

**Office of Chief Counsel  
Internal Revenue Service  
Memorandum**

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date: December 23, 2014

to: , Team Manager

from:  
(Large Business & International)

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subject: exchangeable debentures  
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This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

**LEGEND**

Issuer =  
X Debenture =  
Y Debenture =  
Date 1 =  
Date 2 =  
Date 3 =  
Date 4 =  
Date 5 =  
Date 6 =  
Date 7 =  
Date 8 =  
Date 9 =  
Date 10 =  
Date 11 =  
A Corp. =  
B Corp. =

C Corp. =  
Amount 1 =  
Amount 2 =  
Amount 3 =  
Amount 4 =  
Amount 5 =  
Amount 6 =  
Amount 7 =  
Amount 8 =  
Amount 9 =  
Amount 10 =  
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Amount 17 =  
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s =  
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Year 1 =

ISSUES

- (i) Whether the Issuer created a straddle by issuing the debentures and holding the corresponding reference shares; and
- (ii) Whether the Issuer may deduct interest attributable to the debentures.

CONCLUSIONS

- (i) The Issuer created a straddle by issuing the debentures and holding the corresponding reference shares; and
- (ii) The Issuer must capitalize interest attributable to the debentures.

FACTS

All issues discussed herein apply to the tax treatment for Year 1.

**The X Debentures**

On Date 1, the Issuer privately placed Amount 1 of aggregate original principal amount exchangeable senior debentures ("X Debentures") that provide for quarterly coupon payments at an annual rate of a% and mature on Date 9. At maturity, each holder is entitled to receive a cash payment equal to the adjusted principal amount of the debenture plus accrued and unpaid interest and other distributions, subject to the holder's right to exchange the debentures, described below. The Issuer characterized the X Debentures as contingent payment debt instruments pursuant to section 1.1275-4 and determined that the comparable yield of the debentures would be b% compounded quarterly.

Each Amount 2 of original principal amount of the debentures is exchangeable for a basket of shares in specific public companies ("X Reference Shares"). On Date 1, the basket consisted of c shares of common stock of A Corp. and d shares of common stock of B Corp. At the time of issuance, a share of A Corp. common stock was trading at Amount 3 and a share of B Corp. common stock was trading at Amount 4. Thus, each Amount 2 of X Debentures initially referenced a basket of shares valued at Amount 5. The X Debentures initially were exchangeable for a total of e shares of A Corp. stock and f shares of B Corp. stock, or their cash value.

At the time that the Issuer issued the X Debentures, it owned approximately g shares of A Corp. stock and h shares of B Corp. stock. The Issuer sold i shares of B Corp. stock in the second quarter of Year 1. As of the end of Year 1 tax year, the Issuer held j shares of A Corp. and f shares of B Corp. stock. A Corp. and B Corp. stock are each traded on an SEC-regulated exchange.

Holders of the X Debentures will receive the value of cash dividends paid with respect to the reference shares as well as the cash value of in-kind distributions that are paid in securities or other property, except to the extent such in-kind distributions qualify as additional reference shares. The X Debentures' principal amounts will not be reduced by amounts paid that correspond to any regular cash dividends on the X Reference Shares but will be reduced for any extraordinary dividends. The X Debentures contain a yield adjustment provision whereby extraordinary distributions result in the reduction of the principal amount such that the annualized yield on the X Debentures does not exceed a% of the adjusted principal amount. Any reduction to the principal will not result in a reduction in quarterly interest payments (because the interest is based on the original principal), but will necessitate further reductions in the adjusted principal amount on subsequent interest payments. In no event will the adjusted principal amount be reduced below zero.

Per the Issuer's projected payment schedule, total accrued contingent interest over the life of the X Debentures is Amount 6. The projected adjusted issue price on Date 9 is Amount 7. As of the end of the Year 1 taxable year, the total interest equated to Amount 8 (Amount 9 of interest and in dividends paid in cash plus Amount 10 in accrued contingent interest). For each Amount 2 of adjusted issue price of a X Debenture at the beginning of the period, total interest accrued for the first quarter at comparable yield was Amount 11 (Amount 12 in coupon interest paid + Amount 13 in dividend pass-through + Amount 14 in contingent interest).

### **Holders' Exchange Option**

The holders of the X Debentures may, at any time, exchange the debentures. Upon exchanging a X Debenture, the holder will be entitled to receive the X Reference Shares attributable to the X Debenture or, at the Issuer's option, the cash equivalent or any combination thereof.

### **The Issuer's Redemption Option**

The Issuer may, at its option, redeem the X Debentures for an amount in cash, equal to the adjusted principal amount of the debenture plus accrued and unpaid interest and other distributions (the "X Redemption Price") in whole or in part, on or after

- (i) Date 6, if at the time the Issuer exercises its redemption, the current market price<sup>1</sup> of the X Reference Shares attributable to each Amount 2 original principal amount of the X Debentures equals or exceeds k% of the original principal amount; and
- (ii) Date 8, at which time, the Issuer will pay the redemption price.

Under the terms of the X Debentures, the holders can exchange their debentures if they are called for redemption or when the Issuer's right of redemption becomes

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<sup>1</sup> The current market price will be determined by using the following valuation period: the 15 scheduled trading day period ending on the fourth scheduled trading day preceding the purchase date.

effective. In light of the holders' right to exchange the X Debentures at any time, Issuer would effectively be required to pay the greater of the value of the X Reference Shares or the X Redemption Price.

### **Holders' Purchase Option**

The holders may tender the X Debentures for the Issuer's purchase on Date 7 for an amount equal to the adjusted principal amount of the debentures plus accrued and unpaid interest and other distributions (the "X Purchase Price"). The Issuer may elect to pay the X Purchase Price in cash, reference shares with a value equal to the purchase price, or a combination thereof. At least l days before the purchase date, the Issuer will inform the holders of its method of payment for the X Debentures.

### **The Y Debentures**

On Date 2, the Issuer privately placed Amount 15 of aggregate original principal amount exchangeable senior debentures ("Y Debentures") that provide for quarterly coupon payments at an annual rate of m% and mature on Date 11. At maturity, each holder is entitled to receive a cash payment equal to the adjusted principal amount of the debenture plus accrued and unpaid interest and other distributions, subject to the holder's right to exchange the debentures, described below. The Issuer characterized the Y Debentures as contingent payment debt instruments pursuant to section 1.1275-4 and determined that the comparable yield of the debentures would be n% compounded quarterly.

The exchange rates for these debentures are referenced to shares of common stock of C Corp. Each Amount 2 of original principal amount is exchangeable for o shares of C Corp. stock ("Y Reference Shares"). At the time of issuance, a share of C Corp. common stock was trading at Amount 16 and thus each Amount 2 of Y Debentures initially referenced shares valued at Amount 17. The debentures initially are exchangeable for a total of p Y Reference Shares or their cash value.

At the time the Issuer issued the Y Debentures, it owned approximately q shares of C Corp. common stock. The documentation attributable to the Y Debentures does not impose any legal or contractual obligation on the Issuer to continue to hold its Y Reference Shares while the Y Debentures are outstanding and, if any of the C Corp. stock is sold, the holders would not receive any additional rights as the result of such sale. The Issuer did not pledge the Y Reference Shares for the benefit of the holders.

The Issuer beneficially held approximately r% of the outstanding common stock of C Corp. as of Date 2, and two members of C Corp's nine-member board of directors are the Issuer's nominees. Accordingly, the Issuer is deemed an affiliate of C Corp.

under the Securities Act of 1933, as amended.<sup>2</sup> C Corp. stock is publicly traded on an SEC-regulated exchange.

Holders of the Y Debentures will receive the value of regular cash dividends paid with respect to the reference shares in excess of Amount 18 per share as well as the cash amount of extraordinary dividends, including the cash value of in-kind distributions that are paid in securities or other property, except to the extent such in-kind distributions qualify as additional reference shares. The Y Debentures' principal amounts will not be reduced by amounts paid that correspond to any regular cash dividends on the Y Reference Shares but will be reduced for any extraordinary dividends. The Y Debentures contain a yield adjustment provision whereby extraordinary distributions result in the reduction of the principal amount such that the annualized yield on the Y Debentures does not exceed m% of the adjusted principal amount. Any reduction to the principal will not result in a reduction in quarterly interest payments (because the interest is based on the original principal), but will necessitate further reductions in the adjusted principal amount on subsequent interest payments. In no event will the adjusted principal amount be reduced below zero.

Per the Issuer's projected payment schedule, total interest over the life of the Y Debentures is Amount 19. Total contingent interest accrued is Amount 20. The projected adjusted issue price on Date 2 is Amount 21. As of the end of the Year 1 taxable year, the total interest equated to Amount 22 (Amount 23 of coupon interest, Amount 24 in dividends, and Amount 25 in accrued contingent interest).

### **Holders' Exchange Option**

The Y Debentures are exchangeable at the option of the holder during certain periods under certain circumstances. The debentures are exchangeable:

- (1) During any calendar quarter after the calendar quarter ending on Date 3, if the closing price of the reference shares for 20 out of 30 days ending on the last trading day of the quarter multiplied by the number of reference shares exceeds s% of the adjusted principal amount of the debenture;
- (2) From and after Date 3, during the 5-day period following a 5-day period in which the trading price per debenture for each day was less than t% of the closing price of the shares each day multiplied by the number of reference shares;
- (3) If they are called for redemption;
- (4) Between Date 4 and the second trading day preceding Date 5; and
- (5) On or after Date 10, up to the second trading day preceding the maturity date.

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<sup>2</sup> "The term 'affiliate of the issuer' means a person that directly or indirectly, through one or more intermediaries, controls or is controlled by or is under common control with, the issuer." Securities Act of 1933, Pub. L. No. 73-22, § 16(f)(1), codified as amended at 15 U.S.C. § 77a et seq.

Upon exchanging a Y Debenture, the holder will be entitled to receive the Y Reference Shares attributable to the Y Debenture or, at the Issuer's option, the cash equivalent or any combination thereof.

**The Issuer's Redemption Option**

The Issuer may, at its option, redeem the Y Debentures, in whole or in part, on or after Date 5, for an amount in cash, equal to the adjusted principal amount of the debenture plus accrued and unpaid interest and other distributions (the "Y Redemption Price").

Under the terms of the Y Debentures, the holders can exchange their debentures if they are called for redemption or when the Issuer's right of redemption becomes effective. In light of the holders' right to exchange the Y Debentures when called for redemption, Issuer would effectively be required to pay upon redemption the greater of the value of the Y Reference Shares or the Y Redemption Price.

**Holder's Purchase Option**

The holders may tender the Y Debentures for the Issuer's purchase on Date 5, for an amount equal to the adjusted principal amount of the debentures plus accrued and unpaid interest and other distributions (the "Y Purchase Price"). The Issuer may elect to pay the Y Purchase Price in cash, reference shares with a value equal to the Y Purchase Price, or a combination thereof.

LAW AND ANALYSIS

(i) **The Issuer created a straddle by issuing the X and Y Debentures and holding the X and Y Reference Shares.**

A "straddle" consists of offsetting positions with respect to personal property. I.R.C. § 1092(c)(1).

A taxpayer holds offsetting positions with respect to personal property if there is a substantial diminution of risk of loss from holding any position with respect to personal property by reason of holding one or more other positions with respect to personal property (whether or not of the same kind). I.R.C. § 1092(c)(2)(A). The term "personal property" means any personal property of a type which is actively traded. I.R.C. § 1092(d)(1). In the case of stock, whether the term "personal property" includes such stock is determined under section 1092(d)(3). Section 1092(d)(3)(1)(A)(i) provides that for purposes of paragraph (d)(1), 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.

**Offsetting Positions**

The term “position” means an interest (including a futures or forward contract or option) in personal property. I.R.C. § 1092(d)(2). Under Treas. Reg. section 1.1092(d)-1(d), if a taxpayer is the obligor under a debt instrument one or more payments on which are linked to the value of personal property or a position with respect to personal property, then the taxpayer’s obligation under the debt instrument is a position with respect to personal property and may be part of a straddle. Section 1.1092(d)-1(d) applies to straddles established on or after January 17, 2001.

Two or more positions are presumed to be offsetting if: (1) the positions are in the same personal property; (2) the positions are in the same personal property, even though such property may be in a substantially altered form; or (3) the positions are in debt instruments of a similar maturity or other debt instruments described in the Regulations prescribed by the Secretary. I.R.C. § 1092(c)(3)(A). Specifically, under section 1092(c)(3)(A)(i), 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), but only if the value of one or more of such positions ordinarily varies inversely with the value of one or more other such positions. Taxpayers may present evidence to rebut the presumption. I.R.C. § 1092(c)(3)(B).

Based on the above facts, the debentures qualify as positions in the reference shares for purposes of section 1092(d)(2) and, as discussed further below, the shares qualify as personal property under section 1092(d)(3). For purposes of section 1092(d)(2), both the X Debentures and the Y Debentures constitute “positions” in their corresponding reference shares because, as required under section 1.1092(d)-1(d), one or more payments on the debentures are linked to the value of the reference shares through the exchange feature of the debentures. Here, the Issuer issued debentures exchangeable for shares previously acquired by the Issuer. The debentures are exchangeable during certain periods, some of which depend on the trading price of the reference shares. If a holder exercises its exchange right and surrenders a debenture, the Issuer must deliver either the number of reference shares or the cash equivalent; the holders cannot demand the shares. Additionally, upon redemption, the Issuer is required to pay to the holders an amount equal to the greater of the value of the reference shares or the adjusted principal amount of the debenture plus accrued but unpaid interest and other distributions.

Furthermore, under these facts, Issuer’s obligations under the debentures ordinarily will vary inversely with the value of the corresponding reference shares. As a result of the exchange features, as the value of the reference shares increase, the debentures increase in value to the holders, and conversely become more costly to the Issuer. Although the debentures were issued when the trading price of reference shares was less than the Amount 2 face amount of the debentures, the Issuer’s position in the debentures would ordinarily vary inversely with the value of Issuer’s corresponding reference shares.

Therefore, the X Reference Shares and X Debentures are presumed to be offsetting because they are positions in the same property and the value of such

positions ordinarily vary inversely. I.R.C. § 1092(c)(3)(i). Likewise, the Y Reference Shares and Y Debentures are presumed to be offsetting because they are positions in the same property and the value of such positions ordinarily vary inversely. Id.

### **Personal Property**

Section 1092(d)(3)(A)(i) provides that for purposes of paragraph (d)(1), 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 one of the positions offsetting such stock is a position with respect to such stock or substantially similar or related property. The X and Y Reference Shares are actively traded property on SEC-regulated exchanges. Thus, the stock is of a type which is actively traded.

In addition, as discussed above, the debentures qualify under section 1092(d)(3)(A)(i) because the Issuer’s debentures constitute a position in the corresponding reference shares under Treas. Reg. § 1.1092(d)-1(d). As a result, the offsetting position is a position with respect to actively traded stock and therefore the stock qualifies as “personal property” for purposes of section 1092.

Thus, because (i) A Corp., B Corp. and C Corp. stock is actively traded, (ii) the X and Y Debentures and their corresponding reference shares are offsetting; and (iii) satisfy the special rules for stock under section 1092(d)(3), the X and Y Debentures, and their corresponding reference shares represent offsetting positions with respect to personal property under section 1092(c).

(ii) **The Issuer may not deduct interest attributable to the X and Y Debentures.**

There shall be allowed a deduction for all interest paid or accrued within the taxable year on indebtedness. I.R.C. § 163(a). However, no deduction is allowed for interest and carrying charges properly allocable to personal property which is part of a straddle (as defined in section 1092(c)). Instead, any amount not allowed as a deduction is chargeable to the capital account with respect to the personal property to which such amount relates. I.R.C. § 263(g)(1).

“Interest and carrying charges” is the difference between (1) the interest on the indebtedness incurred or continued to purchase or carry the personal property *plus* all other amounts paid or incurred (*e.g.*, insurance, storage, transportation costs) to carry the personal property; and (2) the sum of (i) the amount of interest includible in gross income with respect to the property, (ii) any amount treated as ordinary income related to OID, market discount, and short-term indebtedness, (iii) dividends received less any applicable dividends received deduction, and (iv) any amount which is a payment with respect to a security loan (within the meaning of I.R.C. § 512(a)(5)). I.R.C. § 263(g)(2).

Section 263(g) does not define “indebtedness incurred or continued to purchase or carry the personal property” that is part of a straddle, but the same phrase appears in

section 265(a)(2), which disallows a deduction for interest on indebtedness “incurred or continued to purchase or carry” tax exempt obligations. In the absence of direct tracing of debt proceeds used to purchase or carry tax-exempt obligations, a determination will be made, based on the all 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, 1972-1 C.B. 440.

The economics of the debentures reveal close relationships between the debentures and the corresponding reference shares because payments on the debentures are indexed to the performance of the corresponding reference shares as well as dividends payable on those shares. When the debentures are redeemed, or at maturity, the holders are entitled to receive the greater of an amount determined by the price of the reference shares or the adjusted issue price of the debentures plus accrued interest, due to the holders’ right to exchange the debentures for the reference shares. The holders are entitled to all regular dividends on the X Reference Shares and all regular dividends in excess of Amount 18 per share on the Y Reference Shares. The holders are also entitled to extraordinary dividends on all reference shares, subject to the reduction in the principal amount of the debentures due to the receipt of such extraordinary dividends. Holders of the debentures have agreed to receive interest payments well below the market rate in exchange for the opportunity to share in the appreciation in the value of the reference shares.

Based on the foregoing facts, a sufficiently direct relationship has been established between the debentures and the reference shares to determine that the debentures were incurred or continued to carry the reference shares. Thus, interest and carrying charges properly allocable to the X and Y Debentures are chargeable to the capital account with respect to the personal property to which such amounts relate.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

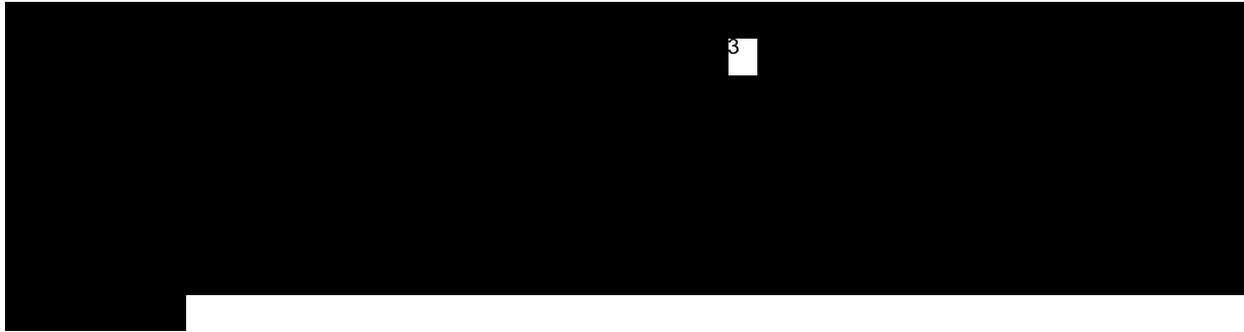
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