X, a corporation, creates PRS, a partnership, to allow X to achieve its financing objectives. X contributes $20x to PRS in return for a limited partnership interest. GP, the general partner of PRS, contributes $5x to PRS. X or GP also may contribute additional capital to PRS. PRS then issues debt instruments (notes) to third-party investors for $80x. Of the $105x in capital raised by PRS, $100x is used to purchase newly issued preferred stock of X. X intends to take the position that (a) the dividends it pays to PRS are not income to the extent that they are allocable to X because X, in effect, is paying a dividend to itself, and (b) it is entitled to deduct its distributive share of interest deductions for payments on the notes.

The IRS believes that the overall substance of the arrangement as to X is simply an issuance of preferred stock. Accordingly, the deduction by X of an allocable portion of PRS’s interest expense on the notes without an offsetting inclusion of dividend income by X is inappropriate. To allow X an interest deduction in this situation is the economic equivalent of affording X a deduction for a part of the dividends it pays on its preferred stock. The existence of the partnership does not justify an interest deduction by X. Depending on the facts and circumstances, at least to the extent of all or part of X’s interest in PRS, PRS may not be respected as a partnership for federal income tax purposes. Instead, PRS may be considered to be a mere financing arrangement used to facilitate the issuance of the X preferred stock. Moreover, even if X were treated as having issued its share of the notes, the notes, in substance, would be nonrecourse as to X and secured solely by the X preferred stock. Depending on all the facts and circumstances, the notes would be economically equivalent to debt instruments that are convertible into X preferred stock at the option of X and, as such, could be treated as equity for federal income tax purposes. See, e.g., Notice 94-47.

Finally, even if PRS were respected as a partnership for federal income tax purposes and X were not required to include in income its distributive share of dividends that it pays to PRS, X’s distributive share of the partnership interest deductions could be disallowed as a deduction to X because they relate to income that would not be taxable to X. The Service will challenge transactions of the type described in this notice.

HUNDREDS of additional charts at www.andrewmitchel.com