the Mexican debt and \$19.5 million.⁹⁹

Kohler then filed with the IRS an amended tax return in which it claimed a refund of income taxes for 1987 in the amount of \$3,350,383 (the amount of the additional tax assessed against Kohler as a result of the IRS's adjustment to Kohler's income).¹⁰⁰ The IRS disallowed the refund claim and Kohler filed suit for a refund.¹⁰¹

Kohler then filed a motion for summary judgment, which was denied by the United States District Court for the Eastern District of Wisconsin on February 20, 2003.¹⁰² Next, Kohler petitioned the court to certify an interlocutory appeal to the Seventh Circuit, which was

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ *Kohler Co. v. United States* ("*Kohler IV*"), 468 F.3d 1032, 1033 (7th Cir. 2006), *reh'g denied and reh'g en banc denied*, No. 05-4472, 2007 U.S. App. LEXIS 3929 (7th Cir. Feb. 12, 2007).

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Kohler Co. v. United States* ("*Kohler I*"), 247 F. Supp. 2d 1083, 1088 (E.D. Wis. 2003).

¹⁰¹ *Id.*

¹⁰² *Id.* at 1083-84.

granted.¹⁰³ Then, Kohler moved again for summary judgment, which was granted on September 1, 2005.¹⁰⁴ Finally, the case went to the Seventh Circuit.¹⁰⁵

C. Seventh Circuit Decision

The first part of the court's decision consisted of a history of Mexico's debt-equity swap program and a description of the transaction involving Kohler.¹⁰⁶

Basically, under the terms of the debt-equity swap program, the Mexican government swapped the \$11.1 million debt Kohler had bought from Bankers Trust for \$19.5 million worth of pesos, as calculated at the then current market exchange rate of 2245 pesos to the dollar.¹⁰⁷ The Seventh Circuit thought that the qualification in "as calculated at the then current market exchange rate" was critical.¹⁰⁸

If that was not the right exchange rate to use for the transaction, then the pesos that Kohler received may not have really been worth \$19.5 million.¹⁰⁹ The court reasoned that the pesos were worth less because 1) Mexico was willing to offer \$19.5 million in pesos for debt that Kohler had purchased for only \$11.1 million, and 2) Mexico had to compensate Kohler for accepting pesos that came with restrictions that reduced their value (the pesos had to be spent in Mexico on projects approved by the government and could not be freely converted to dollars or other foreign currencies until 1998).¹¹⁰ As a

¹⁰³ Kohler Co. v. United States ("*Kohler II*"), No. 01-C-753, 2003 WL 21693705 (E.D. Wis. June 4, 2003).

¹⁰⁴ Kohler Co. v. United States ("*Kohler III*"), 387 F. Supp. 2d 921, 922 (E.D. Wis. 2005).

¹⁰⁵ Kohler Co. v. United States ("*Kohler IV*"), 468 F.3d 1032 (7th Cir. 2006), *reh'g denied and reh'g en banc denied*, No. 05-4472, 2007 U.S. App. LEXIS 3929 (7th Cir. Feb. 12, 2007).

¹⁰⁶ *Id.* at 1032-33.

¹⁰⁷ *Id.* at 1033.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

result, Kohler received an exchange rate of 3939 pesos to the dollar, rather than 2245 pesos to the dollar, which is what the court said turned \$11.1 million of dollar debt into \$19.5 million in pesos.¹¹¹

The second part of the Seventh Circuit's decision outlined three different ways of accounting for Kohler's purchase of Mexican debt.¹¹²

First, the court proffered its preferred approach, which was "to add \$11.1 million to the basis of Kohler's investment in the Mexican plant."¹¹³ The court reasoned that this would prevent Kohler from receiving a "windfall."¹¹⁴

Second, the court acknowledged an alternative way of accounting for the swap would have been to accept Kohler's argument.¹¹⁵ Kohler had argued that the value of the debt that it purchased was unascertainable at the time of purchase.¹¹⁶ Thus, the exchange of the debt for the peso account should be treated as a swap yielding no taxable income.¹¹⁷ However, treating the swap in that manner would

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.* It is somewhat unclear whether the court wants to increase Kohler's basis by \$11.1 million or decrease Kohler's basis by \$8.4 million. The relevant section of the opinion reads, "One might have thought that the way to account for Kohler's purchase of Mexican debt would have been to *add \$11.1 million to the basis* of Kohler's investment in the Mexican plant, so that if it ever sold the plant the difference between on the one hand the sale price and on the other hand the sum of \$11.1 million and all the other costs of the plant would be taxable income attributable to the sale. Then if the Mexican government's purchase of \$ 11.1 million in debt from Kohler for \$ 19.5 million in pesos was a windfall for Kohler, reducing the real cost of the plant, Kohler would realize a greater profit from the eventual sale of the plant than it would have realized otherwise, and that profit would be taxable. Even if the plant was never sold, the windfall would give Kohler higher profits (presumably taxable) on sales of the plant's output because the deductions from taxable income that it could take for depreciation of the cost of the plant would be lessened by the \$ 8.4 million reduction in its basis." *Id.* at 1033-34 (emphasis added).

¹¹⁴ *Id.* at 1033.

¹¹⁵ *Id.* at 1034.

¹¹⁶ *Id.*

¹¹⁷ *Id.*

not mean that the results of Kohler's transaction would never be taxable, as any capital gains that resulted in the future from Kohler's use of the pesos to purchase goods and services for its projects would be taxable.¹¹⁸

Third, another alternative method to evaluate the transaction, would be to deem the difference between the two amounts (the face value of the pesos and the amount paid for the debt) a contribution to capital to Kohler by the Mexican government.¹¹⁹ A contribution to capital would not be included in Kohler's gross income,¹²⁰ but would be recorded on Kohler's books as having a zero basis,¹²¹ and so could not be depreciated.¹²² The Seventh Circuit noted that this approach was adopted by the Fifth Circuit in *G.M. Trading Corp. v. Commissioner*, but that it felt "dubious" about it.¹²³

The court reasoned that compensation for a "specific, quantifiable service" could not be classified as a contribution to capital and that the Mexican government, to the extent it "overpaid" Kohler for the debt, was buying a service from Kohler, which was the retirement of a portion of Mexico's foreign debt.¹²⁴ The Fifth Circuit thought the purpose of the Mexican debt-equity swap program was to encourage foreign investment in Mexico.¹²⁵ However, the Seventh Circuit said that was *a* purpose, albeit a secondary purpose, to Mexico's desire to retire its foreign debt.¹²⁶

After outlining these three approaches, the Seventh Circuit stated that the parties had taken none of these approaches.¹²⁷ Kohler and the IRS had both treated the sale of the Mexican debt for the pesos as a

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ 26 U.S.C. § 118(a) (2000).

¹²¹ 26 U.S.C. § 362(c).

¹²² *Kohler IV*, 468 F.3d at 1034.

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Id.*

taxable sale under 26 U.S.C. § 1001(c).¹²⁸ The dispute concerned only the value to Kohler of the exchange when made.¹²⁹ Kohler argued that it had no gain from the sale.¹³⁰ The IRS argued that the entire difference between the \$19.5 million in pesos that the Mexican government gave Kohler and the \$11.1 million that Kohler had paid to buy the debt that it swapped for the pesos was taxable.¹³¹

The court disagreed with both sides.¹³² In the court's opinion, Kohler must have had some gain because "\$11.1 million in Mexican foreign debt was worth more to it than to Bankers Trust. It wanted pesos; Bankers Trust did not."¹³³ However, the pesos were not worth the full \$19.5 million at which the Mexican government valued them for purposes of the exchange, because the pesos were not convertible into dollars or any other currency.¹³⁴

In the last section of its decision, the court tasked itself with choosing between the two adversaries' valuations, both of which, the court believed were "manifestly erroneous."¹³⁵ The court noted that Kohler had argued that it needed no evidence, citing to *United States v. Davis*,¹³⁶ which the court characterized as being "superficially similar" to the Kohler transaction.¹³⁷ The Seventh Circuit stated that the Supreme Court "merely assumed," but did not hold that the wife's marital rights could not be ascertained with sufficient precision to enable a calculation of the husband's gain or loss.¹³⁸ The court distinguished *Davis* by stating, "The problem in our case is different.

¹²⁸ *Id.* at 1035.

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ *Id.*

¹³² *Id.*

¹³³ *Id.*

¹³⁴ *Id.*

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ *Id.*

It is what to do when the value of the property exchanged may well be ascertainable but has not been ascertained.”¹³⁹

Nevertheless, the court found that the government’s assessment of the value of the pesos was “undeniably excessive” because it took no account of the restrictions that the Mexican government had placed on the pesos.¹⁴⁰ However, the court found “Kohler’s efforts [at valuation] . . . equally pathetic.”¹⁴¹

In the court’s words, “The same thing can be worth more to one person (Kohler) than to another (Bankers Trust); that is the basis of market transactions. To a holder of Mexican debt that had no use for pesos, the debt was worth only half its face amount; to someone like Kohler who needed a great many pesos, the debt was worth more.”¹⁴²

The court emphasized that, “the Service could have justified a more modest estimate yet one well above \$ 11.1 million, but clinging stubbornly to its untenable valuation it suggested no alternative to \$19.5 million.”¹⁴³ Finally, the court concluded that since the government “played all or nothing” and lost, it would “ge[t] nothing.”¹⁴⁴

III. ANALYSIS

This section will first discuss three problems with the Seventh Circuit’s decision in *Kohler*: 1) the Seventh Circuit misunderstood the difference between gain and taxable gain, 2) the court needlessly found *Davis* distinguishable, and 3) that courts basis-increase (or decrease) approach was baseless. Then, this section will comment on the Seventh Circuit’s correct decision to reject 26 U.S.C. § 118 as a

¹³⁹ *Id.* at 1036.

¹⁴⁰ *Id.*

¹⁴¹ *Id.* at 1037.

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ *Id.* The usual rule is that the party with the burden of proof (Kohler) would lose. *Id.* at 1035.

way to account for the transaction. Finally, this section will conclude that the *Davis* rule should have applied to the Kohler transaction.

*A. The Seventh Circuit Misperceived the Difference
Between Gain and Taxable Gain.*

The overriding problem with the Seventh Circuit’s reasoning in *Kohler* is the court’s confusion between gain (i.e. “I entered into this transaction because I am better off after the transaction is complete”) and taxable gain. As discussed previously, taxable gain is equal to the amount realized minus basis.¹⁴⁵

Kohler had argued that it had no gain from the sale of its debt to Mexico.¹⁴⁶ The court’s reaction was that Kohler’s position was “untenable.”¹⁴⁷ To the court, \$11.1 million in Mexican foreign debt was worth more to Kohler than to Bankers Trust because Kohler wanted pesos, while Bankers Trust did not want pesos.¹⁴⁸ Kohler had argued, in the court’s opinion, “absurdly,” that if Kohler had gained from the purchase, the bank must have lost, which Kohler contended the bank would not have done.¹⁴⁹ The court’s position was that, “most transactions produce a gain to both parties—that is what induces the transaction.”¹⁵⁰ In this sentence, the court is illustrating gain, but not taxable gain.

For example, assume that Kate has a digital camera and Matt has a projector, both of which have a fair market value of \$100 and a basis of \$10. Let’s say that Kate trades her digital camera for Matt’s projector, because Kate really wants a digital camera and Matt really wants a projector. Perhaps Kate likes Matt’s projector so much that she would be willing to pay him \$125 for the projector. Even though Kate’s new projector was worth \$125 to her, Kate’s taxable gain from

¹⁴⁵ 26 U.S.C. § 1001 (2000). Taxable gain = amount realized – basis.

¹⁴⁶ *Kohler IV*, 468 F.3d at 1035.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

the exchange is only \$90, because the fair market value of the projector was only \$100.¹⁵¹ For non-cash sales, what is taxed by the government is the difference between the fair market value of the property and the taxpayer's basis in the property.¹⁵² Nowhere in the Internal Revenue Code does it state that a taxpayer's personal value in the property, for example, the fact that Kate really wanted a projector or pesos, come into play.

Or, suppose I buy a bottle of soda from a vending machine. I'm really thirsty, so I would be willing to pay \$3.00 for a drink. Luckily, the vending machine only needs \$1.25 in order to release a bottle. The government does not tax me on my \$1.75 "gain."¹⁵³

This first misstep leads the court down the wrong path—looking for a way to measure non-existent "gain" it finds to be inherent in the Kohler transaction.¹⁵⁴ Since the court has concluded there must be "gain," the court needs to find a way to distinguish the Kohler transaction from *Davis*. If the *Davis* rule had been applied to the Kohler transaction, Kohler's swap would have been a "wash," given

¹⁵¹ \$90 gain = \$100 amount realized - \$10 basis.

¹⁵² 26 U.S.C. § 1001 (2000).

¹⁵³ A similar idea to the concept described above is known as "imputed income." Imputed income, which is not taxed, is a form of non-cash income that stems from the enjoyment of property, or from goods used by the taxpayer, or from services performed for or by the taxpayer. John K. McNulty & Daniel J. Lathrope, *FEDERAL INCOME TAXATION OF INDIVIDUALS*, 46 (Thomson West 2004) (1972). For example, the benefit a student receives in excess of the cost of tuition paid, would be imputed income. *Id.* While nothing in the Internal Revenue Code excludes imputed income from taxation, an "unstated exclusion" generally shelters such income from tax, partly because of the administrative and compliance problems involved with attempting to tax imputed income. *Id.* For example, 26 U.S.C. § 132 taxes some employee fringe benefits, which can be considered a form of imputed income. *Id.*

¹⁵⁴ *But c.f.* Christopher Gottscho, Note, *Debt-Equity Swap Financing of Third World Investments—Will the I.R.S. Hinder U.S. Swappers?*, 8 VA. TAX REV. 143, 169 (1988) ("The popularity of debt-equity swap financing of [less developed countries] investments among investors indicates there may be some merit to this perception of gain.")

that the debt interest and the restricted pesos would be deemed to have equal values.¹⁵⁵

B. The Court Needlessly Finds Davis Distinguishable.

The second flaw in the Seventh Circuit's reasoning occurs when the court concludes that *United States v. Davis* is not applicable to the Kohler transaction.¹⁵⁶ Recall that *Davis* held that absent a readily ascertainable value, the value of two properties exchanged in an arms-length transaction are either equal or presumed to be equal in value.¹⁵⁷

The court misconstrues the Supreme Court's holding in *Davis* by claiming, "[t]he problem in our case is different. It is what to do when the value of the property exchanged may well be ascertainable¹⁵⁸ but has not been ascertained."¹⁵⁹

This of course is not what *Davis* said.¹⁶⁰ The Court stated that, "Absent a *readily ascertainable* value it is accepted practice where property is exchanged to hold, as did the Court of Claims in *Philadelphia Park Amusement Co. v. United States* that the values 'of the two properties exchanged in an arms-length transaction are either equal in fact, or are presumed to be equal.'"¹⁶¹ The key phrase in *Davis* was "readily ascertainable." "Readily" means "without much difficulty: easily."¹⁶² It follows that if the value of the debt interest is easily ascertainable whereas the value of the restricted pesos is not

¹⁵⁵ *United States v. Davis*, 370 U.S. 65, 72 (1962).

¹⁵⁶ *Kohler Co. v. United States* ("*Kohler IV*"), 468 F.3d 1032, 1036 (7th Cir. 2006), *reh'g denied and reh'g en banc denied*, No. 05-4472, 2007 U.S. App. LEXIS 3929 (7th Cir. Feb. 12, 2007).

¹⁵⁷ *Davis*, 370 U.S. at 72.

¹⁵⁸ For examples of different ways to value restricted currency, see Leslie A. Sowle, Comment, *International Debt for Equity Swaps: Does Revenue Ruling 87-124 Make Sense?*, 83 NW. U. L. REV. 1079 (1989).

¹⁵⁹ *Kohler IV*, 468 F.3d at 1036.

¹⁶⁰ *Davis*, 370 U.S. at 72.

¹⁶¹ *Id.* (internal citations omitted) (emphasis added).

¹⁶² WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY (Frederick C. Mish, ed. 1987).

easily ascertainable, the court should have followed the *Davis* rule and concluded that the value of the debt interest and restricted pesos were equal.

Other commentators have noted that the use of the *Davis* rule should be acceptable in debt equity swaps.¹⁶³ This is because the fair market value of debt-equity currency, in this case, the restricted pesos, is affected by the limitations on the use of the currency.¹⁶⁴ In contrast, the fair market value of the debt obligation may be more readily and reliably ascertained¹⁶⁵ because there is a market for the debt obligations.¹⁶⁶ Providing further proof of the sensibility of the *Davis* rule (*i.e.* the value of the restricted pesos was equal to the value of the debt obligation) is the fact that, “[e]ven if, despite the investment restrictions, a buyer could be found who met the [swap country’s] restrictions, the buyer probably would not pay more for the investment than the U.S. parent paid, assuming the buyer also could utilize debt-equity swaps.”¹⁶⁷

The discussion of why *United States v. Davis*¹⁶⁸ is the preferred analysis will resume in Subsection E.

C. Adding Basis is Baseless.

The Seventh Circuit suggests in *dicta* that the proper way to account for Kohler’s debt purchase would be to add \$11.1 million to

¹⁶³ Leslie A. Sowle, Comment, *International Debt for Equity Swaps: Does Revenue Ruling 87-124 Make Sense?*, 83 NW. U. L. REV. 1079, 1110 (1989).

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

¹⁶⁶ *Kohler Co. v. United States* (“*Kohler I*”), 247 F. Supp. 2d 1083, 1086 (E.D. Wis. 2003); see Christopher Gottscho, Note, *Debt-Equity Swap Financing of Third World Investments—Will the I.R.S. Hinder U.S. Swappers?*, 8 VA. TAX REV. 143, 147-49 (1988).

¹⁶⁷ Christopher Gottscho, Note, *Debt-Equity Swap Financing of Third World Investments—Will the I.R.S. Hinder U.S. Swappers?*, 8 VA. TAX REV. 143, 172 (1988).

¹⁶⁸ 370 U.S. 65 (1962).

the basis of Kohler's investment in the Mexican plant.¹⁶⁹ It is somewhat unclear whether the court desires to add \$11.1 million to Kohler's basis¹⁷⁰ or subtract \$8.4 million from Kohler's basis.¹⁷¹ The court reasoned that this basis-increase (or basis-decrease) approach would prevent Kohler from receiving a "windfall."¹⁷²

Here, adding \$11.1 million to its basis would be a gift to Kohler. Taxpayers love basis because it lowers their potential taxable gain.

For example, if Kohler sold the factory for \$50 million and its basis was \$29 million¹⁷³ adding \$11.1 million to Kohler's basis would result in basis being \$40.1. Upon the sale, the taxable gain would then be \$50 million minus \$40.1 million, or \$9.9 million. Without adding the "extra" \$11.1 million to the basis, Kohler's taxable gain would have been \$21 million, \$50 million minus \$29 million. Obviously, giving Kohler additional basis is not a good solution if the court wants to ensure Kohler is not receiving a tax-free windfall.¹⁷⁴

On the other hand, the court's basis-decrease (or "wait-and-see"¹⁷⁵) approach is more sensible. If this is the case, it seems that the court is alluding to treating the Kohler transaction as an "open

¹⁶⁹ Kohler Co. v. United States ("*Kohler IV*"), 468 F.3d 1032, 1033 (7th Cir. 2006), *reh'g denied and reh'g en banc denied*, No. 05-4472, 2007 U.S. App. LEXIS 3929 (7th Cir. Feb. 12, 2007).

¹⁷⁰ *Id.* at 1033-34 ("One might have thought that the way to account for Kohler's purchase of Mexican debt would have been to *add \$11.1 million to the basis* of Kohler's investment in the Mexican plant, so that if it ever sold the plant the difference between on the one hand the sale price and on the other hand the sum of \$11.1 million and all the other costs of the plant would be taxable income attributable to the sale") (emphasis added).

¹⁷¹ *Id.* ("Even if the plant was never sold, the windfall would give Kohler higher profits (presumably taxable) on sales of the plant's output because the deductions from taxable income that it could take for depreciation of the cost of the plant would be lessened by the *\$ 8.4 million reduction in its basis*") (emphasis added).

¹⁷² *Id.* at 1033.

¹⁷³ *Id.* at 1032 (Kohler estimated the plant in Mexico would cost at least \$29 million to build).

¹⁷⁴ *Id.* at 1033.

¹⁷⁵ *Id.* at 1035.

transaction.” An “open transaction” is when the sale or exchange of property does not result in reported income at the time of the sale or exchange.¹⁷⁶ If the transaction is treated as “open,” Kohler would not be deemed to have received taxable income until Kohler’s basis (the \$11.1 million it had paid for the debt obligation) had been recovered.¹⁷⁷ However, receipt of property, in this case the pesos, is usually “treated as a final sale and a value is somehow placed upon it.”¹⁷⁸

In any case, the court’s suggestion does not matter because the swap is considered a taxable sale;¹⁷⁹ and the court’s approach does not appear to be allowed by either statute or precedent. Moreover, the open transaction issue may not arise as the IRS, in Revenue Ruling 87-124, which the IRS promulgated to govern foreign debt-equity swaps, views the gain “as occurring at the conversion stage of the transaction.”¹⁸⁰

D. Correct to Reject Section 118

The Seventh Circuit was correct in rejecting the Fifth Circuit’s endorsement of 26 U.S.C. § 118 as a way of handling the debt-equity swap tax problem. Section 118(a) of the Internal Revenue Code states, “In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.”¹⁸¹ This exclusion “applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the

¹⁷⁶ John K. McNulty & Daniel J. Lathrope, *FEDERAL INCOME TAXATION OF INDIVIDUALS*, 348 (Thomson West 2004) (1972).

¹⁷⁷ *Id.* at 349.

¹⁷⁸ *Id.*

¹⁷⁹ *Kohler IV*, 468 F.3d at 1035.

¹⁸⁰ Christopher Gottscho, Note, *Debt-Equity Swap Financing of Third World Investments—Will the I.R.S. Hinder U.S. Swappers?*, 8 VA. TAX REV. 143, 178-79 (1988).

¹⁸¹ 26 U.S.C. § 118(a) (2000); *G.M. Trading Corp. v. Comm’r*, 121 F.3d 977, 980 (5th Cir. 1997).

corporation to locate its business in a particular community.”¹⁸²

Contributions to capital can also be made by foreign governments for purposes of inducing business location or expansion.¹⁸³

The primary test for whether a transaction will be considered a section 118 contribution to capital is the intent of the person who made the payment.¹⁸⁴ Here, it is clear the Mexican government’s motivation was two-fold, to encourage economic development, but mainly to retire its foreign debt.¹⁸⁵ The law is that compensation for a “specific, quantifiable service” cannot be a contribution to capital.¹⁸⁶ Here, Mexico was buying a service from Kohler—the retirement of a portion of Mexico’s foreign debt,¹⁸⁷ which would exclude the application of 26 U.S.C. § 118 to the Kohler transaction.¹⁸⁸

E. The Davis Rule Should Have Applied to the Kohler Transaction.

Davis should be applied exactly in situations such as the transaction at issue in *Kohler*, where the value of restricted pesos is not easily ascertainable, but the value of the debt interest is readily ascertainable.

¹⁸² 26 C.F.R. § 1.118-1 (1996); *G.M. Trading Corp.*, 121 F.3d at 980.

¹⁸³ 26 C.F.R. § 1.118-1; Rev. Rul. 70-226.

¹⁸⁴ Ridgeley A. Scott, *Taxation of Maquiladora Exchanges: The Taming of the Shrew*, 5 TUL. J. INT’L & COMP. L. 201, 211 (1997).

¹⁸⁵ *Kohler Co. v. United States (“Kohler IV”)*, 468 F.3d 1032, 1034 (7th Cir. 2006), *reh’g denied and reh’g en banc denied*, No. 05-4472, 2007 U.S. App. LEXIS 3929 (7th Cir. Feb. 12, 2007).

¹⁸⁶ *Id.* (citing *United States v. Chicago, Burlington & Quincy R.R. Co.*, 412 U.S. 401, 413 (1973)).

¹⁸⁷ *Kohler IV*, 468 F.3d at 1034.

¹⁸⁸ 26 U.S.C. § 118(a) (2000).

First, the *Davis* rule is generally accepted¹⁸⁹ and it is a principle of tax law that has been reaffirmed many times.¹⁹⁰ It is generally accepted because it is intuitively sensible. Unrelated parties in arms-length transactions generally do not give the other side more money for their property than it is worth.¹⁹¹ The motivation of unrelated

¹⁸⁹ *United States v. Davis*, 370 U.S. 65, 72 (1962) (“Absent a readily ascertainable value it is accepted practice where property is exchanged to hold, as did the Court of Claims in *Philadelphia Park Amusement Co. v. United States*, 130 Ct. Cl. 166, 172, 126 F. Supp. 184, 189 (1954), that the values ‘of the two properties exchanged in an arms-length transaction are either equal in fact, or are presumed to be equal.’ *Accord*, *United States v. General Shoe Corp.*, 282 F.2d 9 (C. A. 6th Cir. 1960); *International Freighting Corp. v. Commissioner*, 135 F.2d 310 (C. A. 2d Cir. 1943)”).

¹⁹⁰ *G.M. Trading Corp. v. Comm’r*, 121 F.3d 977, 983 (5th Cir. 1997) (citing *see, e.g., Keener v. Exxon Co., USA*, 32 F.3d 127, 132 (4th Cir.1994) (“An actual price, agreed to by a willing buyer and a willing seller, is the most accurate gauge of the value the market places on a good”); *Dessauer v. Comm’r*, 449 F.2d 562, 566 (8th Cir.1971); *Bar L Ranch, Inc. v. Phinney*, 426 F.2d 995, 1001 (5th Cir.1970); *Pulliam v. Comm’r*, 329 F.2d 97, 99 (10th Cir.1964); *see also United States v. Garber*, 607 F.2d 92, 97 (5th Cir.1979) (*en banc*) (assuming, without deciding, the applicability of *Davis*); *cf. United States v. Cartwright*, 411 U.S. 546, 551, 93 S. Ct. 1713, 1716 (1973) (“The willing buyer-willing seller test of fair market value is nearly as old as the federal income, estate, and gifts taxes themselves”); *McDonald v. Comm’r*, 764 F.2d 322, 329 (5th Cir.1985) (“We express initially a strong disinclination to disturb the established meaning of the term ‘fair market value’ as it was enunciated by the Supreme Court in *United States v. Cartwright*”); *but cf. Mitchell v. Comm’r*, 590 F.2d 312, 314 (9th Cir.1979) (declining to apply the *Davis* rule to a stock option, the value of which could be easily determined when sold (though the value could not easily be determined when the option was granted), and cautioning that the *Davis* rule should be applied only as a last resort to prevent taxable exchanges without readily ascertainable values from escaping taxation altogether)).

¹⁹¹ Leslie A. Sowle, Comment, *International Debt for Equity Swaps: Does Revenue Ruling 87-124 Make Sense?*, 83 NW. U. L. REV. 1079, 1105 (1989) (“After all the market price on which the negotiated cost of the obligation would be based presumably reflects what debt for equity swaps are worth to buyers and sellers of developing country debt”); Christopher Gottscho, Note, *Debt-Equity Swap Financing of Third World Investments—Will the I.R.S. Hinder U.S. Swappers?*, 8 VA. TAX REV. 143, 174 (1988) (“Yet the best reason for applying the presumed equivalence-in-value [*Davis*] rule is that there is no reason to believe an investor

parties is to get the best price they can; not to give their opponent “freebies.”

In addition to being intuitively sensible, the *Davis* rule has been applied to an analogous fact situation.¹⁹² The Fifth Circuit, in *G.M. Trading Corp. v. Commissioner*, concluded that since G.M. had surrendered \$600,000 of debt to the Mexican government in exchange for an unknown value of restricted pesos, the court had to assume that the value received for \$600,000 of debt was, in fact, \$600,000 since the transaction was at arms-length and the value of the restricted pesos was not readily ascertainable.¹⁹³ The *G.M.* court reaffirmed *Davis*,¹⁹⁴ and noted that this principle reflects the common sense notion that an asset’s value is the price persons are willing to pay for it.¹⁹⁵

Further strengthening the appeal of the *Davis* rule is that Court of Claims, the court that originated the rule in *Philadelphia Park Amusement Co. v. United States*,¹⁹⁶ believes that the *Davis* rule can be to some extent widely applied.¹⁹⁷ The Court of Claims in *Tasty Baking Co.* considered the situation of a taxpayer who had contributed real property to his employee’s pension plan.¹⁹⁸ The court said, “[i]t is clear . . . that the technique of presuming an intangible and unappraisable contribution as an equal exchange for property transferred *is to be applied to a variety of situations broad enough at least to include a taxpayer who desires the separation of a wife, and one who wishes the continued adhesion of an employee.*”¹⁹⁹ The court concluded that the *quid pro quo* for the contribution was the past and future services of the taxpayer’s employees, which was presumptively

would pay any more for an equity investment that it believes the investment is worth”).

¹⁹² *G.M. Trading Corp. v. Comm’r*, 121 F.3d 977, 983 (5th Cir. 1997).

¹⁹³ *Id.*

¹⁹⁴ *Id.* (citing *see* *United States v. Davis*, 370 U.S. 65, 72 (1962)).

¹⁹⁵ *G.M. Trading Corp.*, 121 F.3d at 983.

¹⁹⁶ 126 F. Supp. 184 (Ct. Cl. 1954).

¹⁹⁷ *Tasty Baking Co. v. United States*, 184 Ct. Cl. 56, 61-62 (Ct. Cl. 1968).

¹⁹⁸ *Id.* at 59.

¹⁹⁹ *Id.* at 61-62 (emphasis added).

equal to the fair market value of the real property contributed to the pension plan.²⁰⁰

Most importantly, the fact situations of the cases where the *Davis* rule has been effectively applied are more similar to the characteristics of debt-equity swaps than the characteristics of transactions where the *Davis* rule did not apply.²⁰¹

For example, in *Bar L Ranch, Inc. v. Phinney* the court held that the *Davis* rule applied in a situation where a taxpayer²⁰² traded 51.576 acres of land and improvements in exchange for the taxpayer's indebtedness and open accounts.²⁰³ The court noted that there was no market established for the note and open accounts and that it would be difficult, even for an expert, to value the note and open accounts.²⁰⁴

The *Davis* rule has also been applied to value gasoline distribution agreements,²⁰⁵ and stock that has no readily ascertainable market value because no sales of the stock had ever been made.²⁰⁶

In contrast, in *Dessauer v. Commissioner* the court held that the *Davis* rule was inapplicable because, “[t]here is nothing inherently difficult in ascertaining the value of commercial paper which is regularly bought and sold on the market.”²⁰⁷ In another case, the court found that a taxpayer was not entitled to rely on *Davis* to value a stock option because the value of the option, although not readily ascertainable at the time it was granted, could be determined with precision at the time it was sold.²⁰⁸

²⁰⁰ *Id.* at 63.

²⁰¹ *Bar L Ranch v. Phinney*, 426 F.2d 955, 996 (5th Cir., 1970); *Spartan Petroleum Co. v. United States*, 437 F. Supp. 733, 736 (D. S.C. 1977); *S. Natural Gas Co. v. United States*, 188 Ct. Cl. 302, 352 (1969); *but c.f.* *Dessauer v. Comm’r*, 449 F.2d 562, 566 (8th Cir. 1971); *Mitchell v. Comm’r*, 590 F.2d 312, 314 (9th Cir. 1979).

²⁰² *Bar L Ranch*, 426 F.2d at 999 (The taxpayer was insolvent).

²⁰³ *Id.* at 1001.

²⁰⁴ *Id.*

²⁰⁵ *Spartan Petroleum Co.*, 437 F. Supp. at 733-36.

²⁰⁶ *S. Natural Gas Co.*, 188 Ct. Cl. at 352.

²⁰⁷ 449 F.2d at 566.

²⁰⁸ *Mitchell v. Comm’r*, 590 F.2d 312, 314 (9th Cir. 1979).

Unlike commercial paper and stock options, it is difficult to ascertain the value of restricted pesos, such as the ones at issue in *Kohler*.²⁰⁹ One commentator has noted that, “[t]he main limitation on the practice of valuing property received according to the appraisable property exchanged is that its use is confined to cases where there is ‘little or no market’ for the unappraisable property . . . [but the] restrictions imposed by [swap countries] on investments financed by debt-equity swaps assure that this limitation is inapplicable.”²¹⁰ The restricted pesos offered by Mexico “can only be used for approved investments and cannot be sold.”²¹¹ In addition, “[t]he secondary market exists only for debt; there are no firm indicators of the local currency’s value apart from subjective discounting which is inaccurate due to lack of liquidity and political risk.”²¹²

Moreover, not following the *Davis* rule leads to unreasonable results, given the fact that the debt-equity swap valuation problem can be easily solved by application of the *Davis* rule. The only solution offered by the Seventh Circuit is that the court could estimate the value of the restricted currency itself. After the court determined that the value of the pesos “may well be ascertainable but has not been ascertained,”²¹³ the court suggested that the IRS present evidence that could persuade a rational fact finder that the pesos Kohler received from the Mexican government were worth well above \$11.1 million.²¹⁴

²⁰⁹ See *Kohler Co. v. United States (“Kohler IV”)*, 468 F.3d 1032, 1037 (7th Cir. 2006), *reh’g denied and reh’g en banc denied*, No. 05-4472, 2007 U.S. App. LEXIS 3929 (7th Cir. Feb. 12, 2007).

²¹⁰ Christopher Gottscho, Note, *Debt-Equity Swap Financing of Third World Investments—Will the I.R.S. Hinder U.S. Swappers?*, 8 VA. TAX REV. 143, 172-73 (1988). “The presumed-equivalence-in-value rule of *Davis* has generally been limited to ‘cases involving valuation of property for which there is little or no market.’” *Bar L Ranch v. Phinney*, 426 F.2d 995, 1001 (5th Cir. 1970) (quoting *Seas Shipping Co. v. Comm’r*, 371 F.2d 528, 529 (2d Cir. 1967)).

²¹¹ Christopher Gottscho, Note, *Debt-Equity Swap Financing of Third World Investments—Will the I.R.S. Hinder U.S. Swappers?*, 8 VA. TAX REV. 143, 172-73 (1988).

²¹² *Id.*

²¹³ *Kohler IV*, 468 F.3d at 1036-37.

²¹⁴ *Id.* at 1037.

This suggestion seems to inapposite to the court's own dismay surrounding Kohler's and the IRS's "pathetic" attempts as valuing the restricted pesos.²¹⁵

Furthermore, the application of this policy would be very problematic for a debt-equity investor.²¹⁶ This type of rule is "judgmental" as opposed to "mechanical."²¹⁷ Mechanical rules are rigid and can be predictably applied, while judgmental rules can be manipulated.²¹⁸ In addition, judgmental rules require legal advice and often litigation, which makes their application expensive.²¹⁹ On top of which, the outcome will be unpredictable, especially when there is an absence of judicial precedents and a lack of reliable expert testimony.²²⁰ These disadvantages could discourage debt-equity swaps, especially when investors consider that their estimate could be different from the court's estimate, making them liable for taxes that they never expected to pay.²²¹

²¹⁵ *Id.*

²¹⁶ Leslie A. Sowle, Comment, *International Debt for Equity Swaps: Does Revenue Ruling 87-124 Make Sense?*, 83 NW. U. L. REV. 1079, 1102 (1989).

²¹⁷ *Id.*

²¹⁸ *Id.*

²¹⁹ *Id.*

²²⁰ *Id.*

²²¹ *Id.* at 1084 ("[t]he uncertain tax consequences of swaps may actually deter potential investors from embarking on these transactions").

CONCLUSION

The Seventh Circuit should have applied the *Davis* rule in *Kohler Co. v. United States*.²²² The *Davis* rule is generally accepted²²³ and it is a principle of tax law that has been reaffirmed many times.²²⁴ The *Davis* rule is intuitively sensible; unrelated parties in arms-length transactions do not give their adversary more money for their property than it is worth.²²⁵ Most importantly, the fact situations of the cases

²²² *Kohler Co. v. United States* (“*Kohler IV*”), 468 F.3d 1032 (7th Cir. 2006), *reh’g denied and reh’g en banc denied*, No. 05-4472, 2007 U.S. App. LEXIS 3929 (7th Cir. Feb. 12, 2007).

²²³ *United States v. Davis*, 370 U.S. 65, 72 (1962) (“Absent a readily ascertainable value it is accepted practice where property is exchanged to hold, as did the Court of Claims in *Philadelphia Park Amusement Co. v. United States*, 130 Ct. Cl. 166, 172, 126 F. Supp. 184, 189 (1954), that the values ‘of the two properties exchanged in an arms-length transaction are either equal in fact, or are presumed to be equal.’ *Accord*, *United States v. General Shoe Corp.*, 282 F.2d 9 (C. A. 6th Cir. 1960); *International Freighting Corp. v. Commissioner*, 135 F.2d 310 (C. A. 2d Cir. 1943)”).

²²⁴ *G.M. Trading Corp. v. Comm’r*, 121 F.3d 977, 983 (5th Cir. 1997) (citing *see, e.g., Keener v. Exxon Co., USA*, 32 F.3d 127, 132 (4th Cir.1994) (“An actual price, agreed to by a willing buyer and a willing seller, is the most accurate gauge of the value the market places on a good”); *Dessauer v. Comm’r*, 449 F.2d 562, 566 (8th Cir.1971); *Bar L Ranch, Inc. v. Phinney*, 426 F.2d 995, 1001 (5th Cir.1970); *Pulliam v. Comm’r*, 329 F.2d 97, 99 (10th Cir.1964); *see also United States v. Garber*, 607 F.2d 92, 97 (5th Cir.1979) (*en banc*) (assuming, without deciding, the applicability of *Davis*); *cf. United States v. Cartwright*, 411 U.S. 546, 551, 93 S. Ct. 1713, 1716 (1973) (“The willing buyer-willing seller test of fair market value is nearly as old as the federal income, estate, and gifts taxes themselves”); *McDonald v. Comm’r*, 764 F.2d 322, 329 (5th Cir.1985) (“We express initially a strong disinclination to disturb the established meaning of the term ‘fair market value’ as it was enunciated by the Supreme Court in *United States v. Cartwright*”); *but cf. Mitchell v. Comm’r*, 590 F.2d 312, 314 (9th Cir.1979) (declining to apply the *Davis* rule to a stock option, the value of which could be easily determined when sold (though the value could not easily be determined when the option was granted), and cautioning that the *Davis* rule should be applied only as a last resort to prevent taxable exchanges without readily ascertainable values from escaping taxation altogether)).

²²⁵ Leslie A. Sowle, Comment, *International Debt for Equity Swaps: Does Revenue Ruling 87-124 Make Sense?*, 83 NW. U. L. REV. 1079, 1105 (1989) (“After

where the *Davis* rule has been applied are more similar to the characteristics of debt-equity swaps than the characteristics of transactions where the *Davis* rule has not been applied.²²⁶ This is because “[t]he main limitation on the practice of valuing property received according to the appraisable property exchanged is that its use is confined to cases where there is ‘little or no market’ for the unappraisable property . . . [but the] restrictions imposed by [swap countries] on investments financed by debt-equity swaps assure that this limitation is inapplicable.”²²⁷

Moreover, not following the *Davis* rule leads to unreasonable results. If *Davis* is applied, the Kohler transaction described above would be treated as a “wash.”²²⁸ This means that Kohler would not have any taxable gain (or loss) from the exchange of \$11 million debt for \$19 million of restricted pesos.

all the market price on which the negotiated cost of the obligation would be based presumably reflects what debt for equity swaps are worth to buyers and sellers of developing country debt”); Christopher Gottscho, Note, *Debt-Equity Swap Financing of Third World Investments—Will the I.R.S. Hinder U.S. Swappers?*, 8 VA. TAX REV. 143, 174 (1988) (“Yet the best reason for applying the presumed equivalence-in-value [*Davis*] rule is that there is no reason to believe an investor would pay any more for an equity investment that it believes the investment is worth”).

²²⁶ *Bar L Ranch v. Phinney*, 426 F.2d 955, 996 (5th Cir., 1970); *Spartan Petroleum Co. v. United States*, 437 F. Supp. 733, 736 (D. S.C. 1977); *S. Natural Gas Co. v. United States*, 188 Ct. Cl. 302, 352 (1969); *but c.f.* *Dessauer v. Comm’r*, 449 F.2d 562, 566 (8th Cir. 1971); *Mitchell v. Comm’r*, 590 F.2d 312, 314 (9th Cir. 1979).

²²⁷ Christopher Gottscho, Note, *Debt-Equity Swap Financing of Third World Investments—Will the I.R.S. Hinder U.S. Swappers?*, 8 VA. TAX REV. 143, 172-73 (1988).

²²⁸ Leslie A. Sowle, Comment, *International Debt for Equity Swaps: Does Revenue Ruling 87-124 Make Sense?*, 83 NW. U. L. REV. 1079, 1106 (1989) (“If an investor may validly apply this equation [*Davis* rule] in determining the tax consequences of a debt for equity swap, the amount realized on the swap will equal the swap’s cost to the investor, yielding no taxable gain”).

On the other hand, if the Seventh Circuit's *dicta* in *Kohler*²²⁹ is applied to debt-equity swaps, companies, like Kohler would not know the cost of their debt-equity swap transactions beforehand.²³⁰ Companies would have to hire experts to value the restricted currency, and then litigate the matter if the IRS disagreed with the expert's valuation.²³¹ This is unreasonable, especially since the debt-equity swap valuation problem can be easily solved by application of the *Davis* rule.²³²

²²⁹ *Kohler Co. v. United States* (“*Kohler IV*”), 468 F.3d 1032, 1037 (7th Cir. 2006), *reh'g denied and reh'g en banc denied*, No. 05-4472, 2007 U.S. App. LEXIS 3929 (7th Cir. Feb. 12, 2007).

²³⁰ Leslie A. Sowle, Comment, *International Debt for Equity Swaps: Does Revenue Ruling 87-124 Make Sense?*, 83 NW. U. L. REV. 1079, 1102 (1989).

²³¹ *Id.*

²³² *United States v. Davis*, 370 U.S. 65, 72 (1962).