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## IRS Issues Private Letter Ruling on Debt/Equity Treatment Under Liberalized Ruling Procedures

The classification of a financial instrument as debt or equity is a fundamental, recurring question under the Internal Revenue Code of 1986, as amended (the “Code”). On June 25, 2010, the Internal Revenue Service (the “Service”) released a copy of a private letter ruling (“PLR”) addressing a class of preferred shares issued by closed-end funds as a form of refinancing for auction rate preferred shares; it is the first PLR that the Service has issued pursuant to newly liberalized ruling guidelines for resolving the debt/equity treatment of certain corporate instruments. The change in guidelines, announced in early 2010 (see Revenue Procedure 2010-3, § 4.02(1), 2010-1 I.R.B. 110), had signaled the availability of a potentially important planning tool. PLR 201025045 (March 10, 2010) (the “Ruling”) now demonstrates the Service’s credibility in wielding it in appropriate circumstances.

### Background

Whether to classify a financial instrument as debt or equity for tax purposes is a basic and ubiquitous issue in federal tax law because the tax treatment of an entity’s capital structure generally determines the taxation of the entity and the holders of interests therein. The tax character of an instrument figures materially in reorganizations and other important business transactions and may be vital to the identity of the issuer under the tax law.

Despite the importance of debt/equity classification to corporations and other business entities and the desirability from a capital markets standpoint of providing an efficient means for streamlining the classification, the tax law has not evolved a stable, comprehensive framework in the form of statutory or regulatory standards. Section 385 of the Code, enacted in 1969, grants the Secretary of the Treasury the authority to issue regulations on the treatment of interests in corporations, but the government never adopted final regulations, although it made several attempts. In the absence of such a framework, the courts and the Service have relied on a multi-factor analysis, applied on an *ad hoc* basis, in case law, revenue rulings, revenue procedures, and other determinations, within the traditional cycle of tax reporting and examination.

Even though a PLR may be used or cited as precedent only by the specific taxpayer covered by the ruling,<sup>1</sup> the Service nevertheless has historically been reluctant even to issue PLRs on the classification of instruments as debt or equity. Indeed, the annually revised standards and procedures for issuing PLRs have for a long time begun the list of “areas in which [PLRs] will not ordinarily be issued” with “[a]ny

<sup>1</sup> See Code § 6110(k)(3). PLRs nonetheless “reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws” (*Hanover Bank v. Commissioner*, 369 U.S. 672, 686 (1962)) and may be helpful in establishing consistency of administrative treatment. *Cf. Rowan Companies v. United States*, 452 U.S. 247, 261 n.17 (1981).

matter in which the determination requested is primarily one of fact, *e.g.*, . . . *whether an interest in a corporation is to be treated as stock or indebtedness.*” (Emphasis added.) Although the “will not ordinarily rule” standard seemed to allow for the possibility of a PLR in “unique and compelling” circumstances, the Service’s stance was generally interpreted as a bar to obtaining a binding advance determination on the classification of a particular instrument.

### Revenue Procedure 2010-3 and the Ruling

In early 2010, the Service announced a significant change in its ruling procedures by adding the following qualifying language to the traditional proscription against issuing PLRs on debt/equity questions:

Although it is generally inappropriate for the Service to issue a letter ruling on whether an interest in a corporation is stock or indebtedness, there may be instances in which the Service may issue a letter ruling. For example, the Service may issue a letter ruling with respect to an instrument issued by a domestic corporation if (1) the taxpayer believes that the facts strongly support the classification of the instrument as stock and (2) the taxpayer can demonstrate that there are unique and compelling reasons to justify the issuance of a letter ruling.

The Service has now fulfilled the promise of administrative flexibility in Revenue Procedure 2010-3 by issuing the Ruling to a taxpayer seeking confirmation that a proposed class of mandatorily redeemable preferred stock should be treated as equity for federal tax purposes.

### Analysis

The instrument in the Ruling was preferred shares (“New Preferred Shares”) to be issued by a closed-end management investment company (the “Fund”) operating as a regulated investment company under subchapter M of the Code (a “RIC”). The Fund already had outstanding (i) a class of “auction rate

preferred shares” (“ARPS”),<sup>2</sup> (ii) a series of mandatorily redeemable preferred shares issued for the purpose of raising capital to redeem a portion of the Fund’s outstanding ARPS, and (iii) common shares. New Preferred Shares would be issuable in two additional series and would be subject to mandatory redemption at the end of a certain number of years and would further facilitate the refinancing of ARPS. Although the Ruling did not identify the specific terms of years of the two series of New Preferred Shares, one may infer that the redemption periods are relatively short, because authority in other contexts seems to have endorsed equity treatment for mandatorily redeemable preferred stock having a term of five years. (See, *e.g.*, Rev. Rul. 78-142, 1978-1 C.B. 111.)

In the Ruling the status of New Preferred Shares as equity for tax purposes was not merely important in clarifying the nature of the investment return to the holders of a public security and the tax accounting for the Fund’s payments on the shares. It was crucial to the Fund’s operation as a RIC, because dividends with respect to equity issued by a RIC -- as opposed to interest on a RIC’s debt -- are eligible to pass through to its shareholders the character of the income the RIC earns (in this case, exempt interest on municipal bonds). If the New Preferred Shares failed to qualify as equity for federal tax purposes, the dividend-accounting mechanism that ensures subchapter M compliance would likely fail to preserve the Fund’s status as a RIC. It is not an exaggeration to describe the loss of the pass-through treatment for the Fund’s exempt interest as catastrophic.

Under the multi-factor tests customarily used by the Service to analyze the debt/equity treatment of instruments, preferred stock generally has been treated as equity. However, dicta in a few older cases, combined with facts suggestive of a debt character, seemed to support holdings that certain preferred stock with mandatory redemption terms should be treated as debt for tax purposes. As a

<sup>2</sup> ARPS, although perpetual, were designed to be liquid through an auction or remarketing process that reset their dividend rates periodically at a market-clearing price that facilitated resale. However, the national market for ARPS had “frozen” in February 2008, when ARPS remarketing mechanisms experienced severe liquidity difficulties, and it has generally remained impaired since then.

theoretical matter, a sufficiently short mandatory redemption period, considered as one of the traditional debt/equity factors, could be viewed as imparting a debt-like flavor to an instrument because of the contractual assurance that holders would receive a return of their investment on a date certain, especially when a mandatory redemption term is coupled with a regular preferred stock dividend rate. Despite the near-century of interpretations by the courts and the Service in the debt/equity area, the status of mandatorily redeemable preferred stock had never received a clear resolution, at least at terms of less than five years. For a RIC like the Fund, even a possibility that the New Preferred Shares might be treated as debt, rather than equity, would thwart the marketability of the instrument and thus further frustrate efforts to find economically viable alternative financing and to restore liquidity to the ARPS market.

In the Ruling, the Service held that interests in the form of New Preferred Shares having either of the two mandatory redemption terms would qualify as equity for federal tax purposes. The Ruling noted that the Fund had made the following representations, among others:

- The shares of each series would rank on a parity with shares of each other series of New Preferred Shares and with any other preferred shares series as to the payment of dividends and the distribution of assets upon dissolution, liquidation or winding up of the affairs of the Fund.
- Each series of New Preferred Shares would have preference in distributions over shares of common stock.
- No holder of New Preferred Shares would have, solely by reason of being such a holder, any preemptive or other right to acquire, purchase or subscribe for any New Preferred Shares or common shares or other securities the Fund might thereafter issue or sell.
- The holders of New Preferred Shares of any series would be entitled to receive, when, as and if declared by, or under the authority granted by, the Board of Trustees, out of funds legally available therefor and in preference to distributions on common

shares of the Fund, cumulative cash distributions on each share of such series.

- In the event of any dissolution, liquidation or winding up of the affairs of the Fund, whether voluntary or involuntary, the holders of New Preferred Shares would be entitled to receive out of the Fund's assets available for distribution to shareholders, after satisfying claims of creditors but before any distribution or payment made in respect of the common shares, a liquidation distribution.
- The Fund would redeem all shares of a series of New Preferred Shares on the redemption date for such series, at a price per share described in the appropriate documents, but only out of funds legally available therefor under state corporate law.
- Holders of New Preferred Shares would possess voting rights that are at least as extensive as the voting rights possessed by holders of the Fund's common shares.

In holding that the New Preferred Shares were equity for tax purposes, the Service did not change or depart from the multi-factor test or otherwise act inconsistently with respect to the extensive body of case law and administrative law dealing with debt/equity questions. Rather, it illustrated how the mandatory redemption terms being proposed for the Fund's New Preferred Shares should be applied within the traditional multi-factor approach.

## Conclusion

While the Ruling should not be interpreted as altering any substantive standards of debt/equity classification, it resolved an important gap in existing law in the circumstances presented by the Fund. By providing this clarification in advance, in the form of a PLR, the Service helped eliminate a market imperfection that might have taken years to resolve under the traditional *laissez-faire* policy that relegated debt/equity questions to the tax reporting and examination cycle. Looking beyond the effects on the Fund and its securities holders, it is not difficult to predict that other ARPS issuers may imitate this capital structure as part of their efforts to thaw their frozen ARPS. More broadly still, other corporate taxpayers in need of clarification of the status of other instruments as equity for tax purposes should consider availing themselves of the

new tool provided by Revenue Procedure 2010-3  
and exemplified by the Ruling.

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