INTERNAL REVENUE SERVICE NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-108570-04/CC:CORP:B6

Taxpayer's Name: Taxpayer's Address:

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

LEGEND:

Taxpayer = Promoter = Underlying Instruments =

lssuer =

Issuer Trustee =

Primary Trust = Holding Trust = P.O. Certificate =

I.O. Certificate =

P. Unit =

T. Unit =

Year 1 = Year 2 = Period 1 = Date 1 = =

Reference Event =

Series Redemption Date =

Trust Termination Date = \$\frac{A}{S}\$ = \$\frac{B}{S}\$ = \$\frac{C}{S}\$ = \$\frac{E}{S}\$ = \$\

ISSUES:

- I. Whether the Underlying Instruments should be characterized as debt or equity.
- II. Whether the P.O. Certificates create multiple classes of ownership in the assets of the Primary Trust so that the Primary Trust should be classified as a business entity under Reg. §301.7701-2.
- III. What are the consequences of treating the Primary Trust as a business entity under §301.7701-4(c)(1).
- IV. Whether the interest retained by Taxpayer in the Underlying Instruments represents merely income rights.

CONCLUSIONS:

- I. The Underlying Instruments are characterized as equity.
- II. The P.O. Certificates create multiple classes of ownership interests in the assets of the Primary Trust so that the Primary Trust is classified as a business entity under §301.7701.
- III. The Primary Trust will initially be treated as a disregarded entity and then treated as a partnership when Taxpayer transfers the P.O. Certificates to the Promoter. As a result of the partnership formation, the transfer of the P.O. Certificates to the Promoter will be treated as constituting a transfer of a proportionate (by value) share in all of the Primary Trust's/partnership's assets.
- IV. The interest retained by Taxpayer in the Underlying Instruments does not represent merely income rights.

FACTS:

Taxpayer acquired through the Promoter foreign bank notes paying a variable rate of interest having no fixed maturity date. Taxpayer dropped the notes into a trust, and in return, Taxpayer received two classes of trust certificates: one certificate entitling

the holder to all payments of income from the notes for the first bb years; the other entitling the holder to payments of note principal plus the rights to later year income payments. Taxpayer retained the certificates embodying the rights to the first bb years of income and sold to the Promoter the other certificates. At the same time, Taxpayer and an affiliate of the Promoter entered into a Termination Agreement, which provided that the affiliate would pay Taxpayer a portion of any principal payment the Promoter received on the Underlying Instruments in the event of either a default or a repurchase of the Underlying Instruments by its Issuer.

In computing a loss on the sale of the principal certificates to the Promoter, the Taxpayer treated the purchase price of the entire note as its basis in the sold certificates. On its Years 1 and 2 consolidated income tax returns, Taxpayer reported capital loss deductions on the sales of the certificates to the Promoter. Taxpayer contends that the sale of the corpus of the notes and the effective retention of the right to income from those same notes was a means of achieving intermediate term cash flow as well as adding negative duration to its asset portfolio in order to manage duration mismatches between assets and liabilities, and this was not an effort to generate artificial tax losses. The field, however, takes the position that the Taxpayer is not entitled to the losses and seeks technical advice as to whether Taxpayer is justified in taking these deductions. This transaction is described more fully below.

The Transaction:

During Year 1 and Year 2, Taxpayer entered into three transactions with the Promoter, which the Promoter characterized as "selling off the back-end of a single or a series" of the Underlying Instruments. All three transactions are very similar in structure, and therefore the same analysis below can be applied to all three transactions. Because of the similarity of the transactions, the Field has submitted a TAM request with respect to only one of the three transactions, which is described below.

Taxpayer acquired a portfolio consisting of cc Underlying Instruments from or through the Promoter during Period 1. The Underlying Instruments are labeled by their issuers as undated/perpetual/subordinated/capital floating rate notes. The terms of the Underlying Instruments are generally similar, with some differences that are not material to our discussion, such as differences in interest rates. For the purposes of the following discussion, "Underlying Instrument" will refer to all of the notes from a particular issuance, and "Underlying Instruments" will collectively refer to all cc Underlying Instruments.

The Underlying Instruments have no fixed, final maturity date. The principal amount due will only be repaid in the event: a) an Issuer is subject to winding up and the Issuer Trustee recovers funds on behalf of the Underlying Instruments holders; b) an Issuer exercises its option to purchase Underlying Instruments directly from the Underlying Instrument holders; c) an Issuer purchases Underlying Instruments on the

open market; or d) an Issuer, after a change in its local law, becomes required to withhold taxes on payments made on the Underlying Instruments.

The Underlying Instruments are unsecured obligations of the Issuers, ranking pari passu without any preference as between such Issuer and the holders of other similar undated/perpetual/subordinated/capital floating rate notes issued by such Issuer, and are subordinate to senior creditors of the Issuers. Payments of principal and income are subject to the Issuer being solvent at the time of payment and immediately thereafter. If an Issuer would be insolvent after payment of the income or principal payment, such principal and income payments will not be required. Rather, the amount of principal and income in respect of the Underlying Instruments will be used to meet the losses of the Issuer. In the event that an Issuer goes through a winding up, holders of the Underlying Securities will be treated as if they were the holders of a class of preference shares in the capital of the Issuer having a preferential right to a return of assets in the winding up over the holders of all other classes of shares in the capital of the Issuer.

The Underlying Instrument holders are entitled to receive "interest" from the Issuers. Some of the Underlying Instruments pay interest semi-annually, while others pay interest quarterly. All of the Underlying Instruments bear an interest rate based upon LIBOR (London Interbank Offered Rate) plus a set number of basis points. In the event of the nonpayment of interest, the Underlying Instrument holders have no recourse against an Issuer so long as the Issuer for such period has not paid dividends to its shareholders. Unpaid interest goes into arrears and becomes due in full on the earliest of (i) the date upon which a dividend is next paid on any class of share capital, (ii) the date fixed for any repayment pursuant to certain conditions having to do with the repayment of the Underlying Instruments, or (iii) the commencement of a winding up of the Issuer. Arrears of interest do not themselves bear interest. In the event an Issuer defaults on an interest payment, the Issuer Trustee may bring a proceeding on the holders' behalf in the Issuer's country of incorporation.

The Underlying Instruments do not convey to their holders any voting rights with respect to an Issuer's operations. The Underlying Instruments, however, do entitle their holders to vote upon significant modifications to the terms of the Underlying Instruments, whereas non-significant modifications may be approved by the Issuer Trustee without obtaining the approval of the Underlying Instrument holders. The Underlying Instruments also entitle their holders to join with other holders to request the Issuer Trustee to institute proceedings to wind up the Issuer in the event of default. The Issuer Trustee is not required to take any action against the Issuer unless it is requested to do so, either by an extraordinary resolution of the holders of the Underlying Instruments or by a written request of the holders of at least 25 percent of the principal amount of the Underlying Instruments then outstanding. The holders of the Underlying

¹ The Underlying Instruments have a stated interest component. For purposes of this technical advice memorandum, the terms "income" or "income interest" will be used interchangeably with the term "interest." No inference should be drawn from our use of one term or the other.

Instruments do not have any remedy against an Issuer other than the institution of proceedings for the winding up of the Issuer.

On Date 1, Taxpayer acquired a portfolio consisting of cc Underlying Instruments from or through the Promoter. On that same date, Taxpayer established the Primary Trust, transferring to the Primary Trust its portfolio of Underlying Instruments. Each Underlying Instrument was deposited into a separate series or sub-account of the Primary Trust, with each sub-account administered and accounted for separately from the other sub-accounts of the Primary Trust. The series have been labeled Series A-J in the submissions. The trust agreement for the Primary Trust (Trust Agreement) states that Taxpayer intends to treat the Primary Trust, a Delaware business trust, as a grantor trust.

Also on Date 1, the Primary Trust issued P.O. Certificates and I.O. Certificates to Taxpayer. P.O. Certificates are certificates issued by the Primary Trust which represent the right to the Underlying Instrument at the termination of the trust. I.O. Certificates are certificates issued by the Primary Trust representing all interest payments on the Underlying Instrument prior to the termination of the trust. The Primary Trust will terminate approximately 19 years after its formation. Separate I.O. Certificates and P.O. Certificates were issued for each series in the Primary Trust. In the technical advice request submissions, the I.O. Certificates have been labeled I.O. Certificates A-J., and the P.O. Certificates have been labeled P.O. Certificates A-J. For purposes of the following discussion, "I.O. Certificate" will refer to all of the I.O. certificates issued by a single series of the Primary Trust, and "I.O. Certificates" will refer collectively to all of the P.O. certificates issued by a single series of the Primary Trust, and "P.O. Certificates" will refer collectively to all of the P.O. certificates issued by Series A-J.

An I.O. Certificate represents the right to receive payments from the trustee of The Primary Trust "in an aggregate amount equal to the amount of Interest received by the Trust on account of the aggregate face amount of [the Underlying Instrument]" through the applicable Series Redemption Date. The Series Redemption Date for a given I.O. Certificate is separately stated from the Series Redemption Dates of the I.O. Certificates for the other series in the Primary Trust. Each Series Redemption Date for the Primary Trust is approximately bb years after the formation of the Primary Trust. As long as at least one of the Underlying Instruments remains outstanding, the Primary Trust will not terminate except on the Trust Termination Date, which is approximately 6 months after the last Series Redemption Date; otherwise, the Primary Trust will terminate when there is no P.O. or I.O. Certificate outstanding.

Each P.O. Certificate states that it "evidences a fractional undivided beneficial interest in the [Underlying Instrument] other than the right to receive Interest actually paid on the [Underlying Instrument] during the restricted period and any and all Permitted Investments made in respect of amounts other than Interest" paid during the restricted period.

On Date 1, Taxpayer sold the P.O. Certificates to the Promoter, who simultaneously deposited the P.O. Certificates into the Holding Trust and received in return a P. Unit and a T. Unit for each P.O. Certificate deposited. The P. Unit entitles the holder to instruct the trustee how to vote a corresponding P.O. Certificate and to receive payments in amounts equal to all payments on the P.O. certificate, other than the right to receive the amounts paid to the holder of the T. Unit. The T. Unit entitles the holder to no rights with respect to the P.O. Certificate other than the right to be paid certain amounts by the Issuer upon the occurrence of a default or partial redemption of the Underlying Instruments.

Also on Date 1, and simultaneous with the creation of the Primary and Holding Trusts and the sale of the P.O. Certificates, Taxpayer entered into a Termination Agreement with an affiliate of the Promoter, for which Taxpayer paid \$\frac{A}{2}\$ per series covered, for a total of \$\frac{B}{2}\$. The Termination Agreement provides that, in the event of a receipt of principal related to an Underlying Instrument prior to the Trust Termination Date, the Promoter's affiliate agrees to pay Taxpayer a portion of the amount received in the liquidation or redemption of the Underlying Instruments. The amounts due to Taxpayer are computed using a formula and schedules that are identical to those used to compute payments on the T. Units.

The amount of the portion of any principal payment that may be received with respect to an Underlying Instruments due to Taxpayer under the Termination Agreement is the "relevant market value," which decreases over time and is based upon a formula described in the allocation schedules attached to the agreement. A separate allocation schedule is provided for each Underlying Instrument. Each schedule provides a list of percentages that apply on specific dates. For a payment received between specified dates, a linear interpolation based upon an agreed-upon formula (basically straight line allocation) is used to determine the applicable allocation ratio. The relevant market value is equal to (1- applicable allocation ratio) x total principal received. Over time, the applicable allocation ratio (which begins at roughly 25 percent) increases until it equals 100 percent on the appropriate Series Redemption Date, at which time the rights under the Termination Agreement will expire. Taxpayer's submission states that it considers the occurrence of Reference Events, resulting in a principal payment, as "remote contingencies." Taxpayer also stated that without the Termination Agreement, the parties would either not have undertaken the transaction or the pricing on the transaction would have been materially different.

The Promoter's promotional materials state that the P. Units may be sold by the Promoter but that it will retain the T. Units to hedge its obligation to Taxpayer under the Termination Agreement. Each P. Unit represents the right to all principal received with respect to a particular Underlying Instrument minus the amount owed to the holder of the T. Unit. Over time the portion of the principal payment retained by the P. Unit holder increases until, on the applicable Series Redemption Date, the P. Unit holder is entitled to retain 100 percent of any principal payments.

Taxpayer claims that the transfer of the P.O. Certificates to the Promoter was a sale of the entire principal portion of the Underlying Instruments that results in a $\underline{\$C}$ loss for tax purposes. Taxpayer argues that this loss arises because, as it contends, it is required by case law to allocate 100 percent of its $\underline{\$D}$ basis in the Underlying Instruments to the P.O. Certificates and 0 percent of its basis to the retained I.O. Certificates.

To date, Taxpayer represents that it continues to hold all the I.O. Certificates. There have been no defaults or call events or other Reference Events with respect to the Underlying Instruments.

LAW AND ANALYSIS:

I. The Underlying Instruments constitute equity interests in the Issuer.

Under Code section 385(a), the Secretary of the Treasury is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an "interest" in a corporation is to be treated as stock or indebtedness (or as in part stock and in part indebtedness). Section 385(b) sets forth some of the factors that the regulations take into account in determining whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. These factors include the following: (1) whether there is a written unconditional promise (a) to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth and (b) to pay a fixed rate of interest, (2) whether there is subordination to or preference over any indebtedness of the corporation, (3) the ratio of debt to equity of the corporation, (4) whether there is convertibility into the stock of the corporation, and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

Proposed regulations under Code section 385(a) were issued on March 24, 1980, which set forth the factors to be considered in determining whether an instrument was stock or debt. Final regulations under section 385(a) were then issued in December 1980 (with a delayed effective date that was extended several times). The final regulations, however, were withdrawn in 1983. T.D. 7920, 1983-2 C.B. 69. There currently are no regulations under section 385.

Notice 94-47, 1994-1 C.B. 357, provides that the characterization of an instrument as debt for federal income tax purposes depends on the terms of the instrument and all surrounding facts and circumstances. Among the factors that may be considered in making such a determination are: (1) whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future; (2) whether holders possess the right to enforce the payment of principal and interest; (3) whether the rights of the holders of the instrument are subordinate to rights of general creditors; (4) whether the instruments

give the holders the right to participate in the management of the issuer; (5) whether the issuer is thinly capitalized; (6) whether there is identity between holders of the instruments and stockholders of the issuer; (7) the label placed upon the instrument by the parties; and (8) whether the instrument is intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes. The weight given to any factor depends upon all of the facts and circumstances. <u>John Kelley Co. v. Commissioner</u>, 326 U.S. 521 (1946).

The various factors listed in Notice 94-47 are "aids in answering the ultimate question whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship." Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3rd Cir. 1968). The important issue is whether there was "genuine intention to create a debt with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship?" Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 377 (1973).

Under Code § 385(c)(1), the characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness is binding on the issuer and on all holders of such interest (but is not binding on the Secretary of the Treasury). Although this provision mandates that both the holder and the issuer treat the financial instrument consistently for U.S. income tax purposes, this mandate does not affect how one or both of the parties treat it for purposes of foreign law. Consequently, it does not prohibit inconsistent treatment or reporting of the instrument under the laws of the United States and a foreign jurisdiction.

In the instant case, an application of section 385(c) is not compelled nor violated by the treatment of these instruments under foreign law. The Issuer, a foreign entity, treated the Underlying Instruments as debt for financial accounting purposes. Moreover, the Issuer's reference to the Underlying Instruments in the prospectus as "notes" indicates that it considers them debt for foreign financial purposes. There is no indication that the Issuer files a U.S. tax return and/or reports income, gain, loss, or takes any deduction with regard to these "notes" on its or a related entity's U.S. tax return. The purchasers and the holders of the Underlying Instruments have reported them as equity for U.S. tax purposes, Any resulting inconsistent treatment with respect to the Underlying Instruments is due to the way it is reported in foreign countries, not to the way it is reported in the U.S. Accordingly, Section 385(c) is neither implicated nor violated here.

No other Code or regulation section requires the holder of an interest in a corporation to treat that interest as it is characterized by the issuer. We must therefore determine whether the Underlying Instruments, in substance, are debt or equity by applying a traditional debt/equity analysis.

In Substance the Perpetual Securities Are Equity.

The prospectus, pursuant to which the Underlying Instruments are issued, shows the following facts concerning the Underlying Instruments that weigh in favor of a finding of equity: (1) they have no fixed maturity date; (2) they are unsecured; (3) they are not payable upon default of payment of interest or principal;(4) they are subordinated to the Issuer's Senior Creditors, which it defines broadly to include trade creditors; (5) the rights to payment of interest and principal are conditional upon the Issuer being solvent at the time of payment and immediately thereafter; (6) the holders have no remedy for nonpayment of interest so long as no dividend has been paid or declared in respect of any class of Issuer's share capital; (7) in the event of the winding up of the issuer, the holders of the Underlying Instruments, will, for purpose only of calculating the amounts payable, be treated as if they were the holders of preference shares in the Issuer's capital; and (8) the prospectus provides that no payment of interest or principal can be accelerated or paid before its due date.

The following facts weigh in favor of a finding of debt: (1) if and when the Issuer redeems the Underlying Instruments, it will pay (if it will not become insolvent as a result of such payment) 100 percent of their principal amount; (2) interest is payable biannually on an annual rate of ¼ percent above LIBOR; and (3) the Holders of the Underlying Instruments have no right in the management of the Issuer nor do they have a right to elect directors to the Issuer's Board of Directors.

One of the most important of the factors is the provision for a fixed or ascertainable time when the purported creditor is unconditionally entitled to require payment of the principal. Where there is an absence of an unconditional right to demand payment, the investor has "embarked upon the corporate adventure" and has assumed its risks. This factor (i.e., absence of a maturity date) alone is not determinative, however when coupled with the other factors listed above which weigh in favor of a finding of equity, leads us to conclude that the Taxpayer's investment in the Underlying Securities is at the risk of the Issuer's business and therefore the Underlying Securities resemble equity more than debt.

II. P.O. Certificates create multiple classes of ownership in the assets of the Primary Trust and therefore the Primary Trust is a business entity under §301.7701-2.

An analysis of whether multiple classes of ownership interests exist depends upon a determination of the rights and obligations attached to the ownership of the two types of certificates (i.e., the I.O. and P.O. certificates). In identifying these rights and obligations, we have considered the rights and obligations of Taxpayer and the Promoter, including its affiliates, provided under the Termination Agreement. For the facts and reasons set forth below, we conclude that the Termination Agreement is an

integral part of the formation of the Primary Trust/partnership and therefore the rights and obligations created by the agreement are relevant in determining the rights and obligations attached to the ownership of the I.O. and P.O. certificates.

a) The Termination Agreement is an integral part of the formation of the Primary Trust/partnership.

In support of its position that the Termination Agreement is a separate transaction, Taxpayer asserts that: (1) the Termination Agreement was supported by adequate, separately bargained-for consideration; (2) the affiliate, although related to the Promoter, is an entity separate from the Promoter; (3) the Termination Agreement expressly states that the Promoter is not guaranteeing the affiliate's performance under the agreement; (4) the affiliate was not a party to the sale of the P.O. Certificates or to either of the trust agreements; (5) the affiliate was not obligated to enter into the Termination Agreement; and (6) the Promoter was not obligated to enter into a termination or similar agreement by reason of its purchase of the P.O. Certificates or its participation in either of the trusts.

We find, however, that the following facts compel a conclusion that the Termination Agreement should be included as part of the transaction under which the Primary Trust/partnership was formed: a) the Termination Agreement appears to have been executed simultaneously with the rest of the transactions; b) the Termination Agreement was executed by the Taxpayer and the Promoter's affiliate, the parties to the agreement; c) the payments under the Termination Agreement are identical to those due to the Promoter as holder of the T. Units; d) the Termination Agreement specifically references and adopts the terminology of the Holding Trust; and e) the Promoter's write up states that the T. Units are to serve as a hedge of its obligation on the Termination Agreement.

Pursuant to the Termination Agreement, in the event of receipt of any principal redemption payment on an Underlying Instrument prior to its Series Redemption Date, the Promoter's affiliate must pay to Taxpayer the relevant market value. The relevant market value is determined based upon a self-amortizing allocation ratio that distributes the principal redemption payment between the Promoter and Taxpayer. Under the Termination Agreement, Taxpayer receives a decreasing portion of any principal redemption payment the longer the Note is outstanding, and, ultimately, at the Series Redemption Date, Taxpayer will not receive any of the principal redemption payment. It is important to note that up to the day before the Series Redemption Date, Taxpayer is still entitled to receive at least some small amount of any principal redemption payment. Thus, to the extent of any substantive principal rights in the Underlying Instruments, they have been divided between Taxpayer (as holder of the I.O. certificates) and the Promoter (as holder, initially of the P.O. certificates, and later as holder of the T. Units) through the operation of the Termination Agreement.

Moreover, without the Termination Agreement, any call event would render worthless the Taxpayer's I.O. Certificates. With regard to the Taxpayer, who owns the right to the payment of income, its entering into the transaction would not make economic sense without the rights afforded to it by the Termination Agreement. Taxpayer readily admits that it would not have engaged in the transaction, as structured and priced, without the Termination Agreement.

Taxpayer asserts that the Termination Agreement is a separate insurance policy which it purchased for small consideration from the affiliate of the Promoter. Taxpayer claims that the affiliate has no interest (economic or otherwise) in the Underlying Instruments. We conclude however that the Termination Agreement is not like an insurance policy. Here, the Termination Agreement actually creates the rights to receive payments in the event of either default or a repurchase of the Underlying Instruments by its Issuer instead of merely insuring that the principal payments will be made. Without the Termination Agreement, the Taxpayer would have no rights to payments (in the case of one of these events) for which even another party could provide a guarantee.

Taxpayer also claims that it has no recourse against the Promoter or the transferred P.O. Certificates, which are held in the Holding Trust, and therefore it could not have retained any rights in the principal of the Underlying Instruments. The fact that the Taxpayer's recourse upon the occurrence of either a default or partial redemption of the Underlying Instruments is against a wholly-owned subsidiary of the Promoter does not change the fact that this, as part of the formation of the Primary Trust/partnership, effectively served to protect the Taxpayer's rights to the value of its future income payments.

We conclude that under the Termination Agreement the Taxpayer effectively has received rights to principal redemption payments in connection with setting up the Primary Trust/partnership. Accordingly, we believe that the Termination Agreement is not a separate transaction, but is an integral part of the formation of the Primary Trust/partnership.

b) The Primary Trust is a business entity

Section 301.7701-4(c)(1) of the Procedure and Administration Regulations provides, in part, that an investment trust that has multiple classes of ownership interests is ordinarily classified as a business entity under section 301.7701-2. An investment trust that has multiple classes of ownership interest, however, is classified as a trust for tax purposes if (1) there is no power under the trust agreement to vary the investment of the certificate holders, and (2) the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interest is incidental to that purpose.

In the instant case, there are two classes of certificates. Holders of I.O. Certificates are entitled to all scheduled and unscheduled payments of interest until their certificates are retired and a declining percentage of any unscheduled payments of principal while their certificates are outstanding. Holders of P.O. Certificates receive payments of interest, only after the I.O. Certificates have been retired, and receive an increasing percentage of any unscheduled payments of any principal redemption payments while the I.O. Certificates are outstanding. There are no subordination rights as between the two certificates.

The allocation of unscheduled payments is based upon a formula set forth in the Termination Agreement that applies whether the principal redemption payment is made due to an event of default or a repurchase of the Underlying Instruments by its Issuer. As a result, in the event of a shortfall in payment of part or all of the Underlying Instruments due to an event of default, the amount of the shortfall will reduce the distribution on both certificates.

In light of these facts, the two classes of certificates represent different classes of ownership in the Primary Trust. The Certificates effectively separate current income rights on the Underlying Instruments from a portion of the right to appreciation on the value of the Underlying Instruments, similar to the circumstance described in Example 3 of section 301.7701-4(c)(2). In addition, the Termination Agreement provides Taxpayer protection from the risk that an Underlying Instrument will be prepaid. This type of protection is similar to that described as "call protection" in Example 1 of section 301.7701-4(c)(2). The Primary Trust thus serves to create investment interests with respect to the Underlying Instruments that differ significantly from direct investment in the Underlying Instruments. As a result, the existence of multiple classes is not incidental to any purpose of the trust to facilitate direct investment in the assets of the Primary Trust, and therefore, the trust is classified as a business entity under section 301.7701-2.

III. The Primary Trust will be treated as a partnership and the transfer of interests will be treated as a transfer of a proportionate (by value) share of the trust's assets.

Based on the default classification rules of §301.7701-3(b)(1), the Primary Trust, as a business entity, will be disregarded for the period in which it has one owner, and will be treated as a partnership for the periods in which it has multiple owners. In addition, we conclude that through retention of income rights coupled with the Termination Agreement, benefits and burdens of ownership associated with the principal interest in the Underlying Instruments continue to reside with the Taxpayer even after Taxpayer has transferred the P.O. Certificates to the Promoter. The identity of a partner for federal tax purposes is not dependent on legal title; rather it is dependent on an analysis of the benefits and burdens of ownership. See, e.g., Red Carpet Car Wash, Inc. v. Commissioner, 73 T.C. 676 (1980), acq., 1980-2 C.B. 2

(dummy corporation held partnership interest as nominee for true partner). Because benefits associated with the principal of the Underlying Instruments flow to Taxpayer, we conclude that this right to a portion of the principal of the Underlying Instruments actually serves to define the nature of Taxpayer's partnership interest.

Because the Primary Trust is treated as a business entity, the transfer of the interest to the second owner should be analyzed in accordance with the holding of Situation One of Rev. Rul. 99-5. That ruling describes the federal tax consequences when a single member limited liability company that is disregarded becomes an entity with more than one owner that is then classified as a partnership. Where the Primary Trust is treated as a business entity, then by definition it has to be a single member business entity when it is formed by the Taxpayer. When the P.O. Certificates are transferred away by the Taxpayer, a partnership is created such that the Primary Trust has been effectively converted into a partnership.

Situation One of the ruling addresses a fact pattern where A transfers a portion of the ownership interest in the disregarded entity to B for consideration. The ruling concludes that in such a situation, the disregarded entity is converted to a partnership when the new member, B, purchases an interest in the disregarded entity from the owner, A. B's purchase of 50 percent of A's ownership interests in the LLC is treated as the purchase of a 50 percent interest in each of the LLC's assets, which are treated as held directly by A for federal tax purposes. Immediately thereafter, A and B are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership. Under §1001, A recognizes gain or loss from the deemed sale of the 50 percent interest in each asset of the LLC to B. Under §721(a), no gain or loss is recognized by A or B as a result of the contribution of their separately held assets to the partnership.

The present transaction falls within Situation One of the ruling. When interests are transferred away from Taxpayer, it is equivalent to the sale to B in the ruling. Accordingly, Taxpayer is treated as disposing of an appropriate proportion of the underlying assets in a §1001 transaction. Taxpayer is treated as if it disposed of some, but not all, of the right to principal payments on the Underlying Instrument as well as the rights to later year income payments. Thus, the Taxpayer is treated as retaining the rights to the first bb years of income with regard to the Underlying Instruments as well as some, but not all, of the rights to any principal redemption payment of these instruments.

Where the underlying assets consist of \$D worth of the Underlying Instruments, and Taxpayer receives \$C in consideration, Taxpayer is treated as transferring a aa% interest in the undivided Underlying Instruments (rights to principal and interest payments), that portion transferred having a basis equal to the \$C amount Taxpayer received as consideration. To the extent that Taxpayer has a fair market value basis in the Underlying Instruments, it will recognize no gain or loss on the deemed sale.

As a caveat, while the revenue ruling treats B as purchasing a 50 percent interest in each of the entity's assets, we do not believe that the analysis of the ruling requires proportionate sales in all cases. We draw this conclusion from the policy determinations that were expressed in the finalization of the §707 disguised sale regulations.

When the disguised sale regulations were proposed (PS-163-84), they contained a rule addressing the treatment of part-sales and part-contributions for contributions of multiple properties. To avoid "cherry picking" of high basis asset sales, the rule required a sale of a proportionate amount of each property. Commentators criticized this provision as inconsistent with authorities under §§ 351 and 453 where taxpayers could plan for divergent treatment for certain assets. The preamble to the final regulations acknowledged the comments and the rule was not included in the final regulations. Thus, in the disguised sale context, it appears that taxpayers have some residual ability to identify the assets that will be treated as sold, and the assets that will be treated as contributed. There is no sound policy rationale for providing for a different treatment in scenarios that fall under Situation One of Rev. Rul. 99-5.

Based upon an examination of the authorities identified in the context of §§351 and 453, it appears that the ability to identify assets for divergent treatment is not unfettered. The case law appears to require both a business purpose for the different treatment, and factual indicia that the different treatment was understood and intended by the parties. See, Brown v. Commissioner, 27 T.C. 27 (1956), acq. 1957-2 C.B. 4; Collins v. Commissioner, 48 T.C. 45 (1966), acq. 1967-2 C.B. 2. We believe that a similar result is appropriate in the present context. Where there are not strong indications of different treatment, we believe that the appropriate treatment is a proportionate transfer of all underlying assets.

Taxpayer claims that it transferred to the Promoter the entire interest in the principal payments of the Underlying Instruments. However, Taxpayer retained rights to principal redemption payments under the Termination Agreement; this fact undercuts Taxpayer's argument. Thus, the present case lacks the strong factual indicia of an intended and understood outright transfer of the entire interest in the principal of the Underlying Instruments. Under the circumstances, it is appropriate for the Service to treat the transfer as a transfer by the Taxpayer to the Promoter of a proportionate interest (based on value) of the Underlying Instruments.

a qualified liability

partnership pursuant to a plan, the amount realized from any transfer of money or other consideration made by the partnership pursuant to the plan that is treated as part of a sale of property under paragraph (a) of this section is allocated among each item of property transferred pursuant to that plan based upon the relative fair market values of the properties. For purposes of applying the preceding sentence, the fair market value of an item of property transferred to a partnership is reduced by the amount of any qualified liability with respect to that property. See §1.707-5(a)(6) for the meaning of qualified liability of a partner. The allocation rules of this paragraph do not apply to consideration transferred in the form of the assumption of or taking subject to

² The provision, §1.707-3(e), read as follows: *Multiple properties transferred pursuant to a plan.* If a partner transfers more than one item of property to a

IV. Taxpayer retained not merely the rights to payment of income.³

Taxpayer's primary argument to avoid basis allocation between the interest retained and the interest sold is that it retained merely an income interest and, therefore, it must allocate its entire basis to the disposed of P.O. Certificates. According to the Taxpayer, the P.O. Certificates represent the entire interest in the right to principal redemption payments of the Underlying Instruments. Because Taxpayer allocated its entire basis to the P.O. Certificates, Taxpayer claimed capital losses in both Years 1 and 2 when it sold the P.O. Certificates to the Promoter.

In support of its position, Taxpayer cites <u>Commissioner v. P.G. Lake, Inc.</u>, 356 U.S. 260 (1958); <u>Helvering v. Horst</u>, 311 U.S. 112 (1940); and <u>Estate of Stranahan v. Commissioner</u>, 472 F.2d 867 (6th Cir. 1973). Taxpayer interprets these cases as standing for the proposition that an income component is not a property right separate from the stripped corpus, and therefore basis cannot be allocated between the corpus and the income component.

These cases however are easily distinguishable from the present case. In Horst, a father who owned a bond attempted to transfer taxable interest income to his son by detaching a negotiable interest coupon before the maturity date and giving it to his son, who ultimately collected the interest payment. The Court held that the father was the owner of the coupons, notwithstanding his assignment of the interest, and his son's ultimate receipt of the cash paid as interest. In P.G. Lake, Inc., a corporate taxpayer paid off a debt owed to its corporate president through assigning an "oil payment right" to him, and it reported that disposition as a capital-gain-producing transaction. The "oil payment right" entitled the holder to payment of \$600,000 out of a portion of oil revenues due to the corporation, plus an additional 3% per year on the unpaid balance. The Supreme Court held that the corporate taxpayer was the owner of the oil payment, notwithstanding its assignment of the interest and the corporate president's ultimate receipt of cash. Finally, In Estate of Stranahan, the taxpayer sold the right to future dividend income to his son in an attempt to accelerate income to the taxable year of the sale so as to offset a large unused interest deduction. The taxpayer claimed the entire amount realized as ordinary income without any basis recovery. The court upheld the taxpayer's characterization of the transaction and treated the sale of dividend rights as generating ordinary income in the year of sale.

All three cases involved an income interest resulting from the taxpayer's assignment of future income. Since we have concluded that both the interest retained and the interest disposed of by the Taxpayer were property, instead of income, interests, Taxpayer cannot look to those cases to support its position. Therefore, <u>P.G.</u>

³ Because we have concluded that Taxpayer has retained not only the rights to future income but also rights to principal redemption payments, we therefore do not reach the question of whether the mere right to future income payments constitutes an income interest and, if so, whether basis should be allocated to it.

<u>Lake</u>, <u>Horst</u> and <u>Estate of Stranahan</u> are not relevant to the basis allocation issue of our case.

As we pointed out in our analysis of Issue II above, the Taxpayer had termination rights through the Termination Agreement. These termination rights actually create rights to receive principal redemption payments upon the occurrence of a Reference Event. Without the Termination Agreement, Taxpayer would have no rights to payments (in the case of a Reference Event) upon which he could have another party guarantee payment.

We conclude that Taxpayer has retained both (a) the right to future income payments for the next bb years, and (b) through its continuing interest in any principal redemption payments, wasting rights with regard to any principal payments on the Underlying Instruments. Because Taxpayer has retained the right to future income payments as well as a continuing interest in any principal redemption payments in the formation of the Primary Trust/partnership, the Taxpayer has retained a principal interest in the Underlying Instruments. Accordingly, Taxpayer must allocate a portion of his basis in the Underlying Instruments to the retained interests and a portion of his basis to interests sold to the Promoter. See Treas. Reg. Section 1.61-6(a) (when a part of a larger property is sold, the basis of the entire property is equitably apportioned among the parts); Commissioner v. Roeser & Pendleton, Inc., 118 F.2d 462 (5th Cir. 1941) (taxpayer who sold an interest in a leasehold and reserved an oil payment must allocate basis between the interest and the reserved payment, in proportion to their fair market values at the time of the sale); McGowin-Foshee Lbr. Co. v. Commissioner, 10 B.T.A. 961, 965 (1928) (taxpayer must allocate its basis where it retains the timber rights to land that the taxpaver sells along with the rights to any turpentine produced from the timber).

CAVEATS:

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.

No opinion is expressed herein as to any other issues that were raised in the incoming technical advice request or that may be raised based on the facts of this case. Specifically, the Service is not ruling on whether: (1) a retained right to payment of income would constitute a mere income interest to which no basis would be allocated, and (2) the sale of the P.O. Certificates can be characterized as a lending transaction. Furthermore, for purposes of this advice only, we have accepted that the Taxpayer sold to the Promoter only a part interest in the Underlying Instruments rather than selling the whole interest in the Underlying Instruments. Consequently, we are not expressing any opinion as to whether the transaction would be treated as a sale by the Taxpayer of a whole interest in the Underlying Instruments with the Taxpayer acquiring the "income" interest as an additional amount realized (i.e., an addition to the purchase price). See Alstores Realty Corporation v. Commissioner, 46 T.C. 363 (1966).