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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR MICHAEL J. O'BRIEN
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FROM: DEBORAH A. BUTLER
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SUBJECT: Financing Arrangement Involving Fast-pay Stock

This Field Service Advice responds to your memorandum dated February 17,2000, as supplemented by your memorandum dated March 10, 2000. 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 =
Promoter =
Corporation =
Corporation 2 =
Corporation 3 =
Bond Rating Firm =
Trust 1 =
Trust 2 =

Trust 3 =
Bank =

Firm =
State =
Country =

Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 11	=
Date 12	=
Date 13	=
Date 14	=
Date 15	=
Date 16	=
Date 17	=
A	=
B	=
C	=
D	=
E	=
F	=
G	=
H	=
I	=
J	=
K	=
L	=
M	=
N	=
O	=
P	=

Q	=
R	=
S	=
T	=
U	=
V	=
W	=
X	=
Y	=
Z	=
AA	=
BB	=
CC	=
DD	=
EE	=
FF	=
GG	=
HH	=
II	=
JJ	=
KK	=

ISSUES:

1. Whether the subject financing arrangement falls within the definition of a “fast-pay arrangement,” as defined in Treas. Reg. § 1.7701(l)-3(b).

2. If so, whether the application of Treas. Reg. § 1.7701(l)-3 has an immediate effect on the current examination cycle.

3. If Treas. Reg. § 1.7701(l)-3 applies, whether the “financing instrument,” as described in Treas. Reg. §1.7701(l)-3(c), should be treated as debt or equity.

CONCLUSIONS:

1. The financing arrangement falls within the definition of a “fast-pay arrangement,” as defined in Treas. Reg. § 1.7701(l)-3(b). Accordingly, Treas. Reg. § 1.7701(l)-3 applies.

2. Application of Treas. Reg. § 1.7701(l)-3 has no immediate effect on the current examination cycle. The entire examination cycle is covered by the Treas. Reg. § 1.7701(l)-3(c)(3)(iv) basis adjustment rule. Treas. Reg. § 1.7701(l)-3(c)(3)(iv) provides that, for amounts paid or accrued in taxable years ending before February

27, 1997, the fast-pay recharacterization rules are not immediately implemented. Instead, the regulations require certain basis adjustments to the benefitted stock. See Treas. Reg. § 1.7701(l)-3(c)(3)(iv).

3. We conclude that the financing instrument is more properly viewed as equity.

FACTS:

Real Estate Investment Trust Transaction

_______________________, Promoter approached Taxpayer with a financing structure. purported to provide $ A of financing to Taxpayer using a real estate investment trust ("REIT") vehicle. The Promoter's promotional materials mention that, for GAAP purposes, the financing should be treated like an amortizing loan. But, the financing would be reported on Taxpayer's balance sheet as a minority interest in subsidiary, instead of as debt.

, a special purpose REIT was to provide $ A of financing to Taxpayer. B percent of the financing was to be provided in the form of a loan from the REIT to Taxpayer. C percent of the financing was to be provided in the form of a between the REIT and Taxpayer.

The REIT was to have two classes of stock. Taxpayer was supposed to contribute D percent of the capital in exchange for Class B shares. investors, and 100 other qualifying REIT shareholders were to contribute the remaining E percent of the REIT's capital in exchange for Class A shares. During the first F years of operations, all REIT distributions were to be paid to the Class A shares. During years G through H, all REIT distributions were to go to the Class B shares owned by Taxpayer. After H years (or upon earlier liquidation of the REIT), all distributions were to be made on a pro rata basis with E percent going to the Class A shares and D percent to the Class B shares. However, the Class A shareholders had a liquidation preference equal to their initial capital contributions.

, Taxpayer was to enter into a buy-sell agreement with effective after the first F years. The buy-sell agreement was to give Taxpayer the right to purchase all Class A shares at their fair market value. The buy-sell agreement also was to give the right to put the shares to Taxpayer at their fair market value. If Taxpayer or exercised the options to transfer the Class A stock to Taxpayer, Taxpayer could either unwind the deal or keep the REIT intact.

Promoter anticipated raising I -J percent of capital by way of a private placement of debt. , Promoter believed the private placement would be rated The private placement debt was to be fully amortized by the REIT's dividend distributions during the first F years. The remaining K-F percent of capital was to be raised through a private placement of Promoter anticipated raising this from one or more pension funds.

After considering the financial and tax implications, Taxpayer decided to pursue the transaction promoted by Promoter. The eventual transaction modeled Promoter’s original promotional materials. But, there were some variations to fit the particular needs of Taxpayer or to anticipate some potential challenges from the government.

REIT

Corporation (hereinafter, “REIT”) was incorporated to serve as a REIT. REIT had Class A and Class B stock. The Class A stock had two series.

The Class A, Series 1 stock was subscribed to by Trust 1, a grantor trust established to raise most of the outside capital for the financing. Trust 1 contributed $ L to purchase the Class A, Series 1 shares. This represented M percent of the REIT capital. The Class A, Series 2 stock was subscribed to by N individuals. All of the Series 2 stockholders were members of Firm. Firm acted as Taxpayer's in the REIT financing.

Taxpayer subscribed to most of the Class B stock, providing $O in capital. This represented P percent of the REIT capital. Each of the Class A, Series 2 shareholders, the Firm also received minor amounts of Class B stock. The members of Firm provided $Q of the capital for the REIT financing through their subscriptions of the Class A, Series 2 stock and Class B stock.

The Class A shares were entitled to receive all declared dividends between Date 1 and Date 7. The Class B shares were entitled to receive all declared dividends beginning Date 8 and continuing for the next C years. Thereafter, the

Class A and Class B shares were to share equally in any declared dividends. Dividends were to be paid twice a year on and of each year.

The REIT Articles of Incorporation set forth certain expected dividend payment amounts for each semi-annual dividend. The anticipated dividend payment was the "Expected Net Cash Flow." If REIT failed to declare the anticipated dividend amount, the difference between the "Expected Net Cash Flow" and the actual amount of the cash dividend was treated as a dividend arrearage. Dividend arrearages accrued interest at a rate of R percent per annum. The "Expected Net Cash Flow" for the first dividend on Date 2, was $S. Thereafter, the "Expected Net Cash Flow" on each dividend payable date was $T.

Trust 1 and Taxpayer entered into an option agreement covering the trust's Class A stock ("Option Agreement"). Taxpayer could exercise the option to purchase the Trust 1 stock on or before three dates, Date 3, Date 11, and Date 12. If Taxpayer failed to exercise the option on any of these dates, Trust 1 then had the right to put the stock to Taxpayer. The option price for the shares was the fair market value as of certain specified dates defined as the "Determination Date" plus interest through settlement. If Taxpayer exercised the option, the "Determination Date" was the next dividend date after the exercise. The first such date was Date 6. If Trust 1 exercised the option, the first "Determination Date" was Date 10, if Trust 1 exercised the option prior to Date 4. Thereafter, the "Determination Date" was either the next dividend date where exercise occurs prior to of the year, or otherwise the 180th day after exercise.

Fair market value is defined as the value agreed upon by Taxpayer and Trust 1. Where the parties are unable to reach an agreement, the fair market value is to be determined by a qualified appraiser. The option agreement sets forth the methodology the appraiser is to use. The valuation formula is tied to the Class A shareholder's interest in the REIT assets discounted from Date 6 to the applicable "Determination Date" in Year 4, Year 5 or Year 6. This has the effect of producing a small option price for the Class A stock in Year 4, Year 5 and Year 6 in comparison to the capital contributed for the Class A stock.

To hedge certain risks relating to the exercise of the put and call options, Trust 1 entered into a Hedge Agreement with Corporation 2. The Hedge Agreement had an effective date of Date 10 and a termination date of Date 14.

Trust 1 Funding

Trust 1 funded its Class A stock subscription obligation in two ways. First, Trust 1 privately placed $U in senior secured notes due Date 7 ("Trust 1 notes"). Corporation 3 placed the Trust 1 notes for Trust 1. Trust 2 was to acquire the Trust 1 notes. Trust 2 was a State business trust to be formed to carry out the Taxpayer financing transaction.

The Trust 1 notes were amortized with semi-annual payments of principal and interest commencing Date 2 and ending Date 7. Except for the initial semi-annual principal and interest payment of $V, the semi-annual principal and interest payments were approximately $W. The semi-annual principal and interest payments approximately tied to the "Expected Net Cash Flow" payable as semi-annual dividends through Date 7 on the REIT Class A stock. Thus, the principal and interest payments on the Trust 1 notes were to be fully paid out of the REIT Class A dividend payments. The Trust 1 notes were rated by Bond Rating Firm.

Trust 1 entered into a Pledge and Intercreditor Agreement ("Intercreditor Agreement") with Corporation 2 and Corporation 3 to secure both its obligations under the Trust 1 notes and its obligations under the Hedge Agreement. Under the Intercreditor Agreement, Trust 1 pledged its REIT Class A stock and all its rights under the various agreements entered into as part of the REIT financing transaction. The agreement set forth the relative priority in the collateral between the Trust 1 notes holders and Corporation 2.

Trust 1 also raised an additional $X in capital through issuance of a certificate ("Equity Certificate") representing a 100% beneficial interest in Trust 1. The initial holder of the Equity Certificate was to be Trust 3, a State business trust formed as part of the REIT financing. Trust 3 had only a transitory ownership interest in the Equity Certificate. By the time of closing, Trust 3 had transferred its rights in the Equity Certificate to Bank. Bank is based in Country.

Taxpayer also entered into an option with respect to the Equity Certificate ("Equity Certificate Option"). The Equity Certificate Option permitted Taxpayer to acquire the Equity Certificate if certain events occurred. The events generally pertained to occurrences which altered the anticipated tax results of the transaction, or which required REIT to be treated as an investment company or as an ERISA fiduciary. The option exercise price was the greater of the Equity Certificate's fair market value or certain fixed price set forth. The fixed price began at $Y and increased with every semi-annual Trust 1 notes principal and interest payment date through Date 7. On Date 7, the fixed option price was set at $Z. After Date 7, the fixed option price was set at $AA.

The Equity Certificate Option also gave the Equity Certificate holder the right to put the certificate to Taxpayer in certain circumstances. The put option generally became effective when: (1) a new direct tax was imposed by the United States or any state or local authority on the holder's property rights under or income associated the Equity Certificate; or (2) the holder determined it will be subject to registration as an investment company. The put option price is fixed based on certain schedules set forth in the agreement. Like the call option, the fixed price increases with each Trust 1 notes principal and interest payment date through Date 7. Thereafter, the fixed price is frozen.

REIT Funding for Taxpayer

REIT provided funding to Taxpayer in two ways. First, REIT provided a mortgage loan to Taxpayer for $BB. The remaining $CC was provided through a sale/leaseback transaction involving ground rights on

The mortgage loan had a maturity date of Date 9. However, Taxpayer had the right to extend the maturity for a longer term through Date 13 if certain credit rating requirements were met on Date 5. The entire principal amount was due at the maturity date. Interest of DD percent per annum was payable semi-annually on January 15 and July 15 of each year. The loan was secured by mortgages on EE Taxpayer properties with an aggregate appraised value of $FF.

The purchase price for the was $HH, their aggregate appraised value. The sale was closed at the same time as the other REIT financing transactions.

At the same time, REIT leased back to Taxpayer. The basic term of the lease extended through Date 6. Taxpayer then had the option to extend the lease for three additional periods of F years each at a fixed rent. Thereafter, Taxpayer had an option to extend the lease for three additional periods of F years each based on the fair market value of the

During the short period between Date 1 and Date 15, the aggregate rental payment was $II. After that, Taxpayer was to pay $JJ semi-annually on July 15 and January 15 through Date 6. This same semi-annual rental payment was required during the three F-year fixed rental periods.

The lease also required Taxpayer to pay all taxes associated with the lease In addition, Taxpayer was required to maintain property and casualty, worker's compensation and flood insurance on the lease at its own cost.

Taxpayer had the right to purchase at the end of the basic term and any renewal terms. With one exception, the purchase price was the fair market value at the time the option was exercised. But, at the end of the last fixed rent renewal term, Taxpayer had the option to purchase at certain predetermined prices. Taxpayer also had a right of first refusal on REIT chose to sell.

An unusual lease provision dealt with the substitution of properties. Taxpayer was given the right to substitute other for some of covered by the lease. When this provision is utilized, Taxpayer will cause a deed covering the substitute property to be issued to REIT. Thereafter, REIT will transfer the original leased parcel to Taxpayer.

LAW AND ANALYSIS:

Issue 1. Whether the subject financing arrangement falls within the definition of a "fast-pay arrangement," as defined in Treas. Reg. § 1.7701(l)-3(b).

I.R.C. § 7701(l) provides that the Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any two or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent the avoidance of tax.

Treas. Reg. § 1.7701(l)-3 sets forth rules for recharacterizing financing arrangements involving fast-pay stock. The regulation applies to all fast-pay arrangements. Treas. Reg. § 1.7701(l)-3(a).

A fast-pay arrangement is any arrangement in which a corporation has fast-pay stock outstanding for any part of its taxable year. Treas. Reg. § 1.7701(l)-3(b)(1). Fast-pay stock is stock structured so that dividends paid by the corporation with respect to the stock are economically a return of the holder's investment (as opposed to only a return on the holders investment). Treas. Reg. § 1.7701(l)-3(b)(2)(i). Unless clearly demonstrated otherwise, stock is presumed to be fast-pay stock if it is structured to have a dividend rate that is reasonably expected to decline (as opposed to a dividend rate that is reasonably expected to fluctuate or remain constant). Treas. Reg. § 1.7701(l)-3(b)(2)(i).

Under Treas. Reg. § 1.7701(l)-3(c), certain fast-pay arrangements are recharacterized to ensure the participants are taxed in a manner reflecting the economic substance of the arrangements. Treas. Reg. § 1.7701(l)-3(c) applies to any fast-pay arrangement in which the corporation that has outstanding fast-pay stock is a REIT. Treas. Reg. § 1.7701(l)-3(c)(1)(i).

A fast-pay arrangement described in Treas. Reg. § 1.7701(l)-3(c)(1) (e.g., any fast-pay arrangement in which the corporation that has outstanding fast-pay stock is a REIT) is recharacterized as an arrangement directly between the benefitted shareholders and the fast-pay shareholders. Treas. Reg. § 1.7701(l)-

3(c)(2). Benefitted stock is defined with respect to any fast-pay stock as all other stock in the corporation (including other fast-pay stock having any significantly different characteristics). Treas. Reg. § 1.7701(l)-3(b)(3).

The inception and resulting relationships of the recharacterized arrangement are deemed to be as follows:

> Relationship between benefitted shareholders and fast-pay shareholders. The benefitted shareholders issue financial instruments (the "financing instruments") directly to the fast-pay shareholders in exchange for cash equal to the fair market value of the fast-pay stock at the time of issuance (taking into account any related agreements). The financing instruments have the same terms (other than issuer) as the fast-pay stock. Thus, for example, the timing and amount of the payments made with respect to the financing instruments always match the timing and amount of the distributions made with respect to the fast-pay stock. Treas. Reg. § 1.7701(l)-3(c)(2)(i).

> Relationship between benefitted shareholders and corporation. The benefitted shareholders contribute to the corporation the cash they receive for issuing the financing instruments. Distributions made with respect to the fast-pay stock are distributions made by the corporation with respect to the benefitted shareholders' benefitted stock. Treas. Reg. § 1.7701(l)-3(c)(2)(ii).

> Relationship between fast-pay shareholders and corporation. For purposes of determining the relationship between the fast-pay shareholders and the corporation, the fast-pay stock is ignored. The corporation is the paying agent of the benefitted shareholders with respect to the financing instruments. Treas. Reg. § 1.7701(l)-3(c)(2)(ii).

Treas. Reg. § 1.7701(l)-3(c)(3)(i) provides that the character of a financing instrument (for example, stock or debt) is determined under general tax principles and depends on all the facts and circumstances.

If any benefitted stock has any significantly different characteristics from any other benefitted stock, the recharacterization rules of Treas. Reg. § 1.7701(l)-3(c) apply among the different types of benefitted stock as appropriate to match the economic substance of the fast-pay arrangement. Treas. Reg. § 1.7701(l)-3(c)(3)(ii).

In the instant case, the REIT transaction meets the basic definition of a fast-pay stock arrangement. REIT is a corporation with fast-pay stock outstanding for part of the taxable year. Treas. Reg. § 1.7701(l)-3(b)(1). REIT had fast-pay stock outstanding during its taxable years ended Date 16 and Date 17. REIT Class A stock was structured so that the dividends payable on the stock returned a large portion of the holder's investment between Year 2 and Year 4. Treas. Reg. § 1.7701(l)-3(b)(2)(i). In addition, the dividend rate on REIT Class A shares was reasonably expected to decline after Year 4. Treas. Reg. § 1.7701(l)-3(b)(2)(i)(A). This was true between Year 4 and Year 7, when the Class A shares received no dividends. It also is true after Year 7, when both the Class A and Class B shares received dividend payments.

Since REIT is a REIT, the fast-pay arrangement would be recharacterized under Treas. Reg. § 1.7701(l)-3(c). The fast-pay arrangement would be recharacterized as an arrangement directly between the Class B benefitted shareholders, Treas. Reg. § 1.7701(l)-3(b)(3), and the Class A fast-pay shareholders. Treas. Reg. § 1.7701(l)-3(c)(2). The Class B shareholders would be treated as issuing financing instruments directly to the Class A shareholders in exchange for cash.[1] Treas. Reg. § 1.7701(l)-3(c)(2)(i). The financing instruments would have the same terms as the fast-pay stock. Id. In this case, Taxpayer would be treated as issuing an instrument which provides sufficient cash flow to provide a return on the invested cash plus amortization of the principal between Year 2 and Year 4.

Under Treas. Reg. § 1.7701(l)-3(c)(2)(ii), Taxpayer will be treated as contributing the cash to REIT for the Class B benefitted stock. The REIT distributions to the Class A shareholders will be deemed to be distributions to Taxpayer with respect to its Class B stock and taxable to Taxpayer as dividends. Id. The Class A fast-pay stock will be ignored in determining the relationship between the Class A shareholders and REIT. Treas. Reg. § 1.7701(l)-3(c)(2)(iii). In analyzing that relationship, REIT will be treated simply as a paying agent for the Class B shareholders. Id.

Issue 2. If the financing arrangement falls within the definition of a fast-pay arrangement, whether the application of Treas. Reg. § 1.7701(l)-3 has an immediate effect on the current examination cycle.

Treas. Reg. § 1.7701(l)-3 applies to taxable years ending after February 26, 1997. Treas. Reg. § 1.7701(l)-3(g)(1). Thus, all amounts accrued or paid during the first taxable year ending after February 26, 1997, are subject to the regulations. Id.

[1] Here, the Class B shareholders consist not only of Taxpayer, but also the ___ Firm who received minimal amounts of Class B shares. Taxpayer and the ___ Firm Class B shareholders would be treated as holding different types of benefitted shares. Treas. Reg. § 1.7701(l)-3(c)(3)(ii). The ___ Firm shareholders do not have any options to acquire the Class A shares in Year 4. Taxpayer has such rights through the Option Agreement. Taxpayer also has the right to acquire the Equity Certificate, while the ___ Firm Class B shareholders do not.

In the case of a fast-pay arrangement involving amounts accrued or paid in taxable years ending before February 27, 1997, and recharacterized under Treas. Reg. § 1.7701(l)-3(c), a benefitted shareholder must decrease its basis in any benefitted stock (as determined under Treas. Reg. § 1.7701(l)-3(c)(2)(ii)) by the amount (if any) that–(A) Its income attributable to the benefitted stock (reduced by deductions attributable to the financing instruments) for taxable years ending before February 27, 1997, computed by recharacterizing the fast-pay arrangement under Treas. Reg. § 1.7701(l)-3(c) and by treating the financing instrument as debt; exceeds (B) Its income attributable to such stock for taxable years ending before February 27, 1997, computed without applying the rules of Treas. Reg. § 1.7701(l)-3(c).

The regulations provide for an election to limit taxable income attributable to a recharacterized fast-pay arrangement for periods before April 1, 2000. Treas. Reg. § 1.7701(l)-3(g)(2). For periods before April 1, 2000, provided the shareholder recharacterizes the fast-pay arrangement consistently for all such periods, a shareholder may limit its taxable income attributable to a fast-pay arrangement characterized under either–(A) Notice 97-21, 1997-1 C.B. 407; or (B) Treas. Reg. § 1.7701(l)-3(c), computed by assuming the financing instrument is a debt. Treas. Reg. § 1.7701(l)-3(g)(2)(i).

Under Treas. Reg. § 1.7701(l)-3(g)(2)(ii), a shareholder that limits its taxable income to the amount determined by recharacterizing the transaction under Notice 97-21 must include as an adjustment to taxable income the excess, if any, of the amount determined by recharacterizing the transaction under Treas. Reg. § 1.7701(l)-3(c), over the amount determined by recharacterizing the transaction under Notice 97-21. The adjustment to taxable income must be made in the shareholder's first taxable year that includes April 1, 2000. The shareholder must include a statement in its books and records identifying each fast-pay arrangement for which an adjustment must be made and providing the amount of the adjustment for each such fast-pay arrangement. Treas. Reg. § 1.7701(l)-3(g)(2)(ii).

In the instant case, application of Treas. Reg. § 1.7701(l)-3 has no immediate effect on the current examination cycle; the entire examination cycle is covered by the Treas. Reg. § 1.7701(l)-3(c)(3)(iv) basis adjustment rule. Treas. Reg. § 1.7701(l)-3(c)(3)(iv) provides that, for amounts paid or accrued in taxable years ending before February 27, 1997, the fast-pay recharacterization rules are not immediately implemented. Instead, the regulations require certain basis adjustments to the benefitted stock. Treas. Reg. § 1.7701(l)-3(c)(3)(iv).

Issue 3. If Treas. Reg. § 1.7701(l)-3 applies, whether the "financing instrument," as described in Treas. Reg. §1.7701(l)-3(c), should be treated as debt or equity.

As set forth in detail above, in Year 2, REIT issued Class A stock, mostly to a Trust 1, and Class B stock to Taxpayer. The Class A stock will return a large portion of the holders' investments as dividends between Year 2 and Year 4, because the Class A stock receives all potential dividends and the Class B stock receives none. The Class A stock pays no dividends for the next C years (these go to the Class B stock). Thereafter, the Class A and B stock are entitled to share in corporate profits and on liquidation. Taxpayer, the holder of the Class B shares, also issued a put option to Trust 1, which holds the bulk of the Class A stock. Under the option, the Trust 1 can put the Class A stock to Taxpayer on one of three dates and after the end of the initial F year period. The exercise price of the option is to be the fair market value of the Class A stock as agreed by the parties, or, if not agreed, as determined by appraisal. REIT invested its proceeds from issuing the Class A and Class B stock in mortgage loans to Taxpayer (or affiliates)

to Taxpayer (or affiliates).

As discussed above, the financing arrangement falls within the definition of a fast-pay arrangement, as defined in Treas. Reg. § 1.7701(l)-3(b). Accordingly, Treas. Reg. § 1.7701(l)-3 applies. Since REIT is a REIT, the fast-pay arrangement is recharacterized under Treas. Reg. § 1.7701(l)-3(c), which treats Taxpayer as issuing financing instruments directly to the Class A shareholders in exchange for cash, and treats the financing instruments as having the same terms as the fast-pay stock. The regulation further treats Taxpayer as contributing the cash received in issuing the financing instruments to REIT for the Class B stock, and treats the REIT's distributions to the Class A shareholders as distributions to the Class B shareholders.

Treas. Reg. § 1.7701(l)-3(c)(3)(i) provides that the determination of whether the financing instrument is debt or equity is based on general tax principles and is dependent on all the facts and circumstances.

A determination of whether a financing instrument is debt or equity is inherently factual. The determination depends on a weighing of various factors in which no one factor is controlling and in which the various factors are not given equal weight. John Kelley Co. v. Commissioner, 326 U.S. 521 (1946).

Some of the factors developed by the courts to aid in the difficult task of determining whether a financing instrument is debt or equity include the following: (a) 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; (b) whether holders of the instruments possess the right to enforce the payment of principal and interest; (c) whether the rights of the holders of the instruments are subordinate to rights of general creditors; (d) whether the instruments give the holders the right to participate in the management of the issuer; (e) whether the issuer is thinly capitalized; whether there is identity between holders of the instruments and stockholders of

the issuer; (f) the label placed upon the instruments by the parties; (g) whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.
Notice 94-47, 1994-1 C.B. 357; John Kelley Co. v. Commissioner, 326 U.S. 521 (1946); Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir. 1968).

The various factors are aids in answering the question of whether the investment, analyzed in terms of its economic reality, constitutes risk capital subject to the fortunes of the corporate venture or a strict debtor-creditor relationship. Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3d Cir. 1968); Astleford v. Commissioner, 33 T.C.M. 793, 798 (1974), aff'd per curiam, 516 F.2d 1394 (8th Cir. 1975). Applying the above criteria to the facts of the instant case, we conclude that the financing instrument is more properly viewed as equity, rather than debt.

If this issue were litigated, a court is more likely to view the financing instruments as equity, rather than debt. In reaching this conclusion, we believe it significant that the terms of the arrangement fail to provide for the payment to the Class A shareholders of a sum certain on a fixed maturity date. Whether an instrument has a definite maturity date on which the creditor is entitled to an unconditional repayment of principal is an important factor used in classifying an instrument as either debt or equity. Plumb, "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and A Proposal," 26 Tax Law Review 369, 413 (1971); Matter of Uneco, Inc. v. United States, 532 F.2d 1204 (8th Cir. 1976).

Classic debt involves an unqualified obligation to pay a sum certain, with a fixed interest rate, at a reasonably close maturity date, regardless of whether the debtor has income. Gilbert v. Commissioner, 248 F.2d 399, 402 (2d Cir. 1957); Sutherland v. Commissioner, 62 T.C. M. 1533, 1535 (1991); Cf. Treas. Reg. § 1.166-1(c) (providing that a bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money). The presence of a fixed maturity date indicates a definite obligation to repay. To the contrary, the absence of a fixed maturity date indicates repayment may depend on the fortunes of the issuer. In the instant case, the terms of the arrangement provide neither a fixed maturity date for when the Class A shareholders will receive payments nor an unconditional entitlement, on the part of the Class A shareholders, to a sum certain.

If the debt/equity issue were litigated, the taxpayer would argue that the economics of the transaction weigh towards viewing the arrangement as debt. REIT is expected to earn a stable income from and mortgages. Therefore, the instrument arguably involves the payment of reasonably predictable amounts in the first F years. Although the Class A shareholders only receive the dividends in the first F years if the board of directors declares them (which is indicative of equity), under REIT's governing documents, the Board of Directors is required to authorize dividend payments necessary for REIT to maintain its status as a REIT, absent a supermajority vote of the board. Additionally, if the board does not declare as dividends the “Expected Net Cash Flow” amounts, the amounts become “dividend arrearages” that accrue interest.

However, the economics of stock is, in certain cases, substantially similar to the economics of debt. For example, shareholder returns on the preferred stock of certain utilities are often stable, involving fairly predictable returns and minimal risk of nonpayment. Although the board of directors of the utilities must declare dividends for the utility shareholders to receive the dividends, they routinely do so, for to not declare dividends might jeopardize investor interest, i.e., the raising of capital. In any case, however stable REIT’s income may seem, the Class A holders are nevertheless subject to whatever risks are inherent in REIT’s ventures. Even taking into account the special provisions of the governing documents concerning dividends, the Class A holders’ entitlement is to payments out of corporate profits, an inherently equity-like return.

The fact that the Class A stock carries preferred stockholder, rather than creditor, remedies carries substantial weight in supporting the view that the financing arrangement is equity. See Plumb at 430-432; 451-452. The holder of a debt instrument has the right to enforce the payment of principal and interest. The holder of stock, however, has no legal right to payment of a sum certain and is less assured of the return of capital than creditors. Furthermore, although preferred stockholders have preference on dissolution or a winding up over the common stockholders, they do not have preference over creditors.

In the instant case, the holders of the instruments do not have the right to force the payment of principal and interest. Instead, upon a failure of the board of directors to declare dividends, the holders’ remedy is the typical preferred shareholder remedy of taking over direction of the corporation by electing a fixed portion of the board of directors. Additionally, the holders of the instruments do not have a creditor’s preference on the dissolution or winding up of the entity.

As noted above, the Class A stock does not provide for the payment of a sum certain at maturity. The stock provides for distributions out of corporate profits for F years, and after a KK-year hiatus, for a conventional proportionate stock interest in REIT. The taxpayer may argue that, because Taxpayer is treated as the issuer of the financing instrument under the recharacterization of the regulations, and Taxpayer is the issuer of the put option, the option should be viewed as a potential maturity date because the holder can demand payment from Taxpayer, the deemed issuer, at certain specified times. However, even if it were appropriate to view the put as part of the terms of the financing arrangement, there would be, at best, a maturity date but no sum certain. The amount to be paid to the Class A holders is to be based on an appraisal of the discounted value of REIT’s assets, that is, of their remaining equity interest in REIT. Although the parties may expect the put to be exercised and the payment to the Class A shareholders to be relatively small (reflecting the KK years without cash flow), the amount to be paid is reflective of an equity investment, and not true debt.

Stated differently, if the financing arrangement could otherwise be viewed as debt, it would involve contingent principal. The lack of a fixed principal amount weighs against treating the arrangement as debt.

Further, the parties labeled the instrument as equity, and Taxpayer reported the arrangement on its financial statements as equity --

A taxpayer labeling and reporting of an instrument as equity weighs towards treating the instrument as equity. Taiyo Hawaii Co., Ltd. v. Commissioner, 108 T.C. 590 (1997); Calumet Industries, Inc. v. Commissioner, 95 T.C. 257, 286 (1990). This is particularly true when a taxpayer chooses to label an instrument as stock under domestic law, since that designation imposes genuine economic limitations on the holder's position.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

As set forth in your supplemental FSA request, dated March 10, 2000, [redacted] made a proposal to resolve the issue basically by following Treas. Reg. § 1.7701(l)-3. One difference in the [redacted] proposal is an agreement to apply the regulations to payments made prior to February 1997. This would result in a [redacted] adjustment for [redacted] taxable year and would be in lieu of the basis adjustment for pre-February 1997 payments set forth in the regulations.

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

Please call if you have any further questions.

By: JOEL E. HELKE
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cc: William F. Hammack
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