Office Symbols: CC:DOM:FS:FI&P
Case Number: TL-6149-98

UILC: 163.00-00
385.01-00
385.03-00
385.03-02

MEMORANDUM FOR DISTRICT COUNSEL
MIDSTATES REGION CC:MSR:HOU
Attn: Janet Balboni

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service)

Internal Revenue Service National Office Field Service Advice

This Field Service responds to your memorandum dated May 6, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

A	=	Enron Corp.
B	=	Enron Capital LLC
C	=	Enron Capital Resources L.P.
D	=	Enron Preferred Capital Corp.
E	=	Organizational Partner, Inc.
F	=	Enron Oil & Gas Company
INSTRUMENT A	=	Monthly Income Preferred Shares ("MIPS")
INSTRUMENT B	=	Cumulative Preferred Shares
YEAR 1	=	1993
YEAR 2	=	1994
DATE 1	=	December 31, 1992
DATE 2	=	October 25, 1993
DATE 3	=	November 4, 1993
DATE 4	=	November 15, 1993
DATE 5	=	November 30, 1993
DATE 6	=	November, 1993
DATE 7	=	December 31, 1993
DATE 8	=	July 15, 1994
DATE 9	=	August 3, 1994
DATE 10	=	August 31, 1994
DATE 11	=	August, 1994

DATE 12	=	March 1, 1998
DATE 13	=	November 30, 1998
DATE 14	=	August 31, 1999
DATE 15	=	August 31, 2024
DATE 16	=	November 30, 2043
DATE 17	=	November 30, 2093
F MONTHS	=	18 Months
G MONTHS	=	60 Months
H YEARS	=	30 Years
I YEARS	=	49 Years
J YEARS	=	50 Years
K YEARS	=	60 Years
L YEARS	=	100 Years
M %	=	8 Percent
N %	=	8.2 Percent
O %	=	8.9 Percent
P %	=	9 Percent
Q %	=	10 Percent
R %	=	21 Percent
S %	=	66-2/3 Percent
T %	=	100 Percent
$U	=	$25.00
$V	=	$2,137,497
$W	=	$3,512,658
$X	=	$19,936,709
$Y	=	$21,645,596
$Z	=	$53,165,000
$AA	=	$75,000,000
$BB	=	$94,936,709
$CC	=	$200,000,000
$DD	=	$253,165,000
$EE	=	$270,569,621
FF	=	1
GG	=	4,997
HH	=	4,998
II	=	5,000
JJ	=	1,200,000
KK	=	3,000,000
LL	=	8,000,000
MM	=	9,200,000
NN	=	1.2:1
OO	=	1:1
PP	=	30
COUNTRY A	=	Turks and Caicos Islands
YEAR 1 Prospectus	=	Enron Capital LLC 1993 Supplement

		to Prospectus (October 25, 1993)
YEAR 1 Terms	=	Terms of the 8% MIPS of Enron Capital LLC, November 4, 1993
YEAR 1 Loan Agreement	=	Loan Agreement, November 15, 1993
YEAR 1 Guarantee	=	Payment and Guarantee Agreement, November 15, 1993
YEAR 2 Prospectus	=	Enron Capital Resources 1994 Prospectus Supplement (July 15, 1994)
YEAR 2 Loan Agreement	=	Loan Agreement, August 3, 1994
YEAR 2 Guarantee	=	Payment and Guarantee Agreement, August 3, 1994

ISSUES:

(1) Whether the Loans from B and C to A should be respected as debt?

(2) Whether the Service may disallow the interest paid to B and C on the Loans because of a lack of economic substance?

(3) Whether B and C should be treated as partnerships or as associations taxable as corporations for federal income tax purposes?

CONCLUSION:

Based upon a review of the documents, the YEAR 1 Loan from B to A and the YEAR 2 Loan from C to A should be respected as debt. Further, the interest deductions on the debt should not be disallowed because the Loans possess economic substance.

The use of partnerships to issue INSTRUMENT A and INSTRUMENT B is not an abuse of the partnership entity. Accordingly, we do not recommend challenging the federal income tax classification of such partnerships. Furthermore, the following analysis concludes that reclassifying these entities as associations taxable as corporations rather than as partnerships is unlikely to succeed.

FACTS:

INSTRUMENT A

A borrowed an aggregate principal amount of $DD from B. A paid interest on this amount, and took an interest deduction of $V in YEAR 1, and an interest deduction of $Y in YEAR 2.

Examination stated in the Statutory Notice of Deficiency (hereinafter referred to as the "Stat. Notice") dated DATE 12, that it determined that the amounts paid by A to B are not deductible interest payments, the obligations do not constitute indebtedness, and the obligations under which payments were accrued do not constitute indebtedness because the entity with whom A contracted is not sufficiently distinct to be considered an unrelated party contracting at arm's-length. Examination has proposed to reduce the interest expense in the amount of $V for YEAR 1 and $Y for YEAR 2.

A formed B under the law of COUNTRY A as a limited life company for the sole purpose of issuing shares and lending the net proceeds to A. B was a T % subsidiary of A, and as of YEAR 1, A owned directly GG of the outstanding and issued common shares of B, out of II shares. YEAR 1 Prospectus at S-6. D, a T % subsidiary of A, owned FF shares. A purchased the common shares of B for approximately $Z. YEAR 1 Prospectus at S-14.

In DATE 6, B authorized MM shares of M % INSTRUMENT A. YEAR 1 Terms at 1. Of the authorized INSTRUMENT A, B issued LL shares at $U per share, for a total of $CC. The unissued JJ shares of INSTRUMENT A were reserved for the Underwriters' over-allotment option. YEAR 1 Prospectus at S-6.

B loaned to A both the $Z proceeds from the sale of the common shares to A, and the $CC proceeds from the sale of the INSTRUMENT A for an aggregate principal amount of $DD (hereinafter referred to as the "YEAR 1 Loan"). YEAR 1 Prospectus at S-14. However, the YEAR 1 Loan Agreement states that B agreed to make loans to A in the principal amount of $EE in next day funds. YEAR 1 Loan Agreement at 1. The YEAR 1 Loan to A bears interest at an annual rate equal to M % until maturity; this is the same rate as the M % "dividend" rate payable on INSTRUMENT A. YEAR 1 Loan Agreement at 3. Interest on the Loan was payable on the last day of each calendar month of each year beginning on DATE 5. YEAR 1 Prospectus at S-15.

The YEAR 1 Loan Agreement between B and A states that the Loan shall be due as follows:

> The entire principal amount of the Loans shall become due and payable, together with any accrued and unpaid interest thereon, including Additional Interest as defined below, if any, on the earliest of [DATE 16], or the date upon which [A] is dissolved, wound-up or liquidated or the date upon which [B] is dissolved, wound-up or liquidated.

YEAR 1 Loan Agreement at 2.

Upon repayment of the YEAR 1 Loan, B can redeem INSTRUMENT A or reloan these funds to A. The amounts can be reloaned to A only if: (a) A is not in bankruptcy; (b) A is not in default on any loan relating to the INSTRUMENT A; (c) A has made timely payments on the repaid loan for the preceding F MONTHS; (d) B is not in arrears in dividend payments; (e) A is expected to be able to make timely payment of principal and interest on the Loan; (f) the Loan is being made on terms, and under circumstances, that are consistent with those which a lender would require for a loan to an unrelated party; (g) the Loan is being made at a rate sufficient to pay dividends that accrue on the shares; (h) the senior unsecured long-term debt of A is rated BBB- or better by Standard & Poor or Baa3 or better by Moody's, or the equivalent by another rating organization; (i) the Loan is made for a term that is consistent with market circumstances and A's financial condition; and (j) the final maturity can be no later than the L YEARS anniversary of the issuance of the INSTRUMENT A, or DATE 17. YEAR 1 Terms at 3-4. A has the right to prepay the YEAR 1 Loan without premium or penalty on or after DATE 13. YEAR 1 Loan Agreement at 2.

A has the right to extend the interest payment period for up to F MONTHS. At the end of this, A shall pay all accumulated and unpaid interest. YEAR 1 Loan Agreement at 4. During any extended interest payment period, neither A nor any majority owned subsidiary of A will declare or pay any dividend on, or redeem, purchase, acquire or make a liquidation payment or Guarantee Payment with respect to any of its capital stock (other than Guarantee Payments). YEAR 1 Loan Agreement at 4.

A also guarantees the full payment, when due, of any of the indebtedness and liabilities of B. Agreement as to Expenses and Liabilities, DATE 4, at 1.

In the event of default by A in the payment of interest, in the payment of principal when due, in the event of a dissolution, winding up or liquidation of B, upon the bankruptcy, insolvency or liquidation of A, or upon the breach of any covenants, B shall have the following rights:

> to declare the principal of and the interest on the Loans (including any Additional Interest and any interest subject to an extension of the interest payment period) and any other amounts payable on the Loans to be forthwith due and payable, whereupon the same shall become and be forthwith due and payable without presentment, demand, protest or other notice of any kind, all of which are hereby expressly waived, anything in this Agreement to the contrary notwithstanding.

YEAR 1 Loan Agreement at 10-11. An event of default is defined as a default by A in repayment of the principal or interest on the Loans when due, the dissolution, winding up or liquidation of B, the bankruptcy, insolvency or liquidation of A, or the breach of any covenant in the Loan Agreement. YEAR 1 Prospectus at S-18.

The YEAR 1 Loan is "subordinate and junior in right of payment to all Senior Indebtedness of A as provided herein." YEAR 1 Loan Agreement at 5. The Senior Indebtedness of A's includes the principal, premium, and interest on:

> (i) all indebtedness of [A], whether outstanding on the date hereof or hereafter 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, (ii) any indebtedness of others of the kinds described in the preceding clause (i) for the payment of which [A] is responsible or liable (directly or indirectly, contingently or non-contingently) as guarantor or otherwise, (iii) any indebtedness secured by a lien upon property owned by [A] and upon which indebtedness [A] customarily pays interest, even though [A] has not assumed or become liable for the payment of such indebtedness and (iv) amendments, renewals, extensions and refunding of any such indebtedness unless ... it is expressly provided that the indebtedness is not superior in right of payment to the Loans.

YEAR 1 Loan Agreement at 5.

If A defaults in the payment of principal, premium or interest on any Senior Indebtedness when it becomes due and payable, or in the event of a default on the Senior Indebtedness, then until such default has been cured or waved, no direct or indirect payment will be made on the YEAR 1 Loan. YEAR 1 Loan Agreement at 6.

In the event of insolvency, bankruptcy, receivership, liquidation, reorganization, composition, or similar proceeding against A or its property, all Senior Indebtedness of A's shall be paid in full before any payment or distribution of the YEAR 1 Loan. YEAR 1 Loan Agreement at 6-7.

B has no right to participate in the management of A; however, the holders of the INSTRUMENT A will have creditors' rights against A if B fails to pay "dividends" on the INSTRUMENT A for F MONTHS (consecutive monthly dividend periods), if an event of default occurs or if A is in default on any of its payment or other obligation under the Guarantee Agreement. YEAR

1 Terms at 6. The holders of a majority in liquidation preference of INSTRUMENT A in YEAR 1 will be entitled to the following rights:

> to appoint and authorize a trustee to enforce [B's] creditor rights under the Loans against [A], enforce the obligations undertaken by [A] under the Guarantee Agreement and the Agreement as to Expenses and Liabilities pursuant to which [A] will agree to guarantee payment of any liabilities incurred by [B] (other than obligations to holders of [INSTRUMENT A] in their capacities as holders)... and declare and pay dividends on [INSTRUMENT A].

YEAR 1 Terms at 6. Not later than PP days after such 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 INSTRUMENT A holders of Q % in liquidation preference of outstanding shares will be entitled to convene the meeting. YEAR 1 Terms at 6.

The holders of the INSTRUMENT A shall have the following rights:

> If any resolution is proposed for adoption by the shareholders of [B] providing for, or the Manager otherwise proposes to effect, (x) any variation or abrogation of the rights, preferences and privileges of [INSTRUMENT A], whether by way of amendment of [B]'s Articles of Association ... or (y) the liquidation, dissolution or winding up of [B], then the holders of outstanding [INSTRUMENT A] will be entitled to vote on such resolution or action of the Manager (but not on any other resolution or action), and such resolution or action shall not be effective except with approval of the holders of [S] % in liquidation preference of the outstanding [INSTRUMENT A]....

YEAR 1 Terms at 6-7.

In the event of any voluntary or involuntary liquidation, dissolution or winding up of B, the INSTRUMENT A holders will be entitled to receive out of the assets of B available for distribution to shareholders, before any distribution of assets is made to holders of common shares or any other class of shares of B ranking junior to INSTRUMENT A, an amount equal to the stated liquidation preference of $U per share and all accumulated and unpaid "dividends" to the date of payment. YEAR 1 Terms at 5.

The holders of the INSTRUMENT A are entitled to receive, when, as and if declared by B out of funds held and legally available, cumulative cash "dividends" at the annual rate of M % of the stated liquidation preference of $U per share per annum. The "dividends", payable in U.S. dollars monthly in arrears on the last day of each calendar month, will accrue and be cumulative whether or not they have been declared and whether or not there are profits, surplus or other funds of B legally available. YEAR 1 Terms at 2. "Dividends" must be declared on the INSTRUMENT A in any calendar year to the extent that A reasonably anticipates that at the time of payment B will have and must pay cash on hand that is sufficient to permit such payments. YEAR 1 Terms at 2.

B will not pay any dividends on any shares of B ranking junior to the INSTRUMENT A, or redeem, purchase or otherwise acquire any junior shares of B, until such time as all accumulated and unpaid "dividends" on the INSTRUMENT A have been paid in full. YEAR 1 Terms at 3.

In YEAR 1, A had a debt-to-equity ratio of approximately NN. YEAR 1 Prospectus at S-5.

The obligation at issue between A and B is labeled as a loan in the YEAR 1 Prospectus. YEAR 1 Prospectus at S-14. The YEAR 1 Loan Agreement, as well as all other documents reviewed, labels the obligation as a loan.

A used the proceeds from the YEAR 1 Loan from B to repay other indebtedness, and for general corporate purposes. YEAR 1 Prospectus at S-5. In the Form 10-K Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (hereinafter referred to as the "10-K" for YEAR 1) that A filed with the Securities and Exchange Commission for YEAR 1, A reported that "the average cost of long-term debt declined to N % at DATE 7 from O % at DATE 1. The decline was accomplished primarily through the retirement of additional higher coupon long-term debt which was subject to call provisions during [YEAR 1]." YEAR 1 A 10-K at 32.

A has irrevocably and unconditionally agreed to pay the holders of the INSTRUMENT A the following Guarantee Payments, in the event that B fails to pay: any accumulated and unpaid "dividends" declared on the INSTRUMENT A from legally available funds; the $U redemption price per preferred share, from legally available funds; the lesser of either the liquidation preference of $U per share plus accumulated and unpaid "dividends" or the amount of assets of B available for distribution to INSTRUMENT A holders; and any interest payable on the INSTRUMENT A. YEAR 1

Guarantee at 2. A irrevocably and unconditionally agrees to pay in full to the INSTRUMENT A holders the Guarantee Payments when due, except to the extent paid by B, regardless of any defense, right of set-off or counterclaim that B may have or assert. YEAR 1 Guarantee at 2. A's obligation to make Guarantee Payments may be satisfied by direct payment by A to the INSTRUMENT A holders or by causing B to pay such amounts to the holders. YEAR 1 Guarantee at 2-3.

This Guarantee Agreement is an unsecured obligation of A, the Guarantor, and is subordinate and junior in right of payment to all of the liabilities of A, is *pari passu* with the most senior preferred or preference stock, and is senior to A's common stock. YEAR 1 Guarantee at 6. A's obligations under the Guarantee Agreement are independent of B's obligations with respect to the INSTRUMENT A. In addition, A will be liable as principal and sole debtor to make the Guarantee Payments.

If any INSTRUMENT A remain outstanding and A is in default with respect to its obligations under the Guarantee Agreement or the Loan Agreement, then neither A nor any majority owned subsidiary of A will declare or pay any dividend on, or redeem, purchase, acquire or make a liquidation payment or guarantee payment with respect to, any of its capital stock. YEAR 1 Guarantee at 5.

Under the Guarantee Agreement, A covenants that, as long as the INSTRUMENT A remain outstanding, it will maintain direct or indirect ownership of the common shares of B, maintain R % of the value as common shares, and not voluntarily dissolve, wind up or liquidate B or cause it to lose its status as an LLC. YEAR 1 Guarantee at 5.

INSTRUMENT B

In YEAR 2, A borrowed an aggregate principal amount of $BB from C and paid $W in interest expenses to C.

Examination stated in the Stat. Notice that it determined that the amounts paid by A to C in YEAR 2 are not deductible as interest payments, and the obligations under which payments were accrued do not constitute indebtedness because the entity with whom A contracted is not sufficiently distinct to be considered an unrelated party contracting at arm's-length. Examination has proposed to reduce A's interest expense in the amount of $W in YEAR 2.

A and E (a T % subsidiary of A) formed C as a limited partnership organized under the laws of Delaware. A, as a general partner, holds an R % interest in the partnership; the remainder of C is owned by the holders of INSTRUMENT B. E withdrew after the issuance of INSTRUMENT B. C exists solely for the purpose of issuing limited partner interests and lending the net proceeds from the interests to A. YEAR 2 Prospectus at S-2. A paid $X to C for the partnership interest.

A, as general partner, will furnish to each cumulative preferred instrument holder a Schedule K-1 each year setting forth the holder's allocable share of income for the prior calendar year. YEAR 2 Prospectus at S-21.

C issued KK shares of P % INSTRUMENT B, Series A, in DATE 11. Each instrument was issued at $U per individual INSTRUMENT B, for a total of $AA. Although these INSTRUMENT B are not INSTRUMENT A, the two instruments are similar. The holders of the instruments shall be entitled to "dividends", fixed at a rate per annum of P % per $U per INSTRUMENT B. Amended and Restated Agreement of Limited Partnership of C at 14. "Dividends" must be paid on the INSTRUMENT B in any calendar year to the extent that A reasonably anticipates that at the time of payment C will have and must legally pay funds available for the payment of such "dividends", and sufficient cash to permit such payments. YEAR 2 Prospectus at S-8.

C loaned to A the proceeds from the sales of both the capital shares and the INSTRUMENT B, an aggregate principal amount of $BB (hereinafter referred to as the "YEAR 2 Loan"). YEAR 2 Prospectus at S-16.

The YEAR 2 Loan bears interest at an annual rate equal to P % until maturity, with interest payable on the last day of each calendar year as of DATE 10. The YEAR 2 Loan Agreement between C and A provides for the following:

> The entire principal amount of the Loan shall become due and payable, together with any accrued and unpaid interest thereon, including Additional Interest as defined below, if any, on the earliest of [DATE 15] or the date upon which A is dissolved, wound-up or liquidated or the date upon which [C] is dissolved, wound-up or liquidated.

YEAR 2 Loan Agreement at 2.

A has the right to prepay the Loan at any time on or after DATE 14, without premium or penalty, and if legislation is enacted or existing law is modified that causes C to be treated as an association taxable as a corporation, provided that C has elected to redeem the instruments. YEAR 2 Loan Agreement at 2. The INSTRUMENT B instruments are redeemable at the option of C and subject to the consent of A on or after DATE 14, at the redemption price of $U per instrument plus accumulated "dividends". YEAR 2 Prospectus at S-9.

Upon any repayment or prepayment of principal on the YEAR 2 Loan, the proceeds from such payment will be applied to redeem INSTRUMENT B. However, such amounts may be reloaned to A, and not used for redemption, if at the time of such loan: (a) A is not in bankruptcy; (b) A is not in default on any loan relating the INSTRUMENT B; (c) A has made timely payments on the Loan for the immediately preceding F MONTHS; (d) C is not in arrears on payments of the "dividends" on INSTRUMENT B; (e) A is expected to be able to make timely payments of principal and interest on the Loan; (f) the Loan is made on terms and under circumstances that are consistent with one made to an outside party; (g) the rate on the Loan is sufficient to provide for dividends on the INSTRUMENT B; (h) the senior unsecured long-term debt of A is rated BBB- or better by Standard & Poor or Baa3 or better by Moody's or the equivalent; (i) the terms are consistent with market and A's financial condition; (j) the term of the Loan is no more than H YEARS; and (k) the final maturity of such Loan is not later than the I YEARS anniversary of the issuance of the INSTRUMENT B. YEAR 2 Prospectus at S-9-S-10.

A has the right to an extended interest period on the YEAR 2 Loan, to extend the interest payment period on the YEAR 2 Loan for up to G MONTHS (consecutive), deferring also the monthly dividend payments on the INSTRUMENT B. YEAR 2 Prospectus at S-4. However, the interest will continue to accrue and will be paid after the G MONTHS period. YEAR 2 Loan Agreement at 3. During any extended interest payment period, A will not declare or pay any dividend on, redeem, purchase, acquire or make a liquidation payment with respect to any of its capital stock. YEAR 2 Loan Agreement at 3.

The YEAR 2 Loan Agreement "constitutes the valid and legally binding obligation of A enforceable in accordance with its terms, subject to bankruptcy, insolvency, fraudulent transfer, reorganization, moratorium and similar laws of general applicability relating to or affecting creditors' rights and to general equity principles." YEAR 2 Loan Agreement at 7.

In the event of a default by A, C:

> will have the right to declare the principal of and interest on the Loan (including any Additional Interest and any interest subject to an extension of the interest payment period) and any other amounts payable on the Loan to be forthwith due and payable, whereupon the same shall become and be forthwith due and payable without presentment, demand, protest or other notice of any kind, all of which are hereby expressly waived, anything in this Agreement to the contrary notwithstanding.

YEAR 2 Loan Agreement at 8.

An event of default is defined as a default by A in the payment of interest or principal on the YEAR 2 Loan, the dissolution, winding up or liquidation of C, the bankruptcy, insolvency or liquidation of A, and any breach of the Loan Agreement covenants. YEAR 2 Loan Agreement at 8. Thus, upon A's default, C may enforce its creditor rights by declaring the principal and interest on the YEAR 2 Loan to be due and payable (without presentment, demand, protest or other notice).

The YEAR 2 Loan is subordinated as follows:

> the Loan is subordinate and junior in right of payment to all Senior Indebtedness as provided herein. The term 'Senior Indebtedness' shall mean the principal, premium, if any, and interest on (i) all indebtedness of [A], ... 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....

YEAR 2 Loan Agreement at 4. Senior Indebtedness also includes any similar debt on which A is liable as a guarantor, any indebtedness secured by a lien on property which A owns and for which A customarily pays interest, and any amendments, renewals, extensions and refundings of any such indebtedness. YEAR 2 Loan Agreement at 4.

If A defaults on any payments of any principal or interest upon its Senior Indebtedness, no direct or indirect payments shall be made on the YEAR 2 Loan. YEAR 2 Loan Agreement at 5. The Senior Indebtedness shall also be paid in full prior to payments made on the YEAR 2 Loan in the event of insolvency, bankruptcy, receivership, liquidation, reorganization, composition or similar proceeding relating to A; and liquidation, dissolution or winding up of A; any assignment by A for the benefit of its creditors; and any other marshalling of A's assets. YEAR 2 Loan Agreement at 5.

Senior Indebtedness does not include "the indebtedness pursuant to the Loan Agreement dated as of DATE 4 between [A] and [B] and any extensions or refundings thereof (the 'Pari Passu Debt')." YEAR 2 Loan Agreement at 4. The YEAR 2 Loan shall not be subordinate to any other liabilities of A. YEAR 2 Prospectus at S-17.

C has no right to participate in the management of A. However, the holders of INSTRUMENT B shall be entitled to appoint and authorize a trustee to enforce C's creditor rights under the YEAR 2 Loan against A and pay "dividends" if C fails to pay "dividends" in full, or in the event of default by A on principal or interest on the Loan. YEAR 2 Prospectus at S-11.

Not later than PP days after such right to appoint a trustee arises, the general partner, A, will convene a general meeting. If the general partner fails to convene such a meeting, the cumulative preferred instrument holders of Q % in liquidation preference will be entitled to convene the meeting. YEAR 2 Prospectus at S-11.

If any amendment to the C Partnership Agreement is proposed for adoption providing for any variation or abrogation of the rights, preferences and privileges of the INSTRUMENT B, or the liquidation, dissolution, or winding up of C, then the holders of the INSTRUMENT B will be entitled to vote on such proposal. YEAR 2 Prospectus at S-11.

In YEAR 2, A had a debt-to-equity ratio of approximately OO. YEAR 2 Prospectus at S-7, S-19.

A purportedly used the YEAR 2 Loan for general corporate purposes including the repayment of indebtedness. YEAR 2 Prospectus at S-7. A's estimated fair market value of its long-term debt decreased in YEAR 2; the fair market value of debt includes the estimated cost to acquire the debt. YEAR 2 Form 10-K Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (hereinafter referred to as the "10-K" for YEAR 2).

A labeled this obligation between A and C as a loan in the Prospectus that it submitted to the Securities and Exchange Commission for YEAR 2. YEAR 2 Prospectus at S-16. A also labeled the obligation as a loan in the YEAR 2 Loan Agreement and other documents.

Holders of the INSTRUMENT B shall also be entitled to enforce the obligation undertaken by A under the Guarantee Agreement, should C fail to pay "dividends", in the event of a default, or if A is in default on any of its payment or other obligations under the Guarantee. YEAR 2 Prospectus at S-11.

A has also irrevocably and unconditionally agreed to pay the holders of the INSTRUMENT B certain Guarantee Payments in the event that C fails to do so. YEAR 2 Guarantee at 1-2. Guarantee Payments are defined as accumulated and unpaid dividends, the redemption price of $U, the lesser of either the $U liquidation preference plus accumulated and unpaid dividends or assets of C available for distribution, and any additional interest, to the extent that these are not paid by C. YEAR 2 Guarantee at 1-2. A's obligation to make a Guarantee Payment may be satisfied by direct payment by A to the holders of the instruments or by causing C to pay such amounts to the holders.

A's obligations under the Guarantee Agreement are independent of C's obligations with respect to the INSTRUMENT B. A is liable as principal and sole debtor to make the Guarantee Payments.

If any INSTRUMENT B remain outstanding and A is in default under the Guarantee Agreement, the Expense Agreement, or the Loan Agreement, then A shall not declare or pay any dividend on or redeem, purchase, acquire or make a liquidation payment with respect to any of its capital stock. YEAR 2 Guarantee at 4.

Under the Guarantee Agreement, A covenants that, as long as the INSTRUMENT B remain outstanding, it will maintain direct or indirect ownership of the general partner interest in C, it will cause at least R % of the value of C to be represented as a general partner interest, it will not voluntarily dissolve, wind up or liquidate C, and will make every effort to cause C to remain a limited partnership and will perform duties as a general partner. YEAR 2 Guarantee at 4-5.

The Guarantee Agreement is an unsecured obligation of A and ranks subordinate and junior in right of payment to all liabilities of A other than the YEAR 1 INSTRUMENT A Guarantee Agreement, *pari passu* with the most senior preferred or preference stock, and senior to A's common stock. YEAR 2 Guarantee at 5.

ISSUE 1:

Whether the Loans from B and C to A should be respected as debt?

LAW AND ANALYSIS:

I.R.C. § 385 of the Internal Revenue Code of 1986, as amended, ("the Code") discusses the treatment of certain investments in corporations as stock or indebtedness. Both section 385(a) and 385(b) require regulations to be effective. Since neither had regulations in effect for the years in issue, a facts and circumstances approach is required.

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).

Notice 94-47, 1994-1 C.B. 357, provides guidance in the determination of whether an instrument is debt or equity for federal income tax purposes. Notice 94-47 addresses potential abuses of the tax law by instruments that contain both debt and equity characteristics.

The eight factors to be considered under Notice 94-47 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. John Kelley Co. v. Commissioner, 326 U.S. 521 (1946). The Notice is primarily concerned with instruments that combine long maturities (greater than 50 years) with other substantial equity characteristics.

We shall discuss the facts relating to each factor in the Notice in sequence. This analysis is focused on the Loans because the narrow issue is whether the payments made pursuant to the Loans represent interest upon debt.

(a) Whether there is an unconditional promise to pay by the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future. The presence of a fixed maturity date indicates a definite obligation to repay, which is a debt characteristic. Both the YEAR 1 and the YEAR 2 Loans contain a promise by A to pay the principal and interest by a fixed maturity date.

The entire principal amount and interest on the YEAR 1 Loan are due and payable on DATE 16, or earlier if either A or B is dissolved, wound-up or liquidated. YEAR 1 Loan Agreement at 2.

If A repays the YEAR 1 Loan when due or prepays the Loan, the proceeds from the repayment of principal and interest shall be applied to redeem the INSTRUMENT A; alternatively, the proceeds could be reloaned to A for an additional maximum J YEARS, so that the Loan maturity can be no longer than the L YEARS anniversary of the issuance of the INSTRUMENT A. YEAR 1 Prospectus at S-7. Thus, the YEAR 1 Loan could have an effective maximum maturity date of L YEARS, if the optional J YEARS extension is exercised. The YEAR 1 Loan will become due and payable earlier if B redeems the INSTRUMENT A. YEAR 1 Prospectus at S-14. B may redeem the INSTRUMENT A at its option after DATE 13, but redemption is subject to the prior consent of A. YEAR 1 Prospectus at S-7.

Although A may extend the interest payment period for up to F MONTHS, the interest will continue to accrue. YEAR 1 Prospectus at S-20.

Principal and interest on the YEAR 2 Loan are due and payable on DATE 15, or when A or C is dissolved, wound-up or liquidated. YEAR 2 Loan Agreement at 2. If A repays the YEAR 2 Loan when due or prepays the Loan, the proceeds from the repayment will be applied to redeem the INSTRUMENT B, or the funds could be reloaned to A. YEAR 2 Prospectus at S-9. Upon C's redemption of the INSTRUMENT B, the principal and interest on the Loan shall become due and payable; while the INSTRUMENT B are redeemable at the option of C, redemption is subject to the consent of A. YEAR 2 Prospectus at S-9, S-16. If the Loan is paid by A and subsequently reloaned to A, the final maturity of the Loan can be no later than the I YEARS anniversary of the issuance of the INSTRUMENT B. YEAR 2 Prospectus at S-10. Thus, the YEAR 2 Loan could have an effective maximum maturity date of I YEARS, if the extension is exercised.

Additionally, upon an event of default by A on its payments, the YEAR 2 Loan will be forthwith due and payable. If the holders of the INSTRUMENT B fail to receive "dividends" from C, they have creditors' rights against A, and thus, A is obligated to C's holders.

The facts in these documents indicate that A has made an unconditional promise to pay a sum certain on demand or at a fixed maturity date in the reasonably foreseeable future for both Loans. A fixed maturity date indicates a fixed obligation to repay, which is a characteristic of debt. Mixon v. United States, 464 F.2d 394, 404 (5th Cir. 1972). Therefore, based upon the information contained in the available documents, these facts are more indicative of debt.

(b) Whether the holders of the instruments possess the right to enforce payment of principal and interest. Both of the holders of the Loans, B and C, possess the right to enforce payment of the Loans by A.

The YEAR 1 Loan Agreement "constitutes the valid and legally binding obligation of A enforceable in accordance with its terms, subject to bankruptcy, insolvency, fraudulent transfer, reorganization...." YEAR 1 Loan Agreement at 8-9.

Upon an event of default on the YEAR 1 Loan, B has the right to declare the principal and interest forthwith due and payable. YEAR 1 Loan Agreement at 10.

Similarly, C has the right to enforce the YEAR 2 Loan Agreement and the repayment of the YEAR 2 Loan. YEAR 2 Loan Agreement at 7. C has creditor's rights as against A and has the right to declare the principal and interest of the YEAR 2 Loan due and payable upon an event of default by A. YEAR 2 Loan Agreement at 8.

B and C are, in effect, controlled by A, and therefore the rights of these two intermediaries could be questioned. However, A's obligations under the Loans are also for the benefit of the holders of INSTRUMENT A and INSTRUMENT B, and these holders are entitled to enforce the Loan Agreements directly against A. The facts in these documents indicate that holders of the Loan instruments possess the right to enforce payment as creditors. A definite obligation to repay an advance is an indication of a loan. Mixon, 464 F.2d at 405. This factor is more indicative of debt.

(c) Whether the rights of the holders of the instruments are subordinate to the rights of general creditors. The rights of the holders of the YEAR 1 Loan and of the YEAR 2 Loan are not subordinate to the rights of the general creditors of A.

The YEAR 1 Loan is subordinate only to the Senior Indebtedness. The Senior Indebtedness shall be paid first in full before any payment or distribution is made on the YEAR 1 Loans, in the event of insolvency, bankruptcy, receivership, liquidation, reorganization, or the dissolution or winding up of A. YEAR 1 Loan Agreement at 7. See supra at 6. Senior Indebtedness includes generally the principal and interest on all indebtedness of A, evidenced by a note or another instrument, but it does not include debts to general creditors. YEAR 1 Loan Agreement at 5. In addition, the Loan ranks superior to the claims of A's stockholders. YEAR 1 Guarantee at 5.

The YEAR 2 Loan is also subordinate only to the Senior Indebtedness. YEAR 2 Loan Agreement at 4. The definition of Senior Indebtedness for the YEAR 2 Loan is nearly identical to that of the YEAR 1 Loan, that is, both include generally the principal and interest on all indebtedness of A, evidenced by a note or another instrument, but do not include debts to general creditors. YEAR 2 Loan Agreement at 4-5.

If the holder of the obligation has rights that take precedence over the rights of shareholders, this suggests that the instrument is debt, although it is not dispositive. Monon Railroad v. Commissioner, 55 T.C. 345, 360 (1970), acq., 1973-2 C.B. 2. The facts available in these documents indicate that the obligations are not subordinated to the level of general creditors, and therefore the obligations resemble debt more than equity.

(d) Whether the instruments give the holders the right to participate in the management of the issuer. Neither the holder of the YEAR 1 Loan, B, nor the holder of the YEAR 2 Loan, C, has rights to participate in the management of the issuer of the Loans, A.

The holders of B's INSTRUMENT A and the holders of the INSTRUMENT B of C have certain limited creditors' rights as against A. Upon B's failure to pay "dividends" for F MONTHS (consecutive dividend periods), the INSTRUMENT A holders will be entitled to appoint and authorize a trustee to enforce B's creditor rights against A. YEAR 1 Terms at 6. Also, if a resolution is proposed to effect any variation or abrogation of the rights of the INSTRUMENT A holders or that would effect the liquidation, dissolution or winding up of B by way of an amendment to B's Articles of Association, then the holders will be entitled to vote on such resolution or action. YEAR 1 Terms at 6-7.

The holders of the INSTRUMENT B have been granted similar creditors' rights to appoint a trustee to enforce C's creditors' rights under the YEAR 2 Loan against A and also the right to vote upon certain proposals to amend the Partnership Agreement. YEAR 2 Prospectus at S-11.

Also, during any extended interest period under the Loan, neither A nor any majority owned subsidiary can declare or pay any dividend on, or redeem, purchase, acquire or make a liquidation payment with respect to any of its capital stock. YEAR 1 Loan Agreement at 4; YEAR 2 Loan Agreement at 3. (Under the YEAR 1 Loan this limitation does not apply to certain payments; in particular, the dividends paid by F on its common stock.)

These rights to vote for a trustee, to vote upon certain

Articles of Association or Partnership Agreement amendments should B or C fail to pay "dividends", and to restrict certain payments on A's capital stock during an extended interest period do not qualify as giving the holder of the instrument, either B or C, the right to participate in the management of the issuer, A. Rather, B's and C's holders are granted rights as creditors against A only.

Creditors are not usually entitled to vote in the affairs of the debtor corporation, or participate in its management, including electing corporate directors, unlike stockholders. Monon, 55 T.C. at 359-360. Based upon the information provided, there is no indication that B or C have any rights to participate in the management of A, or have any voting rights in A. Therefore, these facts are more indicative of debt.

(e) Whether the issuer is thinly capitalized. If a corporation has a nominal stock investment coupled with excessive debt, this fact would tend to indicate that an instrument labeled debt might constitute stock. As a result, the debt-to-equity ratio is another factor used to determine whether an instrument is debt or equity. The 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 YEAR 1, A had a debt-to-equity ratio of approximately NN. YEAR 1 Prospectus at S-5. In YEAR 2, A had a debt-to-equity ratio of approximately OO. YEAR 2 Prospectus at S-7, S-19.

A at no time has had a debt-to-equity ratio in excess of 2:1. See J.S. Biritz Construction Co. v. Commissioner, 387 F.2d 451, 459 (8th Cir. 1967) ("The debt to equity ratio of 2 to 1 is patently not so inordinately high as to qualify this as a 'thin capitalization' case."). A is not thinly capitalized, a factor which is more indicative of debt.

(f) Whether there is identity between holders of the instruments and stockholders of the issuer. This factor is usually relevant only when a corporation's shareholders have advanced money to the corporation. Advances made by stockholders in proportion to their respective stock ownership are an indication of equity, but a sharply disproportionate ratio is an indication of debt. Mixon, 464 F.2d at 409.

B is T % owned by A, except for T % of the issued and outstanding INSTRUMENT A, which are publicly held. A owns directly or indirectly T % of the HH issued and outstanding common shares of B out of II common shares. A also owns T % of the partnership interests in C other than the interests represented by the INSTRUMENT B, which are publicly held. A is a publicly-held utility company, with millions of dollars of common and preferred stock outstanding. The stockholders of A indirectly own the common shares of B and C through A's ownership. However, other than the shares owned by A, the outstanding instruments of B and C, the INSTRUMENT A and the INSTRUMENT B, are publicly owned.

For purposes of this characteristic, there is no identity between the holders of the instruments and the stockholders of the issuer, and therefore, this indicates debt.

(g) The label placed upon the instruments. The instruments between A and B and C have been consistently characterized as Loans in the documents available. YEAR 1 Loan Agreement, YEAR 2 Loan Agreement.

In addition, under section 385(c), the issuer's characterization of an instrument as of the time of the 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 Service or on a holder that discloses that it is treating the instrument in a manner inconsistent with the issuer's characterization.

The labels on these instruments are not the same as the labels on the INSTRUMENT A and the INSTRUMENT B. However, since the form of the pass-through entities will be respected, and B and C will be treated as partnerships separate and distinct from A, then the label on the obligations (the INSTRUMENT A and INSTRUMENT B) that B and C have with the holders of their instruments will not affect the label on the obligations (the Loans) that A has with either B or C.

Therefore, because the available documents show that A has consistently labeled and treated these obligations as debt, this fact is indicative of debt. See Mixon, 464 F.2d at 403.

(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. There is no indication that the parties have treated the instruments (the Loans) between A and B and C as anything except debt. A labeled the obligations as loans in its YEAR 1 and YEAR 2 Prospectuses submitted to the Securities and Exchange Commission, and also indicated that the income on the shares is taxable as interest income rather than dividend income.

The labels placed upon the INSTRUMENT A and the INSTRUMENT B are different from the labels placed on the Loans. Thus, even though Moody's may have included the YEAR 1 INSTRUMENT A and the

YEAR 2 INSTRUMENT B in with A's capital stock, and INSTRUMENT A and INSTRUMENT B may give A some "equity credit" for purposes of the rating agencies, like Standard & Poor's and Moody's, Solomon B. Samson, Credit Comments: A Hierarchy of Hybrid Securities, Standard & Poor's Creditweek, March 25, 1996, at 43, this fact has no bearing on the analysis of whether the Loans are properly labeled for federal tax purposes.

The obligations have been treated consistently as Loans by A, a factor more indicative of debt. See Crown Iron Works v. Commissioner, 245 F.2d 357, 359 (8th Cir. 1957).

Unreasonably Long Maturity

Notice 94-47 focuses on "recent offerings of instruments that combine long maturities with substantial equity characteristics," and cites to Monon, 55 T.C. 345. The Service cautions taxpayers of the following:

> 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.

In Monon, the court determined that a 50-year maturity term on a debt instrument was not unreasonable in light of the fact that the corporation had been in existence for many years.

There is 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 taxpayer's business, the financial condition of the taxpayer, the length of time the taxpayer has been in existence, and how likely it is that the taxpayer will be in existence when the instrument matures.

A was in existence for over K YEARS when the INSTRUMENT A and INSTRUMENT B were issued. In addition, A is a substantial operating business. Therefore, in this case, the J YEARS and H

YEARS maturity dates appear to be reasonable, as does the extended I YEAR extended term for the YEAR 2 issuance. The L YEARS extended term for the YEAR 1 Loan may appear to be unreasonable on its face. In light of the other characteristics of debt, however, it is not enough to cause recharacterization.

Based on a review of the documents, we do not recommend recharacterizing the debt as equity.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

This analysis has focused on the Loans because the narrow issue is whether the Loans represent debt or equity. The forms of the partnerships (the intermediate entities) are to be respected, as will be discussed infra, at 26. If facts were present in this case that caused the forms of the partnerships to not be respected, the conclusions would not be different, and the instruments would still be properly characterized as debt.

The foregoing analysis is based on the information and documents that we have been given and independent legal research. We have no knowledge that A has acted other than as a debtor or that the intermediaries have not at all times acted as creditors.

If you wish to determine if A has not acted as described in the documents, the following may be considered: Whether A has actually paid the interest or principal on the Loans when payment was due? Has A requested any extensions of time for repayment? Whether B and C have had any reason to enforce the agreements, and if so, whether they have enforced the obligations against A?

These issues may be developed by a review of the intermediaries' operating documents, corporate minutes and all correspondence between the parties regarding these instruments.

Based on a review of the documents, the litigating hazards on this issue are significant, and consequently, we recommend that this issue not be litigated. If you determine that A has not acted consistently with its documents, call us to determine what strategies to pursue.

ISSUE 2:

Whether the Service may disallow the interest paid to B and C on the Loans because of a lack of economic substance?

LAW AND ANALYSIS:

Section 163 allows as a deduction interest paid or accrued within the taxable year on indebtedness.

In United States v. Wexler, 31 F.3d 117, 122-23 (3d Cir.

1994), 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.

In Wexler, the taxpayer took deductions on interest paid on "repo to maturity" transactions involving sales and repurchases of government securities. The interest deduction and the income from the transactions were divided up into different years, and the mismatching of the deduction and income caused the income to be deferred for a second year. Wexler, 31 F.2d at 120. The court determined that none of the debt obligations were entered into for any reason other than for the tax benefits of deducting the interest on the obligations. Wexler, 31 F.3d at 126. In many of the cases upon which the court relied, it 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 v. Commissioner, 94 T.C. 738 (1990), entered into eleven "repo" transactions involving sales and repurchases of U.S. Treasury Bills, or T-Bills. The repos involved were purchases of T-bills financed through repurchase agreements. The court determined that, although ten of these eleven transactions were real and had actually occurred, the transactions were lacking in the requisite substance and denied the interest deductions. Sheldon, 94 T.C. at 769.

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. Sheldon, 94 T.C. at 767. In 1981 and 1982 the partners in the transaction were locked in for a loss in the amount of $60,000, but received more than $5,000,000 in interest deductions to offset against their ordinary income. Sheldon, 94 T.C. at 769. Most of the transactions resulted in a loss, that is, the average interest rates on the repos were higher than the yield upon the maturity of the T-Bills that the taxpayers were to receive. Sheldon, 94 T.C. 746. In addition, the transactions were structured at year end to accommodate the mismatching of the income and deductions, thus creating a large tax benefit. Sheldon, 94 T.C. at 766.

"[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. Sheldon, 94 T.C. at 760. "The need for a profit objective" was of little or insignificant importance in the analysis of the interest deduction for transactions occurring in 1981 and 1982, the years in issue. Sheldon, 94 T.C. at 760. However, the ability to profit is a part of the overall inquiry into purpose, substance and utility. Sheldon, 94 T.C. at 767. The court determined that the transactions at issue were real, but were entered into irrespective of the gain or loss potential, and solely for the tax benefits, and therefore lacked the purpose, substance and utility required for the deduction. Sheldon, 94 T.C. at 769.

In Bealor v. Commissioner, T.C. Memo. 1996-435, 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. One of the primary corporations contracted its employees and independent contractors from a different partnership each year, but the partnerships had common partners and were pre-planned. All of the partnerships, which were the investment vehicles in this transaction, reported substantial losses. The tax benefits of the partnerships were sometimes touted to investors. Investor-partners for the most part did not receive any cash return on their investments.

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. Bealor, T.C. Memo. 1996-435. In its analysis of the economic substance of the overall transaction, the Tax 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. Bealor, T.C. Memo. 1996-435. 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.

Under the profit objective analysis of the overall transaction, the Tax Court looked to the parties' intent and ability to profit from the transactions, specifically that the partners often could not recover any money from their investments.

Upon a realistic view of the employee leasing transactions under the foregoing factors, the Bealor court 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. Therefore, the losses and deductions were properly denied.

A stated in its YEAR 1 Prospectus and YEAR 2 Prospectus that the Loans would be used for general corporate purposes including the repayment of indebtedness. YEAR 1 Prospectus at S-5; YEAR 2 Prospectus at S-7. In the A 10-K for YEAR 1, A stated that the average cost of its long term debt declined. Additionally, A's debt-to-equity ratios decreased from YEAR 1 to YEAR 2, from approximately NN to OO. These statements indicate that A did possess a business reason for entering into the transaction, and that the transactions possess the requisite economic substance.

Because part of the funds loaned to A are from A's own contributions to the capital of B and C, there may be questions concerning the circular flow of funds. However, nothing in the documents indicates that the money from the contributions to capital are treated any differently from the proceeds from the public offerings in either the YEAR 1 or the YEAR 2 Loan documents.

In the balance, it appears from the available information that A entered into the transactions to obtain loans at lower interest rates and at lower costs generally, and therefore the underlying transactions possess economic substance. Thus, the interest deduction should not be disallowed.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

We have analyzed the transaction based upon the documents available to us, and conclude that this issue should not be pursued. Should you discover that the parties have acted inconsistently with these documents, we recommend that you review the minutes of the meetings of the Board of Directors of A, B and C, corporate correspondences, notes, and additional corporate documents.

You may inquire further into A's uses of the Loan proceeds if you have general questions on the economic substance. You may inquire into whether A benefitted from the transaction (from its use of the Loan proceeds), and verify that A paid off higher-rate debt as it claims to have done. You may also inquire into what it would have cost A to have issued straight corporate debt, projecting the interest rates and the transactional costs.

The litigating hazards on this issue are significant, and as such, disallowance of the interest deductions should not be pursued. If you find that the parties have acted inconsistently with the agreements and documents, contact us to discuss further strategy.

ISSUE 3:

Whether B and C should be treated as partnerships or as associations taxable as corporations for federal income tax purposes?

LAW AND ANALYSIS:

Treas. Reg. § 301.7701-3(f)(2) of the regulations (finalized on December 17, 1996) provides that in the case of a business entity that is not automatically treated as a corporation under Treas. Reg. §§ 301.7701-2(b)(1), (3), (4), (5), (6), or (7), and that was in existence prior to January 1, 1997, the entity's claimed classification will be respected for all periods prior to January 1, 1997 if -

> (i) The entity had a reasonable basis (within the meaning of section 6662) for its claimed classification;
>
> (ii) The entity and all members of the entity recognized the federal tax consequences of any change in the entity's classification within the sixty months prior to January 1, 1997; and
>
> (iii) Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification of the entity was under examination (in which case the entity's classification will be determined in the examination).

Treas. Reg. § 301.7701-3(f)(2).

You have indicated that neither B nor C, nor any member therein, was notified in writing on or before May 8, 1996, that the classification of the entity was under examination by the Service. If we assume that there was no change in the entity's classification within the sixty months prior to January 1, 1997, then the tax treatment of B and C must be respected if B and C had a "reasonable basis" for their claimed classifications.

B

COUNTRY A amended its corporate laws to permit limited life companies in a YEAR 1 Ordinance. This entity does not appear on the list of foreign entities that automatically will be treated as "per se" corporations under current Treas. Reg. § 301.7701-

2(b)(8).

A conclusive response concerning B's tax classification would require a careful review of B's organizational documents, which have not been provided to us. However, B was formed under a modern LLC statute which permits the formation of entities which should be taxed as partnerships. It appears very likely that the taxpayers had a "reasonable basis" for B's claimed classification as a partnership, and that this classification must be respected under current Treas. Reg. § 301.7701-3(f)(2).

C

C was formed under Delaware's version of the Revised Uniform Limited Partnership Act (RULPA), which corresponds with the Uniform Limited Partnership Act (ULPA) for purposes of Treas. Reg. § 301.7701-2. Rev. Rul. 95-2, 1995-1 C.B. 221. Limited partnerships which were formed pursuant to a statute corresponding to the ULPA will lack two or more corporate characteristics. Therefore, the taxpayers had a "reasonable basis" for C's claimed classification as a partnership, and this classification must be respected under current Treas. Reg. § 301.7701-3(f)(2).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

The litigating hazards on this issue are considerable. Upon review of this memorandum, please call us to discuss resolution of these issues.

If you have any further questions, please call (202) 622-7870.

DEBORAH A. BUTLER

By: ______________________
JOEL E. HELKE
Chief
Field Service, Financial Institutions and Products