Current Events Roundup: The New Stock Buyback Excise Tax, ILM 202224010, and Deitch v. Commissioner

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In this article, we provide a brief overview of recent events pertinent to the taxation of financial products that have not already been covered by the Journal in other articles.[1] Our discussion is organized as follows: First, we consider the newly enacted Code Sec. 4501,[2] which subjects stock buyback transactions to a one-percent excise tax. Second, we evaluate Internal Revenue Service Legal Memorandum ("ILM") 202224010,[3] in which the Office of Chief Counsel concluded that Code Sec. 1234A applies to merger termination fees. Third, we evaluate the Tax Court's decision in *Deitch v. Commissioner*, which considered the tax characterization of a loan with certain equity-like features.

Stock Buyback Excise Tax

Background

President Biden, on August 16, 2022, signed into law H.R. 5376 (commonly called the "Inflation Reduction Act of 2022" or "IRA"). The IRA includes significant law changes related to tax, climate change, energy, and healthcare. Of particular relevance to this article, the IRA introduces new Code Sec. 4501, which levies a nondeductible one-percent excise tax on repurchases of stock by certain publicly traded domestic companies (*i.e.*, domestic corporations with stock traded on an established securities market). The IRA provides that the excise tax applies to repurchases occurring after December 31, 2022. "Repurchase" is defined broadly as a redemption within the meaning of Code Sec. 317(b),[4] which generally includes any acquisition by a corporation of its stock from a shareholder in exchange for property, except for its stock or rights to acquire its stock. Thus, the excise tax extends to typical stock buy-back programs implemented

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through traditional open market transactions and through privately negotiated purchases. Notably, the excise tax applies to repurchases of "any stock" of the public corporation, regardless of whether the particular stock that is repurchased is publicly traded.

A repurchase by a "Specified Affiliate" of a public corporation is subject to the excise tax.[5] A Specified Affiliate is a corporation or partnership more than 50 percent owned (directly or indirectly) by the public corporation whose stock is being repurchased.[6] The IRA also authorizes the Internal Revenue Service ("IRS") to treat economically similar transactions as repurchases (the "Economically Similar Rule").[7] Special rules apply to certain foreign corporations and surrogate foreign corporations.[8] A discussion of such rules, however, is outside the scope of this article.

The excise tax is imposed on the fair market value ("FMV") of the stock repurchased.[9] The amount subject to tax is reduced by the FMV of any stock issued during the tax year, including stock issued to employees (the "Netting Rule").[10] There are six exceptions to the excise tax under the statute: (i) to the extent a repurchase is part of a reorganization under Code Sec. 368(a) and no gain or loss is recognized by the shareholder; (ii) if the stock repurchased or an amount of stock equal to the value of such stock is contributed to an employer-sponsored retirement plan, an employee stock ownership plan, or similar plan; (iii) if the total value of the stock repurchased during the tax year does not exceed $1 million; (iv) under regulations prescribed by Treasury, repurchases by dealers of securities in the ordinary course of business; (v) repurchases by regulated investment companies ("RICs") or real estate investment trusts ("REITs"); and (vi) repurchases treated as dividends.[11]

While the excise tax may seem straightforward to apply at first glance, the new law raises a number of questions. A discussion of some of these ambiguities is included below with a particular focus on financial product issues.

What is FMV and When Is It Measured?

The excise tax is imposed on the FMV of the stock repurchased (or treated as repurchased). The IRA, however, does not define FMV and does not state when such value should be determined. This omission could lead to uncertainty.

For example, consider a scenario where an equity hedging transaction is entered into in connection with the issuance of a convertible note (*e.g.*, a capped call on the issuer's stock). Upon settlement of the hedging transaction, the issuer may receive physical shares of its stock at a price below the market value. The receipt of shares could possibly be subject to the excise tax. Would the FMV for purposes of the excise tax be the amount paid under the contract, the actual market value, or something else?[12] Would the transaction be treated differently if the hedging transaction was integrated with the convertible debt instrument under Reg. §1.1275-6?

A similar issue arises in the context of accelerated share repurchase transactions ("ASRs"). In an ASR, a company typically makes an upfront payment to a counterparty (*e.g.*, an investment bank) in exchange for a certain amount of the company's stock. An ASR also typically provides for a forward contract under which the company or the counterparty makes a settlement payment (in cash or shares) at the contract's maturity date. The settlement payment is typically based on the difference between the volume weighted average price ("VWAP") of the stock over the forward period and the upfront payment at inception. Accordingly, ASRs effectively allow companies to repurchase stock at the inception of the ASR but for a price based on the VWAP of the stock over the forward period. It is unclear how the FMV should be measured in this type of transaction. For example, would the excise tax be levied at inception of the ASR or upon settlement? Would the FMV be based on the value of the upfront payment, the settlement payment, or the trading price of the shares repurchased? Should the settlement mechanic (cash settled *vs* share settled) affect the amount of shares treated as redeemed or issued?

Economically Similar Rule

Code Sec. 4501(c)(1)(B) indicates that a repurchase includes any transaction determined by Treasury to be economically similar to a repurchase. It is not clear what type of transactions Treasury would subject to this Economically Similar Rule. Further, the statute does not explicitly provide parity—that is, it does not direct Treasury to create rules that would allow taxpayers to treat transactions that are economically similar to stock issuances as issuances for purposes of the Netting Rule. Without refinement of the scope of the Economically Similar Rule, the rule as currently drafted could lead to significant uncertainty.

Consider again a taxpayer that issues convertible debt. Upon conversion of the convertible debt, the issuer "cash settles" the instrument with cash for an amount equivalent to the FMV of the underlying referenced shares (rather than "physically settling" or "net share settling"). Cash settlement of the convertible debt does not appear to be within the scope of the Netting Rule even though the outlay of cash here may be economically similar to the issuance of stock if the debt were physically settled. The potential lack of parity in the Economically Similar Rule between repurchases and issuances could be especially acute in

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this example if the convertible debt issuer entered into an equity hedging transaction to hedge the conversion feature of the debt (*e.g.*, capped call, bond hedge with a warrant). Upon cash settlement of the convertible debt, the taxpayer may also receive funds through the cash settlement of the hedging transaction that references the taxpayer's stock. Depending on the scope of the Economically Similar Rule, Treasury could potentially consider the receipt of funds from the hedging transaction as a repurchase, but the issuer may not be able to reduce the amount subject to the excise tax by the amount paid to cash settle the convertible debt. Hopefully, future guidance would take into account the intertwined nature of these and similar transactions and allow netting in such situations.

Scope of Dealer Exception

As mentioned above, the IRA provides an exception, under regulations, for cases in which the repurchase is by a dealer in securities in the ordinary course of business (the "Dealer Exception"). Presumably, the Dealer Exception is targeted at a scenario where a broker-dealer acquires its own stock (or stock of an affiliate) to facilitate a transaction with a customer regarding such a stock.

Although the Dealer Exception is prefaced by regulations being issued by Treasury, the exception may still be applicable in the absence of regulations. Courts and the IRS have recognized that a tax statute is self-executing if the regulations referred to in the statute deal only with how, not whether, the tax is to be applied.[13]

Until regulations are issued, however, there could be uncertainty with respect to the scope of the Dealer Exception. The exception does not define "dealer in securities" or "in the ordinary course of business." A logical way to define dealer in securities would be by reference to Code Sec. 475(c)(1), which defines such term to mean a taxpayer who (i) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business; or (ii) regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. The definition of the terms "in the ordinary course" and "business," however, may not be as easily interpreted as they are not defined in the Code or regulations. Courts have attempted to define these phrases in various contexts. For example, in *Groetzinger v. Commissioner*,[14] the court considered two factors when deciding whether a taxpayer was engaged in a trade or business: (i) the continuity, frequency, and extent of the activities; and (ii) the intent of the taxpayer to make a profit or to produce income.[15] Courts have also considered "ordinary course" to be a facts-and-circumstances test which generally precludes transactions that are "entirely divorced" from its trade or business or which suggest an intent to depart from a taxpayer's regular business practices.[16] Absent contrary guidance, a dealer could weigh these factors and presume that there needs to be a link between the repurchase and the taxpayer's dealer business to qualify for the Dealer Exception. It would be helpful, however, if Treasury provided clarity here as to how strong such a link needs to be.

ILM 202224010

Background

In ILM 202224010 (June 17, 2022), the IRS ruled, consistent with previous guidance,[17] that termination (or breakup) fees paid by the acquiring corporation in a Code Sec. 368(a)(1)(A) reorganization upon the termination of the transaction were capital losses. Specifically, such fees were treated as capital losses to the extent attributable to the property of the target that would have been a capital asset in the hands of the taxpayer if the mergers had been completed.

IRS Conclusions

In rejecting the taxpayer's position that the termination fees were ordinary business expense deductions under Code Sec. 162, the IRS concluded that:

- The terminations of the transactions resulted in dispositions under Code Sec. 1001 that gave rise to losses under Code Sec. 165 rather than business expenses under Code Sec. 162;
- The regulations under Code Sec. 263(a) do not require that the termination fees be treated as Code Sec. 162 expenses;
- The relevant case law does not require that the IRS accept the taxpayer's treatment of the termination fees as Code Sec. 162 expenses; and
- Code Sec. 1234A applies to characterize the Code Sec. 165 losses that result from the terminations of the transactions as capital losses to the extent those losses were attributable to the termination of rights or obligations with respect to capital assets.

The IRS' Analysis

Code Sec. 1234A

According to the IRS, proper application of Code Sec. 1234A requires a plain reading of the statute, which sets forth the following requirements in determining whether

a transaction is subject to Code Sec. 1234A: (i) there is gain or loss attributable to an extinguishing event (*i.e.*, a cancellation, lapse, expiration, or other termination); (ii) that event extinguishes a contractual right or obligation; (iii) the contractual right or obligation concerns underlying property that is a capital asset in the taxpayer's hands (or that would be a capital asset if the property were acquired by the taxpayer); and (iv) there is a "with respect to" nexus or connection between the right or obligation and the underlying capital asset.

The IRS found that the termination fees came within the purview of Code Sec. 1234A as the merger agreements, which created contractual rights and obligations, were extinguished (*i.e.*, terminated), and both the termination and their tax consequences were attributable to those extinguishing events.

Code Sec. 165

In determining that the termination fees were Code Sec. 165 losses, the IRS noted that the relevant authorities[18] suggest that the "facilitative costs of mergers and other similar major corporate transactions, including acquisitions or dispositions of assets constituting a trade or business, are required to be capitalized" and that if such transactions are abandoned, those costs are recovered as Code Sec. 165 losses.

In reaching its conclusion, the IRS also invoked the legislative history of Code Sec. 1234A, which, in the view of the IRS, "reflects Congress's assumption that the making of a payment to terminate contracts with respect to capital assets results in the requisite gain or loss to apply the statute." Consequently, the IRS concluded that the terminations of the merger agreements were Code Sec. 1001 dispositions of property giving rise to gain or loss, with any loss being deductible under Code Sec. 165.

Code Sec. 263(a)

The taxpayer posited that the termination fees are deductible as expenses under Code Sec. 162. In support of its position, the taxpayer argued that, under Reg. §1.263(a)-5(c)(8), a fee paid to terminate a merger transaction is deductible when paid unless the fee was paid to "engage in a second, mutually exclusive capital transaction," in which case it is required to be capitalized. Thus, according to the taxpayer, if the termination fees are not required to be capitalized under the Code Sec. 263(a) regulations (which, in the taxpayer's view, they are not), then they must therefore be deductible under Code Sec. 162. In essence, the taxpayer argued that without basis in property, there can be no "loss" under Code Sec. 1001.[19]

The IRS did not agree. According to the IRS, Code Sec. 263 does not control whether items like the termination fees are Code Sec. 162 expenses, Code Sec. 165 losses, or subject to Code Sec. 1234A. Rather, Code Sec. 263 requires capitalization (and thus denies current deductibility) for otherwise deductible items, and that once capitalized the item is only recovered under a particular and applicable Code section, the requirements of which must be independently satisfied. In this case, the IRS concluded that the requirements of Code Sec. 165 were satisfied once the transactions were terminated, which resulted in losses equal to the amount of the termination fees. Such losses were subject to Code Sec. 1234A, which resulted in the losses being characterized as capital.

Case Law Relating to Merger Terminations and the Origin of the Claim Doctrine

The IRS also rejected the taxpayer's argument that case law (specifically the *Santa Fe* and *Federated* cases) dictates that the termination fees were Code Sec. 162 expenses by distinguishing those cases from the facts at hand by observing that the courts in those cases permitted a Code Sec. 162 deduction because the fees fit within the rubric of expenses paid to defend an existing business against attack, that was not the case under the facts of the ILM. Moreover, in the IRS' view, the taxpayer's case concerns the issue of whether the termination fees were losses under Code Sec. 165, and potentially subject to Code Sec. 1234A, rather than Code Sec. 162 expenses. The cases, by contrast and according to the IRS, grappled with the question of timing (*i.e.*, were the fees to be expensed or capitalized) rather than one of expense *vs* loss. Further, the IRS asserted that both cases ultimately supported the view that the fees would generate a Code Sec. 165 loss when the transaction was abandoned.

The taxpayer also invoked the origin of the claim doctrine to argue that the termination fees should be Code Sec. 162 expenses as they were negotiated to compensate the target and buyer for their transaction costs. In response, the IRS asserted that, even if a portion of the termination fees may have been paid as compensation for an expense, that does not change the fact that the taxpayer paid the termination fees to dispose of its rights and obligations arising from capital transactions that, under case law that the IRS views as "clear," generally creates a capital loss.

Applying Code Sec. 1234A

In applying Code Sec. 1234A to the termination fees paid by the taxpayer, the IRS ruled that they be allocated,

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based on the respective FMVs, between each ordinary and capital asset the taxpayer would have received under each transaction, had the transactions not failed.

Implications

The conclusion reached by the IRS in this ILM—that termination fees fall within the ambit of Code Sec. 1234A—is not necessarily one shared by all practitioners. Some practitioners, including leading commentators, question whether Code Sec. 1234A should address termination payments (note that other Service memoranda also have applied them to capitalized transaction costs).[20] Also, questions can be raised about the applicability of Code Sec. 1234A to termination payments made by other parties to a transaction such as by a target corporation in a cash stock acquisition. Nevertheless, the ILM presents a forceful articulation of the IRS position on this matter, reminding taxpayers that the IRS continues to closely examine the treatment of termination fees.

Deitch v. Commissioner

Background

In *Deitch v. Commissioner*,[21] the taxpayer was a partner in West Town Square Investment Group, LLC ("WTS"), a partnership formed in 2006 to purchase, renovate, and lease a commercial rental property in Georgia. The purchase and renovation of the commercial rental property was financed with proceeds of a "participating loan" from Protective Life Insurance Co. ("PLI"). The loan comprised three separate, but integrated, documents—the "Original Note Agreement," the "Security Agreement," and the "Additional Interest Agreement."[22] The Original Note Agreement provided the basic terms of the arrangement and required WTS to pay fixed interest accruing at a rate of 6.25 percent ("Fixed Interest") and fixed principal payments; the Security Agreement granted PLI a security interest in the commercial real estate being acquired; and the Additional Interest Agreement required WTS to pay PLI 50 percent of the net cashflow from the property ("NCF Interest")[23] and 50 percent of the appreciation in the value of the property upon the occurrence of certain events, such as the sale of the property or the termination of the loan ("Appreciation Interest").[24] The loan was issued in 2006 and was scheduled to mature in 2009. The loan documents explicitly stated that the arrangement between WTS and PLI was that of a debtor and creditor and that PLI was not responsible or liable in any way for debts, losses, and other obligations of WTS. PLI was not responsible or involved in the management of WTS.

During the years that WTS owned the commercial rental property, it made regular loan payments to PLI. These payments consisted of Fixed Interest and NCF Interest and were characterized as interest for tax purposes. WTS sold the property in 2014 and, in accordance with the loan documents, paid PLI the Appreciation Interest. On its partnership tax return for 2014, WTS claimed an interest deduction for its payment of the Appreciation Interest and reported gain on the sale of the commercial property. The partners reported their distributive shares of income and loss from the partnership on their individual income tax returns for 2014.

The IRS challenged the taxpayer's position, asserting that the Appreciation Interest was a payment pursuant to a WTS–PLI joint venture and should therefore be a reallocation of gain to PLI, rather than an ordinary interest deduction to the WTS partnership (that was passed through to the taxpayer).[25] This adjustment would not change the amount of income reported by the taxpayer in respect to WTS' activities, but it would change the character.[26] The Tax Court rejected the government's argument and sustained the taxpayer's interest expense deduction.

Analysis

The first question considered by the Tax Court was whether the loan arrangement could be bifurcated into an equity interest and a separate debt instrument. The Tax Court concluded that the various components of the overall loan arrangement could not be separated because they were mutually dependent and part of a single negotiated transaction. Moreover, the Tax Court noted that the separation of a single integrated arrangement was at odds with the position espoused by the government in General Counsel's Memorandum (GCM) 36702, issued in response to the opinion of the Second Circuit in *Farley Realty Corp. v. Commissioner*.[27] Specifically, in GCM 36702 the government took the position that *Farley* was wrongly decided to the extent it "suggests that the taxpayer's right to share in the partnership's profits is separable from its right to repayment of its advance with interest thereon and that only the right to share in profits is an equity interest." For its part, the government appears to have agreed with the Tax Court's approach, having stated that "PLI's advance to WTS was ... not part equity, part debt."

This concession forced the government into the uncomfortable position of having to argue that the entire arrangement constituted equity. In this regard, the government did not help itself by also conceding that the Original Note Agreement represented "genuine indebtedness."

The Tax Court felt the government's acceptance that there was "genuine indebtedness" and that the loan documents "must be considered as a whole" contradicted any argument that PLI had acquired an equity interest through the loan arrangement. Nevertheless, the Tax Court proceeded to march through the "Luna factors" and reached the same conclusion on those grounds.[28] However, in doing so, the government's concessions continued to be relied upon heavily—for example, the Tax Court concluded: (i) that PLI did not make a contribution to the venture in an equity capacity because its contribution was "genuine indebtedness" and (ii) that PLI did not share in losses, despite nonrecourse nature of the loan and the very limited equity capital of WTS, because such losses would be borne in a creditor capacity (again, because of the parties' stipulation that there was "genuine indebtedness"). Having rejected the existence of a WTS–PLI joint venture, the Tax Court next considered whether the loan represented a direct equity interest in WTS. This possibility was dismissed on similar grounds and the Tax Court again relied heavily on the government's concession that there was "genuine indebtedness." Thus, the stipulations agreed to by the government proved fatal to its argument that the loan was not *bona fide* indebtedness.

A more charitable interpretation might reconcile the government's stipulations with its litigating position by taking the "genuine indebtedness" concession to apply only to the Original Note Agreement on a standalone basis, such that the addition of the Additional Interest Agreement introduced sufficiently strong equity-like characteristics to result in the entire arrangement being treated as equity. There are certainly situations where elements of an equity instrument, when considered on a standalone basis, would appear to represent debt.[29] Thus, the government's position is not necessarily as contradictory as the Tax Court's opinion might lead one to believe.

Nevertheless, given the Tax Court's conclusion, one might question whether the government's concessions were wise. WTS was engaged in a speculative venture and funded almost entirely by the PLI loan. PLI had no recourse against the partners of WTS and WTS had almost no other assets, such that the return of the funds advanced was entirely dependent upon the success of the commercial real estate venture. Given the thin capitalization of WTS, one could reasonably have concluded, or at least have argued, that even the Original Note Agreement constituted equity under general tax principles. Also of note is the lack of discussion of the rules applicable to contingent payment debt instruments. Generally, when there are non-remote contingencies that could affect the amount paid under a debt instrument, the contingent payment debt instrument rules of Reg. §1.1275-4 determine the accrual of interest. In the case of a contingent payment debt instrument issued for money (as was the case in *Deitch*), the lender and borrower accrue interest at a comparable yield that takes into account the possibility of contingent payments, and then makes positive or negative adjustments when contingencies resolve.[30] Thus, it is possible that a portion of the Appreciation Interest should have been deducted in an earlier tax year … possibly even a tax year closed by statute. It does not appear that the government raised this issue.

ENDNOTES

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1 For other articles covering recent events, *see* Angeliki Vlachou, *The Application of Payments on Distressed Debt, Considering Howland v. Commissioner*, 19, 2 J. Tax'n Fin. Prods. (2022); Jonathan Cutler, *CRS for Crypto: Demystifying the OECD's Proposed Crypto-Asset Reporting Framework*, 19, 2 J. Tax'n Fin. Prods. (2022); and Thomas A. Humphreys, *Fifty Years and One Little Word: Proposed Regulations Exclude OTC Foreign Currency Options from Code Sec. 1256*, 19, 3 J. Tax'n Fin. Prods. (2022).

2 Unless otherwise indicated, Code Sec. and Reg. § references are to the Internal Revenue Code of 1986 as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

3 Jun. 17, 2022.

4 Code Sec. 4501(c)(1)(A).

5 Code Sec. 4501(c)(2)(A).

6 Code Sec. 4501(c)(2)(B).

7 Code Sec. 4501(c)(1)(B).

8 *See* Code Sec. 4501(d).

9 Code Sec. 4501(a).

10 Code Sec. 4501(c)(3).

11 Code Sec. 4501(e).

12 Another question arises as to the scope of the excise tax if the hedging transaction in this example is cash settled or net share settled in light of the Economically Similar Rule. *See* further discussion on this below.

13 *See, e.g., Estate of Neumann*, 106 TC 216, Dec. 51,280 (1996) (applying the statute even absent any regulations in the case of a non-resident alien where the statute [Code Sec. 2663] states that "[t]he Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the provisions of this chapter, including ... regulations ... providing for the application of this chapter in the case of transferors who are [non-resident aliens]"); CCA 201537021 (Sep. 11, 2015) (applying the statute in Code Sec. 1359 absent regulations).

14 SCt, 87-1 USTC ¶9191, 480 US 23, 34, 107 SCt 980 (1987).

15 *See also J.P. Stanton*, CA-5, 68-2 USTC ¶9516, 399 F2d 326, 329 (1968) (The phrase "trade or

business" connotes something more than an act or course of activity engaged in for profit. The phrase must refer not merely to acts engaged in for profit, but to extensive activity over a substantial period of time during which the Taxpayer holds himself out as selling goods or services. A taxpayer can show that his activities are a "business" by demonstrating that he devotes a substantial portion of his time to the activities or that there has been extensive or repeated activity over a substantial period of time.).

[16] *See Guardian Indus. Corp. & Subsidiaries*, 97 TC 308 at 318, Dec. 47,610 (1991); *A.M. Reinach*, CA-2, 67-1 USTC ¶9274, 373 F2d 900 (1967); *M. King*, 89 TC 445, 466, Dec. 44,174 (1987).

[17] *See* ILM 201642035 (Oct. 14, 2016) and FAA 20163701F (Sep. 9, 2016).

[18] In support of its position, the IRS cited Reg. §§1.165-2(a) and 1.263(a)-5(e), as well as a number of cases including *Santa Fe Pac. Gold Co.*, 132 TC 240, Dec. 57,793 (2009) and *Federated Dept. Stores, Inc.*, DC-OH, 94-2 USTC ¶50,430, 171 BR 603 (1994), both of which involved the deductibility of termination fees in failed merger transactions.

[19] Code Sec. 1001(a) provides that a loss is realized for the excess of a property's adjusted basis over the amount realized on the sale or other disposition of the property.

[20] *See, e.g.*, Tax Accounting in Mergers and Acquisitions by Glenn Carrington, ¶603; Robert Willens, *Reverse Termination Fee Ruled a Capital Loss*, 105 TAX NOTES STATE 501 (Aug. 1, 2022).

[21] 124 TCM 101, Dec. 62,097(M), TC Memo. 2022-86.

[22] The loan documents were "integrated" in that they were negotiated and executed as a set and contained cross references to each other. In addition, the Original Note Agreement defined "Loan Documents" to include the Additional Interest Agreement.

[23] The loan documents provided that net cash flow was determined after deducting all expenses. For this purpose, "all expenses" was defined to exclude income taxes, depreciation, any loan expenses or payments except those made on the loan to PLI, any management compensation or fees in excess of those expected in a reasonable, arm's-length arrangement, and any capital improvements to the property.

If the net cashflow calculation for any particular quarter was negative, WTS was not required to make a quarterly payment to PLI, nor was WTS entitled to make an immediate corresponding deduction or offset to PLI's quarterly NCF Interest. However, any negative net cash flow would reduce the amount of any future required payments.

[24] The Appreciation Interest provision could be triggered upon the occurrence of any one of the following events: (i) sale of the property; (ii) recovery of damages or other compensation from a third party in the event of a condemnation or similar circumstance; (iii) junior financing in the form of an additional encumbrance being placed on the property; (iv) any refinancing of the loan or any portion of the property with a third-party lender, in which case the Additional Interest Agreement remained in full force and effect with respect to the property; (v) default under the loan documents; (vi) maturity of the original note; or (vii) prepayment of the original note, including "all modifications, renewals, and extensions thereof."

The manner in which the amount of Appreciation Interest was calculated depended on the nature of the triggering event.

[25] The IRS issued statutory notices of deficiency to the individual partners in the partnership, asserting that their incomes were to be increased by the amount of the disallowed Appreciation Interest. The IRS subsequently acknowledged that there should also be a corresponding reduction in the amount of gain, such that the partners' incomes would not be increased, but the character of the income as capital gain or ordinary deduction would be adjusted. It should also be noted that the IRS initially took the position that the Appreciation Interest payment was a payment made on an equity interest PLI held in WTS, and later changed its position to be that there was a joint venture partnership between WTS and PLI.

[26] Consistent with this equity characterization, the IRS indicated that other payments should be treated as guaranteed payments.

[27] CA-2, 60-2 USTC ¶9525, 279 F2d 701 (1960), *aff'g*, 18 TCM 422, Dec. 23,589(M), TC Memo. 1959-93.

[28] *See H.M. Luna*, 42 TC 1067, Dec. 26,967 (1964). *See also W.O. Culbertson, Sr.*, SCt, 49-1 USTC ¶9323, 337 US 733 (1949).

[29] For example, certain structured products are essentially a combination of a debt instrument and an equity or derivative instrument and these types of arrangements are not always treated as indebtedness for tax purposes.

[30] *See generally* Reg. §1.1275-4(b).

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