INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Third Party Communication: None
Date of Communication: Not Applicable

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Index (UIL) No.: 1092.06-00, 263.21-00
CASE-MIS No.: TAM-147041-04

Laura Prendergast, Executive Officer
Large and Mid Size Business (LMSB)

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year Involved:
Date of Conference: Not Applicable

LEGEND:

Taxpayer =
Parent =
Holding Company =
Business 1 =

Business 2 =
Business Development =

Services =

Corporation A	=
Corporation B	=
Corporation C	=
New Stockholders	=
Investor A	=
Promoter	=
Instruments	=
Exchange	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 11	=
Date 12	=
Date 13	=
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Date 33	=
Date 34	=
Date 35	=
Month 1	=
Month 2	=
Month 3	=
Month 4	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
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e	=
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ISSUE(S):

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

    a. Whether the Instruments issued by Taxpayer in Year 1 constitute a "position" under § 1092(d)(2); and

b. If the Instruments are a “position” under § 1092(d)(2), whether this “position” qualifies under § 1092(d)(3)(B)(i)(III)[1] as “a position with respect to substantially similar or related property (other than stock)” with respect to Corporation A stock held by Taxpayer?

2. Whether payments on the Instruments are interest and carrying charges incurred or continued to purchase or carry the shares for purposes of § 263(g)(2)(A).

CONCLUSION(S):

1. Under § 1092, the Instruments are part of a straddle with the Corporation A stock.

   a. The Instruments constitute a “position” under § 1092(d)(2); and

   b. This “position” qualifies under § 1092(d)(3)(B)(i)(III) as “a position with respect to substantially similar or related property (other than stock)” with respect to stock held by Taxpayer.

2. Payments on the Instruments are interest and carrying charges incurred or continued to purchase or carry the Corporation A stock for purposes of § 263(g)(2)(A).

FACTS:

Background:

Taxpayer is a wholly owned subsidiary of Parent and is included in Parent’s consolidated federal income tax return. Parent is a Holding Company. Taxpayer manages a portfolio of companies involved in Business 1 and related products and services. In order to generate funds to invest in Taxpayer’s Business Expansion and for other general corporate purposes, Taxpayer issued units of exchangeable senior debentures called the “Instruments” on Date 2. Payments on the Instruments are indexed to the performance of a portion of Taxpayer’s holdings of publicly traded stock in Corporation A, referred to as the “reference shares” under the Offering Memorandum dated Date 1, as more fully described below. According to the Offering Memorandum, Taxpayer intended to utilize the proceeds to repay

and indirectly, through an internal transfer of assets, to fund its recent investment in its Business Development and for other general corporate purposes, including funding new investment opportunities. Taxpayer

[1] This provision was amended and renumbered as § 1092(d)(3)(A)(i) by section 888(c)(1) of the American Jobs Creation Act of 2004 (P.L. 108-357). Section 1092(d)(3)(A)(i) provides that in the case of stock, the term “personal property” includes stock only if such stock is of a type which is actively traded and at least 1 of the positions offsetting such stock is a position with respect to such stock or substantially similar or related property.

indicated in its Offering Memorandum that it may initially invest net proceeds that are not immediately required in short-term marketable securities.

a. Taxpayer's Holdings in Corporation A.

As of Date 2, the Parent's consolidated group beneficially owned approximately a shares of common stock of Corporation A

The stock was acquired by Parent, through its subsidiaries, over a period of time predating the issuance of the Instruments from Month 2, Year 2 through Month 3, Year 3, and Parent paid $e, in the aggregate, for such shares.[2]

The Offering Memorandum also states that, although Taxpayer cannot assure investors that the sales of Corporation A shares will not adversely affect the market in such stock, Taxpayer has no reason to believe that any of these sales will have this effect. The market price of the Corporation A stock on the date of issuance of the Instruments was $h, and the price of the stock one week earlier on the date of the Offering Memorandum, Date 1 was $i. The number of the shares of reference shares attributable to each unit of the Instruments is the Reference Share Amount of j shares per unit, subject to dilution adjustments as described in the Offering Memorandum.[3]

The Corporation A stock was publicly traded on the Exchange at the time the Instruments were issued.[4] The Corporation A shares owned by the Parent consolidated group at the time the Instruments were issued represented approximately k percent of the issued and outstanding shares of Corporation A common stock. At this time, none of the Corporation A stock had been pledged as collateral for any loans or debt instruments, including but not limited to, the Instruments.

Corporation A is a Business 2 company providing certain Services.

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[2] Taxpayer's basis in each share of Corporation A stock on the day the Instruments were issued was approximately $g per share.

[3] As a result, the number of reference shares as of Date 3 attributable to each unit of the Instruments was r shares.

[4]

In Year 4, Taxpayer sold approximately m shares

, or n percent of its investment in Corporation A, resulting in pre-tax gains of approximately $ba. In Year 1, Taxpayer sold approximately az Corporation A shares , resulting in pre-tax gains of approximately $bc. No reference shares were sold in Year 5.

b. Issuance of the Instruments

On Date 2 (the "Issue Date"), Taxpayer issued o units of the Instruments by private placement pursuant to a confidential Offering Memorandum dated Date 1 in the original principal amount of $i each, for a total of $p. The original principal amount of $i was equal to the last reported sale price of Corporation A common stock on the Exchange as of Date 1.[5] The Instruments were developed by Promoter and allow issuers to monetize large holdings in liquid stocks. Promotional materials dated Date 8 provided by Promoter to Taxpayer point out that issuance of the Instruments accomplishes multiple goals, including effectively allowing Taxpayer to eliminate economic risk on the entire holding, deferring capital gains tax on stock for q years or more while allowing Taxpayer to retain the dividends received deduction on the stock. The issuer claims interest deductions under the contingent payment debt instrument rules of § 1.1275-4. As a result, the borrowing costs for the issuer are reduced and the issuer is able to retain its holdings of the reference shares. As noted, the Instruments are indexed to common shares of Corporation A. Units of the Instruments are q year instruments that mature on Date 9.

Promoter, who also was the underwriter of the securities, purchased an initial allotment of s units that subsequently were sold to investors. Promoter purchased the Instruments at a discount equal to t percent of the original principal amount. Promoter received its underwriting fees through the discount. Promoter was also eligible to purchase up to u additional Instruments at the same original principal amount less the t percent discount in the event of over-allotments. Eventually, Promoter purchased all of the additional Instruments. Most of the Instruments were sold to a variety of U.S. insurance companies, investment companies, LLC's, and partnerships.

5

Upon issuance, each unit of the Instruments equaled j Corporation A shares (for a total of c shares) subject to dilution adjustments (the "Reference Share Amount").[6] Unless previously redeemed or exchanged, the Instruments will mature on Date 9 (the "Maturity Date"). At maturity, the holders of the Instruments will be entitled to receive a cash amount (the "Contingent Principal Amount") from Taxpayer equal to the greater of (a) the Minimum Amount or (b) the then current market value of the Reference Share Amount of the reference shares (initially j shares) of Corporation A common stock referenced to a unit of the Instruments.

According to the Offering Memorandum, the projected payment at maturity under the contingent payment debt rules is $v per unit of the Instruments. The "Minimum Amount" means the original principal amount of each unit of the Instruments ($i per unit) increased during each quarter by an amount equal to accrued payments of interest, and reduced by the following amounts on the date they are paid to holders of the Instruments: (a) the quarterly payments of interest; (b) any amounts paid on the Instruments in respect of regular cash dividends on the amount of reference shares attributable to each unit; and (c) any amounts paid on the Instruments in respect of the fair market value of any additional interest payments made on the Instruments during the quarter.

The Instruments pay two types of interest over their term, quarterly in arrears on Date 10, Date 11, Date 12,and Date 13 of each year, beginning Date 11, Year 1 but subject to the right to defer the quarterly payments of interest. The first payment is $w per unit of the Instruments, equal to the annual rate of x percent of the original principal amount from the date of issuance. Each unit of the Instruments pays stated interest quarterly at the annual rate of x percent of the original principal amount (for a quarterly payment of $ aj per unit).

If Corporation A distributes regular cash dividends or other property on the reference shares, additional interest will be paid in the form of property or cash in an amount equal to those dividends. As of the date of the Offering Memorandum, Corporation A has never paid a cash dividend on its common stock. Payments of dividends or additional interest will reduce the Minimum Amount payable at maturity to the extent necessary so that the yield to the date of computation does not exceed a x percent annual yield,

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If no conditions of default exist, Taxpayer has the option to defer the payment of interest at any time beginning after the Date 14 payment, for periods not to exceed z consecutive quarterly periods. The additional interest based on Corporation A cash

6

As a result, the number of reference shares currently attributable to each unit of the Instruments is r shares, subject to further dilution adjustments.

dividends cannot be deferred. Interest cannot be deferred beyond the maturity date of the Instruments. If interest payments are deferred, the Minimum Amount of the Instruments will increase by the amount of the deferred quarterly payments of interest, plus accrued interest thereon at an annual rate of aa percent, compounded quarterly, and the early exchange ratio will be ab percent of the reference shares for the quarter following each deferral of a payment of quarterly interest. Once all deferred quarterly interest (plus interest accrued thereon) have been paid, along with the quarterly interest due for the current period, the Minimum Amount will be reduced by the amount of that payment of deferred quarterly interest plus accrued interest thereon, the early exchange ratio will change to ac percent of the reference shares, and interest may again be deferred.

Taxpayer has the right to redeem all, but not less than all, of the Instruments at any time for an amount of cash per unit of Instruments equal to the sum of (a) the greater of (1) the Minimum Amount of the Instruments or (2) the sum of the then current market value of the Reference Share Amount of common stock of Corporation A, plus any deferred quarterly payments of interest (including accrued interest thereon), plus in either case, the final period distribution, and (b) a redemption premium

Each unit of the Instruments is exchangeable, at the holder's option, at any time, for an amount of cash equal to a percentage of the then exchange market value of the reference shares attributable to each unit of the Instruments (the "early exchange ratio"). The early exchange ratio is (a) ac percent of the then exchange market value of the reference shares attributable to each unit of the Instruments or (b) ab percent of the value of those shares during a deferral of the quarterly interest payments on the Instruments, or, if so elected by Taxpayer, during the pendency of any tender or exchange offer for any of the reference shares.

The Instruments represent senior unsecured indebtedness of Taxpayer ranking *pari passu* with all of Taxpayer's existing and future senior unsecured indebtedness, Taxpayer's general trade creditors and all of Taxpayer's equity interests.

c. Other Documents

The Offering Memorandum provides that the Statement of Financial Accounting Standards No. 133 ("SFAS 133") will require Taxpayer to split the value of the Instruments into a debt component and a derivative component for financial accounting purposes.[7] Any change in the fair value of the derivative component will be reflected as an increase or decrease in reported net income. At the date of initial adoption, SFAS 133 provides Taxpayer a one-time opportunity to transfer any of available-for-sale securities, including shares of Corporation A stock, to the trading category. At the date of any such transfer from available-for-sale to trading, Taxpayer would recognize in income the appreciation in the shares transferred. Although Taxpayer is not required to hold a number of shares equal to the number of units of Instruments outstanding, if Taxpayer does so and elects to make this transfer from available-for-sale to trading, changes in the fair value of the shares of stock so transferred will be reflected as an increase or decrease in reported net income. According to the Offering Memorandum, changes in the market value of the Corporation A stock should at least partially offset changes in the fair value of the derivative component of the Instruments; however, there may be periods with significant non-cash increases or decreases to net income pertaining to the Instruments and the related shares of Corporation A stock.

According to Parent's 10-k filed for the year Year 1, on Date 16, Taxpayer and Parent adopted the hedge accounting rules of SFAS 133 and designated ad shares of its beneficial ownership in approximately ee shares of Corporation A stock as trading securities. The 10-k states that it was expected that the derivative component (nondebt) of Taxpayer's Instruments would reflect the fluctuations in value of the Corporation A stock. As stated in the 10-k, it is anticipated that fluctuations in the value of the reference shares will match with and offset significantly fluctuations in the value of the derivative (or nondebt) component of the Instruments. These changes in stock value will be reflected in the net income of Parent as increases or decreases. In addition, non-cash increases or decreases in the Parent's net income will be caused by fluctuations in the time value portion of the derivative component notes. The 10-k states that Parent's Consolidated Statements of Income for Year 1 included an expense of $af related to the change in value of the Corporation A stock which was largely offset by

[7] The Financial Accounting Standards Board has issued Statement of Financial Accounting Standards No. 133 ("SFAS 133"), Accounting for Derivative Instruments and Hedging Activities, which Parent is required to adopt no later than Date 15.

$ag related to the change in value of the Instruments' derivative component. Under the SFAS 133 hedge accounting rules, Taxpayer's Instruments demonstrate a correlation with the reference shares of ah percent.

Parent entered into a series of shareholder and investor agreements with Corporation A and other principal Corporation A shareholders, imposing restrictions on Parent's ability to sell or otherwise transfer Corporation A shares. Taxpayer states that the restrictions were intended to provide for an orderly market in Corporation A shares by ensuring that principal shareholders coordinate significant sales of Corporation A shares. The stockholder agreements were put into place beginning in Year 2, and initially applied to predecessors of Parent and Corporation A along with other shareholders, and later directly to Parent at the time of issuance of the Instruments. Parent or its predecessor was a party to these various shareholder agreements during the period beginning Year 2 and ending Date 18. The shareholders agreements expired on Date 18. Taxpayer was not a party to any of the shareholder or investor agreements.

As noted above, in Year 1, Taxpayer sold approximately az Corporation A shares , resulting in pre-tax gains of approximately $bc. No reference shares were sold in Year 5. In Year 4, Taxpayer sold approximately m shares, or n percent of its investment in Corporation A, resulting in pre-tax gains of approximately $ba.

d. Federal Tax Consequences of the Instruments

Taxpayer reported the Instruments as contingent payment debt instruments (CPDIs) for federal income tax purposes. Under the CPDI regulations § 1.1275-4, Taxpayer determined the amount of its annual interest expense deduction with respect to the Instruments based on Taxpayer's "comparable yield" of b percent (as determined under § 1.1275-4(b)(4)). Taxpayer reported a deduction of $bd with respect to accrued interest on the Instruments for its taxable year ending Date 35, and $be of accrued interest on the Instruments for its taxable year ending Date 18. Thus, the interest expense deducted by Taxpayer for these Instruments in excess of the amount actually paid was $bf in Year 1 and $bg in Year 5. Taxpayer did not defer any interest payments in Year 1 or Year 5. Interest of $bh was paid in Year 1, and $bi in Year 5.

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 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, in general, a taxpayer holds offsetting positions with respect to personal property if there is a substantial diminution of the taxpayer’s risk of loss from holding any position with respect to personal property by reason of his holding one or more other positions with respect to personal property (whether or not of the same kind).

Sections 1092(c)(3)(A)(i) provides that positions will be presumed to be offsetting if the positions are in the same personal property (whether established in such property or a contract for such property). In addition, § 1092(c)(3)(A)(iv) provides that positions will also be presumed to be offsetting if the positions are sold or marketed as offsetting positions (whether or not such positions are called a straddle, spread, butterfly, or any similar name).

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),[8] there are four other exceptions to the general rule excluding stock. The first three exceptions apply to provide that personal property includes, respectively, (1) an option with respect to that stock or substantially similar stock or securities, (2) a securities futures contract (as defined in § 1234B) with respect to such stock or substantially identical stock or securities, or (3) 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) and (III). The fourth exception, § 1092(d)(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, second, and fourth exceptions are not relevant to the instant case, except by analogy.

[8] This provision was amended and renumbered as § 1092(d)(3)(A)(i) by section 888(c)(1) of the American Jobs Creation Act of 2004 (P.L. 108-357). Section 1092(d)(3)(A)(i) provides that in the case of stock, the term “personal property” includes stock only if such stock is of a type which is actively traded and at least 1 of the positions offsetting such stock is a position with respect to such stock or substantially similar or related property.

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 –

(i) 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

(ii) 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 the Instruments and Corporation A stock constitute a straddle under § 1092 of the Code.

   a. Whether the Instruments issued by Taxpayer in Year 1 constitutes a “position” 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 Congress had intended for a debt obligation to be treated as a position in personal property of the issuer, it would not have written § 1092(d)(7)(A) as narrowly as it did. Neither the legislative history nor the express language of § 1092(d)(7), however, indicates that Congress intended to exclude a debt instrument from the definition of position in § 1092(d)(2). A rule that a debt instrument can be a position in nonfunctional currency does not establish that a debt instrument is a position only in nonfunctional currency. 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 Year 3 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 § 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).

As additional support, Taxpayer points to language found in the legislative history to § 1092, which provides: "U.S. currency does not constitute personal property as defined since only property or interests in property that may result in gain or loss on their disposition are subject to the straddle limitations." General Explanation of The Economic Recovery Tax Act of 1981, Prepared by the Staff of the Joint Committee on Taxation, Jan. 18, 1982, at 289. Taxpayer argues that since U.S. currency does not itself constitute personal property for purposes of the straddle rules, a U.S. currency borrowing by a taxpayer whose functional currency is the U.S. dollar should not be treated as a position in personal property under § 1092.

The Service argues that the Instruments create an interest, or position, in the reference shares, rather than in (or in addition to) its functional currency, based upon the express provisions of the Instruments. In addition, Taxpayer's argument suggests that an issuer's own debt instrument, regardless of other rights and obligations inserted into the debt instrument, may never represent a position in personal property for purposes of § 1092. This argument, if adopted, would allow taxpayers to escape the strictures of §§ 1092 and 263(g) simply by writing positions into a debt instrument rather than placing the position in a separate document. Such an argument elevates form over substance.

Taxpayer also argues that because the Service cannot apply the loss deferral rules of § 1092 to the instant transaction, the Service therefore should not be permitted to apply the interest capitalization rules of § 263(g). This argument fails to recognize the separate purposes of each provision. The straddle rules were added to the Code by the Economic Recovery Tax act of 1981, including both §§ 1092 and 263(g) to address different types of abuses arising out of various straddle transactions. If Taxpayer's argument were adopted, § 263(g) would not apply even to the typical cash and carry straddle[9] described in the legislative history of § 263(g). Clearly, such a narrow reading of the statute was not intended.

In light of the foregoing, we believe that the Instruments constitute a "position" in corresponding reference shares under § 1092(d).

b. <u>If the Instruments are a "position" under § 1092(d)(2), whether that "position" qualifies under § 1092(d)(3)(B)(i)(III) as "a position with respect to substantially similar or related property (other than stock)" with respect to Corporation A stock held by Taxpayer</u>.

Section 1092(d)(3)(B)(i)(III) 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. In general, property is substantially similar or related to stock when –

(i) 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

(ii) 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.

Under this standard, in order for the Instruments to qualify as positions in substantially similar or related property with respect to the reference shares, the following tests must be met: (1) the fair market value of the Instruments and the

[9] Under the legislative history, a typical cash and carry straddle involves the purchase of a physical commodity, such as silver, and the acquisition of a futures contract to deliver (sell) an equivalent amount of the same commodity more than twelve months in the future. The net gain on the two positions will be about equal to the interest and carrying charges but will be treated as long-term capital gain. Thus, taxable investment income is deferred and converted into capital gain, while carrying costs and interest are claimed as currently deductible. S. REP. NO. 97-144, 97th Cong., 1st Sess. 153 (1981). In a typical cash and carry straddle, the loss deferral rules of § 1092 would not apply.

reference shares 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 shares 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 asserts that a position must decrease the risk of loss with respect to stock before it will be considered "substantially similar or related property" with respect to that stock." As support, Taxpayer cites to § 1.246-5(b)(2), which provides that a taxpayer "has diminished its risk of loss on its stock holding positions with respect to substantially similar or related property if changes in the fair market value of the stock and the positions are reasonably expected to vary inversely."

As recognized in the language of § 1.246-5(b)(2), the SSRP standard is a standard separate from the diminished risk of loss standard. The definition of SSRP is found in § 1.246-5(b)(1). Section 1.246-5(b)(2) contains a definition of the term "diminished risk of loss" for purposes of determining a reduction in a holding period for the dividends received deduction under § 1.246-5(a).[10]

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

Under the facts of this case, the fair market value of the reference shares and the Instruments both reflect the performance of Corporation A. Upon issuance, the issue price of the Instruments equaled the then-trading price of the corresponding reference shares. The projected payment schedule of the Instruments, as discussed below, was based upon the forward price or other expected value of the corresponding reference shares. 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 appreciated stock price, not the principal amount. Likewise, holders were entitled to exchange their Instruments for an amount that references the stock price equal to ac percent of the price of the reference shares. By issuing the Instruments, Taxpayer essentially economically monetized and reduced its risk of loss on its position in the reference shares over the period that the Instruments were outstanding, at least q years. As discussed in section (2) below, the offsetting nature of the Instruments and the reference shares was noted in the Parent's 10-K filed

[10] The reduced risk of loss standard of § 1.246-5(b)(2) is not otherwise applicable for purposes of determining whether a straddle exists under § 1092(c). In general, § 1092(c)(1) defines a straddle for tax purposes as "offsetting positions with respect to personal property." Section 1092(c)(3)(A) provides that positions will be presumed to be offsetting if – "(i) the positions are in the same personal property (whether established in such property or a contract for such property)," or "(iv) the positions are sold or marketed as offsetting positions (whether or not such positions are called a straddle, spread, butterfly, or any similar name)."

for the year Year 1, where it states under the hedge account rules Taxpayer's Instruments demonstrate a correlation with the reference shares of ah percent.

In light of the foregoing, we believe that the value of the Instruments and the value of the reference shares primarily reflect the performance of the same firm, Corporation A. As discussed in section (2) below, the "fair market value of the reference shares was expected to reasonably approximate changes in the value of the Instruments." The only risk that Taxpayer retained was the risk that it would eventually have to repay a below-market loan in g years (in whole or in part) if the stock depreciated to an amount less than original issue price of the Instruments. Thus, Taxpayer essentially obtained tax-deferred use of the gain that existed in the reference shares at the time the Instruments were issued.

(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 shares 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 correlation in the fair market values between the reference shares and the Instruments, as provided by Taxpayer in its financial statements.

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

Taxpayer paid interest quarterly at an annual rate of x percent on the Instruments . Using the CPDI rules under § 1.1275-4, Taxpayer accrued a comparable yield of b percent compounded quarterly based upon a projected payment at maturity of $v per unit in g years.

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.

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 shares. In the Offering Memorandum, Taxpayer's projected payment amount is stated $v per unit of the Instruments. Thus, based upon Taxpayer's own calculations, changes in the fair market value of the reference shares were reasonably expected to approximate changes in the fair market value of the Instruments to which they relate.[11]

In addition, Taxpayer's projection appears to be consistent with market expectations at the time the Instruments were issued. The relevant standard under § 1.246-5(b)(4) 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. That these expectations were reasonable is supported by the fact that holders invested in the Instruments, agreeing to forego current interest payments, or accept reduced amounts, in consideration for the opportunity to share in future appreciation on the reference shares.

ii. The Economics of the Instruments

The holders' willingness to purchase the Instruments may be explained in part by analyzing the economic nature 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 shares. The call option component affords the holders the opportunity to share in the appreciation in the reference shares.

Each unit of the Instruments has an original issue price of $i, a quarterly coupon of $aj , and a "guaranteed" minimum stated redemption price at maturity (SRPM) of $i. 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 $aj , SRPM of $i, and yield of b percent). Thus,

11

for a comparable straight debt instrument with current coupon payments of $aj per quarter for bj quarters (g years) and a SRPM of $i, a holder would have paid approximately $bk. The remaining $bl 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 shares, above the threshold amount of $i.

As a result, the holders placed at risk a sizeable portion of the purchase price of the Instruments, which would be lost if the reference shares failed to appreciate to the extent projected. Taxpayer, conversely, economically hedged its position in the reference shares for g years by issuing the Instruments because if the value of the reference shares declined, Taxpayer was required to repay only the "debt" portion of the Instruments at maturity.

iii. Correlation between the Price of the Reference Shares and the Price of the Instruments

According to Parent's 10-k filed for Year 1, on Date 16, Taxpayer and Parent adopted the hedge accounting rules of Statement of Financial Accounting Standards (SFAS) 133 and designated ad shares of its beneficial ownership in approximately ae shares of Corporation A stock as trading securities. As described above, the 10-k stated that it was expected that the derivative component (nondebt) of Taxpayer's Instruments would reflect the fluctuations in value of the reference shares. As stated in the 10-k, it is anticipated that fluctuations in the value of the reference shares will match with and offset significantly fluctuations in the value of the derivative (or nondebt) component of the Instruments. The 10-k states that these changes in stock value will be reflected in the net income of Parent as increases or decreases. In addition, non-cash increases or decreases in the Parent's net income will be caused by fluctuations in the time value portion of the derivative component notes. The 10-k indicates that Parent's Consolidated Statements of Income for Year 1 included an expense of $af due to the change in value of the reference shares which was mostly offset by $ag in income from the change in value of the Instruments' derivative component. Under the SFAS 133 hedge accounting rules, Taxpayer's Instruments demonstrate a correlation with the reference shares of ah percent. This strong price correlation the Year 1 10-k clearly satisfies the "primarily reflects" standard.

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

2. Whether payments on the Instruments constitute "interest or carrying charges incurred or continued to purchase or carry" those shares for purposes of § 263(g)(2)(A).

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, 1972-1 740, is the Service’s primary published guidance on the interpretation of the “purchase or carry” nexus test. In the absence of direct tracing of proceeds used to purchase tax-exempt obligations or collateralization of the obligations to incur debt, 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. Illinois Terminal Railroad Co. v. U.S., 375 F.2d 1016, 1021 (Ct. Cl. 1967). Such a purpose will not be inferred, however, where a taxpayer receives tax-exempt obligations from a state or local government in payment for goods or services and there is a bona fide restriction on a taxpayer’s ability to sell or otherwise to dispose of the tax-exempts. See e.g. R.B. George Machinery, 20 B.T.A. 594 (1932) (Acquiesced C.B. XI-2, 4).

The facts of the instant case make clear that Taxpayer’s reasons for incurring the indebtedness were directly related to the carrying of the reference shares. Upon issuance, the principal amount of each unit of the Instruments equaled the Date 1 closing price of one share of Corporation A stock. Taxpayer and Parent held as many or more shares of Corporation A stock as the number of units of the Instruments. In addition, at maturity of the Instruments, holders expect to be paid an amount determined by reference to the appreciated price of the reference shares. Holders of the Instruments received the right to any appreciation in the reference shares, 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 shares.

Taxpayer contends that its use of the proceeds of the Instruments for its Business Development[12] and the fact that the reference shares were subject to SEC and contractual restrictions overrides any connection established between the reference shares and the Instruments. Taxpayer notes that the proceeds of the Instruments were not in excess of business needs, and its Business Development was a non-recurring item that could not have been anticipated at the time the Corporation A shares were acquired. As support, Taxpayer relies on Section 6 of Rev. Proc. 72-18, which sets out guidelines for the application of § 265(a)(2) for a corporation that is not a dealer in tax-exempt obligations where there is no direct evidence of the purpose to purchase or carry tax-exempt obligations.

Section 3.04 of Rev. Proc. 72-18 provides that § 265(a)(2) applies where the "totality of the facts and circumstances supports a reasonable inference that the purpose to purchase or carry" exists. Section 6 of Rev. Proc. 72-18 contains general guidelines that may be rebutted by the "totality of the facts and circumstances." Other than Rev. Proc. 72-18, Taxpayer cites no other authority for its proposition that its use of proceeds is sufficient to overcome the direct connection established between the reference shares and the Instruments. Generally, the courts have recognized a taxpayer's use of proceeds as a factor showing the absence of a requisite connection only in cases in which there was no evidence of a connection between the issuing of indebtedness and the holding of tax-exempt bonds. <u>See</u> <u>Wisconsin Cheeseman, Inc. v. Commissioner</u>, 265 F. Supp. 168 (D. Wis. 1967), <u>aff'd in part and rev'd in part</u>, 388 F.2d 420 (7th Cir. 1968). <u>Handy Button Machine Co., et al. v. Commissiner</u>, 61 T.C. 846 (1974), and <u>Swenson Land and Cattle Co., Inc. v. Commissioner</u>, 64 T.C. 686 (1975). The facts of this case are clearly distinguishable from these cases.

Furthermore, Taxpayer cannot avoid the application of § 263(g) by juggling its available assets in an attempt to separate the Instruments from the holding of the

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[12] The facts also show that Taxpayer applied some of the proceeds to repay

because the indexing allowed Taxpayer to raise funds on more favorable terms, including lower financing rates. The courts have specifically rejected the argument that the use of tax-exempt bonds to obtain cheaper financing rebuts a finding of a "sufficiently direct" relationship under § 265(a)(2). <u>See</u> <u>Wisconsin Cheeseman</u>, <u>supra</u>:

> the issue is not whether taxpayer is free to use this financing device, nor whether other devices may be more costly, nor whether certain financing costs are peculiar to the radically seasonal quality of taxpayer's business. The issue is whether, if taxpayer chooses for these understandable reasons to employ this device, it may deduct its interest payments on the loan for the purpose of determining its income tax.

<u>Wisconsin Cheeseman</u>, 265 F.Supp. at 170 and <u>Illinois Terminal</u>, "efficient use of an available asset cannot, of itself, help a taxpayer avoid the stricture of section 265(2)." <u>Id</u>. at 1022.

reference shares. See Levitt v. U.S., 368, F.Supp. 644, 646 (D. Iowa 1974), aff'd, 517 F.2d 1339 (8th Cir. 1975); Indian Trail Trading Post, Inc. v. Commissioner, 60 T.C. 497, 500 (1973), aff'd, 503 F.2d 102 (6th Cir. 1974). Taxpayer's argument that its use of proceeds should trump the close and direct connection between the Instruments and the reference shares would allow Taxpayer to avoid § 263(g) simply by juggling available funds by applying different funds for different uses.

Taxpayer also relies on the decision in R. B. George Machinery Co. v. Commissioner, 26 B.T.A. 594 (1932), acq. VI-2 C.B. 4 (1932). Section 6.03 of Rev. Proc. 72-18, as modified by Rev. Proc. 87-53, 1987-2 C.B. 669 provides that the required relationship generally will not be present where the taxpayer's holdings of tax-exempts are nonnegotiable obligations acquired in the ordinary course of its trade or business in payment for services performed for, or goods supplied to, state or local governments.

Taxpayer argues that the SEC and contractual restrictions on the sale of Corporation A shares results in a situation similar to that in R. B. George Machinery, supra. In R. B. George Machinery, the taxpayer was engaged in the business of selling wholesale machinery, farm and road equipment, principally to the State of Texas and its municipalities. In payment for some of the machinery sold to these governmental entities, the taxpayer received from those entities "deficiency warrants" paying tax-exempt interest. The taxpayer was unable to sell all of the warrants received, thereby depriving the taxpayer of cash needed to operate its business. The Court found that the warrants were nonnegotiable and that the taxpayer could only obtain the necessary financing to operate its business by pledging the warrants to a bank in exchange for a loan equal to 95 percent of the face value of the warrants. Id. at 594. Thus, the court held in favor of the taxpayer, stating that:

> The warrants held by [taxpayers] were received in payment for goods sold and they were apparently given because the state or its subdivisions could not at the time pay cash. They in no true sense of the word represented investments by petitioner, as it preferred at all times to get its cash out of them.

Id. at 597-598. Subsequent decisions treat R. B. George Machinery as being limited to situations in which taxpayers are forced to accept nonnegotiable or illiquid tax-exempt obligations as payment in the ordinary course of its trade or business. See Illinois Terminal Railroad, supra at 1021; Wisconsin Cheeseman, 388 F.2d at 423.

In R. B. George Machinery, the bonds were themselves nonnegotiable. In addition, as stated by the Court, the bonds were not a voluntary investment made by the taxpayer but were put upon the taxpayer by its main customer, a governmental entity, who was unable to pay cash. In the instant case, Parent entered into the contractual restrictions voluntarily and for a limited duration. Furthermore, unlike the taxpayer in R. B. George Machinery, Taxpayer did not acquire the Corporation A stock subject to the restrictions as payment for goods and services in the ordinary course of its business, but rather the shares represented a voluntary and purposeful investment by Parent and its affiliates.

Taxpayer argues that because Parent was subject to significant contractual limitations on its ability to sell Corporation A shares and the agreements were entered into for legitimate business reasons independent of the Instruments, the connection between the Instruments and reference shares is rebutted.[13] Taxpayer provided a list of approximately bm agreements in all.

While Taxpayer describes certain restrictions on its ability to dispose of the stock, it is unclear to what extent the restrictions actually prevented Taxpayer or Parent from selling or otherwise disposing of the Corporation A stock. For example, in Year 1, Taxpayer sold approximately az Corporation A shares

, resulting in pre-tax gains of approximately $bc. No shares of reference shares were sold in Year 5. In Year 4, Taxpayer sold approximately m shares

, or n percent of its investment in Corporation A, resulting in pre-tax gains of approximately $ba. These sales appear to exceed the amounts permitted under the Shareholder Agreements, absent consent of the Board of Directors.[14]

In addition, under Section 3.1(a) of the Year 7 Agreement, the Board of Directors must afford shareholders a "reasonable opportunity" to transfer not less than bm percent of their holdings or the agreement may be terminated. In fact, Taxpayer expressly noted in the Offering Memorandum that its obligations under the stockholder agreements do not affect its obligations under the Instruments. Under these facts, we do not view the agreements as preventing Taxpayer or its Parent from selling the reference shares in lieu of issuing the Instruments.

As for the SEC restrictions, Taxpayer asserts that, because Parent was considered an "affiliate," Parent therefore could not sell any of its common shares without a registration statement under the Securities Act of 1933 or pursuant to an applicable exemption from registration. Corporation A shares held by Parent were originally acquired in private placements and thus were not subject to an effective registration statement filed with the SEC.

13

14

We do not view a lack of registration under the Securities Act of 1933 as creating nonsalable securities. Taxpayer does not discuss whether there were SEC restrictions on transfers by private placement or prohibitions against applying for registration of the reference shares. Taxpayer acknowledges that under the SEC rules, Parent may dispose of a limited number of Corporation A shares per each three month period. In fact, as described above, Parent sold m shares in Month 4, Year 4.

As stated above, Taxpayer's reasons for incurring the debt were not independent of and unrelated to the holding of the reference shares. See Illinois Terminal, supra at 1023. To the contrary, the Instruments specifically reference the reference shares and are, in form and substance, closely connected to the reference shares. Moreover, the facts surrounding the issuance make clear that Taxpayer made a conscious and purposeful decision to issue the Instruments while continuing to hold the shares. There is clear evidence that Taxpayer intended to take advantage of the referencing created between its holdings in the reference shares and the application of the CPDI rules to the Instruments. The use of the Instruments helps Taxpayer to achieve the deferral and conversion opportunities found in a typical cash-and-carry transaction. Taxpayer projected the forward price of the reference shares at maturity of the debentures and accrued deductions under the CPDI rules such that the deductions taken reference the projected forward price of the reference shares. Therefore, the Instruments are used specifically to carry the reference shares under § 263(g).

The relationship between the Instruments and the reference shares 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 shares.

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 shares to find that the indebtedness was incurred or continued to carry the 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.