INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

October 06, 2004

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CASE-MIS No.: TAM-120070-04

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =
Business =

Promoter A =
Promoter B =
Contingent Debt Instrument A =
Contingent Debt Instrument B =
Corporation A =
Corporation B =
Corporation C =
Corporation D =
Corporation E =
Corporation F =
Corporation G =
Subsidiary A =
Subsidiary B =
Subsidiary C =

Subsidiary D	=
Joint Venture	=
Counterparty A	=
Counterparty B	=
Counterparty C	=
Exchange	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=
Year 9	=
Year 10	=
Year 11	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
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Date 10	=
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Date 29	=
Date 30	=
Date 31	=
Date 32	=
Month 1	=
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Month 3	=
Month 4	=
Month 5	=
Month 6	=
a	=
b	=
c	=
d	=
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ISSUES:

1. Whether Contingent Debt Instrument A (Instrument A) and Contingent Debt Instrument B (Instrument B), and Corporation A stock and Corporation B stock, respectively, constitute a straddle for purposes of § 1092(c) of the Internal Revenue Code of 1986 ("Code"). This issue raises two threshold questions:

    a. Whether Instrument A and Instrument B, issued by Taxpayer in Year 2, constitute "positions" under § 1092(d)(2); and

    b. If Instrument A and Instrument B are "positions" under § 1092(d)(2), whether either of those "positions" qualify under § 1092(d)(3)(B)(i)(II)(1999) as "a position with respect to substantially similar or related property (other than stock)" with respect to Corporation A or Corporation B stock held by Taxpayer?

2. Whether payments on Instrument A and Instrument B constitute interest and carrying charges incurred or continued to purchase or carry the Corporation A and Corporation B stock, respectively, for purposes of § 263(g)(2)(A).

CONCLUSION(S):

1. Under § 1092, Instrument A and Instrument B are part of a straddle with the Corporation A stock and the Corporation B stock, respectively.

    a. Instrument A and Instrument B constitute "positions" under § 1092(d)(2); and

    b. Each "position" qualifies under § 1092(d)(3)(B)(i)(II)(1999) as "a position with respect to substantially similar or related property (other than stock)" with respect to stock held by Taxpayer.

2. Payments on Instrument A and Instrument B constitute interest and carrying charges incurred or continued to purchase or carry the Corporation A and Corporation B stock, respectively, for purposes of § 263(g)(2)(A).

FACTS:

Background:

Taxpayer and its subsidiaries are principally engaged in the operation of Business. Since Year 1 and continuing currently, Taxpayer has dramatically expanded its business through strategies involving joint ventures and other acquisitions in which it acquired equity in other corporations.

Taxpayer's Year 2 expansion strategy required several billion dollars to fund acquisitions and investment in capital infrastructure. In order to raise funds, Taxpayer sold non-core business interests and issued unsecured subordinated debentures called Instrument A and Instrument B (collectively, the Instruments), which were essentially identical in structure, but referenced to different portfolio stock. Payments on these Instruments were referenced to the performance of Taxpayer's publicly-traded portfolio stock: Instrument A was referenced to Taxpayer's holdings in Corporation A and Instrument B was referenced to Taxpayer's holdings in Corporation B (separately or collectively the "Reference Stock"). As a result of this indexing, Taxpayer obtained lower currently payable coupon rates of financing, although Taxpayer accrued interest at a higher rate under the contingent payment debt instrument ("CPDI") rules of Income Tax Regulations § 1.1275-4.

Taxpayer acquired the Reference Stock in prior transactions wholly unrelated to the issuance of Instrument A or Instrument B. The Reference Stock was not pledged as collateral for the Instruments, nor was Taxpayer required to hold any of the stock under the terms of the Instruments. Taxpayer asserts, however, that it did intend to continue to hold that stock for strategic reasons related to its business expansion strategy.

Taxpayer asserts that it was never limited to raising funds through the issuance of the Instruments. At the time of issuance, Taxpayer was able to raise the amounts borrowed via the Instruments without regard to the Reference Stock, and, at that time, Taxpayer's long-term debt ratings were in the process of being upgraded by independent rating agencies. Taxpayer asserts that the purpose of the borrowing was to meet anticipated needs for major capital expenditures in its business operations and that the issuance of the Instruments provided funding at more favorable terms. The proceeds of those debentures were used for general corporate purposes.

a. Contingent Debt Instrument A (Instrument A)

On Date 8, Taxpayer issued a units of Instrument A described as "b% exchangeable extendable subordinated debentures." The issuance of Instrument A resulted in $c in proceeds, reduced by $d in underwriting fees. According to Taxpayer, Instrument A, developed by Promoter A, allows an issuer to monetize the relevant portion of its publicly traded portfolio stock by linking the issue and redemption values of Instrument A to the value of the portfolio stock. As a result, borrowing costs for the issuer are reduced and the issuer is able to retain its holdings of the reference shares. As noted, Instrument A was indexed to common shares of Corporation A.

The original principal amount of each Instrument A unit was $e, which was the Date 6 sale price of one common share of Corporation A. Instrument A paid interest quarterly at the annual rate of b% of the original principal amount (for a quarterly payment of $f per unit), plus the amount of any cash dividend paid on Corporation A stock and the cash value of any property distributed by Corporation A to its shareholders.

Under the terms of Instrument A, Taxpayer had the option to defer payment of interest on Instrument A for up to five years if no conditions of default existed. During the deferral period, the deferred interest would be added to a "contingent principal amount" and accrue interest at a g% annual rate compounded quarterly. The contingent principal amount also would reflect adjustments made to the original principal amount due to any distributions made on the Corporation A shares that were greater than or less than Corporation A's $h quarterly dividend. These adjustments ensured that the yield on Instrument A to the date of the distribution would be g%. In addition, if the Corporation A shares traded at a price greater than the original issue price, Taxpayer had the option of electing to increase the number of shares referenced to each Instrument A at an annual rate of g%. If the election was made, Taxpayer would be deemed current on its quarterly payments of interest and the contingent principal amount would not increase.

Upon issuance, Instrument A was set to mature on Date 29, unless the market price of Corporation A's common shares on that date was greater than i% of the contingent principal amount of Instrument A, in which case maturity would be extended to Date 32. At maturity, Instrument A holders receive a cash amount equal to (i) the higher of (a) the contingent principal amount or (b) the maturity date value of the Corporation A shares and (ii) any deferred quarterly interest (with any accrued interest thereon). In either case, holders also are entitled to a "final period distribution," which would include such items as declared dividends or distributions on the Corporation A shares not yet distributed to the holders. The amount paid at redemption or maturity was required to be adjusted in the event of specific dilutive or anti-dilutive events.

Taxpayer had the right to redeem Instrument A at any time, provided it redeemed all of the units. To redeem, Taxpayer was required to pay holders a cash amount computed in the same manner as a payment at maturity. The terms provided for the payment of certain additional amounts if Taxpayer redeemed Instrument A prior to Date 25, Date 20, or Date 14. In addition, holders had the right to exchange a unit of Instrument A at any time beginning one year subsequent to issuance for cash equal to j% of the then-current trading price of a share of Corporation A common stock. After k years, the exchange ratio increased to m%. Also, if Taxpayer deferred quarterly payments of interest, the early exchange ratio increased to m%.

In Month 4, Taxpayer redeemed all $c of Instrument A. Taxpayer elected to redeem Instrument A because of an impending transaction with Corporation A in which it intended to (and did) use its Corporation A shares as consideration for the purchase of Business assets from Corporation A.[1] Taxpayer redeemed Instrument A at a total price of $c or $e per unit, plus a redemption premium of $n. This price did not reflect the value of Corporation A stock because the reference price with respect to the Corporation A stock had declined to $p (q times the market price of Corporation A shares, $r, as adjusted to reflect a stock split). In addition, Taxpayer wrote off certain unamortized debt issuance costs for a total amount of $s, $t of which was attributable to underwriters' discount, and the remainder attributable to registration fees and other legal expenses.

Instrument A units were actively traded over-the-counter, but were never listed on a securities exchange.

b. Contingent Debt Instrument B (Instrument B)

On Date 12, Taxpayer issued u units of Instrument B-I described as "v% exchangeable subordinated debentures" for gross proceeds of $w. On Date 13, Taxpayer issued x units of Instrument B-II described as "v% exchangeable subordinated debentures" for gross proceeds of $y, resulting in combined proceeds of $z for Instrument B.

Both Instrument B-I and Instrument B-II reference Corporation B stock. Promoter B arranged the transaction. Unlike Instrument A, Instrument B did not contain an option to extend the term to maturity of the instrument if the market price of a share of Corporation B common stock exceeded i% of the contingent principal amount.

The original principal amount and issue price of each unit of Instrument B-I and Instrument B-II was $aa and $bb, respectively, and in each case was the price of the Corporation B stock on their respective issue dates (with underwriting commissions of $cc and $dd, respectively). Instrument B units pay interest quarterly at the annual rate of v% of the original principal amount (for a quarterly payment of $ai per unit for Instrument B-I and $aq for Instrument B-II), plus the amount of any cash dividends paid on the number of Corporation B shares attributable to each unit of Instrument B. Any

[1] It appears from the Form 10-Q filed by Taxpayer on Date 10, that on Date 9, Taxpayer entered into an agreement with Corporation A pursuant to which Taxpayer and Corporation A agreed to exchange certain Business systems. Under the terms of the agreement, Taxpayer would use as consideration for the exchange Corporation A common stock which would permit the exchange to be tax-free as much as possible. Further information is required to determine whether Taxpayer utilized the Corporation A common stock referenced to Instrument A in a tax-free manner. See Form 10-Q, page 4 (Acquisitions and other Significant Events).

property distributed on the Corporation B shares (or the cash value of the property) is to be paid to Instrument B holders as additional interest. As of the date of the prospectus, Corporation B has never paid a cash dividend on its Corporation B common stock.

As in the case of Instrument A, Taxpayer has the option to defer interest for up to five years on Instrument B provided no conditions of default exist. During the deferral period, the deferred interest is added to the contingent principal amount and accrues interest at a v% annual rate compounded quarterly. The contingent principal amount also reflects adjustments that are made to the original principal amount at the time of any extraordinary distributions on Corporation B shares so that the holder's yield on Instrument B to the date of the distribution is v% plus the amount of any regular quarterly dividends. Additionally, if at any time the current trading price of Corporation B common shares is greater than the initial issue price, Taxpayer can, but is not obligated to, increase the amount of Corporation B shares attributable to each Instrument B at an annual rate of v%. If this election is made, Taxpayer will be deemed current on its quarterly payment of interest and the contingent principal amount will not increase.

Instrument B-I matures on Date 30 and Instrument B-II matures on Date 31. At maturity, holders of Instrument B are entitled to receive an amount of cash equal to (i) the higher of (a) the contingent principal amount of Instrument B, or (b) the market value of Corporation B stock plus (ii) any deferred quarterly interest (with any accrued interest thereon). In either case, holders are also entitled to a "final period distribution," which would include such items as declared dividends or distributions on the Corporation B shares not yet distributed to the holders. The amount paid at redemption or maturity will be adjusted in the event of specific dilutive or anti-dilutive events.

Taxpayer has the right to redeem Instrument B-I or Instrument B-II at any time, provided it redeems all of the units of either of them. To redeem, Taxpayer must pay holders an amount of cash computed in the same manner as a payment at maturity. The terms provided for the payment of certain additional amounts if Taxpayer redeemed Instrument B-I prior to Date 16, Date 21, or Date 27, or redeemed Instrument B-II prior to Date 19, Date 22, or Date 28. In addition, holders may exchange a unit at any time after one year after issuance and prior to maturity for cash equal to j% of then-current trading price of Corporation B common stock. If Taxpayer defers quarterly payments of interest, the early exchange ratio will increase to m%.

Taxpayer also had a limited tax call, which was a right to redeem without paying any premium in the event of a "change in law" by Date 14 that created a "substantial risk" that Instrument B would be treated as a constructive sale of Taxpayer's Corporation B shares under § 1259.

Since shortly after their issuance, Instrument B-I units have been listed on the Exchange and Instrument B-II units have been actively traded over-the-counter. Over the past year, Corporation B stock has traded at closing prices from \$ee to \$ff. During this same period, Instrument B-I units have traded from \$gg to \$hh and Instrument B-II units have traded from $ii to $jj. Instrument B-I and Instrument B-II units remain outstanding.

c. Other terms common to Instrument A and Instrument B.

Both Instrument A and Instrument B units are unsecured and subordinate to Taxpayer's existing and future indebtedness. Neither the Corporation A shares nor the Corporation B shares were pledged as collateral for Instrument A or Instrument B, respectively. Taxpayer was not required to hold Corporation A shares equal to the number of the outstanding Instrument A units nor is it required to hold Corporation B shares equal to the number of the outstanding Instrument B units. Taxpayer's obligations at retirement or maturity of Instrument A and Instrument B are payable only in cash, not in Corporation A or Corporation B shares.

d. Taxpayer's Holdings in Corporation A and Corporation B.

Taxpayer acquired its holdings in Corporation A and Corporation B stock in transactions that predated the issuance of Instrument A and Instrument B. Taxpayer's Corporation A holdings were acquired in transactions beginning in Year 1 and Year 6. Taxpayer's Corporation B holdings were acquired in transactions beginning in Year 4. When Taxpayer issued Instrument A and Instrument B, it intended to retain its holdings in Corporation A and Corporation B as part of its Business expansion strategy.

(i) Corporation A Shares

When Taxpayer issued Instrument A on Date 8, it owned approximately kk common shares of Corporation A. Most of these shares (over mm%) were traceable to Taxpayer's investment in Corporation C. In Year 6, a subsidiary of Taxpayer, Subsidiary A, acquired nn shares of Corporation C Class B common stock and pp shares of Corporation C Class A common stock in a § 351 transaction in exchange for m% of all issued and outstanding stock of five lower-tier subsidiaries of Taxpayer. Subsidiary A had initially been capitalized in Year 3 with approximately $qq, of which a significant portion was contributed to Corporation C for pp shares of Class A common stock, which represented a rr% interest in Corporation C. In a merger of Corporation C into Corporation A in Month 1, Taxpayer received approximately ss shares of Corporation A common stock in exchange for approximately nn shares of Corporation C Class B common stock.

The balance of Taxpayer's Corporation A common shares were traceable to an investment by a subsidiary of Taxpayer, Subsidiary B, in Corporation D. In Year 1, Subsidiary B purchased shares representing tt% of the outstanding stock of Corporation D for cash from Corporation E. In Year 5, Subsidiary B transferred its interest in Corporation D to Corporation E in exchange for Class A common shares of Corporation E. Shortly thereafter, Subsidiary B sold most of its unrestricted Corporation E shares, but it still held uu shares of Corporation E as of Date 4. These Corporation E shares were exchanged for vv shares of Corporation A in connection with a merger of Corporation E into Corporation A in Month 3.

In Month 3, Corporation A (via Corporation E) held several business properties which Taxpayer believed were of high strategic importance. Corporation A also had demonstrated a willingness to repurchase its own common stock in the marketplace, having bought back roughly $ww of its shares since Month 2. Taxpayer anticipated the possibility of some form of business transaction with Corporation A that would allow it to employ its Corporation A stock as currency (preferably at a premium due to the size of the position) for the target business systems or other assets of Corporation A. In fact, Taxpayer was able to effect such a transaction sooner than it had expected, in Month 4.

(ii) Corporation B Shares

When Taxpayer issued Instrument B in the fall of Year 7, it owned approximately xx common shares of Corporation B stock. These shares were traceable to a joint venture that predated the issuance of Instrument B. Taxpayer formed Subsidiary C and Subsidiary D on Date 1 and Date 2, respectively, for the purpose of participating in a joint business venture with Corporation B, Corporation E, and Corporation F. The joint venturers committed to contribute $yy in cash to the joint venture ("Joint Venture"). Taxpayer's share was $zz of this funding requirement. It made total cash contributions of $aaa through Date 3 and issued a $bbb guaranty on a portion of Joint Venture's outstanding debt. On Date 5, Subsidiary C and Subsidiary D were merged into a subsidiary of Corporation B. In that merger transaction, Taxpayer received xx shares of Corporation B stock in exchange for its interest in Joint Venture, in addition to ccc shares of Corporation B Seventh Series, Convertible Preferred Stock and ddd warrants exercisable for Corporation B stock.

In Month 5, Corporation B held certain other businesses which, like the business properties of Corporation A, Taxpayer believed could present near-term growth opportunities or provide longer-term strategic opportunities in a related business. Taxpayer had recently held discussions with Corporation B regarding a purchase of some of these operations. Taxpayer also believed that it might be able to structure a transaction like the one it had consummated with Corporation A in Month 4, in which it would exchange its Corporation B shares for certain assets of Corporation B. Taxpayer believed that Corporation G's proposed acquisition of Corporation B improved the chances for such a transaction, because a Corporation B-Corporation G combined entity might be required to shed assets in order to comply with regulatory requirements.

e. Other Facts – Collar Transactions With Other Unrelated Parties

In Year 7, Taxpayer engaged in the following three separate equity "collar" transactions with unrelated counterparties, using Corporation B stock as the referenced property:

(1) eee shares of Corporation B stock with a put strike price of $ggg and a call strike price of $fff per share, with Counterparty A as the counterparty. Under the terms of the collar, if the per share value of the Corporation B stock is less than $ggg on the expiration date, Counterparty A will pay to Taxpayer on the date of settlement the difference between the put strike price and the per share value, multiplied by the applicable number of Corporation B shares. If the per share value of the Corporation B stock is greater than the call strike price on the expiration date, Taxpayer will pay to Counterparty A on the date of settlement the difference between the per share value and the call strike price of $fff, multiplied by the applicable number of Corporation B shares.

(2) hhh shares of Corporation B stock with a low put strike price of $iii, a high put strike price of $jjj, and a call strike price of $kkk, with Counterparty B as the counterparty. If the per share value of the Corporation B stock is less than the high put strike price of $jjj on the expiration date, Counterparty B will pay to Taxpayer on the date of settlement the difference between the high put strike price and the per share value, limited to the low put strike price of $iii, multiplied by the applicable number of Corporation B shares. If the per share value of the Corporation B is greater than the call strike price on the expiration date, Taxpayer will pay to Counterparty B on the date of settlement the difference between the per share value and the call strike price of $kkk, multiplied by the applicable number of Corporation B shares.

(3) Approximately mmm 5 million shares of Corporation B stock with a low put strike price of $nnn, a high put strike price of $ppp, and a call strike price of $qqq, with Counterparty C as the counterparty. If the per share value of the Corporation B stock is less than the high put strike price of $ppp on the expiration date, Counterparty C will pay to Taxpayer on the date of settlement the difference between the high put strike price less the per share value, limited to the low put strike price of $nnn, multiplied by the applicable number of Corporation B shares. If the per share value of the Corporation B stock is greater than the call strike price on the date, Taxpayer will pay to Counterparty C on the date of settlement the difference between the per share value less the call strike price of $qqq, multiplied by the applicable number of Corporation B shares.

The expiration date of the three agreements ranged from Year 8 to Year 10. None of these agreements was settled in Year 7.

f. Federal Tax Consequences of Instrument A and Instrument B.2

(i) Instrument A

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2 For purposes of this technical advice memorandum, the Service and Taxpayer have agreed that any early redemption premiums and debt issuance costs paid in connection with the redemption or issuance of the Instruments will be treated as interest and carrying charges.

The prospectus for Instrument A filed by Taxpayer with the Securities and Exchange Commission on Date 7 (Form 424B2) stated units of Instrument A will be characterized as contingent payment debt instruments, and advised holders that they are required to report as ordinary income certain amounts prior to the holders' receiving the cash attributable thereto. The comparable yield was determined to be rrr%, compounded quarterly based upon a projected payment according to the prospectus in Year 11, assuming the maturity date was extended to sss years, of $ttt per instrument.

Taxpayer's Year 7 Form 1120 claimed a current deduction for all of the previously described expenses pertaining to the early redemption of Instrument A ($uuu). Taxpayer also incurred and deducted legal expenses amounting to $vvv with respect to Instrument A early redemption.

In addition, Taxpayer claimed $www as interest expense in Year 7 for its Instrument A obligations. Approximately $xxx of this total interest was determined based upon the stated interest rate of b%, prorated over four months but based on the actual interest paid instead of the comparable yield of rrr% under the CPDI rules because using the comparable yield had no net effect as the instrument would be redeemed in Year 7. The remaining $yyy was based upon the dividend paid by Corporation A, which, under the terms of Instrument A, was treated as additional interest because holders of Instrument A were entitled to any cash dividends paid on the Corporation A shares as additional interest. Because the dividends were treated as deductible payments on Instrument A, Taxpayer classified the dividends on its consolidated return as other dividend income not subject to the dividends-received deduction. See § 246(c)(1)(B).

(ii) Instrument B

Similarly, the prospectus supplement for Instrument B stated that units of Instrument B will be characterized as contingent payment debt instruments, and it advised holders that they are required to report as ordinary income certain amounts prior to the holders' receiving the cash attributable thereto. The comparable yield was determined to be zzz%, compounded quarterly, for Instrument B-I, and ab%, compounded quarterly, for Instrument B-II, based upon projected final payment amounts of $ac and $ad for Instrument B-I and Instrument B-II, respectively.

Taxpayer's Year 7 Form 1120 claimed a deduction totaling $ae for the amortization of underwriting costs and other expenses pertaining to the issuance of Instrument B-II. In addition, Taxpayer claimed a $af interest expense deduction in Year 7 for its Instrument B obligations under § 1.1275-4.

LAW

Section 163(a) provides that there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

Section 1.163-7(c) provides that if bonds are repurchased by the issuer for a price in excess of its adjusted issue price, the excess (repurchase premium) is deductible as interest for the taxable year in which the repurchase occurs.

Section 263(g)(1) states that no deduction shall be allowed for “interest and carrying charges” properly allocable to personal property which is part of a straddle as defined in § 1092(c).

Section 263(g)(2) defines “interest and carrying charges” to mean the excess of (A) the sum of (i) interest on indebtedness incurred or continued to purchase or carry the personal property and (ii) all other amounts (including charges to insure, store, or transport the personal property) paid or incurred to carry the personal property, over (B) the sum of certain enumerated receipts with respect to the personal property.

Section 1092(c)(1) defines “straddle” for tax purposes as “offsetting positions with respect to personal property.” Section 1092(c)(2)(A) provides that positions are “offsetting” if there is substantial diminution of the taxpayer’s risk of loss from holding one position by reason of holding the other position.

Section 1092(d)(1) defines “personal property” as any personal property of a type which is actively traded. Section 1092(d)(2) defines “position” as an interest (including a futures or forward contract or option) in personal property.

Subject to exceptions listed in § 1092(d)(3)(B), § 1092(d)(3)(A) sets forth a general rule excluding stock from the definition of “personal property.” Section 1092(d)(3)(A) also provides, however, that this general exclusion does not apply to any “interest in stock.” Under § 1092(d)(3)(B), there are three other exceptions to the general rule excluding stock.[3] The first and second exceptions apply to provide that personal property includes, respectively, (1) an option with respect to that stock or substantially similar stock or securities, or (2) a position with respect to any stock that is part of a straddle in which at least one of the offsetting positions is a position with respect to substantially similar or related property (other than stock) as provided in regulations. § 1092(d)(3)(B)(i)(I) & (II). The third exception, § 1092(d)(3)(B)(ii) provides that personal property includes any stock of a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder. The first and third exceptions are not relevant to the instant case, except by analogy.

[3] A fourth exception was added by the Community Tax Relief Act of 2000 (P.L. 106-554) which amended § 1092(d)(3)(B)(i) to take account of the addition of securities futures contracts.

Section 1.1092(d)-2(a), finalized in March 1995, states that for purposes of § 1092, the term "substantially similar or related property" is defined in § 1.246-5. Section 1.246-5(b)(1) provides that the term substantially similar or related property is applied according to the facts and circumstances in each case. In general, property is substantially similar or related to stock when –

(iii) The fair market values of the stock and the property primarily reflect the performance of –
- (A) A single firm or enterprise;
- (B) The same industry or industries; or
- (C) The same economic factor or factors such as (but not limited to) interest rates, commodity prices, or foreign-currency exchange rates; and

(iv) Changes in the fair market value of the stock are reasonably expected to approximate, directly or inversely, changes in the fair market value of the property, a fraction of the fair market value of the property, or a multiple of the fair market value of the property.

Section 1.246-5(b)(4) provides that for purposes of paragraphs (b)(1)(i), (b)(2), or (c)(1)(vi) of this section, reasonable expectations are the expectations of a reasonable person, based on all the facts and circumstances at the later of the time the stock is acquired or the positions are entered into. Reasonable expectations include all explicit or implicit representations made with respect to the marketing or sale of the position.

ANALYSIS:

1. Whether Instrument A and Instrument B, and Corporation A stock and Corporation B stock, respectively, constitute a straddle under § 1092 of the Code.

    a. Whether Instrument A and Instrument B issued by Taxpayer in Year 7 **1999** constitute "positions" under § 1092(d)(2).

Section 1092(d)(2) defines a "position" as an interest (including a futures or forward contract or option) in personal property." Although a debtor's obligation on a debt instrument generally is not personal property, in certain circumstances a debt instrument may represent a position with respect to personal property. See § 1092(d)(7) and § 1.1275-4(b)(9)(vi).

Section 1092(d)(7)(A) provides that an obligor's interest in a nonfunctional currency denominated debt obligation is treated as a position in the nonfunctional currency. Taxpayer asserts that if a position included an obligor's own debt, Congress would not have added § 1092(d)(7) to the Code.

Neither the legislative history nor the express language of § 1092(d)(7) indicates that Congress intended to exclude a debt instrument from the definition of position in section 1092(d)(2). A rule that a debt instrument can be a position in nonfunctional currency does not establish that only debt instruments in nonfunctional currency are "positions." In fact, the Conference Report to the Tax Reform Act of 1986 (P.L. 99-514) characterizes the addition of § 1092(d)(7) as a clarification of existing law:

> The Senate amendment clarifies that an obligor's interest in a foreign currency denominated obligation is a "position" for purposes of the loss deferral rule. The rationale for this treatment is that a foreign currency borrowing is economically similar to a short position in the foreign currency.

H.R. (CONF.) REP. NO. 841, 99TH CONG., 2D SESS., 1986-3 C.B. (Vol. 4), II-670 (1986).

Furthermore, regulations finalized in 1996 recognize that a taxpayer's own debt may constitute a position in a straddle. Section 1.1275-4(b)(9)(vi) provides that increased interest expense on a contingent payment debt instrument issued by a taxpayer may be a straddle loss subject to section 1092 deferral. In addition, § 1.1275-6 recognizes that a debtor's own indebtedness may be a position in a straddle. See §§ 1.1275-6(c)(1)(vii) and 1.1275-6(f)(1).

In light of the foregoing, we believe that the Instruments constitute "positions" in corresponding Reference Shares under § 1092(d).

b. If Instrument A and Instrument B are "positions" under § 1092(d)(2), whether each "position" qualifies under § 1092(d)(3)(B)(i)(II)(1999) as "a position with respect to substantially similar or related property (other than stock)" with respect to Corporation A or Corporation B stock held by Taxpayer.

Section 1092(d)(3)(B)(i)(II) contains an exception to the general stock exclusion for "stock which is part of a straddle at least 1 of the offsetting positions of which is – … under regulations, a position with respect to substantially similar or related property (other than stock)." Section 1.1092(d)-2(a), finalized by T.D. 8590, 1995-1 C.B. 15, states that for purposes of § 1092, the phrase "substantially similar or related property" (SSRP) is defined in § 1.246-5, also finalized under T.D. 8590.

Section 1.246-5(b)(1) provides that the term SSRP is applied according to the facts and circumstances of each case. Under this standard, in order for the Instruments to qualify as positions in substantially similar or related property with respect to the Reference Stock, the following tests must be met: (1) the fair market value of the Instruments and the Reference Stock would need to "primarily reflect" the performance of the same firm or factors; and (2) the changes in the fair market value of the Reference Stock must have been "reasonably expected to approximate" changes in the value of the Instruments. Expectations are considered "reasonable" where they are the expectations of a reasonable person, based on all the facts and circumstances at the time the stock is acquired or the positions are entered into, and include representations made with respect to the marketing or sale of the position. § 1.246-5(b)(4).

Taxpayer argues that Treasury's authority to issue regulations defining the phrase "SSRP" is limited to identifying, in prospective regulations, the specific types of stock-related transactions to be covered by the straddle rules. Although Congress did identify certain types of transactions caught by the exceptions to the general stock exclusion, the legislative history does not indicate that Congress intended to limit Treasury's authority to issue regulations under § 1092(d)(3)(B)(i)(II). The legislative history does indicate, however, Congress' intention that the same SSRP standard apply for purposes of § 1092 and § 246. See 1984 Conference Report, H.R. REP. 98-861, 98TH CONG. 2D. SESS., 908 (1984).

(1) The "primarily reflects" test 1.246-5(b)(1)(i)

Under the facts of this case, the fair market value of Corporation A shares and Instrument A both reflected the performance of Corporation A. Similarly, the fair market value of Corporation B shares and Instrument B both reflect the performance of Corporation B. Upon issuance, the issue price of the Instruments equaled the then-trading price of the corresponding Reference Stock. The projected payment schedules of the Instruments, as discussed below, were based upon the forward price of the corresponding Reference Stock. See § 1.1275-4(b)(4)(ii)(A). The early redemption rights of the issuer and the holders also support this connection. Taxpayer was able to redeem the instruments at any time prior to maturity for the stock price, not the principal amount. Likewise, holders were entitled to exchange their instruments for an amount that references the stock price (j%) but not the contingent principal amount of the instrument. By issuing the Instruments, Taxpayer essentially economically monetized and reduced its risk of loss on its position in the Reference Stock over the period that the Instruments were outstanding, at least k years (and possibly sss years in the case of Instrument A).

Taxpayer argues that the Instruments do not meet the "primarily reflects" test of § 1.246-5(b)(1)(i) because their debt features leave Taxpayer exposed to downside risk on the Reference Stock.

Section 1.246-5(b)(1)(i) requires that the fair market values of the stock and the property reflect the performance of a shared entity, which does not require a diminished risk of loss. In fact, the term "diminished risk of loss" is defined in a paragraph separate from the SSRP standard that relates to a reduction in a holding period for the dividends received deduction under § 1.246-5(a). § 1.246-5(b)(2). However, diminished risk of loss can be evidence of SSRP because it would demonstrate that the value of the stock and the SSRP vary inversely. § 1.246-5(b)(1)(ii).

Furthermore, as discussed in section (2) below, because of the significant non-debt characteristics of the Instruments, we view Taxpayer's exposure to decreases in the value of the Reference Stock as insubstantial.[4] The only risk that Taxpayer retained was the risk that it would eventually have to repay a below-market loan in k years (in whole or in part) if the stock depreciated to an amount less than the original issue price of the Instruments. Taxpayer essentially obtained tax-deferred use of the gain that existed in the Reference Stock at the time the Instruments were issued.

In light of the foregoing, we believe that the value of the Instruments and the value of the Reference Stock primarily reflect the performance of the same firm, Corporation A in the case of Instrument A and Corporation B in the case of Instrument B.

(2) The "approximate changes in fair market value" test 1.246-5(b)(1)(ii)

In considering whether changes in the fair market value of the Reference Stock were "reasonably expected to approximate" changes in the fair market value of the corresponding Instrument under § 1.246-5(b)(1)(ii), three factors were considered: (i) the position taken by Taxpayer in calculating a projected contingent payment schedule under the rules of § 1.1275-4, (ii) the economics of the Instruments, and (iii) the actual correlations in the fair market values between the Reference Stock and the Instruments.

i. The Contingent Payment Debt Rules of § 1.1275-4

For Instrument A, Taxpayer paid interest quarterly at an annual rate of b%. Using the CPDI rules under § 1.1275-4, Taxpayer accrued a comparable yield of rrr% compounded quarterly based upon a projected payment at maturity of approximately $ah in k years or $ttt if the maturity date of Instrument A is extended to sss years. For Instruments B-I and B-II, Taxpayer paid interest quarterly at an annual rate of v%. Using the CPDI rules under § 1.1275-4, Taxpayer accrued a comparable yield of zzz% and ab%, respectively, compounded quarterly based upon a projected payment at maturity of $ac and $ad.

Section 1.1275-4(b)(4)(ii)(A) provides that if a contingent payment is based on market information (a market-based payment), the amount of the projected payment is the forward price of the contingent payment. The forward price of a contingent payment is the amount one party would agree, as of the issue date, to pay an unrelated party for the right to the contingent payment on the settlement date (e.g., the date the contingent payment is made). For example, if the right to a contingent payment is substantially similar to an exchange-traded option, the forward price is the spot price of the option (the option premium) compounded at the applicable Federal rate from the issue date to the date the contingent payment is made.

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[4] It is noted that Taxpayer did protect itself from downside risk on over ag Corporation B shares by entering into equity collar transactions in Year 7. It is also noted that the number of shares covered by the equity collars plus the number of shares traceable to Instrument B are approximately equal to the total number of Corporation B shares held by Taxpayer.

Section 1.1275-4(b)(4)(ii)(B) provides that if a contingent payment is not based on market information (a non-market based payment), the amount of the projected payment is the expected value of the contingent payment as of the issue date.

Section 1.1275-4(b)(4)(ii)(C) provides that the projected payment schedule must produce the comparable yield. If the projected payment schedule does not produce the comparable yield, the schedule must be adjusted consistent with the principles of this paragraph (b)(4) to produce the comparable yield. For example, the adjusted amounts of non-market-based payments must reasonably reflect the relative expected values of the payments and must not be set to accelerate or defer income or deductions. If the debt instrument contains both market-based and non-market-based payments, adjustments are generally made first to the non-market-based payments because more objective information is available for the market-based payments.

Taxpayer accrued deductions at a comparable yield based upon a projected contingent payment at maturity specifically referenced to the expected appreciation in the Reference Stock. According to the Instruments' prospectuses, any amount that a holder would receive above the original issue price of an Instrument is based on the appreciation in the stock. Thus, based upon Taxpayer's own calculations, changes in the fair market value of the Reference Stock were reasonably expected to approximate changes in the fair market value of the Instruments to which they relate.

Taxpayer argues that, in Year 7 when the Instruments were issued, the competitive environment in the industry rendered any prediction as to the fair market value of the Reference Shares speculative. Taxpayer supports its assertion by referring to various public disclosures to potential investors.[5] These disclosures simply make clear to potential investors that the projected payments on the Instruments were not guaranteed. The application of the CPDI rules and the indexing of the Instruments to the Reference Stock demonstrate the expectation that changes in the value of the Instruments would approximate changes in the value of the Reference Stock. In addition, regardless of Taxpayer's subjective expectations regarding the price of the Reference Stock, the relevant standard is the expectations of a reasonable person, based on all the facts and circumstances at the later of the time the stock is acquired or the positions are entered into. The projected payment (and expected value of the Reference Stock) was based upon market information, which represents reasonable expectations regarding price. That these expectations were reasonable is supported by the fact that holders invested in the Instruments agreeing to forego current interest payments in consideration for the opportunity to share in future appreciation on the Reference Stock.

ii. The Economics of the Instruments

[5] Taxpayer's prospectus states that "[T]he comparable yield and the schedule are not provided for any purpose other than the determination of holders' interest accruals and adjustments thereof in respect of [Instrument A] for U.S. Federal income tax purposes and do not constitute a representation regarding the actual amounts payable on [Instrument A]."

The holders' willingness to purchase the Instruments may be explained in part by analyzing the economic characteristics of the Instruments. The issue price of the Instruments may be viewed in economic terms as a payment for a guaranteed future amount plus an option on the Reference Stock. The call option component affords the holders the opportunity to share in the appreciation in the Reference Stock.

For instance, in the case of Instrument B-I, having an original issue price of $aa and a quarterly coupon of $ai, and a "guaranteed" minimum stated redemption price at maturity (SRPM) of $aa, the portion of the issue price that represents economically a guaranteed payback or "debt" component is determined by calculating the issue price of a straight debt instrument with identical payout amounts (i.e. current quarterly coupon of $ai and SRPM of $aa). Thus, for Instrument B-I, a comparable straight debt instrument with current coupon payments of $ai per quarter for ak quarters (k years) and a SRPM of $aa, a holder would have paid approximately $aj. The remaining $am of the issue price represents economically an interest other than a guaranteed payback. In this case, the excess payment is made for the opportunity to share in the appreciation of the reference stock, above the threshold amount of $aa.

Taxpayer asserts that the performance of the Instruments was expected to depend to a substantial degree on their debt characteristics and, as a result, could not be expected to "approximate" the performance of the Reference Stock. Contrary to Taxpayer's argument that the performance of the Instruments was expected to depend to a substantial degree on their debt characteristics, the facts show that a significant portion of the issue price of the Instruments are attributable to the non-debt characteristics of the Instruments. Thus, the holders placed at risk a sizeable portion of the purchase price of the Instruments, which would be lost if the Reference Stock failed to appreciate to the extent projected. Taxpayer, conversely, economically hedged its position in the Reference Stock for k years by issuing the Instruments because if the Reference Stock declined, Taxpayer was required to repay only the "debt" portion of the Instruments at maturity.

iii. Actual Correlation between the Price of the Reference Stock and the Price of the Instruments

The expectation that the issue price of Instrument B would correspond with the trading price of Corporation B stock was borne out for some time after the initial issuance of Instrument B-I and Instrument B-II. Correlation in the trading prices was calculated using the monthly price change percentages for the Corporation B stock, and Instrument B-I and Instrument B-II, using the closing prices as of the first day of each month from Month 5 to Month 6. Correlation was also calculated between the same instruments and stock using the closing prices as of the first day of each quarter from Month 5 to Month 6. These calculations demonstrate that correlation is much tighter using the longer time frames which eliminate the daily "noise" and more clearly identify general trends in the prices. For the three periods of Date 11 through Date 17, Date 18 through Date 23, and Date 24 through Date 26, the correlation values are all greater than <u>an</u>%, and the correlation values for the entire period from Year 7 to Month 6 are all greater than <u>ap</u>%. This strong price correlation from Year 7 to Year 9 clearly satisfies the "primarily reflects" standard of §1.246-5.

Therefore, under the facts of this case, the changes in the fair market value of Instrument A and Instrument B were reasonably expected to approximate changes in the fair market value of the Corporation A stock and Corporation B stock, respectively. As a result, Instrument A and Instrument B are SSRP (other than stock) with respect to the Corporation A stock and Corporation B stock.

2. <u>Whether payments on Instrument A and Instrument B (including for this purpose any early redemption premiums and debt issuance costs?) constitute "interest or carrying charges incurred or continued to purchase or carry" the Corporation A and Corporation B stock, respectively, for purposes of § 263(g)(2)(A).</u>

Section 263(g)(1) requires the capitalization of "interest and carrying charges" properly allocable to personal property that is part of a straddle under §1092(c). Under § 263(g)(2)(A) the phrase "interest and carrying charges" includes the interest on indebtedness "incurred or continued to purchase or carry the personal property" plus all other amounts paid or incurred to carry the personal property, less certain amounts set forth in § 263(g)(2)(B).

While there is no direct authority interpreting the phrase "indebtedness incurred or continued to purchase or carry" in § 263(g), the phrase also appears in § 265(a)(2). Section 265(a)(2) disallows a deduction for interest on indebtedness "incurred or continued to purchase or carry" tax exempt obligations. Although authorities under § 265(a)(2) are not controlling for purposes of § 263(g), they may provide useful guidance.

Rev. Proc. 72-18, 1972-1 C.B. 740, is the Service's primary published guidance on the interpretation of the "purchase or carry" nexus test. In the absence of direct tracing of debt proceeds used to purchase or carry tax-exempt obligations, Rev. Proc. 72-18 provides that § 265(a)(2) requires a determination, based on all of the facts and circumstances, that a taxpayer's purpose in incurring or continuing indebtedness was to purchase or carry the tax-exempt obligations. This prohibited purpose is established by showing a "sufficiently direct relationship" between the indebtedness and the carrying of the tax-exempt obligations. <u>Illinois Terminal Railroad Co. v. U.S.</u>, 375 F.2d 1016, 1021 (Ct. Cl. 1967). Such a purpose will not be inferred, however, where there is a bona fide restriction on a taxpayer's ability to sell or otherwise to dispose of the tax-exempts. <u>See e.g.</u>, <u>R.B. George Machinery</u>, 20 B.T.A. 594 (1932) (Acquiesced XI-2 C.B. 4).

In the instant case, the Instruments were not forced upon Taxpayer and there were no restrictions on Taxpayer's ability to sell or otherwise to dispose of the Reference Stock. Furthermore, the facts make clear that Taxpayer's reasons for incurring the indebtedness were directly related to the carrying of the Reference Stock.

Upon issuance, the principal amount of one unit of Instrument A equaled the Date 6 closing price of one share of Corporation A stock. Also, upon issuance, the principal amount of one unit of Instrument B-1 and B-2 equaled the Date 12 and Date 13 closing prices of one share of Corporation B stock as of those dates, respectively. Taxpayer held as many or more shares of Corporation A stock as the number of units of Instrument A issued, and held as many or more shares of Corporation B stock as the number of units of Instrument B issued. In addition, at maturity of the Instruments, holders are to be paid an amount determined by reference to the price of the Reference Stock. Holders of the Instruments received the right to any appreciation in the Reference Stock, and, in exchange for this right, holders agreed to receive interest payments well below the market rates. Therefore, both in form and in substance, the Instruments were closely and directly tied to the Reference Stock.

This direct relationship is also supported by facts showing Taxpayer's purpose to incur and continue the indebtedness in order to hold the Reference Stock. In Month 4, Taxpayer redeemed all the units of Instrument A. Taxpayer elected to redeem all units of Instrument A because of an impending transaction in which Taxpayer intended to (and did) use its Corporation A stock as consideration for the purchase of additional assets. The redemption occurred four months after issuance of Instrument A, which indicates that Taxpayer did not intend to have Instrument A outstanding absent its continued ownership interest in the referenced Corporation A stock.

Taxpayer argues that its intention to continue to hold the shares for "strategic business purposes" rebuts the relationship otherwise established between the Instruments and the Reference Stock. As support, Taxpayer cites to cases under § 265(a)(2) such as Handy Button Machine Co., et al. v. Commissioner, 61 T.C. 846 (1974) and Swenson Land and Cattle Co., Inc. v. Commissioner, 64 T.C. 686 (1975) for the proposition that a nexus between issuing indebtedness and holding tax-exempt bonds will not be found where the taxpayer had "business oriented" reasons for both the indebtedness and the bonds.

In both cases, the Service failed to establish the requisite relationship between the issuing of indebtedness and the holding of tax-exempt bonds, other than the fact that the taxpayer held them both at the same time. In fact, in Handy Button, the court specifically rejected the Service's "working capital analysis" by which the government attempted to show a connection between the debt and the bonds on the basis that "but for" the borrowing, taxpayer would have had to liquidate the bonds. Id. at 853. Similarly in Swenson, the court found no relationship between the tax-exempt bonds and the indebtedness, noting that § 265(a)(2) does not apply where there is no connection between the debt and the tax-exempt bonds other than their "mere simultaneous existence." Id. at 696.

Therefore, the facts of Handy Button and Swenson, supra, are distinguishable from the facts of the instant case. In addition, as discussed above, Taxpayer's reasons for incurring the debt were not independent of and unrelated to the holding of the

Reference Stock. See Illinois Terminal, supra at 1023. To the contrary, the Instruments specifically reference the Reference Stock and are, in form and substance, closely connected to the Reference Stock.

Moreover, we view Taxpayer's admission that it was a conscious and purposeful decision to issue the Instruments in order to continue holding the shares as support for a finding of the requisite nexus, rather than as evidence rebutting the relationship otherwise established by the facts and circumstances of the transaction. There is clear evidence that Taxpayer intended to take advantage of the referencing created between its holdings in the Reference Stock and the application of the CPDI rules to the Instruments. The use of the Instruments helped the Taxpayer to achieve the deferral and conversion opportunities found in a typical cash-and-carry transaction. Taxpayer projected the forward price of the Reference Stock at maturity of the debentures and accrued deductions under the CPDI rules such that the deductions taken referenced the projected forward price of the Reference Stock. Therefore, the Instruments were used specifically to carry the Reference Stock under § 263(g).

The relationship between the Instruments and the Reference Stock is similar economically to a taxpayer who obtains a loan by collateralizing its portfolio securities. Much like a collateralization transaction, a monetization establishes a direct transactional nexus between the borrowing and the borrower’s continued ownership of the reference stock. Taxpayer would distinguish the monetization transaction at issue from a collateralization on the basis that, in the monetization transaction, Taxpayer is not required to hold the reference shares during the term of the debt instrument. Under a typical pledge arrangement, the obligor is required to hold the collateral and its ability to sell, exchange, or otherwise dispose of the collateral is restricted by contract. In the instant case, although Taxpayer’s ability to dispose of the Reference Stock is not restricted by contract or other agreement, the facts indicate that Taxpayer’s ability or willingness to accept the risk of disposing of the Reference Stock while the debt remained outstanding was economically restricted. Taxpayer’s ownership of the reference shares offset its obligation under the debt instruments to pay holders any and all appreciation on the reference shares. That Taxpayer was unwilling to accept the risks associated with continuing the debt without ownership of the reference shares is established by the fact that Taxpayer redeemed Instrument A as soon as it determined that it was going to dispose of the Corporation A stock.

As a result, based upon the facts and circumstances of the instant case, a sufficiently direct relationship has been established between the Instruments and the Reference Stock to find that the indebtedness was incurred or continued to carry the stock.

If you have any questions, please contact at or at

CAVEAT(S):

Except as specifically ruled upon above, no opinion is expressed or implied regarding the federal income tax aspects of this transaction or any other transaction, including, for example, whether the taxpayer properly applied the noncontingent bond method.

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.