Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:FIP:3/PLR-118180-99

Date:
September 29, 2000

Legend:

Taxpayer =

Date 1 =

Date 2 =

Year 1 =

Amount 1 =

Amount 2 =

Amount 3 =

Amount 4 =

Amount 5 =

Amount 6 =

Amount 7 =

Number 1 =

Number 2 =

Percent 1 =

Percent 2 =

Dear

This letter responds to a letter received on Date 1 requesting a ruling that interest deductions relating to certain notes (described below) will not be disallowed under § 163(l) of the Internal Revenue Code.

FACTS

Taxpayer is a holding company that owns several insurance companies. As of Date 1, Taxpayer's capital structure included approximately Amount 1 of short-term debt, Amount 2 of equity, and a put option that allowed Taxpayer to sell its convertible preferred shares to a third party upon the occurrence of certain catastrophic events that caused losses that exceeded Taxpayer's catastrophe reinsurance coverage. The short-term debt was incurred during the two years preceding Date 1. The put option was purchased in Year 1 as a substitute for upper layer reinsurance. The put option was scheduled to expire on Date 2.

Taxpayer proposes to issue senior subordinated debt (the "Notes") and purchase new put options (the "Put Options").

The Notes will be issued with an aggregate stated principal amount between Amount 3 and Amount 4. They will be general unsecured obligations of Taxpayer. They will have a term of Number 1 years. They will pay interest semi-annually at a fixed interest rate to be determined on a "competitive basis." They will be callable after one year. There will be a call premium that will decrease over Number 2 years. The Notes are not by their terms payable in stock or in an amount determined by the value of stock. The Notes will not be convertible into equity. The payment of principal and interest on the Notes will not be contingent upon or connected to the exercise of the Put Options.

Taxpayer will issue the Notes to replace short-term debt currently on its books. The Notes will provide capital for Taxpayer's general business needs. Taxpayer intends to contribute some of the net proceeds to its insurance subsidiaries for insurance operations and to retain a portion of the proceeds for general corporate purposes.

The Notes will be offered in a private placement exempt from registration under the United States Securities Act of 1933, or to qualified institutional buyers as defined in Rule 144A under the Securities Act. They will be transferable subject to restrictions on the type of the transferee.

The Put Options will allow Taxpayer to put up to a total amount between Amount 3 and Amount 4 of its convertible preferred stock ("Preferred Stock"). The Put Options will have a term of Number 1 years. They will be exercisable only if Taxpayer incurs a significant decline in its net worth resulting from financial

or natural catastrophic events (a "Qualifying Event"). The Put Options will be transferable by their writers subject to certain credit standards and Taxpayer's approval.

A Qualifying Event will occur if Taxpayer's "Net Worth" (gross assets minus gross liabilities, as determined in accordance with generally accepted accounting principles) decreases by Percent 1 or more in any one year, or Percent 2 or more during three consecutive years. For purposes of determining whether a Qualifying Event has occurred during a period, the Net Worth at the beginning of the period will be (1) increased by the amount of any additional equity issued by Taxpayer during the period, and (2) decreased by the amount of any equity retired or repurchased by Taxpayer during the period and by the amount of any extraordinary dividends paid by Taxpayer in excess of its customary common stock dividend rate. Taxpayer's actuaries estimate that there is less than an chance that Taxpayer will suffer a Qualifying Event during the term of the Put Options.

Despite the occurrence of a Qualifying Event, the Put Options will not be exercisable unless Taxpayer's Net Worth at the close of the most recent quarter prior to the date of exercise is at least Amount 5. The Put Options may not be initially exercised with respect to Preferred Stock having an aggregate purchase price of less than Amount 6. Thereafter, the Put Options may be exercised in minimum increments of Amount 7. However, an investor will not be required to purchase Preferred Stock to the extent that the investor's aggregate purchase price for such Preferred Stock would exceed the investor's pro rata portion (based on his Put Option holdings) of the net decrease in Taxpayer's Net Worth resulting from the Qualifying Event, subject to the minimum Put Option exercise.

Taxpayer represents that the Put Options will serve as a substitute for upper layer reinsurance. Taxpayer also represents that the cost of purchasing the Put Options should be less than the cost of traditional reinsurance.

Although the Notes and the Put Options might be issued at the same time, they will be issued as separate and distinct instruments that are not connected to or contingent upon each other. Investors may purchase Notes without selling Put Options, and vice versa. Taxpayer expects, however, that some investors will purchase Notes and also sell Put Options. In that case, Taxpayer represents that, upon the exercise of the Put Option,

the investor may not satisfy its obligation under the Put Option with a Note.

APPLICABLE LAW

Section 163(l)(1) provides that no deduction shall be allowed for any interest paid or accrued on a disqualified debt instrument. Section 163(l)(2) provides that the term "disqualified debt instrument" means any indebtedness of a corporation that is payable in equity of the issuer or a related party. Section 163(l)(3) provides:

> For purposes of paragraph (2), indebtedness shall be treated as payable in equity of the issuer or a related party only if–
>
> > (A) a substantial amount of the principal or interest is required to be paid or converted, or at the option of the issuer or a related party is payable in, or convertible into, such equity,
> >
> > (B) a substantial amount of the principal or interest is required to be determined, or at the option of the issuer or a related party is determined, by reference to the value of such equity, or
> >
> > (C) the indebtedness is part of arrangement which is reasonably expected to result in a transaction described in subparagraph (A) or (B).
>
> For purposes of this paragraph, principal or interest shall be treated as required to be so paid, converted, or determined if it may be required at the option of the holder or a related party and there is a substantial certainty the option will be exercised.

There are no final, temporary, or proposed regulations under § 163(l).

Section 163(l) was added to the Internal Revenue Code by the Taxpayer Relief Act of 1997 (P.L. 105-34). The conference report explained that:

> [A]n instrument is to be treated as payable in stock if a substantial portion of the principal or interest is required to be determined, or may be determined at the

> option of the issuer or related party, by reference to the value of stock of the issuer or related party. An instrument also is treated as payable in stock if it is part of an arrangement designed to result in such payment of the instrument with or by reference to such stock, such as in the case of certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such stock, or certain debt instrument that are convertible at the holder's option when it is substantially certain that the right will be exercised.

Conf. Rep. 105-220 (1997) 524.

HOLDING

Based on the representations made by the Taxpayer and the applicable law, we conclude that § 163(l) will not apply to disallow deductions for interest paid or accrued on the Notes.

Except as specifically ruled on above, no opinion is expressed concerning the tax consequences of this transaction under any other provision of the Code or regulations. In particular, no opinion is expressed concerning whether the Notes are indebtedness for federal income tax purposes.

Temporary or final regulations under § 163(l) have not been adopted. Therefore, this ruling may be modified or revoked if temporary or final regulations when adopted are inconsistent with the conclusion in the ruling. However, when the criteria in section 12.05 of Rev. Proc. 2000-1, 2000-1 I.R.B. 4, 47, are satisfied, a ruling is not modified retroactively or revoked in rare or unusual circumstances.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the provisions of a power of attorney on file with this office, we are sending a copy of this letter ruling to Taxpayer's authorized representative.

Sincerely yours
Acting Associate Chief Counsel
(Financial Institutions & Products)
By: William E. Blanchard,
Senior Technician Reviewer, Branch 3

Enclosure: 6110 copy