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,

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL
CC:DOM:FS

SUBJECT: Non-interest bearing Note

This Field Service Advice responds to your memorandum dated September 20, 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

Taxpayer =
Parent =
A =

B =
C =

D =
Date 1 =
Date 2 =

ISSUES

1. Whether this transaction is subject to I.R.C. § 7872, and, if so, whether it is a demand or a term loan.

2. Whether § 482 may be applied to deem an interest payment subject to withholding tax, assuming that the note will be debt that is not subject to § 7872.

CONCLUSIONS

1. The note issued by the Taxpayer to the Parent should not be treated as debt. Instead, the Taxpayer should be treated as issuing additional stock to the Parent in exchange for the trademarks it received from the Parent. The transaction should be recharacterized as a contribution of the trademarks by the Parent to the capital of the Taxpayer. As so recharacterized, the transaction is tax-free. If this note were to be respected as debt, we conclude that § 1274 would apply instead of § 7872, although there are risks in this position.

2. Under the assumed facts, we conclude that § 482 will not be applicable since the rate on the note, including the original issue discount ("OID") determined under § 1274, will necessarily meet the safe harbor interest rate of between 100% and 130% of the applicable federal rate on the date the note was issued. See § 1.482-2(a)(2)(iii)(B). The amount of OID imputed under § 1274 will be subject to the rules of § 163(e)(3) which defer a deduction to the Taxpayer until the OID is actually paid to its related party Parent. Since no payments have been made on the note, no deduction will be permitted and § 482 will not be applied to deem a payment made. Accordingly, no withholding tax is imposed under § 1442 to the Taxpayer.

FACTS

The Taxpayer is a US corporation wholly owned by the Parent, a foreign entity whose residence is in A. The Taxpayer was incorporated in Date 1 and is in the D business.

On Date 2 the Parent assigned to the Taxpayer certain trademarks. Pursuant to the terms of the Trademark Assignment Agreement (the "note"), the Parent agreed to sell, assign and transfer all of its right, title and interest in the trademarks. The Taxpayer agreed to pay the Parent a total of $B, payable at the rate of C% of the Taxpayer's annual net profit until paid in full. The parties agreed that the net profit would be determined by reference to the Taxpayer's audited annual financial statements. Payment on the note was to be made once a year, and no later than 15 days after the issuance of the Taxpayer's audited annual financial statements, but

no later than April 30 of each year. No interest was provided for in the note, and no repayment date was established.

The Taxpayer has made no payments of any nature pursuant to this note, and no cash has been transferred in connection with this transaction. We have assumed for purposes of this discussion that the Taxpayer has neither claimed an interest deduction nor any other tax benefit associated with classifying this note as debt.

LAW AND ANALYSIS

Issue 1

Section 7872 recharacterizes certain below-market loans as arm's length transactions in which a lender makes a loan to a borrower in exchange for a note requiring the payment of interest at the applicable Federal rate. KTA-Tator, Inc. v. Commissioner, 108 T.C. 100, 102 (1997). Section 7872 applies to a transaction that is: (1) a loan; (2) subject to a "below-market" rate of interest; and (3) described in one of several enumerated categories. See I.R.C. §§ 7872(c)(1), 7872(e)(1) or 7872(f)(8).

1. Debt

The first issue is whether the Taxpayer's note qualifies as a loan under § 7872. The term "loan" is not defined in § 7872. When Congress enacted § 7872, Congress stated it intended "that the term 'loan' be interpreted broadly in light of the purposes of the provision. Thus, any transfer of money that provides the transferor with a right to repayment may be a loan. For example, advances or deposits of all kinds may be treated as loans." H.R. Conf. Rep. No. 98-861, 2d Sess., at 1018 (1984), 1984-3 C.B. (Vol. 2) 272.

A transfer of funds from a corporation to a shareholder is considered debt, rather than equity, if at the time of the distribution the parties intended that it be repaid. Crowley v. Commissioner, 962 F.2d 1077, 1079 (1st Cir. 1992), citing Alterman Foods, Inc. v. United States, 611 F.2d 866, 869 (Ct. Cl. 1979) (involving loans from a shareholder to a corporation). Courts typically determine whether the requisite intent to repay was present by examining available objective evidence of the parties' intentions, such as: the degree of corporate control enjoyed by the taxpayer; the corporate earnings and dividend history; the use of customary loan documentation, such as promissory notes, security agreements or mortgages; the creation of legal obligations attendant to customary lending transactions, such as payment of interest, repayment schedules and maturity dates; the manner of treatment accorded the distributions, as reflected in corporate records and financial

statements; the existence of restrictions on the amount of the distribution; the magnitude of the distributions; the ability of the shareholders to repay; whether the corporation undertook to enforce repayment; the repayment history; and the taxpayer's disposition of the funds received from the corporation. Crowley, supra. Although this case involves a loan from the shareholder to the corporation, the analysis is the same. We discuss the relevant factors below.

Related Party Debt

The advances in this case are subject to strict scrutiny because the purported creditor (the Parent) and the purported debtor (the Taxpayer) are related parties (i.e., the Parent owns all of the stock of the Taxpayer). See In re Uneco, Inc., 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. Finance 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).

However, there must be something more than this to support the inference that the parties did not intend to treat the advance as bona fide indebtedness. See Piedmont Corp. v. Commissioner, 388 F.2d 886 (4th Cir. 1968); Liflans Corp. v. United States, 390 F.2d 965 (Ct. Cl. 1968).

Formal Indicia

The note lacks even the formal indicia of indebtedness. Even though it required the payment of a sum certain ($B), there was no fixed maturity date. Rather, the debt was to be repaid when the Taxpayer had earned sufficient net profit. Compare Commissioner v. O.P.P. Holding Corp., 76 F.2d 11 (2d Cir. 1935) (provision for payment of a sum certain with fixed interest rate supports debt characterization). See also United States v. Title Guarantee & Trust Co., 133 F.2d 990 (6th Cir. 1943) (fixed maturity date one of most important factors in determining debt status).

In this case, the Taxpayer was newly formed. Thus, the Parent had no assurance that the Taxpayer would be able to generate sufficient net profits to repay the note. Therefore, this factor does not favor respecting the characterization of the note as debt.

Treatment By the Parties

The parties' treatment of the note is crucial in determining whether its characterization as debt should be respected. See Yale Ave. Corp. v. Commissioner, 58 T.C. 1062 (1972). See also Waller v. United States, 78-1 USTC ¶ 9394 (D. Neb. 1978) (failure to enforce outweighs formal indicia).

As noted above, the note did not provide for the payment of interest. Therefore, this factor does not favor respecting the characterization of the note as debt.

Expectation of Repayment

Not only must the purported creditor expect repayment, the expectation must be reasonable. Repayments dependent on the fortunes of the business indicate equity. Dixie Dairies Corp. v. Commissioner, 74 T.C. 476 (1980), acq., 1982-2 C.B. 1; Estate of Mixon v. Commissioner, 464 F.2d 394 (5th Cir. 1972). In this case, payment on the note was only intended to be out of the fortunes of the Taxpayer's business, i.e., C% of its net profits. Therefore, this factor does not favor respecting the characterization of the note as debt.

2. Exceptions to § 7872

Assuming, arguendo, that the note at hand represents indebtedness, we shall determine whether § 1274 applies to the note. Pursuant to § 7872(f)(8), § 7872 does not apply to any loan to which § 1274 applies.

Section 1274 generally applies to any debt instrument given in consideration for the sale or exchange of property if the stated redemption price at maturity for the debt instrument exceeds the imputed principal amount of the debt instrument, in any case where there is not adequate stated interest, and some or all of the payments due under such debt instrument are due more than 6 months after the date of such sale or exchange. I.R.C. § 1274(c)(1). Because Taxpayer's note was given in exchange for property (the trademarks) and does not provide for interest, the note's principal amount will be its imputed principal amount, determined pursuant to § 1274(b). The note's stated redemption price at maturity will exceed its imputed principal amount, and some or all of the payments due under the note are due more than 6 months after the date of the sale or exchange. Therefore, § 1274 applies to this transaction unless the transaction is otherwise excepted by regulation.

Treas. Reg. § 1.1274-1(b)(3)(ii) excepts from § 1274 any demand loan that is a below-market loan described in § 7872(c)(1). Section 7872(c)(1)(C) provides that

§ 7872 applies to any below-market loan between a corporation and one of its shareholders. Section 7872(f)(5) defines a "demand loan" as any loan which is payable in full at any time on the demand of the lender.

The Tax Court in KTA-Tator, supra, addressed whether a loan from a closely-held corporation to its sole shareholder was a demand or a term loan. The advances in this case were made without written repayment terms. In determining that the corporation's advances were demand loans pursuant to § 7872(f)(5), the court looked to the fact that the corporation had made loans to its sole shareholder without written repayment terms, and had unfettered discretion to determine when the loans would be repaid. KTA-Tator, 108 T.C. at 104.

Unlike the lender in KTA-Tator, the present Taxpayer's lender Parent did not have unfettered discretion to determine when the note would be repaid. Repayment of Taxpayer's note was required to be made in accordance with the note's written repayment terms, i.e., from Taxpayer's future profits. Thus, this note would not be classified as a demand loan under KTA-Tator and in the absence of regulations under § 7872(f)(5), and would not fit within the exception from § 1274 under Treas. Reg. § 1.1274-1(b)(3)(ii).[1] Accordingly, if the note is not treated as a demand loan for federal income tax purposes, § 1274 would apply to the note.[2]

Under § 1274, the issue price and imputed principal amount of this note would be determined pursuant to §§ 1274(a)(2), 1274(b) and Treas. Reg. § 1.1274-2(b)(1). The amount and timing of imputed interest and OID would be determined pursuant to Treas. Reg. § 1.1274-2(a), § 1272 and the regulations thereunder. Any OID on the note would be deductible only to the extent permitted in § 163. OID on a note held by a related foreign person, as defined in § 267(b), is deductible only to the extent that it is actually paid. I.R.C. § 163(e)(3). A corporation which is a member of the same controlled group as another corporation is included in the definition of a foreign person related to the issuer. I.R.C. §§ 267(b) and (f).

We do not know whether the Taxpayer and the Parent are related foreign persons, as defined in § 163(e)(3) and § 267(b). If they are, however, then the Taxpayer would not be able to deduct OID because no interest was actually paid.

Issue #2

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[1] If § 7872 were to apply to this note, it would be a term loan because a term loan is defined as any loan which is not a demand loan. I.R.C. § 7872(f)(6).

[2] We note that § 1274 applies only to instruments that represent debt for federal income tax purposes.

For purposes of the discussion below, we assume that the value of the transferred intangible is less than the $B face amount of the note. We understand that no information surrounding the valuation is available at this time.

In determining whether § 482 applies, Treas. Reg. § 1.482-2(a)(3) provides an ordering rule for the coordination of § 482 with other sections of the Code including §§ 1274 and 7872. The regulation provides that, first, the substance of the transaction is tested and that only the rate of interest with respect to the principal amount of bona fide indebtedness may be adjusted. The second step is to determine whether any other amount besides stated interest should be treated as interest under another section. Therefore, whether the Taxpayer has OID under § 1274 would be determined under this step. Third, the amount of interest determined under the terms of the debt instrument as adjusted by another other section under the second step is tested under § 482 to determine if the newly adjusted amount of interest would produce an arm's length rate of interest. Pursuant to this step, the amount of OID under § 1273 that is imputed under § 1274 will require the use of an applicable Federal rate pursuant to § 1274(d) and the rules under Treas. Reg. § 1.1274-4. The interest rates in this section correspond to a safe harbor provision provided in Treas. Reg. § 1.482-2(a)(2)(iii)(B). Accordingly, by application of § 1274, the imputed interest will necessarily be at an arm's length rate within the meaning of § 482 if it is correct to treat all interest under the note as OID.

During the tax years at issue, the Taxpayer would not be liable to withhold on OID under § 1442, because no withholding is required on OID until the OID is actually paid. Section 1442(a) provides that withholding tax of 30 percent is imposed on the items of income provided in § 1441(a). Section 1442(b) provides that the items of income in § 1441(a) includes interest other than OID. Accordingly, OID is not subject to withholding until paid. Assuming the note is finally paid, the Taxpayer will deduct the OID, and tax will be imposed on the foreign Parent under § 881(a)(3). The tax imposed by § 881(a) will be subject to withholding under § 1442. See §§ 1442(a) and 1441(b) (reference to § 871(a)(1)(C)).

If, however, the transferred intangible is over or undervalued, § 482 may still be applied to adjust the sale price which in turn may be used to determine whether or not the instrument should be classified as bearing OID under § 1274. Further, if it is determined that the value of the property was not less than the $B amount specified in the term of the note, and if it is determined that § 7872 would not apply to this transaction by operation of Treas. Reg. § 1.7872-5T(b)(10)[3],Treas. Reg.

[3] Treas. Reg. § 1.7872-5T(b)(10) provides an exception from § 7872 for certain loans made to or from a foreign person.

§ 1.482-2(a)(3) provides for the potential application of § 482.

We wish to emphasize that the above analysis is based on the assumption that the instrument, if treated as debt in the first instance, will be properly classifiable under § 1274 and that all interest expense of the Taxpayer will be OID. There may be questions as to the value of the property received in exchange for the note, which may change our analysis. Because we are treating this note as equity, this may be irrelevant.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

As set forth above, we conclude that the note issued by the Taxpayer to the Parent should not be treated as debt. Instead, the Taxpayer should be treated as issuing additional stock to the Parent in exchange for the trademarks it received from the Parent as a contribution of the trademarks by the Parent to the capital of the Taxpayer. As recharacterized, the transaction is tax-free.

If the note were treated as debt for federal income tax purposes, we conclude that § 1274 would apply, and, therefore, § 7872 would not apply. [redacted]

In evaluating whether to pursue a valuation that results in the imputation of interest that may be subjected to a § 482 allocation, Examination should give strong consideration [redacted] In this regard, a permissible allocation will give rise to a current 30% withholding tax that would be offset by a 34% or 35% tax benefit should the deductions ever be utilized. If there is no likelihood that any of the deductions would ever be utilized, additional debt/equity considerations will need to be evaluated notwithstanding that the note was never formally capitalized by the Taxpayer.

If the Taxpayer should characterize this note as a debt instrument to which § 1274 applies, we will be pleased to provide additional assistance on an OID computation if necessary.

Please call if you have any further questions.

JOEL E. HELKE, Chief
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