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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR BENJAMIN DUNCAN
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FROM: LON B. SMITH
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SUBJECT: Financial Instrument Characterization

This Chief Counsel Advice responds to your memorandum dated January 25, 2001, requesting a further explanation regarding the issues discussed in IRS Field Service Advice 199940007, dated June 15, 1999 (the 6/15/99 FSA). The Conclusions stated in such Field Service Advice are unaltered except as explicitly stated below. In accordance with I.R.C. §6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Terms used herein shall have the meaning provided in the 6/15/99 FSA.

CONCLUSIONS

In the 6/15/99 FSA, we described the Instruments as cash-settled collars on Company A common stock. However, other characterizations of the Instrument are possible. The other conclusions stated in the 6/15/99 FSA, that the Instruments were not debt and were part of a straddle with the Company A common stock, are not altered by applying these other characterizations to the Instruments.

FACTS

The facts are stated in the 6/15/99 FSA.

ANALYSIS

As developed in the 6/15/99 FSA, it is possible to characterize the Instruments as a cash-settled collar on Company A common stock. Such an analysis would treat the Instruments as a set of cash-settled put options held by the taxpayer and call options written by the taxpayer on Company A common stock.

Rather than analyzing the Instruments as separate financial instruments which together constitute a collar, the Instruments could be analyzed as a single instrument. For example, the Instruments might be viewed as a type of a Notional Principal Contract (NPC). A NPC is defined by regulation as "a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount." Section 1.446-3(c). NPC's are defined to include equity swaps. The Instruments, by providing for payments at specified intervals and a final cash payment linked to the value of Company A common stock, are similar to an equity swap on Company A common stock. Alternatively, the Instruments might be likened to "prepaid forwards" in which the seller receives a cash payment at the commencement of the transaction in order to in the future deliver some amount of a commodity or security (in this case, Company A common stock). Also, the Instruments could be viewed as sui generis, subject to their own unique rules under the tax system.

Under any of these characterizations, the Instruments should not be treated as debt since the amount payable at maturity does not represent a sum certain. Similarly, the Instruments continue to be offsetting positions with respect to the Company A common stock held by the taxpayer and so part of a straddle with the Company A common stock. Section 1092(c)(1).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

The purpose of this memorandum is to discuss arguments that the Taxpayer might make to limit the application of section 263(g). We believe there are two different ways the Instruments might be characterized. Each characterization is subject to an argument limiting the application of section 263(g). Ultimately, we conclude these arguments are incorrect.

A. Disaggregating the Instruments.

As noted above, the 6/15/99 FSA treats the Instruments into a set of cash-settled put options held by the taxpayer and call options written by the taxpayer on Company A common stock.

However, the Instruments also provide for certain non-contingent payments, characterized as “interest” payments, of h% or $i per share. Since the Instruments are not debt, these non-contingent payments cannot merely be interest. However, non-contingent payments are also not typically a feature of cash-settled options. Therefore, we believe that if a disaggregation approach applied, such non-contingent payments would probably be analyzed as a separate instrument. The conventional financial instrument that this series of noncontingent payments most resembles is a debt instrument or a series of zero coupon bonds. If the noncontingent payments are analyzed as a separate debt instrument embedded in the Instruments, some portion of the noncontingent payments would be characterized as Original Issue Discount (OID).[1]

The effect of treating the noncontingent payments as a separate debt instrument will be to deny a deduction for the payments except to the extent that they are payments of OID[2]. Section 163(e). However, arguably, such OID should be capitalized into the taxpayer’s basis in the Company A common stock since 263(g) requires the capitalization of “all other amounts ... paid or incurred to carry the personal property”, including deductible accruals such as OID. Section 263(g)(2)(A)(ii).

However, the taxpayer may argue that the OID should not be capitalized under section 263(g).

The 6/15/99 FSA argues that the noncontingent payments may be viewed as carrying the Instruments because “they represent the cost of inducing investors to

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[1] In general, the amount of OID on a debt instrument is equal to Stated Redemption Price (SRPM) minus issue price. Section 1.1273-1(a) of the Income Tax Regulations. SRPM is the amount of all payments made on a debt instrument other than qualified stated interest (QSI). In the instant case, the embedded debt instrument does not bear QSI because interest on the imputed debt instrument, as such, is not “stated.” See §1.1273-1(c)(1). The issue price will be determined by treating some portion of the sales price of the Instrument as a whole as a payment for the noncontingent payments. The amount by which the total amounts of the noncontingent payments exceeds the issue price will be OID.

[2] Interest would also be deductible but, as developed in footnote 1, the imputed debt instrument does not bear QSI.

take the position" (i.e. purchase the Instruments). However, in retrospect, we believe the better view is that section 263(g) should apply because the Instruments "carry" the Company A common stock by significantly reducing taxpayer's risk from holding the Company A common stock. Although the recently published proposed regulations on 263(g) are not authority in this context, this view is consistent with the proposed regulations, the preamble to which specifically states that "the term, *to carry* in the context of section 263(g) includes the reduction in the risk of holding as asset." REG-105801-00, 66 Fed. Reg. 4746, 4747 (January 18, 2001) (emphasis added).

Unlike the options embedded in the Instruments, the separate debt instrument is not part of a straddle with the Company A common stock since noncontingent payments and Company A common stock are not offsetting positions. That is, holding one does not diminish the Taxpayer's risk of loss from the other. Sections 1092(c)(1), (c)(2). The taxpayer might, therefore, argue that since the noncontingent payments do not reduce the risk of holding the Company A common stock, the noncontingent payments do not "carry" the Company A common stock. Therefore, the OID imputed to the noncontingent payments should not be capitalized under section 263(g). However, we do not believe that only "risk-reducing" payments can carry a straddle. Indeed, in the "cash and carry" transactions that were the immediate impetus for the adoption of section 263(g), the interest payments that would be capitalized under section 263(g) were not incurred on a risk-reducing instrument but rather on a borrowing the proceeds of which were used to purchase a leg of a straddle[3]. H. R. Rep. No.201, 97th Cong. 1st Sess., 203-205 (1981). In the instant case, similarly, it may reasonably be argued that the

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[3] In a cash and carry transaction, the taxpayer borrows money to purchase or carry a long position in a commodity and simultaneously takes a short position by selling the commodity forward. Because the price differential between the current and forward price of a commodity largely reflects interest rates and carrying charges, the combination of the short and long position acts like a synthetic bond in that there is an assured return based on interest rates. Thus, under prior law, the cash and carry transaction arguably generated an ordinary deduction for interest on the borrowing during the term of the transaction coupled with an approximately equal deferred capital gain when the long position was used to close the short position. Section 263(g) addresses this mismatching of the character and timing of income by requiring that interest and carrying charges properly allocable to personal property which is part of a straddle be capitalized into the basis of such personal property. Thus, in a classic cash and carry transaction, interest payments on the borrowing are not immediately deductible but instead increase the taxpayer's basis in its long position so that the taxpayer recognizes little or no gain or loss when the long position is used to close the forward contract.

noncontingent payments were an integral part of the creation of a position in personal property (i.e. the Instrument) that is part of a leg of a straddle. Therefore, they should be viewed as so closely connected to a transaction that carried part of the straddle as to also carry part of the straddle and so be subject to capitalization under section 263(g).

B. Treating each Instrument as a single financial instrument.

As develop above, the Instruments, rather than being disaggregated, could be analyzed as a single financial instrument, such as an equity swap.

If such an analysis is adopted, the taxpayer may argue that, under current law, common stock and an equity swap on that stock (or a financial instrument similar to an equity swap) cannot be the legs of a straddle. Thus, the Company A common stock and the Instruments could not be a straddle and so would not be subject to section 263(g). Noncontingent payments on the Instruments would be deductible to the extent otherwise permitted by applicable law. See, e.g., section 1.446-3(f)(2)(i).

As a general matter, common stock is not personal property that can be a leg of a straddle. Section 1092(d)(3)(A). However, common stock is part of a straddle if the offsetting position is, among other things, “a position with respect to substantially similar or related property (other than stock) “ as provided by regulation. Section 1092(d)(3)(B)(i)(II). Final regulations adopted under this section, are effective for positions established after March 17, 1995 and, therefore, could apply to the Instruments and Company A common stock. Section 1.1092(d)-2(b)(1).

The taxpayer’s argument would be that the final regulations, as adopted, do not explicitly provide that common stock and an equity swap may be a straddle. Specifically, they may note that the Service has proposed (but not yet finalized) new regulations under this section after adopting the final regulations. FI-21-95, 1995-1 C.B. 935. Unlike the final regulations, the new proposed regulations include an example that specifically illustrates that common stock and an equity swap may constitute a straddle. Proposed § 1092(d)-2(d). Therefore, the taxpayer could argue that the existence of the proposed regulations establish that the final regulations do not provide that common stock and an equity swap on the stock may be a straddle.

It is our view that the proposed regulations merely clarify the final regulations which already provide that common stock and a NPC, such as an equity swap (or a financial instrument similar to an equity swap), may be a straddle. Specifically, the

final regulations provide that stock and an offsetting position "with respect to substantially similar or related property (other than stock)" constitute a straddle. Substantially similar or related property is given the meaning provided in section 1.246-5 (other that section 1.246-5(b)(3)), section 1.1092(d)-2(a), and so includes property if the fair market value of the property and the stock reflect the performance of a single enterprise. Section 1.246-5(b)(1)(i)(A). For example, since fluctuations in the value of an equity swap on Company X common stock would approximate changes in the value of Company X common stock, such equity swap would be within the definition of "substantially similar or related property" to the Company X common stock. Therefore, under the final regulations, the equity swap on the Company X common stock and the Company X common stock may be a straddle.

To counter the argument of the previous paragraph, the Taxpayer may additionally argue that a regulation adopted under section 1092(d)(3)(B)(i)(II) could not provide that common stock and an equity swap on the stock (or a financial instrument similar to an equity swap) are a straddle. Specifically, the taxpayer may argue that the phrase used in section 1092(d)(3)(B)(i)(II) and repeated in the final regulation, "position with respect to substantially similar or related property (other than stock)", the parenthetical modifies the word "property". Thus, the offsetting position that, under regulation, can be part of a straddle with common stock, must be a position in property that is substantially similar to stock (e.g. a stock index) rather than in the stock, itself. Therefore, in the example in the previous paragraph, Company X common stock could not be personal property that is part of a straddle with an equity swap on the Company X common stock since the equity swap is a position directly in the common stock. Similarly, if the Instruments are equity swaps on Company A common stock, the Instruments and Company A common stock cannot be a straddle.

This argument is probably wrong for two reasons. First, reading the parenthetical as modifying "position" rather than "property" (so that the statutory language is read as "position (other than stock) with respect to substantially similar or related property.") simply makes more sense from the perspective of tax policy. Otherwise, Congress must be viewed as paradoxically permitting the Service to adopt regulations that would treat an offsetting position in property similar to common stock as eligible to part of a straddle with the common stock but denying the Service authority to treat similarly an offsetting position in the common stock. However, the need to permit an offsetting position to be part of a straddle with common stock is surely more compelling when the offsetting position is a position in the stock rather than a position in property that is similar to the stock. Therefore, the statute should be read as simply limiting the ability of the Service to treat common stock as an offsetting position with respect to other stock. The Service would have the ability to adopt regulations that would treat a position in common

stock as an offsetting position with respect to the stock so that the offsetting position and the common stock could be a straddle.

Second, even if we accept the argument that the parenthetical refers to "property", it would not follow that an equity swap (or a similar financial instrument) could not be a part of a straddle with common stock. An equity swap is not merely a position in stock. It is also a position in itself, property that is both distinct from the stock and substantially similar to stock[4]. Therefore, an equity swap on common stock or a similar financial instrument (e.g. the Instruments) would, strictly speaking be a "position with respect to substantially similar or related property (other than stock)". The Instruments would, therefore, be eligible to be part of a straddle with the Company A common stock.

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Please call if you have any further questions.

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[4] A position in personal property is defined as "an interest ... in personal property." Section 1092(d)(2). This definition is broad enough to encompass an ownership interest.