Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I Concept Unit

Unit Name	Dividend Distribution with a Debt Issuance	
Primary UIL Code	9423	Inbound Financing

Library Level	**Title**
Knowledge Base	International
Shelf	Business Inbound
Book	Inbound Financing
Chapter	Bona Fide Debt Section 385

Document Control Number (DCN)	INT-C-260
Date of Last Update	05/03/23

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General Overview

Dividend Distribution with a Debt Issuance

Foreign-owned U.S. taxpayers typically are formed through investments of foreign multinationals in the United States. Usually, a foreign parent makes advances to its U.S. subsidiary to fund initial capital investment structure, for major acquisitions, capital spending, or other purposes. The advance can be in a form of debt, equity, or a combination of both.

Over time, with the growth of a foreign parent's U.S. investments (e.g., value and profits), the U.S. subsidiary may wish to distribute its earnings to its foreign parent through a distribution of dividend. Furthermore, the U.S. subsidiary may find it necessary at times to recapitalize its capital structure by conversion of equity into debt or vice versa. Whether it is a recapitalization of the U.S. subsidiary's capital structure or simply making a dividend distribution out of earnings, one method to fund the distribution is with the creation of an intercompany debt.

Whether an interest is treated as debt or equity is important to the capital structure of any taxpayer's business. It affects the taxpayer's cost of capital and borrowing. It also may have significant U.S. tax implications. For example, interest expense relating to a bona fide debt is generally an allowable tax deduction for the U.S. borrower. If the transaction is determined to not be a bona fide debt, the purported amount of "interest" paid would generally be treated as a dividend or a return of capital. As a result, the amount would not be allowable as a tax deduction for U.S. tax purposes.

This Concept Unit examines whether intercompany debt should be respected as debt for U.S. federal income tax purposes. This Concept Unit does not analyze the application of IRC sections that may need to be considered after determining whether an instrument should be characterized as debt or equity for U.S. federal income tax purposes. For example, this Concept Unit does not consider the impact of IRCs 163(j), 267(a)(3), 267A, or 482.

General Overview (cont'd)

Dividend Distribution with a Debt Issuance
The determination of whether intercompany debt should be respected as debt for U.S. federal income tax purposes is made by applying debt and equity factors derived from case law and, for certain debt instruments, IRC 385 and the Treasury Regulations thereunder. See the *Bona Fide Debt Determination* Concept Unit for detailed information regarding IRC 385 and the Treasury Regulations thereunder. The examiner should obtain verification early in the audit process regarding the declared dividend or other distribution amount, the amount of purported intercompany debt, and the related debt interest at stake. This can be done through a review of the U.S. taxpayer's tax return, financial statements, and Board Minutes noting a declaration of a dividend or other distribution.

Relevant Key Factors

Dividend Distribution with a Debt Issuance
Key Factors
▪ Declaration of a dividend or other distribution to a foreign parent ((FP) by a foreign-owned U.S. subsidiary (USS) taxpayer. ▪ USS had sufficient earnings and profits (E&P) to support the declared dividend distribution. ▪ Issuance of an intercompany debt by USS as a declared dividend or distribution. ▪ At the inception of the intercompany debt, USS had sufficient projected cash flow and assets to satisfy both the interest and principal repayment obligations. Otherwise, consider whether purported intercompany debt is treated as equity under IRC 385 common law factors. ▪ The FP, as holder of the intercompany debt, did not directly advance any funds as consideration for the intercompany debt.

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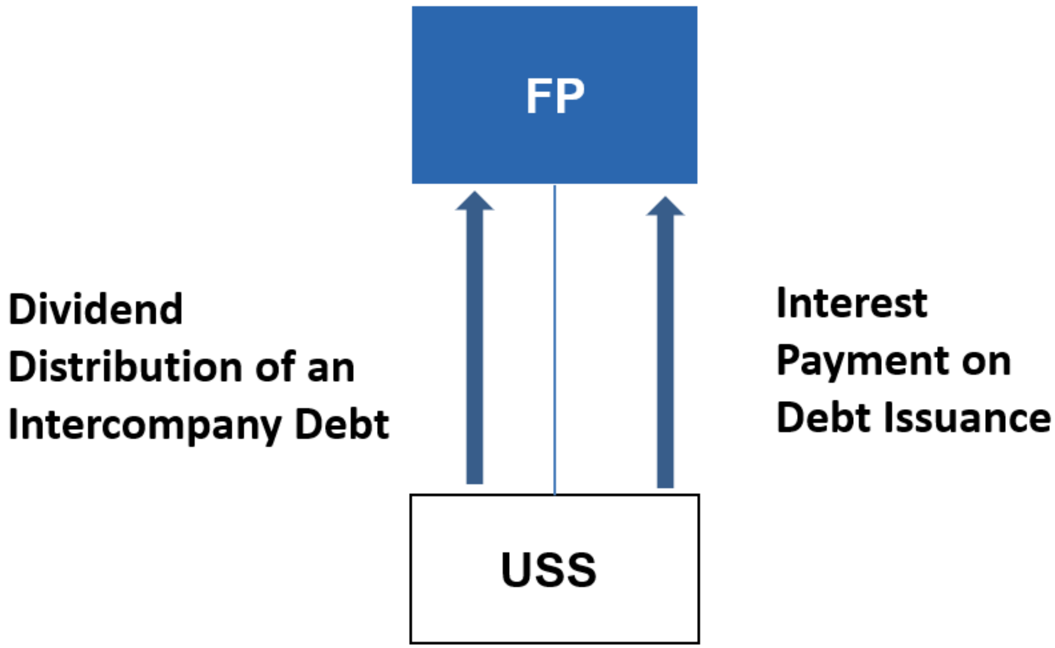
Diagram of Concept

Dividend Distribution with a Debt Issuance
Diagram of Concept



Facts of Concept

Dividend Distribution with a Debt Issuance
Facts of Concept
▪ USS declares a dividend to its FP. ▪ The dividend distribution is paid for with a debt issuance to FP by USS. ▪ USS treats the debt issued to FP as a bona fide debt and deducts the interest payments as interest expense for U.S. tax purposes.

Detailed Explanation of the Concept

Dividend Distribution with a Debt Issuance
Whether intercompany debt should be respected as debt for U.S. federal income tax purposes when a corporation issues its own note as a dividend.

Analysis	Resources
▪ In computing net income there shall be allowed as a deduction interest on indebtedness. ▪ Indebtedness may be created by a distribution or by a recapitalization exchange through issuance of securities out of capital or earnings or both, though the tax treatment may vary with method chosen. Revenue Acts 1934, 1936, 1938, section 23(b), 26 U.S.C.A. (I.R.C.1939) section 23(b). ▪ Courts have held that a dividend creates a debt in favor of the stockholder. ▪ *Kraft* applies debt/equity principles and has been cited for the proposition that a corporation can distribute its own note as a dividend (provided the note otherwise qualifies as debt). ▪ Notwithstanding, "[A]uthorities have [not] relied on the particular legal circumstances present in Kraft Foods (the abolition by Congress of the privilege of an affiliated group of corporations to file a consolidated return) to similarly limit its application." See FSA 200010032.	▪ IRC 163 ▪ *Kraft v. Commissioner* - 232 F.2d 118 (2d. Cir. 1956) rev'g 21 T.C. 513 (1954) ▪ *Bittker and Eustice - Fed. Tax'n of Corps and Shareholders* (7th Ed. 2017) Chapter 8.23 ▪ FSA 200010032

Detailed Explanation of the Concept (cont'd-1)

Dividend Distribution with a Debt Issuance	
Analysis	**Resources**
▪ In *Kraft*, a domestic parent caused its domestic subsidiary to declare a dividend. The form of the distribution was 30 notes, each for $1M at 6% interest per annum, payable in 14 years to the parent. Note that the parent did not directly advance any funds to the subsidiary as consideration for the note. Further, at that time, the consolidated return procedures were abolished. Therefore, the parent and subsidiary filed separate stand-alone returns. ▪ The subsidiary claimed interest deductions on the notes, which the Service disallowed contending that the interest payments were in substance non-deductible dividends. Although not discussed in the case, presumably, the parent included the fair market value of the notes as dividend income but received a 100% dividend received deduction. It is also assumed that the parent reported the interest payments as interest income on its U.S. returns. The Tax Court agreed with the Service and disallowed the interest deductions. ▪ The Second Circuit, reversing the Tax Court, agreed with the Taxpayer. It concluded that the declaration of a dividend generally creates a debtor-creditor relationship between a corporation and its stockholders. Thereafter, the Court employed certain of the debt equity factors to hold that the notes constituted debt rather than equity. ▪ Notwithstanding *Kraft*, the taxpayer must still prove the basic elements of debt such as (i) capacity to service the debt and (ii) whether there was genuine repayment of principal and interest, among other factors. See the *Bona Fide Debt Determination* Practice Unit for a detailed discussion and analysis of the debt versus equity factors. These debt versus equity factors are also known as the Mixon Factors.	▪ *Kraft v. Commissioner* - 232 F.2d 118 (2d. Cir. 1956) rev'g 21 T.C. 513 (1954) ▪ *Estate of Mixon v. United States* - 464 F.2d 394 (5th Cir. 1972), aff'g 324 F. Supp. 977 (M.D. Ala. 1971)

Detailed Explanation of the Concept (cont'd-2)

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<tr><th colspan="2">Dividend Distribution with a Debt Issuance</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td>

Although Kraft dealt with a pure domestic transaction, the National Office has issued Field Service Advice (FSA) applying, in part, a Kraft analysis to cross-border transactions. See, e.g., FSA 199922012 where the National Office concluded that notes issued by a U.S. subsidiary to its sole shareholder, which was a foreign corporation, in exchange for partial redemption of that sole shareholder's stock should be respected as indebtedness for U.S. federal income tax purposes.
Seven months after deciding Kraft, the Second Circuit decided Gregg Co. and explicitly distinguished Kraft by stating the following: "That case [Kraft] is clearly distinguishable from the one at bar for there 'the debentures were simple in form and contained an unconditional promise to pay the principal amount" with interest at a fixed rate (6%) per annum." In short, if the instrument is a hybrid security or is not in the form of a note, the rationale of Kraft does not apply. See, Gregg Co., 239 F.2d at 501. See also McSorley's Inc., v. United States, 323 F.2d 900 (10th Cir. 1963) stating that the note in Kraft was a "conventional unambiguous note."
In Kraft, the domestic subsidiary had ample surplus to supply the consideration for the $30M note dividend. Therefore, it is necessary to determine whether the distributing corporation had adequate surplus, i.e., whether the value of the corporation's assets on the date of the declaration is adequate to cover the face value of the notes distributed. Inadequate surplus may support a position that the notes should not be recognized for federal income tax purposes.
If the amount of the purported note exceeds the US taxpayer's earnings and profits, then the entire amount cannot be a dividend. Instead, the amount that exceeds E&P shall be applied against and reduce the adjusted basis of the stock and to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property per IRCs 301 and 316.

</td><td>

FSA 199922012
Gregg Co. v. Commissioner - 239 F.2d 498 (2d. Cir. 1956)
McSorley's Inc., v. United States - 323 F.2d 900 (10th Cir. 1963)
IRC 301
IRC 316

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Detailed Explanation of the Concept (cont'd-3)

Dividend Distribution with a Debt Issuance	
Analysis	**Resources**
▪ FSA 200010032 dealt with whether the rationale of *Kraft* applies to treat the distribution of notes from a US taxpayer to its foreign parent as a distribution with respect to stock (which would constitute a dividend to the extent of the earnings and profits of the taxpayer). ▪ Taxpayer argued that the distribution of the notes should be treated as a dividend. In support of its position, taxpayer cited the case of *Kraft.* ▪ After applying a debt vs. equity analysis, the Service concluded that *Kraft* is distinguishable, and the distribution would not be given any tax effect. Instead, the note would be treated as a statement by the taxpayer to make payments in the future (according to the terms of the note). ▪ The next slide will compare *Kraft* to FSA 200010032.	▪ FSA 200010032

Detailed Explanation of the Concept (cont'd-4)

<table>
<tr><th colspan="2">Dividend Distribution with a Debt Issuance</th></tr>
<tr><th>Analysis</th><th>Analysis</th></tr>
<tr><td>FSA 200010032

▪ The notes distributed exceeded the total amount of taxpayer's current and accumulated E&P. Thus, taxpayer treated a portion of the distribution, to the extent of the current and accumulated E&P, as a dividend and the remaining amount of the distribution as a return of capital.
▪ As a result of the disposition of assets of the taxpayer's group to unrelated parties, (with the proceeds distributed to foreign subsidiary, as well as the distribution of other assets to the foreign subsidiary parent), the value of the taxpayer's group declined. In addition, the debts for which the taxpayer's group was liable, including the notes, contributed to a decrease in the retained earnings of the taxpayer's consolidated group. Hence, a drastic reduction of assets was available to satisfy the debt.
▪ The parties twice postponed payment of the notes. However, taxpayer cannot argue that unforeseen factors caused these postponements.
▪ The five-year plans of taxpayer stated that it did not intend to pay the notes during the period covered by such plans.
▪ Thus, there was no serious expectation of payment of the note. See also Laidlaw Transportation, Inc., T.C. Memo 1998-232.</td><td>Kraft

▪ Simultaneous with the dividend declaration, the taxpayer revalued its assets. As revalued, the taxpayer had more than enough assets to support the distribution. The notes were issued to preserve taxpayer's cash because it could not have distributed such amount in cash without liquidating a substantial portion of the business. The notes were issued when Congress abolished the privilege of an affiliated group of corporations to file consolidated returns. The transaction could not be disregarded merely because of the presence of a parent-subsidiary relationship.
▪ The taxpayer made regular payments of interest (no payments of principal were made during the stated life of the debentures or at their maturity). Taxpayer had ample surplus to support the debentures when issued. In addition, the taxpayer made other distributions to the parent. Taxpayer was highly profitable and nearly all of its earnings found their way to the parent corporation as interest on the debentures or as dividends.
▪ The expectation of payment was reasonable considering the amount of earnings the taxpayer generated.</td></tr>
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Detailed Explanation of the Concept (cont'd-5)

Dividend Distribution with a Debt Issuance	
Analysis	**Resources**
▪ While the common law factors still apply for purposes of determining whether an interest should be treated as stock or indebtedness, the IRC and Treasury Regulations thereunder, including the Treasury Regulations under IRC 385, may modify the common law determination. IRC 385 authorizes the Secretary to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is treated as stock or indebtedness for U.S. federal income tax purposes.	▪ IRC 385 ▪ Treas. Reg. 1.385-1(b)
▪ See the *Bona Fide Debt* Concept Unit for detailed information regarding IRC 385 and how the Treasury Regulations under IRC 385 recharacterize certain interests as stock.	
▪ Subject to exceptions, the "general rule" under Treas. Reg. 1.385-3(b)(2) generally treats a "covered debt instrument" as stock if it is issued by a "covered member" to a member of the covered member's "expanded group" as part of a transaction (or series of transactions) that does not result in new investment in the operations of the issuer.	▪ Treas. Reg. 1.385-3(b)(2)
▪ Subject to exceptions, the "funding rule" under Treas. Reg. 1.385-3(b)(3) generally treats a covered debt instrument as stock if it is both issued by a covered member to a member of the covered member's expanded group in exchange for property and is treated as funding: − A distribution (other than an "exempt distribution") of property by the "funded member" to a member of the funded member's expanded group; − An acquisition of expanded group stock (other than an "exempt exchange"); or − An acquisition of property by the funded member in an asset reorganization to the extent that a shareholder of the transferor corporation receives "boot."	▪ Treas. Reg. 1.385-3(b)(2)
▪ A covered debt instrument is treated as funding the distribution or acquisitions described above if it is issued 36 months before or 36 months after the date of the distribution or acquisition or if it is issued with a principal purpose of funding the distribution or acquisition.	

Detailed Explanation of the Concept (cont'd-6)

Dividend Distribution with a Debt Issuance	
Analysis	**Resources**
▪ Consistent with the approach for determining whether an interest is debt or equity, the IRS applied common law factors to conclude that the notes in FSA 199922012 (where a U.S. subsidiary issued notes to its sole shareholder, which was a foreign corporation, in exchange for partial redemption of that sole shareholder's stock) should be respected as indebtedness for U.S. federal income tax purposes. ▪ Even after applying common law factors, however, any debt/equity analysis generally involving debt instruments issued after April 4, 2016, must account for Treas. Reg. 1.385-3(b). ▪ Any analysis would need to account for the exceptions under Treas. Reg. 1.385-3(c). ▪ See the *Bona Fide Debt* Practice Unit for detailed information regarding how the Treasury Regulations under IRC 385 recharacterize certain interests as stock.	▪ FSA 199922012 ▪ Treas. Reg. 1.385-3(b) ▪ Treas. Reg. 1.385-3(c)

Index of Referenced Resources

Dividend Distribution with a Debt Issuance
IRC 163
IRC 301
IRC 316
IRC 385
Treas. Reg. 1.385
FSA 199922012
FSA 200010032
Estate of Mixon v. United States - 464 F.2d 394 (5th Cir. 1972), aff'g 324 F. Supp. 977 (M.D. Ala. 1971)
Gregg Co. v. Commissioner - 239 F.2d 498 (2d. Cir. 1956)
Kraft v. Commissioner - 232 F.2d 118 (2d. Cir. 1956) rev'g 21 T.C. 513 (1954)
Laidlaw Transportation, Inc. - T.C. Memo 1998-232
McSorley's Inc., v. United States - 323 F.2d 900 (10th Cir. 1963)
Bittker and Eustice - Fed. Tax'n of Corps and Shareholders (7th Ed. 2017) Chapter 8.23

Training and Additional Resources

Dividend Distribution with a Debt Issuance	
Type of Resource	**Description(s)**
Saba Meeting Sessions	▪ (CBA) Inbound Financing Applicable Tax Doctrines PPT - 2021-04 ▪ (CBA) Treas. Reg. 1.385-3T PPT - 2019 -11
Issue Toolkits	▪ Audit Tool – Post-TCJA Inbound Financing Risking Tool ▪ Audit Tool – Cash Flow Model Spreadsheet ▪ Audit Tool – Writing Best Practices Checklist
White Papers / Guidance	▪ FSA 199922012 ▪ FSA 200010032

Glossary of Terms and Acronyms

Term/Acronym	Definition
E&P	Earnings and Profits
FP	Foreign Parent
FSA	Field Service Advice
USS	United States Subsidiary

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
9423	*Ability to Service and Repay the Debt*
9423	*Arm's Length Standard under IRC Section 482 for Rate of Interest Charged on Intercompany Debt*
9423	*Bona Fide Debt Determination*
9423	*Deductibility of Foreign Related Party Financing Guarantee Fees*
9423	*Guarantee Fee Pricing Methods*
9423	*Hybrid Instrument with a Repurchase Agreement*
9423	*Interest Expense Limitation Computation Under IRC 163(j) – Pre TCJA*
9423	*Interest Expense Limitation Computation Under IRC 163(j) – Post Tax Cut Jobs Act of 2017*
9423	*Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)*
9423	*IRC 245A(e) – Anti-hybrid Rules*
9423	*IRC 482 Arm's Length Interest Rate for Intercompany Debt*
9423	*TCJA Anti-Hybrid Rules of IRC 267A*
9423	*The General and Funding Rules of Treasury Regulations Section 1.385-3*

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