



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

December 17, 1998

CC:DOM:FS:CORP:

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MEMORANDUM FOR DISTRICT COUNSEL,

Attn:

FROM: Chief, Corporate Branch, Field Service Division
CC:DOM:FS:CORP

SUBJECT:

This memorandum responds to your September 10, 1998, request for Field Service advice in connection with the above referenced taxpayer. Specifically, you asked whether a purported loan transaction created a valid debtor-creditor relationship between an unrelated bank and a foreign subsidiary of the taxpayer, or whether the transaction created an interest that should more appropriately be classified as an equity investment in the foreign subsidiary by the taxpayer. Additionally, you asked us to address whether the Original Issue Discount ("OID") provisions of the Code apply to the subject transaction.

The incoming request for Field Service advice does not contain sufficient facts or analysis for us to provide assistance at this time. Although we have discussed this case with _____, as well as with the revenue agent, we remain uncertain about the theories they propose for resolving this case, as well as unenlightened about certain critical facts surrounding the transaction. In terms of determining the substance of the transaction in question, we would need to know such facts as whether payments were made in accordance with the purported debt instrument, the debt-equity ratio of the debtor corporation at the time of the loan, whether the debtor corporation was thinly capitalized, whether an independent creditor would have made a similar loan (absent the taxpayer's guarantee), how the parties treated the purported debt for tax and financial accounting purposes, as well as other facts that are helpful in determining whether a debt instrument should be respected for tax purposes. Your analysis applying these facts to a body of law should also be provided. See CCDM § (35)8(12)7.

The Service has distilled several factors that are helpful in determining whether a given advance to a corporation constitutes debt or equity.

The first factor considers the exact relationship between the purported lender and debtor. If the purported lender owns stock in the purported debtor, the debt is considered related party debt, and is subject to closer scrutiny than unrelated party debt. See § 385(b)(5); Matter of Uneco, Inc. v. United States, 532 F.2d 1204, 1207 (8th Cir. 1976) (quoting Cayuna Realty Co. v. United States, 382 F.2d 298 (Ct. Cl. 1967)) (advances between a parent corporation and a subsidiary or other affiliate are subject to particular scrutiny 'because the control element suggests the opportunity to contrive a fictional debt'). The debt you are attempting to recharacterize may or may not be related party debt. See Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir.), cert. Denied, 409 U.S. 1076 (1972). This issue must be resolved at the outset.

In assessing whether a debt should be recharacterized, courts have also questioned whether a note exists that evidences an unconditional promise to pay a sum certain at a fixed time or on demand, as well as a promise to pay a fixed rate of interest. We do know the terms of the note, and your analysis should incorporate this information into its conclusion. In order to assess whether the advances were more in the nature of equity rather than debt, it would be helpful to know whether the parties complied with the terms of the agreement, and if not, whether the taxpayer or the banks have been diligent in enforcing those terms.

Courts also look to whether an independent creditor would have extended credit to the purported lender in similar circumstances. See Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir. 1968); Fischer v. United States, 441 F.2d Supp. 32, (E.D. Pa. 1977). Important factors include whether there is a reasonable assurance of repayment, whether the loan is subordinated to the equity interests of the corporation, and whether the loan is secured. It would be helpful to know whether the foreign subsidiary was thinly capitalized, and whether the advances were unsecured.

, we still need sufficient facts developed in order to determine whether we would challenge the taxpayer's attempt to characterize the purported debt as equity in this case. Furthermore, without additional facts, and without your analysis of the law, CC:DOM:FS:FI&P cannot provide assistance on the OID issue. Accordingly, we recommend that you withdraw your request for Field Service advice at this time.

If you have any questions regarding the debt versus equity issue, or if you need any assistance regarding the withdrawal of the Field Service advice request, please contact _____ . If you have any questions regarding the OID issue, please contact _____ .

DEBORAH A. BUTLER
Assistant Chief Counsel

By: _____
STEVEN J. HANKIN
Acting Branch Chief