OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

January 9, 2001

Number: **200115015**
Release Date: 4/13/2001
CC:FIP:3
TL-N- 403-00
UILC: 1273.00-00; 1273.02-06

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: LON B. SMITH
ACTING ASSOCIATE CHIEF COUNSEL CC:FIP

SUBJECT: Investment Unit Rules

This Field Service Advice responds to your memorandum dated October 4, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

DISCLOSURE STATEMENT

Field Service Advice is Chief Counsel Advice and is open to public inspection pursuant to the provisions of section 6110(i). The provisions of section 6110 require the Service to remove taxpayer identifying information and provide the taxpayer with notice of intention to disclose before it is made available for public inspection. Sec. 6110(c) and (i). Section 6110(i)(3)(B) also authorizes the Service to delete information from Field Service Advice that is protected from disclosure under 5 U.S.C. § 552 (b) and (c) before the document is provided to the taxpayer with notice of intention to disclose. Only the National Office function issuing the Field Service Advice is authorized to make such deletions and to make the redacted document available for public inspection. **Accordingly, the Examination, Appeals, or Counsel recipient of this document may not provide a copy of this unredacted document to the taxpayer or their representative.** The recipient of this document may share this unredacted document only with those persons whose official tax administration duties with respect to the case and the issues discussed in the document require inspection or disclosure of the Field Service Advice.

LEGEND

Taxpayer =
Holdings =
Limited Partnership =
Partners I =
Parent =
Investment Bankers =
Accounting Firm =
Brokerage Firm =
Ltd. . =

Holdings I =
Bank Affiliate =

Holdings II =
State 1 =
State 2 =
Year A =
Year C =
Year D =
Year E =
Date 1 =
Date 2 =
Date 4 =
Date 5 =
Date 6 =
Date 8 =
Date 10 =
Date 11 =
Date 12 =
Date 13 =
Date 15 =
E =
F =
G =
H =
I =
J =
K =
L =
M =
N =
O =

P =
Q =
R =
S =
T =
V =
W =
X =
Y =
Z =
AA =
BB =

ISSUE:

The sole issue set forth in your Field Service Advice (FSA) request is whether the Taxpayer is entitled to a deduction for original issue discount (OID) in the amount claimed ($P) in its taxable Year C.

CONCLUSION:

We agree that the Taxpayer has provided inconsistent and confusing information concerning the transactions in issue and that additional factual development is required. Therefore, it is impossible to provide conclusive advice as to whether the Taxpayer is entitled to an OID deduction in the amount claimed.

As with other deductions, OID deductions are a matter of legislative grace. See, e.g., Indopco, Inc. v. Commissioner, 503 U.S. 79, 84 (1992) (" 'an income tax deduction is a matter of legislative grace and ... the burden of clearly showing the right to the claimed deduction is on the taxpayer.' "). In this case, we agree that the Taxpayer has failed to clearly show its right to the claimed OID deduction. Unless the Taxpayer provides additional information to substantiate its claimed deduction, based on the facts submitted with the FSA request, we concur with your conclusion and that of the Revenue Agent that the deduction should be disallowed.

FACTS:

The facts, as set forth in your FSA request, and the materials submitted therewith, are as follows: Taxpayer is engaged in the investment banking business. The proposed adjustment in issue is based upon the Revenue Agent's disallowance of a deduction for OID in the amount of $P claimed on Taxpayer's Year C consolidated federal income tax return. The claimed OID deduction arises out of the below-described transactions involving a subordinated note in the principal

amount of $W issued by Holdings on Date 2 in connection with an agreement dated Date 1 (hereinafter, the "Agreement"). The proposed adjustment is based upon the Revenue Agent's determination that there was no OID with respect to the note. The Revenue Agent's conclusion is based on the facts set forth in Taxpayer's "Response to IRS Form 5701" and information contained in the related documents.

Pursuant to the Agreement, the partners of Limited Partnership (Partners 1), Parent, and Taxpayer agreed to acquire the investment banking firm formerly known as Investment Bankers. (Limited Partnership is a State 1 limited partnership; Parent is a U.K. company; and Taxpayer is a State 2 corporation and a J% subsidiary of Parent.)

The acquisition was accomplished as follows: (i) Partners 1 and Taxpayer formed Holdings; (ii) Holdings acquired from Partners 1 the business and assets of Investment Bankers in exchange for L shares of Preferred Stock of Holdings, M shares of Class B Common Stock of Holdings, and cash in the amount of $AA; and (iii) Taxpayer contributed cash in the amount of $Z in exchange for L shares of Preferred Stock of Holdings, M shares of Class A Common Stock of Holdings and $W principal amount of Subordinated Notes Due Year E (the "Note").[1] Thus, the capital structure of Holdings consisted of M outstanding shares of Class A Common Stock, M outstanding shares of Class B Common Stock, N outstanding shares of Preferred Stock,[2] V principal amount of Senior Notes Due Year D (the "Senior

---

[1] The principal of the Note was payable in equal annual installments from Date 13 through Date 15, with interest payable in cash assuming sufficient earnings or, if not, as an increase in principal payable at F% per annum through Date 5 and at G% per annum thereafter. The Note is not publicly traded. On Date 6, Holdings issued to the holder of the Note an additional Subordinated Promissory Note due Year E (the "Additional Note") in the principal amount of $O representing the amount of accrued interest with respect to the Note which had not been paid because Holdings' earnings had been insufficient to permit the payment of interest due and payable under the Note.

[2] According to the Agreement, the par value of the Preferred Stock was $K per share; the par value of Class A Common Stock, voting Class B Common Stock and the non-voting Class B Common Stock was $E per share. Holdings' Consolidated Financial Statements reflect the issuance of the Note (in the amount of $W) and $R of stock and are therefore consistent with these transactions.

Notes"),[3] and the Note. Partners 1 and Taxpayer each obtained an I% interest in Holdings. Collectively these transactions were intended to qualify as a tax free exchange under I.R.C. § 351.

The Agreement further provided that Partners 1 and Taxpayer agreed (i) that, for federal income tax purposes, the Note issued by Holdings would have OID as defined in § 1273 in an amount determined by Accounting Firm, based on advice from Brokerage Firm and another entity, at closing, and (ii) that Holdings would report appropriately such amounts as OID on the tax returns and tax reports of Holdings.

Accounting Firm determined that the amount of OID on the Note was $S based on the Brokerage Firm's determination that the fair market value of the Note was $T.

The Agreement also specified that at the closing the Note was to be issued directly to Taxpayer. In spite of this provision, however, at the closing and at Taxpayer's request, the Note instead was issued directly to Ltd., a wholly owned subsidiary of Parent.[4]

The reason the Note was issued to Ltd. instead of Taxpayer at the closing is unclear. According to Taxpayer, the Note was issued directly to Ltd. because Ltd. agreed to purchase the Note from Taxpayer immediately upon the issuance of the Note pursuant to the Agreement for the fair market value of the Note at that time--$T. Taxpayer maintains that, solely as a matter of administrative convenience, Taxpayer directed Holdings to issue the note directly to Ltd. rather than having the Note issued to it and then immediately assigning it to Ltd. Taxpayer acknowledges it was legally obligated to purchase the Note from Holdings under the Agreement, and it in fact did just that. Taxpayer also acknowledges that Ltd. never entered into any agreement with Holdings regarding the Note. Taxpayer relies on the Accounts of Ltd. (the equivalent of its Financial Statements) as support for its position that Ltd. purchased the Note from Taxpayer for $T.[5]

---

[3] At the time of these transactions, Holdings issued the Senior Notes to unrelated institutional investors. The Senior Notes had an interest rate of H%, a maturity date of Date 12, and an aggregate principal amount of $V. These notes are not at issue here.

[4] Ltd.'s Accounts indicate that Ltd. took a loan from Parent in the amount of $T and the proceeds were used to obtain the Note.

[5] Taxpayer's representations contained in its response to IRS Form 5701 and its Exhibits B and C attached thereto indicate that both Taxpayer, a U.S. entity, and Ltd., a

Taxpayer also states that the Note was issued to Ltd. at Taxpayer's direction to Holdings "because ... [Taxpayer] had agreed to transfer the note to ... [Ltd.]" as evidenced by the Cross Receipt issued in connection with Taxpayer's transfer of cash to Holdings in exchange for the stock and Note. The Cross Receipt indicates that, in exchange for Taxpayer's $Z in cash, Taxpayer received from Holdings $L shares of Preferred Stock, M shares of Common Stock, and the Note issued to Ltd., the transferee of Taxpayer. Although the Cross Receipt suggests Taxpayer may have assigned the Note to Ltd., since Taxpayer's analysis and corresponding diagrams indicate that Taxpayer sold the Note to Ltd., you have assumed for purposes of your analysis that the Note was sold to Ltd. and not simply transferred to Ltd. as an assignee.[6]

Ltd. acquired the Note in Year A. In Year C, Ltd. sold the Note and the Additional Note to Holdings II, a State 2 corporation and a wholly owned subsidiary of Taxpayer, for an amount equal to their fair market value at that time ($BB, plus accrued interest). The sale occurred in Date 8.

Thereafter, in Date 10, Taxpayer acquired Partners I's interest in Holdings (which had since been renamed). Consequently, Holdings claimed deductions for accrued OID with respect to Note in the aggregate amount of $Q. Holdings's OID deductions were not disallowed in the years the deductions were claimed.

In Date 11, Holdings II sold the Note and the Additional Note, together with the right to all accrued but unpaid interest thereon, to Bank Affiliate, an unrelated third party, for an amount equal to their face value and all accrued but unpaid interest thereon ($X)

In Date 11, Holdings repaid the Note and the Additional Note by remitting to Bank Affiliate a cash payment in the amount of Y representing the principal amount of the Note and the Additional Note and all accrued but unpaid interest thereon.

U.K. entity, are wholly owned subsidiaries of Parent. Contrary to these representations, you note that the notes to the consolidated financial statements of Holdings as of Date 4 and the following year indicate that Ltd., not Parent, is Taxpayer's parent. Similarly, Ltd.'s Accounts as of Date 4 indicate that Taxpayer is a subsidiary of Ltd. For the purposes of this memorandum, you have assumed that Taxpayer's representations that Ltd. is a U.K. entity and a wholly owned subsidiary of Parent, and that Taxpayer is a wholly owned subsidiary of Parent, as set forth in Taxpayer's response and as so indicated in its diagrams. You also noted that whether Taxpayer's parent is Parent or Ltd. appears to have no effect on the analysis of the tax consequences of the Note.

[6] You note that if the transaction is treated as an assignment, the tax consequences would be remarkably different.

On its Year C consolidated federal income tax return, Taxpayer claimed a deduction in the amount of $P representing the remaining OID with respect to the Note which had not been deducted in periods prior to its repayment as of Date 11. The Revenue Agent proposes to disallow this deduction.

LAW AND ANALYSIS

The proper tax treatment of "investment units" under the original issue discount (OID) provisions (I.R.C. § 163(e) and §§ 1271-1275) is set forth in I.R.C. § 1273(c).[7] Section 1273(c)(2) provides that in the case of any debt instrument and an option, security, or other property issued together as an investment unit--

> (A) the issue price for such unit shall be determined in accordance with the rules of ... [§ 1273(c)] and ... [§ 1273(b)] as if it were a debt instrument,
>
> (B) the issue price determined for such unit shall be allocated to each element of such unit on the basis of the relationship of the fair market value of such element to the fair market value of all elements in such unit, and
>
> (C) the issue price of any debt instrument included in such unit shall be the portion of the issue price of the unit allocated to the debt instrument under subparagraph (B).

Since I.R.C. § 1273(c)(2) was enacted in 1984, various versions of proposed regulations have been issued under the OID provisions. Final regulations were promulgated in 1994, and except as otherwise provided, they apply to debt instruments issued on or after April 4, 1994. See generally Treas. Reg. § 1.1271-0. Thus, these regulations do not apply to the Note in this case because it was issued in Year A, a year before 1994 but after 1984.

An investment unit is often issued as part of a lending transaction and is comprised of a debt instrument (for example, the note evidencing the loan) and an option, security, or other property right. [8]

---

[7] Your FSA request contained a general overview of the OID provisions. Inasmuch as it was sufficiently comprehensive for purposes of the investment unit issue presented in this case, we have not repeated the discussion here.

[8] For a general discussion of the investment unit rules see David C. Garlock, "Federal Income Taxation of Debt Instruments," Aspen Law & Business (Third Edition,

Under I.R.C. § 1273(c)(2)(A), the issue price of an investment unit is determined as if the investment unit were a debt instrument. If a nonpublicly offered debt instrument is issued for money, the issue price of the debt instrument generally is the amount paid for the instrument. See I.R.C. § 1273(b)(2). Therefore, if an investment unit is issued for money in a lending transaction, the issue price of the investment unit generally is the amount loaned.

Under I.R.C. § 1273(c)(2)(B), the issue price of an investment unit is allocated between the debt and property components as of the issue date of the investment unit. See I.R.C. §1275(a)(2) for the definition of issue date. The allocation is made based on the relative fair market values of the debt and property components as of the issue date. This allocation must be made even if the components do not have readily ascertainable fair market values as of the issue date. See, e.g., Custom Chrome v. Commissioner, T.C. Memo. 1998-317, aff'd in part and rev'd in part, 217 F.3d 1117 (9th Cir. 2000).

In Year A, there were no final regulations in effect under I.R.C. § 1273. However, the regulations under former I.R.C. § 1232(b)(2), which contained rules similar to those in I.R.C. §1273(c)(2), provide detailed rules for allocating the issue price of an investment unit if the fair market value of the property component is not readily ascertainable as of the issue date. Treas. Reg. § 1.1232-3(b)(2)(ii). Although this case concerns stock, rather than warrants, there is analogous authority to consider. See Monarch Cement Co. v. United States, 634 F.2d 484 (10th Cir. 1980), and Rev. Rul. 77-250, 1977-2 C.B. 309, for applications of the I.R.C. § 1232 regulations in situations in which there was not a readily ascertainable fair market value of the non-debt component of the investment unit as of the issue date.

Although not controlling, proposed regulations under I.R.C. § 1273 were published in the Federal Register on April 4, 1986, that would have provided guidance on how to determine the issue price of a debt instrument issued after 1982, including an investment unit treated as a debt instrument (51 FR 12022, 12061). Under Prop. Treas. Reg. § 1.1273-2(d)(2)(iv) of the 1986 proposed regulations, rules similar to those under Treas. Reg. § 1.1232-2(b)(2)(ii) would have applied to allocate an investment unit's issue price to its components as of the issue date. The 1986 proposed regulations were withdrawn in 1992 when a new set of proposed regulations were published in the Federal Register (57 FR 60750). The 1992 proposed regulations were finalized in 1994, as noted above. Under both

---

1999 supplement), Chapter 9, pages 9-2 thought 9-5. See also Kevin M. Keyes, "Federal Taxation of Financial Instruments and Transactions," Warren, Gorham & Lamont (1997 Edition, 2000 supplement), Part 4, paragraph 4.02[3][b], page 4-26.

the 1992 proposed regulations and the final regulations, however, no specific rules are provided to determine the fair market values of the components of an investment unit for purposes of making the allocation.

It is clear that the statute and the regulations (under both I.R.C. §1273 and former I.R.C. §1232) require that value be allocated to the property component of an investment unit as of the time the investment unit is issued, thereby closing the transaction, even if the fair market value of the property component is not readily ascertainable. This allocation must be done in order to determine the portion of the issue price allocable to the debt component and, thus, to determine the amount of OID on the debt component.

In general, the debt component of an investment unit has OID if the debt's stated redemption price at maturity exceeds its issue price. I.R.C. § 1273(a). Under I.R.C. §§ 163(e) and 1272, OID is deductible by the issuer, and includible by the holder, as interest over the term of the debt component.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS.

[9]

We would be pleased to provide ongoing assistance as this case develops.

Please call if you have any further questions.

Lon B. Smith
Acting Associate Chief Counsel
By: WILLIAM E. BLANCHARD
Senior Technician Reviewer
Associate Chief Counsel (Financial Institutions and Products)

9