

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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to: Director, Field Specialists
(Large & Mid-Size Business)

from: Associate Chief Counsel
(Financial Institutions & Products)

subject: Cross-Border Financial Instruments
Hybrid Debt/Equity - Equity in the U.S.

This memorandum addresses the U.S. tax treatment of certain financial instruments issued among a U.S corporation and foreign entities controlled by the corporation.

ISSUE

Whether the promissory note and the forward purchase agreement described below should be considered together with the result that they are not treated as debt for U.S. tax purposes.

CONCLUSION

The promissory note and the forward purchase agreement should be considered together with the result that they are not treated as debt for U.S. tax purposes.

FACTS

P, a U.S. corporation, wholly owns both DE, a foreign entity, and CFC, a foreign corporation. DE and CFC are both organized in Country X. DE is disregarded as an entity separate from its owner for U.S. tax purposes under § 301.7701-3 of the Income Tax Regulations.

DE borrows \$x from Z, an unrelated third party, and loans the \$x to CFC in exchange for a promissory note. The promissory note provides for periodic payments of stated interest in CFC stock and for a single payment of \$x on its maturity date. The promissory note has the form of a debt instrument, including the use of labels such as “principal” and “interest.”

On or about the same date that CFC issues the promissory note to DE, P enters into a forward purchase agreement with CFC, under which P agrees to buy an amount of CFC stock for \$x on the agreement’s settlement date. The maturity date of the promissory note from CFC to DE and the settlement date of the forward purchase agreement are the same. The forward purchase agreement refers to the promissory note, and the payment terms of the forward purchase agreement are tailored to the payment terms of the promissory note. For example, if CFC elects to prepay the stated principal amount of the promissory note of \$x on a date before the maturity date, the forward purchase agreement must be settled on the same date.

For Country X tax purposes, P and DE are treated as separate entities. Therefore, DE is treated as borrowing from Z and transferring the proceeds to CFC in exchange for the promissory note, and P is treated as entering into the forward purchase agreement with CFC. Therefore, for Country X tax purposes, the parties to the promissory note and forward purchase agreement are not the same, and the promissory note and the forward purchase agreement are separate instruments.

On its Country X tax return, CFC reports interest expense for the interest paid to DE on the promissory note. On its Country X tax return, DE reports interest income received on the promissory note and reports interest expense on the loan from Z.

For U.S. tax purposes, P asserts that (1) P and CFC are the parties to both the promissory note and the forward purchase agreement because DE is a disregarded entity; (2) the promissory note and the forward purchase agreement should be treated as a single instrument; and (3) the single instrument should be treated as equity rather than debt. P reported the transaction on its U.S. federal income tax return according to this assertion, and its position under examination is unchanged from its original tax return position.

LAW AND ANALYSIS

Section 301.7701-2(a) provides that, if a business entity with only one owner is disregarded as an entity separate from its owner, “its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.” DE is disregarded as an entity separate from its owner under § 301.7701-3. Thus, for U.S. tax purposes, P and DE are treated as a single entity, and any contract between DE and CFC is treated as a contract between P and CFC.

The facts show that P has structured the promissory note and the forward purchase agreement so that: (1) for Country X tax purposes, the promissory note would be treated as debt and the periodic payments on the promissory note would be deductible, but (2) for U.S. tax purposes, the promissory note would not be treated as debt and the periodic payments on the promissory note would be excluded from income.

The intention of the parties to create a debtor-creditor relationship is a significant factor in the determination whether an instrument is debt, especially when the parties are related. Debt requires an intention to create an unconditional obligation to repay. “The determination of whether advances to a corporation are loans or capital contributions depends on whether the objective facts establish an intention to create an unconditional obligation to repay the advances.” Roth Steel Tube Co. v. Commissioner, 800 F.2d 625, 630 (6th Cir. 1986) (citing Raymond v. United States, 511 F.2d 185, 190 (6th Cir. 1975)), cert. denied, 481 U.S. 1014 (1987). Debt also requires an intention to create a debt with a reasonable expectation of repayment. “[W]e think the determinative question . . . is as follows: Was there a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship?” Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 377 (1973), acq., 1974-2 C.B. 3.

The presence of offsetting obligations in two transactions between the same parties can show that the substance of the transactions is different from their form. Rev. Rul. 2002-69, 2002-2 C.B. 760, explains that, “Where parties have in form entered into two separate transactions that resulted in offsetting obligations, the courts often have collapsed the offsetting obligations and recharacterized the two transactions as a single transaction.” The ruling cites, among other cases, Blue Flame Gas Co. v. Commissioner, 54 T.C. 584 (1970).

In Blue Flame, the taxpayer leased property to a lessee and simultaneously borrowed money from the lessee. The lease and the loan were structured so that the rental payments matched the payments on the loan in amount and due date. The court considered the lease and the loan together because of the offsetting payments. The court stated:

The arithmetic of the transaction is particularly damaging to the petitioner’s position since . . . the loan was in the exact amount of the aggregate rent due under the terms of the leases. . . . In addition, repayment dates of the loan and the rental payments were intentionally designed to coincide. In this factual setting, the only reasonable inference that can be drawn is that the loan and lease transactions were entirely interdependent.

Blue Flame at 596. When the court considered the lease and the loan together, the court concluded that the loan was really prepaid rent because it would never have to be repaid. The court stated:

[P]etitioner's receipt of the purported loan from [the lessee] amounted to the receipt of funds for his immediate and unrestricted enjoyment, which by the nature of the transaction, would never have to be repaid. The fact that no repayment would ultimately be necessary, due to the contemporaneous lease obligations incurred by [the lessee], strongly supports characterization of the cash receipt as advance rentals.

Blue Flame at 595-96.

In other situations involving two contracts between the same parties, the Service has successfully argued that the second contract caused the first contract to be treated differently from its form. For example, in Helvering v. Le Gierse, 312 U.S. 531 (1941), an individual entered into two contracts with an insurance company, one described as a single-premium life insurance contract, the other as a standard annuity contract. The total consideration was prepaid and exceeded the face value of the insurance contract. The individual was not required to pass a physical examination or to answer the questions normally required of a life insurance applicant. It was conceded that the insurance contract would not have been issued without the annuity contract. The Court determined that, "The two contracts must be considered together." Le Gierse at 540. The Court found that, "Considered together, the contracts wholly fail to spell out any element of insurance risk." Le Gierse at 541. As a result, the insurance contract was treated as something other than life insurance.

In several cases, holders of preferred stock in a corporation have successfully argued that a contract between the corporation and the preferred shareholders caused their preferred stock to be treated as debt rather than equity. For example, see Bowersock Mills & Power Co. v. Commissioner, 172 F.2d 904 (10th Cir. 1949), holding that a contract between the preferred shareholders and the common shareholders of a corporation caused the preferred stock to qualify as debt rather than equity. In the contract, the common shareholders guaranteed the payment of dividends on the preferred stock at a fixed interest rate and promised to purchase or cause the corporation to redeem all of the preferred stock in specified amounts on specified dates. Because the court considered that "the corporation was the common stockholders," the court concluded: "We think the contract with the common stockholders bound the corporation quite as effectively as if it had been a formal party to it. Viewed in this light, the two contracts should be construed together as one integrated writing in determining the taxable character of the obligation they impose." Bowersock at 907.

Section 301.7701-2(a) directs us to treat P and CFC as the parties to both the promissory note and the forward purchase agreement for U.S. tax purposes. The payments of money under the instruments are tailored to match exactly in amount and timing. It appears that P and CFC would not have entered into the forward purchase agreement without the promissory note. The forward purchase agreement refers to the promissory note. Under the forward purchase agreement, P is obligated to make a

payment of money to CFC that matches exactly the payment of money that CFC is obligated to make to P under the promissory note. Under the forward purchase agreement, P is entitled to receive CFC stock from CFC. However, P already wholly owns CFC. We conclude under Blue Flame, Le Gierse, and similar cases that the promissory note and the forward purchase agreement should be considered together.

You have asked whether various authorities holding that two instruments should not be treated as a single instrument might apply in this case. For example, Rev. Rul. 2003-97, 2003-2 C.B. 380, holds that the separability of two components of a unit that is listed on a national securities exchange is one of four critical factors in determining that the components should not be treated as a single instrument for federal tax purposes. We consider separability not to be a critical factor in this case because P controls all of the parties to the promissory note and the forward purchase agreement.

The next issue is whether the promissory note and the forward purchase agreement, considered together, are debt for U.S. tax purposes. The resolution of that issue depends on the facts and circumstances of each case. No particular fact is conclusive in making such a determination. John Kelley Co. v. Commissioner, 326 U.S. 521 (1946). Among the factors considered by the courts are (1) whether there is an unconditional promise to pay a sum certain in money on a specific date, (2) the intent of the parties, and (3) the holder's right to enforce the payment of principal and interest. Estate of Mixon v. United States, 464 F. 2d 394 (5th Cir. 1972); Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957); Litton Business Systems, Inc. v. Commissioner, supra. For U.S. tax purposes, based on the facts and circumstances of the transactions described in this memorandum, when the promissory note and the forward purchase agreement are considered together, the promissory note is not treated as debt because the offsetting obligations under the instruments mean that the loan does not have to be repaid. See Blue Flame and similar cases. Moreover, the aggregate obligations under the instruments are not treated as debt in part because the payments that remain after the offsetting obligations are disregarded consist of CFC stock and not money. See, for example, Rev. Rul. 85-119, 1985-2 C.B. 60; Notice 94-47, 1994-1 C.B. 357.

We conclude that, for U.S. tax purposes, the promissory note and the forward purchase agreement should be considered together with the result that they are not treated as debt. Accordingly, for U.S. tax purposes, P is not required to report the periodic payments with respect to the promissory note as interest income.

We have also considered the possible application of the step-transaction doctrine to recast the loan from Z to DE and the loan from DE to CFC into a loan directly from Z to CFC. We do not support such an argument.

Under one version of the step-transaction doctrine, a series of steps may be viewed as a single transaction when the steps are so interdependent that the legal relations created by one step would have been fruitless without a completion of the series. American Bantam Car Co. v. Commissioner, 11 T.C. 397, 406-07 (1948), aff'd

per curiam, 177 F.2d 513 (3d Cir. 1949), cert. denied, 339 U.S. 920 (1950). According to our understanding of the facts, Z has no creditor's rights against CFC. Numerous courts have held that the most significant indicia of debt are a fixed maturity date and a right to force payment in the event of default. See Monon R.R. v. Commissioner, 55 T.C. 345 (1970), acq., 1973-2 C.B. 3; and cases cited therein. Thus, the recast under the step-transaction doctrine would not produce a loan directly from Z to CFC.

We understand that you may be considering other transactions involving certain financial instruments issued among a U.S corporation and its related foreign entities for which the corporation has treated the instruments as a single instrument that is debt for U.S. tax purposes but as separate instruments, one of which is equity, for foreign tax purposes. Please note that the conclusions in this memorandum are based solely on the factual pattern outlined above. Because the proper analysis of substance versus form and debt versus equity is so highly dependent upon the particular facts of a case, a material deviation from the facts described in this memorandum could affect the conclusion. In addition, in other cases you may wish to consider the application of general judicial doctrines, such as economic substance, to challenge the U.S. tax treatment of a transaction. Although this memorandum does not address the transactions in those cases, we are available to assist you in the development of the appropriate legal arguments, and we encourage you to contact us early in the processing of those cases.

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