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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: LON B. SMITH
ACTING ASSOCIATE CHIEF COUNSEL (FINANCIAL INSTITUTIONS AND PRODUCTS) CC:FIP

SUBJECT: TAX TREATMENT OF CERTAIN SECURITIES

This Chief Counsel Advice responds to your memorandum dated February 5, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

Counterparty =

Underwriter =

Remarketing Dealer =

Debt Securities =

Forward Treasury Rate-Lock Payment =

Remarketing
Payment =

ISDA Master Agreement	=
Forward Treasury Rate-Lock Agreement	=
Notional Amount	=
Trade Date	=
Base Treasury Securities	=
Determination Date	=
Payment Date	=
Base Treasury Rate	=
Locked-in Treasury Rate	=
Unwind Confirmation for Forward Treasury Rate-Lock Agreement	=
Prospectus	=
Prospectus Supplement	=

Date A	=
Remarketing Date	=
Stated Maturity Date	=
Base Rate	=
Domestic Subsidiary	=
Foreign Trust	=
LTD 1	=
LTD 2	=
LTD 3	=
Loan Proceeds	=
Loan Stock	=
A	=
B	=
C	=
D	=
E	=
F	=
Date 1	=
Date 2	=
Date 3	=

Foreign =

Specified Factor =

Foreign Group =

ISSUES[1]

1. Whether Taxpayer is entitled to “amortize” the Forward Treasury Rate-Lock Payment (received from Counterparty on the day after the Determination Date) under Treas. Reg. § 1.446-4, rather than include it in income in the taxable year of receipt.

2. If Taxpayer is entitled to “amortize” the Forward Treasury Rate-Lock Payment under Treas. Reg. § 1.446-4, whether Taxpayer is entitled to do so over a period based on the Stated Maturity Date of the Debt Securities, rather than the Remarketing Date.

3. Whether Taxpayer is entitled to “amortize” the Remarketing Payment (received from Remarketing Agent when Taxpayer issued the Debt Securities), rather than include it in income in the taxable year of receipt.

4. If Taxpayer is entitled to “amortize” the Remarketing Payment, whether Taxpayer is entitled to do so over a period based on the Stated Maturity Date of the Debt Securities, rather than the Remarketing Date.

5. Whether the Loan Stock should be characterized as equity, rather than debt, for federal income tax purposes?

CONCLUSIONS

1. On the facts submitted, Taxpayer has failed to demonstrate that it is entitled to "amortize" the Forward Treasury Rate-Lock Payment under Treas. Reg. § 1.446-4.

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[1] Issues one through four were addressed by CC:FIP. Issue five, which addresses a transaction that is unrelated to the transactions involved in issues one through four, was addressed by CC:CORP and CC:INTL.

Accordingly, absent such a showing, Taxpayer is required to recognize the Forward Treasury Rate-Lock Payment in the year of receipt.

2. Even if Taxpayer were to demonstrate that the Forward Treasury Rate-Lock Agreement was a bona fide hedging transaction, and deferral of the Forward Treasury Rate-Lock Payment was appropriate, Taxpayer only would be entitled to an "amortization period" equal to the portion of the term of the Debt Securities that the Forward Treasury Rate-Lock Agreement purportedly hedged, which appears to be the period between the issue date of the Debt Securities and the Remarketing Date.

3. On the facts submitted, Taxpayer should treat the Remarketing Payment as bond issuance premium.

4. On the facts submitted, Taxpayer should “amortize” the premium over the period between the issue date of the Debt Securities and the Remarketing Date, rather than the Stated Maturity Date of the Debt Securities.

5. As discussed below, a traditional debt-equity analysis suggests that the Loan Stock is best characterized as equity, rather than debt. Moreover, I.R.C. § 385(c) does not require that Taxpayer treat the Loan Stock as debt. Accordingly, we recommend the government not attempt to recharacterize the Loan Stock as debt.

FACTS

Issues 1-4

As set forth in your Field Service Advice (“FSA”) request, you have requested advice with respect to the audit of Taxpayer. Specifically, you seek our views on the proper tax treatment of two lump-sum payments that Taxpayer received in connection with its issuance of the Debt Securities: 1) The Forward Treasury Rate-Lock Payment and 2) The Remarketing Payment, both of which were received by Taxpayer on or about the date it issued the Debt Securities.

Forward Treasury Rate-Lock Payment

As one component of this structured financing transaction, Taxpayer entered into a swap agreement (Forward Treasury Rate-Lock Agreement). The general terms of the transaction were set forth in a standard swap agreement (ISDA Master Agreement) and subsequently were confirmed and clarified in a letter agreement between Taxpayer and Counterparty. The letter confirmation specified the Notional Amount, Trade Date, Base Treasury Securities, Base Treasury Rate (which was

based on the yield of the Base Treasury Securities, which had a maturity date of less than two months before the Remarketing Date of the Debt Securities), Determination Date, Locked-In Treasury Rate, Payment Date, Adjustment Amount, and other terms of the agreement, each of which is set forth in the legend.

Under the terms of the agreements, one of the parties would pay the Adjustment Amount to the other party in certain circumstances. In general, the Adjustment Amount equals the product of: (a) a specified percentage of the Notional Amount expressed in millions times (b) the difference in basis points of the Base Treasury Rate minus the Locked-in Treasury Rate. If the Base Treasury Rate is greater than the Locked-in Treasury Rate, then Counterparty will pay the Adjustment Amount to Taxpayer. On the other hand, if the Base Treasury Rate is less than the Locked-In Treasury Rate, Taxpayer will pay the Adjustment Amount to Counterparty. If the Base Treasury Rate equals the Locked-In Treasury Rate, then no payment will be made by either party.

On the Determination Date, the Base Treasury Rate was greater than the Locked-In Rate. Accordingly, on the day after the Determination Date, the Payment Date, Taxpayer received the Forward Treasury Rate-Lock Payment from Counterparty. This aspect of the transaction was confirmed by letter agreement from Counterparty to Taxpayer, in which Counterparty states that this confirms "our agreement that we are terminating" the Forward Treasury Rate-Lock Agreement and states that "[u]pon your receipt of ... [the Forward Treasury Rate-Lock Payment], all future payment obligations of ... [Counterparty and Taxpayer] ... will be terminated." (Emphasis Supplied). Thus, pursuant to the above agreements, Taxpayer received the Forward Treasury Rate-Lock Payment on the Payment Date.[2]

Remarketing Payment and the Issuance of the Debt Securities

On Date A, Taxpayer issued the Debt Securities. The proceeds Taxpayer received from the sale of the Debt Securities included an amount paid by the Remarketing

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[2] The stated term of the Forward Treasury Rate-Lock Agreement was less than one month. Moreover, the Forward Treasury Rate-Lock Payment was received in the Taxpayer's taxable year that included the date the Forward Treasury Rate-Lock Agreement was entered into between Taxpayer and the Counterparty.

Dealer for its right to remarket the Debt Securities.[3] The Remarketing Payment was made to Taxpayer on or about the date of issuance of the Debt Securities.

The Prospectus Supplement sets forth the terms of the Debt Securities, including the annual interest rate, which is payable semi-annually, the Stated Maturity Date, and the Remarketing Date, each of which is set forth in the legend.

Under the terms of the Prospectus Supplement, on the Remarketing Date (a date that occurs one third of the way through the term of the Debt Securities, as measured by the Stated Maturity Date), the Debt Securities will either be (i) mandatorily tendered to and purchased by Remarketing Dealer, in which case Remarketing Dealer will pay all of the principal amount of the Debt Securities and Taxpayer will pay accrued interest, if any, to the Remarketing Date, or (ii) redeemed by Taxpayer by Taxpayer paying all the principal amount of the Debt Securities plus accrued interest, if any, to the Remarketing Date.[4] If purchased by Remarketing Dealer, the Debt Securities will bear interest at a new rate for the period between the Remarketing Date and the Stated Maturity Date of the Debt Securities. The new interest rate will be determined a few days before the Remarketing Date and will equal the sum of the Base Rate and the Applicable Spread (which is based on government securities with a term equal to the remaining term of the Debt Securities).[5]

Under the terms of the Debt Securities, the Remarketing Dealer can elect to remarket the Debt Securities. If this election is made and if the Debt Securities are tendered for remarketing, the Remarketing Dealer may remarket the Debt Securities for its own account at varying prices to be determined by the Remarketing Dealer at

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[3] In the Prospectus Supplement, Taxpayer stated that it will use substantially all of the net proceeds from the sale of the Debt Securities, including the Remarketing Payment, to reduce the outstanding balances on its revolving credit facilities. As a result, Taxpayer will be able to generate financing for its continuing acquisition program and general corporate purposes.

[4] In certain limited circumstances, the Debt Securities may be redeemed at the option of the Taxpayer. For example, if the Remarketing Dealer elects to remarket the Debt Securities, the Taxpayer can notify the Remarketing Dealer by a certain date that is will redeem the Debt Securities on the Remarketing Date.

[5] In the Prospectus Supplement, the Taxpayer states that because the Debt Securities are subject to mandatory tender on the Remarketing Date, the Taxpayer intends to treat the Debt Securities as maturing on the Remarketing Date for federal income tax purposes.

the time of each sale. The Remarketing Dealer, however, will not receive any fees or reimbursement expenses from the Taxpayer in connection with the remarketing. In addition, the Taxpayer will not receive any proceeds from the remarketing.[6]

LAW AND ANALYSIS

Forward Treasury Rate-Lock Payment

For federal income tax purposes, Taxpayer "amortized" the Forward Treasury Rate-Lock Payment on a straight-line basis over the term of the Debt Securities, based on the Stated Maturity Date of the Debt Securities. The Taxpayer treated the amortizable amount as an offset to its interest expense on the outstanding Debt Securities. As authority for this treatment, the Taxpayer has cited Treas. Reg. § 1.446-4. The Financial Products Specialist, however, has indicated that the payment should be included in income in the taxable year of receipt under Treas. Reg. § 1.446-3.

Although the Taxpayer and the Financial Products Specialist have treated the Forward Treasury Rate-Lock Agreement as a notional principal contract subject to Treas. Reg. § 1.446-3, we believe that the agreement is a forward rate agreement, which is basically a cash-settled forward contract on interest rates. Treas. Reg. § 1.446-3(c)(1)(ii) specifically provides that a forward contract is not a notional principal contract for purposes of Treas. Reg. § 1.446-3. As a result, Treas. Reg. § 1.446-3 does not apply to the Forward Treasury Rate-Lock Agreement.

Under the general rules for the taxation of cash-settled forward contracts, the Forward Treasury Rate-Lock Payment is includible in the Taxpayer's income in the taxable year of its receipt (when the forward contract was settled).[7] See I.R.C.

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[6] In response to an IDR, the Taxpayer stated that the purpose of the Remarketing Payment, which was an integral part of the financing, was to obtain more net proceeds on the issuance of the Debt Securities and, therefore, lower the Taxpayer's cost of funds from the stated interest rate of the Debt Securities. In addition, the Taxpayer stated that the benefit to the Remarketing Dealer is that if, at the Remarketing Date, the new interest rate is greater than the Base Rate, the Remarketing Dealer can remarket the Debt Securities for the remainder of their stated term at a premium to new investors, thereby allowing the Remarketing Dealer to profit from such premium.

[7] Even if the Forward Treasury Rate-Lock Agreement were a notional principal contract subject to Treas. Reg. § 1.446-3, the Forward Treasury Rate-Lock Payment

(continued...)

§ 451. However, if the Forward Treasury Rate-Lock Agreement is a hedging transaction subject to Treas. Reg. § 1.446-4, then the Taxpayer may be entitled to "amortize" the Forward Treasury Rate-Lock Payment and, therefore, defer the inclusion of the payment in income.

In general, Treas. Reg. § 1.446-4 provides that a hedging transaction as defined in Treas. Reg. § 1.1221-2(b) (whether or not the character of gain or loss from the transaction is determined under Treas. Reg. § 1.1221-2) must be accounted for under the rules of this section. To the extent that provisions of any other regulations governing the timing of income, deductions, gain, or loss are inconsistent with the rules of this section, the rules of this section control. Treas. Reg. § 1.446-4 applies to hedging transactions entered into on or after October 1, 1994.

Treas. Reg. § 1.1221-2(b) defines a hedging transaction, in part, as a transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily to reduce risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer. Treas. Reg. § 1.1221-2(c) provides rules to determine whether a transaction is a hedging transaction. Where no specific rules of application control, the definition of hedging transaction must be interpreted reasonably and consistently with the purposes of this section. Under Treas. Reg. § 1.1221-2(c)(1)(i), whether a transaction reduces a taxpayer's risk is determined based on all the facts and circumstances surrounding the taxpayer's business and the transaction. In general, a taxpayer's hedging strategies and policies as reflected in the taxpayer's minutes or other records are evidence of whether particular transactions reduce the taxpayer's risk.

Under Treas. Reg. § 1.446-4(b), the method of accounting used by a taxpayer for a hedging transaction must clearly reflect income. To clearly reflect income, the method used must reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item being hedged. Taking gains and losses into account in the period in which they are realized may clearly reflect income in the case of certain hedging transactions. In the case of many hedging transactions, however, taking gains and losses into account as they are realized does not result in the matching required by this section.

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[7](...continued)
would be includible in the Taxpayer's income in the taxable year of its receipt, unless the agreement was a hedging transaction subject to Treas. Reg. § 1.446-4.

Under Treas. Reg. § 1.446-4(c), for any given type of hedging transaction, there may be more than one method of accounting that satisfies the clear reflection requirement of Treas. Reg. § 1.446-4(b). A taxpayer is generally permitted to adopt a method of accounting for a particular type of hedging transaction that clearly reflects the taxpayer's income from that type of transaction.

Treas. Reg. § 1.446-4(e) provides requirements and limitations on the taxpayer's choice of method of accounting for a hedging transaction. Under Treas. Reg. § 1.446-4(e)(4), gain or loss from a transaction that hedges a debt instrument issued or to be issued by a taxpayer must be accounted for by reference to the terms of the debt instrument and the period or periods to which the hedge relates. A hedge of an instrument that provides for interest to be paid at a fixed rate or a qualified floating rate, for example, generally is accounted for using constant yield principles. Thus, assuming that a fixed rate or qualified floating rate instrument remains outstanding, hedging gain or loss is taken into account in the same periods in which it would be taken into account if it adjusted the yield of the instrument over the term to which the hedge relates. For example, gain or loss realized on a transaction that hedged an anticipated fixed rate borrowing for its entire term is accounted for, solely for purposes of Treas. Reg. § 1.446-4, as if it decreased or increased the issue price of the debt instrument.

Treas. Reg. § 1.446-4(f) provides that the rules of Treas. Reg. § 1.446-4 govern the timing of income, deduction, gain, or loss on hedging transactions but do not affect the type or character of income, deduction, gain, or loss produced by the transaction. For example, the rules of Treas. Reg. § 1.446-4(e)(4) do not increase or decrease the interest income or expense of a taxpayer that hedges a debt instrument or a liability.

Treas. Reg. § 1.446-4(d) provides that the books and records maintained by a taxpayer must contain a description of the accounting method used for each type of hedging transaction. The description of the method or methods used must be sufficient to show how the clear reflection requirement of Treas. Reg. § 1.446-4(b) is satisfied. In addition to the identification required by Treas. Reg. § 1.1221-2(e), the books and records maintained by a taxpayer must contain whatever more specific identification with respect to a transaction is necessary to verify the application of the method of accounting used by the taxpayer for the transaction. This additional identification may relate to the hedging transaction or to the item, items, or aggregate risk being hedged. The additional identification must be made

at the time specified in Treas. Reg. § 1.1221-2(e)(2) and must be made on, and retained as part of, the taxpayer's books and records.[8]

Although the Forward Treasury Rate-Lock Agreement appears to hedge the Debt Securities, the information provided in the FSA request is insufficient for us to determine whether Treas. Reg. § 1.446-4 applies in this case. If the Taxpayer can not demonstrate that Treas. Reg. § 1.446-4 applies in this case, the Taxpayer should include the Forward Treasury Rate-Lock Payment in income in the taxable year in which it was received.

Even if Taxpayer were to demonstrate that the Forward Treasury Rate-Lock Agreement was a bona fide hedging transaction, and deferral of the Forward Treasury Rate-Lock Payment was appropriate under Treas. Reg. § 1.446-4, we do not believe that the Taxpayer is entitled to "amortize" the payment over the period from the issue date of the Debt Securities to their Stated Maturity Date. First, if the Forward Treasury Rate-Lock Agreement hedged the Debt Securities, it appears that the agreement only provided a hedge of the interest rate on the Debt Securities for the period from the issue date of the Debt Securities to the Remarketing Date (and not the Stated Maturity Date). Second, the Taxpayer stated in the Prospectus Supplement that, notwithstanding the "Stated Maturity Date" of the Debt Securities, "Taxpayer intends to treat the ... [Debt Securities] as maturing on the Remarketing Date for United States Federal income tax purposes."[9] Third, as indicated below, we believe that the Remarketing Date should be treated as the maturity date of the Debt Securities for federal income tax purposes. Therefore, we believe that the Taxpayer only would be entitled to an "amortization period" equal to the portion of the term of the Debt Securities that the Forward Treasury Rate-Lock Agreement purportedly hedged (that is, the period between the issue date of the Debt Securities and the Remarketing Date).[10]

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[8] However, see PLR 9706002, which indicates that the accounting rules provided in Treas. Reg. § 1.446-4 apply to any hedging transaction that satisfies the definition of a hedging transaction under Treas. Reg. § 1.1221-2(b), without regard to whether each item or transaction involved in the hedging transaction has been identified for purposes of characterizing gain or loss from the hedging transaction.

[9] In a response to an IDR, Taxpayer interestingly states that it "has accounted for the payment over the potential ... maturity date of the notes and fully expects to include any unamortized portion of the payment ... [upon the Remarketing Date] since it is now highly unlikely that the notes will be remarketed."

[10] In a response to an IDR, the Taxpayer referred to Treas. Reg. § 1.1274-
(continued...)

Remarketing Payment and Tax Treatment of Debt Securities

For federal income tax purposes, Taxpayer “amortized“ the Remarketing Payment on a straight-line basis over the term of the Debt Securities, based on the Stated Maturity Date of the Debt Securities. The Taxpayer treated the amortizable amount as an offset to its interest expense on the outstanding Debt Securities. In response to an IDR, the Taxpayer now claims that it should not have “amortized” the Remarketing Payment. Instead, the Taxpayer claims that the payment was paid as a premium for an option and, therefore, should not be taken into account until the option either is exercised or lapses.[11] The Financial Products Specialist, however, believes that the payment should be included in income in the taxable year in which it was received.

Arguably, the Remarketing Payment could be considered an option premium. However, the remarketing feature was an integral part of the terms of the Debt Securities and the proceeds that the Taxpayer received upon the issuance of the Debt Securities included the Remarketing Payment. The Taxpayer itself, in the Prospectus Supplement, stated that the proceeds to the Taxpayer from the sale of the Debt Securities included the Remarketing Payment. As a result, unless the Taxpayer can demonstrate otherwise, we believe that the Taxpayer should treat the Remarketing Payment as bond issuance premium subject to Treas. Reg. § 1.163-13.

Treas. Reg. § 1.163-13, which applies to debt instruments issued on or after March 2, 1998, limits the amount of an issuer’s interest deduction otherwise allowable under I.R.C. §163(a) for loans with bond issuance premium. Bond issuance premium is defined as the excess of the issue price of a debt instrument over its stated redemption price at maturity. In general, the issuer determines its interest deduction by offsetting the qualified stated interest allocable to an accrual period with the bond issuance premium allocable to that period.

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[10](...continued)
4(c)(4) as support for amortizing the Forward Treasury Rate-Lock Payment based on the Debt Securities’ Stated Maturity Date. This section determines the term of a debt instrument that provides for principal payments uncertain as to time for purposes of determining the applicable Federal rate for the instrument. However, the Debt Securities are not subject to I.R.C. 1274 and, therefore, the Taxpayer’s reliance on Treas. Reg. § 1.1274-4(c) is misplaced.

[11] If the option is exercised, the Taxpayer asserts that the payment is “amortized” over the period from the Remarketing Date to the Stated Maturity Date.

Bond issuance premium is allocable to an accrual period based on a constant yield. The use of a constant yield to amortize bond issuance premium is intended to generally conform the treatment of debt instruments having bond issuance premium with those having original issue discount. See Treas. Reg. § 1.163-13(a). Unless otherwise provided, the provisions are applied in a manner consistent with, and the terms used have the same meaning as those in I.R.C. § 163, §§ 1271 through 1275, and the corresponding regulations. In addition, the anti-abuse rule in Treas. Reg. § 1.1275-2(g) applies.

Treas. Reg. § 1.163-13(c) defines bond issuance premium as the excess, if any, of the issue price of a debt instrument over its stated redemption price at maturity. Treas. Reg. §1.1273-2(a) provides that the issue price of a debt instrument issued for money is the amount paid for it (for example, in the case of a loan, the amount loaned to the borrower). The stated redemption price at maturity of a debt instrument is the sum of all payments provided by the debt instrument other than qualified stated interest. See Treas. Reg. § 1.1273-1(b). Under Treas. Reg. § 1.1273-1(c), qualified stated interest generally is stated interest that is unconditionally payable in cash at least annually at a single fixed rate.

In the case of a debt instrument issued at a premium, the adjusted issue price of the instrument as of the beginning of the first accrual period is its issue price. Thereafter, the issue price of the debt instrument is decreased by the amount of any payment previously made on the instrument other than a payment of qualified stated interest. In addition, the issue price is decreased by the amount of bond issuance premium allocable under Treas. Reg. § 1.163-13(d)(3).

Treas. Reg. § 1.163-13(d) provides rules to determine the amount of bond issuance premium that offsets the stated interest for an accrual period. Treas. Reg. § 1.163-13(e)(3) provides that the rules of Treas. Reg. § 1.1272-1(c) generally apply to determine a debt instrument's payment schedule for purposes of Treas. Reg. § 1.163-13. For example, an issuer uses the payment schedule determined under Treas. Reg. § 1.1272-1(c) to determine the amount, if any, of bond issuance premium on the debt instrument, the yield and maturity of the debt instrument, and the allocation of bond issuance premium to an accrual period.

On the facts submitted, we conclude that the Remarketing Payment is properly treated as bond issuance premium and should be treated accordingly, as set forth in the rules under Treas. Reg. § 1.163-13.[12] Moreover, based on the facts

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[12] Treas. Reg. § 1.163-13 does not apply to a contingent payment debt instrument subject to Treas. Reg. § 1.1275-4. Treas. Reg. § 1.163-13(b)(2). For (continued...)

submitted, we believe that the premium should be “amortized” over a period not to exceed the time between the date the Debt Securities were issued and the Remarketing Date, rather than the Stated Maturity Date of the Debt Securities.[13]

ISSUE 5

FACTS

The Taxpayer has domestic and foreign subsidiaries, and it borrowed funds at various times from third-party lenders. These funds (Loan Proceeds) at various times flowed through the following chain of affiliated corporations: The Taxpayer; its domestic subsidiary (Domestic Subsidiary); Domestic Subsidiary’s foreign subsidiary (Foreign Trust); Foreign Trust’s foreign subsidiaries (LTD 1; LTD 2; LTD 3); and certain foreign operating subsidiaries. The Foreign Trust, LTD 1, LTD 2, LTD 3, and the foreign operating subsidiaries constituted the foreign group (Foreign Group).

The general manner in which the proceeds flowed from Taxpayer to Domestic Subsidiary to Foreign Trust to LTD 1, LTD 2, LTD 3, to the foreign operating subsidiaries was as follows:

The Taxpayer transferred Loan Proceeds to Domestic Subsidiary in exchange for notes. The Domestic Subsidiary transferred Loan Proceeds to Foreign Trust in exchange for an equity interest in Foreign Trust. Foreign Trust transferred the Loan Proceeds to LTD 1 (prior to the transfer, Foreign Trust held $B of LTD 1 common stock, LTD 1's only outstanding stock) in exchange for Loan Stock. LTD 1

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[12](...continued)
purposes of this memorandum, we have assumed that the Debt Securities are not subject to Treas. Reg. § 1.1275-4. This is consistent with the Taxpayer’s treatment of the Debt Securities, as evidenced by the Prospectus Supplement and the Taxpayer’s treatment of the Debt Securities on its federal income tax returns. Even if the Debt Securities were subject to Treas. Reg. § 1.1275-4, we still believe that the Remarketing Payment would be taken into account over the term of the Debt Securities as determined under the projected payment schedule for the Debt Securities.

[13] In response to an IDR, the Taxpayer used an interest rate of one percent over the Base Rate for the period after the Remarketing Date to determine the “interest rate to maturity” of the Debt Securities. Based on this rate, it appears that Treas. Reg. § 1.1272-1(c) would treat the Remarketing Date as the maturity date of the Debt Securities for federal income tax purposes. See also Treas. Reg. § 1.1275-4(b)(9)(iii)(A).

transferred Loan Proceeds to LTD 2 in exchange for an equity interest. LTD 2 transferred the Loan Proceeds to LTD 3 in exchange for a note. LTD 3 transferred the Loan Proceeds to certain foreign operating subsidiaries in exchange for stock and/or assets.

One of the issues upon which you seek our advice is whether the Loan Stock should be treated as debt or equity for federal income tax purposes. For purposes of this response then, the only relevant part of the cash flow is Foreign Trust's transfers of Loan Proceeds to LTD 1 in exchange for LTD 1 Loan Stock.

In response to an IDR, Taxpayer stated that for foreign tax purposes, Loan Stock was treated as debt in order to minimize foreign taxes. For U.S. tax purposes, Taxpayer stated that amounts paid in respect of Loan Stock were treated as returns on equity. The Taxpayer maintains that Loan Stock was equity because: (1) amounts payable on Loan Stock were subordinated to all other LTD 1 liabilities; (2) an agreement (the Loan Stock Agreement) gave Foreign Trust the right to appoint the directors of LTD 1; and (3) if the Loan Stock constituted debt, LTD 1's debt-to-equity ratio would have been approximately $C to $A.

LAW AND ANALYSIS:

The Traditional Debt-Equity Analysis Suggests that the Loan Stock was Equity.

In general, the resolution of the debt-versus-equity issue involves a comparison of the advances with a list of factors thought to be characteristic of "true debt" or "true equity." Some of these factors are – the intent of the parties, the name given the instrument, the presence or absence of a fixed maturity date, whether annual payments are dependent upon earnings, the credit status of the holders of the instruments (that is, whether they are superior to or inferior to other creditors of the corporation), and whether the instrument carries with it any right to participate in the management of the company. None of the factors is necessarily controlling.

1st Factor: Intent of the Parties. If, at the time of the transfer of funds, there was an unconditional intention on the part of the transferee to repay the money and an unconditional intention on the part of the transferor to secure repayment, then this fact would indicate that the parties intended to create debt. Here, there was no promissory note or other formal evidences of indebtedness. The Loan Stock Agreement did, however, establish two alternative maturity dates, one D years and the other E years after issuance of the Loan Stock. Which of the two maturity dates became the true redemption date was dependent solely on the discretion of the issuer. There was no provision in the Loan Stock Agreement for the holder to take

a security interest in assets of the issuer. Additionally, whether the holder would receive proceeds from the redemption of the Loan Stock depended solely on there being equity remaining in the issuer after payment of all the issuer's debts. Thus, based on the terms of the Loan Stock Agreement, there does not appear to be an unconditional intent on the part of LTD 1 (the transferee) to repay the principal of the Loan Stock, nor an unconditional intention on the part of Foreign Trust (the transferor) to secure repayment. This 1st factor suggests equity.

The 2nd Factor – Name of Instrument: A factor in determining whether an instrument is debt or equity is the name given to the instrument. Crawford Drug Stores, Inc. v. United States, 220 F.2d 292, 295 (10th Cir. 1955). Here, the name of the agreement, "Loan Stock Agreement" is ambiguous. It does not suggest debt or equity; it merely suggests that it does not have to be a loan. Thus, this factor is neutral.

The 3rd Factor – Fixed Maturity Date: The absence of a fixed maturity date or a distant maturity date suggests equity. A sum certain payable at maturity that is not a distant maturity date suggests debt. A fixed maturity date is also common in preferred stock, however. Therefore, the presence of a fixed maturity date is not dispositive that the instrument is debt for tax purposes. See Ragland Investment Co. v. Commissioner, 52 T.C. 867 (1969), aff'd, 435 F.2d 118 (6th Cir. 1970).

The Loan Stock Agreement provides that the Loan Stock "shall be redeemed" on Date 2, or Date 3, at the option of LTD 1 (the issuer), if LTD 1 nominates the later date on or before Date 2. Thus, the first date on which redemption of the Loan Stock becomes possible is D years after the issue date. The second date on which redemption of the Loan Stock becomes possible is E years after the issue date. Both of these dates are "distant" maturity dates in light of the fact that LTD 1 is capitalized with only $B of equity. This factor suggests that the Loan Stock investment was equity.

The 4th Factor – Source of Payments with Respect to the Loan Stock: If the yield payments are dependent on earnings, this fact strongly suggests equity. An equity holder's profit or loss depends on the success of the business venture. Conversely, a debt holder is entitled to his return without regard to the success of the business. In other words, debt is payable in all events, regardless of whether the debtor has earnings or not. Here, the first step in the determination of the yield on this investment (referred to in the Loan Stock Agreement, and hereafter, as the "Payment") is initially calculated based on the aggregate value of the Loan Stock multiplied by a specified factor ("Specified Factor"). Standing alone, this fact suggests debt.

Payment of the yield amount here, however, can only be made out of profits. Payments are defined in the Loan Stock Agreement in a way that makes them dependent on the profitability of Foreign Group. Payments are payable in full only if Foreign Group's profits (after subtracting current yield payments) is greater than zero. If the Foreign Group's profit or loss for the tax year, after taking into account Payments with regard to Loan Stock, is zero or below, then the Payment amount is reduced by the amount of Foreign Group's after tax loss (treating the loss as a positive number). The effect of this adjustment is to ensure that the payment amount does not reduce Foreign Group's profits below zero.

Payments that could have been otherwise made if there had been profits do not accumulate. Although the Loan Stock Agreement refers to "arrears of Payments," such references include only situations where payments that were to be made out of profits were not made. These references do not mean that where there is no profits, payments that would have otherwise been made if there had been adequate profits become arrearage. These last two facts indicate equity, and we believe that they outweigh the fact that the Payment is first calculated (before adjustments) using established lending market indicators. This 4th factor suggests equity.

The 5th Factor – Subordination: A fifth factor is whether the investments are superior to or inferior to other creditors of the corporation. Here, the Loan Stock Agreement expressly provided that the Loan Stock was subordinated to and ranked after all moneys and liabilities, absolute or contingent, which are or shall be at any time due to creditors of LTD 1. This factor suggests equity.

The 6th Factor – Right to Participate in Management: The fact that an instrument does not confer upon the holder a voting right or any power of management suggests that the instrument is debt. See Charles L. Huisking & Co. v. Commissioner, 4 T.C. 595, 599 (1945). Conversely, if the instrument grants the holder voting rights, this suggests equity. Here, the Loan Stock Agreement provides Foreign Trust has the right to appoint the directors of LTD 1 so long as it holds the Loan Stock. Once it no longer holds the Loan Stock, LTD 1 can immediately release any and all directors chosen by Foreign Trust.

Even though Foreign Trust has the right to participate in management, we believe that such a right is meaningless under the facts here. At the time of the transfer of Loan Proceeds, Foreign Trust already owned all of LTD 1's outstanding stock. Thus, any grant to Foreign Trust of such a right is akin to a meaningless gesture. We find this factor neutral as to whether the Loan Stock was equity or debt.

The 7th Factor – Liquidation Proceeds: Where the claims of the instrument holder are subordinate to the claims of creditors upon liquidation, equity is suggested. Here, the Loan Stock Agreement provides that payment of the redemption amount

in the event of liquidation is subject to the complete prior satisfaction of the claims of all creditors of LTD 1. This factor suggests that the Loan Stock was equity. Ragland, 52 T.C. at 877; Charles L. Huisking & Co., Inc., supra (upon liquidation, the claims of the holders of the preferred stock are subordinate to the claims of creditors; this indicated to the court that the securities are stock rather than evidence of indebtedness).

The 8th Factor – Enforcement Rights: An essential feature of a debtor-creditor relationship, as opposed to a stockholder-corporation relationship, is the existence of a fixed maturity for a principal sum with the right to force payment of the sum as a debt in the event of default. Parisian, Inc. v. Commissioner, 131 F.2d 394 (5th Cir. 1942); Commissioner v. J. N. Bray Co., 126 F.2d 612 (5th Cir. 1942). There is no direct provision in the Loan Stock Agreement allowing Foreign Trust to force payment of the yield amount. There are two provisions in the Loan Stock Agreement, however, that can be read as giving Foreign Trust the right to force payment of both the aggregate value of the Loan Stock and Payments in arrears. One provision states that upon the winding up of LTD 1, the aggregate value of the Loan Stock (that is, the value of the Loan Stock issued on Date 1) and any Payment due or in arrears is immediately due and payable. The second provision provides alternative maturity dates for redemption of the Loan Stock. We note there is no provision granting Foreign Trust the power to terminate the Loan Agreement prior to these "distant" maturity dates, however. Also, the "due and payable" language of the winding-up provision is tempered with the statement that no aggregate amount or yield payment (whether in arrears or current) is due and payable prior to full satisfaction of any LTD 1 debt outstanding.

Neither I.R.C. § 385(c) nor I.R.C. § 964 Requires that Taxpayer Treat Loan Stock as Debt.

Under I.R.C. § 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. This characterization, however, is not binding on the Service or on a holder that discloses on its return that it is treating the instrument in a manner inconsistent with the issuer's characterization. We do not know whether Taxpayer filed a § 385(c) statement. Foreign Trust and LTD 1 are both Foreign corporations and both are owned indirectly by Taxpayer. Importantly, we note that Taxpayer, in its response to the IDR, stated that it is reporting the characterization consistently as equity with regard to both Foreign Trust (the holder) and LTD 1 (the issuer) on its federal tax return. If this is true, then we believe that I.R.C. § 385(c) is not implicated and Taxpayer would not have had to file a § 385(c) statement. We believe that it is irrelevant for purposes of I.R.C. § 385(c) how Foreign Trust and LTD 1 characterize Loan Stock for purposes of foreign tax law.

Moreover, in your FSA request, you asked whether the fact that the Loan Stock is characterized as debt for Australian Tax purposes should affect the characterization of the loan stock under U.S. tax law. I.R.C. § 964(a) generally requires that the earnings and profits of a foreign corporation be determined according to the rules substantially similar to those applicable to domestic corporations. The characterization of the Loan Stock as debt or equity affects LTD 1's earnings and profits, in that had the Loan Stock been debt, interest paid on the Loan Stock would reduce earnings and profits. Accordingly, under I.R.C. .§ 964(a) this determination must be made according to rules substantially similar to those applicable to domestic corporations, that is, using domestic standards of debt/equity characterization. See also Treas. Reg. § 1.964-1(a); cf. United States v. Goodyear Tire & Rubber Co., 493 U.S. 132 (1989) (for purposes of determining the indirect tax credit under I.R.C. § 902, for tax years prior to 1987, the foreign corporation's accumulated profits were determined in accordance with domestic tax principles).

Accordingly, based on the above factors, we conclude that Loan Stock is best characterized as equity, not debt. Further, we recommend the Government not attempt to recharacterize Loan Stock as debt.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

As stated above, it is unclear whether the Forward Treasury Rate-Lock Agreement was a hedging transaction for purposes of Treas. Reg. § 1.446-4. For example, the Counterparty, the Underwriter, and the Remarketing Agent are the same party, or related parties. If the terms of the agreement were not consistent with the terms that would have obtained in a similar agreement with a counterparty that had no other relationship to the transaction, all or some of the payment may have represented a payment properly attributable to a transaction other than a hedging transaction. If so, then the agreement may not be subject to Treas. Reg. § 1.446-4.

The Taxpayer may be able to demonstrate that the Remarketing Payment should not be treated as bond issuance premium. For example, it is unclear whether a payment made by a party other than the buyer of a debt instrument should be included in the issue price of the debt instrument. However, the language in Treas.

Reg. § 1.1273-2(a) appears broad enough to include such a payment.[14] In addition, although the remarketing feature is an integral part of the Debt Securities, the Taxpayer may be able to argue that this feature should be treated as a separate property right (an option) and that the Remarketing Payment was paid for this right. However, as a general rule, the Service has not bifurcated debt instruments into their component parts for tax purposes, such as bifurcating a callable debt instrument into a borrowing and a call option.

[14] We note that in connection with a change in accounting method request submitted by another taxpayer that has issued similar debt instruments, the taxpayer has argued that the remarketing payment is part of the issue price of the debt instruments and, therefore, should be taken into account as bond issuance premium. In its response, the taxpayer stated that the debt instruments include an embedded put and an embedded call option. The debt issuance may be viewed: (i) as a sale of the debt instruments by the issuer to the holders, accompanied by the simultaneous sale by the holders to the remarketing dealer of the call option, or (ii) as a sale of debt instruments with an embedded put by the issuer to the holders, and a simultaneous sale by the issuer to the remarketing dealer of the embedded call. In either event, the issuer is entitled to receive, and does receive, payment for the full value of the bond, including the value of both the embedded put and the embedded call. Thus, regardless of the characterization, the issuer receives a premium upon issuance of the bonds. The taxpayer indicates that it is not aware of any authority that would allow a taxpayer to compute its bond premium differently when the issue price is paid by two separate payors.

We would be pleased to provide ongoing assistance in this matter.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

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