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
DISTRICT COUNSEL

Attn:

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT: Debt vs. Equity

This Field Service Advice responds to your memorandum dated April 2, 1999. 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:

Corporation X =

Corporation XD

Corporation Y =

Sub B =

Individual C =

Entity M =

Entity N =

Entity O =

Word B =

Date B =

Date C =

Date D =

Date E =

Date F =

Date G =

Date H =

Date J =

Date K =

Date L =

Date M =

Date O =

Date P =

Date Q =

Month F =

Month G =

Month H =

Month J =

Month K =

Month L =

Year B =

Year C =

Year D =

Year E =

Year F =

B% =

C% =

D% =

E% =

F% =

G% =

H% =

J% =

K% =

L% =

M% =

N% =

O% =

P% =

Q% =

R% =

S% =

T% =

U% =

W% =

$B =

$C =

$D =

$E =

$F =

$G =

$H =

$J =

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$L =

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$N =

$O =

$P =

$Q =

$R =

$S =

$T =

$U =

$W =

$X =

$Y =

$Z =

$AAA =

$BBB =

#B =

#D =

#E =

#F =

#G =

#H =

#J =

#K	=
#L	=
#M	=
#P	=
Business C	=
Agreement C	=
State Y	=
Time B	=
Type B	=
Party AYY@	=
Party AZZ@	=
Corporation Y=s accountant	=

ISSUE:

Whether payments of contingent interest made to Corporation Y and Corporation X were constructive dividends.

CONCLUSION:

Based upon the facts presented, we recommend that the Examination Division go forward with the recharacterization of the advances at issue from debt to equity. Therefore, payments of contingent interest made by Sub B to Corporation Y and Corporation X were constructive dividends.

FACTS:

Procedural Background- Your request seeks advice as to whether certain purported loans advanced by Corporation Y and Corporation X, two unrelated corporations, to Sub B, are debt or equity. In a series of transactions, Corporation Y and Corporation X created Sub B and advanced additional funds to Sub B in exchange for nonrecourse promissory notes. At a subsequent date, Sub B became a member of the Corporation Y consolidated tax return group the day after Corporation X sold its shares of common stock in Sub B to Corporation Y. Sub B continued to make payments on its promissory notes to both Corporation X and Corporation Y. This memorandum responds to your question as to whether the instruments

received should be treated as debt or equity. The proposed adjustment pertains to payments Sub B made with respect to the promissory note to Corporation X.

Background- Corporation Y is a consolidated group engaged in various activities. The periods at issue are the taxable years ended Date K, and Date M.

Prior to Date C, Corporation Y and another corporation, Corporation X owned K% and L%, respectively, of a corporation called Sub B. Sub B was created for the purpose of allowing Sub B and Corporation X to together engage in real estate development activities. Sub B has never had any employees of its own and has relied on its shareholders for the performance of its functions. Corporation X was controlled by an individual named Individual C. At some point, Corporation X changed its name to Corporation XD. Sub B's shareholders had capitalized Sub B with a total of $W of cash. On Date C, Corporation Y sold a W% interest in Sub B to Corporation X, making Corporation X the K% shareholder.

Agreement C- On Date B, Sub B entered into Agreement C with Entity M. The Agreement C created a partnership called Entity N. Sub B became a general partner of Entity N and had an F% interest in the partnership. Entity M held the remaining P% interest in the partnership. Entity N was created for the purpose of Business C. Sub B and Entity M initially agreed that Entity N would be capitalized with $G from Sub B and $Y from Entity M.

The Agreement C provided that operating cash flow was to be distributed to Sub B and Entity M, first in an amount per year equal to T% of each partner's capital contribution. The remaining cash flow was to be paid F% to Sub B and P% to Entity M.

Entity N expected to receive payments of administrative and management fees from the Entity O

First and Second Letters- According to a letter dated Date D, from Sub B to Entity M (the "First Letter"), Entity N was to pay F% of any such amounts to Sub B and P% to Entity M. The letter further described these payments as guaranteed payments as defined at I.R.C. ' 707(c).

The agreement to make these payments to Sub B and Entity M was also memorialized in a letter dated Date D, from Sub B to Corporation Y and to Individual C (the "Second Letter").[1] This letter, which described most of the transaction at issue, further indicated that Sub B would pay E% of its share of the Entity O fees to Corporation X and Q% to Corporation Y. The remaining U% of Entity O fees would remain with Sub B.

[1]The letter was signed by representatives of Sub B, Corporation Y, and Corporation X.

The Second Letter also provided that Corporation X would perform all services which Sub B was obligated to perform under the Agreement C between Sub B and Entity M. The Second Letter further recited that the agreed upon allocation of the Entity O fees (E% to Corporation X and Q% to Corporation Y) represented all the compensation or reimbursement to be received by Corporation Y and Corporation X unless additional compensation or reimbursement would be provided for under the Agreement C or in another written agreement entered into by the parties.

The Second Letter further provided that Corporation Y was to loan $J to Sub B. Sub B was obligated to repay this amount only out of distributions paid by Entity N to Sub B. H% of any such payments would represent what the parties labeled "contingent interest."

The Second Letter went on to provide that Corporation Y would lend $W to Corporation X. Corporation X was required to lend to Sub B the $W which Corporation Y had loaned to Corporation X. Rather than using Corporation X as a conduit for funding, Corporation Y could have advanced the $W directly to Sub B. Sub B was obligated to repay the loan from Corporation X only out of distributions paid by Entity N to Sub B. N% of any such payments from Entity N to Sub B would represent contingent interest payable to Corporation X.

Under the anticipated terms of the loan between Corporation Y and Corporation X, Corporation X was to pay Corporation Y interest at S%. We have not been furnished with a copy of the note and therefore rely on the description in the Second Letter. The note was to be payable within #D years, or within #E months of the sale of the last unit of the Word B project, whichever came first. The loan between Corporation Y and Corporation X would be recourse and would have to be repaid regardless of whether distributions from Entity N to Sub B were sufficient to service the loan. Corporation X was to pledge the indebtedness of Sub B to Corporation X as security for its loan from Corporation Y, and Individual C personally guaranteed the loan between Corporation Y and Corporation X.

According to the Second Letter, Sub B was to take the $H loaned to it by Corporation Y and Corporation X and contribute it to the capital of Entity N. This $H would represent part of the $G of capital which Sub B was required to contribute to Entity N pursuant to the Agreement C. Corporation Y had the option of advancing the $H (including the $W to be loaned to Corporation X) directly to Entity N.

Non Recourse Promissory Note Between Sub B and Corporation Y- The note between Sub B and Corporation Y (the "Sub B/Corporation Y Note") is dated Date E. It varied somewhat from the terms described in the Second Letter. The Sub B/Corporation Y note provided for a #E year rather than a #D year maturity period. The principal amount was reduced from $J to $M. J% of distributions received by Sub B from Entity N were to be paid to Corporation Y as contingent interest.

The Sub B/Corporation Y Note had other details not fully described in the Second Letter. Section #L of the Sub B/Corporation Y Note provided that contingent interest payments were to be made in accordance with Section #D of the Sub B/Corporation Y Note. Section #D of the Sub B/Corporation Y Note provided that payments from Sub B to Corporation Y were to be first allocated to principal. After both Corporation Y and Corporation X received full payment of principal, J% of any subsequent distributions from Entity N to Sub B was to be paid to Corporation Y as contingent interest. The Sub B/Corporation Y Note provided that to the extent any interest payable under the note would be usurious under Federal or State Y law, the usurious portion would be reallocated to principal. Finally, the note was non-recourse, and repayment could only come from the distributions from Entity N to Sub B, as described under Section #D of the note.

Non Recourse Promissory Note Between Sub B and Corporation X- The terms of the note between Sub B and Corporation X (the "Sub B/Corporation X Note"), also dated Date E, were essentially identical to the terms of the Sub B/Corporation Y Note. The Sub B/Corporation X Note varied from the terms described in the Second Letter in the same manner as the Sub B/Corporation Y Note varied from the Second Letter's description. The Sub B/Corporation X Note provided for a principal amount of $X. The Sub B/Corporation X Note in effect provides that after principal is paid, M% of distributions from Entity N to Sub B will be paid to Corporation X as contingent interest.

Shareholder Status on Date F- On Date F, Corporation Y repurchased the W% interest in Sub B which it had sold to Corporation X. This purchase left Corporation Y as the K% shareholder.

Revised Non Recourse Promissory Notes- At some point after Date E, Sub B issued revised promissory notes to Corporation Y and to Corporation X. The revised promissory notes were dated Date E.

The revised promissory note between Sub B and Corporation Y (the "Revised Sub B/Corporation Y Note") is essentially identical to the original note, except for the allocation of payments between principal and interest. Section #L of the Revised Sub B/Corporation Y Note states, in part:

> AIn accordance with the provisions of Section #D of this Note, and before the principal amount of this Note has been paid in full, Party AYY@ shall pay to Party AZZ@ concurrently with, or not later than #J Time B after any distributions are received by Party AYY@ from Entity N . . . as interest on the loan, an amount (the "Contingent Interest") equal to J% for Party AZZ@ . . .@

Section #D of the Revised Sub B/Corporation Y Note, however, was unchanged from the original Sub B/Corporation Y Note and still provided that principal would be paid first.[2] The

[2]Thus, under the revised note, payments were still allocated first to principal.

revised promissory note between Sub B and Corporation X (the "Revised Sub B/Corporation X Note") varied from the original Sub B/Corporation X Note in the same manner as the Revised Sub B/Corporation Y Note varied from the original Sub B/Corporation Y Note.

Other Loans to Sub B- Corporation Y had loaned other amounts to Sub B. It is our understanding that those notes were recourse notes and were therefore higher in priority than the notes described above.

Sub B Payments to Corporation X and Corporation Y- On Date G, Corporation XD (f.k.a. Corporation X) sold its interest in Sub B to Corporation Y for Corporation XD's $AAA original cost. After that date, Corporation XD continued to receive payments under the Sub B/Corporation X Note (or the Revised Sub B/Corporation X Note). Sub B became a member of Corporation Y's consolidated tax return group on Date H, and its income was reported on Corporation Y's consolidated return for the period ended Date K. Corporation Y and Sub B are Type B.

At some point prior to Date J, Corporation Y=s accountant requested Sub B=s response as to whether the M% of distributions from Entity N to Sub B which Corporation XD (formerly Corporation X) was receiving was really interest. Sub B replied that only R% of the distributions from Entity N was interest and that the remaining O% was compensation for services.[3]

The venture enjoyed tremendous success. In Month K, Year C, Sub B received a distribution of $D from Entity N. This distribution was almost twice the total principal outstanding. In Month H, Year D, Sub B received a distribution of $L. In Month J, Year D, Sub B received a distribution of $O. In Month G, Year E, Sub B received a distribution of $R. In Month H, Year E, Sub B received a distribution of $Z. The distributions received by Sub B totaled $B. Corporation X received $E of the $C paid to Corporation Y and Corporation X.

On Date L, Sub B issued a check to Corporation Y in the amount of $F. This payment included $N of principal on the Sub B/Corporation Y Note, $BBB of principal on another note issued to Corporation Y, $S of contingent interest, and $U of repayment for amounts loaned by Corporation Y to Corporation XD (formerly Corporation X). Corporation Y also reclassified the principal included in the Date L payment to interest. Corporation Y has produced a document showing handwritten corrections to the schedule allocating the Date L, payment. Based upon the parties' revised allocation of interest and principal, Sub B has

[3]The R% figure was arrived at by assuming that all J% of distributions from Entity N received by Corporation Y was interest. R% of distributions bears the same ratio to $X (the principal owed to Corporation XD) as J% of distributions bears to $M (the principal owed to Corporation Y).

paid no principal whatsoever. It does not appear that Corporation Y has yet claimed a bad debt deduction for the advances at issue.

For the taxable year ended Date K, Sub B accrued and deducted $Q of management expenses. The $Q represented C% of the $P guaranteed payment Sub B had received from Entity N.[4] For the taxable year ended Date M, Sub B accrued and deducted $T of management expenses.

LAW AND ANALYSIS

The Service should assert that the funds advanced by Corporation Y and Corporation X to Sub B was equity instead of debt.

Whether a payment is equity or a debt is a question of fact to be decided on a case by case basis. See Gilbert v. Commissioner, 262 F.2d 512, 513 (2d Cir. 1959), aff=g. T.C. Memo. 1958-8. Courts have traditionally utilized a number of factors in determining whether an instrument is debt or equity.

The Ninth Circuit in Bauer v. Commissioner, 748 F.2d 1365, 1368 (9th Cir. 1984), and Hardman v. U.S., 827 F.2d 1409, 1412 (9th Cir. 1987) has identified eleven factors which distinguish debt from equity[5]. They are as follows:

1) The names given to the certificates evidencing the debt or equity;
2) The presence or absence of a maturity date;
3) The source of the payments;
4) The right to enforce payment of principal and interest;
5) Participation and management;
6) A status equal to or inferior to that of regular corporate creditors;
7) The intent of the parties;
8) AThin@ or adequate capitalization;
9) Identity of interest between creditor and stockholder;

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[4] C% is the sum of the E% to be paid to Corporation X and the Q% to be paid to Corporation Y. It is unclear what services Corporation Y performed to be entitled to such payments.

[5] Bauer v. Commissioner, 748 F.2d 1365 (9th Cir. 1984) (Cash payments by two stockholders to their wholly owned corporation were loans rather than contributions to capital).

Hardman v. U.S., 827 F.2d 1409 (9th Cir. 1987) (Transfer of property to corporation treated as sale rather than capital contribution because consideration of the various factors weighed against finding a capital contribution).

10) Payment of interest only out of Adividend@ money; and
11) Ability to obtain loans from outside lending institutions.

No one factor is controlling or decisive, and the court must look to the particular circumstances of each case. AThe object of the inquiry is not to count factors, but to evaluate them@ Tyler v. Tomlinson, 414 F.2d 844, 848 (5th Cir. 1969). See Bauer v. Commissioner, 748 F.2d at 1368.

1. The names given to the certificates evidencing the debt or equity

The first of the eleven factors favors finding debt rather than equity. The documents governing the transaction are labeled as notes and contain language typical of notes.

2. The presence or absence of a maturity date

The second factor is difficult to apply with regard to this case but suggests the notes may have characteristics of debt. The notes each provide for a #E year maturity period, but Sub B is not required to make a payment at the end of #E years, and it is unclear what remedies are available with respect to the purported loan should Sub B be unable to fully repay it within #E years. A court might find that either the #E year stated term or the obligation to make payments as distributions are received is adequate to establish a debt-like maturity date (cf. Hardman, 827 F.2d at 1413.) or, alternatively, may conclude that the holders are effectively investors over the life of the Entity N development venture, however long or short that may be, and are in no better position than equity investors in this regard. Such a conclusion might be reinforced by the fact that the principal amount, at least in the view of the parties, has never been repaid, notwithstanding the success of the venture.

Nonetheless, the presence of a fixed maturity date does not guarantee recognition of the loan as indebtedness if other factors indicate an equity investment. See Charles L. Huisking & Co. v. Commissioner, 4 T.C. 595 (1955).

3. The source of the payments

Arguably, the third factor tends to demonstrate that the notes with respect to the transaction at hand were equity. An advance is more likely to be equity if the recipient does not have liquid assets or reasonably anticipated cash-flow from which to repay. Estate of Mixon v. United States, 464 F.2d 394, 405 (5th Cir. 1972). Given Sub B's lack of other assets, the non-recourse nature of the arrangement, and the speculative nature of the Entity N development venture, a court should conclude that the prospect of repayment was entirely at the risk of the Entity N development venture; absent its success, there was no possibility of repayment.

4. The right to enforce payment of principal and interest

The fourth factor supports a finding of debt. Corporation Y and Corporation X could compel Sub B to pay interest when Sub B had distributions from Entity N. The ability to enforce payment, even if payment is contingent upon the sale of property, supports a finding that Corporation Y and Corporation X had a right to enforce payment. Hardman, 827 F.2d at 1413.

5. Participation and management

The fifth factor is inapplicable. Whether there is participation in management depends on whether the transfer increases the stockholder's interest in the corporation. Where there is an increase in the ownership interest of the corporation, or an increase in voting rights, as a result of the advances, then the transaction weighs in favor of equity. See Hardman v. United States, 827 F.2d at 1413. Because the shareholders of Sub B advanced funds to Sub B, the advances could not have changed their relative interests as a practical matter.[6] This factor is irrelevant in Sub B=s case since it was wholly owned by both Corporation Y and Corporation X.

6. A status equal to or inferior to that of regular corporate creditors

The sixth factor supports a finding of equity. It is less likely for holders of notes or claims with lower priority, when compared with higher priority claims, to receive payment in the event a corporation files for bankruptcy. As is the case with equity holders, holders of notes with a lower priority will have a greater element of risk in the event of bankruptcy. A holder of a note with higher priority indicates debt. Notes with low priority in an inadequately capitalized corporation resemble equity.

Sub B had other indebtedness to Corporation Y. These other loans were recourse, with a fixed interest rate and therefore, as a practical matter, higher in priority than the advances at issue. Because the advances at issue were lower in priority, this suggests that the advances were equity.

Also, all of Sub B's assets are invested in Entity N. In the event of Entity N=s bankruptcy, Sub B is lower in priority with respect to other creditors of Entity N because Sub B is a general partner in Entity N. Sub B=s status as a general partner in Entity N places Sub B, and its shareholders, at greater risk than other creditors in the event of Entity N=s bankruptcy. Sub B=s exposure to greater risk in the event of Entity N=s bankruptcy, which as well positions Sub B=s shareholders= advances to Sub B at greater risk than other Entity N creditors, is indicative that the advances to Sub B were equity interests.

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[6] Although Corporation Y was only a L% shareholder of Sub B at the time the original notes were signed, the Second Letter gave Corporation Y the option to repurchase the W% of Sub B it had just sold to Corporation X.

7. The intent of the parties- This seventh factor supports a finding of equity.

Risk of Interest Payment Contingent Upon Success- Corporation Y and Corporation X could have structured the transaction, with respect to its investment in Sub B, to receive a steady stream of income from Sub B. Corporation Y and Corporation X instead opted to risk dependence on Sub B=s success in real estate development activities. Corporation Y and Corporation Xs= risk on recovering from Sub B dependent upon Sub B=s success as a real estate development activity, rather than structuring the transaction to obtain a steady and certain stream of income, is indicative of equity.

Payments Reflect Stock Ownership Rather Than Note Values- The ratio of the amounts advanced by Corporation Y and Corporation X pursuant to the notes was exactly #J to #B. The ratio of the capital contributions of Corporation Y and Corporation X was exactly #G to #F without taking into account the advances. The ratio of the capital contributions of Corporation Y and Corporation X was approximately #H to #M if the advances are viewed as equity. The ratio of contingent interest payments, as stated in both the original and revised notes, was approximately #J to #K. Therefore, the stream of contingent interest as contemplated by the parties reflected the stock ownership of Sub B and not the amount of the relative value of the loans to Sub B. This is indicative of equity.

Actions of the Parties Reflect Intentions- The behavior of the parties with regard to their treatment of the notes provides insight to their intentions.

The intentions of parties to a transaction are demonstrated by their actions. See Skeen v. Commissioner, 864 F.2d 93, 95 (9th Cir. 1989) (The Tax Court provided analysis of taxpayers= intent which relied upon facts known when they invested in a tax shelter scheme, and upon their actions in investing). The actions of the parties in the present case do not serve to demonstrate the advances were debt. Of the sizeable payments from Sub B to both Corporation Y and Corporation X, no principal on the purported notes was ever paid. See Yale Avenue v. Commissioner, 58 T.C. 1062, 1074 (1972) (formal indicia of debt outweighed by, among other factors, failure to repay principal). Were this truly debt the principal should have been paid off. No bad debt deduction was ever claimed by Corporation X or Corporation Y when the principal was not paid off. In a true debtor/ creditor relationship a creditor would have claimed a bad debt deduction.

Additional Comments With Respect of the Sub B=s Failure to Pay Principal- As indicated, Sub B was extremely successful. The size of the distributions to Sub B=s shareholders, as well as the frequency of the distributions over at least #M years indicates that some of the principal should have been paid off. There could be alternative explanations not exclusively limited to the following hypothetical examples. For example: a) The Service=s interpretation

of the notes could be incorrect[7]; and b) The parties to the Sub B notes, regardless of the terms, never intended for the principal to be paid off.

Even if the Service=s interpretation of the terms of the notes, as drafted by the parties to the transaction, is incorrect, it is difficult for the parties to the transaction to argue that the notes, to be considered debt instruments, could be drafted without the provision for the principal to be paid off. If the notes, as drafted, never effectively provided that the principal could be paid off, this would suggest the notes were instead equity.

The other alternative explanation likewise suggests the advances were equity. It appears that regardless of the terms of the Sub B notes, there was never any intention to pay down the principal and Sub B attempted to obtain perpetual interest deductions.

Failure to Consistently Report Interest Income- According to our understanding of the facts, during one of the years in question, Corporation Y did not record interest payments made by Sub B[8]. Dependent upon what transpires with this case, an adjustment to Corporation Y might be warranted under the circumstances if Corporation Y did not include the payments into income for which Sub B had taken a corresponding deduction.

Significant Differences in Rates of Interest on Similar Transactions- We must also point out the significant differences in the rates of interest provided for in the Corporation Y/Corporation X note when compared with the notes Sub B had with its shareholders. Although the Corporation Y/Corporation X note is recourse, the rate of interest on the Sub B/Corporation X note is #J times this amount.

Corporation X and Corporation Y are unrelated parties to a recourse note for only S%. However, Sub B issued notes to its owners, Corporation X and Corporation Y, where the interest rates are over D%. Generally, related parties would not charge as high of an interest rate on similar transactions as unrelated parties. Related parties in control of a subsidiary have the requisite control necessary to extract assets or profits from the subsidiary to indemnify themselves where the subsidiary defaults on its obligations to the owners. Parties to a transaction cannot as readily exert influence over each other to enforce the terms and obligations where the parties are unrelated. It is difficult for Corporation X and Corporation Y to argue that the contingent rates of interest payments from Sub B are reasonable where they are the owners of Sub B and require contingent interest of over D%, whereas, a note between unrelated parties is only S%. Merely

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[7]The notes were revised and contain ambiguities and inconsistencies within each of the notes.

[8]Corporation X included and reported all contingent interest paid and deducted by Sub B. However, it is our understanding that Corporation Y did not report and/or include interest paid and deducted by Sub B.

because the note between Corporation X and Corporation Y is recourse, when compared with the Sub B notes, does not justify such a disparity in interest rates. This is especially apparent when the purported nonrecourse nature of a subsidiary=s obligation is trumped via the parent=s effective power to enforce payment.

Furthermore, while there was a cap on the interest payments for the Corporation Y/Corporation X note, there was no cap on the level of interest that can be paid with respect to the notes from Sub B.

If Sub B=s notes to its shareholders were really debt instruments the interest rates would have been comparable to the interest rates reflected in the Corporation Y/ Corporation X Note.

Third Party Scrutiny and Sub B=s Response Attempting to Conceal the Transaction- These considerably large contingent interest payments were material enough in size to cause Corporation Y=s accountants to question whether those payments were really interest. When Sub B was questioned by Corporation Y=s accountant as to whether the large contingent interest payments from Sub B to Corporation X was truly interest it is our understanding that Sub B contended that roughly G% of the contingent amounts were compensation[9]. In its correspondence to Corporation Y=s accountant, Sub B merely ensconced most of the contingent interest distributions Sub B made to Corporation X with the label Acompensation or management fees@. Therefore, Sub B concealed the classification of these significant payments from even Corporation Y=s accountant.

Sub B=s correspondence with Corporation Y=s accountant tends to demonstrate that even Sub B expected third parties to find incredulous that such large distributions could ever be interest.

8. AThin@ or adequate capitalization

The eighth factor tends to favor a finding of equity. Sub B was not adequately capitalized. The ratio of debt to equity, if the advances are regarded as debt, would be approximately #J to #B. See Laidlaw Transportation, Inc. and Subsidiaries v. Commissioner, T.C. Memo. 1998-232 (June 30, 1998) (average debt-equity ratio was 4.56 and exceeded 2:1 for each of the years at issue; court found that this factor favored recharacterizing the purported debt as equity). Furthermore, the money which Sub B advanced to Entity N was identified as part of Entity N's original capital requirements in the Second Letter. Corporation Y and

[9]According to the Revenue Agent there was only one agreement contemplating compensation and management fees. Those compensation or management fees under the separate agreement were already paid, accounted for and reported as such. Therefore, no portion of these sizable contingent interest payments could have been compensation or management fees.

Corporation X had knowledge at the inception of the venture that Sub B was inadequately capitalized.

9. Identity of interest between creditor and stockholder

If advances by shareholders are proportionate to their stock ownership, the advances are more likely to be equity. Estate of Mixon v. United States, 464 F.2d 394, 409 (5th Cir. 1972).

Both of the purported lenders were shareholders in the venture at its inception. Regardless of whether the loans were in exact proportion to the shareholders' initial investments in Sub B, economically, the loans paid an equity-like return that was roughly proportionate to the holders' stock ownership in Sub B. As previously discussed, the division of the stream of contingent interest between Corporations X and Y reflects their stock ownership of Sub B, not the amounts purportedly lent. The large disparity in the sharing ratios between the two purported lenders only proves that the contingent interest was not paid for the use of money over time (i.e., interest). The total amount of the contingent interest has been enormous in relation to the amount lent, and the parties' view that principal is to be paid last (if at all) only serves to reduce the present value of that element of the return, the only one in proportion to the amount "lent."

Therefore, the ninth factor is not necessarily indicative that the advances were debt.

10. Payment of interest only out of Adividend@ money

According to Hardman, 827 F.2d at 1414, this factor is essentially the same as the third factor (the source of the payments) and we defer to the above comments.

11. Ability to obtain loans from outside lending institutions

The eleventh factor heavily favors a finding of equity. Without the advances, Sub B clearly was undercapitalized and would not have been a viable business. Given the enormous risk reflected in the terms of the notes in this case, it is unlikely a commercial lender would have risked an investment in the venture at issue, at least not on conventional lending terms.

Funds Advanced Were Equity

The factors tend to demonstrate the notes were equity. All of the factors which favor a finding of debt were under the complete control of Sub B=s two shareholders (Corporation Y and Corporation X). Corporation Y and Corporation X could invent whatever strategy desired regarding these notes. The Notes in this case are subject to strict scrutiny because the issuer (Sub B) with respect to the holders (Corporation Y and Corporation X) were related parties when the notes were executed. See 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'"). See also P.M. Fin. Corp. v. Commissioner, 302 F.2d 786, 789 (3d Cir. 1962) (sole shareholder-creditor's control of corporation "will enable him to render nugatory the absolute language of any instrument of indebtedness") and Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir. 1968).

Although the instruments have many of the formal trappings of debt, all of the economic terms reflect an equity investment. As non-recourse lenders limited to repayment from partnership distributions, they bore all of the downside risk of the Entity N development venture. A non-recourse lender typically is insulated from risk at least to the extent that it is entitled to a fixed interest return and that the equity investors will bear any losses out of their contributed equity first. Here, each purported loan instruments is entitled only to a percentage of the partnership distributions when received. The remainder is available to the nominal equity on the same terms as the purported debt. Moreover, it is not clear under the instrument that there is ever any potential event of default- if partnership distributions are not made, the purported lenders are not paid. The upside return is likewise characteristic of an equity investment. There is no provision for fixed interest, and the contingent interest is a percentage of cash flow without limit. Over a few years the contingent interest was roughly #D times the amount purportedly lent. This type of return on investment is what would typically be expected where there is an equity investment in an extremely successful venture.

If the notes are equity, payments by Sub B to Corporation X and Corporation Y are dividends rather than interest.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

A. Litigation Hazards

1. Whether a transfer represents debt or equity is a contested question based on the facts and circumstances.

2. Potential Taxpayer Arguments

a) Disregarding Sub B

The parties may contend that the existence of Sub B should be disregarded as a separate entity. Elimination of Sub B eliminates the layer of corporate tax which causes the adjustment in this case.

As your memorandum concludes, Corporation Y and Corporation X chose to interpose a corporation between them and Entity N, perhaps to limit its liability. Having chosen the

benefits of corporate form, Corporation Y and Corporation X must also bear the consequences. Corporation Y cannot reap the benefits of an investment in Sub B as an intermediary and then simply label all of Sub B's profits as interest expenses.

It is a long standing principle that a taxpayer, although free to structure the transaction as chosen, "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), acq. in result in part, 1990-2 C.B. 1. See also, Nestle Holdings, Inc. v. Commissioner, 152 F.3d 83, 87 (2d Cir. 1998); 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); Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943).

According to the Revenue Agent the parties revised the notes to suit their needs[10]. To restrict taxpayers from recasting transactions with the benefit of hindsight to obtain tax advantages, courts have generally subjected taxpayers to a higher standard of proof before allowing them to contradict their chosen form. Estate of Durkin v. Commissioner, 99 T.C. 561, 572-575 (1992). [redacted]

[10] [redacted]

.

[redacted].

[redacted].

[redacted].

b) Relabeling Payments From Sub B to Corporation X as Compensation

As your memorandum indicates, Sub B has contended that much of the contingent interest paid to Corporation X represented compensation for services. The Revenue Agent has pointed out that the Second Letter provided that neither Corporation Y nor Corporation X would be entitled to any compensation for services beyond that set forth in the letter in the absence of a subsequent written agreement or a provision of the Agreement C allowing for additional compensation. Agreement C does not contain such a provision and the Revenue Agent indicated that the parties never entered into a subsequent written agreement for additional compensation. The Second Letter therefore contradicts Sub B=s contention that some of the contingent interest paid to Corporation X was really compensation.

[redacted].

c) Shareholder Status

Sub B may argue Corporation X was no longer a related party shareholder by the time it received the Sub B payments in Month L, Year C. Corporation X sold its shares in Sub B to Corporation Y on Date G. The payments from Sub B to Corporation X were not made until Month L, Year C when Corporation X was no longer a shareholder of record. Sub B could contend that the loans to Corporation X cannot be treated as equity as Corporation X was no longer a shareholder. Regardless of whether Corporation X was a shareholder or not, the note from Corporation X to Sub B was equity and not debt.

Loans can be recharacterized as equity notwithstanding the fact that the transferors are not shareholders of record. See Sherwood Memorial Gardens, Inc. v. Commissioner, 350 F.2d 225, 227 (7th Cir. 1965). Under the circumstances the notes between Sub B and Corporation X would be treated as a proprietary equity, not unlike preferred stock. See Sherwood Memorial Gardens, 350 F.2d at 227.

B. Case Development

1. Responses With Regard to Other Issues

Timing of Interest Accrual- We agree with your memorandum that the Service can assert an alternative argument that Sub B did not become liable for interest payments until it

received a distribution from Entity N in Month L, Year C. Because Sub B was not liable to pay interest to Corporation Y or Corporation X until after Date K, Sub B, pursuant to Treas. Reg. ' 1.461-1(a)(2)(i), may not deduct the interest for the taxable year ended Date K.

Usury Provisions- We also agree with your conclusion that if the Service were to rely on the notes= usury provisions as an alternative argument, the Service would be supporting Sub B=s contention that the advances were loans rather than capital.

Disguised Sale- Another alternative is to assert Corporation X=s Date G sale of its common stock in Sub B for only $AAA, the original capitalization value of the Sub B stock Corporation X owned, as inadequate consideration. It is our understanding Corporation X had knowledge by Date G that Sub B was a prosperous company worth much more than its original capitalization. Therefore, Corporation X should not have sold its Sub B stock to Corporation Y for a meager $AAA. Therefore, the subsequent payments from Sub B, as a part of the Corporation Y consolidated group, to Corporation X could arguably have been the consideration in a disguised sale of Sub B to Corporation Y. [redacted].

2. Factual Development

a) In General

The facts and issues have changed several times since your original memorandum was submitted to us. For instance, the first issue in your original memorandum is with respect to whether payments of contingent interest made by Sub B to Corporation Y were constructive dividends. We have determined that reclassifying the contingent payments from Sub B to Corporation Y as dividends would not result in an adjustment in the years ending Date K, or Date M, because Sub B and Corporation Y were part of the same consolidated group when the payments were made. The first issue therefore, with respect to the adjustment, is whether payments of contingent interest made by Sub B to Corporation X were constructive dividends.

The second issue changed with regard to your memorandum as well. The second issue was originally whether Corporation Y should be allowed to accrue contingent interest in the taxable year ended Date K, when no event triggering the payor's obligation to pay contingent interest occurred during that year.

The second issue was revised to ask whether Sub B should be allowed to accrue a contingent interest expense deduction for the year ended Date K, when it received no distribution from Entity N during such year and in addition there was no event triggering the obligation to pay Corporation Y and Corporation X during such year.

If the facts or issues have developed with regard to this field service advice for which we are unaware of and the new information impacts this advice, we invite you to reapply to request additional guidance.

b) Hazards with Respect to Using I.R.C. section 482

I.R.C. section 482

Generally, I.R.C. section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer as determined according to the standard of an uncontrolled taxpayer.

A District Director has the power to intervene in cases where a controlled taxpayer does not conduct its affairs, transactions, and accounting records to truly reflect taxable income from the property and business of each of the controlled taxpayers. A District Director can make such necessary distributions, apportionments, or allocations of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group. The standard applied, in all cases, is that of an uncontrolled taxpayer dealing at arm=s length with another uncontrolled taxpayer.

According to the conclusion in your memorandum, it is unclear whether Corporation Y and Sub B were commonly controlled for purposes of I.R.C. section 482 when the terms of the notes were negotiated, or whether Corporation X and Sub B were commonly controlled when the notes were negotiated. According to your memorandum, common control is a question of fact, and the shifting ownership of Sub B presents difficulty establishing sufficient facts to establish that Sub B and Corporation Y or Sub B and Corporation X were commonly controlled at the time the original notes were signed.

Your memorandum also concluded that the Service would have difficulty establishing that the effective interest rate(s) agreed to by the parties was not at arm's length. According to your memorandum, the Service could not necessarily establish that the parties to the transaction knew when they agreed to it that the interest rate(s) would be as high as it was. The purpose of the payments by Corporation Y and Corporation X to Sub B was to permit Sub B to engage in a real estate development activity. You have suggested that such activities are inherently extremely risky, and we have no evidence indicating that the parties were aware of how high the return on investment would be. You correctly reasoned that if the parties had known how profitable the venture would be, that they probably could have saved themselves a lot of trouble by becoming direct partners in Entity N. [redacted].

Control- We generally do not agree with your previously suggested conclusion that it might be difficult to determine whether Corporation X had control over Sub B. We point out that utilizing I.R.C. section 482 to allocate income should not necessarily be precluded based on Alack of control@.

We do, however, agree with your memorandum that whether Corporation X or Corporation Y had control over Sub B at the time the notes were issued, for purposes of I.R.C. section 482, is a question of fact. During the periods for which the agreement was negotiated through the period the notes were executed and the contingent interest was paid, Corporation X and Corporation Y owned various percentages of Sub B. Corporation X was a K% shareholder of Sub B when the agreement was negotiated and the notes were issued in Month J, Year B. Therefore, arguably, Corporation X had control over Sub B when the notes were issued based on its K% ownership interest.

Furthermore, we emphasize that I.R.C. section 482 does not require specific levels or percentages of ownership for purposes of determining Acontrol@ under I.R.C. section 482. The language of I.R.C. section 482 includes "owned or controlled"[11]. Additionally, there are circumstances where two or more unrelated parties may be deemed to be in Acontrol@ of another corporation for purposes of I.R.C. section 482[12]. Therefore, whether the Service can determine the exact percentage of ownership, for purposes of an allocation under I.R.C. section 482, can arguably be rendered a moot question. The Service should be able to argue there was sufficient control under I.R.C. section 482 to reallocate income among the parties.

[redacted].[13]

[11]Compare the broad definition of control and ownership under I.R.C. section 482 with other Internal Revenue Code sections providing for precise ownership and control tests, e.g., I.R.C. section 368(c).

[12]There are situations where the Service can assert that two taxpayers acting in concert can exercise control over a taxpayer. We do not believe this assertion will be necessary in the facts before us because Corporation X owned K% of Sub B when the agreement was entered into. K% ownership will suffice to demonstrate Acontrol@ for purposes of I.R.C. section 482. However, we can provide guidance with regard to this issue in another field service advice if requested.

[13]It was contemplated that J% of distributions received by Sub B from Entity N was to be paid to Corporation Y as contingent interest and M% of distributions from Entity N to Sub B was to be paid to Corporation X as contingent interest.

As previously mentioned, there are significant differences in the rates of interest provided for in the Corporation Y/Corporation X note when compared with the notes Sub B had issued to its shareholders. The rate of interest on the Sub B/Corporation X note is #J times amount of the rate of interest on the Corporation Y/Corporation X note.

[redacted]

I.R.C. section 482 is a viable alternative method, when compared with the debt equity argument, which can allow the taxpayer to settle on a small portion of the deduction.

c) Comments with Regard to the 1968 and 1994 Regulations

Your memorandum concluded that, because Sub B and Corporation Y taxable year ended Date K, that this case is subject to the 1968 regulations promulgated with respect to I.R.C. section 482 rather than the 1994 regulations. We do not necessarily agree with this conclusion.

The 1968 I.R.C. section 482 regulations govern taxable years beginning on or before October 6, 1994. Subsequent periods are governed by the 1994 I.R.C. section 482 regulations. Treas. Reg. ' 1.482-1(j)(1). During the years in question, Corporation X filed its tax return on a calendar year basis. Sub B had a short tax year from Date O through Date G. Sub B became a member of the Corporation Y consolidated group on Date H. Sub B=s next short tax year began on Date H and ended Date K. Sub B would then have a recurring Month H #B through Month F #P fiscal tax year as a member of Corporation Y=s consolidated tax return group. Corporation Y had an Month H #B through Month F #P fiscal tax year during the years in question. We are not certain whether the 1968 I.R.C. section 482 regulations govern because the beginning of tax year dates with regard to the adjustments for the entities in question cover dates both before and after October 6, 1994. Corporation X=s beginning of year for the tax year for the adjustment in question is Date P, Sub B=s is Date H and Corporation Y=s is Date Q. Arguably, the 1994 regulations could apply.

Therefore, it is unclear as to whether the 1968 or the 1994 regulations govern the transaction we are reviewing. If you require assistance with respect to further developing

whether either the 1968 or 1994 regulations promulgated under I.R.C. section 482 apply we suggest that you submit a request for field service advice[14].

d) Case Development with Respect to Guaranteed Payments From Entity N to Sub B

Guaranteed Payments from Entity N to Sub B

Pursuant to a letter dated Date D, Entity N was to pay the administrative and management fees it received from Entity O F% to Sub B and P% to Entity M. The letter described the payments as guaranteed payments under I.R.C. section 707(c).

A guaranteed payment is an amount paid for services or the use of capital, made to a partner in his capacity as a partner, and determined without regard to the income of the partnership. I.R.C. ' 707(c). To be a payment determined without regard to the income of the partnership, the payment must not be a function of net income and must be payable in all events, regardless of whether it exceeds the partnership=s net income. Miller v. Commissioner, 52 T.C. 752, 757-60 (1969); Falconer v. Commissioner, 40 T.C. 1011, 1014-17 (1963). The payment need not be a fixed dollar amount and can be based on aspects of the partnership business other than net income. Estate of Boyd v. Commissioner, 76 T.C. 646, 657 (1981). Services rendered by a partner that relate to the purposes for which a partnership is formed or that promote the business of the partnership will likely be characterized as rendered by the partner in his capacity as a partner. Pratt v. Commissioner, 64 T.C. 203 (1975), aff=d in part and rev=d in part, 550 F.2d 1023 (5th Cir. 1977); Rev. Rul. 81-300, 1981-2 C.B. 143.

The facts do not indicate the payments= purpose. Accordingly, it is not possible to determine from the substance of the transaction whether the payments were to be made to Sub B and Entity M in their respective capacities as partners in Entity N or as third-parties. Without such a determination, it is not possible to determine whether the payments should be characterized under I.R.C. section 707(a) (transaction between partnership and partner not in his capacity as a partner) or I.R.C. section 707(c) (guaranteed payment). In addition, to the extent the payment would be made to Sub B and Entity M in their capacity as partners of Entity N, it is uncertain from the facts provided whether the payment is payable in all events, including nonpayment by Entity O. In the absence of such a requirement, the payment could not constitute a guaranteed payment.

e) Other Loans to Sub B-

[14]As you correctly note, the provisions governing these transactions in the 1968 regulations and the 1994 regulations are essentially the same. See Treas. Reg. ' 1.482 (T.D. 8552, 1994-2 C.B. 93) and Temp. Reg. ' 1.482-2T(a)(2).

Corporation Y had loaned other amounts to Sub B. According to your memorandum, it is our understanding that those [other] notes were recourse notes and were higher in priority than the notes described above. We know few of the facts to support your conclusion as to the priority of any other claims with respect to the notes in the event of bankruptcy of Sub B. In the event of bankruptcy, generally, the order of distribution is to: 1) secured creditors; 2) priority claims (such as trustee fees, taxes, etc.); and then 3) unsecured creditors. Secured property is subject to less risk than unsecured property. Whether any of the notes were secured is a significant factor. [redacted].

f) Maturity Period

The notes provided for a #E year maturity period. The notes should have matured in Month J of Year F. [redacted].

If you have any further questions, please call (202) 622-7930.

Deborah Butler
Assistant Chief Counsel
(Field Service)

By: _____
Arturo Estrada
Acting Branch Chief
CC:DOM:FS:CORP

Attachment (1) 4 Page Diagram Detailing Transaction

Slide 1

Slide 2

Slide 3

Slide 4