INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

US Parent	=
Corp A	=
Corp B	=
Corp C	=
LLC	=.
CFC1	=
CFC2	=
F Corp1	=
Bank	=
Lender	=
F Corp2	=
L.P.	=
Fund	=
Business X	=
Date 1	=
Date 2	=

Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
$a	=
$b	=
$c	=
$d	=
$e	=
$f	=
$g	=
$h	=
$i	=
$j	=
$k	=
$l	=
$m	=
Country A	=
Country B	=

ISSUE(S):

1. Whether the preferred stock arrangement can "voluntarily restrict" earnings and profits and, thus restrict the controlled foreign corporation's distribution of subpart F income under sections 951, 952, 954 and 956 of the Code to the common units while any preferred units remain outstanding in CFC2.

2. Whether the preferred stock arrangement can be defined and recharacterized under the "fast pay" regulations of Treas. Reg. §1.7701(l)-3(b) and further, if so should this financing instrument be treated as debt or equity.

CONCLUSION(S):

Based upon the facts submitted by US Parent and LMSB:

1. Notwithstanding the voluntary restriction on the current distribution of earnings and profits of CFC2 on its common units, LLC will still be required to include in income currently its pro rata share of the sum of amounts described under section 951(a)(1); and

2. The preferred units issued by CFC2 are fast-pay stock as defined in Treas. Reg. §1.7701(l)-3(b) and thus, the financing arrangement will be recharacterized under

Treas. Reg. §1.7701(l)-3(c)(2). Further, the arrangement will have the same tax result whether the financing instruments are characterized as debt or equity.

FACTS:

1. Background.

US Parent, a domestic corporation, is the common parent of a group of affiliated corporations that filed consolidated federal income tax returns and used the accrual method of accounting. During the years at issue, US Parent and its affiliates were engaged in Business X.

On Date 1, US Parent completed a $a acquisition by tender offer of Corp C. On Date 2, a date prior to Date 1, Bank presented US Parent with a plan for funding the $a required to acquire Corp C. A refined version of the plan was adopted by US Parent with Bank acting as its exclusive financial advisor with respect to the plan. The financing transaction was completed on Date 5. The financing arrangement was implemented as follows:

1) On Date 3, US Parent formed LLC, a domestic limited liability company, 90 percent owned by Corp A and 10 percent owned by Corp B, both wholly-owned domestic subsidiaries of US Parent and members of US Parent's consolidated group.

2) On Date 4, LLC formed CFC1, a Country B company, by contributing $b to CFC1 in exchange for 500 common shares of CFC1 stock. On Date 5, LLC contributed an additional $c to CFC1 in exchange for 51,598 subordinated convertible equity certificates (SCECs)[1] of CFC1.

3) On or before Date 5, Fund, a non-profit domestic corporation, formed F Corp2, a Country A company, and on Date 5 contributed $e to F Corp2 in exchange for 400 shares of F Corp2. On or before Date 5, F Corp2 borrowed $f from L.P., a domestic limited partnership that is unrelated to US Parent and Fund.

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[1] The SCECs have a term of 99 years and are subordinate to all present and future obligations and interests in CFC1, other than its common stock. A return out of retained earnings may be paid on the SCECs to holders only if and when such a return is declared by CFC1's board of managers or if the SCECs are redeemed. The holders of the SCECs do not have the rights of creditors.

For Country B tax purposes, the SCECs are treated as debt and interest expense is accrued and payable to LLC. This amount offsets CFC1's interest income accrual from CFC2 for Country B tax purposes. For US tax purposes, the SCECs are treated as equity and no income or expense is reported on any US tax return. CFC1's Form 5471 balance sheet reflects a $d investment in CFC2, a Country A company.

4) On or before Date 5, F Corp2 formed F Corp1, a Country A company, and on Date 5 contributed $g ($e + $f) in exchange for 400 F Corp1 shares.

5) On Date 5, F Corp1 entered into a credit agreement with a group of lenders for which Lender, a Bank affiliate, served as administrative agent. Under that agreement, F Corp1 borrowed an aggregate amount of cash equal to $h.

6) On Date 5, US Parent obtained a $d daylight overdraft loan from Lender. On behalf of Corp A, Corp B, and LLC, US Parent arranged for Lender to wire transfer the $d to CFC1. US Parent's accounting books and records reflect this transaction as consisting of a borrowing of $d by US Parent, followed by a contribution to Corp A of $j and to Corp B of $i, followed by contributions of those amounts by Corp A and Corp B to LLC and then finally the contribution of $d to CFC1.

7) On Date 5, CFC1 and F Corp1 formed CFC2, a Country A general partnership that elected to be treated as a corporation for US tax purposes. CFC1 contributed $d in exchange for 12 CFC2 common units and F Corp1 contributed $k in exchange for 1000 CFC2 preferred units. Each common unit was entitled to 115 voting rights compared to a .12 voting right for each preferred unit.

8) On Date 5, CFC2 loaned approximately $l to US Parent in exchange for two promissory notes totaling that amount. In the first loan, in the amount of $m, an amount that is approximately 98 percent of $d, US Parent promised to pay to CFC2 the principal amount due on demand or if no demand is made, on Date 6. Interest on this note is 6.685 percent from Date 5 through Date 7 and thereafter the interest rate is equal to LIBOR + 1.685 percent. The second loan was for a principal amount of $k and otherwise contains the same terms as the first loan. These loans made by CFC2 were permitted assets[2] under CFC2's operating agreement.

9) On Date 5, LLC entered into an agreement with Fund in which Fund granted LLC the option to acquire, at book value, the shares of F Corp2 held by Fund. LLC and Fund agreed the option shall be terminated at the earlier of the disposition by F Corp1 of its entire interest in the preferred units of CFC2, or 180 days preceding the mandatory redemption date of the preferred units of CFC2.

10) US Parent utilized $d of the funds loaned by CFC2 to repay the daylight loan from Lender.

[2] The CFC2 General Partnership Agreement (GPA) limits the amount and types of investments permitted by CFC2.

11) CFC2 has used a portion of the interest income received from US Parent to make additional loans to US Parent and its affiliates.

A. Terms of the preferred units of CFC2

F Corp 1 as the owner of the preferred units of CFC2 has the right to a floating rate[3] cumulative distribution multiplied by the liquidation preference of such units if, as and when declared by the board out of retained earnings. The amount of the distribution is calculated quarterly by multiplying LIBOR + 1.56 percent by the liquidation preference of the preferred units. If this quarterly distribution is not paid, it accrues without interest. This mandatory distribution preference will be described throughout this document as the "first preference distribution."

The preferred units are required to be redeemed on Date 6 for an amount that equals the liquidation preference of the preferred shares, plus any unpaid but accrued first preference distributions reduced by the amount of any redemption proceeds received with respect to the preferred units. The preferred units are generally redeemable, in whole or in part, at the option of the board of directors of CFC2. Any voluntary redemption by CFC2 prior to Date 6 (whether in whole or in part), will reduce the liquidation preference (and ultimately the redemption price as of Date 6) of the preferred units and will be described throughout this document as a "second preference distribution." US Parent, indirectly, can cause CFC2 to redeem its preferred units at any time because CFC1 has voting control of CFC2 by virtue of owning the common units of CFC2 and US Parent indirectly has voting control of CFC1. No second preference distributions have been paid.

The preferred units have an initial liquidation preference equal to the amount contributed by F Corp1, or $k.

Finally, the common units of CFC2 contain a restriction. Section 13.1 of the CFC2 partnership agreement provides that holders of common units of CFC2 are entitled to receive cash distributions when declared by the Directors of CFC2, provided the Board of Directors shall not declare distributions on the common units while any preferred units are outstanding. In effect, the partnership agreement seeks to prohibit distributions on the common units for a period of ten years unless the preferred units are redeemed earlier as a result of a second preference distribution.

2. Facts and factual conclusions submitted by US Parent but not agreed to by LMSB.

US Parent has represented that it expects the preferred stock to be redeemed at par, and believes that it is unlikely (although possible if the business environment changes for US Parent or CFC2) that a second preference distribution will be paid.

[3] The determination of the interest rate is made by reference to a formula contained in CFC2's GPA.

In response to discussions with the IRS regarding the applicability of the fast-pay regulations, US Parent maintains that the preferred stock should not be presumed to be fast-pay stock because of the possibility that the redemption price of the preferred units may be less than the issue price of the preferred units. However, US Parent agreed that the presumption would, in fact, apply if the parties contemplated actual payment of a second preference distribution in structuring the transaction such that the redemption price would be less than the issue price. US Parent further represents that the parties to this transaction did not contemplate that a second preference distribution would be paid under normal circumstances.

SUMMARY OF POSITIONS:

1. LMSB's Position.

LMSB maintains that LLC, the United States shareholder of CFC2, and indirectly US Parent, as parent of the US Parent consolidated group that includes Corp A and Corp B, should include in gross income under section 951(a) of the Code, its proper pro rata share of CFC2's subpart F income. For purposes of determining LLC's pro rata share of CFC2's subpart F income, the restriction contained in CFC2's partnership agreement that purports to prohibit distributions on CFC2's common units should be disregarded. Therefore, LLC's pro rata share of subpart F income should be determined under Treas. Reg. §1.951-1(e) without regard to such restriction.

LMSB further maintains that this financing transaction is a fast-pay transaction and should be recharacterized pursuant to Treas. Reg. §1.7701(l)-3(c). The financing transaction is a fast-pay transaction under Treas. Reg. §1.7701(l)-3(b) because the fast-pay arrangement is structured so that dividends (as defined in section 316) paid on the preferred units are, in whole or in part, a return of F Corp1's investment, rather than only a return on such investment. Therefore, this transaction should be recharacterized as a fast-pay arrangement directly between LLC and F Corp1. Under general tax principles, the financing instrument issued to F Corp1, following a recharacterization pursuant to the fast-pay regulations, should be characterized as equity.

2. US Parent's Position

US Parent maintains that LLC and indirectly, the US Parent consolidated group that includes Corp A and Corp B, has no subpart F inclusion under section 951(a). US Parent maintains that LLC's pro rata share of the subpart F income of CFC2 is zero because no distributions may be made on the common units of CFC2, indirectly owned by LLC, and therefore, under Treas. Reg. §1.951-1(e)(2), all the earnings and profits of CFC2 must be allocated with respect to the first and second preferences of the preferred units of CFC2 owned by F Corp1.

US Parent also maintains that this transaction is not a fast-pay arrangement under the regulations because the preferred units are not fast-pay stock. This position is based upon US Parent's representations that no distributions are contemplated with respect to the second preference distribution rights of the preferred units and that the parties will not be economically compelled to pay a second preference dividend before the option expires. Lastly, US Parent believes that if the preferred units are determined to be fast-pay stock and the financing arrangement is recharacterized pursuant to the fast-pay regulations, the financing instruments issued to F Corp1 should be characterized as debt.

LAW AND ANALYSIS:

The above described arrangement may be subject to challenge under other theories not addressed in this TAM, such as general substance over form arguments (perhaps including circular cash flow). However, based upon the facts as currently developed and presented by US Parent and LMSB in this request, this TAM will address the two primary positions: 1) treatment of the arrangement under subpart F and 2) treatment of the arrangement under the fast-pay regulations.

Issue 1. Subpart F analysis.

A. In General.

Section 951(a)(1)(A)(i) requires each United States shareholder of a CFC to include in income for its taxable year its pro rata share of the CFC's subpart F income. For purposes of determining the amount of a United States shareholder's subpart F inclusions, section 951(a)(2) and Treas. Reg. §1.951-1(b) and (e) define pro rata share.

Treas. Reg. §1.951-1(e)(2) provides a specific rule when the controlled foreign corporation has more than one class of stock. Treas. Reg. §1.951-1(e)(2) provides, in relevant part, that if a controlled foreign corporation has more than one class of stock outstanding, the amount of the corporation's subpart F income for the taxable year which is taken into account with respect to any one class of stock is the amount of earnings and profits that would be distributed with respect to such class of stock if all the earnings and profits of the corporation for such year were distributed on the last day of the corporation's taxable year.

US Parent has taken the position that pursuant to Treas. Reg. §1.951-1(e)(2), none of the earnings and profits of CFC2 should be allocated to US Parent. Specifically, it is US Parent's position that the restriction in CFC2's partnership agreement prohibiting distribution on the common units while any preferred units are outstanding prohibits the allocation of CFC2's earnings and profits to the common units. Therefore, US Parent concludes that because no earnings and profits may be distributed to LLC, and indirectly to US Parent, while the preferred units are outstanding, all the earnings and profits of CFC2 should be allocated to F Corp1. US Parent further maintains Treas. Reg. §1.951-1(e)(2) is the relevant regulation that determines its pro rata inclusion because CFC2 has two different classes of stock outstanding.

In the discussion that follows, it will be shown that US Parent's attempt to prohibit any distribution on the common units does not prevent an inclusion of subpart F income by LLC: 1) because the restriction has no legal significance for purposes of section 951(a)(2) and Treas. Reg. §1.951-1(b) and (e); and 2) because US Parent has represented that payment of second preference distributions (which were structured to be treated as dividends if paid before the option expires) were never contemplated in the ordinary course of the transaction, Treas. Reg. §1.951-1(e)(2) should be applied to determine the earnings and profits allocable to the common units held by LLC without regard to the second preference distribution rights of the preferred units.

B. A voluntary restriction on the payment of dividends has no legal significance and will not affect a United States shareholder's requirement to include in gross income subpart F income pursuant to section 951(a)(1).

Paragraph 13.1 of the General Partnership Agreement (GPA) between CFC1 and F Corp1 provides the general provision for no payment of distributions on the common units of CFC2 until the preferred units are redeemed. This provision, which is the foundation for US Parent's position that Treas. Reg. §1.951-1(e)(2) governs the determination of LLC's pro rata share of CFC2's subpart F income, is a statement agreed to by the parties of the GPA. Arguably, this provision results from arm's-length legal agreements entered into between CFC1 and F Corp1. In essence, US Parent is stating that LLC should not be required to include any of CFC2's subpart F income because it agreed as the United States shareholder of the common units that it cannot, for a limited period (where the length of such period is under the complete control of US Parent), receive a distribution with respect to those units.

Section 951(a)(2) provides, in relevant part, that the pro rata share of a CFC's subpart F income for a taxable year in the case of any United States shareholder is the amount which would have been distributed with respect to the stock which such shareholder owns, within the meaning of section 958(a), in such corporation if on the last day, in its taxable year, on which the corporation is a CFC it had distributed pro rata to its shareholders the subpart F income of the controlled foreign corporation reduced by the amount of distributions received by any other person during such year as a dividend with respect to such stock.

Under section 951(a)(2) and Treas. Reg. §1.951-1(b), a United States shareholder's pro rata share is determined without regard to whether the CFC can actually pay such income as a dividend currently. Pro rata share is determined based upon a hypothetical distribution at the end of the taxable year of the CFC of all of its earnings and profits for that taxable year and is only reduced by dividends actually paid to another person. Other than the blocked income provision of section 964(b), there is nothing in the statute or regulations that limits the United States shareholder's pro rata share of the CFC's subpart F income to what it could actually receive currently. Treas. Reg. §1.951-1(e)(2), which defines "pro rata share" in the case where there is more than one class of stock, follows the general rule of Treas. Reg. §1.951-1(b). Under Treas. Reg. §1.951-1(e)(2), a shareholder's pro rata share of subpart F income is also determined by reference to a hypothetical distribution of the CFC's earnings and profits at the end of the taxable year of the CFC. This regulation also does not limit a subpart F inclusion to dividend amount that the shareholder could actually receive in such taxable year. Therefore, whether the board of directors of CFC2 is, in fact, prohibited from paying a distribution currently with respect to the common units of CFC2 has no effect upon the determination of US Parent's pro rata share of subpart F income under section 951(a)(2) or Treas. Reg. §1.951-1(b) or (e)(2). The fact that LLC is prohibited for a limited time, where the imposition and duration of the limitation is subject to the complete control of LLC and indirectly US Parent, from actually receiving a distribution with respect to its indirect ownership of the common units of CFC2 is irrelevant for purposes of determining its pro rata share of CFC2's subpart F income.

Additionally, section 964(b) and Treas. Reg. §1.964-2(b) limit a subpart F inclusion if it is established that earnings and profits cannot be distributed by the CFC because of currency or other restrictions or limitations imposed under the laws of any foreign country. The restriction on the disposition of earnings and profits in this case is not imposed as a result of a foreign law but as a result of a voluntary agreement entered into by the parties to the transaction. Under subpart F, there is no limitation on a United States shareholder's inclusion in gross income of its pro rata share of its CFC's subpart F income as result of a voluntary restriction on the payment of dividends.

C. US Parent's reliance on Barnette is misplaced.

US Parent seeks to use Barnette v. Commissioner, T.C. Memo 1992-371 (1992), to show that LLC was not required to include as gross income any of its pro rata share of CFC2's subpart F income solely as a result of a voluntary restriction on its common stock. US Parent's reliance on Barnette for this proposition is misplaced. The issue before the Tax Court in Barnette was whether the United States shareholder who owned common shares of a foreign personal holding company (FPHC) or the United States shareholder who owned preferred shares of a FPHC was required, pursuant to Treas. Reg. §1.551-2(c), to include in gross income as a deemed distribution an amount equal to the FPHC's undistributed FPHC income for such taxable year.

The regulation at issue in Barnette, Treas. Reg. §1.551-2(c), requires an allocation of FPHC income pursuant to the interest of the shareholder in the FPHC, taking into account any specified preferred distributions required to be made. The court's decision and the resolution of this issue turned on the allocation of the FPHC income between two classes of United States shareholders, pursuant to the FPHC regulations, rather than determining whether a United States shareholder was required to include a deemed distribution in gross income under section 951(a) and the regulations thereunder because the shareholder was not currently entitled to such income.

In contrast to Barnette, in Mariana Frozen Foods, Inc. v. Commissioner, 81 T.C. 448 (1983), the United States shareholder of a FPHC claimed that he should not be required to include as a deemed distribution the undistributed FPHC income of the FPHC. In Mariana, the United States shareholder held common shares and an unrelated foreign party held preferred shares of the FPHC. The preferred shareholders had the power to block any distribution on the common shares. In addition, the FPHC entered into a commercially reasonable provision with a bank, as part of a bank loan, that prohibited the payment of any distributions on the common shares for so long as the bank loan was outstanding. The taxpayer in Mariana sought to apply the Alvord doctrine to the facts at issue and have the court conclude that the taxpayer was not required to include in gross income any amounts under section 551 due to its inability to declare a dividend with respect to its common stock because of the restriction on the payment of distributions on the common stock. In Alvord v. Commissioner, 277 F.2d 713 (4th Cir. 1960), the court held that a United States shareholder, whose stock was subject to a federal income tax lien and thus restricted from paying dividends to its shareholders, was not required to include in gross income any amount under section 551 because the shareholder was prohibited by governmental action from making a distribution on the stock. The court in Mariana distinguished Alvord on the facts stating, "the U.S. shareholder's alleged inability to force a dividend arises from [the United States shareholder] having transferred to a foreign minority shareholder the power to block dividends, and not from any governmental action." Mariana, 81 T.C. at 484.

US Parent's self imposed restriction argument is identical to the taxpayer's argument in Mariana. Section 951(a) cannot be read to permit a United States shareholder to have the power to restrict an otherwise deemed inclusion under subpart F merely by entering into a contractual agreement that prohibits distributions on the United States shareholder's stock. The terms of the GPA at issue were negotiated between the parties and each party voluntarily agreed to the terms. The voluntary insertion of a provision similar to Paragraph 13.1 of the GPA in no way governs the applicability of subpart F and cannot be relied upon to shift federal income tax liability away from LLC.

Although Barnette properly shows how income is allocated under Treas. Reg. §1.551-2(c) between two United States shareholders for purposes of the FPHC provisions, this is ultimately irrelevant for purposes of this case because subpart F contains specific allocation rules in Treas. Reg. §1.951-1(e). Even if it were determined that the similarity between the allocation rules of Treas. Reg. §1.551-2(c) and Treas. Reg. §1.951-1(e) were relevant, Mariana provides that a United States shareholder will not avoid a FPHC inclusion under the FPHC provisions by entering into an agreement with a foreign shareholder of the FPHC that prohibits distributions with respect to the United States shareholder's stock. As such, US Parent's reliance on Barnette for purposes of allocating subpart F income is misplaced.

D. In the alternative, the restriction on the payment of dividends on the common units has no substantive significance if no second preference distributions are paid.

US Parent has represented that under "normal circumstances" a second preference distribution would never be paid by CFC2 to F Corp1. There has been no suggestion of the presence of extraordinary circumstances. In addition, a second preference distribution has never been paid. Accordingly, F Corp1 has only received first preference distributions and based upon US Parent's representations, will only receive first preference distributions. The preferred units, in substance, are equivalent to ordinary preferred stock, provided US Parent's representation that no second preference distribution will ever be paid, is correct. Therefore, assuming a second preference distribution is not paid, Treas. Reg. §1.951-1(e)(2) should apply to allocate the earnings and profits attributable to the first preference distribution to F Corp1 and the remaining earnings and profits to LLC. See Treas. Reg. §1.951-1(e)(4) Ex. 1.

LLC, as the United States shareholder of CFC2, would be required under section 951(a) to include as its pro rata share of subpart F income, the amount of subpart F earnings and profits that remain following the amount allocated as a first preference distribution with respect to the preferred units.

Issue 2. Application of Treas. Reg. §1.7701(l)-3.

If, contrary to the assumption made above, F Corp1 as owner of the CFC2 preferred units is, in substance, entitled to a second preference distribution, this arrangement is a fast-pay arrangement and would be recharacterized pursuant to Treas. Reg. §1.7701(l)-3. Therefore, LLC would be required to include in gross income as its pro rata share of CFC2's subpart F income all of the subpart F income of CFC2 and further, Corp A and Corp B would be required to include in gross income their distributive share of LLC's gross income, an amount equal to LLC's gross income reduced by an amount equal to the first preference distributions paid to F Corp1 on its CFC2 preferred units.

In 1999, the IRS and Treasury issued final regulations, effective for taxable years ending after February 26, 1997, under section 7701(l) that address fast-pay stock arrangements. Such arrangements are structured as multiple-party financing transactions whereby a person (sponsor) attempts to avoid U.S. tax on income by using a conduit entity, such as a RIC, REIT, or foreign corporation, to artificially allocate the conduit entity's income to tax-indifferent participants in the transaction. Under a typical arrangement, the fast-pay stock economically is a self-amortizing instrument because payments on the instrument are structured to represent both a return “on” and a return “of” the investment. For tax purposes, however, the entire payment is treated as a dividend. This is accomplished by structuring payments that represent an economic return of investment (through a declining yield, for example) as dividends for tax purposes. Alternatively, such arrangements can use stock redemptions that are treated as dividends for tax purposes (often as a result of issuing options or warrants). These structures overstate the amount of dividend income to the tax-indifferent party and therefore understate the amount of income to the sponsor. The fast-pay stock regulations recharacterize fast-pay stock arrangements to prevent such tax avoidance.

Under Treas. Reg. §1.7701(l)-3(c)(1)(ii), if the Commissioner determines that a principal purpose for the structure of a fast-pay arrangement is the avoidance of tax imposed by the Code, the Commissioner may recharacterize the transaction to ensure that the participants are taxed in a manner reflecting the economic substance of the arrangement. A fast-pay arrangement is defined in Treas. Reg. §1.7701(l)-3(b)(1) as 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)(2)(i) defines fast pay stock as stock that is structured so that dividends paid by the corporation with respect to the stock are economically (in whole or in part) a return of the holder’s investment (as opposed to only a return on the holder’s investment).

Stock is presumed to be fast-pay stock: 1) 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); or 2) if it is issued for an amount that exceeds the amount at which the holder can be compelled to dispose of the stock. Treas. Reg. §1.7701(l)-3(b)(2)(i)(A) and (B). The determination of whether stock is fast-pay stock is based on all the facts and circumstances, including any related agreements such as options. When determining if stock is fast-pay stock, the stock is examined when issued. Stock is not fast-pay stock solely because a redemption is treated as a dividend as a result of section 302(d), unless there is a principal purpose of achieving the same economic and tax effect as a fast-pay arrangement.

In this case, the CFC2 preferred stock is presumed to be fast pay stock under the second presumption identified above (Treas. Reg. §1.7701(l)-3(b)(2)(i)(B)). Taking all the facts and circumstances into account, including the related option, the CFC2 preferred stock was issued for an amount that exceeds the amount at which F Corp1 can be compelled to dispose of the stock. During the course of the ten-year term of the preferred units, the terms of the preferred units provide that preferred shareholders are entitled to first and second preference distributions. Specifically, for the first 9 ½ years of such term (up to the point where the option agreement expires), the second preference distribution will be treated as a dividend under section 302(d) because of the option attribution rules of section 318(a)(4).[4] If CFC2 makes a second preference

[4] Section 318(a)(4) provides than an option to acquire stock shall be treated as if such stock were owned by such person. In this case, since LLC entered into an option with Fund to acquire F Corp2, LLC is

distribution anytime during the first 9 ½ years of the arrangement, that distribution will be treated as a dividend even though the liquidation preference (and similarly the redemption price) will decline by a corresponding amount. Thus, in effect the second preference is a return of F Corp1's investment, yet with the option agreement these redemption distributions would receive dividend treatment (i.e., a return "on" the investment). Although US Parent has represented that it does not intend to make a second preference distribution, it is unlikely that US Parent can demonstrate that no second preference distribution will ever be made on the preferred shares. Further, whether or not a second preference distribution is actually paid, the availability of the second preference distribution is, in substance, part of the financing arrangement. Consequently, the preferred shares should be treated as having been issued at a price that exceeds the amount at which F Corp1 could be compelled to dispose of the preferred stock.

US Parent disagrees that the preferred units should be presumed to be fast-pay stock under Treas. Reg. §1.7701(l)-3(b)(2)(i)(B). US Parent maintains that this presumption cannot apply in this case unless a second preference distribution were, in fact, paid or that the parties to this arrangement contemplated the payment of a second preference distribution. US Parent further maintains that this presumption would only apply if the preferred units were issued for an amount that exceeds the amount at which the holder can be compelled to dispose of the stock (original issue premium). Contrary to US Parent's interpretation of Treas. Reg. §1.7701(l)-3(b)(2)(i)(B), the regulations do not provide that the presumption, contained in Treas. Reg. §1.7701(l)-3(b)(2)(i)(B), is subject to such conditions.

As indicated, Treas. Reg. §1.7701(l)-3(b)(2)(ii) provides, in part, that a determination of whether stock is fast-pay stock is made when the stock is issued. There is no requirement in the regulations that in order for the presumption described in Treas. Reg. §1.7701(l)-3(b)(2)(i)(B) to apply, a fast-pay shareholder must actually know, at the time of the issuance of the fast-pay stock, whether the amount it will actually receive at the time of the disposition of such stock is less than the shareholder's initial investment. Moreover, in order for this presumption to apply, the regulations merely require that the stock be issued at a price that exceeds the amount at which the holder can be compelled to dispose of the stock. At the time the preferred units were issued, this presumption applied and therefore, the preferred units are fast-pay stock.

Further, even if US Parent's position, that the preferred units must contain an original issue premium for the presumption under Treas. Reg. §1.7701(l)-3(b)(2)(i)(B) to apply is correct, the preferred units can be viewed as issued for an original issue

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treated as owning F Corp2, and indirectly owning F Corp1. If a second preference distribution is paid, a portion of F Corp1's preferred units will be redeemed by CFC2. This redemption will be treated as a dividend, under section 302(d), to F Corp1 because LLC is treated under section 318(a)(4) as owning F Corp2 and indirectly F Corp1. Since, F Corp1 is treated as indirectly owned by LLC at the time of the redemption, F Corp1 is treated as owning everything that LLC owns, including CFC2.

premium because those units were issued for an amount that exceeds (by more than a de minimis amount) the amount at which F Corp1 can be compelled to dispose of the stock. The presumption contained in Treas. Reg. §1.7701(l)-3(b)(2)(i)(B) does not require that the issue price exceed, at all times, the amount at which the holder can be compelled to dispose of the stock. Instead, the presumption will apply in cases when the issue price will exceed the amount at which the holder can be compelled to dispose of the stock. For instance, if a second preference distribution were, in fact, paid at any time during the course of the arrangement, the amount received by F Corp1 at the end of the arrangement, on Date 9, would be less than the stock's issue price. Therefore, it can be said that the preferred units were issued for an amount that exceeds the amount at which F Corp1 can be compelled to dispose of the stock.

In the alternative, regardless of whether the CFC2 preferred units satisfy the presumption described above, the preferred units satisfy the general definition of fast-pay stock when testing the preferred units at the time of their issuance. At the time of issuance, the preferred units, taking into account the related option agreement, are structured so that distributions actually made would be treated as dividends for tax purposes but would in fact be a return of F Corp1's investment in CFC2 rather than a return on its investment in CFC2. Whether or not any second preference distributions are actually made on the preferred stock, the mere existence of the option will cause any redemption of the preferred units prior to the expiration of the option to be treated as a dividend. The presence of the option at the time of any future redemption of the preferred stock permits F Corp1 to receive its $k investment in the form of a dividend. See Treas. Reg. §1.7701(l)-3(e) Ex. 3. Further, there are no facts to suggest that, at the time of the issuance of the preferred shares, US Parent, as indirect owner of CFC2, could not or would not compel CFC2 to redeem the preferred shares before the expiration of the option.

Based on all of the facts and circumstances CFC2 has a strong economic and tax incentive to redeem the shares while the option is outstanding. As described above, CFC2 has the right to redeem the preferred shares at any time before the final redemption date. The option held by Fund will expire six months before CFC2 must redeem the preferred shares. Before the option expires, CFC2 is neither contractually obligated to redeem the shares nor prohibited from redeeming the shares. However, by having CFC2 redeem the shares before the option expires, LLC and indirectly US Parent will be in a position to avoid recognizing dividend income when the earnings of CFC2 are repatriated.

A taxpayer is generally subject to taxation when earnings and profits of a foreign subsidiary are repatriated, whether by way of dividends or dispositions of the stock. See sections 301, 367(b) and 1248. If CFC2 redeems the preferred shares while the option is outstanding, that redemption will be treated as a dividend to F Corp1. See sections 302(d) and 318(a)(4). Consequently, that redemption will treat the $k of the earnings and profits in CFC2, the majority of which represents an economic return to the common units indirectly held by US Parent, as a dividend to F Corp1 (an entity not subject to United States income tax), with no tax cost to CFC2, LLC or US Parent. As a result, there would be no amount taxable to LLC as a dividend if the assets of CFC2 were distributed to LLC (or if the common units of CFC2 were otherwise disposed of). (At that time $k, all or substantially all of the earnings and profits in CFC2, will have been paid as a dividend to F Corp1.) If, however, CFC2 were to wait until after the option expired to redeem the preferred shares, the redemption would not be a dividend to F Corp1, thus, leaving $k in earnings and profits that would, in general, be taxed to LLC as a dividend when: 1) CFC2 distributes its assets to LLC (through CFC1); 2) CFC2 and CFC1 are liquidated; or 3) the shares of CFC2 are directly or indirectly disposed of.

Both courses of action are equally available to CFC2 (and LLC who indirectly controls CFC2). However, only one confers a significant tax benefit. Therefore, the arrangement was structured so that CFC2 could redeem the preferred shares while the option is outstanding. Similarly, there is no reason to conclude that CFC2 will not, at some point, make distributions, or be liquidated or sold to an unrelated party after the preferred shares are redeemed. CFC2 is a special purpose entity. If the assets of CFC2 are not distributed and it is not liquidated or sold after its preferred units are redeemed, all of its future investment earnings will be subpart F income that LLC and indirectly US Parent, as parent of the US Parent consolidated group that includes Corp A and Corp B, will have to include in gross income.

US Parent disagrees that the parties would be economically compelled to pay the second preference distribution before the option expires due to its reading of Treas. Reg. §1.951-1(e). US Parent maintains that if CFC2 were liquidated in a transaction subject to Treas. Reg. §1.367(b)-3[5], the all earnings and profits amount that must be included in income as a deemed dividend under Treas. Reg. §1.367(b)-3(b)(3)(i) is determined according to the attribution principles of section 1248 and the regulations thereunder. See Treas. Reg. §1.367(b)-2(d). Section 1248 determines the amount of earnings and profits attributable to stock where more than one class of stock is outstanding by reference to Treas. Reg. §1.951-(e). See Treas. Reg. §1.1248-3(c)(4). US Parent, however, maintains that under its interpretation of Treas. Reg. §1.951-1(e), no subpart F income will be allocable to the common units held indirectly by LLC during the term of the preferred units. Thus, US Parent maintains that CFC2's all earnings and profits amount would be zero during the term of the preferred units. As a result, US Parent concludes that there would be no economic compulsion to pay the second preference distribution on the preferred units before the option expires.

The Service, however, does not agree with US Parent's interpretation of the application of Treas. Reg. §1.951-1(e) with respect to amount of earnings and profits

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[5] If CFC2 were directly liquidated into LLC, the liquidation would be subject to section 331 as opposed to section 332. See Treas. Reg. §1.367(b)-3(b)(2) Ex. As a result, all or a portion of the gain recognition on the liquidation would be recharacterized as a dividend pursuant to section 1248(a).

that would be required to be taken into account if the assets of CFC2 were distributed to LLC, if CFC were liquidated into LLC or if the CFC2 common units were sold. For instance, if the CFC2 common units were transferred to US Parent pursuant to a non-recognition transaction (e.g. if LLC distributed the shares of CFC1 to US Parent, and CFC1 liquidated into US Parent) and CFC2 liquidated into US Parent in a transaction subject to section 332, US Parent would be required to include in gross income as a dividend the all earnings and profits amount attributable to the CFC2 stock that was not included in gross income during the time LLC owned such stock, reduced, in part, by amounts previously included in gross income under section 951(a). Assuming US Parent's position with respect to the allocation subpart F income, discussed in Issue 1 infra, is correct, if the preferred units were redeemed by CFC2 by paying a second preference distribution to F Corp1 prior to the expiration of the option, there would be little or no earnings and profits remaining in CFC2 following the payment of the second preference distribution. As a result, if CFC2 subsequently liquidated (as described above), the all earnings and profits amount that LLC would be required to include in gross income as a dividend would be negligible. On the other hand, if the preferred units were redeemed by CFC2 by paying a second preference distribution to F Corp1 after the expiration of the option, there would be a substantial amount of earnings and profits remaining in CFC2. Under these facts, if CFC2 subsequently liquidated (as described above), the all earnings and profits amount that LLC would be required to include in gross income as a dividend would be greater than the amount that would have been included if the redemption occurred prior to the expiration of the option. Thus, LLC and indirectly US Parent would be compelled, from a tax standpoint, to cause CFC2 to redeem the preferred units prior to the expiration of the option in order to treat the redemption as a dividend, thereby reducing any future tax due upon the liquidation of CFC2.

A redemption of the preferred stock while the option is outstanding will result in the arrangement achieving the same economic and tax effect as a fast-pay arrangement in which the preferred stock satisfies either the presumption, as described above, or the general test for fast-pay stock. That is, as a result of the terms of the preferred units and the option, CFC2 will reduce its earnings and profits by an amount that represents both dividends and a return of F Corp1's $k investment in CFC2. Accordingly, as a result of a distribution of CFC2's property or the liquidation or sale of CFC2, LLC, and indirectly US Parent, will not include such earnings in income as a dividend. See Treas. Reg. §1.7701(l)-3(e) Ex. 3 and Notice 97-21.

Furthermore, the principal purpose of the structure of this transaction is an attempt for US Parent to avoid income inclusions under subpart F of the Code and to avoid the inclusion of CFC2's earnings and profits in income. Specifically, US Parent is seeking to use this structure in conjunction with the option agreement to change the character of any second preference distribution from a redemption treated as a sale or exchange to a dividend that would reduce the earnings and profits of CFC2 that would otherwise be available to be distributed with respect to the common units. If US

Parent's interpretation of Treas. Reg. §1.951-1(e)(2) applies, taking into account its position regarding the voluntary restriction on the distribution of earnings and profits to the CFC2 common units, then the principal purpose of this structure is to avoid federal income tax and thus, the financing arrangement may be recharacterized pursuant to the fast-pay regulations.

Treas. Reg. §1.7701(l)-3(c)(2) provides, in part, that a fast pay arrangement is recharacterized as an arrangement directly between the benefited shareholders and the fast-pay shareholders. Thus, for purposes of recharacterizing this fast-pay arrangement, the following transaction would be deemed to occur: 1) LLC as the first United States entity above CFC2 would be determined to be the benefited shareholder[6], 2) LLC would be deemed to issue financing instruments in the amount of $k to F Corp1, 3) LLC would contribute the $k to CFC1, in return for CFC1 stock, 4) CFC1 would contribute the $k to CFC2, in return for CFC2 common units. As a result of recharacterizing the transaction, any distributions on the fast-pay stock would be made with respect to the financing instruments issued by LLC. Thus, F Corp1 would be entitled to its first and second preference distributions from LLC. In addition, the timing and amount of any distribution on the financing instruments will not change from the actual distributions on the fast-pay preferred shares. In essence, recharacterization under the regulations will not affect F Corp1 in any meaningful way.

Following the recharacterization, US Parent, as the indirect benefited shareholder, would be required to include in gross income a portion of CFC2's subpart F income calculated under section 951. CFC2 would only have one class of shares and would be wholly owned by CFC1. CFC1 would continue to be wholly owned by LLC. Corp A and Corp B, as members of LLC would be required to include in gross income their pro rata share of CFC2's subpart F income. As a result, Corp A and Corp B (as members of US Parent's consolidated group) would not be permitted to avoid a subpart F inclusion by the use of a fast-pay arrangement. The ultimate effect of the recharacterization would be that US Parent would include an amount of CFC2's subpart F income that relates to its indirect economic interest in CFC2. Further, it does not appear that in this case there will be any difference for United States tax purposes whether the financing instruments between LLC and F Corp1 are characterized as debt or equity.

[6] Although the common units of CFC2 will be the benefited stock within the meaning of Treas. Reg. §1.7701(l)-3(b)(i)(3), recharacterizing the transaction so that CFC1 issued financing instruments to F Corp1 would only create another fast-pay arrangement. In order to fulfill the purpose of the regulations and thereby prevent the avoidance of tax by persons participating in fast-pay arrangements, LLC will be treated as the benefited shareholder as a result of its indirect interest in the benefited stock.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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