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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

November 16, 1998

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's EIN:

Tax Years:
Date of Conference

LEGEND

Corporation A =
Corporation B =
Corporation C =
LLC =

Preferred Securities =

Group 1 =
Group 2 =
Group 3 =

Country R =
Country S =

State P =
State Q =

Year 1 =
Year 2 =
Year 3 =

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	=
Date 14	=
Date 15	=
Date 16	=
Date 17	=
$G	=
$H	=
$J	=
$K	=
FX1	=
FX2	=
FX3	=
FX4	=
FX5	=
M%	=
N%	=
P%	=
Q%	=
R%	=
S%	=
AA	=
BB	=
CC	=
DD	=
EE	=
FF	=
GG	=
HH	=
Xth	=
Yth	=

J years	=
K years	=
L years	=
M years	=
P years	=
Q years	=
Stock Exchange L	=
Regulation X	=
Year 2 Prospectus	=
Year 3 Prospectus	=
Year 4 Prospectus	=

ISSUES

(1) Whether the "loans" made to Corporation A by LLC constitute debt or equity for federal income tax purposes when the funds for the "loans" were obtained by LLC through the issuance of preferred securities to the public?

(2) Whether the preferred securities constitute debt or equity for federal income tax purposes if the securities were treated as issued directly to the public by Corporation A?

(3) Whether the transactions that involve the issuance of the preferred securities and the subsequent lending of the proceeds to Corporation A lack economic substance?

CONCLUSIONS

(1) Based on the facts provided, the "loans" constitute debt for federal income tax purposes.

(2) If the preferred securities were treated as issued directly to the public by Corporation A, based on the facts provided, the securities would constitute debt for federal income tax purposes.

(3) Based on the facts provided, the transactions involving the issuance of the preferred securities and the subsequent "loans" to Corporation A have economic substance.

FACTS

In Year 2, Corporation A[1] formed LLC, a limited life company organized under the laws of Country R. The sole purpose of LLC was to issue shares and lend the net proceeds to Corporation A. Upon its formation, LLC had AA outstanding shares of common stock; BB shares were owned by Corporation A and CC shares were owned by Corporation C, a wholly owned subsidiary of Corporation A. Corporation A made a capital contribution of approximately $H to LLC upon its formation. Corporation A, as manager, conducts all of the business and affairs of LLC.

(A) Year 2 Transaction--Group 1 Preferred Securities

On Date 2, LLC issued DD shares of M% Preferred Securities ("Group 1 Preferred Securities") for a purchase price of $25 per share.[2] The proceeds from the issuance of the Group 1 Preferred Securities ($G) were loaned by LLC to Corporation A, pursuant to a promissory note dated Date 2.[3] The loan proceeds were used by Corporation A for general corporate purposes, including the repayment of outstanding indebtedness.

The following is a description of the Group 1 Preferred Securities, the loan agreement between Corporation A and LLC relating to the Group 1 Preferred Securities, and the payment and guarantee agreement for the benefit of the Group 1 Preferred Securities holders.

Group 1 Preferred Securities

The holders of the Group 1 Preferred Securities are entitled to receive cumulative cash dividends at the annual rate of M% of the stated liquidation preference of $25 per share per annum. The dividends are payable in U.S. dollars monthly in arrears on the last day of each calendar month of each year, commencing Date 3. The dividends accrue and are cumulative whether or not they have been

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[1] Corporation A was incorporated in State P on Date 1 as Corporation B. It is the successor of a company incorporated in State Q in Year 1.

[2] The Group 1 Preferred Securities are listed on the New York Stock Exchange.

[3] On Date 2, LLC also loaned to Corporation A the proceeds from the issuance of the common stock and capital contribution (approximately $H). This memorandum does not address the federal income tax treatment of this "loan".

declared and whether or not there are profits, surplus or other funds of LLC legally available for the payment of dividends. Dividends on the Group 1 Preferred Securities are cumulative from the date of original issue (Date 2).

Corporation A, as manager, must declare dividends on the Group 1 Preferred Securities in any calendar year to the extent that Corporation A reasonably anticipates that LLC will have earnings legally available for the payment of dividends and cash on hand sufficient to permit such payments. Because Corporation A has the right to extend interest payment periods on the Year 2 Loan (described below) for up to 18 consecutive months, monthly dividend payments on the Group 1 Preferred Securities can be deferred by LLC during an extended interest payment period. Dividends in arrears will accumulate additional distributions thereon at the rate of M% per annum.

LLC will not pay any dividends on any shares of LLC ranking junior to the Group 1 Preferred Securities as to dividends, or redeem, purchase, or otherwise acquire any junior shares of LLC, until all accumulated and unpaid dividends on the Group 1 Preferred Securities have been paid in full.

The Group 1 Preferred Securities are redeemable, at the option of LLC and subject to the prior consent of Corporation A, any time on or after Date 10, at the redemption price of $25 plus accrued and unpaid dividends. The Group 1 Preferred Securities are also redeemable, at the option of LLC and subject to the prior consent of Corporation A, if LLC or Corporation A is required to pay additional amounts on the Group 1 Preferred Securities. (Additional amounts may be required to be paid if the payments to the Group 1 Preferred Securities holders are subject to withholding or other charges.)

Upon any repayment or prepayment of principal on the Year 2 Loan, the proceeds will be used to redeem the Group 1 Preferred Securities. However, the proceeds may be reloaned to Corporation A and not used for redemption, if at the time of each loan, and as determined by Corporation A, as manager, and its financial advisor, (1) Corporation A is not in bankruptcy, (2) Corporation A is not in default on any loan pertaining to the Group 1 Preferred Securities, (3) Corporation A has made timely payments on the repaid loan for the immediately preceding 18 months, (4) LLC is not in arrears on payments of dividends on the Group 1 Preferred Securities, (5) Corporation A is expected to be able to make timely payments of principal and interest on the loan, (6) the loan is made on terms, and under circumstances, that are consistent with those which a lender would require for a loan to an unrelated party, (7) the loan is made at a rate sufficient to provide payments equal to or greater

than the amount of dividend payments required on the Group 1 Preferred Securities, (8) the loan is made for a term consistent with market circumstances and Corporation A's financial condition, and (9) the final maturity of the loan is not later than the Yth anniversary of the issuance of the Group 1 Preferred Securities.

In the event of any voluntary or involuntary liquidation, dissolution or winding up of LLC, the Group 1 Preferred Securities holders will be entitled to receive out of the assets of LLC available for distribution to shareholders an amount equal to the stated liquidation preference of $25 per share plus all accumulated and unpaid dividends (whether or not declared) to the date of payment. This distribution is made before any distribution of assets to holders of common shares or any other class of shares ranking junior to the Group 1 Preferred Securities, but together with the holders of every other series of preferred or preference stock of LLC ranking pari passu with the Group 1 Preferred Securities.

If (1) LLC fails to pay dividends in full on the Group 1 Preferred Securities for 18 consecutive monthly dividend periods or (2) Corporation A breaches any of its obligations under the Year 2 Loan or under the Year 2 Guarantee Agreement (described below), then the holders of a majority in liquidation preference of the outstanding Preferred Securities will be entitled to appoint and authorize a trustee to enforce LLC's creditor rights under the loan against Corporation A, enforce the obligations undertaken by Corporation A under the Year 2 Guarantee Agreement, and declare and pay dividends on the Preferred Securities. Not later than 30 days after the right to appoint a trustee arises, the manager will convene a general meeting for the above purpose. If the manager fails to convene a meeting, the holders of 10% in liquidation preference of the outstanding Group 1 Preferred Securities and other such preferred or preference stock will be entitled to convene the meeting.

If any proposed resolution provides for, or Corporation A proposes to take any action effecting (1) any variation or abrogation of the rights, preferences and privileges of the Group 1 Preferred Securities by amending LLC's Articles of Association or otherwise (including the issuance of shares senior to the Preferred Securities), (2) the liquidation, dissolution, or winding up of LLC, or (3) the modification of Regulation X of the Articles of Association (which prohibits transfers of common stock), then the Preferred Securities holders will be entitled to vote together as a class on such resolution. No such approval is required for (1) or (2) above if the liquidation, dissolution and winding up of LLC is proposed or initiated upon the liquidation, dissolution, or winding up of Corporation A. Any Preferred Securities owned by Corporation A or any entity owned 20% or more by Corporation A, either directly or

indirectly, are not entitled to vote and are treated as if they were not outstanding (for the purposes of the vote).

Year 2 Loan Agreement

On Date 2, Corporation A and LLC entered into a loan agreement ("Year 2 Loan") under which LLC loaned Corporation A $G, the aggregate liquidation preference of the Group 1 Preferred Securities issued and sold by LLC.

The entire principal amount of the Year 2 Loan is due and payable (together with any accrued but unpaid interest including any additional interest[4]) on the earliest of Date 15, or the date upon which Corporation A is dissolved or liquidated or LLC is dissolved or liquidated. If LLC redeems the Group 1 Preferred Securities, the Year 2 Loan is due and payable in a principal amount equal to the aggregate liquidation preference of the redeemed Group 1 Preferred Securities.

Corporation A has the right to prepay the Year 2 Loan, without premium or penalty at any time after Date 10; and, in certain circumstances, at any time Corporation A is required to pay any additional interest on the Year 2 Loan.[5]

The Year 2 Loan bears interest at an annual rate of M% from the date it is made until maturity. Interest is payable in U.S. dollars on the last day of each calendar month of each year, beginning Date 3.

Corporation A has the right at any time during the term of the Year 2 Loan, as long as Corporation A is not in default in the payment of interest on the loan, to extend the interest payment period for up to 18 months. At the end of such period, Corporation A must pay all interest then accrued and unpaid. During any extended

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[4] Corporation A is required to pay additional interest if (1) LLC is required to pay any additional amount with respect to the Group 1 Preferred Securities, or (2) Corporation A is required to withhold or deduct any amounts from the interest payments made to LLC. The amount of the additional interest is the amount needed by LLC to pay the Group 1 Preferred Securities holders the full amount of the stated dividends.

[5] Corporation A does not have the right to prepay the Year 2 Loan, or a portion thereof, based on a technical obligation to pay additional interest in the absence of any actual liability for withholding taxes, duties, assessments or government charges.

interest payment period, or at any time during which there is an event of uncured default under the loan, Corporation A will not pay any dividends on any of its shares of equity stock. Corporation A must notify LLC of the extended interest payment period and LLC must notify the Group 1 Preferred Securities holders of the deferral.

The Year 2 Loan is subordinate and junior in right of payment to all Senior Indebtedness. The term "Senior Indebtedness" means the principal, premium, if any, and interest on (1) all indebtedness of Corporation A, whether outstanding or subsequently created, incurred or assumed, which is for money borrowed, or evidenced by a note or similar instrument given in connection with the acquisition of any business, properties or assets, including securities, (2) any indebtedness of others of the kinds described above if Corporation A is responsible or liable for payment as guarantor or otherwise, and (3) renewals, amendments, extensions and refundings of any such indebtedness, unless it is expressly provided that the indebtedness is not superior in right of payment to the Year 2 Loan.[6]

If (1) Corporation A defaults in the payment of any principal, or premium, if any, or interest on any Senior Indebtedness when it becomes due and payable or (2) an event of default occurs with respect to any Senior Indebtedness, then until the default has been cured or waived, no direct or indirect payment will be made on the Year 2 Loan.

Corporation A's obligations under the loan agreement are also for the benefit of the Group 1 Preferred Securities holders, and the holders are entitled to enforce the agreement directly against Corporation A.

Under the terms of the loan agreement, any of the following constitute an Event of Default: (1) default in the payment of interest on the Year 2 Loan, including any additional interest (a valid extension of the interest payment period is not a default); (2) default in the payment of the principal on the Year 2 Loan when due;

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[6] Corporation A represents that the term "Senior Indebtedness" was not intended to include debt to unsecured general creditors, such as debt to trade creditors. Corporation A intended the term to have the meaning as it is generally understood in the financial community--indebtedness for borrowed money or indebtedness evidenced by a promissory note or bond. Furthermore, Corporation A used the term "liabilities" when it intended to include all debt obligations, including debt to unsecured general creditors. Corporation A also represents that the Year 2 Loan ranks pari passu with the general creditors of Corporation A, including trade creditors.

(3) the dissolution, winding up or liquidation of LLC; (4) the bankruptcy, insolvency, or liquidation of Corporation A; and (5) breach of any covenants. If an Event of Default occurs, then LLC will have the right to declare the principal and the interest on the Year 2 Loan and all other amounts payable on the Year 2 Loan to be due and payable. The Group 1 Preferred Securities holders will have the right to appoint a trustee to exercise LLC's creditor rights under the loan agreement, and Corporation A agrees to cooperate with the trustee.

In the loan agreement, Corporation A agreed (1) to use the proceeds of the loan for working capital, for retirement of debt and for other general corporate purposes, (2) to maintain direct or indirect 100% ownership of the common stock of LLC, (3) not to voluntarily dissolve, wind-up or liquidate LLC so long as any Preferred Securities are outstanding, and (4) to timely perform all of its duties as manager of LLC.

The loan agreement may be amended by mutual consent of the parties; provided that no such amendment will adversely affect the Group 1 Preferred Securities holders unless the holders of 66 2/3% of the outstanding Group 1 Preferred Securities agree to the amendment.

Year 2 Payment and Guarantee Agreement

Under the Year 2 Payment and Guarantee Agreement ("Year 2 Guarantee Agreement"), Corporation A irrevocably and unconditionally agreed to pay the Group 1 Preferred Securities holders the guarantee payments and to make certain other payments.

Guarantee payments are the following payments, without duplication, to the extent not paid by LLC: (1) any accumulated and unpaid dividends that have been declared on the Group 1 Preferred Securities out of moneys legally available for dividends; (2) the redemption price of the Group 1 Preferred Securities called for redemption by LLC as an optional redemption or otherwise out of funds available to LLC; (3) upon a liquidation of LLC, the lesser of (a) the liquidation distribution and (b) the amount of assets of LLC available for distribution to Group 1 Preferred Securities holders in liquidation of LLC; and (4) any additional amounts payable by LLC on the Group 1 Preferred Securities.

Corporation A irrevocably and unconditionally agrees to pay in full to the Group 1 Preferred Securities holders the guarantee payments, as and when due (except to the extent paid by LLC), regardless of any defense, right of set-off or counterclaim that LLC may have or assert. Corporation A's obligation to make a guarantee payment may be satisfied by direct payment by Corporation A to the

Group 1 Preferred Securities holders or by causing LLC to pay such amounts to the holders.

The guarantee is a guarantee of payment and not of collection. A holder may enforce the guarantee directly against Corporation A. The agreement is not discharged except by payment of the guarantee payments in full (to the extent not paid by LLC) and by complete performance of all obligations of Corporation A.

Corporation A's obligations under the agreement are independent of LLC's obligations with respect to the Group 1 Preferred Securities. In addition, Corporation A is liable as principal and sole debtor to make the guarantee payments.

If Corporation A fails to comply with its obligations under the Year 2 Guarantee Agreement and redeems or purchases any shares which rank junior to its obligations under the agreement, then all accumulated arrears of dividends payable on the Group 1 Preferred Securities are immediately due and payable. If Corporation A is in default with respect to its obligations under the Year 2 Guarantee Agreement, then it may not redeem, purchase, acquire, or pay a liquidation preference with respect to any preferred or preference stock which ranks pari passu with the Year 2 Guarantee Agreement.

The Year 2 Guarantee Agreement constitutes an unsecured obligation of Corporation A and ranks (1) subordinate and junior in right of payment to all liabilities of Corporation A; (2) pari passu with the most senior preferred or preference stock now or subsequently issued by Corporation A or any guarantee issued by Corporation A or an affiliate with respect to such stock; and (3) senior to Corporation A's common stock.

Except with respect to any changes that do not adversely affect the rights of the Group 1 Preferred Securities holders (in which case no vote is required), the Year 2 Guarantee Agreement may be amended only with the prior approval of the Group 1 Preferred Securities holders owning not less than 66 2/3% in liquidation preference of the outstanding Preferred Securities.

Prospectus for Group 1 Preferred Securities

The Year 2 Prospectus contained a summary of certain federal income tax considerations for prospective purchasers of the Group 1 Preferred Securities. The following is a summary of some of those considerations:

LLC will be treated as a partnership for federal income tax purposes. Accordingly, each Group 1 Preferred Securities holder will

be required to include in gross income the holder's distributive share of LLC's net income. Such income will not exceed the dividends received on the Group 1 Preferred Securities, except in limited circumstances (i.e., extension of the interest payment period). No portion of such income will be eligible for the dividends received deduction. The payment of such income to U.S. persons and the payment of interest on the loans is not subject to withholding tax under present U.S. federal income tax law.

Corporation A, as manager of LLC, will furnish to each Group 1 Preferred Securities holder a Schedule K-1 each year setting forth the holder's allocable share of income for the prior taxable year.

If an interest payment period is extended under the terms of the Year 2 Loan, LLC will continue to accrue income, equal to the amount of the interest payment due at the end of the extended interest payment period, over the length of the extended payment period. Accrued income will be allocated, but not distributed, to holders of record on the business day preceding the last day of each calendar month. As a result, holders of record during an extended interest payment period will include interest in gross income in advance of the receipt of cash. The tax basis of a Group 1 Preferred Security will be increased by the amount of any interest that is included in income without receipt of cash, and will be decreased when cash is subsequently received from LLC.

(B) Year 3 Transaction--Group 2 Preferred Securities

On Date 4, LLC issued to the public EE shares of Preferred Securities, Group 2 ("Group 2 Preferred Securities").[7] The liquidation preference of the Group 2 Preferred Securities is $25 per share. The proceeds from the issuance of the Group 2 Preferred Securities ($J) were loaned to Corporation A, pursuant to a promissory note dated Date 5.[8] The loan proceeds were used by Corporation A for general corporate purposes, including the repayment of outstanding indebtedness.

The following is a description of the Group 2 Preferred Securities, the loan agreement between Corporation A and LLC relating

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[7] The Group 2 Preferred Securities are listed on the New York Stock Exchange.

[8] On Date 4, LLC also loaned to Corporation A the proceeds from a capital contribution ($K) from Corporation A. This memorandum does not address the federal income tax treatment of this "loan".

to the Group 2 Preferred Securities, and the payment and guarantee agreement for the benefit of the Group 2 Preferred Securities holders.

Group 2 Preferred Securities

The holders of the Group 2 Preferred Securities are entitled to receive cumulative cash dividends at the annual rate of N% of the stated liquidation preference of $25 per share per annum for the initial period from the date of original issuance to Date 7, and thereafter at the Applicable Rate (described below), which is adjusted quarterly. The dividends are payable in U.S. dollars monthly in arrears on the last day of each calendar month of each year, commencing Date 6. The dividends accrue and are cumulative whether or not they have been declared and whether or not there are profits, surplus or other funds of LLC legally available for the payment of dividends. Dividends on the Group 2 Preferred Securities are cumulative from the date of original issue (Date 4).

Corporation A, as manager, must declare dividends on the Group 2 Preferred Securities in any calendar year to the extent that Corporation A reasonably anticipates that LLC will have earnings legally available for the payment of dividends and cash on hand sufficient to permit such payments. Because Corporation A has the right to extend interest payment periods on the Year 3 Loan (described below) for up to 60 consecutive months, monthly dividend payments on the Group 2 Preferred Securities can be deferred by LLC during an extended interest payment period. Dividends in arrears will accumulate additional distributions thereon at the Applicable Rate.

In general, the Applicable Rate for any quarter (other than the initial period) will equal P% of the Effective Rate, but will not be less than Q% per annum nor more than R% per annum. The Effective Rate for any quarter equals the highest of three rates based on Treasury obligations.

LLC will not pay any dividends on any shares of LLC ranking junior to the Group 2 Preferred Securities as to dividends, or redeem, purchase, or otherwise acquire any junior shares of LLC, until all accumulated and unpaid dividends on the Group 2 Preferred Securities have been paid in full.

The Group 2 Preferred Securities are redeemable, at the option of LLC subject to the prior consent of Corporation A, in whole or in part any time on or after Date 11, at the redemption price of $25 per share plus accumulated dividends. The Group 2 Preferred Securities also are redeemable, at the option of LLC and subject to the prior

consent of Corporation A, if LLC or Corporation A is required to pay additional amounts on the Group 2 Preferred Securities. (Additional amounts may be required to be paid if the payments to the Group 2 Preferred Securities holders are subject to withholding or other charges.)

Upon any repayment or prepayment of principal on the Year 3 Loan, the proceeds will be applied to redeem the Group 2 Preferred Securities. However, the proceeds may be reloaned to Corporation A and not used for redemption, if, at the time of each loan, and as determined by Corporation A, as manager, and its financial advisor, (1) Corporation A is not in bankruptcy, (2) Corporation A is not in default on any loan pertaining to preferred shares of any series ranking pari passu with the Group 2 Preferred Securities, (3) Corporation A has made timely payments on the repaid loan for the immediately preceding 18 months, (4) LLC is not in arrears on payments of dividends on the Group 2 Preferred Securities, (5) Corporation A is expected to be able to make timely payments of principal and interest on the loan, (6) the loan is made on terms, and under circumstances, that are consistent with those which a lender would require for a loan to an unrelated party, (7) the loan is made at a rate sufficient to provide payments equal to or greater than the amount of dividends that accrue on the Group 2 Preferred Securities, (8) the senior unsecured long-term debt of Corporation A is rated among the four highest categories by a nationally recognized rating organization, (9) the loan is made for a term consistent with market circumstances and Corporation A's financial condition and is for a term not to exceed J years, and (10) the final maturity of the Year 3 Loan is not later than the Xth anniversary of the issuance of the Group 2 Preferred Securities.

In the event of any voluntary or involuntary liquidation, dissolution or winding up of LLC, the Group 2 Preferred Securities holders will be entitled to receive out of the assets of LLC available for distribution to shareholders an amount equal to the stated liquidation preference of $25 per share and all accumulated and unpaid dividends (whether or not declared) to the date of payment. The distribution is to be made before any distribution of assets to holders of common shares or any other class of shares of LLC ranking junior to the Group 2 Preferred Securities, but together with the holders of every other series of preferred or preference stock of LLC outstanding ranking pari passu with the Group 2 Preferred Securities.

If (1) LLC fails to pay dividends in full on the Group 2 Preferred Securities for 18 consecutive monthly dividend periods or (2) Corporation A breaches any of its obligations under the Year 3 Loan or under the Year 3 Guarantee Agreement (described below), then

the holders of a majority in liquidation preference of the outstanding Preferred Securities are entitled to appoint and authorize a trustee to enforce LLC's creditor rights under the loan against Corporation A, enforce the obligations undertaken by Corporation A under the Year 3 Guarantee Agreement, and declare and pay dividends on the Preferred Securities. Not later than 30 days after the right to appoint a trustee arises, the manager will convene a general meeting for the above purpose. If the manager fails to convene a meeting, the holders of 10% in liquidation preference of the outstanding Group 2 Preferred Securities and other such preferred or preference stock will be entitled to convene the meeting.

If any proposed resolution provides for (1) any variation or abrogation of the rights, preferences and privileges of the Group 2 Preferred Securities by way of amendment of LLC's Articles of Association or otherwise (including the issuance of shares senior to the Preferred Securities) or (2) the liquidation, dissolution, or winding up of LLC, then the Preferred Securities holders will be entitled to vote together as a class on such resolution. No such approval is required for (1) or (2) above if the liquidation, dissolution and winding up of LLC is proposed or initiated upon the liquidation, dissolution, or winding up of Corporation A. Any Preferred Securities owned by Corporation A or any entity owned 20% or more by Corporation A are not entitled to vote and are treated as if they were not outstanding (for the purposes of the vote).

Year 3 Loan Agreement

On Date 4, Corporation A and LLC entered into a loan agreement ("Year 3 Loan") under which LLC loaned Corporation A $J, the aggregate liquidation preference of the Group 2 Preferred Securities issued and sold by LLC.

The entire principal amount of the Year 3 Loan is due and payable (together with any accrued but unpaid interest including any additional interest[9]) on the earliest of Date 14, or the date upon which Corporation A is dissolved or liquidated or LLC is dissolved or liquidated. If LLC redeems the Group 2 Preferred Securities, the Year 3 Loan is due and payable in a principal amount equal to the

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[9] Corporation A is required to pay additional interest if (1) LLC is required to pay any additional amount with respect to the Group 2 Preferred Securities, or (2) Corporation A is required to withhold or deduct any amounts from the interest payments made to LLC. The amount of the additional interest is the amount needed by LLC to pay the Group 2 Preferred Securities holders the full amount of the stated dividends.

aggregate liquidation preference of the redeemed Group 2 Preferred Securities.

Corporation A has the right to prepay the Year 3 Loan, without premium or penalty, at any time following Date 11; and, in certain circumstances, at any time Corporation A is required to pay any additional interest on the Year 3 Loan.[10]

The Year 3 Loan bears interest at a variable rate from Date 5. The rate for the initial period from the date the loan is made to Date 7 is N% per annum. Thereafter, interest is payable at the Applicable Rate. Interest is payable on the last day of each calendar month of each year, beginning Date 6.

Corporation A has the right at any time during the term of the Year 3 Loan, as long as Corporation A is not in default in the payment of interest on the loan, to extend the interest payment period for up to 60 months. At the end of such period, Corporation A must pay all interest then accrued and unpaid. During any extended interest payment period, or at any time during which there is an event of uncured default under the loan, Corporation A will not pay dividends on any of its shares of equity stock. Corporation A must notify LLC of the extended interest payment period and LLC must notify the Group 2 Preferred Securities holders of the deferral.

The Year 3 Loan is subordinate and junior in right of payment to all Senior Indebtedness. The term "Senior Indebtedness" means the principal, premium, if any, and interest on (1) all indebtedness of Corporation A (excluding the Year 2 Loan), whether outstanding or subsequently created, incurred or assumed, which is for money borrowed, or evidenced by a note or similar instrument given in connection with the acquisition of any business, properties or assets, including securities, (2) any indebtedness of others of the kinds described above if Corporation A is responsible or liable for payment as guarantor or otherwise, and (3) renewals, amendments, extensions and refundings of any such indebtedness, unless it is expressly provided that the indebtedness is not superior in right of payment to the Year 3 Loan. Obligations to other creditors,

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[10] Corporation A does not have the right to prepay the Year 3 Loan, or a portion thereof, based on a technical obligation to pay additional interest in the absence of any actual liability for withholding taxes, duties, assessments or government charges as the case may be.

including trade creditors, do not constitute Senior Indebtedness.[11] The Year 3 Loan ranks pari passu with, and is not superior in right of payment, to the Year 2 Loan.

If (1) Corporation A defaults in the payment of any principal, or premium, if any, or interest on any Senior Indebtedness when it becomes due and payable or (2) an event of default occurs with respect to any Senior Indebtedness, then until the default has been cured or waived, no direct or indirect payment will be made on the Year 3 Loan.

Corporation A's obligations under the Year 3 loan agreement are also for the benefit of the Group 2 Preferred Securities holders, and the holders are entitled to enforce this agreement directly against Corporation A.

Under the terms of the loan agreement, any of the following constitute an Event of Default: (1) default in the payment of interest on the Year 3 Loan, including any additional interest (a valid extension of the interest payment period is not a default); (2) default in the payment of the principal on the Year 3 Loan when due; (3) the dissolution, winding up or liquidation of LLC; (4) the bankruptcy, insolvency, or liquidation of Corporation A; and (5) breach of any covenants. If an Event of Default occurs, then LLC will have the right to declare the principal and the interest on the Year 3 Loan and all other amounts payable on the Year 3 Loan to be due and payable. The Group 2 Preferred Securities holders will have the right to appoint a trustee to exercise LLC's creditor rights under the loan agreement, and Corporation A agrees to cooperate with the trustee.

In the loan agreement, Corporation A agreed (1) to use the proceeds of the loan for working capital, for retirement of debt and for other general corporate purposes, (2) to maintain direct or indirect 100% ownership of the common stock of LLC, (3) not to voluntarily dissolve, wind-up or liquidate LLC so long as any Preferred Securities are outstanding, and (4) to timely perform all of its duties as manager of LLC.

The loan agreement may be amended by mutual consent of the parties; provided that no such amendment adversely affects the Group 2 Preferred Securities holders unless the holders of 66 2/3% of the outstanding Group 2 Preferred Securities agree to the amendment.

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[11] Corporation A represents that the Year 3 Loan ranks pari passu with the general creditors of Corporation A, including trade creditors.

Year 3 Payment and Guarantee Agreement

Under the Payment and Guarantee Agreement ("Year 3 Guarantee Agreement"), dated Date 4, Corporation A irrevocably and unconditionally agreed to pay the Group 2 Preferred Securities holders the guarantee payments and to make certain other payments.

Guarantee payments are the following payments, without duplication, to the extent not paid by LLC: (1) any accumulated and unpaid dividends that have been declared on the Group 2 Preferred Securities out of moneys legally available for dividends; (2) the redemption price of the Group 2 Preferred Securities called for redemption by LLC as an optional redemption or otherwise out of funds available to LLC; (3) upon a liquidation of LLC, the lesser of (a) the liquidation distribution and (b) the amount of assets of LLC available for distribution to Group 2 Preferred Securities holders in liquidation of LLC; and (4) any additional amounts payable by LLC on the Group 2 Preferred Securities.

Corporation A irrevocably and unconditionally agrees to pay in full to the Group 2 Preferred Securities holders the guarantee payments, as and when due (except to the extent paid by LLC), regardless of any defense, right of set-off or counterclaim that LLC may have or assert. Corporation A's obligation to make a guarantee payment may be satisfied by direct payment by Corporation A to the Group 2 Preferred Securities holders or by causing LLC to pay such amounts to the holders.

The guarantee is a guarantee of payment and not of collection. A holder may enforce the guarantee directly against Corporation A. The agreement is not discharged except by payment of the guarantee payments in full (to the extent not paid by LLC) and by complete performance of all obligations of Corporation A.

Corporation A's obligations under the agreement are independent of LLC's obligations with respect to the Group 2 Preferred Securities. In addition, Corporation A is liable as principal and sole debtor to make the guarantee payments.

If Corporation A fails to comply with its obligations under the Year 3 Guarantee Agreement and redeems or purchases any shares which rank junior to its obligations under the agreement with respect to participation in assets, then all accumulated arrears of dividends payable on the Group 2 Preferred Securities are immediately due and payable. If Corporation A is in default with respect to its obligations under the Year 3 Guarantee Agreement, then it may not redeem, purchase, acquire, or pay a liquidation preference with respect to any preferred or preference stock which ranks pari passu

with the Year 3 Guarantee Agreement.

The Year 3 Guarantee Agreement constitutes an unsecured obligation of Corporation A and ranks (1) subordinate and junior in right of payment to all liabilities of Corporation A; (2) pari passu with the most senior preferred or preference stock now or subsequently issued by Corporation A or any guarantee issued by Corporation A or an affiliate with respect to such stock; and (3) senior to Corporation A's common stock.

Except with respect to any changes that do not adversely affect the rights of the Group 2 Preferred Securities holders (in which case no vote is required), the Year 3 Guarantee Agreement may be amended only with the prior approval of the Group 2 Preferred Securities holders owning not less than 66 2/3% in liquidation preference of the outstanding Group 2 Preferred Securities.

Prospectus for Group 2 Preferred Securities

The Year 3 Prospectus contained a summary of certain federal income tax considerations for prospective purchasers of the Group 2 Preferred Securities. The following is a summary of some of those considerations:

LLC will be treated as a partnership for federal income tax purposes. Accordingly, each Group 2 Preferred Securities holder will be required to include in gross income the holder's distributive share of LLC's net income. Such income will not exceed the dividends received on the Group 2 Preferred Securities, except in limited circumstances (i.e., extension of the interest payment period). No portion of such income will be eligible for the dividends received deduction. The payment of such income to U.S. persons and the payment of interest on the loans is not subject to withholding tax under present U.S. federal income tax law.

Corporation A, as manager of LLC, will furnish to each Group 2 Preferred Securities holder a Schedule K-1 each year setting forth the holder's allocable share of income for the prior taxable year.

If an interest payment period is extended under the terms of the Year 3 Loan, LLC will continue to accrue income, equal to the amount of the interest payment due at the end of the extended interest payment period, over the length of the extended payment period. Accrued income will be allocated, but not distributed, to holders of record on the business day preceding the last day of each calendar month. As a result, holders of record during an extended interest payment period will include interest in gross income in advance of the receipt of cash. The tax basis of a Group 2 Preferred Security

will be increased by the amount of any interest that is included in income without receipt of cash, and will be decreased when cash is subsequently received from LLC.

(C) Year 4 Transaction--Group 3 Preferred Securities

On Date 9, LLC issued FF shares of Group 3 Preferred Securities, denominated in foreign currency of Country S, in a public offering.[12] The liquidation preference of the Group 3 Preferred Securities is FX1 per share. The proceeds from the issuance of the Group 3 Preferred Securities (FX2) were loaned by LLC to Corporation A.[13] The loan proceeds were used by Corporation A for general corporate purposes, including the retirement of outstanding indebtedness.

The following is a description of the Group 3 Preferred Securities, the loan agreement between Corporation A and LLC relating to the Group 3 Preferred Securities, and the payment and guarantee agreement for the benefit of the Group 3 Preferred Securities holders. (This information was taken from the Year 4 Prospectus.)

Group 3 Preferred Securities

The holders of the Group 3 Preferred Securities are not entitled to any payments until the Group 3 Preferred Securities are redeemed. In general, the Group 3 Preferred Securities will be redeemed on Date 12, at a redemption price of FX4 per share, the original issue price of FX1 plus the amount of FX5 to be declared and paid as a dividend on that date. The amount of FX5 represents a deferred return of S%, compounded annually.

Any holder of Group 3 Preferred Securities may require LLC to redeem the holder's Group 3 Preferred Securities prior to Date 12, if (1) as a result of a change in the income tax laws of Country S, the

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[12] The Group 3 Preferred Securities are listed on Stock Exchange L. The Group 3 Preferred Securities have not been and will not be registered under the United States Securities Act of 1933, as amended and may not be sold within the United States or to U.S. persons. In order to avoid inadvertent breaches of U.S. securities laws, the transfer of Group 3 Preferred Securities to U.S. persons is prohibited both in the initial public offering as well as the secondary market.

[13] On Date 9, LLC also loaned to Corporation A the proceeds from the capital contribution made by Corporation A to LLC (FX3). This memorandum does not address the federal income tax treatment of this "loan".

holder is required to include any dividends in income in a year prior to the year of receipt (a Category A event); or (2) LLC engages in impermissible business activities or Corporation A fails to comply with its covenant regarding ownership of LLC's common stock (a Category B event). LLC may redeem the Group 3 Preferred Securities prior to Date 12, if (1) LLC or Corporation A, as applicable, is required to pay or receives an opinion from independent advisors that there is a significant risk that (a) it will be required to pay additional interest[14] or (b) Corporation A will not be allowed to deduct as interest expense its payments or accruals of interest on the Group 3 Preferred Securities for U.S. tax purposes (a Category A event); or (2) the number of Group 3 Preferred Securities outstanding at any time is less than 50% of the number of Group 3 Preferred Securities initially offered as a result of early redemption (a Category A event). The amount paid upon a redemption will exceed the FX1 issue price; the specific amount will depend upon the redemption date and whether a Category A or Category B event has occurred.

If (1) LLC fails to pay the amount payable upon redemption of the Group 3 Preferred Securities within 2 days of the date fixed for redemption; (2) an event occurs which entitles the holders of the Group 1 Preferred Securities or the Group 2 Preferred Securities to vote pursuant to the terms thereof; or (3) Corporation A breaches any of its obligations under the Year 4 Loan or the Year 4 Guarantee Agreement (described below), then the holders of the outstanding Group 3 Preferred Securities, together with the holders of the Group 1 and the Group 2 Preferred Securities, will be entitled to appoint and authorize a trustee to enforce LLC's creditor rights against Corporation A under the Year 4 Loan, enforce the obligations undertaken by Corporation A under the Year 4 Guarantee Agreement, and pay amounts on redemption as applicable. Not later than 30 days after the right to appoint a trustee arises, the manager will convene a general meeting for the above purpose. If the manager fails to convene a meeting, the holders of 10% in liquidation preference of the outstanding Group 3 Preferred Securities and any other such preferred or preference stock will be entitled to convene the meeting.

In the event of any voluntary or involuntary liquidation,

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[14] Corporation A is required to pay additional interest if (1) LLC is required to pay any additional amount with respect to the Group 3 Preferred Securities, or (2) Corporation A is required to withhold or deduct any amounts from the interest payments made to LLC. The amount of the additional interest is the amount needed by LLC to pay the Group 3 Preferred Securities holders the full amount of the dividends.

dissolution or winding up of LLC, after payment of all liabilities of LLC but before any distribution of assets to holders of common shares or any other class of shares ranking junior to the Group 3 Preferred Securities, the holders of the Group 3 Preferred Securities will be entitled to receive, pro rata with the holders of every other outstanding series of preferred shares of LLC ranking pari passu with the Group 3 Preferred Securities, an amount equal to the amount received if LLC were to redeem the Group 3 Preferred Securities as a result of a Category B event.

If dividends have not been paid in full on the Group 3 Preferred Securities, LLC will not (1) pay, or declare and set aside for payment any dividends on any other preferred or preference stock of LLC ranking pari passu with the Group 3 Preferred Securities; (2) pay, or declare and set aside for payment, any dividends on any shares of LLC ranking junior to the Group 3 Preferred Securities; or (3) redeem, purchase or otherwise acquire any junior shares. This prohibition ends when all accumulated arrears of unpaid dividends on the Group 3 Preferred Securities have been paid in full.

LLC is entitled to specify one or more successive redemption dates (the last of which must occur on or before Date 13), related redemption prices (including related dividends) payable on redemption and details of subsequent loan agreements to be entered into with Corporation A. If LLC specifies a later redemption date, a holder may elect not to have its Group 3 Preferred Securities redeemed on Date 12, and to have its shares redeemed on the later redemption date.

LLC may not vary or abrogate any of the rights, preferences or privileges of the Group 3 Preferred Securities without the approval of the holders of the Group 3 Preferred Securities voting equally with the holders of any other shares of LLC that rank pari passu with the Group 3 Preferred Securities and would be equally adversely affected by such action. Such approval may be obtained by a resolution approved by holders of at least 66 2/3% in liquidation preference of such shares. The rights attached to the Group 3 Preferred Securities will be deemed not to be varied by the creation or issue of any further shares of LLC which rank pari passu or junior to the Group 3 Preferred Securities.

Year 4 Loan Agreement

On Date 9, Corporation A and LLC entered into a loan agreement ("Year 4 Loan") under which LLC loaned Corporation A FX2, the aggregate liquidation preference of the Group 3 Preferred Securities issued and sold by LLC.

The entire principal amount of the Year 4 Loan is due and payable (together with any accrued and unpaid interest including any additional interest) on Date 12, except to the extent that LLC, in connection with subsequent loan agreements with Corporation A, has offered to extend the redemption date and holders of Group 3 Preferred Securities have elected not to redeem their shares. If LLC redeems the Group 3 Preferred Securities prior to such date, the Year 4 Loan is due and payable in a principal amount equal to the aggregate liquidation preference of the redeemed Group 3 Preferred Securities.

Corporation A has the right to prepay the Year 4 Loan, without premium or penalty, on any redemption date after the date Corporation A is or would be required to pay or receives an opinion from independent advisors that there is a significant risk that it would be required to pay any additional interest.

The proceeds of any prepayment or repayment of the Year 4 Loan may be reloaned to Corporation A for a period not to exceed L years.

Interest accrues on the Year 4 Loan at an annual rate equal to S% from the date such loan is made until maturity. Interest compounds annually and is payable together with the outstanding principal amount on Date 12, or when the corresponding principal amount shall become due and payable. If the Group 3 Preferred Securities are redeemed as a result of a Category B event, Corporation A will pay as additional interest on the Year 4 Loan an amount equal to the difference between the aggregate redemption price payable upon the occurrence of a Category B event and the aggregate redemption price payable upon the occurrence of a Category A event.

The Year 4 Loan is subordinate and junior in right of payment to all Senior Indebtedness. The term "Senior Indebtedness" means the principal, premium, if any, and interest on (1) all indebtedness of Corporation A (excluding the Year 2 Loan and Year 3 Loan), whether outstanding or subsequently created, incurred or assumed, which is for money borrowed, or evidenced by a note or similar instrument given in connection with the acquisition of any business, properties or assets, including securities, (2) any indebtedness of others of the kinds described above if Corporation A is responsible or liable for payment as guarantor or otherwise, and (3) renewals, amendments, extensions and refundings of any such indebtedness, unless it is expressly provided that the indebtedness is not superior in right of payment to the Year 4 Loan. Obligations to other creditors,

including trade creditors, do not constitute Senior Indebtedness.[15] The Year 4 Loan ranks pari passu with, and is not superior in right of payment, to the Year 2 Loan and the Year 3 Loan.

Corporation A's obligations under the Year 4 loan agreement are also for the benefit of the Group 3 Preferred Securities holders, and the holders are entitled to enforce this agreement directly against Corporation A.

Under the terms of the loan agreement, any of the following constitute an Event of Default: (1) default in the payment of interest on the Year 4 Loan, including any additional interest; (2) default in the payment of the principal on the Year 4 Loan when due; (3) the dissolution, winding up, or liquidation of LLC; (4) the bankruptcy, insolvency, or liquidation of Corporation A; and (5) breach of any covenants. If an Event of Default occurs, then LLC will have the right to declare the principal and the interest on the Year 4 Loan and all other amounts payable on the Year 4 Loan to be due and payable. The Group 3 Preferred Securities holders will have the right to appoint a trustee to exercise LLC's creditor rights under the loan agreement, and Corporation A agrees to cooperate with the trustee.

In the loan agreement, Corporation A agreed (1) to maintain direct or indirect 100% ownership of the common stock of LLC, (2) not to voluntarily dissolve, wind-up or liquidate LLC so long as any Group 3 Preferred Securities are outstanding, and (3) to timely perform all of its duties as manager of LLC.

The loan agreement may be amended by mutual consent of the parties; provided that no such amendment adversely affects the Group 3 Preferred Securities holders unless the holders of 66 2/3% of the outstanding shares agree to the amendment.

Year 4 Payment and Guarantee Agreement

Under the Payment and Guarantee Agreement ("Year 4 Guarantee Agreement"), dated Date 9, Corporation A irrevocably and unconditionally agreed to pay the Group 3 Preferred Securities holders the guarantee payments and to make certain other payments.

Guarantee payments are the following payments, without duplication, to the extent not paid by LLC: (1) any accumulated and

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[15] Corporation A represents that the Year 4 Loan ranks pari passu with the general creditors of Corporation A, including trade creditors.

unpaid dividends that have been declared on the Group 3 Preferred Securities out of moneys legally available for dividends; (2) the redemption price payable with respect to any Group 3 Preferred Securities called for redemption by LLC as an optional redemption or otherwise out of funds available to LLC; (3) upon a liquidation of LLC, the lesser of (a) the redemption preference and (b) the amount of assets of LLC, and (4) any additional amounts payable by LLC on the Group 3 Preferred Securities.

The guarantee is a guarantee of payment and not of collection. A holder may enforce the guarantee directly against Corporation A. The agreement is not discharged except by payment of the guarantee payments in full (to the extent not paid by LLC) and by complete performance of all obligations of Corporation A. The guarantee payments may be satisfied by direct payment of the required amounts by Corporation A to the holders of Group 3 Preferred Securities or by causing LLC to pay such amounts to the holders.

Except with respect to any changes which do not adversely affect the rights of holders, the Year 4 Guarantee Agreement may be changed only with the prior approval of the holders of not less than 66 2/3% in liquidation preference of the Group 3 Preferred Securities given either in writing or by vote at a meeting of the holders.

Corporation A may not purchase, redeem, pay dividends on or make guarantee payments with respect to any preferred or preference stock of Corporation A or its affiliates ranking pari passu or junior to the Year 4 Guarantee Agreement if Corporation A is in default with respect to its obligations under the agreement or LLC is in arrears or default on any of its Group 3 Preferred Securities obligations.

The Year 4 Guarantee Agreement constitutes an unsecured obligation of Corporation A and ranks (1) junior to all liabilities of Corporation A, (2) pari passu with the most senior preferred or preference stock issued by Corporation A and with any guarantee entered into by Corporation A with respect to any preferred or preference stock of any affiliate of Corporation A, and (3) senior to Corporation A's common stock.

Prospectus for Group 3 Preferred Securities

The Year 4 Prospectus contained a summary of certain U.S. federal income tax considerations that may be relevant to prospective purchasers of the Group 3 Preferred Securities. The following excerpts are from this summary (assuming that the holders of the Group 3 Preferred Securities are resident in Country S):

LLC will be treated as a partnership for federal income tax

purposes. Accordingly, each holder of the Group 3 Preferred Securities will be treated as earning a distributive share of LLC's interest income accrued from Corporation A as borrower pursuant to the Year 4 Loan. However, a holder who is (1) a nonresident alien individual or (2) a non-U.S. corporation, partnership, estate, or trust may receive payment of dividends from LLC which are not subject to any U.S. income or withholding tax provided certain requirements are met.

Corporation A, as manager of LLC, will furnish each Group 3 Preferred Securities holder a Schedule K-1 each year setting forth the holder's allocable share of income for U.S. tax purposes for the prior taxable year. The receipt of the Schedule K-1 is informational only and does not require a U.S. tax return to be filed by any holder that is not subject to U.S. income or withholding tax on income or gain derived from the Group 3 Preferred Securities.

LAW AND ANALYSIS

ISSUE 1

Whether the "loans" made to Corporation A by LLC constitute debt or equity for federal income tax purposes when the funds for the "loans" were obtained by LLC through the issuance of preferred securities to the public?

Under section 385(a) of the Internal Revenue Code, the Secretary of the Treasury is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated as stock or indebtedness (or as in part stock and in part indebtedness). Section 385(b) sets forth some of the factors that the regulations should take into account to determine whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. These factors include the following: (1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest, (2) whether there is subordination to or preference over any indebtedness of the corporation, (3) the ratio of debt to equity of the corporation, (4) whether there is convertibility into the stock of the corporation, and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

Under section 385(c)(1), the characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness is binding on the issuer and on all holders

of such interest (but is not binding on the Secretary of the Treasury).

Proposed regulations under section 385(a) were issued on March 24, 1980, which set forth the factors to be considered in determining whether an instrument was stock or debt. Final regulations under section 385(a) were then issued in December 1980 (with a delayed effective date that was extended several times). The final regulations, however, were withdrawn in 1983. T.D. 7920, 1983-2 C.B. 69. There currently are no regulations under section 385.

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. Among the factors that may be considered in making such a determination are: (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. The weight given to any factor depends upon all the facts and circumstances. No particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity. John Kelley Co. v. Commissioner, 326 U.S. 521 (1946).[16]

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[16] The Fifth Circuit of the United States Court of Appeals has considered the following factors in classifying an instrument as either debt or equity: (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a fixed maturity date; (3) the source of payments; (4) the right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay

(continued...)

The various factors listed in Notice 94-47 are "...aids in answering the ultimate question whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship." Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3d Cir. 1968). The important issue is whether there was "...a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship?" Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 377 (1973).

Notice 94-47 was issued in response to a number of transactions in which instruments were issued that were designed to be treated as debt for federal income tax purposes but as equity for regulatory, rating agency, or financial accounting purposes. The instruments typically contained a combination of debt and equity characteristics. The notice states that, upon examination, the Service will scrutinize instruments of this type to determine if their purported status as debt for federal income tax purposes is appropriate.

The following discussion applies the factors listed in Notice 94-47 and other debt/equity factors to the facts in this case.[17] For purposes of Issue (1), the application of these factors is based on the form of the transactions.[18]

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[16](...continued)
on the due date or to seek a postponement. Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972).

[17] For a more detailed description of the debt/equity factors, see Plumb, "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 Tax. L. Rev. 369 (1971); and Chapter 4 of Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders (Sixth Edition). For a detailed analysis of Notice 94-47, see Hariton, "Essay: Distinguishing Between Equity and Debt in the New Financial Environment," 49 Tax. L. Rev. 499 (1994).

[18] In general, if LLC is respected as a partnership for tax purposes, the Preferred Securities represent partnership interests. As a result, the income and other rights attributable to the loans held by LLC flow through to the holders of the Group 1, Group 2, and Group 3 Preferred Securities.

(1) 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?

An important factor used in classifying an instrument as either debt or equity is whether the instrument has a definite maturity date on which the creditor is entitled to an unconditional repayment of principal. The presence of a fixed maturity date indicates a definite obligation to repay (a debt characteristic), and the absence of a fixed maturity date indicates that the repayment may depend on the fortunes of the issuer (an equity characteristic).

In addition, although the presence of a fixed maturity date to repay the principal is one of the indicia of debt, the date on which payment is due must be a date that is in the reasonably foreseeable future. Otherwise, the creditor's principal may be at risk, and repayment of the principal becomes contingent on the issuer's profitability. There is, however, no bright-line test to determine whether a maturity date for a particular instrument is in the reasonably foreseeable future. In determining whether a maturity date for a particular instrument is a reasonable date, the courts have considered a number of factors, including the nature of the issuer's business, the financial condition of the issuer, the length of time the issuer has been in existence, and how likely it is that the issuer will be in existence when the instrument matures. For example, see Monon Railroad v. Commissioner, 55 T.C. 345 (1970), acq., 1973-2 C.B. 3, in which the court, for purposes of classifying instruments with a 50-year term, took into consideration the substantial nature of the taxpayer's business, and the fact that the taxpayer had been in corporate existence for 61 years prior to the issuance of the instruments.[19]

In this case, Corporation A has an unconditional obligation to repay the principal amount of each loan by a certain date. The principal amount of the Year 2 Loan is due no later than Date 15 (a term of K years), the principal amount of the Year 3 Loan is due no later than Date 14 (a term of J years), and the principal amount of the Year 4 Loan is due no later than Date 12 (a term of M years).

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[19] In United States v. Snyder Brothers Company, 367 F.2d 980 (5th Cir. 1966), cert. den., 386 U.S. 956 (1967), the court cited the long term of the debentures (20 years) as one factor in classifying the debentures as equity. The debentures were issued, upon the taxpayer's formation, to the taxpayer's shareholders in exchange for assets. The debentures were unsecured and subordinated to other creditors and there was no limitation on the payment of dividends or provision for any sinking fund.

However, under the terms of the Year 2 Loan and Year 3 Loan, upon the repayment or prepayment of the loan, the proceeds may be reloaned to Corporation A if certain conditions are met at that time. For the Year 2 Loan, one condition is that the maturity date of the new loan will not be later than the Yth anniversary of the issuance of the Group 1 Preferred Securities. In the case of the Year 3 Loan, one condition is that the maturity date of the new loan will not be later than the Xth anniversary of the issuance of the Group 2 Preferred Securities. In the case of the Year 4 Loan, the term of the loan may be extended under certain circumstances (for example, if the holders of the Group 3 Preferred Securities elect not to have their shares redeemed on Date 12); however, the maturity date of any new loan must be on or before Date 13 (a maximum term of N years).

Although Corporation A has the right, in effect, to postpone the payment of the principal amounts of the Year 2 Loan and the Year 3 Loan, there are meaningful limitations and conditions on Corporation A's ability to exercise this right. For example, Corporation A must have an investment grade credit rating, the loan must be made on terms and under circumstances that are consistent with those required by a lender for a loan to an unrelated party, and the terms of the loan must be based on market conditions at the time of exercise. Therefore, Corporation A does not have an unconditional option to extend the maturity of these debt instruments. Consequently, for purposes of determining the maturity dates and terms of the Year 2 Loan and the Year 3 Loan, Corporation A's right to postpone the payment of the principal amounts of the loans should not be taken into account.[20] In the case of the Year 4 Loan, because Corporation A's ability to extend the term of the Year 4 Loan depends upon whether the holders of the Group 3 Preferred Securities elect not to have their shares redeemed, the Year 4 Loan should be treated as having a maturity date of Date 12.

Corporation A was in existence for over P years when the loans were issued. In addition, since its formation, Corporation A has been a substantial operating business and has a history of repaying all of its debt. Therefore, in this case, the stated maturity dates of the Year 2 Loan (resulting in a term of K years), the Year 3 Loan (resulting in a term of J years), and the Year 4 Loan (resulting in a

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[20] Compare section 1.1272-1(c)(5) of the Income Tax Regulations in which an <u>unconditional</u> option to extend the maturity date of a debt instrument may be taken into account to determine the overall maturity date of the instrument.

term of M years) appear to be reasonable dates.[21]

(2) Do the holders of the instruments possess the right to enforce the payment of principal and interest?

Another important factor used in classifying an instrument as either debt or equity is whether the holder of the instrument has the right to enforce the payment of principal and interest. A fixed right to enforce the payment of principal and interest by the holder is a debt characteristic, and the absence of this right is an equity characteristic.

Under the provisions of all three loan agreements, if an Event of Default occurs (for example, a default in the payment of interest on the loan), the holder of the loan (LLC) has certain creditor rights. For example, LLC would have the right to declare the principal and interest payable on the loan to be due and payable. Because LLC is, in effect, controlled by Corporation A, these rights could be viewed as meaningless.

However, Corporation A's obligations under each loan agreement are also for the benefit of the holders of the Group 1, Group 2, and Group 3 Preferred Securities, and the holders (as a group) are entitled to enforce the loan agreements directly against Corporation A. For example, under the terms of the Preferred Securities, if there is an Event of Default under the loan agreement, the holders of a majority in liquidation preference of the outstanding Preferred Securities have the right to appoint a trustee to exercise LLC's creditor rights under the loan agreement, and Corporation A has agreed to cooperate with the trustee. As a result, the provisions of the Year 2 Loan, the Year 3 Loan, and the Year 4 Loan also provide the holders of the Preferred Securities with the rights of creditors, including the right to enforce the payment of principal and interest on the loans.[22]

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[21] If Corporation A's "right" to postpone the payment of the principal amount of each loan were to be taken into account, the resulting term of K years for the Year 3 Loan and the resulting term of Q years for the Year 2 Loan would appear to be reasonable in this case. If the latest possible maturity date for the Year 4 Loan (Date 13) were to be taken into account, the resulting term of N years would appear to be reasonable in this case.

[22] Under the Guarantee Agreements, Corporation A only guarantees those payments that LLC is already legally obligated to make to the holders. In effect, the guarantees are meaningless and

(continued...)

(3) Are the rights of the holders of the instruments subordinate to rights of general creditors?

If an instrument is subordinate to the claims of general creditors, the instrument appears to resemble equity (the instrument lacks at least one of the significant characteristics of the debtor-creditor relationship). However, an instrument is not automatically denied debt status if it is subordinate to the claims of general creditors but ranks ahead of the issuer's preferred and common stock. Moreover, debt status generally is not impaired if payments can be made on the instrument while senior claims are outstanding.

In this case, the Year 2 Loan, the Year 3 Loan, and the Year 4 Loan are subordinate and junior in right of payment to all Senior Indebtedness. In general, Senior Indebtedness is all indebtedness of Corporation A that is for money borrowed or evidenced by a note or similar instrument given in connection with the acquisition of any business, properties or assets. It also includes certain indebtedness for which Corporation A is responsible or liable for payment as guarantor or otherwise and any indebtedness secured by a lien upon property owned by Corporation A. The Year 3 Loan and the Year 4 Loan specifically indicate that the term "Senior Indebtedness" does not include the indebtedness of unsecured general creditors, including trade creditors. Therefore, the Year 3 Loan and the Year 4 Loan are not subordinate to the unsecured indebtedness of general creditors, including trade creditors. In addition, the Year 2 Loan does not appear to be subordinate to the unsecured indebtedness of general creditors, including trade creditors. In the case of all three loans, the loans rank superior to the claims of holders of Corporation A's common stock.

(4) Does the instrument give the holders the right to participate in the management of the issuer?

The presence of voting and other management rights in an instrument generally is one of the indicia of equity.

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[22](...continued)
the holders of the Preferred Securities do not rely on them for their creditor rights. The guarantees are provided to satisfy certain technical requirements of section 3(a)(3) of the Investment Company Act of 1940 (the "1940 Act"). A finance subsidiary will not be considered an investment company under section 3(a)(3) of the 1940 Act if any debt securities of the finance subsidiary issued to or held by the public are unconditionally guaranteed by the parent as to the payment of principal, interest, and premium, if any. See 17 CFR 270.3a-5(a)(1).

In this case, under the provisions of the Year 2 Loan and the Year 3 Loan, Corporation A will not pay dividends on any of its shares of equity stock during an extended interest payment period or when there is an event of uncured default.

In addition, in certain situations (for example, an Event of Default under the loan agreement), the holders of a majority in liquidation preference of the Preferred Securities can appoint and authorize a trustee to enforce LLC's creditor rights against Corporation A under the applicable loan agreement. In addition, certain actions (for example, amendment of the loan agreement) cannot be taken without the approval of the holders of 66 2/3% in liquidation preference of the Preferred Securities.

These rights provide the holders of the securities very limited rights to participate in (or affect) the management of Corporation A and do not indicate that the loans are equity.

(5) Is the issuer thinly capitalized?

In general, if a corporation has a nominal stock capitalization coupled with excessive debt, this fact would tend to indicate that an instrument labeled debt might constitute equity. As a result, the debt/equity ratio is another factor used to determine whether an instrument is debt or equity. The debt/equity ratio indicates to what extent a corporation may suffer losses without impairment of the interests of the corporation's creditors. A high ratio lowers the protection afforded to the creditors against sudden business slumps. As a result, a high ratio of debt to equity indicates that the issuance of the instrument is a contribution to capital rather than a bona fide loan.

In this case, Corporation A is not thinly capitalized. In general, for the period during which the securities were issued, Corporation A's debt/equity ratio appears to range from approximately GG to HH, which are acceptable ratios.

(6) Are the holders of the instruments and the stockholders of the issuer the same?

The relationship between a holder's ownership of a corporation's stock and debt is another factor used to determine whether an instrument is debt (a disproportionate relationship) or equity (a proportionate relationship). In general, this factor is relevant only when a corporation's shareholders have advanced money to the corporation (typically a closely held corporation).

In this case, LLC, the holder of the loans, does not own stock

in Corporation A. In addition, although Corporation A owns a controlling interest in LLC, the holders of the Preferred Securities have adequate protection against any non-arm's length dealings between Corporation A and LLC.

(7) What labels are placed on the instruments by the parties?

In general, the issuance of a stock certificate indicates an equity interest while the issuance of an instrument labeled a bond, debenture, or note is indicative of debt. In addition, under section 385(c), the issuer's characterization of an instrument (as of the time of issuance) as either debt or equity is binding on the issuer and on all holders of the instrument. However, this characterization is not binding on the Internal Revenue Service or on a holder that discloses that it is treating the instrument in a manner inconsistent with the issuer's characterization.

In this case, the loans are labeled debt. In addition, Corporation A has treated the loans as debt for federal income tax purposes. Moreover, Corporation A has described the loans as debt in filings with the Securities and Exchange Commission (SEC) and other government agencies.

The loans also bear all the indicia traditionally associated with the creation of debt: written agreements describing the debt, provisions regarding fixed maturity dates and the payment of interest, as well as a description of the rights afforded the holder in the event of default.[23]

(8) Are the instruments intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial purposes?

The intent of the parties regarding the treatment of the instruments as debt or equity for non-tax purposes is an important factor in determining whether a debtor-creditor relationship or a corporation-shareholder relationship exists. For purposes of this factor, the treatment of the instrument for non-tax purposes may be relevant.[24]

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[23] See the discussion in Post Corp. v. U.S., 640 F.2d 1296 (1981).

[24] The Clinton Administration has proposed several times to deny interest deductions on (1) instruments that are not treated as debt for financial purposes and (2) certain "super-maturity" debt.

(continued...)

In assigning a rating to a company's senior debt, the rating agencies (for example, Standard and Poor's and Moody's) are concerned primarily with the company's ability to make payments on the instrument. A key component of that rating analysis is the composition of the company's capital structure and the degree of financial flexibility that would allow the company to deal with a downturn in cash flow without triggering a default on its securities.[25]

Most companies use a mix of short-term and long-term debt, including both senior and subordinated debt, along with common stock. In analyzing the consequences of the issuance of a security for the financial stability of the issuer, the term "equity credit" denotes the degree to which an instrument affords the company more financial flexibility than commercial paper--based on factors such as the term of the instrument, the ability of the company to defer stated payments without triggering default, and the ranking of the instrument in a liquidation of the company. In using the term "equity credit", the rating agencies focus on the impact of the issuance of a particular security on other investors. By contrast, the classification of a particular security as debt or equity for tax purposes generally focuses on the rights of the investors in the specific instrument. Because one of the factors used by the rating agencies is the remaining term of an instrument, the "equity credit" assigned to an instrument may change over the term of the instrument as its maturity date approaches (unlike the characterization of the instrument as debt or equity under tax law). In addition, unlike tax law characterization, a company receives various degrees of equity credit from the rating agencies for the issuance of a given instrument. For example, bonds with very long maturities (as compared to short-term debt) are given some equity credit even though the debt component is much larger. Finally, rating agency analysis applies on a consolidated group basis, without consideration of intercompany transactions between group members.

The terms of the Year 2 Loan, the Year 3 Loan, and the Year 4 Loan which were, in effect, passed through to the Preferred Securities holders, provide several features that increase Corporation A's financial flexibility (for example, the relatively

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[24](...continued)
However, these proposals have not been adopted. For example, see the Balanced Budget Bill of 1996, § 215(a).

[25] See "A Hierarchy of Hybrid Securities," Standard & Poor's Creditweek, March 25, 1996; Reid, "MIPS Besieged--Solutions in Search of a Problem," 77 Tax Notes 1057 (December 1, 1997).

long maturity, the subordination to senior debt, and the ability to defer interest payments). On this basis, the rating agencies agreed that the issuance of Preferred Securities provides some "equity credit" for Corporation A because the issuance results in greater financial flexibility than the issuance of commercial paper or even long-term senior debt. This treatment is, however, not equivalent to classifying the Preferred Securities as equity. In addition, the assignment of some "equity credit" to the Preferred Securities is not inconsistent with the treatment of the Preferred Securities as participations in the loans, which give the holders full creditor rights against Corporation A, or with the treatment of the loans as debt for tax purposes.

For financial purposes, the Preferred Securities are recorded on Corporation A's consolidated financial statements as a "minority equity interest in subsidiary." Financial accounting rules, unlike tax rules, require results to be presented on a consolidated group basis (including foreign affiliates) that ignores the individual assets and liabilities of separate but commonly controlled legal entities. Under generally accepted accounting principles (GAAP), LLC is included in Corporation A's consolidated group for financial statement purposes because Corporation A has voting control over LLC (at least until a default on the underlying loans occurs). The Preferred Securities represent an ownership interest in the assets of LLC and, therefore, are recorded for GAAP purposes as a "minority equity interest in subsidiary." The Year 2 Loan, the Year 3 Loan, and the Year 4 Loan are eliminated in Corporation A's consolidated financial statements because they reflect inter-company assets and liabilities that are ignored for GAAP purposes. If Corporation A and LLC were to prepare stand-alone financial statements, the Year 2 Loan, the Year 3 Loan, and the Year 4 Loan would be recorded as long-term debt by Corporation A and as an investment by LLC.[26]

Other factors

Other factors that may be relevant in classifying an instrument as either debt or equity for federal income tax purposes include the following:

(1) Convertibility of the instrument into stock of the issuer (an equity characteristic). In this case, the loans do not have a conversion feature.

(2) A sinking fund (a debt characteristic). In this case, there is

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[26] See CONSOLIDATION, General Accounting Standards, §§ C51.101-C51.401 (Fin. Accounting Standards Bd., 1998).

no sinking fund provision.

(3) Contingent payments (an equity characteristic). In this case, there are no contingent payments.

(4) Ability of the issuer to obtain loans from outside lending institutions (a debt characteristic). In this case, it appears that Corporation A can borrow from outside lending institutions.

(5) Failure of the debtor to repay on the due date or to seek a postponement (an equity characteristic). In this case, Corporation A has made the scheduled interest payments when due.

Based on the facts of this case and the factors described above, the Year 2 Loan, the Year 3 Loan, and the Year 4 Loan should be treated as debt for federal income tax purposes.

ISSUE 2

Whether the preferred securities constitute debt or equity for federal income tax purposes if the securities were treated as issued directly to the public by Corporation A?

Based on the form of the transactions, LLC issued the Preferred Securities to public investors. The proceeds of the issuance were then lent to Corporation A. The payments made on the loans are used by LLC to make the payments on the Preferred Securities. Corporation A represents that LLC is a partnership for federal income tax purposes and that the Preferred Securities represent interests in a partnership. The partnership allocates to the holders of the Preferred Securities the interest income accrued from the loans made to Corporation A. In essence, LLC serves as a "tax-transparent" vehicle through which investors receive distributions of interest income.

In certain circumstances, it may be appropriate to recharacterize a series of transactions for federal income tax purposes. For example, see ASA Investerings Partnership v. Commissioner, T.C. Memo, 1998-305, and section 7701(l). In this case, if the transactions were recharacterized so that Corporation A is treated as the issuer of the Preferred Securities to the public, the issue is whether the securities would be treated as debt of Corporation A for federal income tax purposes. However, in "looking through" LLC to analyze the relationship between Corporation A and the public, all of the rights and obligations of the relevant transactions must be considered, regardless of whether they arise from the terms of the loan agreements or the terms of the Preferred Securities. In recasting the transaction, the rights that attach to

the Preferred Securities must include those rights conferred on holders under the loan agreements. The economic realities of the relationship created by the direct issuance of the Preferred Securities to the public by Corporation A are an important factor in the determination of whether or not a debtor-creditor relationship exists.[27]

The following discussion applies the factors listed in Notice 94-47 and other debt/equity factors to an analysis of the Preferred Securities based on recharacterizing the transactions involving Corporation A, LLC, and the holders of the Preferred Securities as a direct issuance of the Preferred Securities by Corporation A to the public.

(1) 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 terms of the Group 1 and Group 2 Preferred Securities do not provide for a fixed maturity date. However, because the Preferred Securities must be redeemed upon the repayment of the "underlying loan" associated with the Preferred Securities, the Preferred Securities, in effect, have a fixed maturity date. By incorporating the terms of the Year 2 Loan with the terms of the Group 1 Preferred Securities, the Group 1 Preferred Securities must be redeemed on Date 15. However, in certain circumstances, Corporation A can defer the redemption of the Group 1 Preferred Securities until no later than Date 17. By incorporating the terms of the Year 3 Loan with the terms of the Group 2 Preferred Securities, the Group 2 Preferred Securities must be redeemed on Date 14. However, in certain circumstances, Corporation A can defer the redemption of the Group 2 Preferred Securities until no later than Date 16.

The terms of the Group 3 Preferred Securities provide for a stated redemption date of Date 12. However, in certain circumstances, the redemption date of the Group 3 Preferred Securities may be deferred until no later than Date 13.

Corporation A was in existence for over P years when the Preferred Securities were issued. In addition, since its formation, Corporation A has been a substantial operating business and has a history of repaying all of its debt. Therefore, in this case, the

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[27] See the discussion in Fin Hay Realty Co. v. United States, supra; Litton Business Systems v. Commissioner, supra; Dixie Dairies Corp. v. Commissioner, 74 T.C. 476 (1980).

"stated maturity dates" of the Group 2 Preferred Securities (resulting in a term of J years) and the Group 1 Preferred Securities (resulting in a term of K years) appear to be reasonable dates. In addition, the "stated redemption date" of the Group 3 Preferred Securities (resulting in a term of M years) appears to be a reasonable date.[28]

(2) Do the holders of the instruments possess the right to enforce the payment of principal and interest?

Corporation A's obligations under the loans are also for the benefit of the Preferred Securities holders, and the holders (as a group) are entitled to enforce the loan agreements directly against Corporation A. For example, under the terms of the Preferred Securities, if there is an Event of Default (for example, default in the payment of principal or interest on the loan) under the applicable loan agreement, the holders of a majority in liquidation preference of the outstanding Preferred Securities have the right to appoint a trustee to exercise LLC's creditor rights under the loan agreement, and Corporation A has agreed to cooperate with the trustee. As a result, by incorporating the terms of the loans with the terms of the Preferred Securities, the holders of the Preferred Securities have certain creditor rights, including the right to enforce the payment of amounts due on the securities as well as the right to initiate bankruptcy proceedings.

(3) Are the rights of the holders of the instruments subordinate to rights of general creditors?

The Year 2 Loan, the Year 3 Loan, and the Year 4 Loan are subordinate to the Senior Indebtedness of Corporation A. However, the loans are not subordinate to the unsecured debt of Corporation A's general creditors, including trade creditors. In addition, the loans rank superior to the claims of holders of Corporation A's common stock. By incorporating the terms of the loans with the terms of the Preferred Securities, the rights of the holders of the Preferred Securities are subordinate to the rights of the holders of the Senior Indebtedness but are not subordinate to the rights of

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[28] If Corporation A's "right" to postpone the payment of the principal amount of each loan were to be taken into account, the resulting term of K years for the Group 2 Preferred Securities and the resulting term of Q years for the Group 1 Preferred Securities would appear to be reasonable in this case. If the latest possible redemption date for the Group 3 Preferred Securities (Date 13) were to be taken into account, the resulting term of N years would appear to be reasonable in this case.

holders of Corporation A's unsecured debt, including debt of trade creditors. In addition, the rights of the holders of the Preferred Securities rank superior to the claims of holders of Corporation A's common stock.

(4) Does the instrument give the holders the right to participate in the management of the issuer?

The holders of Preferred Securities have limited voting rights even if the terms of the loans are incorporated with the terms of the securities. In certain situations (for example, an Event of Default), the holders of a majority in liquidation preference of the Preferred Securities can appoint and authorize a trustee to enforce their creditor rights against Corporation A. In addition, certain actions (for example, amendment of the loan agreement) cannot be taken without the approval of the holders of 66 2/3% in liquidation preference of the Preferred Securities.

These rights, however, provide very limited rights to participate in (or affect) the management of Corporation A and do not indicate that the Preferred Securities are equity.

(5) Is the issuer thinly capitalized?

In this case, Corporation A is not thinly capitalized. In general, for the period during which the securities were issued, Corporation A's debt/equity ratio appears to range from approximately GG to HH, which are acceptable ratios.

(6) Are the holders of the instruments and the stockholders of the issuer the same?

This factor could be relevant if a particular holder owns both Corporation A stock and the Preferred Securities. However, there is no indication that the holders of the Preferred Securities own a proportionate amount of Corporation A stock. Moreover, because Corporation A stock and Preferred Securities are publicly traded instruments, it is unlikely that there is any relationship between holdings of Corporation A stock and holdings of Preferred Securities.

(7) What labels are placed on the instruments by the parties?

For purposes of this factor, if Corporation A were treated as the issuer of the Preferred Securities, the labels given the Preferred Securities may be relevant. The Preferred Securities are labeled preferred shares, and the documents associated with the instruments describe the income from the shares as dividends. However, the prospectuses filed with the SEC indicate that the income

from the shares is taxed as interest income rather than as dividend income. For example, the tax opinion in the prospectuses states that the income from the shares is not eligible for the dividends received deduction. The tax opinion also states that any income that accrues during an extended interest payment period is included in income as interest even though it is not paid (the income is treated as original issue discount, a form of interest, rather than as dividend income). In addition, the holders of the Preferred Securities receive annual tax reporting documentation showing interest income payable on the shares.

(8) Are the instruments intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial purposes?

The Preferred Securities were designed to provide Corporation A with "equity credit." As discussed above, the term "equity credit" is used by the rating agencies to denote the degree to which an instrument affords the issuer more financial flexibility than commercial paper. The rating agencies focus on the impact of the issuance of a particular security upon other investors. Because the Preferred Securities have several features that increase Corporation A's financial flexibility, the rating agencies agreed that the issuance of these securities would provide some "equity credit" for Corporation A.[29] This treatment, however, is not equivalent to classifying the Preferred Securities as equity. In addition, the assignment of some "equity credit" to the Preferred Securities is not inconsistent with the treatment of the Preferred Securities as participations in the loans, which give the holders full creditor rights against Corporation A.

For financial purposes, the Preferred Securities are recorded on Corporation A's consolidated financial statements as a "minority equity interest in subsidiary". The "minority interest" amount for the Preferred Securities are shown on Corporation A's consolidated balance sheet as a separate category of obligation--junior to third party debt claims but senior to shareholders' equity. On the income statement, payments made with respect to these "minority interests" are deducted from net earnings as separate items of expense and therefore reduce earnings per share for equity holders in the same manner as interest expense. In addition, the Preferred Securities are not counted as shares in measuring Corporation A's earnings per share ratios.

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[29] The Preferred Securities have relatively long maturities and are subordinated to senior debt. In addition, the issuer has the ability to defer interest payments.

Other factors

Other factors that may be relevant in classifying an instrument as either debt or equity for federal income tax purposes include the following:

(1) Convertibility of the instrument into stock of the issuer (an equity characteristic). In this case, the Preferred Securities do not have a conversion feature.

(2) A sinking fund (a debt characteristic). In this case, there is no sinking fund provision.

(3) Contingent payments (an equity characteristic). In this case, there are no contingent payments on the Preferred Securities.

(4) Ability of the issuer to obtain loans from outside lending institutions (a debt characteristic). In this case, it appears that Corporation A can borrow from outside lending institutions.

(5) Failure of the debtor to repay on the due date or to seek a postponement (an equity characteristic). In this case, Corporation A (LLC) has made the scheduled payments on the Preferred Securities.

Based on the facts of this case and the factors described above, if the Preferred Securities are treated as issued by Corporation A directly, the Preferred Securities should be treated as debt for tax purposes.

ISSUE 3

Whether the transactions that involve the issuance of the preferred securities and the subsequent lending of the proceeds to Corporation A lack economic substance?

Section 163 allows a deduction for interest paid or accrued on indebtedness within the taxable year. However, in order to be deductible, the interest expenses must be the result of transactions that have economic substance. For example, see United States v. Wexler, 31 F.3d 117 (3d Cir. 1994); Sheldon v. Commissioner, 94 T.C. 738 (1990); and Bealor v. Commissioner, T.C.M. 1996-435. See also ACM Partnership v. Commissioner, 1998 WL 710617 (3rd Cir.), aff'g in part and rev'g in part, T.C.M. 1997-115 (in which the Court of Appeals held that the economic substance doctrine precluded the taxpayer from deducting certain losses attributable to a series of transactions involving contingent installment notes).

In Wexler, the court determined that, while section 163 does not expressly require that the transactions that gave rise to deductions have a business purpose or profit motive, nevertheless, case law establishes that the sham transaction doctrine bars interest deductions under section 163 if the underlying transaction does not have a business purpose or profit motive. The taxpayer in Wexler took deductions for interest paid on "repo to maturity" transactions involving the sale and repurchase of government securities. The interest deduction and the income from the transactions were taken into account in different taxable years, and the mismatching of the deduction and income caused the income to be deferred for a second taxable year. The court determined that the only reason for incurring the debt obligations was the tax benefits of deducting the interest on the obligations. In many of the cases upon which the court relied, the court found that "a key requirement is that the interest obligation be *economically substantive*, defined in every decision ... to mean that the transaction have a potential non-tax benefit." Wexler, 31 F.3d at 127.

The taxpayers in Sheldon entered into eleven transactions involving sales and repurchases of U.S. Treasury Bills. The court determined that, although ten of these eleven transactions were real and had actually occurred, the transactions were lacking in the requisite economic substance and denied the interest deductions.

The Sheldon court found that the taxpayers' sole objective was to obtain the interest deduction for transactions that had locked-in losses with no potential for any profit. In addition, the transactions were structured at year end to accommodate the mismatching of the income and deductions, thus creating a large tax benefit.

"[L]oans or other financing transactions will merit respect and give rise to deductible interest only if there is some tax-independent purpose for the transactions." Sheldon, 94 T.C. at 759. Interest is not deductible if the underlying transaction is a sham or if it has no purpose, substance, or utility apart from the expected tax consequences. However, the ability to profit is a part of the overall inquiry into purpose, substance and utility. The court determined that, although the transactions at issue were real, the transactions were entered into solely for the tax benefits, and therefore lacked the purpose, substance and utility required for the deduction.

In Bealor, the Tax Court reiterated that the substance of the underlying debt must be genuine in order for interest to be deductible under section 163(a).

The taxpayers in Bealor structured highly complex employee leasing transactions between a fuel trucking corporation and numerous partnerships. The Tax Court determined that the taxpayers were not entitled to interest and loss deductions because the transactions giving rise to the claimed deductions had neither economic substance nor a profit objective. In its analysis of the economic substance of the overall transaction, the court examined the real parties in interest, the structure of the financing, the taxpayers' prospects of actually making payments on their obligations, arm's-length negotiations, the parties' adherence to the contractual terms, the reasonableness of the income projections, and the introduction of new entities to buffer the existing parties from liability. The court noted that "where a debt transaction is not conducted at arm's-length by two economically self-interested parties, or where a debt is incurred in 'peculiar circumstances' indicating that it will not be paid, we have disregarded that debt for tax purposes." Bealor, T.C. Memo. 1996-435, at 776.

Upon a realistic view of the employee leasing transactions under the foregoing factors, the Tax Court in Bealor found that the transactions were shams lacking in economic substance, and the parties at issue did not demonstrate that they had profit as their primary purpose or any actual and honest profit objectives. As a result, the Tax Court held that no deductions or losses should be permitted in this situation.

In this case, Corporation A formed LLC in order to issue securities to public investors and to lend the net proceeds from the issuance to Corporation A. The loans were used for general corporate purposes, including the repayment of outstanding indebtedness. As a result of repayment of the indebtedness (along with other financing and investing activities), Corporation A's overall cost of capital declined.[30] Additionally, based on the information provided, Corporation A's debt/equity ratio decreased from GG to HH for the period during which the Preferred Securities were issued.

Based on the facts submitted, the transactions involving the issuance of the Preferred Securities appear to have economic substance; the available information indicates that Corporation A entered into the transactions to obtain funds at lower costs and to reduce its overall cost of capital. Corporation A used the funds for working capital, for the retirement of outstanding debt, and for other general corporate purposes. The fact that LLC earns no profit on the issuance of the Preferred Securities and the subsequent loans

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[30] See the summary of Management Discussion and Analysis extracted from Form 10-Q for the quarterly period ended Date 8.

made to Corporation A does not imply the transactions lack economic substance. Although LLC is a "tax-transparent" investment vehicle that acts to pass through the interest earned on the loans to the Preferred Securities holders, the underlying transactions have economic substance. As a result, the interest deduction should not be disallowed in this case (whether or not Corporation A is treated as the issuer of the securities).

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.

-END-