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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR [redacted]

FROM: DEBORAH A. BUTLER
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CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated April 22, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

X=
Y=
Z=
A=
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a=
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Date 3=
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Date 5=
Date 6=
Date 7=
Date 8=

Date 9=
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Date 11=
Date 12=
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Calendar Year 8=
Taxable Year 1=
Taxable Year 2=
Taxable Year 3=
Taxable Year 4=

ISSUE(S): 1. Whether X is entitled to deductions under section 163 for unpaid and accrued interest on a% junior subordinated debentures (a% debentures) issued to fund a leveraged buyout of X's stock on Date 1 and a% debentures issued Date 2 and Date 3 for taxable years 1 through 4 inclusive.

2. Whether the discharge granted to X under 11 U.S.C. § 1411 terminated X's liability to pay any of the interest that may have accrued from Date 4 through Date 5, inclusive on the following obligations:

a. ESOP loan facility due year 5.
b. b% senior notes due Date 6.
c. c% senior subordinated debentures due Date 7.
d. d% subordinated debentures due Date 8.
e. Advances related to a% debentures due Date 9.

CONCLUSION: 1. There is nothing in the statute or case law which would prevent the Service from challenging the debt characterization of junk bonds, including those traded in an open market to third party holders. Nevertheless, while there is an argument in this case that the a% notes constitute equity rather than debt, such an argument presents severe litigation hazards. Accordingly, we conclude that the interest deduction should not be disallowed on a debt/equity basis.

2. More factual development will be required to determine whether X is entitled to the interest deductions. Specifically, deduction of the prepetition interest will be allowed to the extent that it was paid by the issuance of replacement debt instruments, stock and other property in the confirmed plan.

FACTS:

This Field Service Advice is a reconsideration of a prior advice issued on December 1, 1997. We have abstracted the relevant facts from that memorandum.

After considering alternatives and the availability of financing and concluding that X was an attractive investment opportunity due to market undervaluation of its stock, X's Management Group decided to take X private through a leveraged buy out (LBO) and by establishing an employee stock ownership plan (ESOP). The Management Group decided that the LBO and ESOP would allow X's Management Group and other employees and certain members of the founder's family the opportunity to benefit from X's expected future growth and upside equity potential and terminate the voice and equity rights of X's public shareholders in exchange for the value of their stock.

After the merger, X's management expected X's business and operations to continue substantially as conducted before the merger.

The analyses of Y, as an investment banker and lender, and other outside experts hired by X to evaluate the LBO, indicated that X's projected income could support the increased debt load that would be generated by the LBO. X asserts that the debt instruments were oversubscribed, that independent lenders were lining up to lend to X, and that ten financial institutions were involved in lending funds to X. In addition, X asserts that a financial appraisal prepared by an outside financial expert hired by X was disclosed to these ten financial institutions, but that such financial institutions made their own credit decisions.

The Prospectus/Proxy Statement issued by X in connection with the a% Junior Subordinated Debentures due on date 12, told X's public common shareholders the following:

a. As holders of the debentures (other than those who exercise appraisal rights), public shareholders would become X's creditors and no longer have any equity interest in X.

b. After the proposed merger, public shareholders would lose their rights to vote on corporate matters that must be submitted to stockholders (such as election of directors), to receive declared dividends, and to share in X's future earnings or growth, but would obtain a claim to X's assets upon dissolution that is superior to the rights of the holders of X's common and preferred stock and will be entitled to interest payments on the debentures.

The a%, c%, and d% debentures were unsecured obligations of X and subordinated to senior debt. Although the c% and d% debentures were subject to unsecured guarantees, no such guarantees existed for the a% debentures.

X consistently treated all a% debentures as debt in its books of account. For example, X: (a) advised the holders of such debentures that the instruments constituted debt and that they were required to report interest income paid by issuance of X's PIK bonds on their income tax returns as if the debentures were debt; and (b) deducted OID as interest expense accrued in accordance with such statutory and regulatory provisions. Specifically, the Prospectus told the holders that they would be required to include OID in income under I.R.C. § 1272(a)(1) before their receipt of any cash associated with that OID. In addition, each a% debenture bore a legend reflecting the amount of OID and its yield to maturity.

Furthermore, X provided annual Forms 1099 to the holders of the a% debentures and the Service stating the amount of OID that accrued on such debentures during each of the calendar years 1 through 5, inclusive.

After the LBO, the industry in which X conducted business experienced a significant downturn resulting from rapid adverse changes in the industry that were unforeseeable at the time of the LBO by X's management, industry analysts, investment bankers, and X's competitors.

Although X had experienced a high growth period after the LBO, the adverse industry changes began affecting X by late year 2. X's growth continued after the LBO, but at a slower pace than before the LBO.

Consequently, X, which was heavily leveraged from the LBO, began experiencing difficulty in meeting its debt service obligations. In addition to the industry-wide conditions, operating results of X's businesses and X's cash flow available to service its heavy debt service in taxable year 2 were significantly impaired by these changed economic conditions.

After the merger, X's management planned to meet X's increased debt service obligations through successful operation of its business and by expansion. X's forecasted earnings showed that X could cover interest and pay down its debt.

X's actual performance exceeded its projections during the first fiscal year after consummation of the merger. X made all of its debt service payments in the first quarter of the taxable year 3, but was unable to meet all of its debt service requirements in the remaining three quarters. By that time, X had exhausted its ability to borrow under various credit agreements. X continued to be unable to meet its obligations through the first part of Taxable Year 4.

Accordingly, on Date 6, X filed a Chapter 11 petition with the United States Bankruptcy Court in Z (Bankruptcy Court).

The order by the Bankruptcy Court confirming X's Chapter 11 plan was signed on Date 7 and the effective date was Date 8.

In its confirmed plan, X treated the a% debentures as unsecured debt that ranked ahead of all equity, including X's preferred and common stock.

The distributions of new senior notes, new debentures, new common stock, cash, and other property under X's confirmed plan resulted in the satisfaction, discharge and release of X and its property from any claims, debts, liens, security interests, encumbrances, and interests of allowed claims (including principal and interest accrued thereon from Date 6 until Date 8) of holders of the b% senior notes, the c%, d%, and a% debentures, and preferred and common stock that arose before the confirmation Date. Consequently, all these holders were permanently enjoined from asserting against X or its assets any other or further claims that occurred before Date 7, including claims based on any act or omission, transaction, or other activity that occurred before Date 7.

There is no language in X's Chapter 11 plan or the related order of confirmation allowing payment of postpetition interest on any debt or interest that accrued during the pendency of the bankruptcy case (from Date 6 through the effective date of Date 8). In addition, X's plan defined an allowed claim to specifically exclude interest on the principal amount of any claim maturing or accruing from and after the petition date.

LAW AND ANALYSIS

Issue 1:

Related Party Debt

The issuer (i.e., X) and the holders (i.e., the public) of the a% debentures in general were not related parties. Therefore, the instrument and dealings between the parties with respect to this instrument are not subject to the same level of scrutiny as in the case of related party debt. *See Matter of Uneco, Inc. v. United States*, 532 F.2d 1204, 1207 (8th Cir. 1976) (quoting *Cayuna Realty Co. v. United States*, 382 F.2d 298 (Ct. Cl. 1967)) ("Advances between a parent corporation and a subsidiary or other affiliate are subject to particular scrutiny `because the control element suggests the opportunity to contrive a fictional debt'"). *See also P.M. Fin. Corp. v. Commissioner*, 302 F.2d 786, 789 (3d Cir. 1962) (sole shareholder-creditor's control of corporation "will enable him to render nugatory the absolute language of any instrument of indebtedness") and *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968). Therefore, this factor favors respecting the characterization of the a% debentures as debt.

It is true that the original holders of these instruments received them in exchange for stock and in their capacity as shareholders of X. In other words, there was a relationship between the parties at the time the a% debentures were issued. However, after the a% debentures were issued, many holders began to immediately trade them in the public debt market. Therefore, it is likely that, very quickly after they were issued, many holders of the a% debentures were not former shareholders of X.

Formal Indicia

The a% debentures have the formal indicia of indebtedness because they are in the form of debt, require the repayment of a sum certain on a fixed maturity date and bear a stated rate of interest. *See Commissioner v. O.P.P. Holding Co.*, 76 F.2d 11 (2d Cir. 1935) (provision for payment of a sum certain with fixed interest rate supports debt characterization). *See also United States v. Title Guarantee & Trust Co.*, 133 F.2d 990 (6th Cir. 1943) (fixed maturity date one of most important factors in determining debt status).

Because the long-term applicable Federal rate for the months the a% debentures were issued (compounded semi-annually) ranged from approximately 8% to 9%, it could be argued that the interest rate of the a% debentures was unreasonably high and, in fact reflected their riskiness. However, absent other evidence suggesting that a% return was designed to allow debt holders to participate in the fortunes of X's business, it is unlikely the Service could argue successfully that the instrument is equity solely by virtue of its high interest rate. Compare *Aldon Homes, Inc. v. Commissioner*, 33 T.C. 582 (1959); *Merlo Builders, Inc. v. Commissioner*, T.C. Memo. 1964-35.

Finally, we note that, in the early years, the holders could not expect to be paid in cash (but instead in PIK bonds). Payment of interest (or repayment of principal) in a medium other than cash is a factor supporting equity classification. In fact, the holders never received interest payments in the form of cash. Although X's inability to pay cash interest is relevant in evaluating X's creditworthiness, an instrument nevertheless may return interest in the form of discount and still be characterized as debt for tax purposes.

Treatment By the Parties

Since "actions speak louder than words," the parties' treatment of the a% debentures is crucial in determining whether its characterization as debt should be respected. *See Yale Ave. Corp. v. Commissioner*, 58 T.C. 1062 (1972). *See also Waller v. United States*, 78-1 USTC ¶ 9394 (D. Neb. 1978) (failure to enforce outweighs formal indicia).

X consistently treated the a% debentures as debt in its books of account. For example, X: (a) advised the holders of the a% debentures that the instruments constituted debt and that they were required to report interest income paid by issuance of X's PIK bonds on their income tax returns as if the a% debentures were debt; and (b) deducted OID as interest expense accrued in accordance with such statutory and regulatory provisions. Specifically, page 52 of the Prospectus told the holders that they would be required to include OID in income under section 1272(a)(1) before their receipt of any cash associated with that OID. In addition, each a% debenture bore a legend reflecting the amount of OID and its yield to maturity.

Furthermore, X provided annual Forms 1099 to the holders of the a% debentures and the Service stating the amount of OID that accrued on such a% debentures during each of the calendar years 1 through 5, inclusive. Therefore, this factor overwhelmingly favors respecting the characterization of the a% debentures as debt.

Expectation of Repayment

Not only must the purported creditor expect repayment, the expectation must be reasonable. Repayments dependent on the fortunes of the business indicate equity. *Dixie Dairies Corp., supra; Estate of Mixon v. United States, supra.*

In this case, there is contrary evidence and opinion. Contemporaneous evaluations of the debentures, prepared by unrelated analysts A and B, were optimistic about the prospects for repayment of all the debt. Other independent analysts commented favorably about investments in the a% debentures shortly after their issuance. On the other hand, the expert hired by Examination has prepared a strong report, based upon the expected cash flows to be earned by X, suggesting that in reality the debt was very unlikely to be repaid.

Independent Creditor Test

"The acid test of the economic reality of a purported debt is whether an unrelated party would have extended credit in the circumstances." Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 Tax Law Review 369, 530 (1971). *See Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968). *See Nassau Lens Co. v. Commissioner*, 308 F.2d 39 (2d Cir. 1962) (independent creditor test based on comparability to the general standards of the financial community, not on actual availability of outside credit). *See also Baker Commodities, Inc. v. Commissioner*, 48 T.C. 374 (1967), *aff'd*, 415 F.2d 519 (9th Cir. 1969), *cert. denied*, 397 U.S. 988 (1970) (hindsight test).

In this case, as noted above, the interest rate on the a% debentures was substantially higher then the market rate for long-term debt. On the other hand, the a% debentures were traded in the market, suggesting that the public believed that X would pay the required amount of interest with respect to the a% debentures. Therefore, this factor favors respecting the characterization of the a% debentures as debt.

Debt-Equity Ratio

The field attorney argued that X's debt-equity ratios of 3.6:1 (during calendar year 1), 2.2:1 (during calendar year 2), and 1.9:1 (during calendar year 3) indicates that X had adequate capitalization on the date of issuance of each Debenture (which in each case was the date in parenthesis). We note that X's average debt-equity ratio during this period was 2.6:1 and declining. Compare *Laidlaw Transportation, Inc. and Subsidiaries v. Commissioner*, T.C. Memo. 1998-232 (June 30, 1998) (average debt-equity ratio was 4.56 and increasing; court found that this factor favored recharacterizing the purported debt as equity). In view of the expected cash flow requirements by X, this debt-equity ratio is not as conservative as it might appear. In cases where we have successfully argued that a purported debt instrument is equity, however, the debt-equity ratios have been much higher. Therefore, this factor favors respecting the characterization of the a% debentures as debt.

Other Factors

Some factors favor equity characterization. For example: (1) the a% bonds are subordinate to most of the dollar value of X's debt; (2) the likely source for any repayment of the a% interest would be corporate profits, to such a degree that repayment is contingent on X's success; and (3) the interest on the a% debentures was never paid in cash.

Issue 2:

Section 163(a) allows a deduction for all interest paid or accrued on indebtedness during the taxable year. Under the accrual method of accounting, the deduction is taken in the taxable year "in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy." Section 1.461-1(a)(2).

There is a split in the circuits as to whether doubt as to collectibility prevents the accrual of interest. The Fifth and Eighth Circuits hold that it does not. *Fahs v. Martin*, 224 F.2d 387 (5th Cir. 1955); *Zimmerman Steel Co. v. Commissioner*, 130 F.2d 1011 (8th Cir. 1942). The instant case would be appealable to the Eleventh Circuit which would treat as controlling precedent Fifth Circuit cases decided prior to September 30, 1981. *Bonner v. City of Prichard*, 661 F.2d 1206, 1209 (11th Cir. 1981).

In the instant case, however, there is more than doubt as to collectibility with respect to interest accruing in Taxable Year 4 prior to the bankruptcy petition. In fact, except to the extent provided for in the confirmed bankruptcy plan, such interest was discharged during Taxable Year 4, never to be paid. In such circumstances, the Tax Court has held that no interest deduction is available. *McConway & Torley Corp. v. Commissioner*, 2 T.C. 593 (1943). See also *Zimmerman Steel*, *supra*; *Southeastern Mail Transport, Inc. v. Commissioner*, T.C. Memo. 1992-252 (cases imply that if nonpayment became certain during taxable year, interest deduction would not be allowed.) On the facts of this case, some of the X's obligation for interest may not have been extinguished by virtue of discharge in bankruptcy, but rather paid in the form of replacement debt instruments and stock issued as part of the confirmed plan. That part that was paid will be deductible; the part that was discharged is not deductible.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]