

ments) and priority distributions that equal a fixed percentage of the unreturned capital (Prioritized Payments). Redemption Payments have to be made by the final due date, which in most cases, is approximately 10 years from the day the participating security is issued. Before the final due date, a SBIC may make Redemption Payments at its discretion, or may be required to make Redemption Payments for reasons such as its insolvency. Prioritized Payments are scheduled to be made at least annually, but are due only to the extent that the SBIC has sufficient profits. Any scheduled amount that goes unpaid accumulates. Every participating security also entitles the SBA to receive a portion of the SBIC's remaining profits (Profit Participation Payments) and gives the SBA the right to bar any changes affecting its interests.

Once every quarter, the SBA acquires new participating securities and assembles them into a pool to be securitized. Every security in a newly formed pool has the same final due date for making Redemption Payments and uses the same percentage for calculating Prioritized Payments. The percentage used to calculate the Prioritized Payments is established with reference to current interest rates.

To securitize a pool, the SBA assigns the Redemption Payments and Prioritized Payments to a group of underwriters and simultaneously enters into a guarantee relating to the assigned payments (the Payment Guarantee). All rights in the participating securities, other than the Redemption Payments and Prioritized Payments, are retained by the SBA, and the SBA has no duty to exercise them for anyone else's benefit. The underwriters transfer the assigned payments and the Payment Guarantee to a trust. In exchange, the underwriters receive a single class of marketable trust certificates that in form evidence beneficial ownership of the transferred assets. Proceeds from the underwriters' sale of the trust certificates are paid to the SBICs whose participating securities make up the pool.

Under the Payment Guarantee, the SBA must disburse quarterly the amount by which (1) the Prioritized Payments made by the SBICs and available to the trust fall short of (2) the Prioritized Payments that would be due if Prioritized Payments had to be made regardless of financial condition and were paid

in quarterly installments rather than annually. 15 U.S.C. § 683(g) (1994). Thus, if a SBIC's profits are so low that the SBIC has no obligation to make a Prioritized Payment, the SBA nevertheless has to pay, in quarterly installments, the amount that would be owed if the SBIC's profits were unlimited. Making a payment in this case does not entitle the SBA to seek immediate restitution from the SBIC. Instead, the SBA has to recover the payment from whatever future Prioritized Payments the SBIC may generate.

The Payment Guarantee also obligates the SBA to pay any shortfall in a pool's Redemption Payments. The SBA, therefore, has to make up any Redemption Payment that a SBIC fails to pay on the final due date or cannot pay when forced to redeem a participating security (for instance, in the case of insolvency or commencement of receivership proceedings). Under these circumstances, the right to receive the Redemption Payment from the SBIC is released by the trust in favor of the SBA.

By the terms of the Payment Guarantee, the obligations of the SBA are unconditional and must be performed despite any legal or equitable defense. Each time a new pool is created, the SBA will reasonably expect to disburse and not recover, during the pool's first three years, an amount exceeding 15 percent of the Prioritized Payments that would be due on the participating securities in the pool if Prioritized Payments had to be made regardless of financial condition and were paid in quarterly installments rather than annually. The Payment Guarantee cannot be transferred separately from the rights to the Redemption Payments and Prioritized Payments.

The trust that holds the Payment Guarantee and the rights to the Redemption Payments and Prioritized Payments is authorized by statute, 15 U.S.C. § 687(l)(a) (1994), and governed by an agreement among the SBA, the SBA's fiscal agent, and an independent trustee. These parties may amend the agreement without the consent of the certificate holders, provided the amendment does not adversely affect payments on the certificates.

In form, each trust certificate represents a fractional undivided ownership interest in the transferred assets. The SBA guarantees (the Passthrough Guarantee) that the certificate holders will

Section 61.—Gross Income Defined

26 C.F.R. 1.61-1: *Gross Income*. (Also §§ 851, 856, 895, 7701; 1.851-2, 1.856-2, 1.895-1, 301.7701-13A.)

SBA guaranteed payment rights; participating securities. The Small Business Administration (SBA) is the primary obligor of the guaranteed payment rights that are created under its participating security program and investors in those rights are treated as owning SBA debt.

Rev. Rul. 97-3

ISSUE

For federal tax purposes, is the Small Business Administration (SBA) the primary obligor of certain guaranteed payment rights that are created under its participating security program?

FACTS

The SBA is an independent agency of the United States. Its activities include regulating and providing financial assistance to small business investment companies (SBICs), which furnish venture capital to small business concerns. One way SBICs raise money for investment is by issuing participating securities to the SBA. See 15 U.S.C. §§ 683 and 687(l) (1994). Participating securities may take the form of preferred stock, preferred limited partnership interests, or similar instruments. 15 U.S.C. § 683(g) (1994).

Regardless of their form, or the rights they may provide under state and local law, all participating securities share the following characteristics. Every participating security entitles the SBA to both a return of capital (Redemption Pay-

receive timely an amount equal to their proportionate share of all amounts received by the trust. 15 U.S.C. § 6871(b) (1994). The Passthrough Guarantee is enforceable regardless of the defenses available to the SBICs or the trustee. Although the certificate holders can enforce the Passthrough Guarantee, they cannot enforce any obligation of the SBICs. Specifically, the certificate holders have no right to enforce the Prioritized Payments or Redemption Payments, and the underlying SBICs owe no duty to the certificate holders.

The trustee has no duty or authority to enforce collection of the trust assets other than the Payment Guarantee. Instead, the SBA services (at its expense) the Redemption Payments and Prioritized Payments and has the sole right to take action and assert claims with respect to the Redemption Payments and Prioritized Payments. As servicer, the SBA can waive or agree to amend any term of any participating security; those modifications, however, cannot decrease or defer the aggregate payments to the trust. No federal or state law may limit the exercise by the SBA of its ownership rights in the participating securities. 15 U.S.C. § 6871(e)(2) (1994).

Because the SBA forms a new pool of participating securities each quarter, several pools may exist at any time. The SBA has the right (but not the obligation) to replace Redemption Payments and Prioritized Payments due on one pool with Redemption Payments and Prioritized Payments due on another. Specifically, if the SBA believes a participating security in a pool is about to make a Redemption Payment, the SBA can exchange the rights to all or part of that Redemption Payment (and related Prioritized Payments) for the rights to all or part of the Redemption Payments and Prioritized Payments due on participating securities in other pools.

The SBA can exercise the right of substitution at any time provided three conditions are met. These conditions ensure an adequate match between the payments relinquished on a redeeming security and the payments to be received in exchange from any “replacement” securities. First, the sum of the Redemption Payments to be received with respect to the replacement securities must equal the amount of the Redemption Payment relinquished with respect to the redeeming security. Second, the final due date for each replacement security must be no later than the final due date for the redeeming security. Third, the percentage

used for calculating the Prioritized Payments on each replacement security must be no less than the percentage used for calculating the Prioritized Payments on the redeeming security.

There are common situations in which the SBA can benefit from using the substitution power. For example, if a pool holds a 6 percent security that is about to be redeemed, the SBA can replace it with an 8 percent security from an older pool. Certificate holders in the older pool, after receiving the Redemption Payment from the 6 percent security, will no longer be entitled to Prioritized Payments on the redeemed amount. Certificate holders in the 6 percent pool will receive Prioritized Payments from the 8 percent security, but only at a 6 percent rate. Consequently, the exchange will advance the termination of the older, higher interest rate pool, and allow the SBA to retain the extra 2 percent of Prioritized Payments that are not required to service the 6 percent pool.

LAW

The economic substance of a transaction generally governs its federal tax consequences. *Gregory v. Helvering*, 293 U.S. 465 (1935), XIV-1 C.B. 193. Affixing a label to an undertaking (for example, referring to an arrangement as a “guarantee”) does not alone decide its character. *Sun Oil Co. v. Commissioner*, 562 F. 2d 258, 263 (3d Cir. 1977); *Oesterreich v. Commissioner*, 226 F. 2d 798, 801-02 (9th Cir. 1955); *Boulez v. Commissioner*, 83 T.C. 584, 591 (1984); see also *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958), 1958-1 C.B. 516.

A guarantee of an instrument is a secondary and collateral promise to pay the amounts due under the instrument in the event the primary obligor (ordinarily the issuer) defaults. *Zappo v. Commissioner*, 81 T.C. 87-88 (1983); *Perry v. Commissioner*, 47 T.C. 159, 163 (1966). The Commissioner may recharacterize any transaction that has the preceding attributes in appearance but not in substance. See *Estate of Durkin v. Commissioner*, 99 T.C. 561, 571 (1992). How the transaction may be recharacterized depends on the facts, including the terms of the “guarantee” and any related agreements and the circumstances existing at the time the “guarantee” is made.

For example, at the time a taxpayer “guarantees” an instrument, the finances of the issuer may be so precarious that

the taxpayer (rather than the issuer) is expected to pay the instrument. Under such facts, the taxpayer may be, in substance, accepting primary (rather than secondary) responsibility for the instrument. *Lang v. Commissioner*, 32 B.T.A. 522 (1935); see Rev. Rul. 94-42, 1994-2 C.B. 15. As another example, under the terms of a “guarantee” and any related agreements, a taxpayer may have to pay regardless of any default on the “guaranteed” instrument and may enjoy beneficial ownership of the instrument. Beneficial ownership may be evidenced by, among other things, a power in the taxpayer to replace the instrument or to exercise for its own advantage any privileges inherent in the instrument. See *Schoellkopf v. Commissioner*, 32 B.T.A. 88 (1935); cf. Rev. Rul. 77-137, 1977-1 C.B. 178. Under such facts, the taxpayer may be, in substance, issuing its own primary obligation and using the “guaranteed” instrument to secure that obligation. Rev. Rul. 78-118, 1978-1 C.B. 219; see *Schoellkopf v. Commissioner*. Different facts may support other characterizations. No single fact is conclusive, and all aspects of a transaction must be considered to determine its substance.

ANALYSIS

The trust holds a group of inseparable rights consisting of the rights to the Redemption Payments, the Prioritized Payments, and the amounts paid under the Payment Guarantee. Based on all of the facts and circumstances, this group of rights (the Guaranteed Payment Rights) constitutes, in substance, a primary obligation of the SBA. It does not represent an ownership interest in SBIC securities backed by an SBA guarantee. Among the reasons for this conclusion are not only the differences between the payment obligations of the SBA and the payment obligations of the SBICs but also the continuing interest of the SBA in the participating securities.

The payment obligations of the SBA and the SBICs differ in that the SBA has to make payments even if the SBICs are not in default. A SBIC has to make a Prioritized Payment only if it has sufficient profits, but the SBA must disburse an amount equivalent to that Prioritized Payment in all events. Also, a SBIC has to make Prioritized Payments only on an annual basis, but the SBA must make payments quarterly. These differences are more than a matter of form. Each time a new pool is

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created, the SBA will reasonably expect to disburse and not recover, during the pool's first three years, an amount exceeding 15 percent of the Prioritized Payments that would be due on the participating securities in the pool if Prioritized Payments had to be made regardless of financial condition and were paid in quarterly installments rather than annually.

The principal author of this revenue ruling is Kenneth Christman of the Office of Assistant Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling contact Mr. Christman on (202) 622-3950 (not a toll-free call).

In addition, the SBA retains beneficial ownership of the participating securities. Although, in form, the rights to the Redemption Payments and Prioritized Payments are transferred to the trust, neither the trust nor the certificate holders enjoy any rights of beneficial ownership in the participating securities. No federal or state law can limit the exercise of the SBA's ownership rights in the participating securities, and the SBA makes no promise to exercise these rights for the trust's benefit. 15 U.S.C. § 687l(e)(2) (1994). The SBA never transfers its interests in the Profit Participation Payments and continues to service (at its expense) the Redemption Payments and Prioritized Payments. Moreover, neither the trustee nor the certificate holders can force the SBICs to make these payments. The SBA enjoys a right to replace Redemption Payments and Prioritized Payments due on one pool with Redemption Payments and Prioritized Payments due on another. This right allows the SBA to exercise control over a participating security for its own rather than the certificate holders' benefit. It also demonstrates that a certificate does not represent an interest in any identifiable participating security.

HOLDING

For federal tax purposes, the SBA is the primary obligor of the Guaranteed Payment Rights created under its participating security program, and the trust certificate holders are treated as owning indebtedness of the SBA.

This revenue ruling is predicated on the law governing the SBA participating security program as of December 24, 1996. Therefore, before relying on this revenue ruling, taxpayers, Service personnel, and others are cautioned to determine whether the law referred to has materially changed since that date. See § 7.01(6), Rev. Proc. 89-14, 1989-1 C.B. 814.