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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR MARK O. LEARY
ASSOCIATE AREA COUNSEL CC:LM:NR:DAL

FROM: Lon B. Smith
Acting Associate Chief Counsel CC:FIP

SUBJECT: Financial Instrument Characterization

This Chief Counsel Advice responds to your memorandum dated January 30, 2001. In accordance with I.R.C. section 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

<u>LEGEND</u>

Company A =

Company B =

Instruments =
Issue Date =

Maturity Date =
<u>a</u> =
$<u>b</u> =

$<u>c</u> =

<u>d</u> =
<u>e</u>% =

$f =

g% =

$h =

ISSUES

(1) Are the quarterly payments on the Instruments, further described below, “interest” deductible under section 163(a) of the Internal Revenue Code?
(2) Are the Instruments part of a straddle subject to the capitalization rules of section 263(g)?

CONCLUSIONS

(1) The Instruments are not debt instruments and, therefore, the quarterly payments cannot be “interest.” The quarterly payments are, therefore, not deductible under section 163(a).
(2) The Instruments are part of a straddle subject to the capitalization rules of section 263(g).

FACTS

On or about Issue Date, Company A issued a units of the Instruments. The proceeds of such issuance to Company A were $b in the aggregate or $c per unit. The proceeds of the issuance were used to acquire another company in a related line of business. At the time at which the units were issued and subsequently, Company A owned approximately d shares of Company B common stock. At the end of the day that was four days prior to Issue Date, the Company B common stock had a fair market value of $c per share. Thus, the aggregate issue price of the units was equal to the fair market value of a units of Company B common stock four days prior to Issue Date.

The terms of the Instruments were somewhat unusual. The units made quarterly payments that resulted in a yield of e% per annum based on initial issue price. The units were not redeemable earlier than 30 days prior to the Maturity Date. At maturity, the units were exchangeable for Company B shares on a sliding scale that depended on the value of the Company B common stock on the Maturity Date: (1) if the value of a share of Company B common on the maturity date was equal to or less than $c, each unit was exchanged for one share of Company B common stock; (2) if the value of a share of Company B common on the maturity date was greater than $c but less than $f, then each unit would be exchanged for a fractional share of Company B common stock with a fair market value equal to $c; (3) If the value of a share of Company B common stock was $e or greater, each unit would be exchanged for g% of a share of Company B common stock. However, Company A had the sole discretion to decide to deliver cash equal to the market value of the Company B shares rather than the shares, themselves.

In the event that Company elected to redeem any units in the 30 days prior to maturity, the redemption would be at the exchange rate discussed above and could be made in cash or through the delivery of Company B shares. The redemption would also include the amount of any accrued but unpaid quarterly payments and a small additional cash payment of $h per unit.

Thus, as can be seen, the holder of a unit has purchased a right to a series of noncontingent quarterly payments and a “long” position in Company B common stock such that for each unit, the holder had all the risk of the price of Company B common stock falling below $c per share, received no appreciation (above $c per unit) if the price of Company B common stock rose was between $c and $f, and received g% of any appreciation in the value of Company B common stock above $f. Similarly, Company A, by issuing the Instruments, had taken a “short” position in Company B common stock.

The units were issued subject to an indenture giving the holders enforceable rights against Company A. The units were not secured by Company B stock and ranked on parity with the other unsecured and unsubordinated indebtedness of Company A. The units confer no voting rights with respect to Company A or company B common stock. For regulatory purposes, the units were reported as a forward sale of Company B common stock rather than as indebtedness.

LAW AND ANALYSIS

1. Are the Instruments properly characterized as debt instruments?

Under section 385(a) of the Internal Revenue Code, the Secretary of the Treasury is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an “interest” in a corporation is to be treated as stock or indebtedness (or as in part stock and in part indebtedness). Section 385(b) sets forth some of the factors that the regulations should take into account in determining whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. These factors include the following: (1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest, (2) whether there is subordination to or preference over any indebtedness of the corporation, (3) the ratio of debt to equity of the corporation, (4) whether there is convertibility into the stock of the corporation, and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

Under section 385(c)(1), the characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness is binding on the issuer and on all holders of such interest (but is not binding on the Secretary of the Treasury).

Proposed regulations under section 385(a) were issued on March 24, 1980, which set forth the factors to be considered in determining whether an instrument was stock or debt. Final regulations under section 385(a) were then issued in December 1980 (with a delayed effective date that was extended several times). The final regulations, however, were withdrawn in 1983. T.D. 7920, 1983-2 C.B. 69. There currently are no regulations under section 385.

Notice 94-47, 1994-1 C.B. 357, provides that the characterization of an instrument as debt for federal income tax purposes depends on the terms of the instrument and all surrounding facts and circumstances. Among the factors that may be considered in making such a determination are: (1) 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; (2) whether holders possess the right to enforce the payment of principal and interest; (3) whether the rights of the holders of the instrument are subordinate to rights of general creditors; (4) whether the instruments give the holders the right to participate in the management of the issuer; (5) whether the issuer is thinly capitalized; (6) whether there is identity between holders of the instruments and stockholders of the issuer; (7) the label placed upon the instrument by the parties; and (8) whether the instrument is intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes. The weight given to any factor depends upon all of the facts and circumstances. John Kelley Co. v. Commissioner, 326 U.S. 521 (1946).[1]

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[1] The Ninth Circuit of the United States Court of Appeals has considered the following eleven factors in classifying an instrument as either debt or equity: (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a maturity date; (3) the source of payments; (4) the right to enforce payment of principal and interest; (5) participation and management flowing as a result; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) payment of interest only out of “dividend” money; and (11) the ability

The following discussion applies the factors listed in Notice 94-47 and other debt/equity factors to the facts in this case.

(1) Is there an unconditional promise to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future?

An important factor used in classifying an instrument as either debt or equity is whether the instrument has a definite maturity date on which the creditor is entitled to an unconditional repayment of principal. The presence of a fixed maturity date indicates a definite obligation to repay (a debt characteristic), and the absence of a fixed maturity date indicates that the repayment may depend on the fortunes of the issuer (an equity characteristic).

In this case, the taxpayer has an unconditional obligation to distribute Company B common (or cash equal to the value thereof) stock to each holder of a Unit on the Maturity Date in an amount based on the market value of Company B common stock. Redemption may occur within 30 days of the Maturity Date on slightly different terms Consequently, in this case, the maturity date is fixed and is in the reasonably foreseeable future.

However, significantly, the sum payable at maturity is not certain but is based on the future market value of the common stock of Company B.

(2) Do the holders of the instruments possess the right to enforce the payment of principal and interest?

Another important factor used in classifying an instrument as either debt or equity is whether the holder of the instrument has the right to enforce the payment of principal and interest. A fixed right to enforce the payment of principal and interest by the holder is a debt characteristic, and the absence of this right is an equity characteristic. The facts presented indicate there is an indenture under which the holder's rights under the Instruments are enforceable although the holder's rights under the indenture are not discussed in detail. However, it is important to note that, although the holders may have access to remedies similar to those of bondholders, the holders do not necessarily have the right to receive a sum certain (notably, they may receive less than the amount initially paid for the units) during the term of the Instruments or at maturity.

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of the corporation to obtain loans from outside lending institutions. O.H. Kruse Grain & Milling v. Commissioner, 279 F.2d 123 (9th Cir. 1960).

(3) Are the rights of the holders of the instruments subordinate to rights of general creditors?

If an instrument is subordinate to the claims of general creditors, the instrument appears to resemble equity (the instrument lacks at least one of the significant characteristics of the debtor-creditor relationship). However, an instrument is not automatically denied debt status if it is subordinate to the claims of general creditors but ranks ahead of the issuer's preferred and common stock. Moreover, debt status generally is not impaired if payments can be made on the instrument while senior claims are outstanding.

In this case, the Instruments are unsecured and unsubordinated obligations of the taxpayer and rank equally and ratably with all other unsecured and unsubordinated debt of the taxpayer. The Instruments do not constitute Senior Indebtedness. In general, Senior Indebtedness does not include the indebtedness of unsecured general creditors, including trade creditors.[2] Therefore the Instruments are not subordinate to the unsecured indebtedness of general creditors, including trade creditors. The Instruments rank superior to the claims of holders of the taxpayer's common stock.

However, in contrast to a typical debt instrument, the Instrument holders are subject to a second set of credit risks: Company B’s as well as the taxpayer’s. In effect, the Instruments holders are subordinated to all of Company B’s creditors, and rank pari passu with the holders of Company B’s common shareholders. A Company B bankruptcy would devastate the Instruments’ holders, without regard to the strength of Company A’s credit standing.

(4) Does the instrument give the holders the right to participate in the management of the issuer?

The presence of voting and other management rights in an instrument generally is one of the indicia of equity.

The holders of the Instruments generally do not have voting rights in Company A or Company B. It is unclear from the facts presented whether the holders may have limited rights to participate in (or affect) the management of

[2] The term “Senior Indebtedness” is generally understood in the financial community to mean indebtedness for borrowed money or indebtedness evidenced by a promissory note or bond. It does not include debt to unsecured creditors, such as trade creditors. See Charles J. Woelfel, Encyclopedia of Banking and Finance (10th ed.)

Company A in the event that Company A defaults on its obligations under the Instruments.

(5) Is the issuer thinly capitalized?

In general, if a corporation has a nominal stock capitalization coupled with excessive debt, this fact would tend to indicate that an instrument labeled debt might constitute equity. The facts presented do not discuss the taxpayer's debt/equity ratio. However, we are aware of no facts suggesting that Company A was unusually highly leveraged and, therefore, will assume Company A was not thinly capitalized.

Although Company A is presumed not to be thinly capitalized, we do not believe this fact alone supports according debt treatment to the Instruments. Thin capitalization traditionally is used as a factor because it aids in determining whether an investor with a nominally fixed return in fact is at a substantial risk that the amount or timing of that return will turn on the risks of a business. The Instruments are designed to provide a variable return which corresponds with the performance of Company B's stock. From the investors' standpoint, they are at the risk of Company B's business and of the taxpayer's venture in holding that stock, no matter how well Company A is capitalized.

(6) Are the holders of the instruments and the stockholders of the issuer the same?

The relationship between a holder's ownership of a corporation's stock and debt is another factor used to determine whether an instrument is debt (a disproportionate relationship) or equity (a proportionate relationship). This factor could be relevant if a particular holder owns both the taxpayer's stock and the Instruments. However, there is no indication that the holders of the Instruments own a proportionate amount of the stock of Company A. Moreover, because both the Instruments and the taxpayer's stock are publicly traded instruments, it is unlikely that there is any relationship between holdings of the taxpayer stock and holdings of the Instruments.

(7) What labels are placed on the instruments by the parties?

In general, the issuance of a stock certificate indicates an equity interest while the issuance of an instrument labeled a bond, debenture, or note is indicative of debt. The taxpayer did not use these terms or other terminology indicating indebtedness to label the Instruments.

(8) Are the instruments intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial purposes?

The intent of the parties regarding the treatment of the instruments as debt or equity for non-tax purposes is an important factor in determining whether a debtor-creditor relationship or a corporation-shareholder relationship exists. For purposes of this factor, the treatment of the instrument for non-tax purposes may be relevant.

The facts provided indicate the Instruments were treated as a forward sale of Company B stock for regulatory purposes. However, the instruments were reported as debt instruments for financial accounting purposes.

Other factors

Other factors that may be relevant in classifying an instrument as either debt or equity for federal income tax purposes include the following:

(1) Convertibility of the instrument into stock of the issuer (an equity characteristic). In this case, the Instruments are not convertible into the stock of the issuer. The amount payable at maturity is based on the market value of Company B common stock not Company A common stock.

(2) A sinking fund (a debt characteristic). In this case, there is no sinking fund provision.

(3) Contingent payments (an equity characteristic). In this case, the amount payable at maturity depends upon the market value of Company B common stock.

(4) Ability of the issuer to obtain loans from outside lending institutions (a debt characteristic). In this case, it appears that Company A could have borrowed from outside lending institutions; indeed we believe that all or most holders of the Instruments are unrelated to Company A. However, many conventional lenders could not or would not invest on these terms because the promised return is not a lender's, but an equity investor's, return. Notwithstanding Company A's credit rating, we would expect the Instruments to have been sold to investors who were able to take common stock-type risks and were interested in a common stock-type of return.

Summary

In the instant case, the Instruments do have some debt-like characteristics. The Instruments have a fixed maturity date and are senior to the claims of equity holders, ranking equally with the unsecured, unsubordinated obligations of Company A. The Instrument holders do have the right to enforce their payment rights under the Instruments and these rights include noncontingent quarterly payments. The Instruments were reported as debt for financial acounting purposes.

The Instruments also lack certain characteristics that would indicate that the Instruments are equity interests in Company A. The holders do not have the right to participate in Company A management (or company B management, for that matter). The amount due to the holders is unrelated to the economic performance of Company A and is not convertible into Company A stock (but is instead convertible to Company B stock). There is apparently no reason to believe there is a substantial overlap between the holders of the Instruments and Company A stockholders and Company A is apparently not thinly capitalized.

Nevertheless, the Instruments lack many of the indicia of indebtedness. Company A has an existing, unconditional, and legally enforceable obligation to pay the Instrument holders at the Maturity Date (or up to 30 days earlier) either Company B common stock or a cash amount equal to the market value of Company B common stock at or around that time. Consequently, although there is a fixed maturity, the amount payable at maturity does not represent a sum certain but is rather contingent. In addition, the Instruments are not labeled as debt nor are they treated as debt for regulatory purposes.

In Gilbert v. Commissioner, 248 F.2d 399 (2nd Cir. 1957), cert. denied, 359 U.S. 1002 (1959), the court concluded that the first prerequisite of an interest deduction is indebtedness—an existing, unconditional and legally enforceable obligation to pay a sum certain at a fixed maturity date. If there is no promise to pay a principal amount, there is no indebtedness on which interest can be paid. Johnson v. Commissioner, 108 F.2d 104 (8th Cir. 1939).[3]

Notwithstanding the foregoing, it is clear that a bona fide debt instrument may include contingent payments. See section 1.1275-4 (discussing the accrual of Original Issue Discount on Contingent Payment Debt Instruments). Nevertheless, if the contingencies are such that it is entirely possible that the investor will never receive the return of his initial investment, it is difficult to conclude that the instrument includes the promise to repay a principal amount which is indicative of debt. Similarly, payments received seem more like a return on an equity investment and thus not within the traditional definition of “interest” as “the amount one has

[3] Section 385(b)(1) provides that the existence of a written unconditional promise to pay on demand or an a specified date a sum certain in money is a factor to be considered in determining whether a debtor-creditor relationship exists.

contracted to pay for the use of borrowed money." Deputy v. DuPont, 308 U.S. 488, 498 (1939).

Company A does have a noncontingent obligation to make quarterly payments during the term of the Instruments. Nevertheless, the total amount of the noncontingent payments on each unit is substantially less than the issue price of each unit. Thus, it is entirely possible that a holder of a unit will never receive the amount of his initial investment. Based on the facts of this case and the factors described above, the Instruments should not be treated as debt for federal income tax purposes.

2. Are the Instruments part of a straddle subject to the capitalization rules of section 263(g)?

(a) Are the Instruments and the Company B common stock part of a straddle?

Under section 1092(c)(1), the term "straddle" means offsetting positions with respect to personal property. Section 1092(c)(2)(A) provides that a taxpayer holds offsetting positions with respect to personal property if there is substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of holding one or more other positions with respect to personal property (whether or not of the same kind).

Section 1092(d)(1) defines personal property as any personal property of a type which is actively traded. Section 1092(d)(3)(A) sets forth the general rule that stock is excluded from the definition of personal property. Under section 1092(d)(3)(B) the general rule excluding stock from the definition of personal property does not apply in three situations. The first two exceptions apply to any stock that is part of a straddle in which at least one of the offsetting positions is (1) an option with respect to that stock or substantially similar stock or securities; or (2) as provided in regulations, a position with respect to substantially similar or related property (other than stock). Sections 1092(d)(3)(B)(i)(I) and 1092(d)(3)(B)(i)(II)[4].

In this case, the taxpayer has a long position in the equity of an unrelated issuer referenced by the Instruments. The issuance of the Instruments results in a straddle if one of the section 1092(d)(3)(B) exceptions is applicable.

(1) If the Instruments are treated as a collar

[4] The third exception provides that personal property includes any stock of a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder. Section 1092(d)(3)(B)(ii). This exception is not relevant to the instant case.

In Rev. Rul. 88-31, 1988-1 C.B. 302, the Service concluded that a taxpayer that held publicly traded stock and cash settlement contingent payment rights relating to that stock was subject to the rules of section 1092. A corporation had issued investment units, consisting of one common share and a separately tradeable contingent payment right, the value of which varied inversely with the market value of the underlying common stock. The contingent payment would be made to the holder two years after the date of issue of the right. The Service concluded that the contingent payment right was a property right separate from the common stock. It next determined that the right was a cash settlement put option under section 1234(c)(2). The contingent payment right also constituted an option for purposes of the stock straddle exception of section 1092(d)(3)(B)(I).

Similarly, in the instant case, the Instruments may be analyzed as cash settlement collars, that is, a combination of put and call options.[5] If such an

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[5] In this view, the Instruments represents a combination of options on Company B common stock. Specifically, the Instruments are equivalent to a "collar" such that Company A has purchased a put option and has written a call option that will be exercised at different strike prices.

A holder of a put option has taken a "short" position in the underlying security. That is, the holder will make money if the value of the security has fallen below the "strike price" since the holder can force the grantor of the put to purchase the security at greater than the security's fair market value. In the instant case, Company A is in a situation analogous to the holder of a put option since it has sold each unit of the Instruments for $c. However, if the fair market value of the Company B common stock falls below $c, it need merely give each holder of a unit a share of Company B common stock per unit or cash equal to the market value of the Company B stock. Thus, one could say that as holder of the put option embedded in each unit of the Instruments, Company A has the right to sell Company B stock at the strike price of $c. Of course, this analogy is not exact since the holder of a put option typically receives the strike price only at the time the put is exercised rather than, as in this case, when the option is first created. Similarly, the holder of the option usually makes an up-front "premium" payment to purchase the option (although, in this case, the noncontingent quarterly payments might be viewed as the equivalent of a premium payment or, alternatively, the purchase price for the Instruments might be viewed as a net amount reflecting both the premium payment paid by Company A for its put and the premium payment paid by holders of the Instruments for the call option discussed in the next paragraph).

A grantor of a call option has also taken a "short" position in the underlying security. That is the grantor will make money if the value of the security does not rise above the "strike price" since the grantor receives a premium payment up front and the analysis is applied, the exception of section 1092(d)(3)(B)(i)(I) will apply on its face. Therefore Company A's position in the Instruments and the Company B common stock will be a straddle provided that the two positions are offsetting.

In Rev. Rul. 88-31, the contingent payment right constituted a short position that served to substantially diminish the risk of loss from a decline in value of the underlying common stock. Therefore, the Service ruled that a taxpayer who held both the contingent payment right and the stock held a straddle subject to section 1092.

Similarly, in the instant case, Company A has a long position in Company B common stock by directly owning d shares. Company A has also taken a short position in the Company B common stock by issuing the Instruments. The economic cost of a decline in the market value of the Company B stock held by Company A is substantially diminished through the exercise of the "put" option embedded in the Instruments. Similarly, Company A's risk of loss from having written the call option embedded in the Instruments is substantially diminished by holding Company B common stock. Consequently, as in Rev. Rul. 88-31, Company A's position in the Instruments is an offsetting position that substantially diminishes Company A's risk of loss from holding the long position in the Company B common stock (just as holding the Company B common stock reduces Company A's downside risk from issuing the Instruments). Thus, by issuing the Instruments, Company A has entered into a straddle.

(2) If the Instruments are not treated as a collar

In the instant case, the Instrument may also be analyzed as a single financial instrument rather than as a collar. 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

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holder will not exercise its option to purchase the underlying security unless the fair market value of the security exceeds the strike price. In the instant case, Company A is in a situation analogous to the grantor of a call option for which the strike price is $f (although each unit of the Instruments is actually analogous to a call option on only g% of a Company B share). Thus, if the value of the Company B common stock exceeds $f per share, the holders of the Instruments, will be in a position that is economically equivalent to the holder of a call option on g% of a share of Company B stock for each unit held. That is, for each dollar increase in value of a Company B share above $f, the holders of the Instruments will receive g% of a dollar per each unit held (either in the form of cash or in the form of the fair market value of each Company B share received).

swaps. The Instruments, by providing for payments at specified intervals and a final cash payment linked to the value of Company B common stock, are similar to an equity swap on Company B 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 B 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 alternatives, the exception of section 1092(d)(3)(B)(i)(II) will apply so that Company A's position in the Instruments and the Company B common stock will be a straddle.

Final regulations adopted under this section, are effective for positions established after March 17, 1995 and, therefore, could apply to the Instruments and Company B common stock. Section 1.1092(d)-2(b)(1). The 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)) and so includes property if the fair market value of property and stock reflect the performance of a single enterprise. Sections 1.246-5(b)(1)(i)(A), 1.1092(d)-2(a). In the instant case, since fluctuations in the value of the Instruments would approximate changes in the value of Company B common stock, the Instruments would be within the definition of "substantially similar or related property" to the Company B common stock. As developed previously, Company A's positions in the Instruments and the Company B common stock are offsetting. Therefore, under the regulations, the Instruments and Company B common stock are a straddle.

(2) <u>Are the Instruments and the Company B common stock part of a straddle subject to the Capitalization rules of section 263(g)?</u>

Section 263(g)(1) states that no deduction shall be allowed for "interest and carrying charges" properly allocable to personal property which is part of a straddle as defined in section 1092(c). Section 263(g)(2) defines "interest and carrying charges" to mean "interest on indebtedness incurred or continued to purchase or carry the personal property" and "all other amounts (including charges to insure, store, or transport the personal property) paid or incurred to carry the personal property... . " net of certain receipts with respect to the personal property.

As developed previously, the Instruments should not be characterized as debt. Consequently, the quarterly payments cannot be characterized as interest. However, the quarterly payments will be within the definition of carrying charge if the payments are an amount "paid or incurred to carry the personal property" (emphasis added). Section 263(g)(2)(A)(ii).

There is no direct authority interpreting the term "carry" for the purposes of section 263(g)[6]. However, the phrase "interest on indebtedness incurred or continued to purchase or carry" appears in section 265(a)(2) as well as section 263(g)(2)(A)(i). Section 265(a)(2) provides that no deduction shall be allowed for interest on indebtedness incurred or continued to purchase or carry tax-exempt bonds. Rev. Proc. 72-18, 1972-1 C.B. 740, establishes administrative guidelines for the audit of cases involving section 265(a)(2). Among other things, Rev. Proc. 72-18 provides guidelines for the application of the "purchase or carry" phrase in section 265(a)(2) to require disallowance of interest only if: (1) the proceeds of the indebtedness can be directly traced to the purchase of the tax-exempt obligations; (2) the tax-exempt obligations are pledged to secure the indebtedness; or (3) the totality of the facts and circumstances support a reasonable inference the indebtedness was issued to purchase or carry the tax-exempt obligations. Significantly, one of the sets of facts and circumstances that Rev. Proc. 72-18 discusses as specifically indicating a purpose to carry tax-exempt obligations occurs if "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 Railway Company v. United States, 375 F.2d 1016, 1021 (Ct. Cl. 1967))

Interpreting the term "carry" in section 263(g)(2)(A)(ii) by reference to section 265(a)(2) and Rev. Proc. 72-18 is subject to certain objections. To begin with, section 265(a)(2) denies deduction for interest not "carrying charges". Therefore, turning to a Revenue Procedure that interprets section 265(a)(2) to aid in defining "carrying charges" is somewhat inapposite. Indeed, the mere fact that section 265(a)(2) does not deal with carrying charges suggests that the term "carry" in 265(a)(2) has a more limited meaning than in section 263(g). In addition, reliance on Rev. Proc. 72-18 somewhat overstates the significance of the revenue procedure which establishes administrative guidelines for the audit of cases rather than legal interpretations. The Revenue Procedure itself is clear that the governing test for determining whether interest meets the statutory nexus test of section 265(a)(2) is set forth in case law. See, e.g., Illinois Terminal Railway Company v. United States, 375 F.2d 1016 (Ct. Cl. 1967) and Wisconsin Cheeseman, Inc. v.

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[6] On January 18, 2001, the Service published proposed regulations under section 263(g) at 66 F.R. 4746. REG-105801-00, 2001-13 I.R.B. 965. However, the proposed regulations would not apply to straddles created prior to January 17, 2001 and, therefore, are inapplicable . Proposed section 1.263(g)-5. Consequently, the proposed regulations will not be further discussed here.

United States, 388 F.2d 420 (7th Cir. 1968). Finally, Rev. Proc. 72-18 does not give a definitive interpretation for the phrase “incurred or continued to purchase or carry” since Rev. Proc. 72-18 incorporates a “facts and circumstances” test that is, itself, subject to further interpretation.

Nevertheless, even though the term “carry” may have a broader meaning in section 263(g) than in section 265(a)(2), it is useful to consider whether the Instruments carry the Company B common stock if “carry” is given the meaning used in section 265(a)(2). Rev. Proc. 72-18 treats interest on a borrowing as carrying tax-exempt obligations if the obligations are first purchased and then pledged as collateral to secure the borrowing. That is, Rev. Proc. 72-18 implies that money is fungible and a taxpayer generally cannot avoid the application of section 265 by raising money to purchase tax exempt obligations indirectly rather than directly. Therefore, had Company A used its existing investment in Company B shares to raise cash by pledging the shares to secure a loan, Rev. Proc. 72-18 indicates that interest on the loan “carries” the Company B stock. Accord Wisconsin Cheeseman v. United States, 388 F.2d at 422 (“[O]ne who borrows to buy tax-exempts and one who borrows against tax-exempts already owned are in virtually the same economic position”). The question is: can we infer a similar intent to carry Company B common stock if Company A monetizes a significant portion of its existing economic interest in Company B not by formally pledging the Company B stock but instead by selling an obligation that is tied to the economic performance of the Company B stock?

Section 6.02 of Rev. Proc. 72-18, by inferring a purpose to carry tax exempt obligations if a corporation continues indebtedness which it could discharge by liquidating tax-exempt obligations, indicates the answer is yes.

Company A, by issuing the Instruments rather than pledging the Company B stock, has reduced its risk from a decline in the value of Company B stock and ability to gain from the appreciation of Company B stock. By issuing the Instruments, Company A has evidenced a willingness to cede substantial elements of its ownership rights in the Company B stock (that is, its right to gain and risk of loss) for an up-front payment. Thus, issuing the Instruments was effectively an alternative to liquidating part of the investment in the Company B stock. Therefore, one can reasonably infer on the basis of the totality of the facts and circumstances that the Instruments were incurred to continue the investment in the Company B stock and, therefore, “carry” the Company B stock. Cf. Illinois Terminal Railway Company v. United States, 375 F.2d at 1021; Rev. Proc. 72-18, § 6.02.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

1. Characterization of the Instruments.

The argument that the Instruments are not debt instruments is quite strong. Nevertheless, there are certain factual points that were not discussed in the submission to this office that are relevant. [redacted]

[redacted]

2. Applicability of section 263(g).

(a) Are the Instruments part of a straddle?

As indicated above, there are two different ways the Instruments might be characterized. Each characterization is subject to an argument limiting the application of section 263(g).

(1) Disaggregating the Instruments.

As noted above, the Instruments could be treated a set of put options held by Company A and call options written by Company A on Company B common stock.

However, the Instruments also provide for certain non-contingent quarterly payments, providing an annual yield of e%. 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).[7]

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[8]. Section 163(e). However, arguably, such OID should be capitalized into the taxpayer's basis in the Company A common stock since section 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, Company A may argue that the OID should not be capitalized under section 263(g).

The options treated as embedded in the Instruments and the Company B common stock are a straddle as per section 1092(d)(3)(B)(i)(I). However, unlike the options embedded in the Instruments, the separate debt instrument is not part of a straddle with the Company B common stock since noncontingent payments and Company B common stock are not offsetting positions. That is, holding one does not diminish Company A'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 B common stock, the noncontingent payments do not "carry" the Company B 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

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[7] 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 section1.1273-1(c)(1). The issue price will be determined by treating some portion of the sales price of the Instruments 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.

[8] Interest would also be deductible but, as developed in footnote 6, the imputed debt instrument does not bear QSI.

straddle.[9] H. R. Rep. No.201, 97th Cong. 1st Sess., 203-205 (1981). In the instant case, similarly, it may reasonably be argued that the noncontingent payments were an integral part of the creation of a position in personal property (i.e. the Instrument) that carried the Company B stock. 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).

(2) 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.

If such an analysis is adopted, Company A 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 B 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 developed above, 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,

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[9] 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.

could apply to the Instruments and Company B common stock. Section 1.1092(d)-2(b)(1).

Company A's argument would be that the final regulations, as adopted, do not explicitly provide that common stock and an equity swap (or a financial instrument similar to an equity swap) may be a straddle. Specifically, it 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 section 1.1092(d)-2(d). Therefore, Company A 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, Company A 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, Company A 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 B common stock (or a financial instrument similar to such an equity swap), the Instruments and Company B common stock cannot be a straddle.

We believe Company A's argument is incorrect 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 be 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[10]. 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 B common stock.

(b) Are the Instruments and the Company B common stock part of a straddle subject to the Capitalization rules of section 263(g)?

As developed above, the crucial question in determining the applicability of section 263(g) to the quarterly payments on the Instruments is whether the payments are an amount "paid or incurred to carry the [Company B common stock]." Section 263(g)(2)(A)(ii). Arguably, the scope of the term "carry" may be determined by reference to Rev. Proc. 72-18. Rev. Proc. 72-18 cites <u>Wisconsin Cheeseman v. U.S.</u> 338 F2d 420, at 422 (1968) as authority for the proposition that a purpose to

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[10] 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.

carry tax-exempt obligations exists where tax-exempt obligations are used as collateral for indebtedness.

However, in Wisconsin Cheeseman, the taxpayer not only pledged tax-exempt obligations as collateral for short-term loans. It also borrowed money to build a new plant to meet growing demand for its product. This borrowing was secured by a mortgage on the plant. The Seventh Circuit allowed the taxpayer a deduction for the interest on the mortgage loan although denying the deduction for interest on the short-term loans collateralized by tax-exempt obligations. The Seventh Circuit concluded that the Service had not demonstrated "a sufficient relationship between the mortgage indebtedness and the holding of the municipal bonds to justify denial of deduction of the mortgage interest." 388 F.2d at 423. It based this conclusion on the following factors: (1) selling tax-exempt obligations to pay for the plant would have compromised the taxpayer's liquidity; (2) plant construction is a major non-recurring expense typically financed over the long-term; and (3) tax-exempt obligations did not collateralize the mortgage loan. Id; Cf. also, section 4.02 of Rev. Proc.72-18 (section 265 does not disallow interest deduction by individual on indebtedness incurred to acquire a residence).

Relying on this case, Company A may argue that the proceeds from the Instruments were so clearly and directly associated with its purchase of another company that the amounts at issue were not incurred to carry the Company B stock. The problem with such an argument is that the Seventh Circuit's conclusion was predicated on the lack of relationship between the mortgage loan and the taxpayer's holdings of tax-exempt obligations. The Seventh Circuit was reluctant to disallow interest on a mortgage loan merely because the taxpayer simultaneously held tax-exempt obligations. However, the Seventh Circuit did not hold that interest would not be disallowed on a borrowing merely because the proceeds of the borrowing are not used to purchase tax exempt obligations. Indeed, the Seventh Circuit's opinion specifically notes that: "No municipal bonds were put up as collateral." Id. The implication is that the Seventh Circuit would have disallowed the interest on the mortgage loan had there been a sufficient nexus between the mortgage loan and the tax-exempt obligations (e.g., if the tax-exempt obligations had been pledged as additional collateral to secure the mortgage loan). Similarly, in Illinois Terminal Railroad Company, 375 F.2d at 1016, the Court of Claims disallowed interest deductions on a borrowing used to purchase non-tax-exempt assets when the assets were sold in return for cash (used to reduce the loan balance) and tax-exempt obligations.

In the instant case, a nexus between the Instruments and the Company B common stock is established by the terms of the Instruments, themselves. As developed previously, the Instruments effectively transfer both upside gain and downside risk in Company B stock to investors and, thus, are substantively an alternative to liquidating Company B common stock. Thus, there is a good argument that the Instruments carry the Company B common stock.

In addition, Section 6.02 of Rev. Proc. 72-18 indicates that indebtedness will not be deemed to “carry” tax-exempt obligations that are not liquidated to discharge indebtedness if the obligations are “committed to, or held in reserve for, the corporation’s regular business activities.” Arguably, a similar exception could apply in the instant case if the Company B stock could not be sold because it was already committed to finance Company A’s regular business operations. On the facts presented, it is obvious that at least a shares of the Company B stock were not so committed since Company A ceded much of the economic value of those shares in issuing the Instruments. Therefore, this exception should not apply.

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Please call if you have any further questions.

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