OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE) CC:DOM:FS

SUBJECT: Financial Instrument Characterization

This Field Service Advice responds to your memorandum dated March 5, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =
Company A =
Instrument =

DATE 1 =
DATE 2 =
DATE 3 =
DATE 4 =
DATE 5 =
DATE 6 =
DATE 7 =

DATE 8 =
DATE 9 =
DATE 10 =
DATE 10 =

a =
b =
c =
d =
e =
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o =
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ISSUE:

What is the proper characterization of the Instruments for federal income tax purposes?

CONCLUSION:

We conclude that, by issuing the Instruments, the taxpayer has entered into a straddle. The Instruments are cash settlement collars. The Instruments do not represent indebtedness of the taxpayer.

FACTS:

The taxpayer purchased a shares of Company A stock, representing a b% ownership interest in Company A, in a private placement in DATE 1. The taxpayer purchased the stock for $k per share. The taxpayer was required by securities law to hold the Company A stock for at least c years. The taxpayer is not affiliated with Company A.

The Company A stock split in DATE 10, and converted the taxpayer=s holdings to e shares. The value of the Company A stock increased to more than $f per share.

On DATE 2, the taxpayer issued d Instruments to the public. Proceeds from the issuance of the Instruments totaled approximately $j. The taxpayer stated that it would use the proceeds for general corporate purposes.

The Instruments were issued at $g per share, and provided for Ainterest@[1] at an annual rate of h%, or $i. Interest is payable quarterly in arrears on DATE 7, DATE 8, DATE 9 and DATE 10 of each year beginning on DATE 3.

When the Instruments mature on DATE 5, the holders of the Instruments will be entitled to receive an amount in cash equal to the market value of the reference property, that is, initially one share of the Company A common stock, as of the second business day prior to the maturity date. Thus, an investment in the Instruments may result in a loss to an investor if the market value of the Company A stock is less than the issue price of the Instruments.

The Instruments are redeemable by the taxpayer at any time after DATE 4. If the Instruments are redeemed by the taxpayer prior to maturity, the taxpayer may redeem all or a part of the outstanding Instruments for cash in an amount equal to the product of the redemption ratio and the market price of one share of Company A stock plus an amount equal to all unpaid Ainterest,@ whether or not accrued, payable on the Instruments through the maturity date. The redemption ratio is equal to n.

The Instruments are subject to mandatory redemption, in whole but not in part, on any delisting day. The delisting day is the first day on which the Company A common stock is not listed on any national securities exchange or system or is permanently suspended from trading. If fewer than all of the outstanding Instruments are called for redemption, the Instruments to be called will be selected by a Trustee from the outstanding Instruments by lot, pro rata or by any other method determined by the Trustee to be equitable. The holders of the Instruments have no right to require early redemption.

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[1] For convenience only, we use the word interest to refer to the stream of payments made on the Instruments.

The taxpayer stated its intention to hold the Company A stock until the maturity date or redemption date of the Instruments, and to sell the shares during the ten trading days ending on the second business day prior to the maturity date or the redemption date. Although the redemption price of the Instruments at maturity is linked to the price of the Company A stock, the taxpayer is not obligated to either hold the Company A stock for any period or to sell the Company A stock prior to either the maturity date or the redemption date.

The taxpayer treated the Instruments as indebtedness for federal income tax purposes, although it acknowledged that the proposed Treasury regulations concerning the tax treatment of contingent debt instruments under the original issue discount regime could apply to the Instruments but for the effective date of the regulations. The taxpayer acknowledged that, for federal income tax purposes, there are no statutory, judicial, or administrative authorities that directly address the characterization of the Instruments.

The Instruments were issued under the provisions of an indenture between the taxpayer and a Trustee. The Instruments are unsecured and unsubordinated obligations of the taxpayer and rank equally and ratably with all unsecured and unsubordinated debt of the taxpayer.

An "Event of Default" is defined under the indenture for the Instruments as being any one of the events in <u>o</u>.

If an Event of Default has occurred and continues, either the Trustee or the holders of not less than 25% in Aprincipal@ amount of the Instruments outstanding under the indenture for Instruments may declare the Aprincipal@ amount of all Instruments under that indenture to be due and payable immediately.

The holders of not less than a majority in aggregate Aprincipal@ amount of all outstanding Instruments will have the right on behalf of the holders of all outstanding Instruments to waive certain defaults and to direct the time, method and place of conducting any remedy available to the Trustee or exercise any trust or power conferred on the Trustee with respect to the Instruments.

<u>LAW AND ANALYSIS:</u>

1. <u>Are the Instruments properly characterized as debt?</u>

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

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

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

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

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

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

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

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

In this case, the taxpayer has an unconditional obligation to pay to each holder of an Instrument on the maturity date an amount of cash equal to the market value of Company A common stock. The Instruments will mature on DATE 5 (subject to extension upon the occurrence of non-trading days) but in no event later than DATE 6. 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 common stock of Company A.

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**C**an existing, unconditional and legally enforceable obligation to pay a sum certain at a fixed maturity date. If there is no promise to pay a principal amount, there is no indebtedness on which interest can be paid. Johnson v. Commissioner, 108 F.2d 104 (8th Cir. 1939).[3]

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

Another important factor used in classifying an instrument as either debt or equity is whether the holder of the instrument has the right to enforce the payment of principal and

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payment of interest only out of Adividend@ money; and (11) the ability of the corporation to obtain loans from outside lending institutions. O.H. Kruse Grain & Milling v. Commissioner, 279 F.2d 123 (9th Cir. 1960).

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

interest. A fixed right to enforce the payment of principal and interest by the holder is a debt characteristic, and the absence of this right is an equity characteristic.

The Instruments were issued under an indenture between the taxpayer and a Trustee. Under the provisions of the indenture, if an Event of Default occurs (for example, a default in the payment of interest on the loan), the holders of the Instruments have certain creditor rights. For example, the holders of not less than 25% in principal amount of the Instruments outstanding have the right to declare the principal amount of all Instruments to be due and payable immediately.

Under the terms of the indenture, 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 in aggregate principal amount of all outstanding Instruments will have the right on behalf of the holders of all outstanding Instruments to waive certain defaults and to direct the time, method and place of conducting any remedy available to the Trustee.

Although in form, the holders have remedies typical of bondholders, it is important to note that, as discussed above, unlike bondholders, they do not have the right to get their money back at maturity (whether on the scheduled maturity date or an accelerated date under the indenture).

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

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

In this case, the Instruments are unsecured and unsubordinated obligations of the taxpayer and rank equally and ratably with all other unsecured and unsubordinated debt of the taxpayer. The Instruments do not constitute Senior Indebtedness. In general, Senior Indebtedness does not include the indebtedness of unsecured general creditors, including trade creditors.[4] Therefore the Instruments are not subordinate to the unsecured

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

indebtedness of general creditors, including trade creditors. The Instruments rank superior to the claims of holders of the taxpayer's common stock.

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

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

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

The holders of the Instruments do not have any voting rights. In certain situations (for example, an Event of Default under the loan agreement), 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 or can exercise any trust or power conferred on 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 the taxpayer.

(5) Is the issuer thinly capitalized?

In general, if a corporation has a nominal stock capitalization coupled with excessive debt, this fact would tend to indicate that an instrument labeled debt might constitute equity. As a result, the debt/equity ratio is another factor used to determine whether an instrument is debt or equity. The debt/equity ratio indicates to what extent a corporation may suffer losses without impairment of the interests of the corporation's creditors. A high ratio lowers the protection afforded to the creditors against sudden business slumps. As a result, a high ratio of debt to equity indicates that the issuance of the instrument is a contribution to capital rather than a bona fide loan.

In this case, the taxpayer is not thinly capitalized. In general, for the period during which the Instruments were issued, the taxpayer's debt/equity ratio appears to range from approximately l to m, which are acceptable ratios.

Although the taxpayer 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 A=s stock. From the investors= standpoint, they are at the risk of Company A=s business and of the taxpayer=s venture in holding that stock, no matter how well the taxpayer is capitalized.

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

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

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

In general, the issuance of a stock certificate indicates an equity interest while the issuance of an instrument labeled a bond, debenture, or note is indicative of debt. The taxpayer labeled the Instruments with a description which includes the terms t and u, both of which are indicative of t and v, which is ambiguous in that it is descriptive of either. These descriptions would be meaningful to potential investors, for whom the degree of participation in Company A stock presumably was the most salient term. The Instruments do have some formal characteristics of debt, and the taxpayer has treated the Instruments as debt for federal income tax purposes. Moreover, the taxpayer has described the Instruments as debt in filings with the Securities and Exchange Commission and other government agencies.

Under section 385(c), the issuer's characterization of an instrument (as of the time of issuance) as either debt or equity 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 instrument in a manner inconsistent with the issuer's characterization.

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

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

For financial purposes, the Instruments are recorded on the taxpayer's consolidated financial statements as an unsecured and unsubordinated obligation of the Company. In a discussion of the capitalization of the taxpayer, Standard & Poor=s rating agency lists the Instruments as a component of long-term debt but describes the instruments under a heading entitled AStock Data.@

<u>Other factors</u>

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

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

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

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

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

(5) Failure of the debtor to repay on the due date or to seek a postponement (an equity characteristic). Under the terms of the Instruments, interest accrues until the maturity date.

<u>Summary</u>

While the taxpayer has described the Instruments as indebtedness of the corporation, this characterization is not binding on the Service. The taxpayer has an existing, unconditional, and legally enforceable obligation to pay the Instruments holders at a fixed maturity date a cash amount equal to the market value of Company A common stock at or around that time. Consequently, the amount payable at maturity does not represent a sum certain.

The presence of a sum certain payable at maturity is a sine qua non of debt treatment under the Code. 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 issued by the taxpayer part of a straddle subject to the capitalization rules of section 263(g)?

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

Section 1092(d)(1) defines personal property as any personal property of a type which is actively traded. Section 1092(d)(3)(A) sets forth the general rule that stock is excluded from the definition of personal property. Under section 1092(d)(3)(B) the general rule excluding stock from the definition of personal property does not apply in three situations. The first two exceptions apply to any stock that is part of a straddle in which at least one of the offsetting positions is (1) an option with respect to that stock or substantially similar stock or securities; or (2) as provided in regulations, a position with respect to substantially similar or related property (other than stock). '' 1092(d)(3)(B)(i)(I) and 1092(d)(3)(B)(i)(II).[5] The third exception states 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).

[5] Under Treas. Reg. ' 1.1092(d)-2(a), the term substantially similar or related property is defined in Treas. Reg. ' 1.246-5. Treas. Reg. ' 1.246-5(b)(1) states that, in general, property is substantially similar or related to stock when the fair market value of the stock and the property primarily reflect the performance of a single firm or enterprise. Treas. Reg. ' 1.1092(d)-2(b)(1) provides that this section applies to positions established on or after March 17, 1995.

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

In Rev. Rul. 88-31, 1988-1 C.B. 302, the Service concluded that a taxpayer that held publicly traded stock and cash settlement contingent payment rights relating to that stock was subject to the rules of section 1092. A corporation had issued investment units, consisting of one common share and a separately tradeable contingent payment right, the value of which varied inversely with the market value of the underlying common stock. The contingent payment would be made to the holder two years after the date of issue of the right.

The Service concluded that the contingent payment right was a property right separate from the common stock. It next determined that the right was a cash settlement put option under section 1234(c)(2). The contingent payment right also constituted an option for purposes of the stock straddle exception of section 1092(d)(3)(B)(I). Because the right served to substantially diminish the risk of loss from a decline in value of the underlying common stock, the Service ruled that a taxpayer who held both the contingent payment right and the stock held a straddle subject to section 1092.

In this case, the Instruments are cash settlement collars, that is, a combination of put and call options.[6] The taxpayer has a long position in Company A common stock and a short

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[6] In essence, each Instruments represents a combination of options on Company A common stock. Each Instruments is a collar in which the taxpayer has purchased a put option and has written a call option that will be exercised at different strike prices. The strike prices are given by g.

The holder of the put option has the right to sell Company A stock at the strike price. If the market value of Company A stock is less than the strike price, the put option is Ain the money.@ The holder of the put option will want to sell Company A stock at the higher strike price. If the market price of Company A stock is less than $g, the taxpayer will want to redeem the Instruments. Redeeming the Instruments amounts to giving the holder of the Instruments an amount of cash which is equal to the market value of the Company A stock. Were it not for the fact that this is a cash settled option, this strategy is equivalent to the taxpayer delivering a share of Company A stock to an investor. If the taxpayer is doing this, then it is exercising an option to put the stock. Hence, when the market price is less than the strike price (as given by the formula above), the put is Ain the money@ and the put option will be exercised.

The holder of the call option has the right to buy Company A stock at the strike price. If the market price of Company A stock is greater than the strike price, the call option is in the position in the Instruments. The economic cost of a decline in the market value of the Company A stock held by the taxpayer is eliminated through the exercise of the put option. The taxpayer=s risk of loss from having written a call option is reduced by the mechanics of the formula for the strike price: the taxpayer retains p% of the appreciated value of Company A stock above w. Consequently, under section 1092(c), the short position in the Instruments is an offsetting position that substantially diminishes the risk of loss from holding the long position in the Company A common stock since the terms of the Instruments shift all the downside risk to the Instruments= holder.[7] The section 1092(d)(3)(B)(i)(I) exception applies to Company A stock. Thus, by issuing the Instruments, the taxpayer has entered into a straddle and is subject to the rules of section 1092.

Section 263(g)(1) states that no deduction shall be allowed for interest and carrying charges properly allocable to personal property which is part of a straddle as defined in section 1092(c). Section 263(g)(2)(A) provides that the term "interest" refers to interest on indebtedness incurred or continued to purchase or carry the personal property. The flush language of section 263(g)(2) provides that for purposes of subparagraph A, the term Ainterest@ includes any amount paid or incurred in connection with property used in a short sale.

There is no direct authority interpreting the phrase Aindebtedness incurred or continued to purchase or carry@ in section 263(g). However, the phrase also occurs in section 265(a)(2) as well as several other Code sections. 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, provides an interpretation for the Apurchase or carry@ test. However, section 265(a)(2) is not necessarily controlling for purposes of section 263(g).

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money and will be exercised. If the market value of Company A stock is above $r, the call option will be exercised and holders of the Instruments will receive s percent of the market price. In essence, they will receive s percent of a share of Company A stock.

[7] Treas. Reg. ' 1.1092(b)-2T(a)(1) provides that the holding period of any position that is part of a straddle shall not begin earlier than the date the taxpayer no longer holds an offsetting position with respect to that position. Treas. Reg. ' 1.1092(b)-2T(a)(2) provides that paragraph (a)(1) shall not apply to a position held by a taxpayer for the long-term capital gain holding period (or longer) before a straddle that includes that position is established. In this case, the taxpayer acquired the Company A shares on DATE 1, and issued the Instruments in DATE 2. Under Treas. Reg. ' 1.1092(b)-2T(a)(1), any gain or loss with respect to either the Company A common stock or the Instruments would not be treated as long-term capital gain or loss.

The h% coupon payments on the Instruments are not interest on indebtedness. However, if the payments are treated by a court as either interest on indebtedness or as some type of carrying charge that is (before consideration of section 263(g)) deductible under some section of the Code other than section 163, it would be necessary to determine whether these payments are amounts paid or incurred to carry personal property that is a position in a straddle. If so, such payments must be capitalized under section 263(g).

In this case, the taxpayer has stated that it used the proceeds of the Instruments for "general corporate purposes," and not to purchase or carry the long position in the Company A stock. However, the coupon payments on the Instruments carry the offsetting short position because they represent the cost of inducing investors to take that position. An investor who holds Instruments has all the downside risk inherent in the Company A common stock and receives less than the full amount of appreciation in the value of the stock. The investor is compensated by coupon payments of h% of the face value of the Instruments. As a result, the coupon payments of h% represent the costs of carrying the straddle for purposes of section 263(g).

Section 263(g)(3) states that section 263(g) shall not apply in the case of any hedging transaction as defined in section 1256(e). Section 1256(e) defines a hedging transaction as any transaction entered into by the taxpayer in the normal course of the taxpayer=s business primarily to reduce the risk of price changes or currency fluctuations with respect to property which is held by the taxpayer. The gain or loss on such transactions must be treated as ordinary gain or loss, and the taxpayer must clearly identify the transaction as being a hedging transaction.
' 1256(e)(2)(A)(i), (B), and (C).

The taxpayer represents that its obligations under the Instruments are hedged by its investment in e shares of Company A common stock. The Company A common stock is a capital asset held by the taxpayer. The taxpayer is not obligated to hold the Company A common stock for any period or to sell the Company A common stock prior to the redemption date or maturity date of the Instruments. Consequently, the issuance of the Instruments does not amount to a hedging transaction under section 1256(e).

The deduction taken by the taxpayer for the coupon payments accruing on the Instruments should be disallowed under section 263(g). The coupon payments of h% are not deductible under section 163(a) because the payments do not represent interest on indebtedness of the taxpayer. An alternative argument for challenging the deductibility of the coupon payments is to be found in section 263(g) requiring capitalization of interest and carrying costs allocable to personal property which is part of a straddle. There is no direct authority for the application of section 263(g) to carrying costs of the type represented by the h% coupon payments.

3. Did the issuance of the Instruments result in a Sale or Disposition of Company A stock?

Under section 1001, if there has been a sale or other disposition of property and the taxpayer=s basis in the property is less than the amount realized, then the entire amount of gain or loss is to be recognized unless subtitle A provides otherwise.
'' 1001(a), and 1001(c). Treas. Reg. ' 1.1001-1(a) provides that a conversion or exchange of property must take place before a gain or loss is sustained. Furthermore, a material change in the taxpayer=s property is necessary before a realization of gain or loss occurs. Treas. Reg. ' 1.1001-1(a). Treas. Reg.
' 1.1002-1(d) provides that in order to constitute an exchange, the transaction must involve a reciprocal transfer of property, as distinguished from a transfer of property for monetary consideration only.

In the instant case, the taxpayer sold the Instruments to investors for $g per Instrument. The taxpayer has retained legal title to the Company A common stock. The Instruments holders will receive cash payments upon either redemption or maturity of the Instruments, but will not receive stock in Company A. Holders of the Instruments do not have the right to receive dividends declared on the Company A stock nor do they possess any voting or option rights with respect to the Company A common stock. The taxpayer has retained all the benefits associated with ownership of Company A stock. The taxpayer is not required to hold the Company A common stock until the maturity or redemption date of the Instruments. Instead, under the terms of the Instruments, the taxpayer may consider all relevant economic and market factors in determining whether to hold the Company A common stock until maturity or redemption of the Instruments.

Because the taxpayer has retained ownership of the Company A common stock and has transferred the Instruments to investors for monetary consideration only, no sale or exchange under section 1001(a) occurred. The issuance of the Instruments did not result in a sale or other disposition of the Company A common stock held by the taxpayer. Consequently, the taxpayer realized no gain upon issuance of the Instruments.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Although we have concluded the Instruments are not debt, we recognize our determination could present litigating hazards. The taxpayer, as an alternative argument, may assert that the Instruments should be bifurcated into component parts, with the h% coupon being treated as a separate debt instrument. Should this issue be raised, our section 1092 analysis likely would change. We will be pleased to provide additional advice on the bifurcation issue if the need arises.

Our position that the taxpayer may not deduct its coupon payments to the Instrument holders pursuant to section 263(g) likewise presents a litigating hazard. Section 263(g)(2)(A)(ii) defines carrying charges as Aall other amounts (including charges to insure, store, or transport the personal property) paid or incurred to carry the personal property.@ One reasonable reading of this statute is to stress the word Aall@ resulting in the inclusion of the coupon payments in the definition of carrying charges. The taxpayer, however, may argue for a narrow reading of section 263(g), limiting carrying charges to charges similar to those described by the parenthetical language in section 263(g)(2)(A)(ii). If a narrow statutory interpretation were accepted by a court, the coupon payments of h% would be excluded from the definition of Acarrying charges.@

Please call if you have any further questions.

By: ____________________________

CAROL P. NACHMAN
Special Counsel
Financial Institutions and Products Branch
Field Service Division

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