

INTERNAL REVENUE SERVICE  
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

August 30, 2004

Number: **200448047**  
Release Date: 11/26/2004  
Index (UIL) No.: 1273.02-00  
CASE-MIS No.: TAM-148343-03, CC:FIP:BR03

Taxpayer's Name:  
Taxpayer's Address:

Taxpayer's Identification No  
Years Involved:  
Date of Conference:

**LEGEND:**

Seller =  
Seller's Subsidiary =

Buyer =  
Note Buyer =

Business =  
Modification =

CN #1 =  
CN #2 =  
SN =

Date 1 =  
Date 2 =  
Date 3 =  
Date 4 =  
Date 5 =  
Date 6 =

Payment Date 1 =  
Payment Date 2 =

Year 1 =

Principal 1 =

Principal 2 =

Principal 3 =

Principal 4 =

Issue Price 1 =

Issue Price 2 =

Issue Price 3 =

Issue Price 4 =

Issue Price 5 =

Issue Price 6 =

Amount 1 =

Amount 2 =

Amount 3 =

Amount 4 =

Amount 5 =

Number 1 =

Number 2 =

Number 3 =

Rate 1 =

Yield 1 =

Yield 2 =

#### ISSUES:

1. How are the issue prices of notes CN #1, CN #2, and SN determined?
  - a. Does § 1.1275-2(c) of the Income Tax Regulations apply to aggregate CN #2 and SN?
  - b. If CN #2 and SN are aggregated, what is the issue price of the aggregated note?
  - c. If CN #2 and SN are aggregated, what is the issue price of CN #1?
2. If CN #2 and SN are aggregated, what is the adjusted basis of SN on the date that Seller sells SN to Note Buyer?

#### CONCLUSIONS:

1. The issue prices of notes CN #1, CN #2, and SN are determined as follows:
  - a. Section 1.1275-2(c) applies to aggregate CN #2 and SN.

- b. The issue price of the aggregated note is the aggregate amount of cash Seller's Subsidiary paid for them, which is Amount 2.
  - c. The issue price of CN #1 is its stated redemption price at maturity under § 1273(b)(4) of the Internal Revenue Code, which is Principal 1.
2. When Seller sells SN to Note Buyer, the adjusted basis of the aggregated note is allocated between CN #2 and SN in proportion to their stated principal amounts.

#### FACTS:

Buyer purchased Seller's Business on Date 2. Buyer delivered Number 1 unregistered shares of Buyer common stock worth Amount 1 and a note, CN #1, to Seller for the Business. Also on Date 2, Buyer delivered two notes, CN #2 and SN, to Seller's Subsidiary for Amount 2 cash. The acquisition was done pursuant to an acquisition agreement dated Date 1, as subsequently amended ("Acquisition Agreement").<sup>1</sup>

CN #1 and CN #2 pay interest semi-annually, with payment dates on Payment Date 1 and Payment Date 2, beginning on Date 4, at the rate of Rate 1 per annum. The notes mature on Date 6. They have stated principal amounts of Principal 1 and Principal 2, respectively, Principal 4 in the aggregate. They are convertible into a total number of Number 2 shares of Buyer common stock, at an effective conversion price equal to Amount 4 per share.

SN pays interest semiannually, with payment dates on Payment Date 1 and Payment Date 2, beginning on Date 4, at the rate of Rate 1 per annum. The note matures on Date 5, one day earlier than Date 6. It has a stated principal amount of Principal 3. It is subordinated to CN #1 and CN #2, and substantially all of Buyer's other indebtedness. It is not convertible into stock.

None of the notes are traded on an established market within the meaning of § 1.1273-2(f). The notes provide for adequate stated interest for purposes of § 1274. In addition, for purposes of this memorandum, we assume that the interest on CN #1, CN #2, and SN is qualified stated interest ("QSI") under § 1.1273-1(c) and that CN #1 was not issued in a potentially abusive situation under § 1274(b)(3)(B) and § 1.1274-3.

Seller claimed one set of issue prices for CN #1, CN #2, and SN on its federal income tax return for Year 1 and a different set in an informal claim raised during examination:

Face

Return

Informal

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<sup>1</sup> Note Buyer, a person unrelated to both Buyer and Seller, participated in the structuring of the transactions.

CN #1:	Principal 1	Issue Price 1	Issue Price 4
CN #2:	Principal 2	Issue Price 2	Issue Price 5
SN:	Principal 3	Issue Price 3	Issue Price 6

On Date 3, less than six months after Date 2, Seller purchased SN from Seller Subsidiary and then sold SN to Note Buyer for Amount 3. The sale price, Amount 3, is greater than the tax return issue price of SN, Issue Price 3, but less than the informal claim issue price of SN, Issue Price 6.

In response to an IDR, Seller stated that CN #1, CN #2, and SN were all issued as part of “a common plan or as a single transaction or a series of related transactions” (quoting language from § 1.1275-1(f)(2)(ii)). Seller stated that the three notes were issued pursuant to a single contract and as an integral part of Seller’s sale of Seller’s Business to Buyer. In its annual report for Year 1, Seller stated that CN #1, CN #2, and SN were issued as a result of the sale of Seller’s Business to Buyer. The Acquisition Agreement describes closing date deliveries between Seller and Buyer with respect to Seller’s Business in two sections. The Acquisition Agreement describes closing date deliveries between Seller’s Subsidiary and Buyer with respect to CN #2 and SN in a third section. In its annual report for Year 1, Seller stated that Buyer received Amount 2 in cash to facilitate the deployment of Buyer’s Modification throughout the Business.

The Acquisition Agreement states that, for purposes of § 1273, the issue prices of CN #1, CN #2, and SN will be determined by the formula, Amount 5 issue price per \$1,000 face. Those issue prices imply that the three notes all have the same yield to maturity. In a regulatory report for the period including Date 2, Buyer stated that certain notes, which appeared to be CN #1 and CN #2, had an “effective yield to maturity” of Yield 1, and that another note, which appeared to be SN, had an “effective yield to maturity” of Yield 2. Those yields are inconsistent with the issue prices in the informal claim.<sup>2</sup>

#### LAW AND ANALYSIS:

##### Issue 1.a

Section 1.1275-2(c)(1) provides generally that debt instruments issued in connection with the same transaction or related transactions (determined based on all the facts and circumstances) are treated as a single debt instrument for purposes of §§ 1271 through 1275 and the regulations thereunder (“OID rules”). This rule ordinarily applies only to debt instruments of a single issuer that are issued to a single holder. The Service may, however, aggregate debt instruments that are issued by more than one issuer or that are issued to more than one holder if the debt instruments are issued

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<sup>2</sup> The yield for SN implied by the informal claim issue price, Issue Price 6, is approximately Number 3 percentage points less than the yield implied by the price for which Seller sold SN to Note Buyer, Amount 3. At the adverse conference, Seller was unable to explain the change in yield. In particular, Seller was unable to explain the change by reference to changes in interest rates or changes in Buyer’s credit rating.

in an arrangement that is designed to avoid the aggregation rule (for example, debt instruments issued by or to related parties or debt instruments originally issued to different holders with the understanding that the debt instruments will be transferred to a single holder). Section 1.1275-2(c)(2) provides two exceptions to the general rule of § 1.1275-1(c)(1).

The general rule of § 1.1275-2(c)(1) effectively consists of two component rules. The first component rule is an absolute rule that applies in cases involving debt instruments issued by a single issuer to a single holder. The second component rule authorizes, but does not require, the Service to aggregate debt instruments in cases involving multiple issuers or multiple holders. Both rules are subject to the exceptions in § 1.1275-2(c)(2).

CN #1, CN #2, and SN were issued in connection with Buyer's acquisition of Seller's Business. They were issued pursuant to the Acquisition Agreement. Seller described them as having been issued in connection with Buyer's acquisition of Seller's Business. Seller stated that the Amount 2 in cash delivered by Seller's Subsidiary to Buyer in exchange for CN #2 and SN was intended to facilitate the deployment of Buyer's Modification throughout the Business. We conclude that CN #2 and SN were issued in connection with the same transaction.

Section 1.1275-2(c)(2) provides that § 1.1275-2(c)(1) does not apply to a debt instrument if (i) the debt instrument is part of an issue a substantial portion of which is traded on an established market within the meaning of § 1.1273-2(f), or (ii) the debt instrument is part of an issue a substantial portion of which is issued for money (or for property traded on an established market within the meaning of § 1.1273-2(f)) to parties who are not related to the issuer or holder and who do not purchase other debt instruments of the same issuer in connection with the same transaction or related transactions.

Neither CN #2 nor SN is part of an issue a substantial portion of which is traded on an established market within the meaning of § 1.1273-2(f). Nor is either note part of an issue a substantial portion of which is issued to parties unrelated to Seller's Subsidiary. We conclude that neither of the exceptions in § 1.1275-2(c)(2)(i) and (ii) applies to prevent aggregation under § 1.1275-2(c)(1). We conclude that CN #2 and SN are aggregated under the first component rule of § 1.1275-2(c)(1). Thus, CN #2 and SN are treated as a single debt instrument ("Aggregated Note") for purposes of the OID rules.

#### Issue 1.b

Section 1273(b) provides, in part, that (1) in the case of any issue of debt instruments (A) publicly offered, and (B) not issued for property, the issue price is the initial offering price to the public (excluding bond houses and brokers) at which price a substantial amount of such debt instruments was sold; (2) in the case of any issue of debt instruments not issued for property and not publicly offered, the issue price of each such instrument is the price paid by the first buyer of such debt instrument; (3) in the

case of a debt instrument which is issued for property and which (A) is part of an issue a portion of which is traded on an established securities market, or (B) (i) is issued for stock or securities which are traded on an established securities market, or (ii) to the extent provided in regulations, is issued for property (other than stock or securities) of a kind regularly traded on an established market, the issue price of such debt instrument shall be the fair market value of such property; and (4) except in any case (A) to which § 1273(b)(1), (2), or (3) applies, or (B) to which § 1274 applies, the issue price of a debt instrument which is issued for property shall be the stated redemption price at maturity ("SRPM").

Section 1.1273-2(a)(1) provides that if a substantial amount of the debt instruments in an issue is issued for money, the issue price of each debt instrument in the issue is the first price at which a substantial amount of the debt instruments is sold for money. Thus, if an issue consists of a single debt instrument that is issued for money, the issue price of the debt instrument is the amount paid for the instrument.

Section 1.1275-1(f)(2) provides that two or more debt instruments issued on or after April 4, 1994, and before March 13, 2001, are part of the same issue if the debt instruments (i) have the same credit and payment terms and (ii) are sold reasonably close in time either pursuant to a common plan or as part of a single transaction or a series of related transactions.

The Aggregated Note comprises an issue because no other debt instrument has the same credit and payment terms. The entire amount of the debt instruments in that issue is issued for money. We conclude that the issue price of the Aggregated Note is determined under § 1.1273-2(a)(1). That issue price is the aggregate amount Seller's Subsidiary paid for CN #2 and SN, which is Amount 2.

#### Issue 1.c

After aggregation, CN #2 and SN are treated as a single debt instrument for purposes of the OID rules. After aggregation, CN #2 is no longer treated as a separate debt instrument and therefore is not available to be determined to be part of the same issue with CN #1 under § 1.1275-1(f)(2). In addition, the Aggregated Note does not have the same credit and payment terms as CN #1. Thus, CN #1 is not part of an issue a substantial amount of which is issued for money. We conclude that the issue price of CN #1 is not determined under § 1.1273-2(a)(1).

Section 1.1273-2(b)(1) provides that if a substantial amount of the debt instruments in an issue is traded on an established market (within the meaning of § 1.1273-2(f)) and the issue is not described in § 1.1273-2(a)(1), the issue price of each debt instrument in the issue is the fair market value of the debt instrument, determined as of the issue date (as defined in § 1.1273-2(b)(2)).

CN #1 is not traded on an established market. We conclude that the issue price of CN #1 is not determined under § 1.1273-2(b)(1).

Section 1.1273-2(c)(1) provides that if a substantial amount of the debt instruments in an issue is issued for property that is traded on an established market (within the meaning of § 1.1273-2(f)) and the issue is not described in § 1.1273-2(a)(1) or (b)(1), the issue price of each debt instrument in the issue is the fair market value of the property, determined as of the issue date (as defined in § 1.1273-2(c)(2)).

CN #1 is not issued for property that is traded on an established market. We conclude that the issue price of CN #1 is not determined under § 1.1273-2(c)(1).

Section 1.1273-2(d)(1) provides that if an issue of debt instruments is not described in § 1.1273-2(a)(1), (b)(1), or (c)(1), the issue price of each debt instrument in the issue is determined as if the debt instrument were a separate issue. If the issue price of a debt instrument that is treated as a separate issue under the preceding sentence is not determined under § 1.1273-2(a)(1), (b)(1), or (c)(1), and if § 1274 applies to the debt instrument, the issue price of the instrument is determined under § 1274. Otherwise, the issue price of the debt instrument is its SRPM under § 1273(b)(4).

Section 1.1274-1(b)(1) provides that § 1274 does not apply to a debt instrument if (i) all interest payable on the instrument is QSI; (ii) the stated rate of interest is at least equal to the test rate of interest (as defined in § 1.1274-4); (iii) the debt instrument is not issued in a potentially abusive situation (as defined in § 1.1274-3); and (iv) no payment from the buyer-borrower to the seller-lender designated as points or interest is made at the time of issuance of the debt instrument. We conclude that § 1274 does not apply to CN #1.

We conclude that the issue price of CN #1 is its SRPM under § 1273(b)(4). Section 1.1273-1(b) provides, in part, that a debt instrument's SRPM is the sum of all payments provided by the debt instrument other than QSI payments. Because all of the interest on CN #1 is QSI, the SRPM of CN #1 is its stated principal amount, which is Principal 1. We conclude that the issue price of CN #1 is Principal 1.

This conclusion is not affected by the fact that CN #1 and the Number 1 unregistered shares of Buyer common stock constitute an investment unit. Section 1.1273-2(h)(1) provides that, under § 1273(c)(2), an investment unit is treated as if the investment unit were a debt instrument. The issue price of the investment unit is determined under § 1.1273-2(a)(1), (b)(1), or (c)(1), if applicable. The issue price of the investment unit is then allocated between the debt instrument and the property right (or rights) that comprise the unit based on their relative fair market values. If § 1.1273-2(a)(1), (b)(1), and (c)(1) are not applicable, however, the issue price of the debt instrument that is part of the investment unit is determined under § 1273(b)(4) or 1274, whichever is applicable.

The issue price of the investment unit consisting of CN #1 and the Buyer stock is not determined under § 1.1273-2(a)(1), (b)(1), or (c)(1) for the same reasons that the issue price of CN #1 was not so determined. Thus, the issue price of CN #1 is

determined under § 1273(b)(4), in the same way it was determined for CN #1 separately.

## Issue 2

After aggregation, CN #2 and SN are treated as a single debt instrument for purposes of the OID rules. The basis and the issue price of the Aggregated Note are both equal to the aggregate purchase price of CN #2 and SN. Section 1012 and § 1.1273-2(a)(1). The SRPM of the Aggregated Note exceeds the issue price of the Aggregated Note. Thus, the Aggregated Note has OID in an amount equal to that excess. The basis and the adjusted issue price of the Aggregated Note are then adjusted for the OID accruals on the Aggregated Note. Sections 1.1272-1(g) and 1.1275-1(b)(1). Those OID accruals generally will not be equal to the sums of the OID accruals that would have been computed separately for CN #2 and SN, regardless of the allocation of the aggregate purchase price between the two notes. When SN is sold and CN #2 is retained, it is necessary to determine separate bases and adjusted issue prices for CN #2 and SN. The OID rules do not explain how to determine separate bases and adjusted issue prices when debt instruments that have been aggregated under § 1.1275-2(c) are disaggregated.

The pro rata prepayment rule of § 1.1275-2(f) suggests a way to determine separate bases and adjusted issue prices for CN #2 and SN that is consistent with the principles of the OID rules. Section 1.1275-2(f)(1) provides that a pro rata prepayment is treated as a payment in retirement of a portion of a debt instrument, which may result in a gain or loss to the holder. Generally, the gain or loss is calculated by assuming that the original debt instrument consists of two instruments, one that is retired and one that remains outstanding. The adjusted issue price, holder's adjusted basis, and accrued but unpaid OID of the original debt instrument, determined immediately before the pro rata prepayment, are allocated between these two instruments based on the portion of the instrument that is treated as retired by the pro rata prepayment. Section 1.1275-2(f)(2) provides that, for purposes of § 1.1275-2(f)(1), a pro rata prepayment is a payment on a debt instrument made prior to maturity that (i) is not made pursuant to the instrument's payment schedule (including a payment schedule determined under § 1.1272-1(c)); and (ii) results in a substantially pro rata reduction of each payment remaining to be paid on the instrument.

A straightforward extension of § 1.1275-2(f) to pro rata separations allocates the adjusted issue price, holder's adjusted basis, and accrued but unpaid OID of the Aggregated Note between CN #2 and SN in the same way as § 1.1275-2(f)(1). Under this extension, a pro rata separation of a debt instrument is a substantially pro rata separation of each payment remaining to be paid on the instrument. (A pro rata prepayment on a debt instrument produces the same result as a pro rata separation of the instrument followed by the retirement of one of the resulting debt instruments.)

The separation of the Aggregated Note into CN #2 and SN qualifies as a pro rata separation. After aggregation, CN #2 and SN are treated as a single debt instrument for purposes of the OID rules. For this Aggregated Note, corresponding payments on CN



#2 and SN must be aggregated, with the result that all of the remaining payments on the Aggregated Note are separated when the Aggregated Note is separated into CN #2 and SN. It remains to be shown that the separations of those payments are “substantially pro rata.”

The separations of the payments on the Aggregated Note are substantially pro rata with respect to amount. Even though CN #2 is convertible and SN is subordinated, the OID rules generally disregard convertibility and default risk. Section 1.1272-1(c)(1) provides, in part, that a debt instrument does not provide for an alternative payment schedule merely because there is a possibility of impairment of a payment (or payments) by insolvency, default, or similar circumstances. Section 1.1272-1(e) provides, in part, that for purposes of § 1272, an option is ignored if it is an option to convert a debt instrument into the stock of the issuer. Section 1.1273-1(c)(1)(ii) provides, in part, that for purposes of determining whether interest is unconditionally payable, the possibility of nonpayment due to default, insolvency, or similar circumstances, or due to the exercise of a conversion option is ignored. Section 1.1275-2(h)(1) provides, in part, that for purposes of § 1.1275-2(h), the possibility of impairment of a payment by insolvency, default, or similar circumstances is not a contingency. When the convertibility of CN #2 and the subordination of SN are disregarded, the separations of the payments on the Aggregated Note into the payments on CN #2 and SN are substantially pro rata. Thus, the separation of the Aggregated Note into CN #2 and SN is a pro rata separation, provided that it is appropriate to disregard convertibility and default risk for purposes of the pro rata separation rule.

It is appropriate to disregard convertibility and default risk when applying the pro rata separation rule to an aggregated debt instrument because the aggregation rule, in effect, disregards convertibility and default risk. As stated previously, in cases involving a single issuer and a single holder, the aggregation rule is an automatic rule subject to only two exceptions. Those exceptions refer to circumstances in which an established market or an unrelated purchaser provides evidence of fair market value that is independent of the issuer and the holder. In all other cases, the aggregation rule makes no effort to determine the actual fair market values of the debt instruments, but simply aggregates. The OID accruals on the aggregated debt instrument generally are equal to the sums of the separate OID accruals that would have been produced if the issue prices of the separate debt instruments were set equal to the present values of all of their principal and interest payments, using the yield to maturity of the aggregated debt instrument to compute present values. Under the OID rules, convertibility and default risk generally are disregarded in the determination of payment schedules and yields to maturity. Thus, the aggregation rule, in effect, computes OID accruals by using present value as a substitute for fair market value. Those present values are determined using a single yield obtained from the aggregated debt instrument instead of a yield curve, and disregarding the effects of convertibility and default risk in the determination of that yield.

We conclude that the adjusted issue price, adjusted basis, and accrued but unpaid OID on the Aggregated Note can be properly allocated between CN #2 and SN

according to the pro rata separation rule, and that such an allocation is consistent with the principles of the OID rules.

CAVEAT(S):

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