Tax Reporting for Equity Units

Remarketing of Debt Component

Introduction

The following is generally based upon information provided by the issuers in their prospectus supplement. The discussion is limited to the federal tax treatment of U.S. holders, which includes persons who are either a citizen or resident of the U.S.; corporations or partnerships that are organized in a state within the U.S.; and U.S. trusts and estates. The discussion does not address all aspects of U.S. federal income taxation that may be relevant to U.S. holders in light of their particular circumstances. It is provided for informational purposes only and is not intended to constitute tax advice. Merrill Lynch is not a tax advisor and is not responsible for the accuracy of its content. For more detailed information please review the prospectus supplement and/or other information made available by the particular company. Clients should contact their tax advisor in order to determine their specific tax consequences.

Overview

In tax year 2013, there was an equity unit that consisted of a debt component and a purchase contract component where the debt component of the unit was remarketed (i.e., sold), with the proceeds from the remarketing used to fund the purchase of replacement debt (i.e., a Treasury STRIP) within the unit. Typically, the Treasury STRIP would mature on the date that the unit holder was required to purchase stock under the purchase contract, and those funds would be used to purchase the stock. The following is a brief discussion of the tax reporting associated with these units. Generally, the equity units that are the subject of this writing are comprised of two components:

1) a purchase contract under which the unit holder is obligated to purchase common stock the issuer at a fixed price on a future date; and
2) a debt instrument that is held by the issuer as collateral to secure the unit holder' purchase obligation.

The price at which the unit is originally issued is typically the same as the principal amount of the original debt security, and the fixed price that the unit holder is required to pay for the common stock under the purchase contract.

Usually, the maturity date of the debt component falls *after* the date on which the holder is required to purchase the common stock. Thus, in order to make funds available for the purchase of the stock, the issuer will often remarket (i.e., sell) the debt portion of the unit and use all or a portion of the remarketing proceeds to purchase a Treasury STRIP that will mature on the purchase date. The remarketing event is generally taxable and typically takes place three months prior to the stock purchase date. On the stock purchase date, the proceeds from the maturity of the Treasury STRIP are used to purchase the common stock. The purchase of common stock is generally not a taxable event.

In order to determine the cost basis of the debt component for purposes of calculating gain/loss on the remarketing event, the unit holder must allocate his/her purchase price of the equity unit between the purchase contract and the debt based upon their respective fair market values on the purchase date.

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If a unit holder purchases at original issuance, the prospectus generally provides the allocation. However, no such information is available for secondary market purchases, which makes it difficult to determine the relative fair market values of the components. In the absence of specific fair market value information, for purposes of allocating the purchase price to the components of the equity unit, we have presumed that the amount of the purchase price allocable to the debt component is equal to its adjusted issue price on the date of purchase. Further we have presumed that the amount of the purchase price allocable to the purchase contract is equal to the purchase price of the unit less the amount allocable to the debt component. It is important to note that there are other methods that can be used for allocating purchase price to the components and that the Internal Revenue Service may not respect the presumptions we have applied. Clients should contact their tax advisor to determine the most appropriate method for their circumstances.

To determine a holder's gain or loss on the remarketing of the debt component, a holder must generally compare the remarketing proceeds (reported on Form 1099-B) with the holder's basis in the debt component. Generally, the debt component is a contingent payment debt instrument, which requires the holder to include income with respect to the debt instrument on an accrual basis (i.e., as Original Issue Discount (OID)). The OID will be reported to the holder on Form 1099-OID. Thus, a holder's basis in the debt component is the amount of the unit purchase price originally allocated to the debt component increased by the amount of OID and decreased by the amount of projected payments with respect to the debt.
Gain recognized on the sale of the debt component is generally treated as ordinary income. Loss recognized on the sale will generally be treated as ordinary loss to the extent of prior inclusions of original issue discount on the debt. Any loss in excess of such amount will be treated as a capital loss. The deductibility of capital losses is subject to limitations.
Following the remarketing, the proceeds, or some portion thereof, typically will be used to purchase a Treasury STRIP that will mature on the purchase date of the stock. During the period the Treasury STRIP is held within the unit, the holder will be required to include income with respect to the Treasury STRIP on an accrual basis. This income (i.e., OID) will be reported to the holder on Form 1099-OID).

Upon maturity of the Treasury STRIP, the proceeds from the maturity of the Treasury STRIP will be used to fund the purchase of the common stock. The holder's basis in the common stock is generally the amount paid plus the holder's basis in the purchase contract (if any). A unit holder's basis in the purchase contract is the amount of the purchase price originally allocated to the purchase contract. However, the basis of the purchase contract is generally decreased by the amount of the contract adjustment payments unless they are included in income at the time they are received. For this purpose, we presume that the holder has included any contract adjustment payments in income when received and thus we do not reduce cost basis in the purchase contract with respect to such payments.

In terms of cash flow, cash interest payments are typically made with respect to the debt component of the unit. In many cases, the unit holder will also be paid a contract adjustment fee. For tax reporting purposes, the cash interest payments are not reported as they are accounted for in the OID reporting. The contract adjustment payments are reported on Form 1099-MISC, subject to certain reporting thresholds.
Clients should contact their tax advisor to determine the manner in which they should treat the equity units and associated transactions on their income tax returns.

Example Assumptions

For purposes of the examples, assume that the holder has purchased the Nextera Energy Inc. Equity Unit (65339F507) that was issued on September 21, 2010 for $50 per unit. Assume further that the unit is comprised of:

1) purchase contract under which the unit holder is obligated to purchase FPL Group common stock on September 21, 2013 for $50; and
2) contingent payment debt instrument with a stated principal amount of $50 that matures on September 1, 2015, and which is pledged to the issuer as collateral against the purchase obligation;
3) interest payments on the debt instrument are paid quarterly at 1.9%; and
4) contract adjustment payments are paid quarterly at 5.1%.

Example 1

Purchase of Nextera Energy Inc. Equity Unit (65339F507) at Original Issuance

Assume that the holder purchased the unit for $50 at original issuance. In order to determine his/her initial basis in each component, the holder must allocate the $50 purchase price between the components based upon their respective fair market values on the purchase date. The prospectus provides that for purchases at original issuance, $50 should be allocated to the debt instrument and $0 should be allocated to the purchase contract.

Because the debt instrument is a contingent payment debt instrument the holder will receive a Form 1099-OID each year reporting the annual OID with respect to the instrument. Although the holder will receive quarterly cash interest payments of $0.2375 per unit, those payments will not be reported because they are already accounted for within the OID accrual. The holder will also receive quarterly contract adjustment payments of $0.6375 per unit. These payments will be reported on Form 1099-MISC if they aggregate $600 or more annually.

On August 9, 2013 the debt component is remarketed for a price of $50.1825 per unit. This amount is reported to the holder as gross proceeds on Form 1099-B. The proceeds are distributed as follows:

1) $50.18237 is used to purchase the replacement Treasury STRIP and;
2) $0.1251450 is retained by the issuer as a remarketing fee.

Gain/loss on the remarketed debt is determined by comparing the gross proceeds from the sale to the holder's basis in the debt instrument. The holder's basis in the debt instrument is its allocable cost ($50) plus accrued OID from issue date to remarketing date ($3.95) less the projected payments from issue date through remarketing date ($2.79), which totals $51.16.

Thus, the holder has a loss with respect to the remarketing equal to $0.98 per unit ($50.1825 - $51.16). The loss is an ordinary loss.

Following the remarketing, the holder will include the accrued OID with respect to the Treasury STRIP in income through its maturity on purchase date. The holder will receive a Form 1099-OID with respect to this accrual.

On purchase date, the Treasury STRIP matures and $50 of the proceeds are used to purchase the common stock (excess proceeds are distributed to the holder as part of the income flow). The holder's basis in the stock is $50 plus his/her basis in the purchase contract (if any). The original basis in the purchase contract was determined to be $0. Because we assume that the contract adjustment payments are included in income by the holder when received, no adjustment to the holder's basis in the purchase contract is necessary. Thus, the holder's basis in the common stock is $50.

Example 2

Purchase of Nextera Energy Inc. Equity Unit (65339F507) in the Secondary Market

Assume that the holder purchased the unit for $50.95 on June 1, 2012. In order to determine his/her initial basis in each component, the holder must allocate the $50.65 purchase price between the components based upon their respective fair market values on the purchase date.

Because we are presuming that the amount of the purchase price allocable to the debt component is equal to its adjusted issue price on the date of purchase, we allocate $50.65 as the original basis in the debt component. The remaining $0.30 of purchase price is necessarily allocated to the purchase contract.

Because the debt instrument is a contingent payment debt instrument the holder will receive a Form 1099-OID each year reporting the annual OID with respect to the instrument. Although the holder will receive quarterly cash interest payments of $0.2375 per unit, those payments will not be reported because they are already accounted for within the OID accrual. The holder will also receive quarterly contract adjustment payments of $0.6375 per unit. These payments will be reported on Form 1099-MISC if they aggregate $600 or more annually.

On August 9, 2013 the debt component is remarketed for a price of $50.1825 per unit. This amount is reported to the holder as gross proceeds on Form 1099-B. The proceeds are distributed as follows:

1) $50.182537 is used to purchase the replacement Treasury STRIP and;
2) $0.1251450 is retained by the issuer as a remarketing fee.

Gain/loss on the remarketed debt is determined by comparing the gross proceeds from the sale to the holder's basis in the debt instrument. The holder's basis in the debt instrument is its allocable cost ($50.65) plus accrued OID from the purchase date to remarketing date ($1.69) less the projected payments from purchase date through remarketing date ($1.19), which totals $50.85. Thus, the holder has a loss with respect to the remarketing equal to $0.97 per unit ($51.15 - $50.18). The loss is ordinary income.

Following the remarketing, the holder will include the accrued OID with respect to the Treasury STRIP in income through its maturity on purchase date. The holder will receive a Form 1099-OID with respect to this accrual.

On purchase date, the Treasury STRIP matures and $50 of the proceeds are used to purchase the common stock (excess proceeds are distributed to the holder as part of the income flow). The holder's basis in the stock is $50 plus his/her basis in the purchase contract (if any). The original basis in the purchase contract was determined to be $0.30. Because we assume that the contract adjustment payments are included in income by the holder when received, no adjustment to the holder's basis in the purchase contract is necessary. Thus, the holder's basis in the common stock is $50.30 ($50 + $0.30).

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