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

MEMORANDUM FOR Associate Area Counsel, LMSB Area 5, Seattle
Attn: Gregory Hahn

FROM: Jasper L. Cummings
Associate Chief Counsel (Corporate) CC:CORP

SUBJECT:

This Chief Counsel Advice responds to your memorandum received on April 26, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Holding	=
Sub	=
FSub1	=
FSub2	=
FSub3	=
Year 1	=
Year 2	=
Year 3	=
Date 1	=
Date 2	=

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 x = y units = z =

Country M =

Bank =

ISSUE

Whether a note can be characterized as debt when all interest payments due thereon must be paid solely in voting common stock of the issuer, and the principal amount must be paid solely in a fixed number of shares of the issuer's voting common stock determined on the date the note was issued?

CONCLUSION

The note cannot be characterized as debt.

FACTS

Holding is a U.S. corporation and the common parent of an affiliated group of corporations filing a consolidated federal income tax return. Holding operates primarily through wholly owned Sub, a domestic corporation, and another wholly owned domestic corporation. Sub wholly owns FSub1, a Country M corporation that is treated as a disregarded entity for U.S. tax purposes, and FSub2, a Country M corporation. FSub2 wholly owns FSub3, a Country M corporation.

Starting in Year 1, Holding engaged in a series of transactions that were designed to retire $\$x$ of FSub3's debt. Shortly before the transactions described below, FSub1 was incorporated.

On Date 1, the following transactions (among others) occurred:

(1) FSub1 borrowed $\$x$ from Bank (the "Bank Loan"). The entire principal balance of the Bank loan was due on Date 2 (which was several years after Date 1), and interest payments were due periodically.

(2) Sub and FSub1 entered into a currency swap agreement that required FSub1 to initially exchange the $\$x$ proceeds from the Bank Loan with Sub for an equivalent amount of Country M currency (" y units"), to make offsetting payments of interest and principal in U.S. and Country M currency over the term of the loan, and to re-exchange the $\$x$ and the y units on Date 2.

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(3) FSub1 advanced the y units to FSub2 in exchange for a y units promissory note (the "Note"). The Note provided for annual interest payments to be made in FSub2 voting common stock. The Note also provided that the y units principal amount of the Note would be paid on Date 2 (or earlier, on demand by FSub1).

(4) FSub1 and FSub2 entered into a purchase agreement (the "Purchase Agreement") requiring FSub1 to buy z shares of FSub2 voting common stock from FSub2 on Date 2, or on any earlier date when a repayment of the principal of the Note was made. The fair market value of z shares of FSub2 common stock on Date 1 equaled the y units principal amount due on the Note. The Purchase Agreement also provided that FSub1 could pay for the z shares of FSub2 stock by tendering the Note if FSub2 failed to pay the principal amount due on the Note. Finally, the Purchase Agreement provided that FSub2 could repay the Note by issuing z shares of stock if FSub1 failed to acquire the z shares pursuant to the Purchase Agreement.

(5) FSub2 advanced y units to FSub3 in exchange for a y units promissory note from FSub3 (the "FSub3 Note"). The FSub3 Note provided for annual interest payments to be made in Country M currency; the principal amount of the FSub3 Note was due on Date 2.

The parties made the required payments under the notes and agreements above each year and completed the transactions above on Date 2. In accordance with the Purchase Agreement, FSub1 tendered the Note to FSub2 on Date 2 in exchange for the z shares of FSub2 in satisfaction of the principal amount due on the Note.

Because FSub1 is a disregarded entity, for the tax years at issue (Years 1, 2, and 3), the Note was treated on Holding's U.S. consolidated tax return as a direct equity investment by Sub in FSub2. Therefore, Sub did not report any payments received by FSub1 on the Note as interest income.

For Country M tax purposes, in Years 1, 2, and 3, FSub1 and FSub2 were treated as separate Country M corporations, and the Note was treated as debt. FSub1 and FSub2 reported the interest paid on the Note as interest income and deduction, respectively. Under Country M law, FSub2 was able to deduct the interest payments made in its own stock.

You have asked us to consider whether the Note can be characterized as equity for U.S. tax purposes, and thus whether the payments received by FSub1 on the Note should be reported by Sub as interest on Holding's consolidated return.

LAW AND ANALYSIS

Under the Note, as modified by the Purchase Agreement, FSub2 was in

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substance required to repay the entire principal amount due by issuing FSub2 stock. The Note and Purchase Agreement essentially provided for repayment of principal in one of two ways: either FSub2 could have paid y units to FSub1, with FSub1 immediately recontributing the y units to FSub2 in exchange for z shares of FSub2 stock, or FSub1 could simply have tendered the Note to FSub2 in exchange for the z shares. In either case, FSub1 would end up with the z shares and the Note would be cancelled. The latter scenario actually occurred.

The Note, as modified by the Purchase Agreement, thus lacked the indicia of debt in several important respects, the most significant of which are that all payments of interest and principal were required to be made in voting common stock of FSub2, and that FSub1 was not entitled to receive a sum certain on Date 2. See e.g., Notice 94-47, 1994-1 C.B. 357; Rev. Rul. 83-98, 1983-2 C.B. 40; and § 385(c) of the Internal Revenue Code (all stating that one of the factors in a debt-equity analysis is whether there is an unconditional promise to pay on demand or on a specified maturity date a “sum certain”)¹.

In Notice 94-47, the Service announced that it will scrutinize certain instruments reported as debt for federal income tax purposes but which contain equity features, such as the ability to repay the instrument’s principal with the issuer’s stock. Notice 94-47 discusses Rev. Rul. 85-119, 1985-2 C.B. 60. In that ruling, a bank holding company issued twelve-year notes repayable in shares of the company’s stock or in cash. The holder was entitled to receive stock with a fair market value equal to the principal amount of the notes on the date of repayment. The ruling holds that the notes constitute debt based on all the facts and circumstances, including the fact that a holder of the notes had the right to be repaid in cash or in stock.

Notice 94-47 states that ...” an instrument does not qualify as debt if it has terms substantially identical to the [notes in Rev. Rul. 85-119] except for a provision that requires the holder to accept payment of principal solely in stock of the issuer....” Notice 94-47, at 357. In the instant case, FSub1 was required to accept

¹We note that § 385(c) is not applicable in the instant case. Under § 385(c), the issuer's characterization of an instrument as of the time of issuance as either debt or equity is binding on the issuer and on all holders of the instrument. This characterization, however, is not binding on the Internal Revenue Service or on a holder that discloses to the Service on its return that it is treating the instrument in a manner inconsistent with the issuer’s characterization. We do not know whether the Holding consolidated group filed a § 385(c) statement (since no § 385(c) statement was included in the documents we’ve examined in this case). We do know, based on the documents we’ve examined, that the Holding consolidated group treated the Note as equity for U.S. federal tax purposes, and that FSub2, the issuer, did not file a U.S. federal tax return treating the Note as debt for U.S. tax purposes. Accordingly, we do not believe that § 385(c) would be implicated here, even if the § 385(c) statement were not filed.

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all payments on the Note solely in FSub2 stock. Furthermore, the number of shares to be issued in repayment of the Note was fixed on Date 1: the principal amount of the Note was to be repaid in z shares of FSub2 stock regardless of the value of such shares on Date 2. Thus, FSub1 participated in any increases or decreases in value of FSub2 over the term of the Note, and was not entitled to receive a “sum certain” on Date 2. See Rev. Rul. 83-98, supra, at 41 (holding that twenty-year adjustable convertible rate notes were equity because of the “very high probability” that all of the notes would be converted into a fixed number of shares of the issuer’s stock, and stating that the notes thus did not represent a “promise to pay a sum certain”).

Accordingly, the Note cannot be characterized as debt under these circumstances. We do not, however, opine on the U.S. tax treatment of the Note, or on any other aspect of the above transactions, except as specifically provided in the above sentence.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call 622-7750 if you have any further questions.

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CC:CORP:1