

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

Number: **20121201F**

Release Date: 3/23/2012

CC:LM:RFPH:ATL:
POSTF-137586-11

UILC: 246.05-03

date: November 10, 2011

to:

(LB&I/FS)

from: Associate Area Counsel
(Atlanta)

subject: Holding Period Requirement for Dividends -Received Deduction
(“Taxpayer”)

In accordance with § 6110(k)(3), this advice should not be cited as precedent.¹ This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

LEGEND

A =
B =
C =
D =
E =
F =
G =
H =
I =
J =
K =
Amount 1 =

¹ Unless otherwise stated, all section references refer to the Internal Revenue Code of 1986, as amended.

Amount 2 =
Amount 3 =
Amount 4 =
Amount 5 =
Amount 6 =
Amount 7 =
Amount 8 =
Amount 9 =
Amount 10 =
Amount 11 =
Amount 12 =
Amount 13 =
Amount 14 =
Amount 15 =
Amount 16 =
Amount 17 =
Amount 18 =
Amount 19 =
Amount 20 =
Amount 21 =
Amount 22 =
Amount 23 =
Amount 24 =
Amount 25 =
Amount 26 =
Amount 27 =
Amount 28 =
Amount 29 =

ISSUE

Whether, based on the facts described herein, Taxpayer diminished its risk of loss and therefore failed to satisfy the holding-period requirement in § 246(c) for a dividends-received deduction?²

CONCLUSION

Yes. Through the arrangements and agreements, Taxpayer diminished its risk of loss and, as a result, reduced its holding period to zero days. Accordingly, Taxpayer is not eligible for a dividends-received deduction under § 243.

FACTS

Parties to the Transaction

² For purposes of rendering this advice, we have assumed that the interests at issue are equity rather than debt. We have made no legal conclusion that the interests are equity interests.

Taxpayer is a domestic corporation and the common parent of an affiliated group of corporations that files a consolidated Federal income tax return. Taxpayer conducts its business primarily through its operating entity,

is an
is a wholly owned subsidiary of
formed ("Issuer"), a domestic entity that elected
for Federal income tax purposes to be treated as an association taxable as a
corporation.³

Taxpayer (indirectly, through its subsidiaries) transferred \$ to
(indirectly) through its purchase of preferred shares of Issuer (described herein). The preferred shares pay dividends for which Taxpayer claimed a dividends-received deduction under § 243.

Preferred Shares of Issuer

bought the following preferred shares of Issuer:⁴

- (1) shares (all issued and outstanding) of series A preferred stock at \$
per share (total: \$);⁵
- (2) shares (all issued and outstanding) of series B preferred stock at \$
per share (total: \$);⁶ and
- (3) shares (all issued and outstanding) of series C preferred stock at \$ per
share (total: \$).⁷

By holding these preferred shares, owned % of Issuer's value.⁸
retained shares (all issued and outstanding) common shares of Issuer.⁹

Dividend Rates

Issuer paid dividends quarterly on the preferred shares as follows:¹⁰

Class A: % for months, then the rate is reset¹¹

³ See Operating Agreement of ("Operating Agreement") § .

⁴ Limited Liability Company Interest Purchase Agreement.

⁵ The series A preferred shares carry the right to vote 1 vote. Operating Agreement § .

⁶ Neither the series B preferred shares nor the series C preferred shares carry voting rights. Operating Agreement § .

⁷ See also Operating Agreement § .

⁸ Memorandum p. .

⁹ The common shares carry the right to vote 6 votes. Operating Agreement § .

¹⁰ Operating Agreement § . must make additional capital contributions to Issuer to the extent necessary to ensure that Issuer can pay any additional dividends and additional payments.

Operating Agreement § .

¹¹ Issuer's Operating Agreement provides that to reset the dividend rates for dividends on class A and class B shares, Issuer and must first try to agree either on the dividend rate or method to determine

Class B: % for months, then the rate is reset¹²
 Class C: %

Upon reset of the dividend rates for class A and B shares, if the shares are remarketed, the purchaser pays the remarketing price for the shares. The “remarketing price” equals ’s purchase price for the shares.¹³

Note that the rates previously described are the rates in the ordinary course. If, however, income tax laws change to cause either the “tax rate” or the “DRD rate” to reduce the after-tax return to , as holder of the preferred shares, the dividend is increased to offset the decrease (*i.e.*, “additional dividends”). must make additional capital contributions to Issuer to the extent necessary to ensure that Issuer can pay any additional dividends and additional payments.¹⁴

Redemption

Issuer may redeem the preferred shares upon a “preferred redemption event” such as a DRD rate reduction, change in tax law, or interpretation disallowing a dividends received deduction under § 243. If Issuer redeems the preferred shares, the redemption price is the liquidation amount for the shares (*i.e.*, ’s purchase price), plus any redemption premium.¹⁵

Appointment of Directors

the dividend rate. If they cannot agree, Issuer will remarket the preferred shares. § . The remarketing agent will solicit bids, from which Issuer will select the lowest bid rate as the winning bid rate. The bidder with the winning bid rate is the secondary purchaser. § . The secondary purchaser buys the preferred shares at the remarketing price. § . Upon a failed remarketing, the dividend rates are set at the maximum bid rate permitted under the maximum scales in Rev. Rul. 90-27.

¹² See *supra* n.11.

¹³ See *supra* n.11 for an explanation of the auction procedures. The “remarketing price” equals % of the aggregate outstanding preferred stock liquidation amount, which is (1) \$ per share for the series A preferred stock, (2) \$ per share for the series B preferred stock, and (3) \$ per share for the series C preferred stock, plus any accrued and unpaid dividends and special dividends with respect to each share of preferred stock. Operating Agreement at pp. .

¹⁴ Operating Agreement §).

¹⁵ After the first reset date, Issuer may redeem all (but not part) of the preferred shares for the preferred stock liquidation amount, plus any redemption premium. Operating Agreement

A “redemption premium” means (i) \$ if the preferred stock is redeemed during the period beginning on the Closing Date, (ii) \$ if the preferred stock is redeemed during the period beginning on the day after the first anniversary of the Closing Date and ending on the second anniversary of the Closing Date, or (iii) \$ if the preferred stock is redeemed during the period beginning the day after the second anniversary of the Closing Date and ending on the first Reset Date.

Upon a preferred redemption event, Issuer may redeem all (or a portion) of the preferred shares outstanding for the preferred stock liquidation amount for each share being redeemed. If the redemption is before the first reset date, Issuer must also pay a redemption premium. If Issuer has insufficient redemption funds to redeem all of the preferred shares, Issuer will redeem a *pro rata* portion from each class of preferred shares and redeem additional preferred shares as more redemption funds become available. Operating Agreement § .

Issuer has 4 directors on its board of directors. Upon a specified event, the number of directors increases to 6.¹⁶ A “specified event” is either a type A event or a type B event. A “type A event” generally regards events adversely affecting the creditworthiness of _____ to _____ (e.g., a default by _____ in its senior banking facility, an unreleased security interest on _____’s assets, the acquisition of _____, bankruptcy of a _____ entity).¹⁷ Upon the occurrence of a type A event, _____, as holder of the class A preferred shares, appoints 2 additional directors to Issuer’s board.¹⁸

A “type B” event occurs generally after _____ delivers to Issuer its preferred A shares in Issuer upon certain specified events, including indebtedness of Issuer or _____ (“Partnership”) other than a permitted liability, a security interest on the assets of Issuer or Partnership, or the failure to pay a dividend or additional dividend when due.¹⁹

Issuer’s Investments

Issuer owns Partnership, a _____ partnership. Partnership can hold only cash and certain highly rated liquid investments and can incur only “permitted liabilities” (i.e., liabilities for taxes; debts and liabilities as defined in the transaction documents, and debts and liabilities not in excess of \$ _____ (in the aggregate) incurred in the ordinary course of business).

Performance Guarantee

_____ guaranteed to Issuer the punctual performance of _____ of the guaranteed obligations.²⁰ Upon a liquidating event of Issuer,²¹ _____ guaranteed to _____ that it would pay any unpaid debt, additional dividends, or additional payments.²²

¹⁶ Operating Agreement § _____ .

¹⁷ Operating Agreement § _____ .

¹⁸ Operating Agreement § _____ .

¹⁹ Operating Agreement § _____ .

²⁰ Performance Guarantee, _____

_____ in favour of _____ (“Performance Guarantee”) at § _____. The “guaranteed obligations” consist of _____’s obligation to make Additional Capital Contributions to Issuer to the extent necessary to ensure that Issuer can pay the Additional Dividends and Additional Payments. See Performance Guarantee, p _____ and Operating agreement § _____ “Additional Capital Contributions” occur when:

Members may make additional capital contributions pursuant to Section _____, Section _____, Section _____, and Section _____ and in the case of _____ pursuant to clause _____ or _____ of the _____

(amounts contributed pursuant to this Section are referred to as “Additional Capital Contributions”). Members shall not receive any shares of Preferred Stock or Common Stock in exchange for Additional Capital Contributions.

Operating Agreement § _____ .

“Additional dividends” occur when a

change in either Tax Rate or DRD Rate (or both) after the date upon which the Dividend Rate for a Dividend Period is determined (and for purposes of this Section _____ the date that the Dividend Rate is reduced in connection with the provision of Additional Credit Enhancement or Other Credit Enhancement shall not be treated as the date upon

Purchase Warranty Deed

indemnified from and against any claims, damages, losses, cost, and expenses as a result of any breach or inaccuracy in:

- 's representations and warranties in the Purchase Warranty Deed or the Performance Guarantee;²³
- 's and Issuer's representations and warranties in the Preferred Purchase Agreement;²⁴ and
- 's representations and warranties in the Contingent Asset and Sale Agreement.²⁵

may recover from , Issuer, or up to:²⁶

1. The unpaid portion of the aggregate preferred stock liquidation amount (i.e., 's purchase price),
2. Any applicable redemption premium, and
3. Any enforcement costs and expenses and additional amounts.

which the Dividend Rate is determined) whether it is determined at its Closing Date or by Remarketing – that would have the effect of reducing the after-tax return to Holder in respect of such Dividend, then each affected Dividend shall be increased to the extent necessary to ensure that Holder shall be in the same position after tax as if there had been no such change; *provided, however*, if the affected Dividend is paid prior to a determination that such a change in Tax Rate or DRD Rate has occurred, then the Company [Issuer] shall declare and pay an additional dividend at the time or times specified in the first sentence of Section in an amount sufficient to ensure that Holder shall be in the same position after tax as if there had been no such change (such additional dividends as well as the additional dividends payable under Sections and are referred to herein as “**Additional Dividends**”);

Operating Agreement §

“Additional payments” occur when:

In the event that any adjustment in respect of a previously-declared Dividend is required under Sections or above and such adjustment occurs at a time when a Holder no longer holds Preferred Stock (whether as a result of a redemption or other permitted disposition), the Company shall make such additional payments (an “Additional Payment”) to such Holder as are necessary to ensure that such Holder is in the same position on a net after-Tax basis as it would have been had no failure described in Sections or above occurred.

Operating Agreement §

²¹ A “liquidating event” occurs (1) upon the unanimous vote or consent of the board to dissolve the company, or (2) if the company ceases to have any members (unless the business of the company is continued in a manner otherwise permitted by the operating agreement or under the Delaware Limited Liability Company Act. Upon a liquidation event, the company dissolves and commences winding up.

Operating Agreement §

²² Performance Guarantee at §

²³ Purchase Warranty Deed between and

(“ Purchase Warranty Deed”) §

²⁴ Purchase Warranty Deed §

²⁵ Purchase Warranty Deed §

²⁶ Purchase Warranty Deed §

Group Guarantee

and related companies of jointly and severally guaranteed the punctual payment on demand to of all debts and monetary liabilities of a obligor to under or in relation to any guaranteed document, and in any capacity irrespective of whether debts or liabilities are present or future, or actual, prospective, contingent, or otherwise.²⁷

Parent Guarantee

unconditionally and irrevocably (1) guaranteed to the due and punctual performance of of the guaranteed obligations; and (2) indemnified for all losses, costs, expenses, damages, and liabilities suffered or incurred by in connection with any nonperformance of Finance of any guaranteed obligation.²⁸

Memorandum

prepared a Memorandum (“ ”), in which it analyzed the transaction. The summarizes the rate reset procedures as:

Although the Pref. Shares are perpetual, can choose not to participate in the auction at months, after which the Pref Shares will be sold to a third party or the dividend rate will step up to the default rate. If the default rate is not paid, can take control of the Issuer. As the default rate is uneconomical, the Issuer is expected to call. Additionally, has the right to call for an early action at 30 months.²⁹

The “Transaction Overview” of the states:

Redemption of [the principal investment is supported by the assets of Issuer which must include:

USD	High quality marketable securities, risk level , with the Custodian
USD	assets whose minimum value is supported by a put to a [sic] an SPV, whose ability to pay is supported by AA- rated bank LCs with the Custodian, risk level .
USD	assets whose minimum value is supported by a put to a guaranteed entity, risk level . If deteriorates significantly in credit quality (as measured by CDS spreads), the put will become supported by AA- bank LCs with the Custodian, thus largely eliminating our exposure to 's credit risk and converting these assets to risk.

²⁷ Group Guarantee (and 19 enumerated companies in favour of Issuer and) § 4.1(b).
²⁸ Parent Guarantee (in favour of) § .
²⁹ Memorandum, pp. .

The Issuer is [30] because it is a special purpose LLC with an Operating Agreement which has been carefully negotiated as part of the transaction documents, with its assets of high quality and controlled per above, and its liabilities strictly controlled so as to limit claims on the Issuer senior to ours. Overall our exposure to this structure is lower risk (lower probability of default, lower severity of loss) than the same amount of exposure to (). [31]

A swap is used to protect us from interest rate risk on an early redemption. If the pref shares are early redeemed and if interest rates have fallen, our loss of the fixed rate dividend stream on the pref shares will be offset by our gain on unwinding our fixed rate payments to on the swap. This swap has risk, and is rated . [32]

The “key credit risks and mitigants” described in the provide:

While liabilities at the Issuer are strictly and explicitly limited to preserve the seniority of pref shares in the capital structure, tax liabilities are an exception and are not explicitly limited as we need to preserve the equity nature of our investment by taking equity-like risk.

- The Issuer cannot pay dividends on its common stock while the pref shares are outstanding.
- Other than USD of Permitted Liabilities, the Issuer’s liabilities are restricted such that there are no other claims senior to ours other than tax.
- Although tax liabilities are potentially unlimited, the Issuer’s and (each subsidiary’s activities are carefully prescribed to prevent a tax liability that is not covered by Liquid Investments held by the custodian.
- The documentation (Operating Agreement) provides an affirmative covenant on the company to place Liquid Investments on deposit with the custodian in an amount equal to (i) USD , (ii) a quarter’s worth of dividends (approximately USD) and (iii) the tax liability that the company in good faith believes will be due and owing for a quarter (expected to be USD but must be topped up if tax liabilities are created).
- The Issuer’s custodian will hold the LCs and cash necessary to redeem our pref shares. If the Issuer gets dragged into a insolvency, we may lose control of our source of repayment.
 - We have counsel opinion that this is very unlikely.
- If US tax law changes and the value of our dividends received is greatly reduced (ie to the point of negative cash flow) we will suffer an economic loss for which we are not indemnified, and will earn a negative return.
 - believes this is very unlikely, and accepts the P&L risk.
 - While the dividend yield will be negative, the Principal redemption will still occur in full. The security is not one which is marked to market, so its credit risk does not change even though its economic value changes for the balance of the months.

The describes the “Financial Overview” of Issuer as follows: [33]

- the USD in cash and equivalents must be kept by the Custodian
- the value of the Investment in Subs is supported by the puts as described

30

31

32

Memorandum, p. .

33

Memorandum p. .

- the company may not dispose of its investment in subs or invest in other assets other than defined permitted assets without our consent.
- Liabilities (other than tax liabilities as described in Key Credit Risks) are strictly limited.
- Common stock cannot receive dividends or be redeemed without our consent.

The Memo discusses sources of repayment as follows:³⁴

Primary Source of Repayment: Strong

As to Dividends: Earnings at the Issuer level generated by the underlying companies, Adequate earnings to pay the dividends, grossed up for tax as needed, are guaranteed by

As to the redemption of Pref Shares at year 3: General liquidity at time of settlement, augmented by financing in the debt capital markets as needed.

* * * * *

Secondary Source of Repayment: Strong

If cannot redeem the securities when required (effectively at year 3), will take % of Board seats of the Issuer and have the ability to control and reliaze [realize] the

a) for the USD portion of our exposure which is supported by high quality liquid securities owned by the issuer:

→ sale of securities: **Very Strong and Independent**

b) for the USD portion of our exposure which is supported by assets whose value is underpinned by a put to an SPV credit enhanced by AA- LCs:

→ put to the SPV/draw on the LCs: **Very Strong and Independent**

c) for the USD portion of our exposure which is supported by assets whose value is underpinned by a put to a guaranteed entity

→ i) if 's credit deteriorates to low/non investment grade levels (trigger: credit default swap spreads widen 50% or up to 135 bp) 's credit risk will be credit enhanced with AA- LCs in favor of the Issuer and held by a custodian:

Very Strong and Independent

→ ii) if – highly unlikely – should suddenly default on its redemption obligation without having triggered credit enhancement per i) above, sale of Assets

Moderate and Dependent

- Although not independent of primary source of repayment, liquidation of assets through the divestment of business segments:

- Divisible business segments that could be liquidated (eg.,)

-

-

³⁴

A “diminished risk of loss” occurs when a taxpayer holds positions with respect to substantially similar or related property if changes in the fair market value of the stock and the positions are reasonably expected to vary inversely. Treas. Reg. § 1.246-5(b)(2). Regarding paragraph (C), the regulations elaborate:

The term substantially similar or related property is applied according to the facts and circumstances in each case. In general, property is substantially similar or related to stock when—

- (i) The fair market value of the stock and the property primarily reflect the performance of—
 - (A) A single firm or enterprise;
 - (B) The same industry or industries; or
 - (C) The same economic factor or factors such as (but not limited to) interest rates, commodity prices, or foreign-currency exchange rates; and
- (ii) Changes in the fair market value of the stock are reasonably expected to approximate, directly or inversely, changes in the fair market value of the property, a fraction of the fair market value of the property, or a multiple of the fair market value of the property.

Treas. Reg. § 1.246-5(b)(1). Further, a taxpayer has diminished its risk of loss by holding substantially similar or related property “if the taxpayer is the beneficiary of a guarantee, surety agreement, or similar arrangement and the guarantee, surety agreement, or similar arrangement provides for payments that will substantially offset decreases in the fair market value of the stock.” Treas. Reg. § 1.246-5(c)(4). These regulations were promulgated in T.D. 8590. The preamble to T.D. 8590 states:

The final regulations retain the rule in the proposed regulations that a guarantee, surety agreement, or similar arrangement is treated as substantially similar or related property if it substantially offsets decreases in the fair market value of the stock. The IRS and Treasury caution that these arrangements or similar rights (even if they do not substantially offset decreases in the fair market value of the stock) may also be treated as options (whether settled in cash or property) to sell the stock for purposes of section 246(c)(4)(A).

The reduced holding period is not limited to short positions;³⁶ rather, a holding period is reduced for any period in which the taxpayer has a concurrent option to sell the same stock. For example, in Progressive Corp. v. US, the U.S. Court of Appeals for the 6th Circuit reduced a holding period to zero because the taxpayer held an option to sell. The court said that “the statute requires that the holding period in this case be reduced by the period of time during which Progressive held put options on the same stock it

³⁶ “A ‘short position’ is created when an investor borrows a stock in order to sell it, figuring the price of the stock will decline. The investor is in a ‘short position’ until he purchases the stock to repay the lender.” Progressive Corp. v. US, 71A A.F.T.R.2d 93-4088 at n.6 (N.D. Ohio 1990) (quoting BLACK’S LAW DICTIONARY 1236 (5th ed. 1979)), *rev’d on another issue* 970 F.2d 188 (6th Cir. 1992).

owned, and, because it held put options on the same stock it owned at all times during its ownership, the holding period was zero, and Progressive was not entitled to the dividends received deductions it took.” Progressive Corp. v. US, 970 F.2d 188, 191-193 (6th Cir. 1992).

ANALYSIS

Taxpayer receives dividends on the series A and series B preferred shares.³⁷ The dividend rates associated with these shares are fixed for months, then reset. The dividend rates are reset to an agreed upon rate (or method to compute the rate). If the parties cannot agree, then the shares are remarketed. If the shares are successfully remarketed, Taxpayer receives its purchase price for the shares. If the shares are not successfully remarketed, the dividend rate is reset at a high rate, which economically compels to redeem the shares. Upon redemption, Taxpayer receives its purchase price, plus a redemption premium. If Issuer liquidates the shares, Taxpayer receives its purchase price.

Taxpayer’s ability to receive its purchase price for the shares upon a redemption, upon a liquidation, and, after months, upon a remarketing is essentially a put option to sell the shares for their purchase price.³⁸ See Rev. Rul. 88-31, 1988-1 C.B. 302 (holding that a cash payment guarantee of stock value was a put option). Taxpayer’s ability to receive its purchase price under these scenarios equates to an option to sell within the intent of § 246(c)(4)(A) (reducing a holding period for periods during which a taxpayer has an option to sell substantially identical stock or securities), which reduces Taxpayer’s holding period.

Further, Taxpayer is the beneficiary of four guarantees, which further insulate Taxpayer from risk of loss. Under the performance guarantee, guarantees to Issuer that will make any additional required capital contributions to the extent necessary for Issuer to pay any additional dividends or additional payments. also guaranteed to Taxpayer that, upon a liquidating event, it would pay any unpaid debt, additional dividends, or additional payments. Under the purchase warranty deed, Taxpayer may recover from , , or Issuer up to the unpaid portion of the preferred stock liquidation amount (*i.e.*, Taxpayer’s purchase price), any redemption premium, and any enforcement costs upon breach of any representation or warranty in the purchase warranty deed, the performance guarantee, the preferred purchase agreement, and the

³⁷ The advice expresses no opinion about the holding period of the series C shares.

³⁸ A “put” is an option to sell specified property, including corporate stock, at a stipulated price (the strike price) on or before a specific future date. A put is distinguishable from a stock purchase right, such as a call or a warrant. The value of a stock purchase right increases as the value of the stock increases. In contrast, as the value of the underlying property decreases, the value of the put increases. Thus, there is an inverse relationship between the value of a put and the value of the underlying property. Rev. Rul. 88-31, 1988-1 C.B. 302.

contingent asset and sale agreement. Under the group guarantee, and its related companies guaranteed to Taxpayer the punctual payment of all debts and monetary obligations. Under the parent guarantee, guaranteed to Taxpayer the punctual performance of the guaranteed obligations. These documents, each signed on the same day, are all part of a single transaction and, accordingly, are viewed together. Comm'r v. Clark, 489 U.S. 726, 738 (1989) (“interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction.”) The collective guarantees significantly reduce Taxpayer’s risk, as acknowledged in the . Taxpayer does not own % of , yet the interrelated guarantees give Taxpayer the protection of the entire group in its investment in Issuer. This fact is also reflected in the , which analyzes credit risk of , not Issuer. These guarantees assure not only that Taxpayer will receive its dividend payments, but also that Taxpayer will receive a return of its purchase price for the preferred shares. These guarantees offset decreases in the fair market value of the stock because even if the stock value declines, and its affiliates are required to make Taxpayer whole for the redemption price or the liquidation price, which is a proxy for Taxpayer’s purchase price. Therefore, under Treas. Reg. § 1.246-5(c)(4), the guarantees are also substantially similar or related property that also diminish Taxpayer’s risk of loss.

The transaction features were all implemented simultaneously with each other and with Taxpayer’s acquisition of the preferred shares of Issuer. Because these features diminish Taxpayer’s risk of loss, Taxpayer’s holding period for the preferred shares is reduced to zero. As a result, Taxpayer is ineligible for a dividends received deduction for dividends attributable to the series A and series B preferred shares of Issuer.

* * * * *

This advice has been coordinated with Financial Products Associate Industry Counsel and has been reviewed by the Financial Institutions and Products Division.

If you have any questions, please contact the undersigned.

CLINTON M. FRIED
Associate Area Counsel
(Large Business & International)