Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **200932049**
Release Date: 8/7/2009

:
POSTU-147940-06

UILC: 385.03-00, 385.03-02

date: March 10, 2009

to:

Area Counsel
(Large & Mid-Size Business)

from:

Associate Chief Counsel
(Financial Institutions & Products)

---

subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Trust =
Bank =
Notes =

Preferred Securities =

Common Securities =
State Q =
Business 1 =
Business 2 =

Date 1 =
Date 2 =
Date 3 =

Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 11	=
Date 12	=
Date 13	=
Day 1	=
Day 2	=
Day 3	=
Day 4	=
Year 1	=
Year 2	=
$a	=
$b	=
$c	=
A%	=
B%	=
C%	=
D%	=
E%	=
F%	=
G%	=
H%	=
I%	=
J%	=
K%	=
L%	=
M%	=
N%	=
O%	=
$\underline{q}$	=
$\underline{r}$	=
$\underline{s}$	=
$\underline{t}$	=
$\underline{u}$	=
$\underline{v}$	=

w =
x =
y =
z =

INTRODUCTION

The purpose of this memorandum is to consider the proper tax treatment of a new version of trust-preferred securities with significantly more equity characteristics embedded in order to qualify the securities either fully or partially as equity for regulatory and rating purposes.

The characterization of an instrument for federal income tax purposes depends upon the terms of the instrument and all surrounding facts and circumstances analyzed in terms of its economic or practical realities.

The fact that an issuer intentionally structures an instrument to qualify as equity for certain purposes while continuing to claim to qualify as debt for federal income tax purposes brings the instrument under close scrutiny. The addition of merely formalistic equity features that lack economic or practical realities under the facts of a specific case, however, will carry little weight in the ultimate analysis.

ISSUE

Whether the Notes and Preferred Securities constitute debt or equity for federal income tax purposes?

FACTS

In General. Taxpayer is engaged primarily in Business 1 through its principal operating subsidiary. Taxpayer or its corporate predecessors have conducted Business 1 for an extended period using long-lived assets. Taxpayer has a lengthy history of paying regular dividends on its common stock. Taxpayer is well capitalized, with a debt to equity ratio of q and a ratio of earnings to fixed charges of r at the end of Year 2.

On Date 1, Taxpayer created the Trust by contributing $a in return for all of the Common Securities issued by the Trust. The Trust then issued t Preferred Securities with a liquidation amount of $b for each of the Preferred Securities. Immediately after issuance of the Common Securities and Preferred Securities, all the proceeds were invested in the Notes issued by Taxpayer. The Preferred Securities and Common Securities represent an undivided beneficial ownership interest in the assets of the Trust, a State Q statutory trust, which is treated by Taxpayer as a grantor trust for federal income tax purposes.

The Trust was created solely for the purpose of issuing the Preferred Securities, and the Notes are the only assets of the Trust. The Trust is precluded from borrowing money or issuing debt or mortgages or pledging any of its assets as a borrower. The payments Taxpayer makes on the Notes are the Trust's sole source of funds for the Trust's payments on the Preferred Securities. The prospectus and supplemental prospectus ("Offering Documents") for the Notes and Preferred Securities, respectively, provide the information below.

The Notes

Generally. The Notes are general, unsecured junior subordinated obligations of Taxpayer, bearing interest as discussed more fully below. The Notes mature on Date 2, but may be redeemed or modified as set forth below.

Use of Proceeds. At the time of issuance, Taxpayer intended to use A% of the proceeds from the sale of the Notes to repurchase its common stock through share repurchase arrangements. The balance of the proceeds was to be used for general corporate purposes, including but not limited to, working capital, capital expenditures, repurchases of common stock pursuant to Taxpayer's share repurchase program and the repayment of commercial paper that may be outstanding.

Rate of Return. The Notes bear interest from the date of issuance to Date 3, at the fixed annual rate of B% of their principal amount, payable semi-annually in arrears on Day 1 and Day 2 of each year, beginning Date 4. After Date 3, the Notes bear interest at an annual rate equal to the 3-month LIBOR Rate plus C%, reset quarterly, payable quarterly in arrears on Day 1, Day 3, Day 2 and Day 4 of each year beginning Date 5. If interest payments are deferred or otherwise not paid during the fixed rate period, they will accrue and compound at the fixed rate until paid. If interest payments are deferred or otherwise not paid during the floating rate period, they will accrue and compound at the floating rate until paid.

Interest Deferral Provisions. *Optional Deferral.* Taxpayer, at its option, may elect to defer payment of all or part of the current and accrued interest otherwise due on the Notes for a period of up to u consecutive years (optional deferral period). So long as no indenture event of default has occurred and is continuing, Taxpayer may elect to defer the payment of interest provided that - -

(i) the deferral period does not end after the final maturity date of Year 1,
(ii) previously optionally deferred interest has not been deferred for more than w consecutive years, and
(iii) interest otherwise due and payable is not more than x consecutive years in arrears.

The Offering Documents state that Taxpayer has no current intention to exercise the right to defer interest payments.

If Taxpayer fails to pay interest after u years, Taxpayer is required to use the net proceeds from the sale of its common stock and/or perpetual, non-cumulative preferred stock ("replacement shares") to pay all accrued and unpaid interest on the Notes, unless there is a market disruption event, described below. Under such circumstances, Taxpayer is prohibited from paying interest on the Notes from any other source until all deferred interest is paid. Generally, the failure to pay interest for an additional u years following the optional deferral period will not constitute an event of default if a market disruption event is continuing. Once Taxpayer pays all accrued and unpaid interest resulting from an optional deferral period, it may later defer interest again for a new period under the optional deferral provisions.

Mandatory Deferral. During any period when Taxpayer is not in compliance with certain financial tests ("Mandatory Deferral"), and unless prevented by a "market disruption event," Taxpayer will be required to sell replacement shares and use the net proceeds from those sales to pay all accrued and unpaid interest on the Notes. Taxpayer will be prohibited from using any other funds (other than proceeds from a sale of replacement shares) to pay deferred interest, even if it has other funds.

A Mandatory Deferral will occur with respect to any interest period if, on the 30th day of such period, Taxpayer fails to meet a minimum stated leverage ratio or a maximum stated interest coverage ratio. A Mandatory Deferral will last until the earlier of (1) the next test date on which a Mandatory Deferral event is no longer continuing or (2) Taxpayer fails to pay all accrued and unpaid interest for more than y consecutive years. An event of default will occur, despite any combination of optional and mandatory deferrals, if Taxpayer fails to pay all accrued and unpaid interest for a period of x consecutive years.

Taxpayer's failure to pay interest on the Notes during a mandatory deferral period will not constitute an indenture event of default to the extent that a market disruption event has occurred and is continuing. A market disruption event includes a suspension of trading generally in any national securities exchange or over-the-counter market on which Taxpayer's stock is listed or traded or its settlement generally is materially disrupted, the requirement and failure to get regulatory authority to issue common or perpetual non-cumulative preferred stock, or the occurrence of an event that results in the failure to disclose a material fact in Taxpayer's reasonable judgment in an offering document and (i) disclosure would have a material adverse effect on Taxpayer's business in Taxpayer's reasonable judgment or (ii) or disclosure relates to a previously undisclosed proposed or pending material business transaction, the disclosure of which would impede Taxpayer's ability to consummate a pending business transaction. Disclosure concerns cannot be used to justify a market disruption event with respect to more than one interest payment date during the fixed rate period or more than two interest payment dates during the floating rate period. If due to a market disruption event, Taxpayer is able to raise some, but not all the proceeds with respect to an interest payment date, proceeds will be applied pro rata to the interest on the Notes and, if applicable, deferred interest on any other securities entitled to payment from that source.

The Offering Documents warn that Taxpayer may not be able to sell stock when necessary to pay interest after a u-year optional interest deferral period or during a mandatory deferral period.

Interest Caps in Bankruptcy. If because of a market disruption event, Taxpayer does not pay all accrued and unpaid interest for v consecutive years during a mandatory deferral period, all claims with respect to the unpaid interest on the Notes accruing during the period commencing after those v years until the last day of the mandatory deferral period will be extinguished if a bankruptcy proceeding is commenced with respect to Taxpayer during that period.

Dividend Stopper. To the extent there are interest arrearages on the Notes (as a result of either an optional or a mandatory deferral) Taxpayer may not declare or pay dividends on, or redeem, any class of capital stock, subject to certain limitations.

Subordination/Guarantees. The Notes are subordinate in payment to all existing and future senior indebtedness of the Taxpayer, which includes all of Taxpayer's obligations for borrowed money, including capital lease obligations, but excluding trade account payables and certain other liabilities arising in the ordinary course of Taxpayer's business. No payments of principal or interest on the Notes can be made if a default in any payment with respect to senior debt has occurred and is continuing or if a default has caused any senior debt's maturity to be accelerated. The Trust indenture in no way limits Taxpayer's ability to incur additional senior indebtedness. Taxpayer's federal income tax return for Year 2 shows that Taxpayer, operating as a Business, does not have any trade payables. The Notes are structurally subordinated to all existing and future liabilities, including trade payables, of Taxpayer's subsidiaries.

Creditor's Rights. Upon the occurrence of certain bankruptcy events, the Notes will become immediately due and payable. Upon the occurrence of any other event of default, the property trustee may, or upon the written instruction of the holders of at least D% of the liquidation amount of Preferred Securities shall, declare the principal and the interest on the Notes due and payable. An indenture event of default occurs only if (a) Taxpayer fails to pay principal on the Notes when due (b) Taxpayer fails to pay interest in accordance with the terms of the Notes as described above (c) Taxpayer redeems stock or pays dividends during a period when interest has been deferred on the Notes (d) Taxpayer breaches its obligations under the guarantee (e) upon Taxpayer's bankruptcy or insolvency or (f) upon certain dissolutions of the Trust.

Redemption. The Notes are not redeemable at the option of the holder(s). However, on or after Date 3, Taxpayer has the right to redeem the Notes at a redemption price equal to the aggregate principal amount of the Notes to be redeemed, plus all accrued and unpaid interest thereon. Prior to Date 3, Taxpayer has the right to redeem the Notes, but it must pay the greater of the principal amount of the Notes or a make-whole premium based on the sum of present values of the remaining scheduled payments of principal and interest discounted to the redemption date at the Treasury rate plus E%. The Notes may also be redeemed if either a particular tax event or a regulatory event occurs, for the greater of the principal amount of the Notes or the sum of present values of the remaining scheduled payments of principal and interest discounted to the redemption date at the Treasury rate plus F%. Redemption of the Notes will result in a corresponding redemption of the Preferred Securities by the Trust, as discussed below.

Despite its redemption rights, Taxpayer covenanted to senior lenders that it would not redeem the Notes and the Trust would not redeem the Preferred Securities on or before Date 6 unless some or all of the redemption price is funded from proceeds received during s days prior to the redemption from the sale of common stock or securities with the same, or more, equity-like characteristics than found in the Notes. The amount of proceeds that must be generated by the replacement capital to fund the redemption or repurchase varies depending upon the date of the redemption or repurchase and is at its lowest for redemptions or repurchases between Date 11 and Date 6. Under this agreement, the total redemption or repurchase price must be equal to or less than the sum of (a) the Stated Percentage of proceeds received from the sale of common stock within 180 days prior to such redemption or repurchase plus (b) 100% of proceeds from the sale of additional replacement securities within 180 days prior to such redemption or repurchase. There is no provision restricting redemptions or repurchases after Date 12.

Modification of Instruments. The Taxpayer and the indenture trustee may modify the indenture or any supplemental indenture in any manner with the consent of the holders of a majority of the aggregate principal amount of the Notes.. However, without the consent of the holders of each Note so affected, none of the modifications may: (i) extend the maturity date (ii) reduce the rate of interest (iii) extend the time for payment of interest (iv) reduce the principal amount of the Notes or reduce the amount payable on redemption of the Notes or (v) reduce the percentage of principal amount of Notes, the holders of which are required to consent to any modification of the indenture.

The Preferred Securities

Use of Proceeds. As noted above, all proceeds from the issuance of the Preferred Securities were used to purchase the Notes.

Rate of Return. The distribution rate and the interest payment dates for the Preferred Securities are expected to correspond to the interest rate and the interest payment dates on the Notes.

Holder Tax Treatment of Deferred Interest. The Offering Documents provide that, if a deferral of an interest payment occurs on the Notes, the holders of the

Preferred Securities will continue to accrue original issue discount for federal income tax purposes.

Subordination/Guarantees. To the extent that Taxpayer pays accumulated and unpaid distributions on the Notes to the Trust, Taxpayer guarantees the payment in full of such amounts on the Preferred Securities (guarantee). With regard to the preference on distributions made by the Trust, the holders of the Preferred Securities generally will be of equal rank to the holders of the Common Securities. However, if a trust event of default or an indenture event of default has occurred and is continuing, the rights of the holders of the Preferred Securities to receive payments from the Trust will have priority over the rights of the holders of the Common Securities.

Creditor's Rights. If a trust event of default has occurred and is continuing, the holders of a majority of the aggregate liquidation amount of the Preferred Securities have the right to direct the time, method, and place of conducting any proceedings for any remedy available to the property trustee, or to direct the property trustee to exercise the remedies available to it as holder of the Notes. If the trust event of default is due to Taxpayer's failure to pay principal or interest on the Notes when due, then a holder of the Preferred Securities may sue Taxpayer directly to collect its proportionate share of payments owed.

A trust event of default occurs upon (a) the occurrence of an indenture event of default described above; (b) default by the property trustee in the payment of any redemption price when it becomes due and payable; (c) default by the property trustee in the payment of any distribution when it becomes due and payable and continuation of the default for five business days; (d) the failure of the Trust to pay accumulated and unpaid distributions in full for a period of more than twelve consecutive years; (e) default in the performance or breach in any covenant or warranty of the Trustees; and (f) bankruptcy, dissolution or liquidation of the property trustee, and Taxpayer fails to appoint a successor within 60 days.

Repayment. *Upon Redemption.* In general, to the extent any Notes are redeemed, the Trust will redeem a like amount of Preferred Securities and Common Securities. The Preferred Securities must either (i) be repaid on Date 2, which corresponds to the stated maturity of the Notes, or (ii) be redeemed with the maturity of the Notes, if not redeemed earlier under the optional redemption procedures. The Preferred Securities are not redeemable at the option of their holders. Any redemption of the Preferred Securities will be made, and the applicable redemption price will be payable, on the redemption date only to the extent that the Trust has funds legally available for the payment of the applicable redemption price.

Upon Dissolution. Upon expiration of the Trust due to maturity of the Notes, or other dissolution event, the Notes may be distributed to the holders of the Preferred Securities. The holders of the Preferred Securities may suffer a loss if the Notes are distributed to the holders in exchange for the Preferred Securities. Also, upon a liquidation event, the holders of the Preferred Securities have no other rights except to receive certificates in lieu of the Preferred Securities that represent a like amount of the Notes.

Replacement of Securities. The Taxpayer may request that the Trust, with the consent of the administrative trustees, and without the consent of the other trustees or the holders of the Preferred Securities, merge or consolidate with, be replaced by or convey to, or transfer or lease its assets to, a successor trust. The successor trust must either: (i) assume all the obligations of the Trust regarding the Preferred Securities, or (ii) substitute for the Preferred Securities other securities having substantially the same terms as the Preferred Securities, so long as the successor securities rank the same as the Preferred Securities with respect to distributions and payments upon liquidation, redemption and otherwise.

Trustees/Management Rights. There are four trustees of the Trust. Bank will be the property trustee and the State Q trustee. Two officers or employees of the Taxpayer serve as administrative trustees. There is also an indenture trustee. Unless an indenture event of default has occurred and is continuing, the Taxpayer, as holder of the Common Securities, has the ability to remove any of the trustees of the Trust at any time. However, if a trust event of default has occurred and is continuing, the holders of a majority in liquidation amount of Preferred Securities will be entitled to appoint, remove or replace the property trustee and the State Q trustee. The administrative trustees may be appointed, removed or replaced solely by Taxpayer as holder of the Common Securities.

The property trustee holds legal title to the Notes for the benefit of all holders of the Preferred Securities, and has all power to exercise any rights, powers and privileges as holder of the Notes. The property trustee has the power to exercise all right, powers and privileges under the indenture with respect to the Notes, including the right to enforce Taxpayer's obligations on the Notes upon the occurrence of an indenture event of default and the right to enforce the guarantee. However, if no trust event of default has occurred and is continuing and the property trustee is required to decide between alternative causes of action, construe ambiguous provisions, or is unsure of the application of a provision, and the matter is not one on which the holders of the Preferred Securities are entitled to vote, then the property trustee will take whatever action the Taxpayer directs.

Once an event of default occurs and until an event of default is cured, waived by the holders of the Trust Preferred Securities, or otherwise eliminated, the property trustee will act solely on behalf of the holders of the trust preferred securities, and only the holders of the trust preferred securities will have the right to direct the property trustee to act on their own behalf.

Taxpayer's Tax Position The Offering Documents state that a law firm will issue an opinion that the Notes are debt for federal income tax purposes, and that Trust is a grantor trust for federal income tax purposes. The Offering Documents treat holders of the Preferred Securities as owning undivided interests in the Notes, and therefore they must include in gross income interest, original issue discount (OID), and any gain recognized relating to its share of the Notes. According to the Offering Documents, Taxpayer believes that the likelihood of its exercising its option to defer interest is "remote" within the meaning of applicable Treasury regulations (apparently § 1.1275-2(h)), so there will be no OID at the time of original issuance.

LAW

Under section 385(a) of the Internal Revenue Code, the Secretary of Treasury is authorized to prescribe regulations to determine whether an interest in a corporation is to be treated as stock or indebtedness. No such regulations are outstanding.

Notice 94-47, 1994-1 C.B. 357, provides that the characterization of an instrument for federal income tax purposes depends on the terms of the instrument and all surrounding facts and circumstances. The Notice identifies the following factors as being among those that may be considered in making such a determination: (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. In addition to the factors articulated in Notice 94-47, the courts have identified a number of potential additional factors.

The factors are not of equal weight or significance, Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972), and no particular factor is controlling. In determining whether an instrument constitutes debt or equity, the investment should be analyzed in terms of its economic or practical realities. TIFD III-E, Inc. v. Commissioner, 459 F.3d 220 (2nd Cir. 2006), rev'g 342 F. Supp. 2d 94 (D. Conn. 2004); Fin Hay Realty Co. v. United States, 398 F.2d 694 (3rd Cir. 1968); Alterman Foods, Inc. v. United States, 505 F.2d 873 (5th Cir. 1974).

ANALYSIS

As an introductory matter, we note that the analysis of the instruments as debt or as equity for federal income tax purposes requires us to focus primarily on the rights provided under the Notes. Based upon the structure of the transaction, the holders of the Preferred Securities are the sole investors; Taxpayer reports the Trust as a grantor trust in which the holders of the Preferred Securities hold undivided interests in the

Notes. Although most of the Note terms flow through to the holders of the Preferred Securities, certain rights of these holders are impaired by the trust structure. In this situation, it is appropriate to supplement the terms of the Notes with the terms of the Preferred Securities, especially where those provisions directly impact the holders' ability to enforce repayment on the Notes. See Alterman Food, Inc. v. United States, 505 F.2d 873, 877 (5th Cir. 1974), quoting P.M. Finance Corp. v. Commissioner, 302 F.2d 786, 789 (3rd Cir. 1962).

The following analysis looks at the factors identified in Notice 94-47.

a. Is there an unconditional promise to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future?

The Notes promise to pay a sum certain on a definite maturity date. Moreover, the interest rate on the Notes is a debt-like return that does not vary with Taxpayer's earnings. These features are characteristic of debt instruments. However, Date 2 is a date that is z years from the issuance of the Notes. Generally, the use of a distant due date suggests equity because it exposes an investment to greater risk of an issuer's business and creates uncertainty regarding both the timing and certainty of repayment. See Rowan v. United States, 219 F.2d 51 (5th Cir. 1955); United States v. Snyder Brothers Company, 367 F.2d 980 (5th Cir. 1966). See also Notice 94-47, 1994-1 C.B. 357.

There is little judicial guidance as to how far into the future is "reasonably foreseeable." A maturity that is reasonable in one set of circumstances, however, may be unreasonable in another. In Ruspyn Corporation v. Commissioner, 18 T.C. 769 (1952), acq., 1952-2 C.B. 3, an 89-year term was found to be acceptable where the period was substantially coextensive with the term of a ground lease on the corporation's real property. Similarly, the provision for the redemption or retirement of an obligation prior to its maturity supports debt treatment. In Monon Railroad v. Commissioner, 55 T.C. 345 (1970), acq., 1973-2 C.B. 3, a 50-year term was found acceptable where a sinking fund was provided and the debentures were issued in exchange for certain class A shares that had been issued to debt holders in a prior reorganization. On the other hand, under certain other circumstances, even 15-20 year terms have been held excessive where the circumstances so dictate. See, United States v. Snyder Bros. Co., supra.(20-year notes issued by new corporation to controlling shareholders); Reef Corporation v. Commissioner, T. C. Memo. 1965-72 (1965), aff'd on this issue and rev'd on other grounds, remanded 368 F.2d 125 (5th Cir. 1966), cert. denied, 386 U.S. 1018 (1967) (15-year debt to controlling shareholders).

In addition, a distant due date may place greater or lesser weight on other factors. An extended maturity, for example, will decrease the relative economic importance of the eventual return of principal, and concomitantly increase the relative importance of the periodic payments during the term of the instrument. See David C.

Garlock, Federal Income Taxation of Debt Instruments, (Fifth Edition), at 1022-1023 (11-2007).

In this case, the Notes mature on Date 2, which is z years from the date of the Notes' issuance, and which some court decisions have concluded to be an inordinately postponed due date. Taxpayer has the right to cause the redemption of the Preferred Securities with a "make whole" premium prior to Date 3, and thereafter at par, although Taxpayer has covenanted with senior lenders that it would do so on or before Date 6 only using proceeds from the sale of other securities having the same or more equity-like characteristics or common stock. Taxpayer has neither created a sinking fund nor set aside assets for the redemption of the Notes or Preferred Securities, in whole or in part.

However, Taxpayer or its corporate predecessors have operated Business 1, a substantial operating business, for an extended period using long-lived assets. Taxpayer has consistently paid dividends on its common stock, including the period after the issuance of the Notes and the Preferred Securities. Also, the interest rate borne by the Notes suggests that the market did not consider the long maturity of the instruments a significant risk factor.

b. Do holders possess the right to enforce the payment of principal and interest?

The right to enforce the payment of principal and interest, commonly referred to as "creditor rights", is a debt characteristic referring to the holder's ability to bring suit against the issuer. In addition, creditor rights typically include the right to file claims as creditors in bankruptcy. See Miele v. Commissioner, 56 T.C. 556 (1971), aff'd per curiam 474 F.2d 1338 (3rd Cir. 1973). In contrast, the typical remedy for an equity investor upon default is to influence corporate dividend policy through the election of directors. See Kingsmill Corp. v. Commissioner, 28 T.C. 330 (1957).

It is the nature of a holder's rights to enforce repayment, rather than the relative effectiveness of those rights, that indicates a creditor versus investor relationship. Once the nature of the rights are determined to be akin to creditor rights, the strength or weakness of those rights influence the amount of weight to be placed on this particular factor in the overall analysis. However, the fact that the issuer may have driven a "hard bargain" in negotiating creditor rights does not change the type of rights they represent. See Kingsmill, supra.

In this case, the holders of the Preferred Securities have creditor rights with certain limitations. If payments of either principal or interest are not made in accordance with the terms of the Notes or the Preferred Securities, the holders, or the Trust acting for the benefit of the holders, can bring suit to collect those payments and, with certain limitations, can pursue a claim for payment in bankruptcy. The holders or the Trust can also accelerate the payment of the Notes' principal and interest, although acceleration occurs automatically only upon certain bankruptcy events. Other events of default, including failure to pay principal when due or to pay interest in accordance with the terms of the Note and the Preferred Securities, result in acceleration only at the discretion of the property trustee unless the trustee is directed to accelerate the debt by holders of D% of the Preferred Securities. Where holders cannot demand repayment without the consent of other holders, the courts may question the effectiveness of the holder's ability to enforce repayment. See Jewel Tea Co. v. United States, 90 F.2d 451 (2d Cir. 1937). If the trustee does not enforce the payments of principal and interest when due, an individual holder may sue the Taxpayer directly, but is limited to seeking only its proportionate share of the amounts due, without acceleration. In general, these enforcement rights are creditor-type enforcement rights.

In addition, in the instant case, interest may be deferred by the Taxpayer for up to u consecutive years, or for multiple periods each of less than u years, and must be deferred if the Taxpayer violates certain financial covenants. Any deferred interest payments, whether voluntary or mandatory, are cumulative. In the event of bankruptcy, a portion of the accrued but unpaid interest may be excluded from any bankruptcy claim.

The right of an issuer to suspend interest payments is characteristic of equity, since this right runs counter to the assumption of predictable repayment normally associated with debt treatment . Taxpayer's ability to defer interest for extended periods of time, and to extinguish a portion of those deferrals in bankruptcy, generally would argue against debt treatment. In this case, however, the practical economic ability of the Taxpayer to exercise its right to defer payments appears to be remote. The adverse effect on its common shareholders would appear to preclude a voluntary deferral, and Taxpayer's strong financial position makes a mandatory deferral highly unlikely. As a result, we have not placed significant weight on Taxpayer's ability to defer interest. See United States v. Snyder Brothers Co , supra, in which the court decided that the advances in that case were not properly classified as debt and found relevant the fact that there was no restriction on the issuer's ability to declare and pay dividends.

c. Are the rights of the holders subordinate to the rights of general creditors?

In the instant case, the rights of the holders are subordinate to all creditors except trade creditors, with which the debt is pari passu. As a practical matter, the holders are subordinate to all debt of the Taxpayer because the taxpayer is a holding company with little or no debt that is trade debt.

An instrument is not automatically denied debt status because it is subordinate to the claims of general creditors. In U.S. v. Snyder Brothers Co., supra, the purported debt was a long term obligation which was both unsecured and subordinated to all current and future indebtedness of the corporation, but the court also relied in that case on the lack of any restriction on the payment of dividends to the general stockholders. The court found that subordination under those circumstances made the repayment obligations "practically ineffectual" if the issuer decides not to pay principal or interest when due. Id. at 984. See also Rev. Rul. 90-27, 1990-1 C.B. 50, and Rev. Rul. 83-98, 1983-2 C.B. 40 (where subordination, combined with other equity factors, led to holdings that the instruments were equity.) But see, Rev. Rul. 85-119, 1985-2 C.B. 60, and Rev. Rul. 68-54, 1968-1 C.B. 69 (where subordinated obligation treated as debt where other factors pointed toward debt status.)

In this case, the holders of the Preferred Securities are unsecured and subordinated to all current and future indebtedness of the corporation with no limitation as to the use of future senior indebtedness. (Although there are no limitations on the incurrence of debt, violation of a debt coverage ratio or an interest coverage ratio requires Taxpayer to sell stock to pay accrued but unpaid interest unless a market disruption event occurs and is continuing.) The Notes and the Preferred Securities are not subordinate to general trade creditors, although the structure of Taxpayer as a holding company results in few (if any) trade creditors of Taxpayer directly, and in structural subordination to trade creditors of the operating subsidiaries. Certain limitations on the assets available for interest payments also create a structural form of subordination. One of the normal attributes of debt is that the holder can look to the assets of the debtor for payment, and the fact that repayment of principal or interest is restricted as to source is a factor that can be considered by the courts as supporting equity treatment. See e.g., Commissioner v. Meridian and Thirteenth Realty, 132 F.2d 182 (7th Cir. 1942), rev'g 44 B.T.A. 865 (1941). If Taxpayer fails to pay interest after u years, or during a mandatory interest deferral period, it may then pay accrued and unpaid interest only from the net proceeds of the sale of replacement shares. In a similar vein, Taxpayer has covenanted to not redeem or repurchase the Preferred Securities on or before Date 6 unless some or all of the redemption price is funded from proceeds from the sale of common stock or securities with the same or more equity-like characteristics than in the Notes. Under the circumstances described above, the holders of Preferred Securities may not look to any existing assets of the Taxpayer. Payments can be made only from new infusions of cash, raised solely by the sale of securities subordinated to all creditors of the Taxpayer.

The restrictions on the source of assets available for periodic payments apply only if Taxpayer has deferred payments for a significant period or is in violation of financial covenants. As discussed above, these conditions appear to be remote possibilities, and do not warrant substantial weight. The restrictions on redemptions contained in the covenants with senior debt holders do apply currently. These restrict only voluntary redemptions, however, and do not impede the payout of the Preferred Securities in accordance with their terms.

d. Do the instruments give the holders the right to participate in the management of the issuer?

The holders of the Preferred Securities have no right to participate in (or affect) the management of Taxpayer either currently or in the event of default.

e. Is the Taxpayer thinly capitalized?

Taxpayer was adequately capitalized when the Preferred Securities were issued and the Taxpayer's debt to equity ratio was within industry norms.

f. Is there identity between holders of the instruments and stockholders of the issuer?

The Trust Preferred Securities are widely held and publicly traded, and are not proportionate to stock ownership. Ownership of debt that is proportionate to stock ownership generally supports equity treatment because related creditors are less likely to enforce their available remedies in the event of default. See Rev. Rul. 68-54 and Rev. Rul. 85-119. The instruments here are structured to provide the holders of the Trust Preferred Securities with ultimate control over the exercise of those remedies, even though the exercise of certain remedies require an affirmative vote of at least D% of holders.

g. What is the label placed upon the instruments?

In this case, the Preferred Securities are labeled Trust Preferred Securities, which is ambiguous and does not strongly suggest either debt or equity treatment. The Offering Documents indicate that holders of the Preferred Securities will be treated as holding an undivided interest in the assets of the Trust. The only assets of the Trust are the Taxpayer's Notes, which the parties have labeled "debt."

h. How are the instruments intended to be treated for non-tax purposes?

For financial accounting purposes, the Notes are being treated as long-term debt, and the interest payments are treated as interest expense on Taxpayer's income statement. Moody's and Standard & Poor's treated the Notes as <u>A</u>% equity. Standard & Poor's rated the Trust Preferred Securities at BBB – one notch below their senior debt rating of A. It is not clear whether the Taxpayer makes regulatory filings in which full or partial "equity credit" would be meaningful. However, Taxpayer's annual report for Year 2 states that certain rating agencies provide a considerable degree of equity treatment for the Notes for purposes of calculating various ratios and metrics.

<u>CONCLUSION</u>

The term of <u>z</u> years reduces the economic significance of the potential payment of principal at maturity by significantly reducing the relative present value of that principal payment, while also increasing the practical likelihood of redemption of the Preferred Securities prior to maturity. As a result, the ability to accurately predict the scheduled periodic payments takes on relatively greater significance in the analysis of the "economic or practical realities" of the investment.

The fact that the holders of the Preferred Securities have creditor rights of practical significance is probative of debt. However, the Preferred Securities are subject to several conditions which, if implemented, would cause the periodic payments to be more analogous to traditional preferred stock dividends than to traditional interest on long term debt. These include the right of the Taxpayer voluntarily to defer payments for prolonged periods, limitations on the sources from which deferred payments can be satisfied, and the potential loss of a portion of deferred payments in the event of bankruptcy. The likelihood of these conditions being implemented, however, appears to be remote. Taxpayer has an extensive, consistent history of dividend payments on its common stock which it will have a substantial economic incentive to maintain and which would be prohibited if payments were deferred on the Preferred Securities. Taxpayer indicated that it did not intend to defer payments, and has sufficient capitalization, liquidity and long term business prospects to justify the assumption that it will be able to comply with that intention.

An extended term to maturity also affects the degree to which future financial strength and business prospects can be realistically foreseen over the full term of a security. That in turn can lessen the degree to which current financial strength and business prospects can be relied upon for assurance that risks such as voluntary or mandatory deferrals of payments are indeed remote. However, in this case, given the terms of the instruments and the expectations of the marketplace, we do not think that the long maturity date is the decisive factor. Therefore, we recommend that Taxpayer's characterization of these instruments as debt should not be challenged.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any other aspect of the transaction discussed in this memorandum. In particular, this ruling does not address the proper tax treatment of the Trust for federal income tax purposes.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-3950 if you have any further questions.

STEPHEN R. LARSON
Associate Chief Counsel
(Financial Institutions & Products)

By: Christina A. Morrison_____________
Christina A. Morrison
Senior Technician Reviewer, Branch 6
Office of Associate Chief Counsel
(Financial Institutions & Products)