IRS concludes equity-linked debt creates straddle, requires capitalization

In CCA 201310027, the IRS has concluded that contingent debt instruments a corporation issued referencing portfolio shares held by the corporation are part of a straddle under Section 1092. As a result, the Service determined that interest expense on the instruments must be capitalized under Section 263(g)(1), and that the basis of new shares acquired in a non-taxable exchange includes repurchase premium and interest capitalized into the basis of shares transferred.

Facts

Taxpayer issued two classes of PHONES-like unsecured debt (the Debentures) that were exchangeable for X Stock held by Taxpayer that was previously acquired in an unrelated transaction. The Debentures were publicly traded and treated as contingent payment debt instruments (CPDIs) for federal income tax purposes. The Debentures replaced other exchangeable Debentures previously issued (Old Debentures) by the Taxpayer, which were retired.

The Debentures could be put by the holder for a set number of X Stock shares or the equivalent amount of cash, at the discretion of Taxpayer. The stock exchange rate for the Debentures was to be adjusted if certain events occurred, such as a merger or stock split. Such a stock split did occur while the Debentures were outstanding and the exchange rate was adjusted accordingly. Taxpayer retained the right to most cash dividends and to vote the X Stock. Under the Debentures, the Taxpayer was required to maintain a deposit of shares of X Stock with an “exchange agent” sufficient to meet the exchange obligation. Additionally, the Taxpayer could not otherwise use the X Stock, including pledging it for another debt or hypothecating it.
Prior to the maturity date of the Debentures, the holders exercised their right to exchange the Debentures and Taxpayer opted to pay them cash. At all times during the redemption period, the average stock price exceeded the exercise price of a Debenture. Taxpayer deducted the repurchase premium as interest. At a later time, Taxpayer exchanged the X Stock for stock of a new corporation spun off by X and treated the transaction as a non-taxable Section 368(a)(1)(D) reorganization.

Law and analysis

Section 1092(c)(1), in general, defines a straddle for tax purposes as “offsetting positions with respect to personal property.” Section 1092(c)(2)(A) considers positions offsetting if there is substantial diminution of the taxpayer’s risk of loss from holding one position by reason of holding the other position. Section 1092(d)(1) defines “personal property” as any personal property of a type that is actively traded. Section 1092(d)(2) then defines a “position” as an interest (including a futures or forward contract or option) in personal property.

Subject to exceptions listed in former Section 1092(d)(3)(B) (the American Jobs Creation Act of 2004 substantially eliminated the former stock exception to the straddle rules), former Section1092(d)(3)(A) set forth a general rule excluding stock from the definition of personal property. Former Section 1092(d)(3)(A) provided, however, that this general exclusion did not apply to an “interest in” stock. Section 1092(d)(3)(B) provided three other exceptions to the general rule excluding stock, including, under regulations, a “position with respect to substantially similar or related property (other than stock)” (SSRP). Treas. Reg. Section 1.1092(d)-2(a) defines SSRP by reference to Treas. Reg. Section 1.246-5, which uses a facts-and-circumstances approach.

The Service determined that the X Stock and the Debentures are offsetting positions under Section 1092(c) because the Taxpayer’s risk of loss from the Debentures (i.e., the possibility that it will be required to redeem them at a high price) is substantially diminished by holding the X Stock. The underlying issue of the CCA is essentially whether the Debentures, as a liability, can constitute a “position,” i.e., an interest in personal property. While acknowledging that a debtor’s obligation under a straight debt instrument is generally not personal property, the Service concluded that the Debentures constitute a “position” because they were exchangeable at any time by a holder for an amount that referenced the X Stock price and thus were economically equivalent for the Taxpayer to a short position in the stock. In support of this position, the Service cited Treas. Reg. Section 1.1275-6, which recognizes that a borrower’s debt may constitute a position in a straddle, and Section 1092(d)(7), which provides that a nonfunctional currency denominated debt obligation is treated as a position in the nonfunctional currency.

Next, the Service concluded that the X Stock is SSRP to the Debentures because (1) the exchange rate on the X Stock fluctuated and that the fair market value of the stock and the Debentures primarily reflect the performance of X, and (2) the changes in the fair market value of the X Stock were reasonably expected to approximate changes in value of the Debentures. Accordingly, the Service ruled that the stock is personal property for purposes of Section 1092 and the Taxpayer’s X Stock holdings and its issuer position in the Debentures constitute a straddle within the meaning of Section 1092(c)(1).

The Service next addressed whether payments on the Debentures constituted “interest or carrying charges incurred or continued to purchase or carry” the X Stock for purposes of Section 1092(c). Under Section 263(g)(2)(A) the phrase “interest or 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 Section 263(g)(2)(B).

While the prior TAMs addressed the coupon interest associated with the underlying debt, they did
not consider whether repurchase premium is also “interest on indebtedness” for this purpose. Here, the Taxpayer’s early redemption of the Debentures was treated as a repurchase of the debt instrument under Treas. Reg. Section 1.1275-4(b)(7)(ii). Treas. Reg. Section 1.163-7(c) provides that, in general, the repurchase of a debt instrument for a price in excess of its adjusted issue price is deductible as interest for the tax year in which the repurchase occurs. The adjusted issue price is defined in Treas. Reg. Section 1.1275-1(b) as the issue price of the instrument, increased by the amount of original issue discount previously includible in the gross income of a holder and decreased by payments on the instrument other than qualified stated interest. The Service concluded that the repurchase of the Debentures for more than their adjusted issue price is repurchase premium treated as interest under Treas. Reg. Section 1.163-7(c) and this falls within the definition of “interest on indebtedness” for purposes of Section 263(g). The Service additionally ruled, consistent with the prior TAMs, that the coupon interest is also “interest on indebtedness.”

Once the Service determined that both the repurchase premium and the coupon interest were “interest on indebtedness,” it next considered whether the interest was “incurred or continued to purchase or carry personal property that is part of a straddle.” The Service concluded that the facts and circumstances established a direct relationship between the Debentures and the X Stock, including agreements Taxpayer entered into that effectively operated as a collateral arrangement, and, significantly, the fact that holders received the right to appreciation in the X Stock in exchange for agreeing to receive current coupon interest payments at a stated rate below the market rate while accruing interest income on the Debentures at a higher comparable yield under the CPDI rules. Accordingly, based upon the facts and circumstances of this case, the Service concluded that a sufficiently direct relationship had been established between the instruments and the X Stock to find that the indebtedness was incurred or continued to carry the stock and that the interest must be capitalized. Of course, that conclusion might apply to any monetization transaction that is a straddle.

Finally, the Service ruled that the Taxpayer’s basis in new shares exchanged for the X Stock in a “D” reorganization after the retirement of the Debentures includes any repurchase premium and coupon interest previously capitalized into the X Stock.

Implications
This CCA is further evidence of a continuing effort by the Service to apply the theory of the proposed regulations under Section 263(g) to equity-linked debt before the regulations’ proposed effective date (for interest accruing after the regulations are finalized, which has not yet occurred, on debt issued on or after 17 January 2001). As stated in earlier Tax Alerts, taxpayers that have issued PHONES and similar equity-linked debt instruments should be aware of the Service’s position under Section 263(g). The effect of interest capitalization on these instruments can be harsh because it not only defers interest deductions but may convert what would otherwise be ordinary interest deductions into reduced capital gains or increased capital losses on the subsequent disposition of the referenced portfolio stock.

It should be noted, however, that the CCA has limited applicability to transactions occurring after 2004 because of the expansion of Section 163(l) as part of the American Jobs Creation Act. The revisions to Section 163(l) now disallow interest on debt obligations that are payable in (or by reference to) portfolio stock if the option to exchange is the holders’ and there is substantial certainty of the exercise of that option.
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