INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Third Party Communication: None
Date of Communication: Not Applicable

Number: **200530027**
Release Date: 7/29/2005
Index (UIL) No.: 1092.06-00, 263.21-00
CASE-MIS No.: TAM-147769-04/CC:FIP:B3

Walter Harris, Project Director
Large and Mid Size Business (LMSB)

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

LEGEND:

Taxpayer =
Business =

New Business =

Promoter A =
Instruments =

Corporation A =
Corporation B =
Corporation C =
Corporation AC =

Corporation D =

Corporation E	=
Corporation F	=
Corporation G	=
Corporation H	=
Corporation J	=
Exchange	=
a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=
i	=
j	=
k	=
m	=
n	=
o	=
p	=
q	=
r	=
s	=
t	=
u	=
v	=
w	=
x	=
y	=
z	=
aa	=
bb	=
cc	=
dd	=
ee	=
ff	=
gg	=
hh	=
ii	=
jj	=
kk	=
mm	=
Month 1	=
Year 1	=

Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Year 7 =
Year 8 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =

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)(II)[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 and accruals on the Instruments constitute interest and carrying charges incurred or continued to purchase or carry the shares for purposes of § 263(g)(2)(A).

CONCLUSION(S):

---

[1] This provision was renumbered by the Community Tax Relief Act of 2000 (P.L. 106-554) as § 1092(d)(3)(B)(i)(III), and subsequently 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.

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)(II) as "a position with respect to substantially similar or related property (other than stock)" with respect to stock held by Taxpayer.

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

FACTS:

a. Background:

Taxpayer and its subsidiaries are principally engaged in the operation of its Business. In order to raise funds, Taxpayer issued units of unsecured subordinated debentures called the "Instruments" which were actively traded. Payments on these debentures are indexed to the performance of Taxpayer's publicly-traded holdings in Corporation A, referred to as the "reference shares" under the
dated Date 1 (the "Reference Stock"). As a result of this indexing, Taxpayer obtained lower currently payable coupon rates of financing, although Taxpayer accrued interest at a greater rate under the contingent payment debt instrument ("CPDI") rules of § 1.1275-4.

Taxpayer was a substantial early investor in Corporation A. Taxpayer acquired the Reference Stock in prior transactions wholly unrelated to the issuance of the Instruments. The Reference Stock was not pledged as collateral for the Instruments, nor was Taxpayer contractually required to hold any of the stock under the terms of the Instruments. Taxpayer had substantial business reasons to make its investment in Corporation A and to maintain a substantial portion of that investment through the years at issue.

The aggregate issue price of the Instruments was $a. Taxpayer expected to use substantially all of the funds for general corporate purposes, including capital expenditures, working capital, debt repayment, financing of acquisitions, and share repurchase programs. It is undisputed that Taxpayer applied the funds for these purposes, as more fully set forth below, and that Taxpayer was never limited to raising funds through the issuance of the Instruments. It is also undisputed that the indexing of the Reference Stock under the Instruments provide funding at rates lower than comparable market rates.

b. Issuance of the Instruments

On Date 1, Taxpayer issued b units of the Instruments described as "exchangeable subordinated debentures." An over-allotment option allowed the underwriters to acquire another c units of the Instruments. The Instruments were developed by Promoter A. In issuing the Instruments, an issuer monetizes its sizable stock holdings of publicly traded portfolio stock in an unrelated company by linking the issue and redemption values of the Instruments to the value of the portfolio stock, such as the Reference Stock. The issuer claims interest deductions under the contingent payment debt instrument rules of § 1.1275-4. As a result, borrowing costs for the issuer are reduced and the issuer is able to retain its holdings of the reference shares. As noted, the Instruments are indexed to common shares of Corporation A. Units of the Instruments are d year instruments that mature on Date 2.

The states that the Financial Accounting Standards Board has issued a new accounting pronouncement (FAS 133), "Accounting for Derivative Instruments and Hedging Activities" that Taxpayer will elect to adopt as of the beginning of the second quarter of Year 1. FAS 133 requires Taxpayer to split the initial value of the Instruments into a debt component and a derivative component. Any change in the fair value of the derivative component of the Instruments will be recorded in Taxpayer's consolidated income statements. If Taxpayer holds, at its election, a number of shares of the Corporation A stock equal to the number of units of the Instruments outstanding, at the adoption of FAS 133, Taxpayer will also record changes in the market value of the shares related to the Instruments in its consolidated income statements. As stated in the , changes in the market value of the shares of Corporation A stock should at least partially offset changes in the fair value of the derivative component of the Instruments.

The original principal amount of a unit of the Instruments is $e, the last reported sale price of one share of Corporation A common stock on the Exchange on Date 1. The minimum amount payable upon redemption or maturity of a unit of the Instruments, which is referred to as the "contingent principal amount" in the , will initially be equal to the original principal amount adjusted for dividends or special distributions as more fully described below. The refers to the Corporation A shares and any other publicly traded equity securities that may be distributed on or in respect of the Corporation A common stock (or into which any of those securities may be converted or exchanged) as the reference shares.

The Instruments pay interest quarterly at the annual rate of f% of the original principal amount (for a quarterly payment of $g per unit), plus the amount of any cash dividend paid on Corporation A stock and the cash value of any property distributed by Corporation A to its shareholders. Interest will accrue from the issue date of the Instruments, and interest will be paid quarterly in arrears on Date 3, Date 4, Date 5, and Date 6 of each year but subject to the right to defer the quarterly payments of interest. The first payment is on Date 4 of Year 1 with a payment of $h per unit of the

Instruments, equal to the annual rate of f% of the original principal amount, prorated from the date of issuance.

Any property distributed on the Corporation A shares (or the cash value of the property) is to be paid to holders of the Instruments as additional interest. Payments of dividends or additional interest will decrease the contingent principal amount payable at maturity to the extent necessary so that the yield to the date of computation does not exceed a f% annual yield.

If no conditions of default exist, Taxpayer has the option to defer payment of interest for periods not to exceed i consecutive quarterly periods. However, Taxpayer may defer the payment of interest until maturity or redemption if the Corporation A shares cease to exist. Any deferred interest amounts, and interest thereon, will increase the contingent principal amount of each unit of the Instruments. Interest on the deferred interest is at a f% annual rate compounded quarterly. Once all of the deferred quarterly interest is paid, plus any accrued interest thereon, together with the current quarterly interest payment, the contingent principal amount will be decreased by the amount of that payment and quarterly interest may again be deferred. Instead of accruing cash interest during a quarterly deferral period, so long as the current market value of the shares of Reference Stock exceeds the original principal amount of a unit of the Instruments, Taxpayer may increase the number of shares attributable to each unit by j% with respect to any quarterly payment of interest (an annual rate of f%). If Taxpayer elects to make this increase, Taxpayer will be deemed current on that quarterly payment of interest, the contingent principal amount will not increase, the holders of the Instruments will not be entitled to receive interest for that quarter, and the early exchange ratio will be k% for the following quarter. The

states that there is no current plan to defer interest.

Taxpayer has the right to redeem the Instruments at any time, provided Taxpayer redeems all of the Instruments. To redeem, Taxpayer must pay holders an amount equal to the sum of the higher of the contingent principal amount of each unit of the Instruments or the sum of the current market value of the shares of Reference Stock at the time of redemption plus any deferred quarterly payments of interest (including accrued interest thereon), plus in either case, the final period distribution. The terms provide for the payment of certain additional amounts if Taxpayer redeems the Instruments prior to Date 4 of Year 2, Year 3, or Year 4. The current market value

is defined as the average closing price per reference share on the i trading days immediately prior to but not including the fifth business day preceding the redemption date.

Holders have the right to exchange a unit of the Instruments at any time beginning one year subsequent to issuance for cash equal to m% of the then-current trading price of a share of Reference Stock (the "exchange market value"). The early exchange ratio is increased to k% if Taxpayer defers quarterly payments of interest. If a tender or exchange offer is made for the Reference Stock, Taxpayer may increase the early exchange ratio to k% or, alternatively, make a reference share offer adjustment to holders of the Instruments, as described in the . If elected, Taxpayer will distribute as additional interest the average transaction consideration (other than consideration that becomes additional Reference Stock) deemed to be received on the reference shares subject to the reference share offer and attributable to each unit of the Instruments immediately prior to giving effect to certain proportionate reductions relating to that offer. Taxpayer is not required to accelerate maturity or redeem the Instruments if the shares of Reference Stock cease to be outstanding.

At maturity, Date 2, holders of the Instruments may then receive a cash amount equal to the higher of (a) the contingent principal amount or (b) the sum of the maturity date value of the Reference Stock plus any deferred quarterly interest (with any accrued interest thereon). In either case, holders also are entitled to a "final period distribution," which would include such items as declared dividends or distributions on the Corporation A shares not yet distributed to the holders. Terms of the issuance provide for certain anti-dilution measures. The amount paid at redemption or maturity is required to be adjusted in the event of specific dilutive or anti-dilutive events.

Taxpayer states in its that it will use the cash proceeds from the issuance of the Instruments for general corporate purposes, "including capital expenditures, working capital, repayment of long term and short term debt, the financing of acquisitions and share repurchase programs." The issuance of the Instruments resulted in $p in proceeds, reduced by $q in expenses. Taxpayer used approximately $r of the proceeds to pay down higher cost debt, $s in commercial paper and $t of medium term debt. It used approximately $u to finance acquisitions other than Corporation B stock. It used approximately $v to repurchase Taxpayer stock. Approximately $w was used as part of the payment in a tender offer for shares of Corporation B.

c. Taxpayer's Holdings in Corporation A.

As of Date 1, Taxpayer owned approximately x shares of Corporation A stock. Taxpayer may, but is not contractually required to, hold a number of shares of Corporation A stock equal to the number of the outstanding units of the Instruments. Taxpayer acquired its holdings in Corporation A stock in transactions that predated the issuance of the Instruments and was a substantial early investor in Corporation A. Taxpayer's Corporation A holdings were acquired in transactions beginning in Year 5

and Year 6. After the purchases in Year 6, Taxpayer owned z% of the outstanding common stock of that company and was entitled to a seat on the board of directors. Taxpayer's position has been substantially diluted by additional public offerings of the stock made by Corporation A and Taxpayer's sales and charitable donations of Corporation A shares, and it is no longer entitled to a board seat. As of Date 7, Taxpayer owned aa Corporation A shares valued in excess of $bb. Holders of the Instruments are not entitled to any rights with respect to the Corporation A stock other than indirectly pursuant to the terms of the issuance.

Taxpayer's "seed money" purchases of Corporation A stock were part of an overall corporate strategy become involved with New Business companies. During the period from Year 5 through Year 3, the last year currently under examination, Taxpayer made other investments in several New Business companies and joint ventures. Taxpayer's investment in Corporation A, and similar investments in other New Business companies, was in furtherance of its long-established strategy to locate and sell its Business services and products. One of the purposes of these investments was to gain knowledge of industry technology and trends, so as to be able to make sensible choices among alternative ways to deliver its Business services and products. Another purpose was to help forge business alliances.

As a direct result of Taxpayer's position as a longstanding investor in Corporation A, Taxpayer and Corporation A made joint investments in other New Business companies, including Corporation D and Corporation E. Furthermore, Taxpayer and Corporation A formed several joint ventures. They first launched Corporation F in Year 6 and then Corporation G in Year 7. These efforts evolved in Year 8 into the Corporation H joint venture, which provided services through the Corporation A network in cities across the country. In Month 1 of Year 1, Taxpayer owned i% of Corporation H and Corporation A owned the other cc%. Each of Taxpayer's Business units operated the Corporation H affiliate in its market. Otherwise, Taxpayer and Corporation A were unrelated.

The of Corporation A with Corporation C in Year 2, creating Corporation AC, gave Taxpayer added incentive to maintain its investment in Corporation A shares. Taxpayer conducts a substantial amount of business with Corporation C. In addition, Taxpayer and Corporation C are partners in Corporation J. The shares resulting from the new are also included as Reference Stock.

As of Date 8, the value of shares of Corporation A common stock referenced to one unit of the Instruments was $dd, or $ee per share.

d. Federal Tax Treatment of the Instruments.

The states that the Instruments will be characterized as indebtedness of Taxpayer for U.S. federal income tax purposes and that holders will need to include interest payments in income. Units of the Instruments are unsecured

and subordinate to Taxpayer's existing and future indebtedness. Further, it describes the Instruments as a contingent payment debt instrument and advises holders that they will need to report as ordinary income certain amounts prior to the holders' receiving the cash attributable thereto.

Taxpayer applied the contingent payment rules of the original issue discount ("OID") regulations because the Instruments are exchangeable for cash determined with reference to the value of the Corporation A common stock and hence the payout is contingent. Taxpayer applied the noncontingent bond method described in § 1.1275-4 and, pursuant to that regulation, determined the comparable yield to be ff%, compounded quarterly based upon a projected payment at maturity, according to the , of $o per unit. Consistent with these calculations of comparable yield and projected payment, Taxpayer accrued and deducted interest, as well as amortizable issuance costs, on its federal income tax return for Year 2 and Year 3.

For the years Year 2 and Year 3, Taxpayer reported deductions on its issuance of the debentures of $gg and $hh, respectively. These amounts included interest deductions (for both the current coupon and the noncash interest deductions) as well as amortization of underwriting expenses associated with the Instruments issuance.

If (i) Taxpayer does not exercise its right to redeem the Instruments prior to their scheduled maturity date on Date 2, and (ii) all payments on the Instruments are made on the dates and in the amounts assumed in Taxpayer's projected payment schedule, the total OID deductible by Taxpayer and includible by the holders over the d year period that the Instruments are outstanding will be approximately $ii (including annual f% interest payments totaling approximately $jj).

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 positions are

"offsetting" if there is substantial diminution of the taxpayer's risk of loss from holding one position by reason of holding the other position.

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

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

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

---

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

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 an obligor's interest in a debt instrument is an interest only in the currency in which the instrument is denominated, regardless of whether the currency is foreign or U.S. dollar denominated currency. Taxpayer contends that its assertion is "strongly supported" by § 1092(d)(7), and as support, cites to legislative history that:

> 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.

1981 Bluebook at 289.

Neither the legislative history nor the express language of § 1092(d)(7) indicates that Congress intended to exclude a debt instrument from the definition of position in § 1092(d)(2). A rule that a debt instrument can be a position in nonfunctional currency does not establish that a debt instrument can be 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).

Regulations finalized in 1996 also 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).

Taxpayer's argument disregards the express provisions of its own Instruments. The Instruments provide for a payment at maturity in an amount referencing the price of the Corporation A stock. Also, payments for early redemption are directly tied to the fair market value of the Corporation A stock. Thus, by its terms, the Instruments create a direct interest, and position, in the underlying Reference Stock.

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

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

During the years in issue, § 1092(d)(3)(B)(i)(II) contain 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 Stock, the following tests must be met: (1) the fair market value of the Instruments and the Reference Stock would need to "primarily reflect" the performance of the same firm or factors; and (2) the changes in the fair market value of the Reference Stock must have been "reasonably expected to approximate" changes in the value of the Instruments. Expectations are considered "reasonable" where they are the expectations of a reasonable person, based on all the facts and circumstances at the time the stock is acquired or the positions are entered into, and include representations made with respect to the marketing or sale of the position. § 1.246-5(b)(4).

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

Under the facts of this case, the fair market value of the Reference Stock 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 Reference Stock. The projected payment schedule of the Instruments, as discussed below, was based upon the forward price or other expected value of the Reference Stock. See § 1.1275-4(b)(4)(ii)(A). The early redemption rights of the issuer and the holders also support this connection. Taxpayer was able to redeem the Instruments at any time prior to maturity for the stock price, not the principal amount. Likewise, holders were entitled to exchange their Instruments for an amount that references the stock price (m%) but not the contingent principal amount of the Instruments. By issuing the Instruments, Taxpayer essentially economically monetized and reduced its risk of loss on its position in the Reference Stock over the period that the Instruments are outstanding, d years. The offsetting nature of the Instruments and the Reference Stock was noted in the in the discussion of FAS 133. The indicated that changes in the market value of the Reference Stock should at least partially offset changes in the fair value of the derivative component of the Instruments.

As discussed in section (2) below, fair market value of the Reference Stock 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 rate loan in d years (in whole or in part) if the stock depreciated to an amount less than original issue price of the Instruments. Taxpayer essentially obtained tax-deferred use of the gain that existed in the Reference Stock at the time the Instruments were issued.

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

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

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

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

Taxpayer paid interest quarterly at an annual rate of f% on the Instruments. Using the CPDI rules under § 1.1275-4, Taxpayer accrued a comparable yield of ff% compounded quarterly based upon a projected payment at maturity of approximately $o in d 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 paragraph (b)(4) to produce the comparable yield. For example, the adjusted amounts of non-market-based payments must reasonably reflect the relative expected values of the payments and must not be set to accelerate or defer income or deductions. If the debt instrument contains both market-based and non-market-based payments, adjustments are generally made first to the non-market-based payments because more objective information is available for the market-based payments.

Taxpayer accrued deductions at a comparable yield based upon a projected contingent payment at maturity specifically referenced to the expected appreciation in the Reference Stock. In the , Taxpayer's projected payment amount is stated as $o per unit of the Instruments. Thus, based upon Taxpayer's own calculations, the stock was expected to appreciate over the term of the Instruments and changes in the fair market value of the Reference Stock were reasonably expected to approximate changes in the fair market value of the Instruments to which they relate.

In addition, Taxpayer's projections appear 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 in consideration for the opportunity to share in future appreciation on the Reference Stock.

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 Stock. The call option component affords the holders the opportunity to share in the appreciation in the Reference Stock.

For instance, each unit of the Instruments has an original issue price of $e, a quarterly coupon of $g, and a "guaranteed" minimum stated redemption price at maturity (SRPM) of $e. 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 $g, SRPM of $e, and yield of ff%). Thus, for a comparable straight debt instrument with current coupon payments of $g per quarter for kk quarters (d years) and a SRPM of $e, a holder would have paid approximately $mm to obtain a current yield of o%. The remaining $y of the issue price represents economically an interest other than a guaranteed payback. In this case, the excess payment is made for the opportunity to share in the appreciation of the Reference Stock, above the threshold amount of $e.

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 Stock failed to appreciate to the extent projected. Taxpayer, conversely, economically hedged its position in the Reference Stock for d years by issuing the Instruments because if the Reference Stock declined, Taxpayer was required to repay only the "debt" portion of the Instruments at maturity.

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

2. Whether payments and accruals on the Instruments (including for this purpose any debt issuance costs) 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 generally not be inferred, however, where there is a bona fide restriction on a taxpayer's ability to sell or otherwise to dispose of the tax-exempt obligations. See e.g. R.B. George Machinery, 20 B.T.A. 594 (1932) (Acquiesced C.B. XI-2, 4).

In the instant case, there were no restrictions on Taxpayer's ability to sell or otherwise to dispose of the Reference Stock. Neverthless, the facts make clear that Taxpayer's reasons for incurring the indebtedness are directly related to the carrying of the Reference Stock. Upon issuance, the principal amount of one unit of the Instruments equaled the Date 1 closing price of one share of Corporation A stock. Taxpayer held as many or more shares of Corporation A stock as the number of units of the Instruments issued. In addition, at maturity of the Instruments, holders are to be paid an amount determined by reference to the price of the Reference Stock. Holders receive the right to any appreciation in the Reference Stock, and, in exchange for this right, holders agree to receive interest payments well below the market rates. Therefore, both in form and in substance, the Instruments are closely and directly tied to the Reference Stock.

Taxpayer contends that its intention to apply the proceeds from issuance of the Instruments for "extraordinary, nonrecurrent expenditures" rebuts the close relationship between the Instruments and the Reference Stock. As support, Taxpayer cites to cases under § 265(a)(2), including Handy Button Machine Co., et al. v. Commissioner, 61 T.C. 846 (1974) and Swenson Land and Cattle Co., Inc. v. Commissioner, 64 T.C. 686 (1975).

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

Taxpayer argues that its use of proceeds is analogous to the use of mortgage proceeds to fund construction of a plant in of Wisconsin Cheeseman, Inc. v. Commissioner, 265 F. Supp. 168 (D. Wis. 1967), aff'd in part and rev'd in part, 388 F.2d 420 (7th Cir. 1968). In Wisconsin Cheeseman, the taxpayer was in the business of packaging various kinds of cheeses for retail sale. Virtually all of the taxpayer's products were purchased from it during the last three months of the calendar year for holiday gifts. Since receipts from sales generally lagged one to two months behind the date of incurring the operating expenses necessary to produce the sales, the taxpayer obtained a substantial amount of short term financing each year.

During the years in question, each January and February when the taxpayer was in possession of substantial amounts of money from receipts for the prior year's sales, the taxpayer used the balance of the receipts to purchase high quality municipal securities. As capital needs developed during the ensuing year, the taxpayer obtained short term financing, using its municipal securities as collateral. The taxpayer was able to borrow almost 100% of value when such collateral was used. As receipts came in during the following winter, these short term loans were repaid and the balance used to increase the company's municipal bond holdings.

In the second year at issue, the taxpayer borrowed $69,360 from a bank to build a new plant. The loan was secured by a mortgage upon its real estate. The proceeds of the loan were applied directly to pay for construction of the plant.

The District Court held that the taxpayer's purpose in incurring the indebtedness, including the mortgage, was to make it possible for the taxpayer to carry its municipal securities. On appeal, the Court of Appeals for the 7th Circuit affirmed in part and reversed and remanded in part as to the deductibility of the interest on the mortgage loan. The Court of Appeals held that there was an insufficient relationship between the mortgage and the holding of the tax-exempt bonds to justify the denial of a deduction for mortgage interest.

The facts of the instant case are distinguishable from the mortgage loan in Wisconsin Cheeseman. As in Handy Button and Swenson, there was no relationship

established between the mortgage loan and the tax-exempts in Wisconsin Cheeseman. In addition, the plant served as collateral for the mortgage loan so there was a direct relationship between the loan and another asset. By contrast, in the present case there is a direct connection between the Instruments and the Reference Stock due to the indexing of the Instruments to the value of the Reference Stock. No other assets were pledged as collateral to secure payment on the Instruments.

In the instant case, the facts also show that Taxpayer applied some of the proceeds to repay outstanding debt 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). In Wisconsin Cheeseman, neither the District Court nor the Court of Appeals found persuasive the stipulated fact that, because the value of the municipal bonds did not fluctuate, the taxpayer could borrow more against their market value than against that of other investments. In addressing this argument, the District Court stated:

> 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.

Wisconsin Cheeseman, 265 F.Supp. at 170. Likewise, in Illinois Terminal, the taxpayer argued that the tax-exempt bonds were pivotal to obtaining an A-quality rating on its debt and thereby lowering the interest cost. In response, the Court of Claims stated that the "efficient use of an available asset cannot, of itself, help a taxpayer avoid the stricture of section 265(2)." Id. at 1022.

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 Reference Stock. 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 Stock would allow Taxpayer to avoid § 263(g) simply by juggling available funds by applying different funds for different uses.

Finally, Taxpayer's reliance on Investor's Diversified Services, Inc. v. U.S., 575 F.2d 843 (Ct. Cl. 1978) is misplaced. Consistent with the legislative history to § 265(a)(2), in guidance, the Service has placed banks in a separate category of analysis under § 265(a)(2). See Rev. Proc. 72-18, Rev. Proc. 70-20, 1970-2 C.B. 499 (as amplified by Rev. Proc. 78-34, 1978-2 C.B. 535, and modified by Rev. Proc. 83-91,

1983-2 C.B. 618); Rev. Rul. 67-287, 1967-2 C.B. 133; and Rev. Rul. 61-222, 1961-2 C.B. 58. As stated by the Court of Claims in Investor's Diversified:

> It is the 'bank exception'… plus the similarities of [the taxpayer] to banks which provide a strong reason for our inability to see the required relationship between [the taxpayer's] indebtedness and its tax-exempt holding.

Id. at 852. In the instant case, Taxpayer has not contended that its Business is comparable to banking such that special rules should apply.

As stated above, Taxpayer's reasons for incurring the debt were not independent of and unrelated to the holding of the Reference Stock. See Illinois Terminal, supra at 1023. To the contrary, the Instruments specifically reference the Reference Stock and are, in form and substance, closely connected to the Reference Stock.

Moreover, 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 Stock 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 Stock 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 Stock. Therefore, the Instruments are used specifically to carry the Reference Stock under § 263(g).

The relationship between the Instruments and the Reference Stock is similar economically to a taxpayer who obtains a loan by collateralizing its portfolio securities. Much like a collateralization transaction, a monetization establishes a direct transactional nexus between the borrowing and the borrower's continued ownership of the reference stock.

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

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.