IRS OUTLINES ANSWERS TO DEBT-EQUITY QUESTIONS POSED BY NEW FINANCIAL INSTRUMENTS.

APR. 18, 1994

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DEBT/EQUITY ISSUES IN RECENT FINANCING TRANSACTIONS

Notice 94-47

In a number of recent transactions, instruments have been issued that are designed to be treated as debt for federal income tax purposes but as equity for regulatory, rating agency, or financial accounting purposes. These instruments typically contain a combination of debt and equity characteristics.

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. Of particular interest to the Service are instruments that contain a variety of equity features, including an unreasonably long maturity or an ability to repay the instrument's principal with the issuer's stock. Analysis of these instruments must take into account the cumulative effect of these features and other equity features.

General Debt/Equity Analysis

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 this determination are: (a) 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; (b) whether holders of the instruments possess the right to enforce the payment of principal and interest; (c) whether the rights of the holders of the instruments are subordinate to rights of general creditors;

(d) whether the instruments give the holders the right to participate in the management of the issuer; (e) whether the issuer is thinly capitalized; (f) whether there is identity between holders of the instruments and stockholders of the issuer; (g) the label placed upon the instruments by the parties; and (h) whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes. No particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity. The weight given to any factor depends upon all the facts and circumstances and the overall effect of an instrument's debt and equity features must be taken into account.

Payable in Stock

The Service is aware of recent offerings in which taxpayers may be relying on Rev. Rul. 85-119, 1985-2 C.B. 60. In that ruling, a bank holding company issued instruments (the Notes) that permitted the principal amount to be repaid with the company's stock at maturity. The Service held that the Notes constituted debt based on all the facts and circumstances, including the fact that, in substance, a holder of the Notes had the right to obtain repayment either in cash or in stock.

The holding in Rev. Rul. 85-119 is limited to the facts of that ruling. Instruments that are similar to the Notes but that, on balance, are more equity-like are unlikely to qualify as debt for federal income tax purposes. For example, an instrument does not qualify as debt if it has terms substantially identical to the Notes except for a provision that requires the holder to accept payment of principal solely in stock of the issuer (or, in certain circumstances, a related party). Similarly, an instrument does not qualify as debt if it has terms substantially identical to the Notes except that (a) the right to elect cash is structured to ensure that the holder would choose the stock, or (b) the instrument is nominally payable in cash but does not, in substance, give the holder the right to receive cash because, for example, the instrument is secured by the stock and is nonrecourse to the issuer.

Unreasonably Long Maturities

The Service also is aware of recent offerings of instruments that combine long maturities

with substantial equity characteristics. Some taxpayers are treating these instruments as debt for federal income tax purposes, apparently based on authorities such as Monon Railroad v. Commissioner, 55 T.C. 345 (1970), acq., 1973-2 C.B. 3, which involved an instrument with a 50-year term.

The Service cautions taxpayers that, even in the case of an instrument having a term of less than 50 years, Monon Railroad generally does not provide support for treating an instrument as debt for federal income tax purposes if the instrument contains significant equity characteristics not present in that case. The reasonableness of an instrument's term (including that of any relending obligation or similar arrangement) is determined based on all the facts and circumstances, including the issuer's ability to satisfy the instrument. A maturity that is reasonable in one set of circumstances may be unreasonable in another if sufficient equity characteristics are present.

DRAFTING INFORMATION

This notice was drafted in the Office of the Assistant Chief Counsel (Financial Institutions and Products). For further information concerning this notice, contact Andrew C. Kittler or Thomas M. Preston on (202) 622-3940 (not a toll-free call).