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

MEMORANDUM FOR ASSOCIATE DISTRICT COUNSEL
CC:WR:SCA:SD
ATTN: YVONNE PETERS

FROM: Paul Epstein
Senior Technical Reviewer CC:INTL:BR5

SUBJECT:

This Field Service Advice responds to your memorandum dated December 15, 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 =
C =
D =
E =
F =
G
H
J
K
Accounting Firm
Date 1
= Date 2
= Date 3
= Date 4
= Date 5
= Date 6

Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 11	=
Date 12	=
Date 13	=
Date 14	=
Month Z	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Country A	=
State A	=
State B	=
Business X	=
$a	=
$b	=
$c	=
$d	=
$e	=
$f	=
$g	=
$h	=
$j	=
$k	=
$m	=
s%	=
t%	=
u%	=
v%	=
w%	=
x%	=
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ISSUES

1. Whether the transfer of $d by Taxpayer to Parent for the guarantee by Parent of C and D's equity contributions to G is subject to tax under section 4371 of the Internal Revenue Code.

2. Whether the business profits article of the Treaty exempts the $d transfer from U.S. taxation as “commercial or industrial profits” not attributable to a permanent establishment maintained by Parent within the United States.

CONCLUSIONS

1. The transfer of $d by Taxpayer to Parent is not subject to tax under section 4371 because the transfer does not constitute a payment for “insurance” or an “indemnity bond” as defined in section 4371. In the case at hand, there is insufficient risk-shifting and risk-distribution to constitute “insurance” or an “indemnity bond” within the context of insurance and, thus, within the context of section 4371. In addition, a guarantee by a parent corporation of the debt of a subsidiary is not a transaction contemplated by section 4371. The purpose of section 4371 was to equalize the competitive positions of domestic insurance companies that are subject to U.S. taxation and foreign insurers that are not subject to such tax.

2. Assuming that Parent does not maintain a permanent establishment in the United States to which its U.S. source guarantee income is attributable, the business profits article of the Treaty will exempt such income from U.S. taxation only if the income is derived in connection with the active conduct of a trade or business, by Parent, in Country A. If the payment is not derived in connection with the active conduct of a trade or business by Parent in Country A, the payment will not constitute industrial or commercial profits under the Treaty and will be subject to 30 percent withholding tax. We do not have sufficient facts on which to base a determination as to whether the guarantee fee, if such form is respected, will be considered to be attributable to the active conduct, by Parent, of a trade or business in Country A. Thus, we cannot make a determination as to whether such income would be exempt from U.S. taxation under the business profits article of the Treaty.

FACTS

Taxpayer is a wholly owned U.S. subsidiary of Parent, a Country A corporation. Taxpayer is engaged in Business X.

Year 1

On Date 1, Year 1, Taxpayer and Parent entered into a Memorandum of Understanding (MOU) regarding their participation in a Business X project in the United States with F, an unrelated domestic corporation. The MOU included the following provisions:

> Paragraph 2. Development loan – Through a special purpose subsidiary, Taxpayer will provide a development loan to fund the project. In return, Taxpayer and/or the subsidiary will receive a fee and a return on the loan.
>
> Paragraph 3. Equity underwriting – "For consideration and in return of providing back-up guaranty" for Taxpayer's and/or the special purpose subsidiary's equity contributions to the project and for arranging the source of funds for the subsidiary's actual equity contribution, Taxpayer will transfer to [Parent] the special purpose subsidiary's rights to receive an equity distribution from the project ("Receiving Rights").
>
> Paragraph 4. Optional right – Taxpayer will have an option to purchase from Parent the Receiving Rights at fair market value upon completion of the project.

Year 2

On Date 2, Year 2, prior to commencement of the project, F formed G, a limited partnership, under State B law for the purpose of developing, financing, constructing, owning, and operating the project. G's initial partners were two domestic subsidiaries of F, H and J. H held a t% general partnership interest, and J held a u% limited partnership interest.

On Date 3, Year 2, H and Taxpayer executed a "Joint Development Agreement," under which H would be the primary developer of the project, and Taxpayer would participate as co-developer by providing funding. Specifically, Taxpayer agreed to loan G $a ("development loan") and to provide equity funding upon completion of the project equal to the lesser of v% or the project's cost, not to exceed $b. The Joint Development Agreement required Parent to execute a guarantee of this equity funding. The agreement contemplated that most of the project's cost would be funded by other entities, using a combination of debt and equity contributions. The debt would consist of (1) a construction loan which was expected to be in the full amount of the project cost of $f, and (2) a permanent or term loan which was expected to be in the full amount of the project cost, accompanied by a standby letter of credit facility with a term of approximately 15 years from the term loan closing.

Under the terms of the Joint Development Agreement, Taxpayer was entitled to a developer fee ranging from s% to s%+5% of the funds Taxpayer loaned to G and a management fee of the same percentage range, depending on the closing date of the construction loan and/or term loan. These fees were to be paid out of the proceeds of the construction loan at the time of the construction loan closing or later. "Delay interest" accrued to the extent the construction loan or term loan closed after certain specified dates. Any unpaid portion of Taxpayer fees or delay interest outstanding as of the term loan closing was to be converted to debt.

Pursuant to the Joint Development Agreement, Taxpayer provided a $a development loan to G on Date 3, Year 2. The loan was non-interest bearing unless G defaulted. Taxpayer secured the funds for the development loan through a $b line of credit from E, a domestic financing subsidiary of Parent. E was entitled to interest equal to LIBOR plus 75 basis points, plus "additional interest" equal to v% of Taxpayer's book income, subject to the restrictions that total interest payable would not exceed the maximum interest rate permitted under applicable law, and that additional interest would not exceed 12.5% of the outstanding principal.

In the middle of or late in Month Z, K provided the $f construction loan to G. (K also agreed to make capital contributions at a later date to G in exchange for a limited partnership interest.) A condition of K's construction loan and capital contributions was that Parent would provide K a guarantee of Taxpayer's equity funding, i.e. C and D's capital contributions to G discussed below. (Parent executed the guarantee several weeks later, on Date 5, Year 2.) A portion of the proceeds from the construction loan from K was used to pay off Taxpayer's $a development loan and pay Taxpayer a s% developer fee.

On Date 4, Year 2, Taxpayer formed two subsidiaries, C and D, apparently for the purpose of participating in the project. According to the Examination division, the books and records of C and D show that they are shell corporations.

Eight days later, on Date 5, Year 2, J withdrew from G, and C and D became w% and x% limited partners in G, respectively, as a result of a $c initial aggregate contribution. C and D agreed to make additional equity contributions to G so that its aggregate contributions totaled $e. On the same day, Parent executed a guarantee in favor of G and K with respect to C and D's $e equity contributions. The taxpayer states that Parent was at risk for the $e equity contribution "since [Parent] supported [E] by guaranteeing the lending which [E] made to [Taxpayer]."

See IDR IE #2, response 4a (Oct. 3, 1998). Additionally, if E was "unwilling or unable to make the loan at the time the equity contribution was due, [Parent]'s backup guarantee would have been called upon. This is exactly what was contemplated by paragraph 3 of the MOU, which provides that in addition to providing the backup guarantee, [Parent] would arrange a source of funding for the equity contribution." *Id.*

C and D obtained the funds from loans from E of $g and $h, respectively, through a $b line of credit from E. Both loan documents were dated Date 11, Year 2. E was entitled to interest equal to LIBOR plus 75 basis points and "additional interest" in the form of an equity kicker equal to v% of G's equity distribution to C and D. Total interest paid to E, however, was not to exceed v% of the outstanding loan principal. Although the loan documents are dated Date 11, Year 2, C and D did not contribute the loan proceeds until Date 14, Year 4. The current status of the loans from E to C and D is unknown. We note that the closing date of the loans was before the date C and D came into existence.

<u>Year 3</u>

In a letter dated Date 6, Year 3, Taxpayer indicated to Parent that Taxpayer wished to execute its optional right to repurchase the equity rights that Taxpayer had transferred to Parent in accordance with the Date 1, Year 1 MOU. The letter identified three conditions of the exercise of the option:

> 1. Parent will "relinquish the Receiving Rights based on the market value." The current condition is the "net present value based on pre-tax IRR 13%-18%."
>
> 2. Taxpayer requests Parent "to arrange the guaranty as the equity contribution commitment under the construction period."
>
> 3. The amount would be determined after the construction closing, based on the "Project Base Case Cash Flow."

Less than a month later, on Date 7, Year 3, Taxpayer and Parent signed a document entitled "Agreement of Clarification" regarding the Date 1, Year 1 MOU. The four items discussed in the agreement of clarification were:

> 1. Parent's obligations to provide a guaranty for Taxpayer's and/or its special purpose subsidiary's equity contributions to the project and for arranging the source of funds for the subsidiary's actual equity

contribution (see paragraph 3 of MOU) would apply during the construction period only.

2. The Receiving Right “constitutes an undertaking by [Taxpayer, C, and D] to pay [Parent] for [Parent]’s undertakings in paragraph 3 of the MOU by remittances out of a portion of the equity distributions and merely represents an agreed-upon means by which to pay a fee to [Parent] for its surety and assistance services and not a payment to [Parent] for any kind of property interest.”

3. “The remittances specified in paragraph 2 hereof are intended to compensate [Parent] for its undertakings arising pursuant to paragraph 3 of the MOU, such amount having a quantifiable value to which the parties agreed at the time of the original execution of the MOU.”

4. “The option available to [Taxpayer, C, and D] in paragraph 4 of the MOU is a lump sum payment option that represents an election available to [Taxpayer, C, and D] to prepay its fee at fair market value and not to purchase any kind of property right from [Parent].”

Also on Date 7, Year 3, Taxpayer and Parent executed another agreement regarding the amount Taxpayer would pay for exercising its optional right. Referring to an attached document “Base Case Cash Flow,” Taxpayer agreed to pay Parent $d by Date 9, Year 3. The precise reason for the $d payment is unclear, and the taxpayer appears to have provided inconsistent explanations for the payment. The Date 7, Year 3 agreement refers to Taxpayer’s exercise of its optional right as the reason for the $d payment, but Notes to Taxpayer’s Consolidated Financial Statements state that the payment was for “service provided by Parent in connection with securing [Taxpayer]’s limited partnership interest” in G. Further, an IDR response states that the $d payment was compensation for guaranteeing the Taxpayer-E loan <u>and</u> for guaranteeing the $e capital contributions of C and D. IDR IE #2, response 7a (Oct. 30, 1998). We currently only have documentation of Parent’s guarantee in favor of K and G relating to C and D’s $e capital contribution obligations.

Less than a month later, Taxpayer paid $d to Parent on Date 8, Year 3. Taxpayer apparently obtained these funds through a loan from E, although it is unclear whether this loan was part of or separate from the $b credit line extended to Taxpayer that Taxpayer drew upon to make the development loan to G.

In a letter dated Date 10, Year 3, Accounting Firm provided Taxpayer an appraisal of the fair market value of the amount of the fee paid by Taxpayer to Parent pursuant to the MOU. Specifically, Accounting Firm calculated “a range of reasonable pre-tax discount rates to be applied to the projected future cash flows” from G to Taxpayer. Accounting Firm concluded that a 14-16% pre-tax discount rate was reasonable. It is unknown whether Accounting Firm provided a prior appraisal; the letter, which is dated approximately two months after the $d transfer, is labeled “revised.”

Besides the $d payment from Taxpayer to Parent, Parent did not receive any return on its equity rights in G or any other income from the project. Taxpayer contends that it transferred an income stream, not equity rights, to Parent, and that Parent did not receive an income stream because Taxpayer made a $d prepayment.

Year 4

On Date 12, Year 4, K made its first capital contribution of $j to G and became a limited partner. C and D made additional capital contributions totaling $k.

Commercial operation of the power plant began on Date 13, Year 4, and project construction was completed later that year. On Date 14, Year 4, K made a capital contribution, and C and D contributed $e to G (which were from loans of the same amount from E). All outstanding construction loans were deemed repaid.

Taxpayer’s return position

With its Year 3 tax return, Taxpayer attached a balance sheet treating the payment as an asset categorized as “investment in partnerships.” The payment was not otherwise reported on Taxpayer’s Year 3 return. On its Year 4 return, Taxpayer claimed two deductions that totaled $m, almost precisely half of the $d transfer.[1] The deductions were identified as “Amortization – In Service Prior Year” and “Amortization – In Service This Year.” Failing to claim an amortization deduction on its Year 3 return, Taxpayer states that it “forgot” to claim the deduction in Year 3 and requests that it be permitted to amend its Year 4 Net Operating Loss Carryforward to include the $m deduction not taken in Year 3. Taxpayer asserts that for tax purposes the $d payment should be amortized over the life of the guarantee (Date 5, Year 3 to Date 14, Year 4). For financial accounting purposes, however, Taxpayer amortized the $d payment over the 30-year life of the project.

During the audit, Taxpayer has provided inconsistent explanations of the $d payment, stating at one point that Taxpayer regards the payment as a fee paid to Parent in exchange for Parent’s guarantee of equity payments by C and D to G and

[1] It is unclear from the facts as to why the deductions claimed on the Year 4 return totaled $m rather than precisely half of the $d payment.

also for Parent's guarantee of Taxpayer's repayment of one or more loans, and later stating in its protest letter that the guarantee relates only to the obligations of Taxpayer's special purpose subsidiaries, C and D, to make capital contributions to G. For purposes of this Field Service Advice, we assume that Taxpayer's position is as stated in the protest letter.

Taxpayer now asserts that the transaction should be characterized as insurance, and as such, the payment to Parent should be treated as (1) a deductible insurance premium, (2) exempt from U.S. withholding tax under the business profits article of the Treaty, and (3) not subject to tax under section 4371.

LAW AND ANALYSIS

This Advice addresses the international tax issues implicated in the taxpayer's transaction, and also takes into account facts that have been developed since the issuance of the previous Field Service Advice by the Office of Assistant Chief Counsel (Field Service) on November 8, 1999.

Form of the transaction

The form of the transaction at issue is that of a guarantee arrangement between Parent and Taxpayer under which Parent guaranteed that C and D would make equity contributions to G. Taxpayer compensated Parent for the provision of the guarantee by paying Parent $d. Contemporaneous documentation, including the the Parent-Taxpayer guarantee agreement and Agreement of Clarification, evidences that both parties treated the payment as a guarantee fee. For example, the Agreement of Clarification stated that (1) Parent's obligation was to provide a guaranty for Taxpayer's and/or its special purpose subsidiary's equity contributions to the project and for arranging the source of funds for the subsidiary's actual equity contribution; (2) the Receiving Rights discussed in the MOU "merely represents an agreed-upon means by which to pay a fee to Parent for its surety and assistance services and not a payment to Parent for any kind of property interest"; and (3) Taxpayer's option described in the MOU merely allowed Taxpayer to prepay the guarantee fee and was not a purchase of any kind of property right from Parent. Moreover, Parent's guarantee was a precondition to K's construction loan and capital contributions to the project.

Whether the transfer of $d by Taxpayer to Parent for the guarantee by Parent of C and D's equity contributions to G is subject to tax under section 4371 of the Internal Revenue Code.

The taxpayer claims that the payment made by Taxpayer to Parent constitutes a payment for "insurance" or, in the alternative, for an "indemnity bond," for federal income tax purposes and, as such, falls within the scope of section 4371 of the Code.[2]

Section 4371 imposes a tax on each policy of insurance, indemnity bond, annuity contract or policy of reinsurance issued by any foreign insurer or reinsurer. Pursuant to section 4371(1), the tax is imposed at a rate of four cents on each dollar, or fractional part thereof, of the premium paid on a policy of casualty insurance or indemnity bond, if issued to or for, or in the name of an insured as defined in section 4372(d).

Pursuant to Section 4372(a), the term “foreign insurer” is defined as:

> an insurer...who is a nonresident alien individual, or a foreign partnership, or a foreign corporation. The term also includes a nonresident alien individual, foreign partnership or foreign corporation which shall become bound by an obligation of the nature of an indemnity bond.

An “indemnity bond” is defined under section 4372(c) as:

> any instrument by whatever name called whereby an obligation of the nature of an indemnity, fidelity, or surety bond is made, continued, or renewed. The term includes any bond for indemnifying any person who shall have become bound or engaged as surety, and any bond for the due execution or performance of any contract, obligation or requirement, or the duties of any office or position, and to account for money received by virtue thereof, where a premium is charged for the execution of such bond.

The Service has long held that an element of risk-shifting (from the insured to the insurer) and risk-distribution (by the insurer) is one of the requisites of a true insurance contract. *See Helvering v. LeGierse,* 312 U.S. 531 (1941). That being the case, it is clear that section 4371, which imposes a tax on policies of insurance issued by foreign insurance companies, is not applicable in the instant case because there is no insurance contract. In particular, there was no distribution by Parent of any purported risk it had with respect to the obligations of its subsidiaries to capitalize G.

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[2] Taxpayer earlier asserted that for tax purposes the character of the $d payment is an insurance premium deductible under Code section 162. DOM:FS:FI&P concluded in a November 8, 1999 Field Service Advice that the payment does not qualify as a deductible insurance premium because the arrangement does not involve sufficient risk shifting to be considered insurance.

We recognize that the section 4372(c) definition of an indemnity bond might be interpreted to include within its terms contractual arrangements that might not ordinarily be considered insurance. A contract of indemnity may be nothing more than a simple promise to reimburse. In such a case, outside traditional insurance concepts, risk-distribution and risk-shifting are not essential elements of the contract. Nevertheless, within the context of section 4371, which imposes tax on policies of insurance issued by foreign insurers, we are compelled to view the term "indemnity bond" as defined in section 4372(c) to be an indemnity within the insurance context. Accordingly, to be an indemnity issued by a foreign insurer, risk-distribution and risk-shifting are essential elements. Gen. Couns. Mem. 35,483 (September 17, 1973).

Parent's guarantee in the case at hand does not involve sufficient risk-shifting to constitute an "indemnity bond" within the context of "insurance." Further, implicit in the concept of insurance is that the loss occurs as the result of events that are fortuitous, rather than planned, intended or anticipated. At the time C and D were obligated to provide capital to G, C and D were special purpose subsidiaries which had no source of funds other than capital contributions from either Taxpayer or Parent. Accordingly, Parent could "create" a loss event covered by the guarantee by failing to adequately capitalize C and D. Since Parent had complete control over whether C and D were able to meet their obligations to G, the event covered by the guarantee was not "fortuitous" from Parent's standpoint. Therefore, the guarantee cannot constitute insurance or an indemnity bond under section 4371 and, thus, is not subject to the excise tax under section 4371.

In addition to the fact that the guarantee does not fall within the definition of the term insurance or "indemnity bond" as contemplated by section 4372(c); the situation, a guarantee of a subsidiary's obligation by a parent corporation, falls outside the scope of what is contemplated by and taxable under section 4371.

While the insurance premium excise tax originated in legislation enacted in 1918, the format of current section 4371 was the result of the Revenue Act of 1942, §502, P.L. 77-753, which amended section 1804 of the 1939 Code, the predecessor of section 4371. The legislative history of the 1942 legislation indicates that, while the tax is a revenue raiser, it will "at the same time eliminate an unwarranted competitive advantage now favoring foreign insurers." H.R. Rep. No. 2333, 77th Cong., 1st Sess. 61 (1942). The purpose of the insurance excise tax was also explained, as follows, in *United States v. Northumberland Ins. Co., Ltd.*, 521 F.Supp. 70 (D. N.J. 1981):

> [t]he competitive imbalance Congress sought to rectify stemmed from the fact that premiums paid to foreign insurance companies not engaged in a trade or business in the United States were not subject

> to any United States income tax, including withholding tax. [Citations omitted.]

Thus, the attempt was to equalize the competitive positions of domestic insurance companies that are subject to United States taxation and foreign insurers that are not subject to such tax. The situation at hand, does not fall within the scope of what is contemplated by section 4371.

In view of the foregoing, we conclude that fees received by Parent for its guarantee would not be subject to the section 4371 excise tax.

<u>Whether the guarantee payment is subject to withholding tax under the Code.</u>

Section 881 of the Code provides, generally, that a foreign corporation is subject to a 30-percent tax on amounts received from sources within the United States as interest (other than original issue discount as defined in section 1273), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income, but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.

Sections 861, 862, 863, and 865 of the Code provide rules for determining the source of certain types of income. None of these Code sections, however, provide specific rules on the source of guarantee payments. Where an item of income is not characterized by statute or regulation, courts have sourced the item by comparison and analogy with the most closely related items of income specified within the statutes. *Bank of America v. United States*, 680 F.2d 142, 147 (Ct. Cl. 1982). Courts have sourced guarantee fees by analogy to interest because the fees are paid in exchange for the assumption of credit risk. *See Centel Communications Co. v. Commissioner*, 92 T.C. 612 (1989), *aff'd*, 920 F.2d 1335 (7th Cir. 1990); *Bank of America v. United States*, 680 F.2d 142 (Ct. Cl. 1982). Accordingly, because interest is sourced under sections 861(a)(1) and 862(a)(2) by reference to the residence of the obligor, the $d guarantee fee paid by Taxpayer, a U.S. corporation, is U.S. source income.

Because Parent is not actively engaged in the conduct of a trade or business within the United States, any U.S. source income that it earns would not be considered income effectively connected with a U.S. trade or business. Such income would, therefore, be subject to gross basis taxation as fixed, determinable, annual or periodic ("FDAP") income under section 881(a)(1) of the Code if is not otherwise covered by the business profits article of the Treaty. The $d transfer is a guarantee fee that constitutes U.S. source FDAP income, subject to a 30 percent withholding tax under section 1442 of the Code, unless covered by the Treaty.

<u>Whether the business profits article of the Treaty exempts the transfer from U.S. taxation as “commercial or industrial profits.”</u>

As noted above, Taxpayer contends that the fee it paid to Parent is a payment for insurance and, therefore, falls within the scope of section 4371. Taxpayer concludes, however, that such income is not subject to taxation under section 4371 because the income is “commercial or industrial profits” not attributable to a permanent establishment in the United States and, thus, is exempt from U.S. taxation under the business profits article of the Treaty. Taxpayer notes that the term “industrial and commercial profits” is defined under the business profits article of the Treaty to include insurance income. As noted above, it has been determined that the income received by Parent from Taxpayer does not constitute insurance income. Rather, in respecting Taxpayer’s form of the transaction, we conclude that the $d payment is characterized as a guarantee fee.

The business profits article of the Treaty provides, in part, that:

> [i]ndustrial or commercial profits of a resident of a Contracting State shall be exempt from tax by the other Contracting State unless such resident is engaged in industrial or commercial activity in that other Contracting State through a permanent establishment situated therein.

The business profits article of the Treaty defines the term “industrial or commercial profits” as including:

> income derived from the manufacture, mercantile, insurance, agricultural, fishing or mining activities, from the operation of ships or aircraft, from the furnishing of personal services, and from the rental of tangible personal property (other than ships or aircraft). Such term also includes income derived from real property and natural resources; dividends, interest, royalties...; and capital gains but only if the right or property giving rise to such income, dividends, interest, royalties, or capital gains is effectively connected with a permanent establishment which the recipient, being a resident of a Contracting State, has in the other Contracting State.

The Technical Explanation to the business profits article of the Treaty, prepared by the Treasury Department, provides in relevant part that “the term ‘industrial or commercial profits’ is defined by setting forth several examples of activities which constitute the active conduct of a trade or business....”

Regardless of the fact that the income received by Parent does not constitute insurance income and assuming Parent does not maintain a permanent establishment in the United States to which its U.S. source guarantee income is attributable, the business profits article of the Treaty may exempt such income from U.S. taxation, but only if the guarantee income is derived in connection with the active conduct of a trade or business, by Parent, in Country A. There is no requirement that Parent be engaged in the active conduct of a trade or business within the United States for such income to qualify for exemption. *See, e.g.,* Rev. Rul. 86-156, 1986-2 C.B. 297 (interpreting Article III(5) of the 1948 U.S.-Netherlands income tax treaty, as amended by the Protocol signed December 30, 1965).

According to Rev. Rul. 86-156, however, there must be a relationship between the income derived and a trade or business conducted by the company in the foreign contracting state. *Id.* Because the language of the business profits article of the Treaty is very similar to the language of Article III(5) of the 1948 U.S.-Netherlands treaty, as amended by the protocol signed December 30, 1965, the business profits article of the Treaty will exempt U.S. source industrial or commercial profits from U.S. taxation provided that such amounts are attributable to a trade or business actively conducted by the taxpayer, in whole or in part, in Country A. Thus, if Parent is not involved in the active business of providing guarantees, the income derived from the guarantee of the equity contributions of C and D should not fall within the purview of the business profits article of the Treaty.

Some U.S. income tax treaties include an "Other Income" article that covers items or classes of income not otherwise covered by the treaty. The Treaty at issue contains no such provision and, thus, U.S. law applies to determine the appropriate tax treatment for such income. *See* I.R.C. section 894.

We do not have sufficient facts on which to base a determination as to whether the guarantee fee, if such form is respected, will be considered to be attributable to the active conduct, by Parent, of a trade or business in Country A. Thus, we cannot make a determination as to whether such income would be exempt from U.S. taxation under the business profits article of the Treaty.

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS</u>

<u>Application of section 482 by the Service if the Treaty applies</u>

If you determine that the guarantee payment is industrial and commercial profits under the Treaty and thus not subject to withholding tax, you may want to consider whether section 482 applies to the transaction at issue. [redacted]

As a transaction between a wholly owned subsidiary and its parent, the transaction is generally subject to the arm's length standard of section 482. [redacted] Indeed, we are unable to conclude from the facts indicated so far whether the transaction in question is one that would have taken place between unrelated parties, or whether it was a transaction that may be subject to challenge under other Code sections or judicial doctrines, such as substance over form, business purpose, or assignment of income.

<u>Holding Taxpayer to the form of the transaction and Taxpayer's use of section 482 principles</u>

If the Service were to respect the transaction as a guarantee arrangement and determine that the guarantee payment is subject to withholding tax because the payment is not derived in connection with the active conduct of a trade or business by Parent in Country A, Taxpayer may attempt to disavow the form of the transaction initially chosen (payment of a guarantee fee) in order to reduce its liability for withholding tax.[3] If it were successful in disavowing its form, Taxpayer may seek to apply the principles of section 482 to reduce the consideration attributable to the guarantee fee.

Generally, 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). The Supreme Court has long recognized, however, that a taxpayer, although free to structure his transaction as he chooses, "once having done so, he 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). Taxpayer would be subject to the "strong proof" rule articulated by the Tax Court if it were to take a position invoking the substance of a transaction that is contrary to its form. The Ninth Circuit, which governs the present case, has never adopted the *Danielson* rule and as a result, the Tax Court has followed the "strong proof" rule there. *See, e.g., Fountain Valley Transit Mix, Inc. v. Commissioner*, T.C. Memo. 1996-244; *Salyer Grain & Milling Co. v. Commissioner*,

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[3] [redacted]

T.C. Memo. 1986-165, *aff'd*, 815 F.2d 1265 (9th Cir. 1987). Based upon the strong proof rule, we believe it would be difficult for Taxpayer to overcome its burden of proof in attempting to disavow the form of the transaction it has chosen.

Even if Taxpayer were to meet its burden of proof, taxpayers are generally not allowed to make affirmative use of section 482. *See, e.g.*, *Morton-Norwich Products, Inc. v. United States*, 602 F.2d 270 (Ct. Cl. 1979), *cert. denied*, 445 U.S. 927 (1980). However, this general rule is qualified by Treas. Reg. § 1.482-1(a)(3), which allows taxpayers in certain circumstances to report the results of controlled transactions based upon prices different from those actually charged. This regulation leaves open the possibility of filing untimely or amended returns to reflect such results, where taxable income based on allocations or other adjustments with respect to controlled transactions is increased, and includes a cross reference to Treas. Reg. § 1.6662-6(a)(2). This section of the regulations restricts taxpayers, at least with respect to avoiding penalties, to reporting such results only in amended returns that are filed before the Service has contacted the taxpayer regarding the corresponding original return (or, in the case of a CEP taxpayer, before a written statement provided at the initial meeting).

Arguably, a consistent reading of Treas. Reg. §§ 1.482-1(a)(3) and 1.6662-6(a)(2) would require that an untimely or amended return to increase taxable income for purposes of Treas. Reg. § 1.482-1(a)(3) be made by the deadline provided in Treas. Reg. § 1.6662-6(a)(2) with respect to amended returns (or written statements for CEP taxpayers). The latter deadline is past in this case, since examination of the taxable period is complete and the matter is now in Appeals. Nevertheless, Treas. Reg. § 1.482-1(a)(3) does not unambiguously compel this conclusion, and the National Office has never reached a view on this issue, so in our view there are litigation hazards here, as well. If you desire, you could submit this issue relating to Taxpayer's possible use of the principles of section 482 to reduce the consideration attributable to the guarantee fee for further field service advice.

Earnings stripping provisions

Based on the information provided, the earnings stripping provisions do not materially apply to the transaction. In this regard, there is no evidence of a long term guarantee by Parent of Taxpayer's U.S.-based financing that would cause Taxpayer's interest payments to be characterized as disqualified interest under section 163(j). [redacted]

Please call (202) 622-3870 if you have any questions.

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