OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE
NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: Manhattan District Counsel
CC:NER:MAN
Attn: Tyrone J. Montague

FROM: Steven A. Musher, Chief
CC:INTL:Branch 6

SUBJECT:

This Field Service Advice responds to your memorandum dated December 2, 1997. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Country A =
X =
Y =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
D =
E =
F =

G	=
H	=
J	=
K	=
q	=
r	=
s	=
t	=
u	=
v	=
w	=

ISSUE:

Whether, pursuant to Treas. Reg. § 1.482-2(a), the Commissioner may allocate interest income to X with respect to X's advances to Y in order to reflect an arm's length transaction, when X asserts upon examination that its treatment of the advances as debt was a mistake and that the advances were equity?

CONCLUSION:

The Commissioner, pursuant to Treas. Reg. § 1.482-2(a), proposes to allocate interest income to X with respect to X's advances to Y in order to reflect an arm's length transaction. X's assertion upon examination that its treatment of the advances as debt on its tax returns and financial statements was a mistake, and that the advances were equity, subjects X to a heightened standard of proof under the rule of law enunciated in Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974) and its progeny. In order for X to sustain its position, X must come forth with sufficient evidence to satisfy the heightened standard of proof by demonstrating that X and Y consistently respected and reported the advances as equity and that the other facts and circumstances justify treating the advances as equity. Based on the facts presented by X to date, we are unable to reach a conclusion about whether X has met its heightened standard of proof to establish that the advances should be treated as equity and not debt.

FACTS:

X is a domestic company incorporated on Date 1, and has a wholly-owned foreign subsidiary Y in Country A. One of Y's business activities is to act as a conduit for transferring funds received from X and distributing those funds to sister companies that are either directly, or indirectly, owned by X in Country A.

On Date 2, X made a public stock offering of w dollars, and a public bond offering of Senior Deferred Coupon Notes (the "Notes"), maturing on Date 3, with a principal amount of s dollars at 10.875%. In Years 1 and 2, X realized t and u dollars, respectively, as interest expense related to the original issue discount. A deduction for this interest expense will not be recognized until the calendar Year 4. The Notes were also subordinated to all existing and future debts of X.

For the calendar year at issue (Year 2), X made numerous interest-free advances to Y totaling approximately v dollars. These advances were later transferred by Y to its five sister corporations (E, F, G, H and J) that were organized under the laws of Country A. Sister corporations F and G are the only entities that are recognized as corporations for Country A purposes, and as partnerships for U.S. purposes. Y had no direct ownership interests in any of these sister corporations.

For U.S. tax purposes, X reported these advances as intercompany receivables from Y in its Form 1120. Consistent with this reporting, X also reported in Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations) that Y had intercompany payables to X for those advances. As for X's financial statements, it also characterized the advances as loans to Y.

Y's tax and financial statement reporting also recognized the advances as intercompany payables to X with corresponding receivables from Y's sister companies. Thus, Y took a position consistent with X's U.S. tax reporting under Form 5471. For Year 2, the Intercompany Report of Advance Transactions reflected numerous cash advances from Y to sister corporations E, G and H, and cash payments from those sister corporations back to Y. X claims that the cash transfers to Y from E, G and H constituted a return of capital.

The financial statements of E, F, G, H and J also reflected intercompany payables to Y with respect to the advances they received. For instance, during year 2, Y advanced r dollars to sister entity G (a partnership for U.S. tax purposes), which at that time was owned by the following partners: (1) X owned 38.93%, (2) D, a wholly-owned domestic subsidiary of X, owned 51%, and (3) an unrelated entity owned 10.07%. X argues that the advance of r dollars represented capital contribution in G, and that Y acted as X's agent for purposes of disbursing X's funds to G and the other sister corporations. Neither G's Form 1065 (U.S. Partnership Return of Income), nor Schedules K-1 (Item J-Analysis of Partners' Capital Accounts) reflected the subject advances as capital contributions by X, or any other partners. Instead, the partnership return disclosed an ending liability balance of q dollars on December 31, Year 2. That ending liability balance included the r dollars that were advanced by Y during Year 2.

On Date 4, X sold its partnership interest in G to another wholly-owned domestic subsidiary, K. Neither the Form 1065, nor its attachments, disclosed X's basis in G at time of sale, or the amount realized therefrom. The Intercompany Report of Advance Transactions between Y and G showed that after X sold its interest in G, Y continued to advance funds to G on behalf of X.

During the examination, when the Service proposed to allocate interest income to X pursuant to section 482, X represented that it made a mistake in classifying the advances to Y as debt when filing its U.S. income tax return. X stated that the advances do not constitute debt because there is (1) no stated rate of interest, (2) no maturity date, (3) no written agreement containing standard debt provisions (e.g., acceleration or default clause, or sinking fund requirement), and (4) that no independent lender would have made comparable loans to Y under these terms and circumstances. X further explained that Y was required to classify the advances as debt for Country A's book purposes because Country A's generally accepted accounting principles only permitted advances to be classified as capital if Y complied with Country A's legal formalities relating to the issuance of capital shares. X maintained that since Y did not legally formalize any issuance of capital shares, the subject advances could not be treated as capital and thus, had to be reflected as debt in the financial statements. As for Country A's tax purposes, Y treated the advances as non-interest bearing debt.

LAW AND ANALYSIS:

The Commissioner's proposed interest adjustment under section 482 is predicated on treating the advances made by X to Y as debt. Section 482 allows the Commissioner to "distribute income or deductions between or among commonly controlled taxpayers as may be necessary in order to prevent" distortion of income and expenses, and to clearly reflect the true tax liability of the taxpayers. *See* B. Forman Company v. Commissioner, 453 F.2d 1144, 1150 (2nd Cir. 1972), *cert. denied*, 407 U.S. 934 (1972). An allocation to reflect an arm's length rate of interest may be made under section 482 with respect to bona fide indebtedness between controlled taxpayers.

Treas. Reg. § 1.482-2(a)(1), *Interest on bona fide indebtedness*, provides in pertinent part:

> (i) *In general.* Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group and either charges no interest, or charges interest at a rate which is not equal to an arm's length rate of interest (as defined in paragraph (a)(2) of this section) with respect to such loan or

advance, the district director may make appropriate allocations to reflect an arm's length rate of interest for the use of such loan or advance.

(ii) *Application of paragraph (a) of this section*–(A) *Interest on bona fide indebtedness.* Paragraph (a) of this section applies only to determine the appropriateness of the rate of interest charged on the principal amount of a bona fide indebtedness between members of a group of controlled entities, including–

> (*1*) Loans or advances of money or other consideration (whether or not evidenced by a written instrument); and
>
> (*2*) Indebtedness arising in the ordinary course of business from sales, leases, or in rendition of services by or between members of the group, or any other similar extension of credit.

(B) *Alleged indebtedness.* This paragraph (a) does not apply to so much of an alleged indebtedness which is not in fact a bona fide indebtedness.... For example, paragraph (a) of this section does not apply to payments with respect to all or a portion of such alleged indebtedness where in fact all or a portion of an alleged indebtedness is a contribution to capital of a corporation or a distribution by a corporation with respect to its shares.... Payments made with respect to alleged indebtedness (including alleged stated interest thereon) shall be treated according to their substance. See § 1.482-2(a)(3)(i).

Treas. Reg. § 1.482-2(a)(3), *Coordination with interest adjustments required under certain other Code sections*, provides the order in which different provisions of the Code shall be applied in determining the interest adjustment under section 482. Subdivision (i) of this regulation states:

> First, the substance of the transaction shall be determined; for this purpose, all the relevant facts and circumstances shall be considered and any law or rule of law (assignment of income, step transaction, etc.) may apply ....

Treas. Reg. § 1.482-2(a)(4), *Examples*, provides that the principles of Treas. Reg. § 1.482-2(a)(3) may be illustrated by, *inter alia*:

> *Example 1.* An individual, A, transfers $20,000 to a corporation controlled by A in exchange for the corporation's note which bears adequate stated interest. The district director recharacterizes the transaction as a contribution to the capital of the corporation in exchange for preferred stock.

Under paragraph (a)(3)(i) of this section, section 1.482-2(a) does not apply to the transaction because there is no bona fide indebtedness.

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). Thus, the Commissioner has been allowed to discount the form of a transaction, and determine the tax consequences based on its substance. *See* Gregory v. Helvering; Spector v. Commissioner, 641 F.2d 376, 381 (5th Cir. 1981), *cert. denied*, 454 U.S. 868 (1981); Laidlaw Transportation, Inc. v. Commissioner, T.C. Memo. 1998-232. This substance over form approach provided to the Commissioner constitutes a rule of law within the meaning of Treas. Reg. § 1.482-2(a)(3)(i), as exemplified by the district director's recharacterization of a note as a contribution to capital set forth in *Example 1*, *supra.*

The Supreme Court has also long recognized the rule of law that a taxpayer, although free to structure his transaction as he chooses, "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) (citations omitted). Taxpayers have less freedom than the Commissioner to ignore the transactional form that they have adopted, and are ordinarily bound by the tax consequences that flow therefrom. Illinois Power Co. v. Commissioner, 87 T.C. 1417, 1430 (1986). *See also,* Nestle Holdings, Inc. v. Commissioner, 152 F. 3d 83, 87 (2d Cir. 1998); Spector v. Commissioner, 641 F.2d at 381; Taiyo Hawaii Company, Ltd. v. Commissioner, 108 T.C. 590, 601-603 (1997); Estate of Durkin v. Commissioner, 99 T.C. 561, 572-75 (1992); Little v. Commissioner, T.C. Memo. 1993-281, 65 T.C.M. (CCH) 3025, 3032 (1993), *aff'd*, 106 F.3d 1445 (9th Cir. 1997). This rule of law, which limits a taxpayer's ability to disavow the form of its chosen transaction, seeks to avoid the uncertainty that would result from allowing the taxability of a transaction to depend on whether an alternative form exists under which more favorable tax consequences would result. National Alfalfa, 417 U.S. at 149; Television Indus., Inc. v. Commissioner, 284 F.2d 322, 325 (2nd Cir. 1960).

The case law recognizes that taxpayers are advantaged by having both the power to structure transactions in any form they choose and the access to the facts that reflect the underlying substance. In contrast, the Commissioner is disadvantaged because he does not have direct access to the facts underlying a particular transaction. Consequently, the Commissioner must be allowed to rely on representations made by taxpayers in their returns, and must be allowed to evaluate the resulting tax consequences based on such disclosures. This reliance is particularly appropriate in the context of a cross border transaction, such as the

present case, where documents, information and witnesses are not readily available to the Commissioner.

"The Commissioner is justified in determining the tax effect of transactions on the basis in which the taxpayers have molded them ...." Television Industries, Inc. v. Commissioner, 284 F.2d at 325. *See also,* FNMA v. Commissioner, 90 T.C. 405, 426 (1988), *aff'd*, 896 F.2d 580 (D.C. Cir. 1990), *cert denied*, 499 U.S. 974 (1991). To freely allow taxpayers to argue for alternative tax treatment of a transaction upon the examination of the returns would be tantamount to administering the tax laws based on a policy that tax consequences flow from the "transaction taxpayers have chosen or from any other form [of transaction] they might have chosen, whichever is ... [more favorable]." City of New York v. Commissioner, 103 T.C. 481, 493 (1994) (quoting Television Industries, Inc. v. Commissioner, 284 F.2d at 325), *aff'd,* 70 F.3d 142 (D.C. Cir. 1995). For this reason, the courts have generally subjected taxpayers to a heightened standard of proof before they are permitted to contradict the form and have the transaction taxed in accordance with substance. Spector v. Commissioner, 641 F.2d at 382; Estate of Durkin v. Commissioner, 99 T.C. at 572-75; FNMA v. Commissioner, 90 T.C. at 426; Illinois Power v. Commissioner, 87 T.C. at 1431; Little v. Commissioner, 65 T.C.M. at 3032.

The courts have articulated this heightened standard of proof differently. *See* Spector v. Commissioner, 641 F.2d at 382. For example, in Commissioner v. Danielson, 378 F.2d 771 (3rd Cir. 1967), *cert. denied*, 389 U.S. 858 (1967), the court held that where taxpayers executed a contract containing specific terms, conditions and allocations, they may not alter or avoid the tax consequences of that agreement in the absence of fraud, duress, or undue influence.[1] In contrast, the court in Sonnleitner v. Commissioner, 598 F.2d 464 (5th Cir. 1979), determined that before a taxpayer may alter or avoid the tax consequences of a contractual arrangement, the taxpayer must come forth with strong proof that the agreement lacked economic reality. The Tax Court has adopted the strong proof standard and has refused to apply Danielson outside the circuits that recognize it. *See, e.g.*, Meredith Corp. v. Commissioner, 102 T.C. 406, 440 (1994); Elrod v. Commissioner, 87 T.C. 1046, 1065-66 (1986). The strong proof rule, as applied by the Tax Court, requires a showing of somewhat more than a preponderance of the evidence and somewhat less than Danielson. Illinois Power Co. v. Commissioner, 87 T.C. at 1434, n.15. The burden upon the taxpayer is "far heavier when his tax reporting positions and other actions did not consistently reflect the substance which he later

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[1] Only certain courts have adopted the Danielson rule. See, e.g., Lane Bryant, Inc. v. United States, 35 F.3d 1570 (Fed. Cir. 1994); Schatten v. United States, 746 F.2d 319 (6th Cir. 1984); Bradley v. United States, 730 F.2d 718 (11th Cir. 1984), *cert. denied*, 469 U.S. 882 (1984); Spector v. Commissioner, supra.

argues should control the form." Miller v. Commissioner, 57 T.C.M. at 50-51 (citing Illinois Power Co. v. Commissioner, 87 T.C. at 1430).

The Tax Court in Estate of Durkin v. Commissioner, 99 T.C. at 574-575 held that, under either a strong proof or Danielson standard, the taxpayers could not disavow their chosen form where: (1) taxpayers were seeking to disavow their own tax return treatment of the transaction, (2) the taxpayers' reporting position and other actions did not show "an honest and consistent respect for the substance of the transaction", (3) the taxpayers were unilaterally attempting to have the transaction treated differently after it had been challenged, and (4) the taxpayers would have been unjustly enriched if he were permitted to belatedly alter the transaction after well-informed negotiations were held with the other party to the transaction.

The taxpayers in Durkin did not prevail in establishing that the transaction, in substance, was different from that which was initially reported in the tax return as a purchase of coal properties from their corporation at a price below fair market value. Upon examination of the returns, the Commissioner determined that the taxpayers received a constructive dividend for the difference between the price paid and fair market value of the property. After their returns were challenged by the Commissioner, the taxpayers argued that their purchase of coal properties were in substance part of one integrated transaction in which they disposed of their stock ownership to another shareholder, and thus, the transaction should be taxed as a redemption. Based on the four factors discussed above, the Tax Court determined that the taxpayers did not carry their heightened burden to show a substance that is different than their reporting position. Furthermore, the taxpayers would have been unjustly enriched if they were permitted to avoid the tax consequences of a constructive dividend.

In the recent opinion of Norwest Corp. v. Commissioner, 111 T.C. 105 (1998), the Tax Court denied the taxpayer's attempt to have a transaction taxed in accordance with its substance, after it was initially reported on the return as a sale and lease-back of real property. The taxpayer argued that there had been no sale, and that the entire transaction, in substance, was merely a financing arrangement. After considering various approaches, the Tax Court concluded that the "taxpayers cannot elect a specific course of action and then when finding himself in an adverse situation extricate himself by applying the age-old theory of substance over form." Norwest Corp. v. Commissioner, 111 T.C. at 146. A taxpayer's ability

> to ignore the transactional form that he has adopted ... is further curtailed if ... [he] attempts to abandon his tax return treatment of a transaction ... [W]hen a taxpayer seeks to disavow his own tax return treatment ... by asserting the priority of substance only after the Commissioner raises

questions with respect thereto, this Court need not entertain the taxpayer's assertion of the priority of substance.... Id. at 145-146.

Most notably for purposes of the present case, taxpayers have been held to their characterization of transactions as debt despite their attempts to invoke traditional debt versus equity, or other substance considerations . *See* Taiyo Hawaii, Ltd. v. Commissioner, 108 T.C. at 602-603 (debt versus equity); City of New York v. Commissioner, 103 T.C. at 493 (debt versus partial debt, partial grant); Litchfield v. Commissioner, T.C. Memo. 1994-585, 68 T.C.M. (CCH) 1291 (1994), *aff'd in an unpublished order*, 97-2 USTC ¶50,536 (10th Cir. 1997) (debt versus equity); Miller v. Commissioner, 57 T.C.M. at 50-51 (debt versus equity).

For instance, in Taiyo Hawaii v. Commissioner, the U.S. taxpayer received advances from its foreign parent that were not evidenced by a promissory note, had no fixed maturity date or stated rate of interest, and were unsecured. In the financial statements and tax returns, the taxpayer respected the advances as intercompany loans. Further, at the instruction of the parent, the taxpayer accrued interest expense on the advances, and deducted said interest on its tax returns. Upon examination, the Commissioner determined that the taxpayer was liable for excess interest tax under section 884(f). To avoid this tax, the taxpayer attempted to disavow its characterization of the advances as debt, and argued that notwithstanding the "labels originally attached to the advances, they were, in substance capital contributions." Id., at 601-602.

In support of its argument, the taxpayer cited a past line of cases where Tax Court previously resolved debt versus equity disputes by applying the traditional debt versus equity considerations.[2] The Tax Court, in holding for the Commissioner that the advances were debt, found that it was unnecessary under the facts of the case to engage in a traditional debt versus equity analysis, and relegated the cases relied upon by the taxpayer to a footnote. 108 T.C. at 601-602, n. 9 and 10. Instead, working from the fundamental rule of law enunciated in National Alfalfa that a taxpayer must accept the tax consequences of its choice of transaction, the Tax Court noted that taxpayers have been permitted to assert substance over form where their "tax reporting and other actions have shown an honest and consistent respect for "the substance. Id. at 602 (citing FNMA v. Commissioner, 90 T.C. at 426 and Illinois Power Co. v. Commissioner, 87 T.C. at 1430). Taiyo Hawaii,

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[2] J.A. Tobin Construction Co. v. Commissioner, 85 T.C. 1005 (1985); Georgia Pacific Corp. v. Commissioner, 63 T.C. 790 (1975); J.A. Maurer, Inc. v. Commissioner, 30 T.C. 1273 (1958); LDS, Inc. v. Commissioner, T.C. Memo. 1986-293, 51 T.C.M. (CCH) 1433 (1986); Inductotherm Industries, Inc. v. Commissioner, T.C. Memo. 1984-281, 48 T.C.M. (CCH) 167 (1984), *aff'd without published opinion*, 770 F.2d 1071 (3rd Cir. 1975).

however, failed to demonstrate an honest and consistent respect for what it contended after the fact was the substance of the transaction. Relying on cases such as Estate of Durkin v. Commissioner and Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959), aff'g. 29 T.C. 129 (1957), the Tax Court stated:

> Petitioner has, for all purposes, treated the advances as loans and was instructed by its parent corporation to accrue interest. Under those circumstances, we reject petitioner's approach of testing its own choice of form with traditional debt versus equity considerations, such as the absence of a fixed payment schedule, maturity dates, enforcement, or formal debt instruments. We are likewise unpersuaded by petitioner's accountant's . . . after-the-fact testimony that, in retrospect, he should have considered the advances as equity and reported them as such on petitioner's tax returns.
>
> Petitioner's approach does not show that the substance of the advances was not loans. It merely illustrates that the parties to the transactions did not follow all the formalities that might be considered probative that the advances were debt rather than equity. In that regard, petitioner has not shown that the form of the transaction did not comport with its substance.... Accordingly, we hold that petitioner has not carried its burden of showing that the substance of the transaction was different from its form.

108 T.C. at 602-603 (citations and footnote omitted).

Further, the Tax Court adopted a heightened standard of proof when a taxpayer attempted to avoid the Commissioner's interest allocation pursuant to section 482 based on the argument of substance over form. Cayuga Service, Inc. v. Commissioner, T.C. Memo. 1975-4, 34 T.C.M. (CCH) 18 (1975). In response to the taxpayer's urging that the court disregard the form of intercompany advances as loans, and find that the advances were investments, the court stated, "[I]f a taxpayer asserts that the substance is different than the form he used, he must furnish strong proof that the substance was other than the form indicates," citing, *inter alia*, Ullman v. Commissioner. The court found that "petitioner has failed to meet is burden of persuading us that the advances were in fact investments and not loans." 34 T.C.M. (CCH) at 25.

The court decided Cayuga Service based on then existing Treas. Reg. § 1.482-2(a), T.D. 6952 (Apr. 16, 1968) and the decision is consistent with longstanding principles that the Commissioner is allowed to determine the tax consequences of a transaction based on its substance, while imposing a heightened standard of proof on taxpayers that argue for a substance different than the form. These principles are set forth in Treas. Reg. § 1.482-2(a), T.D. 8552 (Jul. 1, 1994), and, unlike the 1968 regulations, are confirmed in Treas. Reg. § 1.482-2(a)(3)(i), which provides

that the substance of the transaction shall be determined, and that "all the relevant facts and circumstances shall be considered and any law or rule of law (assignment of income, step transaction, etc.) may apply."

Although there exist a past line of cases in which some courts were willing to adjudicate debt versus equity disputes raised by taxpayers without expressly subjecting the taxpayers to a heightened standard of proof for determining the substance, the court in Taiyo Hawaii v. Commissioner, as mentioned above, was unpersuaded as to the relevance of these cases and found them unworthy of comment in light of National Alfalfa and its progeny. 108 T.C. at 602, n. 9 and 10. Further, were another court to be persuaded otherwise, these cases are factually or legally distinguishable from the present case.

For instance, in J.A. Tobin Construction Co. v. Commissioner, 85 T.C. 1005, the Commissioner sought to allocate interest pursuant to section 482 with respect to transfers of funds between related parties that were treated by the taxpayer as loans on its books and financial statements. Substantial dividends declared for two years reduced the balance of the transferred amounts. Id. at 1011. The Commissioner relied upon then existing Treas. Reg. § 1.482-2(a)(1), T.D. 6952 (Apr. 16, 1968), for authority to allocate the interest. The taxpayer, in turn, argued that the transfers were corporate distributions, and relied upon then existing Treas. Reg. § 1.482-2(a)(3), which stated that the subparagraph relied upon by the Commissioner "does not apply to alleged indebtedness which was in fact a contribution of capital or a distribution by a corporation with respect to its shares." Both parties argued numerous cases to support their respective characterizations of the funds transferred as loans or corporate distributions. The Tax Court held that the transferred funds were not loans, placing emphasis on the fact that the transferred funds, which appeared only as accounting entries, "were treated as satisfying the obligation of Tobin Construction to pay the dividends declared." Id. at 1019-1021.

Before conducting its analysis of whether the transfers were loans or distributions, the Tax Court in J.A. Tobin Construction Co. noted the principle that "a taxpayer is generally not allowed to argue that the substance of a transaction was other than the form he chose," citing In re Steen v. United States, 509 F.2d 1398, 1402-1403, n. 4 (9th Cir. 1975). However, the court did not subject the taxpayer to a heightened standard of proof in this case, for several reasons. First, the court noted that the regulation relied upon by respondent placed "no express restriction on a taxpayer's (as distinguished from respondent's) ability to challenge the bona fide nature of the loan and nothing in the regulation suggests that only respondent can make that argument." Second, respondent did not argue that the taxpayer, "as a matter of law, is held to the form of the transaction." And finally, the court found that under the circumstances, both the form and substance were in dispute, and

after considering all the facts, the advances were dividends in form and substance. Id. at 1021-1023. Post Corp. v. United States, 640 F.2d 1296 (Cl. Ct. 1981), is similarly distinguishable.

In sum, J.A. Tobin Construction Co. is distinguishable from the present case because the taxpayer did not disavow its initial tax return position, and the Commissioner did not argue that the taxpayer was held to the form of the transaction as a matter of law. Whatever doubt the court may have had about the Commissioner's ability to invoke the rule of law enunciated by National Alfalfa and progeny within the purview of an interest allocation under section 482, had the Commissioner so chosen, would now be alleviated by the language of the present regulation which makes clear that the Commissioner may determine the substance of the transaction, and that "for this purpose, all the relevant facts and circumstances shall be considered and any law or rule of law ... may apply."

The Tax Court was also willing to consider the debt versus equity issue in Georgia-Pacific Corp. based on the substance of the transaction due to the exceptional circumstances involved in that case. The taxpayer in Georgia-Pacific acquired the assets of Colortype Co., which included a related party receivable for advances made by Colortype to its subsidiary. The Commissioner argued that since the taxpayer was Colortype's transferee, the taxpayer was bound by the form in which Colortype characterized the advances. Prior to the acquisition, Colortype executed a note agreement containing stated interest and maturity date. Both Colortype and its subsidiary accrued interest income, and corresponding expense, on their financial statements and tax returns. The taxpayer argued that since its acquisition of Colortype, there had been a change in the economic circumstances of the business, and the related party advances made by Colortype had been transformed into equity. The court opined that:

> [w]hile a taxpayer must in other contexts normally accept the tax consequences of the way in which he deliberately chose to cast his transaction, advances of the type here involved must be characterized in terms of economic reality for the year at issue.... Changing circumstances as time passes may alter the original character of an advance and transform it into equity.... Therefore, the taxpayer was not bound by the form in which it cast this transaction.

Id. at 795-96. The Georgia-Pacific opinion is distinguishable in that there the transaction was created by the taxpayer's predecessor. As such, the decision does not support the proposition that when faced with a taxpayer seeking to disavow its form and argue debt versus equity considerations, a court would feel compelled to take a different tack than that in Taiyo Hawaii.

In J.A. Maurer, Inc. v. Commissioner, 30 T.C. 1273 (1958), the Commissioner determined that the taxpayer had forgiveness of indebtedness income, but the Tax Court found that the advances in questions were contributions to capital. The Commissioner did not argue that the heightened standard of proof should apply, and the case predated the Supreme Court's 1974 opinion in National Alfalfa. As for the decision in LDS, Inc. v. Commissioner, 51 T.C.M. 1433, although the court analyzed the substance of the transaction by applying the traditional debt-equity factors, it determined that the taxpayer proved the substance by proffering strong proof that all factors, taken collectively, weighed in favor of equity. And in Inductotherm Industries, Inc. v. Commissioner, 48 T.C.M. at 186-89, the court allowed advances to be characterized as equity, but the Commissioner did not argue that the heightened standard of proof applies when a taxpayer argues for substance different from its reporting position.

With respect to the present case, X should be subject to the heightened standard of proof when it attempts to argue substance by rebutting its prior financial statement and tax reporting positions regarding the treatment of its advances that were originally reported as debt. Under these circumstances, X must demonstrate that X, Y and the sister corporations (E, F, G, H and J) recognized and respected the advances as capital contributions, and that Y allegedly acted as X's agent for this particular purpose. X's reporting position and other actions do not show an honest and consistent respect for what it now claims to be, in substance, equity contributions. X's argument does not appear to comport with the contemporaneous events underlying the transfer of funds as depicted by the Intercompany Report of Advance Transactions. The report shows that during Year 2, Y advanced significant amounts to G, arguably as equity contributions by X. However, Y continued to make such advances even after X sold its partnership interest in G to a wholly-owned subsidiary K on Date 4. In light of the lack of ownership interest by X, there is no basis for asserting that the advances made after Date 4 constituted equity contributions.

Further, the advances made by Y, and the repayments by G to Y, did not appear to affect X's ownership interest in G. In general, when a partner contributes additional equity, the transaction should increase the partner's ownership interest in the partnership, particularly when the other partners are not making pro rata equity contributions for purposes of maintaining their respective partnership interests. Conversely, if the partnership makes payments as a return of equity with respect to a specific partner, then that partner's ownership interest should be accordingly decreased given that the other partners did not receive a pro rata distribution from the partnership. G's partnership return and Schedule K-1 did not respect the advances made by Y as increases to X's partnership capital, or the repayments by G to Y, as decreases to X's interest. The return and Schedule K-1 never reflected any portion of the advances through X's capital accounts, but rather the entire

advance was recognized as a loan payable to Y at the end of Year 2. Based on these facts, it is evident that X, Y and G did not respect the advances as capital contributions. Reporting the advances as loans in the financial statements and Forms 1120, 5471 and 1065 is probative of an intent that the advances were debt rather than equity.

X's inconsistent conduct also shows that it is unilaterally recharacterizing the outbound aspect of the advances as equity for U.S. tax treatment, while maintaining Y's corresponding treatment of the same advances as non-interest bearing debt for Country A's tax purposes. In situations involving parent/subsidiary advances, it is reasonable to expect that the transaction would be accorded harmonious treatment by both parties. The conflicting classification of the advances further show that both parties do not uniformly respect the advances for their alleged substance. The fact that Y treated the advances as debt in order to comply with Country X rules related to the issuance of capital shares does not provide a sufficient foundation for permitting X to disavow its form in order to avoid U.S. tax consequences. *See* Coleman v. Commissioner, 87 T.C. 178, 202-203 (1986).

Thus, we believe it would be difficult for X to persuade a court that in substance, the advances are capital contributions when in fact the parties themselves did not consistently respect the character of the advances.

In considering whether X can produce sufficient evidence to demonstrate that X and Y consistently respected and reported the advances as equity and that the other facts and circumstances justify treating the advances as equity, we note that no single uniform approach has been adopted by the courts in analyzing the debt versus equity factors. The Tax Court looks to whether there was 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." Nestle Holdings, Inc. v. Commissioner, 70 T.C.M. at 700 *quoting* Litton Business Systems, Inc. v. Commissioner, 61 T.C. at 377. Courts generally look to: (1) the name and presence of a written agreement demonstrating indebtedness, (2) the presence of a fixed maturity date, (3) the source of payments, e.g., whether there is anticipated cash flow to cover payments, (4) the right to enforce payment, (5) increased participation in management as the result of the advance, (6) subordination, (7) intent of the parties, (8) thinness of capital structure in relation to debt, (9) identity of interest between creditor and stockholder, (10) the source of interest payments, e.g., whether from earnings, (11) ability of corporation to obtain credit from outside sources, (12) use of funds for capital assets or risk involved in making the advances, and (13) failure of debtor to repay. See Laidlaw Transportation, Inc. v. Commissioner, T.C. Memo. 1998-232; Nestle Holdings, Inc. v. Commissioner, T.C. Memo. 1995-441, 70 T.C.M. (CCH) 682 (1995); Lansall Company v. United States, 512 F.Supp. 1178, 1180 (S.D.N.Y. 1981).

Further factual development would be required to determine whether the advances constitute debt or equity. There is, of course, evidence that X's intent was to create debt in the U.S. and in Country A. Although X, Y and the sister corporations did not execute a formal written agreement containing certain indicia of debt (e.g., stated rate of interest, maturity date, and default or acceleration clauses), the lack of such terms do not conclusively show that the advances in substance were capital contributions. The determination of debt or equity is not strictly based on those factors alone. For instance, consideration must be given to whether an independent creditor would agree to lend to Y, or its sister corporations, under the same conditions as provided by X in its advances. See Nassau Lens Co. v. Commissioner, 308 F.2d 39 (2nd Cir. 1962) (independent creditor test based on comparability to the general standards of the financial community, not on actual availability of outside credit). "Under an objective test of economic reality it is useful to compare the form which a similar transaction would have taken had it been between the corporation and an outside lender ...." Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3rd Cir. 1968). Further, it should also be considered whether there is any reasonable expectation of repayment from Y or the sister corporations with respect to the advances. Repayments dependent on the fortunes of the business indicate equity rather than debt. See Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972); Dixie Diaries Corp. v. Commissioner, 74 T.C. 476 (1980).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Please consider that cases of this nature always involve a weighing of all facts and circumstances, and that a court may be more inclined to find that a taxpayer has met its heightened standard of proof upon disavowing the form of its transaction if the debt versus equity considerations overwhelmingly favor the taxpayer, particularly in light of the language of Treas. Reg. § 1.482-2(a)(3), which arguably could be read to require a substance analysis only under section 482. *See* Tobin v. Commissioner; Inductotherm Industries, Inc. v. Commissioner.

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