



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

OFFICE OF
CHIEF COUNSEL

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MEMORANDUM FOR Rodney J. Bartlett, Acting District Counsel
CC:SER:IDD:IND

FROM: Deborah A. Butler, Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT: New Financial Instrument

ISSUE:

What is the proper characterization of a new financial instrument?

LEGEND:

INSTRUMENT A =
COMPANY A =
DATE 1 =
x =
y =
z =

FACTS:

This memorandum addresses the tax treatment of a new financial instrument, INSTRUMENT A, which COMPANY A issued to the public.

INSTRUMENT A was pegged to the value of stock of an unrelated company. INSTRUMENT A, upon maturity or redemption, could be settled either in cash or in the stock of the unrelated company. Holders of INSTRUMENT A would receive quarterly "interest" payments at a rate of x% annually.

DISCUSSION:

We coordinated our response with National Office divisions having subject matter jurisdiction over the issues. The following sets forth the discussions that ensued during a telephone conversation between the field attorney, the examining agent, and National Office attorneys.

The National Office attorneys are especially interested in the bifurcation issue inherent in this transaction and believe the field should request Field Service Advice on this issue. Under the bifurcation theory, INSTRUMENT A could be divided into component parts, with the $y\%$ coupon being treated as a separate debt instrument. The authority for bifurcating the instrument is Farley Realty Corp. v. Commissioner, 279 F.2d 701 (2d Cir. 1960). We also discussed the substance-over-form line of cases. [REDACTED]

[REDACTED]

The National Office attorneys also noted that a debt/equity analysis does not apply here. In order to deny the interest deduction, we need not determine that the instrument is equity; thus, references to equity in the Form 886-A are not necessary.

We also discussed our belief that there may be a dividends received deduction ("DRD") issue here. We suggested that sections 246(c)(1) and 246(c)(4)(A) and (B) might be applicable. With respect to section 246(c)(1), we mentioned Duke Energy Corp. v. United States, No. 3:97-CV-40-MU (W.D.N.C. Jan. 15, 1999). Insofar as section 246(c)(4), there are not enough facts to determine whether this is an issue. Nevertheless, it should be explored. Examination had not raised the DRD issue because COMPANY A has held the stock for so many years that the lengthy holding period could preclude denial of the DRD on that basis alone.

Application of the straddle rules was mentioned without an in-depth discussion because the Revenue Agent's Report on this issue was previously forwarded to COMPANY A.

It was agreed that Examination should proceed based upon the following:

1. [REDACTED]
2. [REDACTED]

3. [REDACTED]

4. [REDACTED]

5. [REDACTED]

By: _____
CAROL P. NACHMAN
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