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to:
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subject:

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

LEGEND

Taxpayer =

X =
Exchange =
Year 1 =
Year 2 =
Year 3 =
Month 1 =
Month 2 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =

a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=
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m	=
n	=
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aa	=
bb	=
cc	=
dd	=
ee	=
ff	=
gg	=
hh	=
ii	=
jj	=
kk	=
ll	=
mm	=
nn	=
oo	=
pp	=
qq	=

rr =
ss =

ISSUES

1. Whether Taxpayer's Year 2 Debentures and its holdings of shares of X Stock constitute a straddle for purposes of § 1092(c).

    a. Whether the Year 2 Debentures constitute a "position" under § 1092(d)(2).

    b. Whether the Year 2 Debentures are "a position with respect to such stock or substantially similar or related property" with respect to X Stock held by Taxpayer under § 1092(d)(3)(B)(i)(III)[1] (pre-2004 amendment) .

2. Whether Taxpayer's repurchase premium and coupon interest allocable to the Year 2 Debentures constitute interest or carrying charges "incurred or continued to purchase or carry" the X Stock for purposes of § 263(g)(2)(A).

3. If § 263(g) is applicable, whether the basis of new shares acquired by Taxpayer in a non-taxable exchange for the X Stock includes the repurchase premium and coupon interest capitalized into Taxpayer's basis in the X Stock.

CONCLUSIONS

1. Under § 1092, the Year 2 Debentures are part of a straddle with the X Stock.

    a. The Year 2 Debentures constitute a "position" under § 1092(d)(2); and

    b. The Year 2 Debentures qualify under § 1092(d)(3)(B)(i)(III) as "a position with respect to substantially similar or related property (other than stock)" with respect to stock held by Taxpayer.

2. Payments and accruals on the Year 2 Debentures constitute interest and carrying charges incurred or continued to purchase or carry the X Stock, for purposes of § 263(g)(2)(A).

3. The basis of the new shares acquired by Taxpayer in the non-taxable exchange for the X Stock includes the repurchase premium and the coupon interest capitalized into Taxpayer's basis in the X Stock.

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[1] This provision was amended and renumbered as § 1092(d)(3)(A)(i) by section 888(c)(1) of the American Jobs Creation Act of 2004 (P.L. 103-357). 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.

FACTS

On Date 1, Taxpayer issued two tranches of exchangeable debentures in $ denominations that paid interest semi-annually at stated rates of a percent and b percent (collectively, "Year 2 Debentures"). The Year 2 Debentures were exchangeable for shares of X Stock previously acquired by Taxpayer in an unrelated transaction. The debentures were publicly traded and were to mature in g years on Date 5. Taxpayer treated the Year 2 Debentures as contingent payment debt instruments for federal income tax purposes. The debentures were publicly traded on Exchange. The terms of the Year 2 Debentures are set out in detail below.

Year 2 Debentures issued in exchange for Year 1 Debentures

The Year 2 Debentures replaced Taxpayer's d and e percent exchangeable debentures previously issued in Year 1 (the "Year 1 Debentures"). The Year 1 Debentures also had a g year term and were exchangeable at any time for up to h shares of Taxpayer's X Stock. The issue price of the debentures was f percent greater than the market value of the stock. The d percent debentures were exchangeable at any time by a holder for an exchange rate of approximately i shares per $ principal amount, thus a holder would exercise its exchange right if the stock was trading at $j per share or more. The e percent debentures had an exchange rate of k shares per $, thus a holder would exercise if the stock was trading at $m per share or more. Subsequently, on Date 7, there was a stock split of the X Stock, so the total number of referenced shares doubled to approximately n. The exchange rate for the d and e percent debentures increased to about o and p per $, or about $q and $r per share, respectively.

Approximately s years before the maturity of the Year 1 Debentures and before holders exercised their exchange rights, Taxpayer issued the Year 2 Debentures in exchange for a portion of the outstanding Year 1 Debentures. Immediately prior to this exchange, the stock was trading for $t per share, an amount significantly greater than the exchange rate for the Year 1 Debentures (but less than the exchange rate for the Year 2 Debentures, discussed below).

The d and e percent Year 1 Debentures were exchanged for a and b percent Year 2 Debentures, respectively. The a percent debentures with a principal amount of $u were issued in exchange for $v of the original principal amount of the d percent debentures. The b percent debentures with a principal amount of $w were issued in exchange for $v of the original principal amount of the e percent debentures. The principal amount of the Year 2 Debentures that were exchanged for the Year 1 Debentures was z percent of the average X Stock price at this time multiplied by the number of shares that would otherwise have been exchangeable for the Year 1 Debentures tendered by holders pursuant to the exchange.

Taxpayer called for redemption of the Year 1 Debentures that were not exchanged for Year 2 Debentures. Because the stock was worth more than the original principal amount of the Year 1 Debentures, the holders exercised their exchange rights and received stock in exchange for their debentures, or in some instances, Taxpayer sold the reference stock and delivered cash to these holders.

As discussed below, Taxpayer retained the shares not used to retire the Year 1 Debentures and used them to reference the Year 2 Debentures. Since the Year 2 Debentures referenced approximately f percent fewer (about ss) shares than the Year 1 Debentures that they retired, Taxpayer sold the excess shares for $aa and used the proceeds to retire other long term debt. While Taxpayer might have issued straight debt instead of other exchangeable debentures, the Year 2 Debentures permitted Taxpayer to pay a lower interest rate because of the exchange feature: holders gave up some interest in order to have an opportunity to share in appreciation of the X Stock.

Terms of the Year 2 Debentures

The a percent and b percent Year 2 Debentures were exchangeable upon demand by a holder for bb and cc shares, respectively, for a total of approximately dd shares of X Stock. Each $ of principal amount of the debentures could be exchanged for gg shares (the “Exchange Rate”), thus a holder would exercise its exchange right if the stock was trading at $hh per share or more (the “Exercise Price”). Immediately before issuance of the Year 2 Debentures, the stock was trading at $t, about f percent less than the Exercise Price. It is our understanding that the initial issue price of the Year 2 Debentures was approximately equal to nn percent of the value of the underlying stock at the time of issuance.

The Exchange Rate would be adjusted if certain events occurred that changed the number or value of the shares, such as a merger or stock split, or a payment was made that a debenture holder would be entitled to, such as payment of an extraordinary dividend or a stock dividend. Subsequently, on Date 3, there was a two-for-one stock split in the X Stock which doubled the amount of reference stock to ii shares. After the stock split, the Exchange Rate was doubled to jj shares of X Stock for each $ principal amount of debentures exchanged.

If a holder exercised its exchange right and surrendered a debenture, Taxpayer could either deliver the number of shares required under the Exchange Rate, or the cash equivalent. Holders did not have the right to demand shares. Cash would always be paid in lieu of delivering a fraction of a share. As noted below, under certain circumstances, a holder could require Taxpayer to repurchase the debentures for the greater amount of either the principal amount (with an additional payment if repurchase occurs before a certain date) of the debentures or the total Exercise Price due under the Exchange Rate.

Taxpayer could redeem the debentures at any time beginning Date 2. In order to redeem, Taxpayer was required to pay the holder an amount that equaled or exceeded the stated principal amount of the debentures, plus accrued interest. Beginning on Date

2, Taxpayer could redeem the debentures for oo percent of their principal amount at maturity (i.e. their principal amount plus a premium of mm percent). Thereafter, the premium that Taxpayer would pay to redeem the debentures declined by ee percent per year until by Date 4, the debentures could be redeemed for ff percent of their principal amount at maturity.

If a holder surrendered debentures for exchange after Taxpayer had called them for redemption, then the holder would be entitled to accrued interest at the stated rate up to the effective date of the exchange.

The indentures included an “Exchange Agreement” between Taxpayer and the Exchange Agent. Under this agreement, Taxpayer delegated its responsibilities to the holders under the Year 2 Debentures to the Exchange Agent. Taxpayer deposited a total of approximately dd shares of X Stock with the Exchange Agent in order to satisfy the potential exchange obligation if all holders were to exercise their Exchange Rights under the Year 1 Debentures (the “Exchange Property”). Taxpayer was required to deposit additional shares from time to time as necessary so that there would always be enough shares to meet the exchange obligation if the Exchange Rate increased.

Alternatively, if the exchange obligation was reduced, under certain circumstances, Taxpayer could withdraw the excess shares. However, if Taxpayer withdrew a number of shares such that the Exchange Agent could not to meet its potential exchange obligation to the holders, then a holder would have the right to require Taxpayer to repurchase some or all of its debentures for the greater amount of either the principal amount of the debentures (including any redemption premium, if applicable) or the value of the shares under the Exchange Rate. If a repurchase occurred prior to Date 2, a holder would also receive a premium equal to f percent of the amount otherwise due.

Taxpayer retained the right to most cash dividends and to vote the stock. Extraordinary dividends and other amounts, as defined in the indentures, that might be payable to holders were to be retained by the Exchange Agent and could alter the Exchange Rate, as noted above. Taxpayer was to give notice to the holders of effective dates of certain events that would impact holders of X Stock, including the declaration of a dividend, the grant of other rights with respect to X Stock .

Taxpayer covenanted to preserve the holders’ right to receive the X Stock and other property, if relevant, upon surrender of the debentures in exchange. In addition, Taxpayer agreed that it would not otherwise use the Exchange Property, including pledging for another debt or hypothecating it. If there was a tender offer for shares of X Stock, Taxpayer was required to place the proceeds of the sale of the stock with the Exchange Agent for the benefit of the holders. The Year 2 Debenture holders were treated as unsecured creditors of Taxpayer.

Characterization of the Year 2 Debentures for federal income tax purposes

Taxpayer characterized the Year 2 Debentures as contingent payment debt instruments for federal income tax purposes pursuant to § 1.1275-4(b). Under these rules, Taxpayer applied the noncontingent bond method and accrued interest on the debentures at a comparable yield of c percent and paid a current coupon of a and b percent. The holders were also required to accrue interest on the debentures at the comparable yield.

Early settlement of the Year 2 Debentures

Between Month 1 and Month 2, Year 3, prior to the maturity date of the Year 2 Debentures, the holders exercised their right to exchange the debentures for shares of X Stock. Taxpayer exercised its option to pay cash to the holders, redeeming all of the debentures for $kk in cash. All debentures were thus redeemed on or before Date 5. The redemptions occurred at different times prior to the maturity date of Date 5. At all times during the redemption period, the average stock price exceeded the Exercise Price of a debenture, after being adjusted for a stock split on Date 3.

Pursuant to § 1.163-7(c), Taxpayer deducted the repurchase premium on the exchange as interest.

In Year 3, Taxpayer paid $pp of coupon interest on the Year 2 Debentures. Taxpayer received $qq of dividends on its holdings of X Stock. Taxpayer took an $rr dividends received deduction.

Exchange

On Date 6, Taxpayer transferred ii shares of X Stock to X in exchange for the stock of a new corporation spun off by X. Taxpayer treated the transaction as a non-taxable § 368(a)(1)(D) reorganization .

LAW AND ANALYSIS

1. Taxpayer's Year 2 Debentures and its holdings of shares of X Stock constitute a straddle for purposes of § 1092(c).

A straddle consists of offsetting positions with respect to personal property. Section 1092(c)(1). Positions are offsetting if there is a substantial diminution of risk of loss from holding one position by reason of holding the other position. § 1092(c)(2)(A). Two or more positions are presumed to be offsetting if the positions are in the same personal property (whether established in such property or a contract for such property), and if the value of 1 or more of such positions ordinarily various inversely with the value of 1 or more other such positions. § 1092(c)(3)(A).

The term "personal property" means any personal property of a type which is actively traded. § 1092(d)(1). However, § 1092(d)(3)(A) provides that in general, except as provided in subparagraph (B), the term 'personal property' does not include stock. The preceding sentence shall not apply to any interest in stock. Section 1092(d)(3)(B)(i)(III) provides that the term "personal property" includes under regulations, a position with respect to substantially similar or related property (other than stock).

Because holding the X Stock substantially diminishes Taxpayer's risk of loss from issuing the Year 2 Debentures, the stock and the debentures are offsetting positions within the meaning of § 1092(c).

The remaining question is whether the Debentures are positions with respect to personal property despite the general exclusion for stock under § 1092(d)(3)(A).

a. The Year 2 Debentures constitute a "position" with respect to personal property under § 1092(d)(2).

Section 1092(d)(1) defines "personal property" as any personal property of a type which is actively traded. Although § 1092(d)(3)(A)(pre-2004 amendment) generally excludes stock from the definition of personal property, this exclusion does not apply to interests in stock. Absent this provision, the X Stock otherwise qualifies as personal property under § 1092(d)(1). (Whether the X Stock qualifies as under one of the exceptions to the general exclusion for stock under § 1092(d)(3)(B)(pre-2004 amendment) is analyzed below.) Therefore, the X Stock can be personal property for purposes of testing whether the Year 2 Debentures are a position with respect to personal property.

Section 1092(d)(2) defines "position" as an interest (including a futures or forward contract or option) in personal property. Although a debtor's obligation under a straight debt instrument generally is not personal property, in certain circumstances a debt instrument may be a position with respect to personal property and thus be part of a straddle. For instance, § 1092(d)(7) provides that an obligor's interest in a nonfunctional currency denominated debt obligation is treated as a position in the nonfunctional currency. Legislative history reveals that this provision was intended as a clarification of existing law. See H.R. (Conf.) Rep. No. 841, 99th Cong., 2d Sess., 1986-3 C.B. (Vol. 4), II-670 (1986)("a foreign currency borrowing is economically similar to a short position in the foreign currency."). Treasury regulations also recognize that a debtor's obligation under a debt instrument may be a position in a straddle. Section 1.1275-4(b)(9)(vi) provides that an issuer treats a positive adjustment as a loss with respect to a position in a straddle if the debt instrument is a position in a straddle and the contingency (or any portion of the contingency) to which the adjustment relates would be part of the straddle if entered into as a separate position. 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).

The Year 2 Debentures constitute a "position" for these purposes in the shares of X Stock because they were exchangeable at any time by a holder for an amount that referenced the price of X Stock. Thus, by their terms, the Year 2 Debentures created a direct interest, and position, in the stock. Taxpayer's borrowing under the debentures was economically the same as a short position in the stock because Taxpayer would be required to pay more money to the holders if the stock appreciated. In fact, because the stock had appreciated in value above the Exercise Price of the Exchange Right of the debentures in Year 3, Taxpayer was required to pay the value of the stock to the holders, not merely the principal amount of the debt.

In light of the foregoing, the Year 2 Debentures qualify as a "position" under § 1092(d)(2).

b. The Year 2 Debentures are "a position with respect to such stock or substantially similar or related property" with respect to X Stock held by Taxpayer under § 1092(d)(3)(B)(i)(III) (pre-2004 amendment) .

Section 1092(d)(3)(A)(pre-2004 amendment) provides that in general, except as provided in subparagraph (B), the term 'personal property' does not include stock. Section 1092(d)(3)(B) provides exceptions to this general rule. When the Year 2 Debentures were issued, § 1092(d)(3)(B)(i)(III) provided an exception to § 1092(d)(3)(A) 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. 1, provides that under § 1092(d)(3)(B), personal property includes any stock that is part of a straddle, at least one of the offsetting positions of which is a position with respect to substantially similar or related property (other than stock). For purposes of this rule, the term substantially similar or related property is defined in § 1.246-5 (other than § 1.246-5(b)(3)).

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 of factors such as (but not limited to) interest rates, commodity prices, or foreign currency exchanges 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 in the fair market value of the property, or a multiple of the fair market value of the property.

In order for the Year 2 Debentures to qualify as positions with respect to substantially similar or related property with respect to the X Stock, (1) the fair market value of the debentures and the X Stock must "primarily reflect" the performance of the same enterprise and (2) the changes in the fair market value of the stock must have been "reasonably expected to approximate" changes in the value of the debentures. 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).

a. "Primarily reflects" test under § 1.246-5(b)(1)(i).

Under the facts of this case, the fair market value of the X Stock and the Year 2 Debentures both reflect the performance of X corporation as required under § 1.246-5(b)(1)(i)(A). The holders had the right to exchange their Year 2 Debentures for a fixed number of shares, or their cash value and the Exchange Rate was adjusted to take into account stock splits and other events. As a result of the exchange feature, the debentures would increase in value to a holder (and become more costly to Taxpayer) as the price of the stock increased thus the value of both primarily reflected the value of the same enterprise – X – under § 1.246-5(b)(1)(i). If the X Stock did not increase in value over the term of the debentures, Taxpayer was required to repay the principal amount received. Under the facts and circumstances of the instant case, the holders clearly anticipated receiving payments that "primarily reflected" the value of the X stock otherwise holders would not have purchased debentures paying a current coupon that was significantly less than the comparable yield, the rate at which the holders were to accrue and include for tax purposes. § 1.1275-4(b). Holders were primarily looking to the value of the stock in order to profit on the debentures and were willing to accept a lower coupon in the hopes of doing so.

That the value of the debentures would primarily reflect the value of X is also demonstrated by both party's restrictions on cashing out of the debentures at their principal amount. Taxpayer could only redeem the debentures after a ll year period and would be required to pay initially a premium of mm percent that tapered off as the debentures approached maturity. Once Taxpayer's redemption rights kicked in, Taxpayer was effectively still required to pay the greater of the principal amount of the debentures (as adjusted) or the fair market value of the stock. Other than a limited right to require the issuer to repurchase the debentures, prior to maturity, a holder could only exchange the debenture for the fair market value of the stock. Holders also had the right to certain extraordinary dividends that were payable on the stock.

Thus, the both the fair market value of the stock and the debentures primarily reflect the performance of X.

b. "Reasonably expected to approximate" test under § 1.246-5(b)(1)(ii).

Next, it is clear that the changes in the fair market value of the X Stock were reasonably expected to approximate changes in value of the Year 2 Debentures as required under § 1.246-5(b)(1)(ii). As the stock increased in value above the Exercise Price under the

Exchange Rate, a holder surrendering a debenture for stock would receive stock (or cash value) in excess of the principal amount. Under the facts and circumstances of the instant case, the trading value of the X Stock was reasonably expected to rise above the Exchange Rate over the term of the debentures, such that changes in the value of the stock would approximate changes in value of the Debentures. Specifically, in light of the long term of the debentures, the volatility of the stock referenced, and the degree of difference between the Exchange Rate and the trading value at issuance, the Debentures were expected to payout an amount determined almost entirely by stock value, the same as the Year 1 Debentures. In fact, the exchange feature became highly valuable at the time Taxpayer redeemed the debentures in Year 3, requiring Taxpayer to pay a significant premium to holders over the original principal amount of the debentures.

In addition, Taxpayer's own tax reporting indicate that changes in the value of the Year 2 Debentures were expected to approximate changes in the value of the X Stock. Under § 1.1275-4(b)(3)(i), Taxpayer was required to determine the comparable yield for the Year 2 Debentures. The comparable yield is the yield at which an issuer would issue a fixed rate debt instrument with terms and conditions similar to those of the contingent payment debt instrument. § 1.1275-4(b)(4)(i). Here, Taxpayer selected a comparable yield of c percent, which presumably is the yield at which Taxpayer would have issued a fixed rate debt instrument. Next, under § 1.1275-4(b)(3)(ii), Taxpayer was required to determine the projected payment schedule of the debentures. The projected payment schedule for a debt instrument includes each noncontingent payment and an amount for each contingent payment. § 1.1275-4(b)(4)(ii). If a contingent payment is based on market information, the amount of the projected payment is the forward price of the contingent payment, which 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. § 1.1275-4(b)(4)(ii)(A). Taxpayer's projected payment schedule included noncontingent payments of interest at the stated rates of a and b percent, and the principal amount of the debentures, and any extraordinary dividends.

As a result, Taxpayer's schedule necessarily would have included a contingent payment at maturity determined based on the value of the X Stock, thus a market-based payment. Thus, based on Taxpayers own calculations, the stock was expected to appreciate over the term of the Debentures such that changes in the fair market value of the X Stock would approximate changes in the fair market value of the Debentures.

Finally, as discussed above, Taxpayer's projections appear to be consistent with market expectations at the time the debentures 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 that 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 who invested in the Year 2 Debentures agreed to both forego the amounts that they would have received under the Year 1 Debentures, in exchange for the Year 2

Debentures, and agreed to forego a higher cash payment throughout the term in exchange for the opportunity to share in future appreciation on the X Stock.

Because the value of the Year 2 Debentures primarily reflects the value of and approximates changes in the value of the X Stock under § 1.246-5(b)(1), thus the Year 2 Debentures are a position with respect to substantially similar or related property (other than stock) for purposes of § 1092(d)(3)(B)(i)(III) and § 1.1092(b)-2(a).

STRADDLE CONCLUSION

Accordingly, under § 1092(d)(3)(B), the stock is personal property for all purposes of § 1092. Because ownership of the X Stock and the Year 2 Debentures are offsetting positions with respect to personal property, the X Stock and the Year 2 Debentures constitute a straddle within the meaning of § 1092(c)(1).

2. Taxpayer's repurchase premium and the interest coupon allocable to the Year 2 Debentures constitute interest or carrying charges "incurred or continued to purchase or carry" the X Stock for purposes of § 263(g)(2)(A).

Next, it must be determined whether the repurchase premium and coupon interest deducted by Taxpayer in Year 3 should have instead been capitalized into the basis of the X Stock pursuant to § 263(g).

Section 1092(g) cross references § 263(g) as a provision requiring capitalization of certain interest and carrying charges where there is a straddle. 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).

We first look at whether the repurchase premium qualifies as "interest on indebtedness" under § 263(g)(2)(A)(i) for these purposes and second, whether interest on the Year 2 Debentures qualifies as being "incurred or continued to purchase or carry the personal property" in the straddle under the same provision.

(1) Repurchase premium.

As a threshold matter, we must consider whether Taxpayer's repurchase premium qualifies as "interest on indebtedness" for purposes of § 263(g). During the tax year at issue (Year 3), and prior to the maturity date of the Year 2 Debentures, Taxpayer exercised its option to redeem the debentures for their cash value and paid the holders $kk in cash. At this time, the debentures had an adjusted issue price that was less than the redemption amount.

Taxpayer's redemption of the Year 2 Debentures for cash prior to their maturity dates was an unscheduled retirement of the debentures. Section 1.1275-4(b)(7)(v) provides that an unscheduled retirement of a debt instrument subject to the noncontingent bond method (or the receipt of a pro-rata prepayment that is treated as a retirement of a portion of a debt instrument under § 1.1275-2(f)) is treated as a repurchase of the debt instrument (or a pro-rata portion of the debt instrument) by the issuer from the holder for the amount paid by the issuer to the holder. § 1.1275-4(b)(7)(ii).

Section 1.163-7(c) provides that in general if a debt instrument is repurchased by the issuer for a price in excess of its adjusted issue price (as defined in § 1.1275-1(b)), the excess (repurchase premium) is deductible as interest for the taxable year in which the repurchase occurs.

Section 1.1275-1(b)(1) provides that in general, the adjusted issue price of a debt instrument at the beginning of the first accrual period is the issue price. Thereafter, the adjusted issue price of the debt instrument is the issue price of the debt instrument – (i) increased by the amount of OID previously includible in the gross income of any holder and (ii) decreased by the amount of any payment previously made on the debt instrument other than a payment of qualified stated interest. Section 1.1275-4(b)(7)(ii) provides that the adjusted issue price of a debt instrument is equal to the debt instrument's issue price, increased by the interest previously accrued on the debt instrument under paragraph (b)(3)(iii) of this section and decreased by the amount of any noncontingent payment and the projected payment of any contingent payment previously made on the debt instrument.

Here, because Taxpayer repurchased the Year 2 Debentures for an amount in excess of their adjusted issue price, the excess is interest under § 1.163-7(c). Therefore, the repurchase premium is treated as "interest on indebtedness" for purposes of § 263(g).

(2) "Interest on indebtedness incurred or continued to purchase or carry" personal property that is part of a straddle under § 263(g)(2)(A).

Next, we must determine whether the repurchase premium and interest coupon qualify as "interest on indebtedness incurred or continued to purchase or carry the personal property" that is part of a straddle under § 263(g)(2)(A). This phrase is not defined under § 263(g). 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 do provide useful guidance as to the general meaning of the phrase. See F.D.I.C. v. Meyer, 510 U.S. 471, 476 (1994) (where a term is not defined by statute, it is typically given its ordinary and general meaning).

Rev. Proc. 72-18, 1972-1 C.B. 740, is the Service's primary published guidance on the interpretation of the phrase "incurred or continued to purchase or carry" under § 265(a)(2). In the absence of direct tracing of proceeds used to purchase tax-exempt obligations or collateralization of the obligations to incur debt, § 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. Rev. Proc. 72-18 at 741. This nexus 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, 179 Ct.Cl. 674 (Ct.Cl. 1967); Cf. Rev. Proc. 72-18 at 741.

Rev. Proc. 72-18 provides guidance for determining whether a "sufficiently direct relationship" exists between the indebtedness and the tax-exempts. For instance, "the purpose to *carry* tax-exempt obligations can be inferred where a corporation *continues* indebtedness which it could discharge, in whole or in part, by liquidating its holdings of tax-exempt obligations without withdrawing any capital which is committed to, or held in reserve for, the corporation's regular business activities." Rev. Proc. 72-18 at § 6.02 (citing Illinois Terminal Railroad Co. v. U.S., 375 F.2d 1016, 1021, 179 Ct.Cl. 674 (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 dispose of the tax-exempt obligations. See e.g. R.B. George Machinery Co. v. Commissioner, 26 B.T.A. 594 (1932) (Acquiesced C.B. XI-2, 4); Rev. Proc. 72-18 at § 6.03.

The facts and circumstances of the instant case clearly show that Taxpayer's purpose for incurring the Year 2 Debentures was to carry the X Stock, which is established by the direct relationship between the Debentures and the X Stock. As part of the issuance of the Year 2 Debentures, Taxpayer entered into various agreements that effectively operated as a collateral arrangement. Under these agreements, Taxpayer deposited with the Exchange Agent, and was required to maintain, the minimum number of shares necessary to meet the exchange obligation. Shares could be removed if the exchange obligation decreased and shares would be added if it increased. Taxpayer agreed not to place any encumbrance on the stock, such as a mortgage, lien, pledge, or create a security interest in the stock. If this minimum was not maintained, the holders could redeem the debentures for the principal amount in lieu of exchange. Thus, the arrangement effectively collateralized the obligations and, alone, establishes a sufficient nexus for purposes of § 263(g). However, there are additional connections between the Debentures and the X Stock that strengthens even more the direct relationship between the two.

The economics of the Year 2 Debentures also show a close relationship between the Debentures and the X Stock because payments on the debentures were indexed to the performance of the stock. Upon issuance, each $ principal amount of a Year 2 Debenture referenced the value of the number of shares that would have been exchangeable for the Year 1 Debentures had they not been exchanged by the holders for the Year 2 Debentures. Immediately before issuance of the Year 2 Debentures, the stock was trading at $t, about f percent less than the Exercise Price. The initial issue price of the Year 2 Debentures was approximately equal to nn percent of the value of the underlying stock. At all times prior to and at maturity of the debentures, holders could exchange their debentures for a fixed number of shares of stock (or their cash value). Holders thus received the right to the appreciation in the X Stock in exchange for agreeing to receive current coupon payments at a stated rate below the market rate while accruing interest on the debentures at the comparable yield under the noncontingent bond method. Although Taxpayer retained ordinary dividends, holders could expect to receive certain distributions, including extraordinary dividends, with respect to the stock as well notice of events that would affect their value, such as the declaration of a dividend. Therefore, both in form and in substance, the Year 2 Debentures are closely and directly tied to the X Stock.

Taxpayer's use of the proceeds does not mitigate the close connection between the X Stock and the Year 2 Debentures, but rather affirms the direct relationship between the Year 2 Debentures and the X Stock. Taxpayer applied the proceeds of the Year 2 Debentures to refinance a portion of the Year 1 Debentures and thus was able to continue to hold shares of X Stock that were referenced by the Year 2 Debentures. In addition, the issuance of the Year 2 Debentures produced more proceeds than selling the stock outright because the initial value of the referenced X Stock was somewhat less than principal amount of the debentures. If the holders of the Year 1 Debentures had received shares, Taxpayer would not have received new proceeds. Taxpayer received proceeds by monetizing its position in the stock, thus Taxpayer was able to continue to hold the stock that referenced the Year 2 Debentures, without withdrawing other capital.

In addition, the holders of the Year 1 Debentures that chose not to participate in the exchange offer for the Year 2 Debentures exercised their exchange rights after Taxpayer called the Year 1 Debentures for redemption. Taxpayer disposed of the shares of X Stock that had referenced the Year 1 Debentures (but were not needed for the Year 2 Debentures) by either delivering them to those holders or by selling them and paying cash to those holders. Thus, Taxpayer consistently disposed of shares of X Stock that were not required to reference either the Year 1 or Year 2 Debentures. Taxpayer chose not to hold the stock not required to be held under the Exchange Agreement.

Cases such as Handy Button and Swenson Land and Cattle Co., Inc., where the court considered the taxpayer's use of proceeds in declining to apply § 265(a)(2) are distinguishable. In both of these cases, the Service failed to establish the requisite relationship between the issuing of indebtedness and the holding of 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.

The use of the proceeds in this case is also not analogous to the use of mortgage proceeds to fund construction of a plant in 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 percent 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 $ 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.

Thus, in Wisconsin Cheeseman, as in Handy Button and Swenson, there was no relationship established between the mortgage loan and the tax-exempts. 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 are many direct connections between the Year 2 Debentures and the X Stock due to the indexing of the debentures to the value of the stock. We are not aware of any other assets that were pledged as collateral to secure payment on the debentures.

In the instant case, the facts clearly establish a sufficiently direct relationship. In fact, the relationship between the debentures and the X 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 X Stock. While 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 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, supra, 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(a)(2)." Id. at 1022.

Moreover, the facts surrounding the issuance make clear that Taxpayer made a conscious and purposeful decision to issue the Year 2 Debentures 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 X Stock and the application of the CPDI rules to the debentures. The use of the debentures helped Taxpayer to achieve the deferral and conversion opportunities found in a typical cash-and-carry transaction. Taxpayer projected the forward price of the X 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 X Stock. Therefore, the debentures were used specifically to carry the X Stock under § 263(g).

As a result, based upon the facts and circumstances of the instant case, a sufficiently direct relationship has been established between the Year 2 Debentures and the X Stock to find that the indebtedness was incurred or continued to carry the stock.

3. The basis of the new shares acquired by Taxpayer in the non-taxable exchange for the X Stock includes the repurchase premium and the coupon interest capitalized into Taxpayer's basis in the X Stock.

Under the normal rules of § 358(a), in the case of an exchange to which § 355 applies, the basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged, (A) decreased by (i) the fair market value of any other property (except money) received by the taxpayer, (ii) the amount of any money received by the taxpayer, and (iii) the amount of loss to the taxpayer which was recognized on such exchange, and (B) increased by (i) the amount which was treated as a dividend, and (ii) the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).

Taxpayer transferred ii shares of X Stock to X in exchange for the stock of a new corporation spun off by X. Taxpayer treated the transaction as a non-taxable § 368(a)(1)(D) reorganization.

The basis in the shares of the corporation acquired by Taxpayer in the exchange for the X Stock is equal to Taxpayer's basis in the X Stock. Thus, the basis of the corporation is increased for the repurchase premium and the coupon interest allocable to the Year 2 Debentures that is capitalized into the basis of the X Stock.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. Please call if you have any further questions.