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A company's finance choices may generally be separated into two categories, namely equity and debt. Some instruments, however, contain both equity and debt elements and are not so easily categorized. Furthermore, the tax rules may not be consistent with straight equity or debt instruments and may differ with regard to corporate and individual tax treatment. The comparative survey aims at providing a guidance as to the treatment of proceeds from these instruments in various countries. In this issue, we continue the publication of the comparative survey. In the last issue France, Spain and Switzerland have been covered.

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demand redemption of the shares. However, redemption of a share is different from repayment of a traditional loan, in that the shareholder receives a proportionate share of the company's value, and not the amount that was invested when the

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UNITED STATES

TAXATION OF HYBRID INSTRUMENTS

Viva Hammer¹

I. INTRODUCTION

Corporate instruments are created to serve many purposes, and so may have characteristics that make them difficult to fit into a particular character box. There are many motivations for including various characteristics in an instrument, such as balancing the minority and majority interests in a corporation, as well as the debt and stakeholders. Increasingly, hybrids have proven to be versatile tools in adapting to various regulatory regimes, including Securities and Exchange Commission requirements, Financial Standards Accounting Board guidelines, and federal and state income tax rules.

US tax law does not recognize hybrids as being more than one, unified instrument. For tax purposes, an instrument is treated as either debt, equity, a forward, or an option, among other possibilities. Interest payments on debt instruments are deductible, while dividends on equity securities are not. In addition, premium payments on options are not includible or deductible until exercise, lapse, etc. Taxation of most forward instruments² is deferred until settlement. The chief result that Wall Street is trying to achieve is the creation of instruments which obtain equity treatment for regulatory, rating agency, and financial accounting purposes, while at the same time preserving their status as debt for US tax purposes in order to obtain the highly desired interest deduction for their clients. This is the type of hybrid which will be the focus of this article.

II. DEBT VS. EQUITY CHARACTERIZATION

Distinguishing between debt and equity for US tax purposes is not a simple task. The determination is a highly factual one and has been the subject of numerous court cases and a few Internal Revenue Service (hereinafter: IRS) releases and rulings.

Although legislative attempts have been made in the past, no clear set of rules has been established. In 1969, Congress enacted Section 385,³ which provided the Treasury Department (hereinafter: the Treasury) with the authority to issue

regulations addressing the determination of whether issued securities qualify as debt or equity.⁴ Later, during the early 1980s, the Treasury issued final regulations under Section 385 addressing the debt/equity distinction. However, the regulations were later withdrawn due to the immediate proliferation of hybrid instruments that took maximum advantage of the regulations.⁵

Though the Treasury has not been successful in utilizing its regulatory authority under Section 385, Congress has amended the section twice since its enactment in 1969. In 1989, Section 385 was amended to provide the Treasury the authority to determine whether an instrument is part equity and part debt (i.e. to bifurcate an instrument). In 1992, Section 385(c) was added, requiring the holder of a security to treat the security in a manner that is consistent with that of the issuer, unless properly disclosed on the holder's return.⁶

Presently, case law, IRS rulings and IRS releases that make the distinction between debt and equity govern the tax treatment of hybrid instruments. Some of the more prevalent factors considered by the courts and the IRS in making the distinction between debt and equity will be analysed below. This article will then conclude with an analysis of the taxation of specific hybrid products.

1. PricewaterhouseCoopers, New York.

2. Excluding certain foreign currency based forward instruments for example. See IRC Sec. 1256(g)

3. All statutory references are to the Internal Revenue Code of 1986 (as amended), unless otherwise indicated. All regulatory references are to the regulations issued under the Internal Revenue Code.

4. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969).

5. The Treasury Department issued proposed Sec. 385 regulations in Notice of Proposed Rulemaking, 45 Fed. Reg. 18,957 (1980); made final in TD 7747, 1981-1 CB 141; revised by TD 7774, 1981-1 CB 168 and TD 7801, 1982-1 CB 60, respectively; issued proposed amendments in Notice of Proposed Rulemaking, 1982-1 CB 531; and withdrew all Sec. 385 regulations in TD 7920, 1983-2 CB 69. For a discussion of a hybrid instrument created to benefit from the regulations, see Rev. Rul. 83-98, 1983-2 CB 40, where the Service held that "adjustable rate convertible notes" (hereinafter: ARCNs) constitute equity for federal income tax purposes.

6. Sec. 385(a) was enacted by Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, Sec. 7208(a)(1), 103 Stat. 2106 (1989); Sec. 385(c) was enacted by Energy Policy Act of 1992, Pub. L. No. 102-486, Sec. 1936(a), 106 Stat. 3111 (1992).

A. Case law factors

The courts have never relied on any one factor to determine whether securities issued by a corporation represent debt or equity.⁷ As no single factor is controlling, the courts make the debt/equity distinction by considering and applying a long list of factors to the facts and circumstances of each case.⁸ A scholarly law review article by William T. Plumb, Jr concisely lists and groups the majority of factors utilized by courts.⁹ Plumb's list is summarized in the following table:

Formal rights and remedies of creditors	Genuineness of intention to create debt
– maturity	– formal documentation
– remedies for default	– declarations of the parties
– subordination	– security and sinking fund
– certainty of income	– proportionality
– absence or inadequacy of interest	– disproportionality
– participation in success of the venture	– guaranties by shareholders
– participation in both success and failure	– variations on the theme
– participation in control	– payment history
– the name of the instrument	– failure to enforce on default
	– voluntary subordination
	– change of ownership
Rhetorical expressions – no evidentiary weight	Reasonableness or economic reality of intention
– tax motivation and business purpose	– thin or inadequate capitalization
– dividend and salary policy	– use of funds advanced
– arbitrary separation	– source of payments
– no new capital	– independent creditor test
– double taxation	– salvage loans

Many tax professionals consider Plumb's article to be the most definitive work on the issue and it is often used as a starting point in considering the debt/equity distinction. However, it must be noted that as none of the factors are conclusive and the weight given to each varies among jurisdictions and courts, it is important to consider all factors in light of the circumstances giving rise to the security when structuring and issuing such instruments.

B. Maturity date

The maturity date is often considered one of the most important factors in determining debt status.¹⁰ The maturity date indicates the time when the creditor is unconditionally entitled to require payment of the principal.¹¹ A fixed or ascertainable maturity date is virtually essential to debt classification of an instrument. However, the presence of a maturity date is not conclusive since other factors may indicate that the instrument represents an equity investment. On the other hand, the absence of an unconditional right to demand payment is virtually conclusive.¹²

The amount of time between issuance and maturity also needs to be considered. The shorter the time between

issuance and maturity, the more likely the instrument will be considered debt. The IRS has said that it would scrutinize instruments with "unreasonably" long maturities.¹³ What is considered an unreasonably long maturity depends on all facts and circumstances, including the nature of the enterprise issuing the security.¹⁴ In this context, the ability of the issuer to satisfy the instrument is an important consideration. For example, an established company like Walt Disney is at a lesser risk of default on the maturity date of a 100-year term instrument than an Internet start-up firm. Again, it is important to remember that this analysis does not take place in a black box. If the term of the instrument is longer than the life of the issuer's principal asset or if the instrument is overly weighed with equity characteristics, it is unlikely that a court will characterize the instrument as debt.

C. Remedies for default

The remedy afforded a security holder in the event of default is also considered an important factor. The question here is whether the holder can force payment when the issuer fails to make a scheduled payment.¹⁵ A debt instrument generally gives the holder the right to sue the issuer if the issuer fails to make a scheduled payment.¹⁶ On the other hand, a disappointed equity holder's only recourse is to exercise its voting rights to replace the board of directors. In order to be classified as debt, some courts have required that the instrument contain a maturity acceleration clause, in addition to the right to sue.¹⁷ Grace period provisions, allowing a debtor a period of time to make good on its obligation before the debtor enforces its remedies, generally do not have a negative effect on the determination of whether an instrument is debt.¹⁸

D. Subordination

Debt holders generally have a right to share with general creditors in the event that the issuer liquidates,¹⁹ whereas

7. *John Kelley Co. v. Commissioner*, 326 US 521, 66 S.Ct. 299.

8. See e.g. *Berkowitz v. United States*, 411 F2d 818, 820 (5th Cir. 1969); *Tyler v. Tomlinson*, 414 F2d 844, 847 (5th Cir. 1969).

9. Plumb, "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal", 26 *Tax L. Rev.* (1971), at 369-640.

10. *Id.*, at 413.

11. *Wood Preserving Corp. v. United States*, 347 F2d 117, 119 (4th Cir. 1965); *Commissioner v. Schmoll Fils Associated*, 110 F2d 611, 613 (2nd Cir. 1940).

12. The case of *Helvering v. Richmond, F. & P.R.R. Co.*, 90 F2d 971 (4th Cir. 1937) is a rare exception. The court held that guaranteed stock with characteristics of both equity and debt constituted debt, even though the holders could not demand the principal payment as long as annual guaranteed dividends were paid.

13. Notice 94-47, 1994-1 CB 357.

14. *Id.*, note 9, at 357.

15. See *United States v. South Georgia Ry. Co.*, 107 F2d 3, 5 (5th Cir. 1939).

16. Terms requiring a majority vote of bondholders or a judgment of a bond indenture trustee in order to accelerate the maturity upon default have been found to be consistent with indebtedness. *Luden's Inc. v. United States*, 196 F. Supp. 526, 533 (E.D. Pa. 1961); *Charles E. Curry*, 43 TC 667, 686 16 (1965).

17. *National Farmers Union Serv. Corp. v. United States*, 400 F2d 483, 485 (10th Cir. 1968); *Coleman Good, Inc. v. United States*, 65-2 USTC 9750 (W.D. Pa. 1965), *aff'd*, 359 F2d 434 (3d Cir. 1966).

18. *Elliott-Lewis Co.*, 4 TCM 136, 142 (1945), *aff'd*, 154 F2d 292 (3d Cir. 1946); *Commissioner v. J.N. Bray Co.*, 126 F2d 612, 613 (5th Cir. 1942).

19. *P.M. Finance Corporation v. Commissioner*, 302 F2d 786, 789-90 (3rd Cir. 1962).

equity holders' rights are subordinated to those of general creditors upon liquidation.²⁰ However, if an instrument is subordinated to the claims of general creditors, but ranks ahead of preferred and common stock holders, it is not necessarily denied debt status. For instance, the debt of a holding company is necessarily subordinated to all debt claims against its operating subsidiaries.²¹ Furthermore, the degree to which an instrument is subordinated to senior claims is also relevant. If subordination is only triggered by a default in payment of the senior claims or by bankruptcy, that instrument is more likely to be considered debt than would be an instrument where the subordinated claimants cannot be paid until all other claims have been discharged.²²

E. Certainty of income

Shareholders are generally entitled to receive dividends only if there are corporate earnings or surplus and upon discretionary action of the board of directors. On the other hand, bondholders are entitled to interest as specified in the relevant contract. The contract can provide for unconditional interest, or provide that interest is contingent upon adequate corporate earnings and becomes absolute when the condition is satisfied. However, if payment of interest is conditional upon corporate earnings and is only payable upon board discretion, the instrument resembles stock rather than debt.

Related to this factor is the adequacy of interest. The failure to provide for interest is generally fatal to the finding of debt with respect to an instrument.²³ A true lender would not subject his or her capital to the risks of a venture without being adequately compensated for those risks. The failure to be compensated for such risks has been said to be evidence of a primary concern for enhancing the issuer's earnings and increasing the market value of its stock; this is the attitude of a shareholder, not a lender.²⁴ As mentioned above, it is important that the interest provided be commensurate with the risk involved. The IRS held that adjustable variable-interest convertible notes were equity because (1) the guaranteed return was unreasonably low for comparable debt and (2) it was highly probable that the notes would be converted into equity.²⁵

F. Participation in the success of the venture

An instrument that allows an investor to participate in the profits of the issuer is not necessarily inconsistent with a creditor-debtor relationship. Indeed, this is quite common, particularly in the case of convertible debentures. However, if the issuer makes the deal too sweet (i.e. too good to resist) by providing a specified conversion ratio that is virtually certain to be exercised, the instrument will be viewed as equity and not debt.²⁶ Furthermore, if the assets from which an instrument is to be satisfied are insignificant relative to the purported debt, it would appear that the instrument is more like equity as payment would be dependent upon the upside potential of the assets.

G. Participation in control

Some courts have stated that the right to participate in management and the right to vote are generally indicative of equity rather than debt.²⁷ Though many courts have analysed these factors in dictum, they have rarely stressed these factors in determining debt/equity status, making it no more than a marginal factor.²⁸ In the United States it is very common to find debt agreements that impose restrictions on business matters such as the payment of dividends, major acquisitions and granting creditors a seat on the board of directors.

H. The name of the instrument

Although the nomenclature used to describe an instrument is not conclusive, it is an important factor that should not be ignored.²⁹ Courts are sometimes reluctant to allow the issuer and investor to repudiate the label chosen by them.³⁰

I. Intention of the parties

The intention of the parties is frequently highlighted by the courts as being important in determining whether an instrument is debt or equity.³¹ As intent is not an objective factor, all facts and circumstance giving rise to the instrument are usually examined. For example, how the issuer and investor treat the instrument for tax and book purposes may indicate the intentions of the parties. It should be noted that some commentators, particularly Professor Plumb, argue that intent of the parties should not serve as a factor having independent weight, but rather it should be gleaned from an examination of all other factors.³²

J. Thin or inadequate capitalization

An issuer with a high debt-to-equity ratio could be at risk of having an instrument denominated as debt actually treated as stock.³³ Thin capitalization may create the presumption that

20. *Helvering v. Richmond, F. & P.R. Co.*, 90 F2d 971, 974 (4th Cir. 1937).

21. Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, 6th ed. (Warren, Gorham & Lamont of the RIA Group, 1998)(hereinafter: Bittker and Eustice).

22. *Id.*

23. Unless of course, the instrument was issued at a discount or some other factor in the transaction compensates for the time value of money. *Potter Electrical Signal & Mfg. Co.*, 19 TCM 160, 168 (1960); *Gyro Engineering Corp. v. United States*, 417 F2d 437, 440, note 5 (9th Cir. 1969).

24. *Curry v. United States*, 396 F2d 630, 634 (5th Cir.), *cert. denied*, 393 US 967 (1968).

25. Rev. Rul. 83-98, 1983-2 CB 40.

26. See Rev. Rul 83-98, 1983-2 CB 40. IRC Sec. 163(l).

27. *Zilkha & Sons, Inc. v. Commissioner*, 52 TC 607, 616 (1969), *acq.* 1970-2 CB; see e.g. *Fin Hay Realty Co. v. United States*, 398 F2d 694, 696 (3rd Cir. 1968).

28. Plumb, see note 9, at 447.

29. *Crawford Drug Stores, Inc. v. United States*, 220 F2d 292, 295 (10th Cir. 1955).

30. Plumb, see note 9, at 450.

31. See e.g. *Crawford Drug Stores*, note 29, at 296.

32. Plumb, see note 9, at 411.

33. See e.g. *Plantation Patterns, Inc. v. Commissioner*, 462 F2d 712 (5th Cir. 1972), *cert. denied*, 409 US 1076 (1972).

an instrument is so at risk of the business that it may be regarded as venture capital.³⁴ Some courts have disregarded the thin capitalization of an issuer where there the facts indicate a reasonably assured cash flow sufficient to service the purported debt.³⁵

III. TAXATION OF SPECIFIED HYBRIDS

A. Convertible bonds, debts, loans, notes and debentures

Convertible debt is generally treated as a debt instrument until conversion, after which it becomes equity.

If an instrument is issued at a premium (i.e. in excess of the face amount) for cash,³⁶ the holder may amortize the premium over the life of the bond using a compound-interest method.³⁷ The issuer must include the premium in income ratably over the life of the debt.³⁸ The premium that is amortized cannot include any amount attributable to the bond's conversion features.³⁹ Furthermore, the bond premium does not include any difference between the fair market value of securities received in the conversion and the value of converted bonds.

If an instrument is issued at a discount (i.e. at a price below its face amount) for cash,⁴⁰ the holder must accrue what is called the "original issue discount" (hereinafter: OID) in income over the life of the debt.⁴¹ OID is defined as the excess of the debt instruments "stated redemption price at maturity" (hereinafter: SRPM) over its "issue price".⁴² The SRPM is defined as the:

amount fixed by the last modification of the purchase agreement and includes interest and other amounts payable at that time (other than any interest based on a fixed rate, and payable unconditionally at fixed periodic intervals of one year or less during the entire term of the debt instrument).⁴³

The issuer may deduct the OID amount as additional interest over the life of the debt.⁴⁴ It should be noted that in computing the OID, no adjustments are made for the value of the conversion privilege.⁴⁵

When a bond is retired for cash, the amount by which the repurchase price exceeds the bond's "adjusted issue price"⁴⁶ is treated like a premium. This premium is deductible to the extent that it is not greater than a call premium on comparable non-convertible debt.⁴⁷ The portion that is not deductible is treated as attributable to the repurchase of the bond's conversion features. In this situation, the holder's gain will generally constitute capital gain.⁴⁸

In the case where a bond is retired for less than its face amount, the issuer may have to recognize "cancellation-of-debt" (hereinafter: COD) income.⁴⁹ COD income is measured by the spread between the amount paid to discharge the debt and the debt's "adjusted issue price".⁵⁰

The exercise of an option to convert a bond into stock of the issuer is not a taxable exchange. Gain or loss on the conversion is recognized only when the taxpayer disposes of the stock. This rule applies only if the conversion feature is pro-

vided for in the bond and only where the stock received in the conversion is the same stock of the issuer of the bond.⁵¹

B. Warrants, options, and rights

The cash or property that a corporation receives when it issues a warrant to purchase its own stock is not taxable (it is viewed as non-taxable capital receipts).⁵² The proceeds remain tax-exempt even when the warrant lapses without being exercised. However, if the corporation repurchases the warrant, the proceeds used to buy it back are not deductible.⁵³

Often, warrants are issued as part of an "investment unit". An investment unit generally consists of a debt obligation with a warrant attached. The issue price of the investment unit must be allocated between the debt and warrant in proportion to their relative fair market values.⁵⁴ The bifurcation often results in the creation of OID.

The following example illustrates the investment unit bifurcation rules. Larry Lender purchased a bond from Tech Corp. Larry paid USD 100 for a 5 per cent, 20-year bond, with a principal amount of USD 100, together with a 5-year warrant entitling Larry to purchase 10 shares of Tech's stock at USD 10 per share. On the date Tech issued the bond to Larry, the bond was worth USD 88, the warrant was worth USD 12, and Tech's stock was worth USD 9 per share.

In this example, Tech is treated as issuing and Larry is treated as purchasing the bond for USD 88 and the warrant for USD 12.⁵⁵ The bifurcation creates USD 12 of OID on the bond, which Tech may deduct and Larry must report as ordinary

34. *Gilbert v. Commissioner*, 248 F2d 399, 407 (2nd Cir. 1957).

35. See e.g. *Piedmont Corp. v. Commissioner*, 388 F2d 886, 890-91 (4th Cir. 1968).

36. Similar rules applies to convertible debt securities issued for property at a premium. See Secs. 1273 and 1274.

37. Sec. 171 and the regulations thereunder.

38. Treas. Reg. Secs. 1.161-12(c)(2) and 1.163-13.

39. Sec. 171(b)(1).

40. It is unclear on how to treat convertible debt issued for property at a discount.

41. Sec. 1272.

42. Sec. 1273(a). The "1/4 of 1 per cent *de minimis* rule" is an exception to the OID rules. Sec. 1273(a)(3) states that if OID is "less than 1/4 of 1 per cent of the stated redemption price at maturity, multiplied by the number of complete years to maturity, then the original issue discount shall be treated as zero".

43. Sec. 1273(a)(2).

44. Sec. 163(e).

45. See *Chock Full O'Nuts Corp. v. United States*, 453 F2d 300 (2nd Cir. 1971); *Honeywell, Inc. v. Commissioner*, 87 TC 624 (1986)(acq.).

46. The "adjusted issue price" is the original issue price increased by any discount previously deducted by the issuer or reduced by any premium previously included in income.

47. See Treas. Regs. Sec. 1.163-3(c); *Clark Equip. Corp. v. United States*, 912 F2d 113 (6th Cir. 1990), cert. denied, 500 US 941 (1991).

48. See Sec. 1271(a)(1); *Prudential Ins. Co. v. Commissioner*, 882 F2d 832 (3rd Cir. 1989); Treas. Regs. Secs. 1.163-7(c) and 1.1271-2.

49. Sec. 61(a)(12).

50. The "adjusted issue price" is the original issue price adjusted under Sec. 108(e)(3) for unamortized issue premium or discount.

51. See Rev. Rul. 72-265, 1972-1 CB 222.

52. Secs. 118 and 1032.

53. Sec. 1032.

54. Sec. 1273(c)(2).

55. Under Secs. 1273(b)(2) and 1273(c)(2), respectively.

income.⁵⁶ If Larry exercises the warrants, he will not realize any gain or loss and his basis in the Tech stock will be USD 112 (USD 100 exercise price plus USD 12 basis in the warrants). If Larry decides to sell the warrants instead of exercising them, he will realize a capital gain or loss on the difference between his USD 12 basis in the warrants and the amount realized on the sale.⁵⁷ If Larry allows the warrants to lapse, he would incur a USD 12 capital loss.⁵⁸ Furthermore, the issuer, Tech Corp., does not recognize any gain or loss on the issue, exercise, repurchase or lapse of the warrants.

C. Preferred shares/stock

Preferred stock is a security where the blurred line between debt and equity is often tested. The type of preferred stock and how it is structured will determine its status as debt or equity. The most basic form of preferred stock, that which enjoys limited rights and privileges (i.e. with respect to dividends and liquidation rights) in relation to other outstanding stock but without participating in corporate growth to any significant extent,⁵⁹ is generally treated as equity.

Dividends are distributions that are treated as ordinary income and included in gross income by the recipient.⁶⁰ When a distribution is in excess of current and accumulated earnings and profits, it is not considered a dividend and is not included in income.⁶¹ The distribution decreases the recipient shareholder's basis in the stock to the extent of his or her basis, and thereafter it is usually treated as a capital gain.⁶²

Special rules apply to corporate shareholders that receive dividends. Generally, corporate shareholders can deduct dividends received from taxable domestic corporations.⁶³ The amount that the recipient corporation can deduct depends upon the extent of its ownership interest in the issuing corporation. The recipient corporation can generally deduct:

- 70 per cent of the dividend if it owns less than 20 per cent of the voting power and value of the stock of the issuing corporation;⁶⁴
- 80 per cent of the dividend if it owns at least 20 per cent but less than 80 per cent of the voting power and value of the stock of the issuing corporation;⁶⁵ and
- 100 per cent of the dividend if it is a small business investment company or if the recipient and issuer are members of the same affiliated group.⁶⁶

Dividends are included in income in the year in which the income is unqualifiedly made subject to the shareholder's demand, which generally occurs at the time the dividends are received.⁶⁷ This rule applies to both accrual- and cash-basis taxpayers.⁶⁸ For instance, a dividend distributed on 31 December 1998 and received by an accrual-basis shareholder on 2 January 1999 is included in income in 1999.

A recent example of preferred stock that has been treated as debt is monthly income preferred stock (hereinafter: MIPS). A MIPS transaction provides a borrower with an interest expense deduction for tax purpose while avoiding reporting the borrowing for financial accounting purposes. Generally, a pass-through entity, such as a partnership (or an entity treated as a partnership for US federal income tax purposes), is set up

by the borrower. The pass-through entity then issues equity interests (the MIPS) that have a debt-like return. The proceeds from the sale of the MIPS are lent to the borrower, thereby allowing the borrower to take an interest expense deduction. Commonly, the borrower and the pass-through entity are consolidated for financial accounting purposes, which results in the elimination of the debt and allows the issuer to treat the MIPS as a minority equity interest in a subsidiary resulting in an increase of its capital.

The IRS recently issued a technical advice memorandum⁶⁹ in which it found a MIPS transaction to be debt. The IRS applied the factors discussed in a notice previously issued in response to MIPS and DECS (i.e. debt exchangeable for common stock) transactions.⁷⁰ In this notice, the IRS stated that it would scrutinize certain instruments designed to be treated as debt for federal income tax purposes but as equity for regulatory, rating agency, or financial accounting purposes. The IRS stated that its characterization of an instrument as debt or equity will depend on the terms of the instrument and all surrounding facts and circumstances. The factors the IRS said it would consider are:

- 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;
- whether holders of the instruments possess the right to enforce the payment of principal and interest;
- whether the rights of the holders of the instruments are subordinate to rights of general creditors;
- whether the instruments give the holders the right to participate in the management of the issuer;
- whether the issuer is thinly capitalized;
- whether there is identity between holders of the instruments and stockholders of the issuer;
- the label placed on the instruments by the parties; and

56. Under Secs. 163(e) and 1272(a), respectively.

57. Sec. 1234.

58. *Id.*

59. Treas. Reg. Sec. 1.305-5(a).

60. Secs. 61(a)(7) and 301(c)(1). Dividends are taxed to the person who has the right to receive them, rather than the legal or record owner, if different. *Commissioner v. Sunnen*, 333 US 591 (1948), 68 S Ct 715, 48-1 USTC 9230; *Watson v. Commissioner*, TC Memo 1960-255, 19 TCM 1409; *Hume v. Commissioner*, TC 1982-525, 44 TCM 1108, *appeal dismissed* (9th Cir. 1983).

61. Sec. 316(a).

62. Secs. 301(c)(2) and 301(c)(3); *Shield Co. Inc v. Commissioner*, 2 TC 763 (1943).

63. Sec. 243(a).

64. Sec. 243(a)(1).

65. Sec. 243(c).

66. Sec. 243(a)(3).

67. Sec. 301 and Treas. Reg. Sec. 1.301-1(b).

68. *Avery v. Commissioner*, 292 US 210 (1934), 54 S Ct 674, 41 USTC 1277; *Allied Fidelity Corp. v. Commissioner*, 66 TC 1068 (1976), *aff'd* 572 F2d 1190 (7th Cir. 1978), *cert denied* 439 US 835; Rev. Rul. 78-117, 1978-1 CB 214; *Commissioner v. American Light & Traction Co.*, 156 F2d 398 (7th Cir. 1946), 46-2 USTC 9312; *Frelbro Corporation v. Commissioner*, 36 TC 864 (1961); *Tar Prods Corp. v. Commissioner*, 130 F2d 866 (3rd Cir. 1942), 42-2 USTC 9662; *Beneficial Corp v. Commissioner*, 18 TC 396 (1952), *aff'd per curiam* 202 F2d 150 (2nd Cir. 1953).

69. TAM 199910046.

70. Notice 94-47, see note 13. DECS will be discussed in the next section.

- whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency or financial accounting purposes.⁷¹

The IRS stated that no particular factor is conclusive in determining whether an instrument constitutes debt or equity.⁷²

D. Debt exchangeable for common stock

Debt exchangeable for common stock (hereinafter: DECS) is a security that is used by issuers as means to monetize their appreciated investments in other corporations without recognizing the gain at the time the DECS securities are issued. Although no IRS rulings or technical advise memoranda have been specifically issued with respect to DECS,⁷³ based on other authorities, issuers have been treating the security as debt.⁷⁴

A DECS transaction is generally structured as follows. An issuer borrows funds by using stock⁷⁵ as collateral for the debt that is convertible into the referenced stock. The principal amount of the debt is set at the then-prevailing market price of the stock. At maturity, the principal amount of the debt will be exchanged into a number of shares of stock based upon a formula that fluctuates with the value of the stock. DECS securities are generally subject to a conversion cap, thereby shifting the downside risk on the stock to the holder of the debt instrument (i.e. DECS instrument) while retaining the upside in excess of the cap.

The issuer and holder of the DECS security agree in the indenture that, for tax purposes, the DECS will be treated as

an investment unit consisting of a debt instrument in the principal amount of the DECS and a forward purchase contract to acquire the stock with the principal that is payable at maturity. Thus, allowing the DECS issuer to claim current interest expense deductions (as interest is paid on the debt) and avoid recognition of gain on the referenced stock until the date the debt is exchanged for stock.

IV. CONCLUSION

As the financial engineers of Wall Street continue to test the boundaries of the debt/equity distinction with increasingly aggressive hybrid products, it is likely that more guidance on the issue will be seen.

71. This factor is generally not considered relevant under case law. Hariton, "Distinguishing Between Equity and Debt in the New Financial Environment", 49 *Tax L. Rev.* 499 (1995), at 517. Furthermore, in TAM 199910046, the IRS did not seem to be as concerned with this factor either.

72. Notice 94-47, see note 13.

73. The only authority with respect to DECS is Notice 94-47, see note 13, which is general in scope and is discussed in the previous section.

74. Tax practitioners have relied in part on Revenue Ruling 85-119 to justify debt treatment. It should be noted that Notice 94-47, see note 13, warned that Rev. Rul. 85-119 is limited to its facts and that instruments that are more equity-like are unlikely to qualify as debt for federal income tax purposes.

75. The stock is generally the stock of another corporation that the DECS issuer holds.