

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

December 29, 2003

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CASE-MIS No.: TAM-138289-03, CC:INTL:B05

Advisee's Office

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

Parent1 =
Parent2 =
Sub1 =
Sub2 =
FSub3 =
Country1 =
Date1 =
Date2 =
Date3 =
Date4 =
Date5 =
Date6 =
Date7 =
Date8 =
Date9 =
Date10 =
Date11 =
Date12 =
Amount1 =
Amount2 =
Amount3 =
Amount4 =

Amount5 =
Amount6 =
Amount7 =
Amount 8 =
Amount9 =
Amount10 =
Amount11 =
Amount12 =
Amount13 =
Amount14 =
Amount15 =
Amount16 =
Year1 =
Year2 =
Year3 =
Year4 =
Business =
Type1 =
Firm1 =
Person1 =
Person2 =
Percent1 =
Percent2 =
Percent3 =
Percent4 =
Title1 =
Title2 =

ISSUE(S):

- (1) Whether certain subordinated loan agreements (the "Instruments") are equity for U.S. Federal income tax purposes.
- (2) Assuming the Instruments are equity for U.S. Federal income tax purposes, whether Sub2, the holder of the Instruments, should include in income deemed dividends from the Instruments.

CONCLUSION(S):

(1) The Instruments are properly characterized as equity for U.S. federal income tax purposes.

(2) Sub 2 does not need to include in income any deemed dividends from the Instruments.

FACTS:

Parent1, a domestic corporation, is the parent of a U.S. consolidated group. This group includes Sub1, a wholly-owned domestic subsidiary of Parent1, and Sub2, a wholly-owned domestic subsidiary of Sub1. For purposes of the discussion herein, Parent1, Sub1, and Sub2 are referred to collectively as the "Taxpayer."

During taxable years Year1 through Year3, Sub2 made a number of investments in FSub3, Sub2's wholly-owned Country1 subsidiary. Sub2 and FSub3 are referred to collectively herein as the "Parties." The investments consisted of both (i) a series of interest-bearing notes and (ii) a series of "subordinated loan agreements." At issue in this case is the proper treatment of the subordinated loan agreements (the "Instruments").

The Instruments are non-interest bearing instruments with no fixed maturity date. Under the terms of the Instruments, the rights of the lender (Sub 2) are subordinate to the rights of all creditors of the borrower (FSub3), but are superior to all rights of the shareholders of the borrower. Thus, in the event of liquidation or bankruptcy, repayment of the Instruments would occur after all creditors claims have been satisfied but before any payments or distributions to the shareholders.

Under Country1 law, except in the case of a liquidation or bankruptcy of FSub3, any payments made with respect to the Instruments are determined solely at the discretion of FSub3. In other words, Sub2, as holder of the Instruments, has no legal right under Country1 to force any payment of principal or interest.

Taxpayer has consistently characterized the Instruments as equity for U.S. Federal income tax purposes for all taxable years. For example, no interest income with respect to the Instruments was reflected on Taxpayer's Form 1120 for the taxable years at issue. Furthermore, no interest expense with respect to the Instruments was deducted in determining FSub3's earnings and profits, and the amounts advanced pursuant to the Instruments were not included in the amount of the maximum loan balance outstanding as reflected on Schedule M, on FSub3's Form 5471 for each taxable year at issue. The Form 5471 Schedule F, Balance Sheet, reported the Instruments as Common Stock. In

addition, the Instruments were consistently reported as equity contributions on Form 926 for all relevant years.

The Instruments have been characterized as inter-company indebtedness on FSub3's financial statements. However, the Instruments were eliminated in Sub1's consolidated financial statements. (For book purposes, the Instruments would be eliminated regardless of whether they were characterized as equity or debt.)

The Parties intended to create an equity investment in FSub3 for U.S. tax purposes. The Parties made use of the Instruments to minimize Country1 taxes. On Date8, Sub2 approached Country1 tax authorities to obtain an advance clearance regarding the capital tax treatment of the Instruments. Country1 tax authorities confirmed that the Instruments would be treated as indebtedness for Country1 capital tax purposes. As a consequence, no Country1 capital tax was imposed on the transfer of funds pursuant to the Instruments.

For the tax years at issue, FSub3 made interest payments on the interest-bearing notes, but no "interest" or "principal" payments on the Instruments – consistent with the Parties' intention to treat the amounts advanced under the Instruments as an equity investment. FSub3's projected cash flows at the time the Instruments were executed, as well as its actual cash flows during the term of the Instruments through the end of the years at issue, would have been insufficient to make payments on the Instruments.

Country1 Capital Tax and Income Tax Law, Commercial and Corporate Law, and Accounting Rules

For purposes of Country1 commercial and corporate law, capital tax, income tax law, and statutory accounting rules, the principal of the Instruments is treated as indebtedness. Accordingly, the Parties have treated the Instruments as indebtedness for such purposes.

Country1 civil law does not legally require that principal or interest ever be paid for the Instruments to qualify as indebtedness. However, Country1 law requires interest to be imputed on the Instruments on an annual basis. FSub3 does not pay the imputed interest to Sub2 and the imputed interest is treated as an equity contribution to FSub3 which is subject to Country1 capital tax.

LAW AND ANALYSIS:

In support of treating the Instruments as debt not equity, IRS Examiners make two arguments. First, the Instruments should be treated as debt for U.S. tax purposes because (1) Taxpayer cannot disavow the form of the Instruments and the Instruments are debt in Country1 and (2) the Instruments are in substance debt not equity under

U.S. tax principles. Second, assuming the Instruments are equity for U.S. tax purposes, the interest imputed on the Instruments under foreign law should be treated as deemed dividends paid to Sub2 for U.S. income tax purposes.

Taxpayer responds to these arguments as follows. First, the Instruments are equity, not debt, for U.S. tax purposes because (1) Taxpayer has consistently treated the Instruments as equity for U.S. tax purposes and has never disavowed the form of the Instruments and (2) the Instruments are equity under debt/equity principles. Second, Sub2 did not receive dividends from the Instruments under section 301 and thus there is no basis for deeming that dividends were paid for U.S. tax purposes.

A. The Instrument is Equity for U.S. Tax Purposes

1. The Nondisavowal Rule Does Not Apply

In general, the substance rather than the form of a transaction governs for Federal income tax purposes. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935). However, courts have long recognized that a taxpayer is free to structure his transactions as he chooses, but once having done so, must “accept the consequences of his choice, whether contemplated or not. . . and may not enjoy the benefit of some other route he might have chosen to follow but did not. Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974). For this reason, the courts have generally subjected taxpayers to a heightened standard of proof, among other requirements, before permitting them to disavow the form chosen and have the transaction taxed in accordance with substance. See, e.g. Spector v. Commissioner, 641 F.2d 376, 382 (5th Cir. 1981); Estate of Durkin v. Commissioner, 99 T.C. 561, 572-75 (1992); FNMA v. Commissioner, 90 T.C. 405, 426 (1988).

Based on the facts provided, Taxpayer has not disavowed the form it originally chose. Taxpayer has consistently characterized the Instruments as equity for U.S. income tax purposes for all taxable years. For example, no interest income with respect to the Instruments was reflected on the Taxpayer’s Form 1120 for the taxable years at issue. Furthermore, no interest expense with respect to the Instruments was deducted in determining FSub3’s earnings and profits, and the amounts advanced pursuant to the Instruments were not included in the amount of the maximum loan balance outstanding as reflected on FSub3’s Form 5471 for each taxable year at issue. The Form 5471, balance sheet, reported the Instruments as common stock for each taxable year at issue. In addition, the Instruments were consistently reported as equity contributions on Form 926 for all relevant years. Accordingly, Taxpayer is not subject to the heightened standard of proof here because Taxpayer did not disavow its form.

2. The Instruments Are Equity under Debt/Equity Principles

Examinations also argues that the Instruments should be treated as in substance debt, not equity, based on the eight factors set forth in Notice 94-47, 1994-1 C.B. 357.

Taxpayer argues that the Instruments should be treated as equity based on the factors in Notice 94-47 as well as additional common law factors not addressed in Notice 94-47.

a. Notice 94-47 Factors

Notice 94-47 provides that the characterization of an instrument as debt or equity for U.S. Federal income tax purposes depends on the terms of the instrument and all surrounding facts and circumstances. Among the factors that may be considered in making such a determination are the following:

- (i) 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;
- (ii) whether the holder possesses the right to enforce the payment of principal and interest;
- (iii) whether the rights of the holder of the instrument are subordinate to rights of general creditors;
- (iv) whether the instrument gives the holder the right to participate in the management of the issuer;
- (v) whether the issuer is thinly capitalized;
- (vi) whether there is identity between the holders of the instrument and the equity holders of the issuer;
- (vii) the label placed upon the instrument by the parties; and
- (viii) whether the instrument is intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

The weight given to any factor depends upon all of the facts and circumstances. John Kelley Co. v. Commissioner, 326 U.S. 521 (1946). The application of the foregoing factors is discussed below.

- (i) Whether there is an unconditional promise to pay a sum certain on demand or at a fixed maturity date.

It is a well-established principle that a fixed maturity date or repayment on demand is virtually essential for an instrument to be characterized as debt for U.S. Federal income tax purposes, and thus, the lack of such a date strongly suggests that in substance the instrument is equity. See, e.g., Laidlaw Transportation Inc. v. Commissioner, 75 T.C.M. (CCH) 2598 (1998) (citing Estate of Mixon v. United States, 464 F.2d 394, 404 (5th Cir. 1972)). The Instruments do not provide for a fixed maturity date or for repayment on demand. Accordingly, this factor weighs strongly in favor of treating the Instruments as equity.

- (ii) Whether the interest holders possess the right to enforce the payment of principal and interest.

Courts have historically treated an instrument as equity when under the terms of the instrument the holder lacks the right to enforce payment of principal and interest. See, e.g., United States v. South Georgia Railway, 107 F.2d 3 (5th Cir. 1939). The Instruments do not provide for interest payments. Also, the Instruments only provide Sub2 with a limited right to repayment of principal on condition of the dissolution or bankruptcy of FSub3. Thus, this factor also suggests the Instruments are equity.

- (iii) Whether the rights of holders of the instrument are subordinate to the rights of general creditors.

If the rights of a related-party lender are subordinate to the rights of other corporate creditors, such subordination generally is strong evidence that the related-party advance is an equity contribution rather than a loan, because it indicates that the related party shares more in the risks of the venture. Ragland Investment Co. v. Commissioner, 52 T.C. 867, 877 (1969), aff'd, 435 F.2d 118 (6th Cir. 1970). Under the Instruments, the rights of Sub 2, the lender, are subordinate to the rights of all creditors of FSub3, the borrower, but are superior to all rights of the shareholders (Sub2) of FSub3. Thus, this factor also strongly favors characterizing the Instruments as equity.

- (iv) Whether the instrument gives the holder the right to participate in the management of the issuer.

Sub2, the holder of the Instruments, is the sole shareholder of FSub3, the issuer of the Instruments. Because Sub2 controls FSub3 without regard to the Instruments, this factor is controlling.

- (v) Whether the issuer is thinly capitalized.

Courts generally consider a borrower's debt-to-equity ratio and other financial data in deciding if it is thinly capitalized because thin or inadequate capitalization suggests that an advance is equity. See, e.g., Bauer v. Commissioner, 748 F.2d 1365 (9th Cir. 1984). However, there is no maximum or minimum debt-to-equity ratio that defines whether an instrument is debt or equity, and courts often weigh other factors such as the purported borrower's cash flow and other means by which the borrower could repay the loan more heavily than the debt-to-equity ratio. See Hardman v. United States, 827 F.2d 1409, 1414 (9th Cir. 1987).

In light of the fact that FSub3's cash flow appears to be insufficient to pay principal and interest on the Instruments, the Taxpayer may be inadequately capitalized. However, it is not possible to determine from the facts whether this is the case.

- (vi) Whether there is identity between holders of the instrument and stockholders of the issuer.

The holder of the Instruments (Sub2) and the sole shareholder of FSub3 are the same. Thus, this factor supports treating the Instruments as equity.

- (vii) The label placed upon the instrument by the parties.

The Instruments are entitled "Loan Agreement" for Country 1 purposes. Thus, this factor supports debt treatment for Federal income tax purposes.

- (viii) Whether the instrument is intended to be treated as debt or equity for non-tax purposes.

Taxpayer characterizes the Instruments as equity for U.S. Federal income tax purposes, but as debt for Country1 book and tax purposes. For U.S. book purposes, the Taxpayer consolidates FSub3 and Sub2 so all inter-company debt and equity is eliminated in consolidation. As discussed above, the foreign law characterization of the Instruments has little or no weight because Country1 and the U.S. use different standards for classifying instruments as debt or equity. For these reasons, this factor has little or no impact on the Federal income tax characterization of the Instruments.

Based on the foregoing analysis of the Notice 94-47 factors, the Instruments are properly characterized as equity for U.S. Federal income tax purposes.

Taxpayer notes that Notice 94-47 only addresses a portion of the debt/equity characterization factors that have been developed in the case law. Some additional factors derived from the case law also support characterizing the Instruments as equity. The fact that a corporation cannot borrow similar amounts at rates and terms similar to those of the instrument from third parties, strongly suggests that the instrument is equity. A touchstone of economic reality is whether an outside lender would have made the payments in the same form and on the same terms. Segel v. Commissioner, 89 T.C. 816 (1987).

As noted above, the Instruments by their terms gives the holder no right to interest or any other return on the funds advanced, no right to demand repayment of the funds advanced (except as a liquidation preference that is subordinate to the claims of FSub3's general creditors). It is very doubtful that any third-party creditor would lend funds on such terms. Thus, this factor strongly suggests that the Instruments should be treated as equity.

Based on the debt/equity factors in Notice 94-47 and case law discussed above, we conclude that the Instruments are properly treated as equity, not debt.

B. Country1 Tax Treatment Does Not Create a Deemed Dividend

Examinations further contends that if the Instruments are characterized as equity, Sub2 should be treated as receiving deemed dividends from FSub3 for U.S. Federal income tax purposes because (1) FSub3 is treated for foreign law purposes as imputing interest on the Instruments which is deemed re-contributed as a capital contribution and (2) Country1's tax treatment of the Instruments results in an increase in share capital, which confers a benefit on Sub2 that constitutes a distribution of property for U.S. Federal income tax purposes.

Taxpayer counters that (1) Country1 tax treatment does not control U.S. federal income tax characterization and (2) the economic effects of a fictional capital contribution under foreign law does not create a dividend distribution on the Instruments.

It is well established that U.S. tax provisions are interpreted according to U.S. tax concepts absent a clear congressional expression that foreign tax concepts control. Biddle v. Commissioner, 302 U.S. 573, 578 (1938); Goodyear Tire & Rubber Co. v. Commissioner, 493 U.S. 132, 145 (1989). In general, section 301 provides rules governing the distribution of property by a corporation to a shareholder with respect to stock. A distribution may be actual or constructive. The hallmark of a constructive distribution is value passing from, or sufficiently specific economic benefit conferred by, the corporation to the shareholder, for which the shareholder did not give value in the

exchange. U.S. v. Smith, 418 F.2d 589,593 (5th Cir. 1969). Section 301(c) generally provides rules for determining the amount of any distribution that constitutes a dividend.

For foreign law purposes, interest payments were imputed from FSub3 to Sub2 and the imputed amounts were treated as contributed to FSub3 as capital contributions. However, FSub3 did not make any actual distributions to its shareholder, Sub2. Furthermore, the imputed interest and corresponding capital contribution did not confer value on Sub2 because it is the sole shareholder of FSub3. Because Sub2 did not receive an actual or constructive distribution from FSub3, Sub2 did not receive dividends from Sub 3 for U.S. tax purposes.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.