Office of Chief Counsel
Internal Revenue Service

memorandum

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MJCalabrese

date: June 12, 2002

to: Percy Weathington, Team Coordinator
Dennis Leonardi, Financial Products Specialist

from: Associate Area Counsel (LMSB), Chicago

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subject: **Opinion - Tax Treatment of [redacted] - Financial Product**

Taxpayer: [redacted]

This memorandum responds to your office's ongoing request for assistance on this taxpayer. We are coordinating this matter with Financial Products Industry Counsel Rose Gole and Thomas Kerrigan. This memorandum should not be cited as precedent.

ISSUES

1. Whether the [redacted] financial product issued by [redacted] constitutes debt, where the [redacted] pay holders [redacted]% annual interest and the principal amount at issuance and the redemption amount at maturity reference the then current value of the common stock of [redacted] (a corporation unrelated to the taxpayer).

2. Are [redacted]'s [redacted] and holdings of [redacted] common stock part of a straddle subject to the capitalization rules of I.R.C. § 263(g)?

CONCLUSIONS

1. The [redacted] financial product issued by [redacted] constitutes a contingent payment debt instrument.

2. [redacted]'s [redacted] and holdings of [redacted] common stock are part of a straddle subject to the capitalization rules of I.R.C. § 263(g).

FACTS

The [redacted] ([redacted]) financial product was developed by [redacted]

It allows an issuer to monetize its sizable stock holdings of an unrelated company while attempting to take advantage of the contingent payment debt instruments rules.

[redacted] issued the [redacted] units in the original principal amount of $[redacted], the [redacted] sale price of one share of [redacted] common stock. The prospectus refers to the [redacted] shares and any other publicly traded equity securities that may be distributed on or in respect of the [redacted] common stock (or into which any of those securities may be converted or exchanged) as the reference shares[1].

The underwriters agreed to purchase the [redacted] authorized [redacted]. An over-allotment option allowed the underwriters to acquire another [redacted]. In [redacted] of [redacted] owned approximately [redacted] shares of [redacted]. Upon redemption or maturity, terms of the issuance provide for a minimum amount payable (called the contingent principal amount) equal to the $[redacted] original principal amount.

[redacted] units pay interest quarterly at the annual rate of [redacted]% of the original principal amount (for a quarterly payment of $[redacted] per unit). The quarterly payments also include the amount of any cash dividends paid on the [redacted] shares attributable to [redacted] units. As of the date of the prospectus, [redacted] had never paid a cash dividend on its common stock. Any property distributed on the [redacted] shares (or the cash value of the property) is to be paid to [redacted] holders as additional interest. Payment of dividends or additional interest will decrease the contingent principal amount payable at maturity to the extent necessary so that the yield to the date of computation does not exceed a [redacted]% annual yield.

If no conditions of default exist, [redacted] has the option to defer payment of interest for periods not to exceed [redacted] consecutive quarterly periods. [redacted] may defer the payment of interest until maturity or redemption if the [redacted] shares cease to exist. Any deferred interest amounts, and interest thereon, will increase the contingent principal amount of the [redacted]. Interest on the deferred interest is at a [redacted]% annual rate compounded quarterly.

The [redacted] mature on [redacted]. [redacted] holders may then receive the higher of the contingent principal amount or the sum of the maturity date value of the reference shares plus any

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[1] Herein, the "reference shares" are sometimes simply referenced as the [redacted] common shares or the [redacted] shares.

deferred quarterly interest (with any accrued interest thereon). In either case, holders are also entitled to a "final period distribution". The final period distribution includes such items as declared dividends or distributions on the [redacted] shares not yet distributed to the holders.

[redacted] may redeem all but not some of the [redacted] at any time. To redeem, [redacted] must pay holders an amount equal to the sum of the higher of the contingent principal amount of the [redacted] or the sum of the current market value of the reference shares at the time of redemption plus any deferred quarterly payments of interest (including accrued interest thereon), plus in either case, the final period distribution. Terms provide for the payment of certain additional amounts if [redacted] redeemed prior to [redacted], [redacted], or [redacted].

Terms of the issuance provide for certain anti-dilution measures. The amount paid at redemption or maturity will be adjusted in the event of specific dilutive or anti-dilutive events.

The prospectus states that the [redacted] will be characterized as [redacted] indebtedness and that holders will need to include interest payments in income. Further, it describes the [redacted] as contingent payment debt instruments and advises holders that they will need to report as ordinary income certain amounts prior to the holders' receiving the cash attributable thereto.

[redacted] units are unsecured and subordinate to [redacted]'s existing and future indebtedness.

[redacted] estimated that the offering would generate proceeds of over $[redacted]. [redacted] expected to use substantially all of the funds for general corporate purposes, including capital expenditures, working capital, and debt repayment.

For [redacted] [redacted] took a $[redacted] interest expense deduction for its [redacted] obligations. It calculated the amount based upon [redacted]% annual interest on a principal amount of $[redacted] for approximately [redacted] months.

Prior to issuance of the [redacted] financial product, [redacted] held approximately [redacted] shares of [redacted]. [redacted] may, but is not required to, hold a number of [redacted] shares equal to the number of the outstanding [redacted] units.

In [redacted] [redacted] owned [redacted]% of [redacted] and [redacted] owned the other [redacted]%. [redacted]. As of [redacted], each

[redacted] operated the [redacted] affiliate in its market. [redacted] provided information to [redacted] in several of its [redacted] markets. Otherwise, [redacted] and [redacted] were unrelated.

ANALYSIS

1. The facts and circumstances show that the [redacted] units constitute a contingent payment debt instrument

Whether an obligation constitutes debt or equity is a question of both fact and law. In the Matter of Larson, 862 F.2d 112 (7th Cir. 1988). Determining the existence of a bona fide indebtedness depends upon the particular facts of the case. In the Matter of Uneco, Inc., 532 F.2d 1204 (8th Cir. 1976); Flint Industries Inc. v. Commissioner, T.C. Memo. 2001-276. Various courts have considered different tests and relevant factors; however, "in the final analysis . . . the question depends on the facts and circumstances of each case". Kean v. Commissioner, 91 T.C. 575 (1988). Assessing the various factors "may often be difficult because it is the result of adding and weighing several elements of a situation some of which may give rise to conflicting inferences." Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182 (7th Cir. 1942).

Not all factors may apply in a particular case. Courts generally have said that the question of genuine debt does not turn on any one factor. In reviewing certain corporate obligations, called "income debenture bearer bonds" in one case and "registered notes" in another, the Supreme Court in John Kelley Co. v. Commissioner, 326 U.S. 521 (1946) said that "[t]here is no one characteristic, not even exclusion from management, which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts." See also Saviano v. Commissioner, 765 F.2d 643, 649 (7th Cir. 1985)(no one characteristic is "decisive in the determination of whether the obligations are risk investments in the corporations or debts); Smith v. Commissioner, 370 F.2d 178, 180 (6th Cir. 1966)("[n]o single factor is controlling"); Arlington Park Jockey Club v. Sauber, 262 F.2d 902, 905 (7th Cir. 1959) (in determining whether certain payments constituted debt or equity, "no single test can provide the answer"); Dixie Dairies Corp. v. Commissioner, 74 T.C. 476 (1980); Brazoria County Stewart Food Markets v. Commissioner, T.C. Memo. 2001-220. Sometimes a court will say that the question *rarely* turns on one factor. See Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957) ("[r]arely should any one element be determinative").

Courts have identified a number of relevant factors in making a debt or equity determination. In Notice 94-47, 1994-1 CB 357, the Service gave notice that it would scrutinize financial instruments characterized as debt for federal tax purposes and characterized as equity for regulatory, rating agency, or financial accounting purposes. The Notice described some of the relevant factors it would consider:

> (a) whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future; (b) whether holders of the instruments possess the right to enforce the payment of principal and interest; (c) whether the rights of the holders of the instruments are subordinate to rights of general creditors; (d) whether the instruments give the holders the right to participate in the management of the issuer; (e) whether the issuer is thinly capitalized; (f) whether there is identity between holders of the instruments and stockholders of the issuer; (g) the label placed upon the instruments by the parties; and (h) whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

In Notice 94-47 the Service recognizes that no factor conclusively establishes debt or equity and that the weight given to any particular factor depends upon the facts and circumstances. See also John Kelly Co. v. Commissioner, 326 U.S. 521 (1946); Dixie Dairies Corporation v. Commissioner, 74 T.C. 476 (1980). The Service will take account of the overall effect of the financial product's debt and equity features. The following analysis of the Notice 94-47 factors examines whether the [redacted] units are properly characterized as debt.

(a) An important indication of debt is an unconditional promise on the part of the obligor to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future. Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957). The lack of a maturity date on a financial instrument constitutes strong evidence of equity. Wood Preserving Corporation v. United States, 347 F.2d 117, 119 (4th Cir. 1965); United States v. Title Guarantee and Trust Co., 133 F.2d 990 (6th Cir. 1943); Rev. Rul. 90-27, 1990-1 CB 50.

In this case, the [redacted] had a fixed maturity date of [redacted]. [redacted] had an unconditional promise to pay a minimum amount per [redacted] unit equal to the $[redacted] original principal

amount (with certain possible adjustments in the event that [redacted] pays dividends or makes any special distributions with respect to [redacted] common shares) plus the final period distribution. If higher, holders may receive from [redacted] the sum of the current market value of the reference shares at the time of redemption or maturity plus any deferred quarterly payments of interest (including accrued interest thereon), plus the final period distribution. To this extent, the factor suggests debt. [redacted] does not have an obligation to pay a fixed dollar amount; however it has a fixed obligation to pay $[redacted] per [redacted], or a higher amount that depends upon the price of the [redacted] shares at maturity.

Unlike the [redacted]'s [redacted] obligation (discussed in a prior memorandum to you) [redacted] has an obligation to make a payment at maturity, even if the maturity price of [redacted] has no value. [redacted] has an obligation to make a payment at maturity, the exact amount of which depends upon the maturity price of the [redacted] shares.

(b) A right to enforce payment of principal and interest suggests debt. Bauer v. Commissioner, 748 F.2d 1365 (9th Cir. 1984). Here, [redacted] had a limited right to defer interest payments. In addition, the obligations were subordinated to senior indebtedness. Nevertheless, default in payment of interest (not covered by [redacted]'s limited right to defer payment) or principal would allow holders to pursue enforcement or collection remedies available to creditors. Terms of [redacted] issuance did not prohibit holders from enforcing payment upon default.

(c) Here the [redacted] units, like equity interests, are subordinated to [redacted]'s existing and future indebtedness. Still, a creditor may have a claim subordinate to other creditors. Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2nd Cir. 1956). Subordination may suggest equity when combined with other equity factors. Trans-Atlantic Company v. Commissioner, 469 F.2d 1189 (3rd Cir. 1972); Rev. Rul. 83-98, 1983-2 CB 40.

(d) The ability of the security holder to participate in management is a factor suggesting equity. Gloucester Ice & Cold Storage v. Commissioner, 298 F.2d 183 (1st Cir. 1962) rev'g T.C. Memo. 1960-195. In this case, the [redacted] indenture did not provide for any real rights of management participation, a factor characteristic of debt.

(e) A shareholder's advance is more likely to be treated as equity when the corporation is thinly or inadequately capitalized. Stinnett's Pontiac Service, Inc. v. Commissioner, 730 F.2d 634 (11th Cir. 1984), aff'g T.C. Memo. 1982-314; Tyler

v. Tomlinson, 414 F.2d 844 (5th Cir. 1969). [redacted] is a large, publicly traded corporation. We know of no facts showing it to be thinly capitalized.

(f) A factor suggesting equity may exist where the shareholder and the financial product holder are the same. Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972); Tampa & Gulf Coast Railroad Co. v. Commissioner, 56 T.C. 1393 (1971). Here, [redacted] is a large, publicly traded corporation. The [redacted] units were publicly issued; they were not developed for [redacted]'s shareholders. We have no reason to believe that the [redacted] holders were the same as the shareholders. This factor, which looks at the identity of the shareholders and [redacted] holders, does not support an equity determination, and it is consistent with a debt determination.

(g) The name given to the security is a factor in making a debt/equity determination. Bauer v. Commissioner, 748 F.2d 1365 (9th Cir. 1984). The intent of the parties is another factor. Id. These two factors are related, as the name given to the security is often good evidence of the intent of the parties. See also Clyde Bacon, Inc. v. Commissioner, 4 T.C. 1107 (1945). Here, [redacted] described the financial product as a debt security. It provided for [redacted]% interest payments. [redacted]'s prospectus advised that the [redacted] constituted a contingent payment debt obligation that would require holders to include in income more than just the [redacted]% payment to be made by [redacted].

(h) Treating an obligation as debt for tax purposes and equity for other purposes gives rise to questions as to the true nature of the financial product. Here, the facts do not indicate that [redacted] treated the [redacted] as equity for nontax purposes.

Here, the [redacted] have little indication of equity. None of the debt-equity factors strongly suggest equity in [redacted]. The [redacted] interest provides the holder with a future payment contingent on the value of [redacted] shares, not [redacted] stock. Payment to the [redacted] holders does not depend upon [redacted]'s earnings or financial performance. The [redacted] holders have no management rights, no voting rights, and no rights to convert the [redacted] into [redacted] stock. A [redacted] interest does not provide the holder with an equity interest in [redacted].

In this case, the Notice 94-47 factors on balance indicate debt. Though [redacted] does not have an obligation to repay holders a fixed amount, it has an obligation to repay a minimum amount equal to the original principal amount. [redacted] holders are not restricted in their ability to enforce [redacted]'s payment obligations. The [redacted] units do not give holders a right to

participate in [redacted] management. [redacted] was not thinly capitalized. No identity of interest between shareholders and [redacted] holders exists. [redacted] labeled the [redacted] as a debt instrument and, as far as we know, treated it as a debt instrument for nontax purposes. A holder's [redacted] interest is subordinated to [redacted]'s present and future indebtedness. The subordination may suggest equity if combined with other equity factors. The facts and circumstances suggest little in the way of other equity factors. On balance the totality of the circumstances indicates debt.

I.R.C. § 1275(e) provides the Secretary with authority to prescribe regulations where the original issue discount (OID) provisions of the Code do not adequately deal with the circumstances of an issuance of a financial product. I.R.C. § 1275(e) specifically mentions contingent interest as one of the possible circumstances that may warrant such regulations. Treas. Reg. § 1.1275-4 contains rules for contingent payment debt instruments.

[redacted] as debt would constitute contingent payment debt instruments subject to Treas. Reg. § 1.1275-4. Payment at maturity or redemption depends upon the maturity or redemption price of [redacted]. Holders are guaranteed for each [redacted] a minimum of $[redacted]. More may be payable depending upon the price of [redacted]. The contingency is not remote or incidental.

If a contingent payment debt instrument is issued for cash, the noncontingent bond method of § 1.1275-4(b) generally applies to the instrument. Under this method, interest accrues on the instrument as if it were a fixed payment debt instrument. Constructing the fixed payment debt instrument requires using the instrument's comparable yield and a projected payment schedule. Reg. § 1.1275-4(b); Rev. Rul. 2002-31, 2002-22 I.R.B. 1.

The comparable yield for a contingent payment debt instrument is the yield for a fixed rate instrument issued with terms and conditions otherwise comparable to the contingent payment debt instrument. The yield determination does not take account of the riskiness of the contingencies or the liquidity of the debt instrument. The yield must be reasonable for the condition and circumstances of the issuer and may not be less than the applicable federal rate (AFR). Reg. § 1.1275-4(b)(4)(i)(B); Rev. Rul. 2002-31, 2002-22 I.R.B. 1. The long-term AFR, compounded quarterly, for [redacted] was [redacted]%. Rev. Rul 99-17, 1999-1 C.B. 869.

Pursuant to the contingent payment debt instruments regulations, [redacted] accrues comparable yield interest. For

[redacted]'s [redacted] issuance, [redacted] determined a comparable yield amount of [redacted]%, compounded quarterly.

If [redacted]'s maturity or redemption payment exceeds the issue price, the excess for the holder is interest income and for [redacted] it is interest expense. If the maturity or redemption payment is less than the adjusted issue price, the difference constitutes ordinary loss to the holder and ordinary income to [redacted]. See Reg. § 1.1275-4(b)(6)-(8).

2. [redacted] holds the [redacted] and [redacted] shares as a straddle subject to the capitalization rules of I.R.C. § 263(g)

No deduction is allowed for "interest and carrying charges" properly allocable to § 1092 straddle property. I.R.C. § 263(g). For purposes of this disallowance, the term "interest and carrying charges" is the interest on indebtedness used to acquire and carry personal property plus all other amounts paid or incurred to hold the property, less certain amounts as set forth in I.R.C. § 263(g)(2)(B). I.R.C. § 263(g)(2).

We know of no decisions, rulings, or other official pronouncements interpreting the word "carry" as used in § 263(g) for the year at issue. I.R.C. § 265, regarding the treatment of interest and expenses relating to tax exempt income, also uses the word "carry". I.R.C. § 265(a)(2) disallows a deduction for "[i]nterest on indebtedness incurred or continued to purchase or carry" tax exempt obligations.

The clearest case of when an indebtedness "carries" a tax exempt obligation under § 265 occurs when borrowed sums are used for, and are directly traceable to, the purchase or continuation of the tax exempt obligation. See E.F. Hutton Group, Inc. v. United States, 811 F.2d 581 (Fed. Cir. 1981); Bishop v. Commissioner, 342 F.2d 757 (6th Cir. 1965), aff'g 41 T.C. 154 (1963); Jacobson v. Commissioner, 28 T.C. 579 (1957). A second situation (where an indebtedness may be found to carry a tax exempt obligation) occurs when the taxpayer uses its ownership of a tax exempt obligation as collateral for the indebtedness. In substance this "tax exempt property as collateral" situation is the same as the first situation where the indebtedness is used to purchase the tax exempt obligation. See Rev. Proc. 72-18, 1972-1 C.B. 140; Wisconsin Cheeseman v. United States, 388 F.2d 420, 422 (7th Cir. 1968)(the rule denying a deduction for indebtedness carrying a tax-exempt obligation makes no distinction between "one who borrows to buy tax-exempts and one who borrows against tax-exempts already owned").

Citing Wisconsin Cheeseman, the Service has said that

evidence of indebtedness carrying a tax exempt obligation may also be found in the totality of facts and circumstances establishing "a 'sufficiently direct relationship' between the borrowing and the investment in the tax-exempt obligations." Rev. Proc. 72-18 at § 3.04. The revenue procedure says that a "purpose to *carry*" a tax exempt obligation may "be inferred where a corporation *continues* indebtedness which it could discharge, in whole or in part, by liquidating its holdings of tax-exempt obligations without withdrawing any capital which is committed to, or held in reserve for, the corporation's regular business activities". Rev. Proc. 72-18, at § 6.02, citing Illinois Terminal Railroad Co. v. United States, 375 F.2d 1016 (Ct. Cl. 1967).

Interpreting the term "carry" in § 263(g) the same as it is used in § 265, we may conclude that [redacted]'s quarterly payments to the [redacted] holders is a charge that carries [redacted]'s holding of [redacted] common stock. The quarterly payments are an amount [redacted] pays for use of the money it generated from the [redacted] issuance. The principal amount of the [redacted], issued in [redacted], equaled the [redacted] closing price of [redacted] common stock. [redacted] held as many or more shares of [redacted] shares as the number of [redacted] units issued. At maturity the [redacted] holders are to be paid an amount determined by reference to the price of the [redacted] shares.

[redacted]'s use of the [redacted] shares is similar to a taxpayer who obtains a loan by collateralizing the tax exempt securities it already owns. [redacted] could have raised funds by going to a lender, offering the [redacted] shares as collateral, and obtaining a loan that approximated the value of the [redacted] shares. In obtaining such a loan, the indebtedness would "carry" [redacted]'s holding of [redacted] shares. Similarly, funds raised by issuance of the [redacted] (an alternative to using the stock as collateral for a loan) "carry" [redacted]'s holding of [redacted] shares.

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Though the position may be challenged, we have concluded that [redacted] holds property as part of a straddle subject to the capitalization rules of I.R.C. § 263(g).

We are requesting the national office's 10 day post review of this opinion. It is possible that the national office may supplement, revise, or change the advice contained herein. Please do not act on this advice until the national office completes its 10 day review.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions on this matter, please call Michael Calabrese of this office at (414) 297-4241.

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By:_____
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