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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR MICHAEL J. COOPER
ACTING ASSOCIATE AREA COUNSEL CC:LM:NR:DEN

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

SUBJECT: Financial Instrument Characterization

This Chief Counsel Advice responds to your memorandum dated May 7, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Company A =

Company B =
Instruments =

Issue Date =

Maturity Date =

a =

$b =

$c =

d	=	
e%	=	
$f	=	
g%	=	______
Trustee	=	
h%	=	___
i%	=	___
Exchange Note	=	
Forward Contract	=	

ISSUES

(1) Are the quarterly payments on the Instruments, further described below, "interest" deductible under § 163(a) of the Internal Revenue Code?

(2) Are the Instruments part of a straddle subject to the capitalization rules of § 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 § 163(a).

(2) The Instruments are part of a straddle subject to the capitalization rules of § 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 (less the underwriting discount). The proceeds of the issuance were used for general corporate purposes, including the reduction of short-term and long-term borrowings and other business opportunities. When the Instruments were issued, Company A owned approximately d shares of Company B common stock. At the end of the day that was six days prior to Issue Date, the Company B common stock had a fair market value of $c per share. The aggregate issue price of the Instruments was equal to the fair market value of a shares of Company B common stock six days prior to Issue Date.

Under the terms of the Instruments, Company A made quarterly payments that resulted in a yield of e% per annum based on initial issue price. At maturity, the Instruments 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 stock on the Maturity Date was equal to or less than $c, each unit would be exchanged for one share of Company B common stock; (2) if the value of a share of Company B common stock on the Maturity Date was greater than $c but less than $f, then the Instruments 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 $f or greater, the Instruments would be exchanged for g% of a share of Company B common stock (the "Exchange Rate"). 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 addition, no fractional shares of Company B common stock will be issued at maturity. In lieu of any fractional share otherwise issuable, such holder shall be entitled to receive an amount in cash equal to the value of such fractional share.

The Exchange Rate is subject to adjustment upon the occurrence of certain events. The rate may be adjusted, if necessary, to provide anti-dilution protection to holders of the Instruments upon the occurrence of certain dilution events. Also, the rate may be adjusted upon the occurrence of certain reorganization events (for example, any consolidation or merger of Company B with or into another entity). An adjustment upon the occurrence of certain reorganization events may require a change in the consideration received by the holders of the Instruments. No adjustments will be made for certain other events, such as offerings of Company B common stock by Company B for cash or in connection with acquisitions.

The Instruments were issued subject to an Indenture giving the holders enforceable rights against Company A. The Instruments are unsecured and unsubordinated obligations of Company A and rank equally and ratably with Company A's other unsecured indebtedness. The Instruments are not subject to redemption or any sinking fund prior to maturity. In the event of default (for example, a default in the payment of interest on the loan), either the Trustee or the holders of not less than h% in "principal" amount of the Instruments outstanding of that series may declare the "principal" amount of all Instruments to be due and payable immediately. The Instruments confer no rights with respect to Company B common stock (including, without limitation, voting rights and rights to receive any dividends or other distributions in respect thereof) until such time, if any, as Company A shall have delivered shares of Company B common stock to holders of the Instruments.

Company A's position with respect to the federal income tax consequences of the Instruments is that the Instruments consist of (i) a written debt obligation bearing a stated rate of interest (the "Exchange Note), and (ii) a forward purchase contract in which the holder agrees to use the principal payment due on the debt obligation to purchase at maturity Company B common stock (the "Forward Purchase Contract"). Company A acknowledges, however, that the proposed Treasury regulations concerning the treatment of contingent debt instruments under the original issue discount regime could apply to these Instruments but for the effective date of the regulations. Company A acknowledges that, for federal income tax purposes, there are no statutory, judicial, or administrative authorities that directly address the characterization of these Instruments.

LAW AND ANALYSIS

1. Are the Instruments properly characterized as debt instruments?

Under § 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 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, but are not limited to, 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 § 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 § 385(a) were issued on March 24, 1980, which set forth the factors to be considered in determining whether instruments were stock or debt. Final regulations under § 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 § 385.

Notice 94-47, 1994-1 C.B. 357, provides that the characterization of instruments as debt for federal income tax purposes depends on the terms of the instruments 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 of the instruments possess the right to enforce the payment of principal and interest; (3) whether the rights of the holders of the instruments are subordinate to rights of general creditors; (4) whether the instruments give the holders of the instruments 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 instruments by the parties; and (8) whether the instruments are 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 instruments 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; (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 of the

We need not discuss here whether these Instruments entitle their holders to an equity interest in Company A or its subsidiaries. Clearly they do not. An equity holder (i.e., a shareholder) has an ownership interest in the corporate assets. Here, the holders of the Instruments do not have any right to Company A's corporate assets other than the Company B stock as a result of holding the Instruments. Nor do the holders have any current right to own Company A's stock as a result of holding the Instruments. Nor are the Instruments convertible in whole or in part into Company A stock. If an equity interest is implicated, it is with regard to Company B's stock and its assets.

Accordingly, the only question that we decide herein is whether these Instruments constitute debt. Thus, the following Notice 94-47 factors indicate whether characteristics of debt are implicated:

(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 instruments as debt is whether the instruments have a definite maturity date on which the creditor is entitled to an unconditional repayment of a fixed principal amount. The presence of a fixed maturity date indicates a definite obligation to repay, which is a characteristic of debt. The absence of a fixed maturity date indicates something other than debt.

In this case, Company A has an unconditional obligation to exchange these Instruments on the Maturity Date into either Company B common stock at the Exchange Rate, or cash in an amount equal to the amount of Company B common stock the holder would otherwise be entitled to receive under the Exchange Rate. Here, the Instruments mature on the Maturity Date. Consequently, in this case, the maturity date is fixed and is in the reasonably foreseeable future. However, the sum payable at maturity is not certain but is based on the future market value of the Company B common stock.

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

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

pay a principal amount, there is no indebtedness on which interest can be paid. Johnson v. Commissioner, 108 F.2d 104 (8th Cir. 1939).[2]

Here, if at maturity, the market value of the Company B common stock is: (a) less than $c, the holder of the Instruments receives one share of Company B common stock for each Instruments exchanged, thereby he alone suffers a loss in the amount of the depreciation in value of the Company B common stock below the principal amount of the Instruments; (b) greater than $c but less than $f, the holder of the Instruments receives a fractional share of Company B common stock equal to the principal amount of the Instruments exchanged, and therefore he does not share in any of the appreciated value of the Company B common stock; and (c) greater than $f, the holder of the Instruments receives an amount of Company B common stock equal to the principal amount of the Instruments held ($c per Instruments) plus the holder shares with Company A in the appreciation of value in excess of $f. Therefore, the amount the holder would receive on the Instruments at maturity is not fixed but variable, based on the market value of Company B stock on or around the Maturity Date.

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

Another important factor used in classifying instruments as debt is whether the holder of the instruments 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 characteristic of debt.

The Instruments here were issued under an Indenture between Company A and the Trustee. According to the provisions of the Indenture, if an event of default occurs (for example, if Company A fails to make payment of interest on the Instruments), the holders of the Instruments have certain creditor rights. For example, the holders of not less than h% in principal amount of the Instruments outstanding have the right to declare the principal amount of all Instruments to be due and payable immediately (which is referred to in the Indenture as a “declaration of acceleration”).

The Trustee may also declare the principal amount of all Instruments outstanding to be due and immediately payable in the event of default. The holders of not less than a majority of aggregate principal amount of all outstanding

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

Instruments have the right on behalf of the holders of all outstanding Instruments to waive certain defaults.

Although in form, the holders have remedies typical of bondholders, it is important to note that unlike bondholders, they do not have the right to enforce the payment of "principal and interest," as described under the Indenture. There is no fixed principal amount to be received under the Instruments, as discussed under factor (1), above, whether on the scheduled Maturity Date or on an accelerated date under the Indenture. Thus, this factor indicates that Instruments are something other than debt.

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

A characteristic of a debtor-creditor relationship is that the instruments are not subordinated to the claims of general creditors. The lack of subordination is a characteristic of debt. Instruments are not automatically denied debt status if they are subordinate to the claims of general creditors but rank ahead of the claims of the issuer's preferred and common stockholders. Moreover, debt status generally is not impaired if payments can be made on the instruments while senior claims are outstanding.

In this case, the Instruments are unsecured and unsubordinated obligations of Company A and rank equally and ratably with Company A's other indebtedness. Therefore the Instruments are not subordinate to the unsecured indebtedness of general creditors. The Instruments rank superior to the claims of holders of Company A's common stock. However, in contrast to a typical debt instrument, the holders of the Instruments are subject to a second set of credit risks: Company B's as well as Company A's. In effect, the rights of the holders of the Instruments are subordinated to all of Company B's creditors, and rank pari passu with the holders of Company B's common stock. A Company B bankruptcy would devastate the holders of the Instruments, without regard to the strength of Company A's credit standing.

(4) Do the Instruments give the holders the right to participate in the management of the issuer?

The holders of the Instruments do not have any voting rights. In certain situations (for example, in the event of default under the loan agreement) the Trustee or the holders of a majority in aggregate principal amount of the Instruments outstanding can direct the time, method, and place of conducting any remedy available to the Trustee with respect to the Instruments. In addition, certain

actions (for example, amendment of the loan agreement and certain other modifications to the Indenture) cannot be taken without the approval of the holders of a majority in principal amount of the Instruments outstanding. These rights provide the holders of the securities very limited rights to participate in (or affect) the management of Company A. Such limited rights are characteristic of debt.

(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 instruments were not debt. Consequently, the debt-equity ratio (or percentage of debt) is another factor used to determine whether instruments are debt. The debt-equity ratio (or percentage of debt) indicates to what extent a corporation may suffer losses without impairment of the interests of a corporation's creditors. A high ratio (or high percentage) lowers the protection afforded to the creditors against sudden business slumps. As a result, a high ratio of debt to equity (or high percentage of debt) indicates that the issuance of the instruments is a contribution to capital rather than a bona fide loan.

In this case, Company A was not thinly capitalized and its debt-equity ratios during the period the Instruments were issued appears to be i%, within the range of acceptable ratios. Although Company A is not thinly capitalized, we do not believe this fact 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 Company A'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 instruments are debt (a disproportionate relationship). This factor could be relevant if a particular holder owns both Company A'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. Therefore, this factor has neutral impact on this analysis.

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

In general, the issuance of instruments labeled bonds, debentures, or notes is indicative of debt. In this case, the titles of the Instruments, Exchange Note and Forward Contract, are indicative of both debt and non-debt. Thus, such labels are ambiguous. These descriptions would be meaningful to potential investors, for whom the degree of participation in Company B stock presumably was the most salient term. The Instruments do have some formal characteristics of debt, and Company A has treated the Exchange Note portions of the Instruments as debt for federal income tax purposes.

Under § 385(c), the issuer's characterization of instruments (as of the time of issuance) as debt is binding on the issuer and on all holders of the instrument. However, this characterization is not binding on the Service or on a holder that discloses that it is treating the instruments in a manner inconsistent with the issuer's characterization.

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

The intent of the parties regarding the treatment of the instruments as debt 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 instruments for non-tax purposes may be relevant.

It is clear that Company A treated the Exchange Note portion of these Instruments as debt for federal tax purposes. However, neither the Indenture nor the Prospectus clearly portrays how Company A treated these Instruments for non-tax purposes. Thus, we cannot determine whether this factor indicates debt.

Other factors

Other factors that may be relevant in classifying instruments as either debt or non-debt for federal income tax purposes include the following:

(1) Convertibility of the instruments into stock of the issuer (a non-debt characteristic). In this case, the Instruments are not convertible into the stock of the issuer. At maturity, the Instruments must be converted into Company B common stock, or equivalent cash value. The amount of Company B common stock receivable by the holders of the Instruments at maturity depends solely upon the market value of Company B common stock.

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

(3) Contingent payments (a non-debt characteristic). In this case, the amount payable at maturity is contingent 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. Because the Instruments are mandatorily convertible into Company B common stock, 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

While Company A has described the Instruments as indebtedness of the corporation, this characterization is not binding on the Service. Company A has an existing, unconditional, and legally enforceable obligation to exchange the Instruments at a fixed maturity date for Company B common stock. However, the amount Company A had to pay at maturity did not reflect a sum certain. The amount of stock each holder received at maturity did not depend on the principal amount of the Instruments held, rather it is contingent on the market value of Company B common stock. Thus, whether the holder of the Instruments was compensated at maturity and the amount of such compensation was subject to the risk of Company B's success.

The presence of a sum certain payable at maturity is a sine qua non of debt treatment under the Code. In Towne Square, Inc. v. Commissioner, the court stated, "[a] bona fide debt...is classically "an unqualified obligation to pay a sum certain..." [and that t]he certainty of the payment of principal and interest is one of the most important factors to be utilized in judging the true nature of advances." 45 T.C.M. 478 (1983), citing Gooding Amusement Company v. Commissioner, 23 T.C. 408, 418-19 (1954). Moreover, the court in Commissioner v. Page Oil Co., which found an instrument to be debt stated that "[t]he fact that ultimately [one] must be paid a definite sum at a fixed time marks his relationship to the corporation as that of creditor rather than shareholder." 129 F.2d 748, quoting Commissioner of Internal Revenue v. O.P.P. Holding Corp., 76 F.2d 11, 12, 35-1 U.S. Tax Cas. (CCH) P9179 (2nd Cir. 1935). See also Gilbert v. Commissioner, supra.

Notwithstanding the foregoing, it is clear that bona fide debt instruments may include contingent payments. See § 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 instruments include 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 contracted to pay for the use of borrowed money." Deputy v. DuPont, 308 U.S. 488, 498 (1939).

Company A has 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 the Instruments 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 § 263(g)?

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

Under § 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 § 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). §§ 1092(d)(3)(B)(i)(I)-(II).[3]

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 § 1092(d)(3)(B) exceptions is applicable.

(1) If the Instruments are treated as a collar

In Rev. Rul. 88-31, 1988-1 C.B. 302, the Service held that § 1092 applied to a taxpayer that held publicly traded stock and cash settlement contingent payment rights relating to that stock. 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 § 1234(c)(2). The contingent payment right also constituted an option for purposes of the stock straddle exception of § 1092(d)(3)(B)(i)(I).

Similarly, in the instant case, the Instruments may be analyzed as cash settlement collars, that is, a combination of put and call options.[4] If such an

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[3] 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. § 1092(d)(3)(B)(ii). This exception is not relevant to the instant case.

[4] In this view, the Instruments represent 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 the Instruments a share of Company B common stock per unit or cash equal to the market value of the Company B stock.

analysis is applied, the exception of § 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 § 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

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Thus, one could say that as holder of the put option embedded in each 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 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).

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 Instruments 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." § 1.446-3(c). NPCs 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 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 deliver in the future 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 § 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. § 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 § 1.246-5 (other than § 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. §§ 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.

(3) Are the Instruments and the Company B common stock part of a straddle subject to the capitalization rules of § 263(g)?

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 § 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). § 263(g)(2)(A)(ii).

There is no direct authority interpreting the term "carry" for the purposes of § 263(g).[5] However, the phrase "interest on indebtedness incurred or continued to purchase or carry" appears in § 265(a)(2) as well as § 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 § 265(a)(2). Among other things, Rev. Proc. 72-18 provides guidelines for the application of the "purchase or carry" phrase in § 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."

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[5] On January 18, 2001, the Service published proposed regulations under § 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 § 1.263(g)-5. Consequently, the proposed regulations will not be further discussed here.

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 § 263(g)(2)(A)(ii) by reference to § 265(a)(2) and Rev. Proc. 72-18 is subject to certain objections. To begin with, § 265(a)(2) denies deductions for interest, not "carrying charges." Therefore, turning to a revenue procedure that interprets § 265(a)(2) to aid in defining "carrying charges" is somewhat inapposite. Indeed, the mere fact that § 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 § 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 § 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. 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 § 263(g) than in § 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 § 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 § 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 infers a purpose to carry tax exempt obligations if a corporation continues indebtedness which it could discharge by

liquidating tax-exempt obligations. Similarly, we can infer such an intent upon Company A to carry Company B stock.

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 its 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

As an initial matter, we note that, although the issue cannot be considered free of doubt, the Service has substantial arguments that support the conclusion that the quarterly payments on the Instruments are not immediately deductible. Issues remain with respect to (i) those particular factors from § 385(b) and Notice 94-47 which signify debt and (ii) bifurcation of the Instruments into debt and equity components. For example, the Instruments provide for non-contingent payments of e% of the principal amount per annum. The taxpayer may assert that the Instruments should be bifurcated into component parts, with some part or all of the non-contingent payments being treated as separate debt instruments. It is not the Service's usual policy to bifurcate instruments, but we do recognize that bifurcation is a possibility and certain courts have bifurcated instruments into component parts. However, the conclusion in this case is that such Instruments do not constitute debt.

Therefore, we request that this Office be kept informed of the current status of this case.

As noted above, the Instruments could be treated as 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).[6]

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.[7] § 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. § 263(g)(2)(A)(ii).

However, Company A may argue that the OID should not be capitalized under § 263(g).

The options treated as embedded in the Instruments and the Company B common stock are a straddle as per § 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. §§ 1092(c)(1)-(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 § 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 § 263(g), the interest payments that would be capitalized under § 263(g) were not incurred on a risk-reducing instrument but rather on a borrowing

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[6] In general, the amount of OID on a debt instrument is equal to Stated Redemption Price (SRPM) minus issue price. § 1.1273-1(a). 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 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.

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

the proceeds of which were used to purchase a leg of a straddle.[8] 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 Instruments) 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 § 263(g).

(2) Treating each Instruments 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 § 263(g). Noncontingent payments on the Instruments would be deductible to the extent otherwise permitted by applicable law. See, e.g., § 1.446-3(f)(2)(i).

As developed above, common stock is not personal property that can be a leg of a straddle. § 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

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[8] 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.

regulation. § 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 B common stock. § 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 § 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 § 1.246-5 (other than § 1.246-5(b)(3)), § 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. § 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 § 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 § 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 adoption of 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.[9] 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 § 263(g)?

As developed above, the crucial question in determining the applicability of § 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]." § 263(g)(2)(A)(ii). Arguably, the scope of the term "carry" may be determined by

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

reference to Rev. Proc. 72-18. Rev. Proc. 72-18 cites Wisconsin Cheeseman v. U.S. 338 F2d 420, at 422 (1968) as authority for the proposition that a purpose to 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, 4.02 of Rev. Proc. 72-18 (§ 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.

Sincerely yours,
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