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

MEMORANDUM FOR

FROM:

SUBJECT:

This Field Service Advice responds to your memorandum dated November 5, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND

Corp A
Corp B
Sub C
Sub D
Sub E
Bank M
Bank N
Bank O
Date 1

Date 2
Date 3
Year F
Year G
Year H
Notional Amount P
Notional Amount Q
Notional Amount R
Sum U
Sum V
Sum W
Sum X
Sum Y
Sum Z
Country A
Area B

ISSUES

1. Should the entire transaction described below, which took the form of a notional principal contract between the U.S. parent and an unrelated foreign bank followed by the assignment of some of the contract's cash flows to two foreign subsidiaries of the U.S. parent, be recharacterized as a set of loans from the foreign subsidiaries to the U.S. parent on the ground that the transaction lacks economic substance?

2. If the transaction described below is recharacterized as a set of loans from the foreign subsidiaries to the U.S. parent, do such loans constitute an investment in U.S. property under section 956 of the Internal Revenue Code?

CONCLUSIONS

1. The transaction should be recharacterized as a set of loans from the foreign subsidiaries to the U.S. parent on the ground that it lacks economic substance.

2. Such recharacterized loans constitute an investment in U.S. property under section 956.

FACTS

A. Tax Planning Background

Corp A, a domestic corporation, owns indirectly all of the stock of Corp B, also a domestic corporation. Corp B owns directly all of the stock of Sub C, which owns directly all of the stock of Sub D, which owns directly all of the stock of Sub E. Sub C, Sub D, and Sub E are all Country A corporations.

In general, Sub C generated substantial earnings from its foreign manufacturing operations, none of which was subject to current U.S. taxation under subpart F of the Code. In contrast, the second- and third-tier Country A subsidiaries, Sub D and Sub E, traded mostly with affiliates and generated a small amount of income, all of which was subject to current U.S. taxation under Subpart F and thus constituted previously taxed income ("PTI") under section 959 of the Code. All of Sub D's and Sub E's earnings were distributed to Sub C as PTI.

Corp A's treasury department in the United States provided cash management services to Corp A, Corp B, and the Country A subsidiaries. Management in Country A had only minimal authority over the operating budgets of the Country A subsidiaries.

A significant portion of Sub C's earnings were transferred to Sub E, which held them in bank accounts in the United States. As of Date 1, Sum W had been transferred to Sub E. These transfers were booked as intercompany advances from Sub C to Sub E, but were designated on the balance sheet included with Forms 5471 on Corp A's tax returns as increases in "trade accounts payable/receivable." They were not evidenced by any notes, no interest was paid, and they were not disclosed on schedule M of the Forms 5471. Corp A explains these discrepancies by claiming that these transactions were actually capital contributions to Sub D, which were disguised to avoid liability for the Country A stamp tax on capital contributions.

The issues in this case arise because Corp A wanted to "unlock" Sub C's non-PTI earnings and have use of these funds for its own operations without incurring any adverse tax consequences. (Non-PTI earnings of Sub C could not be made directly available to Corp A (*i.e.*, through a dividend distribution or a loan) without triggering an inclusion in Corp A's income under either section 61 (in the case of a dividend) or section 956 (in the case of a loan).) At strategic planning meetings in Years F, G, and H, numerous discussions were held to identify ways to repatriate cash out of Country A "on a tax-free basis." In this regard, Corp A was approached by Bank M. Corp A had a close relationship with Bank M, Bank M offered Corp A a “solution” that, if successful, would achieve Corp A’s goals. Corp A was to engage in a transaction with a third party that would be documented as a notional principal contract but would result in Sub C’s available cash being transferred to Corp A without it being taxed immediately to Corp A as either an actual dividend or a deemed distribution under section 951(a)(1)(B). For purposes of illustrating the effect of the transaction, the promotional materials assumed that the interest rates used to compute payments under the notional principal contract would be 10% “floating” payments for 10% fixed payments. The promotional materials thus focused on the benefits derived from repatriation of the cash and assumed that potential differences in interest rates were irrelevant. Further analysis by Corp A also focused on the benefits of cash repatriation and ignored the potential hedging benefits that could have been derived from the transaction.

Sometime on or around the end of Year F, Corp A agreed to adopt Bank M’s proposal. As part of this agreement, Corp A agreed to pay Bank M an engagement fee in the amount of Sum U. There is also an indication that Corp A and Bank M may have negotiated a fee based on the expected tax savings derived by Corp A from of the proposed transaction, although it is not clear whether such a negotiation, if it occurred, resulted in an agreement between the parties.

B. The Transaction[1]

On Date 2, as per the plan presented by Bank M, Corp A entered into a twenty-year basis swap with a notional principal amount of Sum V with Bank N. While the charts in the promotional materials used by Bank M in its presentation reflected fixed rate payments in exchange for floating rate payments, Corp A and Bank N ultimately agreed to exchange similar floating rate payments ((LIBOR in the case of Corp A and federal funds in the case of Bank N) semi-annually on the notional principal amount. It was contemplated from the outset that this swap would be broken into its component parts and, rather than a single confirmation for the swap in the amount of Sum V, there were several confirmations in various amounts in anticipation of the subsequent assignment of portions of the swap to related and unrelated parties. In fact, the agreement between Corp A and Bank N specifically anticipated and permitted the assignment of portions of the swap to some of Corp A’s foreign affiliates.

[1]Corp A actually engaged in two of these transactions. For purposes of brevity, only one is described herein.

At the core of the plan was Corp A's anticipated assignment in year 1 of the receiving leg of the swap for years 6 to 20 (*i.e.,* a stream of payments starting in year 6 and ending in year 20) to Sub C in exchange for an immediate lump-sum payment. Corp A, however, had to ensure that it could support the validity of the pricing set for the assignment. In addition, except to the extent of Sub C's PTI, Corp A wanted to ensure that Sub C would not appear to be the originator of the funds used to make the lump sum payment.

To inject the appearance that the transaction was priced at market, Corp A initially assigned the right to receive payments with respect to Notional Amount P of the receiving leg of the swap for years 6 through 20 to Bank O, an unrelated party, in exchange for Sum X. With this "market price" in hand, Corp A assigned the right to receive payments with respect to Notional Amount Q of the receiving leg of the swap for years 6 through 20 to Sub C in exchange for Sum Y, and it assigned the right to receive payments with respect to Notional Amount R of the receiving leg of the swap for years 6 through 20 to Sub D in exchange for Sum Z.

Sum Y and Sum Z were obtained by Sub C and Sub D, respectively, from the funds that Sub C had earlier "advanced" to Sub E as increases in Sub E's accounts payable and which Sub E held in U.S. bank accounts. The transfer of Sum Y, which amount approximated Sub C's PTI, by Sub E to Sub C was booked as a decrease in Sub E's accounts payable to Sub C. The transfer of Sum Z by Sub E to Sub D was booked first as a decrease in amounts payable by Sub E to Sub C and then as an increase in accounts payable by Sub D to Sub C. These transfers appear to have been intended to move cash funds of Sub C to Sub D, an entity that had no earnings and profits.

C. Corp A's Tax Return Position

During the first five years of the swap, Corp A treated the net amount of the swap payments as an adjustment to interest expense. It did not report as income any portion of Sums Y and Z during those years. Instead, in years 6 through 20, Corp A treated these amounts in the same manner as a prepayment on a notional principal contract. Relying on Notice 89-21, 1989-1 C.B. 651, which provides that a swap prepayment must be amortized over the life of the swap in some reasonable manner, Corp A amortized the receipt of Sum Y and Sum Z over years 6 through 20. The transaction, therefore, gave Corp A the use of a significant amount of its foreign subsidiary's revenues in year 1 of the swap and allowed it to defer tax on that income until years 6 through 20 of the swap.

D. <u>Elimination of Economic Risks</u>.

The transaction engaged in by Corp A, Sub C, Sub D, Bank N, and Bank O had the potential of putting Corp A, its affiliates, and the participating banks at risk. The parties, however, engaged in further activities and took certain positions in order to eliminate such risk. Corp A entered into a series of mirror swaps with Bank M to eliminate any market risk associated with the basis swap. Bank N also entered into a mirror swap with Bank M in order to eliminate its market risk associated with the basis swap. As a result, neither Corp A nor Bank N could incur any losses from the notional principal contract, regardless of how interest rates moved during the life of the swap.

Bank N also had to protect itself against credit risk. In this regard, the agreement provided that if Corp A's credit rating fell below a threshold level, or if Corp A failed to make a payment, Bank N would have the right to terminate the transaction. Although these rights were supposed to be suspended with respect to any "permissible assignee" of Corp A's rights under the basis swap, Bank N's view was that the occurrence of either event was grounds for dissolution of the swap, regardless of whether some or all of Corp A's rights were assigned to its subsidiaries. In other words, following the assignments, Bank N continued to view Corp A as the obligor under the notional principal contract. This view was reflected in both the original credit proposal and in internal Bank N memoranda written after the swap agreement was executed.

Corp A's own actions were consistent with Bank N's view that Corp A was ultimately the obligor under the notional principal contract. The original agreement provided for the netting of payments unless Corp A assigned any of its rights under the swap to a "permissible assignee." In such a case, payments were to be made on a gross basis (*i.e.,* the assignee's right to receive its payments from Bank N were independent of Corp A's obligation to perform). In order to be able to net the swap payments on its balance sheet, Corp A took the position that the assignments did not affect its right of offset on the ground that the assignees were entitled to require Corp A to repurchase the assigned rights at any time at current market value without the consent of Bank N. The assumption implicit in this position is that the decision as to whether to assign the rights back to Corp A would be made by Corp A's treasury department in the United States.

As was the case with Bank N, Bank O had to be protected from both market and credit risks in connection with its purchase of the right to receive payments with respect to Notional Amount P of the receiving leg of the swap. This was accomplished by ensuring that Bank O never actually received any of the payments for years 6 through 20 from Bank N. Specifically, Bank N held a call option on the portion of the basis swap purchased by Bank O effective in year 3 of the swap, and Bank O was given a put option on the purchased portion effective in year 5 of the swap. The evidence in the record shows that the parties contemplated that Bank O would be cashed out prior to that time so that “consequently the underlying transaction would never take place.”

E. Rewards Limited to Fees

Corp A claims that it engaged in the transaction for dual purposes. With respect to the basis swap, Corp A states that its purpose for entering into this part of the transaction was to hedge against the interest rate risk attributable to the differences in the commercial paper rates of its domestic debt versus the LIBOR rates earned on its overseas cash (which amounts were held primarily by Sub E). According to Corp A, the basis swap was an appropriate means of accomplishing this goal for at least two reasons. First, although LIBOR rates historically had exceeded Corp A’s commercial paper rates, the spread between these rates had narrowed during Years F, G, and H. Corp A claims that it entered into the basis swap out of concern that the spread might turn negative. Documents generated by Corp A contemporaneous to the transaction, however, do not reflect this concern. Specifically, although there is evidence that the taxpayer analyzed interest rate movements in general in connection with the swap, it did not prepare an analysis of the impact of the swap as an interest rate hedge.

Another reason given by Corp A for its decision to enter into this particular basis swap, notwithstanding the fact that its debt consisted primarily of short-term obligations, was its “tendency to enter into long-term deals” and because “the length of the swap helped in the creation of the financial asset with one leg,” *i.e.*, the longer the swap, the greater the value of the asset that was to be sold to Sub D. Corp A apparently did not analyze the cost of terminating the swap if changes in interest rates rendered the swap uneconomical. Moreover, it acknowledged that at the time it entered into the swap it was aware that no liquid secondary trading market for derivatives like the swap existed. According to Corp A, these issues were irrelevant, since Corp A fully intended to continue the swap throughout its 20-year life.

With respect to the assignments, Corp A acknowledged that the sole reason for this part of the transaction was to repatriate cash, and that the transfer of ownership of the receiving leg of the swap from Corp A to its Country A subsidiaries had no economic significance apart from the transfer of cash.

In the case of the banks, all three received accommodation fees for their participation in the transaction. Bank M, which initially presented the transaction to

Corp A and which provided the hedges to the various parties, was paid an engagement fee of Sum U (and possibly other fees) by Corp A. Bank N, which entered into the swap with Corp A and hedged its exposure by entering into a mirror swap with Bank M, was allowed to lock in a 10 basis point spread between the basis swap and its hedge. Bank O, which agreed to establish the “market price” for the assigned portions of the swap by purchasing the right to receive payments with respect to Notional Amount P of years 6 through 20 of the receiving leg of the swap, was to receive a 15 basis point fee over the life of its transaction.

LAW

A. Substance Over Form Principles

1. General

As a general rule, taxpayers have the right to arrange their affairs in order to minimize their taxes Gregory v. Helvering, 293 U.S. 465, 469 (1935). The key question in analyzing a tax-motivated transaction is “whether what was done, apart from the tax motive, was the thing the statute intended.” Id. In Gregory, the Court disregarded the potential tax consequences of a corporate reorganization despite the fact that the taxpayer had complied with all statutory requirements because the transaction had no valid economic purpose and on its face lay outside the intent of the statute. Subsequent to its decision in Gregory, the Court held that to be respected for federal income tax purposes, a transaction must have economic purpose beyond a tax reduction. Knetsch v. U.S., 364 U.S. 361 (1960). In Frank Lyon Co. v. U.S., 435 U.S. 561 (1978), the Court looked to objective realities rather than form. In that case, however, the Court found that the taxpayer had a business purpose sufficient to justify a sale-leaseback. The Court found this to be “a genuine multiparty transaction with economic substance that was compelled by regulatory considerations, and not shaped solely by tax avoidance features that had meaningless labels attached.” Id. at 583-584. The Court stressed that the taxpayer had a downside risk of loss and the possibility of a significant return.

Transactions that lack economic substance have been routinely struck down by the lower courts. As stated by the Seventh Circuit in Saviano v. Commissioner, 765 F.2d 643, 654 (7^{th} Cir. 1985), aff’g. 80 T.C. 955 (1983):

> The freedom to arrange one’s affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the Internal Revenue Service and the courts will play along. The Commissioner and the courts are empowered, and in fact duty-bound, to look beyond the contrived

forms of transactions to their economic substance and to apply the tax law accordingly.

See also, Compaq Computer Corporation v. Commissioner, 113 T.C. No. 17 (1999).

2. Economic Substance

In evaluating the validity of a transaction, the courts typically attempt to determine, first, whether it genuinely occurred or whether it was merely “papered” in order to generate unwarranted tax benefits. Transactions that are determined to be factual shams are, of course, disregarded. See, e.g., Malden Knitting Mills v. Commissioner, 42 T.C. 769 (1964); Empire Press, Inc. v. Commissioner, 35 T.C. 136 (1960).

A transaction that is determined to have genuinely occurred is analyzed next in terms of its economic substance. Generally, the courts have developed a two-pronged approach to the economic substance analysis that looks to the subjective business purpose and the objective profit potential of the transaction. See Rice’s Toyota World, Inc. v. Commissioner, 81 T.C. 184, aff’d in relevant part, 752 F.2d 89 (4th Cir. 1983); United Parcel Service of America, Inc. v. Commissioner, T.C. Memo. 1999-268 (Aug. 9, 1999). These aspects of the inquiry do not constitute a rigid two-step test, but represent related factors in the analysis of “whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.” ACM Partnership v. Commissioner, 157 F.3d 231, 247 (3rd Cir. 1998), aff’g in relevant part 73 T.C.M. 2189 (1997).

Various articulations of the subjective prong of the economic substance analysis have been set forth by the courts. See, e.g., ACM, 73 T.C.M. at 2217 (whether the transaction is “rationally related to a useful nontax purpose . . . in light of the taxpayer’s economic situation and intentions.”); ACM, 157 F.3d at 253 (whether the transaction was intended to serve any “useful non-tax purpose”); Rice’s Toyota World, 752 F.2d at 91 (whether “the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering in the transaction”); Friendship Dairies, Inc. v. Commissioner, 90 T.C. 1054, 1062 (1988) (same). See also Yosha v. Commissioner, 861 F.2d 494, 501 (7th Cir. 1988) (“Judges can’t peer into people’s minds or ’weigh’ motives.... Rather, the usual approach is to focus the analysis on whether any non-tax goals or functions were or plausibly could have been served by the action.”). The common thread of these articulations, however, is whether the transaction has a business purpose other than obtaining tax benefits.

Like the subjective prong of the economic substance analysis, the phrasing of the objective test has varied among the different courts. For example, the Tax Court in ACM articulated the objective prong as requiring that there be "a reasonable expectation that the non-tax benefits would be at least commensurate with the transaction costs." 73 T.C.M. at 2217. The Third Circuit, on appeal of the same case, repeatedly searched for "any practical economic effects" of a transaction other than the creation of income tax benefits by examining the taxpayer's financial condition before and after the transaction. 157 F.3d at 248-252. Under the Fourth Circuit's expression of the objective prong in Rice's Toyota World, a transaction has no economic substance where "no reasonable possibility of a profit exists." 752 F.2d at 91. See also Friendship Dairies, 90 T.C. at 1062. Cf. Killingsworth v. Commissioner, 864 F.2d 1214, 1218 (5th Cir. 1989) (objective analysis involved examination of "profit making potential"). While the specific articulation of the objective prong has differed among the courts, the fundamental principle is that a transaction must have real and practical economic effects other than the creation of income tax benefits in order to satisfy the objective aspects of the sham analysis.[2] Central to this notion is that where profit derived from the transaction is "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed [tax benefit]," the fact of the profit does not automatically preclude a finding that the transaction failed the objective prong of the economic substance analysis. See, e.g., Sheldon v. Commissioner, 94 T.C. 738, 768 (1990).

3. Step Transaction.

In contrast to transactions that have no substance and that can be disregarded as shams, others do have substance but are disguised, typically through the interposition of meaningless steps. These steps, however, are to be ignored, for "[a] given result at the end of a straight path is not made a different result because reached by following a devious path." Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938). In the context of a sale of property, the Supreme Court has stated:

> The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exists solely to

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[2] See Sochin v. Commissioner, 843 F.2d 351, 354 (9th Cir. 1988), cert. denied 488 U.S. 824 (1988) (objective and subjective factors are considered in determining "whether the transaction had any practical economic effects other than" generating tax benefits); Rose v. Commissioner, 868 F.2d 851, 853 (6th Cir. 1989); Chapman v. Commissioner, 73 T.C.M. 2405, 2414 (1997).

> alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

Commissioner v. Court Holding, 324 U.S. 331, 334 (1945). See also, Security Indus. Ins. Co. v. U.S., 702 F.2d 1234, 1244 (5th Cir. 1983) ("The step-transaction doctrine is a corollary of the general principle that the incidence of taxation depends upon the substance of a transaction rather than its form.").

The step-transaction doctrine is invoked when a taxpayer interposes economically meaningless steps in an otherwise economically significant transaction in order to avoid certain tax consequences, and can result in the recharacterization of the transaction according to its true substance. "The step-transaction doctrine ... treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result." Penrod v. Commissioner, 88 T.C. 1415 (1987). As noted in Penrod, courts have used any one of three different tests to apply the step-transaction doctrine:

> The narrowest alternative is the 'binding commitment' test, under which a series of transactions are collapsed if, at the time the first step is entered into, there was a binding commitment to undertake the later step. ...
>
> At the other extreme, the most far-reaching alternative is the 'end result' test. Under this test, the step transaction will be invoked if it appears that a series of formally separate steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result. ... The end result test is based upon the actual intent of the parties as of the time of the merger.... [I]n contrast to the binding commitment test, the end result test is flexible and bases tax consequences on the substance of the transactions, not on the formalisms chosen by the participants. ...
>
> The third test is the 'interdependence' test, which focuses on whether 'the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.' ... This test concentrates on the relationship between the steps, rather than on their 'end result'. However, since the interdependence test requires a court to find whether the individual steps had independent significance or whether they had meaning only as part of the larger transaction, the court may be called upon to determine the result the participants hoped to achieve. Thus, the interdependence test is a variation of the end result test." (Citations omitted.)

88 T.C. at 1429-1430.

The substance over form doctrine has also been applied in some cases in which the courts were asked to recharacterize what purported to be sales transactions as loans. The cases involved primarily taxpayers that, for various reasons, wished to accelerate income and who would "sell" future cash flows in exchange for an immediate discounted lump sum payment. Courts that have recharacterized the sales as loans have relied in large part on the minimization of risk and the lack of the usual benefits associated with ownership of property, the virtual certainty that the lender would be paid back, that the borrower was not free to dispose of the proceeds as it wished, that the lender was only to receive a sum certain at an interest rate approximating the standard prevailing rate. Generally, the courts also took note of the fact that the transactions at issue were tax motivated. See Mapco Inc. v. U.S., 556 F.2d 1107 (Ct. Cl. 1977).

B. Investments in U.S. Property[3]

During the taxable years at issue, section 951(a)(1)(B) provided, in part, that a U.S. shareholder of a controlled foreign corporation ("CFC") must include in income currently its pro rata share (determined under section 956(a)(2)) of the CFC's increase in earnings invested in U.S. property for such year. Section 956(a)(2) provided, in part, that a United States shareholder's pro rata share of the CFC's increase for any taxable year in earnings invested in United States property was the amount determined by subtracting the United States shareholder's pro rata share of the amount of the CFC's earnings invested in United States property at the close of the preceding taxable year (reduced by certain amounts under section 959), from the amount of the CFC's earnings invested in United States property at the close of the current taxable year. Section 956(a)(1) provided that the amount of earnings of a CFC invested in United States property at the close of any taxable year is the aggregate amount of such property held, directly or indirectly, by the CFC at the close of the taxable year, to the extent such amount would have constituted a dividend if it had been distributed to the CFC's shareholders.

The term "controlled foreign corporation" means any foreign corporation if more than 50 percent of the total combined voting power of all classes of its stock or more than 50 percent of the total value of its stock is owned by United States shareholders on any day during the taxable year of such foreign corporation. Section 957(a). The term "United States shareholder" means any United States person (as defined in section 957(c)) who owns (within the meaning of section 958) 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. Section 951(b). A United States

[3]All references to the Internal Revenue Code in this section are to the Internal Revenue Code as in effect during the years at issue.

person is defined as including a domestic corporation. Sections 957(c), 7701(a)(30)(C).

Section 956(b)(1)(C) defined the term “United States property” as including an obligation of a United States person. The term does not include, however, obligations of domestic corporations that are unrelated to the CFC making the investment. Section 956(b)(2)(F). See also Treas. Reg. § 1.956-2(b)(1)(viii). For purposes of this rule, a domestic corporation is considered unrelated to the CFC making the investment if it is neither a United States shareholder of the CFC, nor a corporation 25 percent or more of whose total combined voting power of all classes of stock entitled to vote is owned or is considered as owned (within the meaning of section 958(b)) by a United States shareholder of the CFC. Treas. Reg. § 1.956-2(b)(1)(viii). The term “obligation” is defined, generally, as including any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other indebtedness, whether or not issued at a discount and whether or not bearing interest. Temp. Reg. § 1.956-2T(d)(2).

Temp. Reg. § 1.956-1T(b)(4)(i) provides that a CFC will be considered to hold indirectly investments in United States property acquired by any foreign corporation that is controlled by the CFC, if one of the principal purposes for creating, organizing, or funding (through capital contributions or debt) such other foreign corporation is to avoid the application of section 956 with respect to the CFC. For purposes of this rule, a foreign corporation is considered to be controlled by a CFC if the CFC owns more than 50% of the total combined voting power of all classes of stock of the foreign corporation. Temp Reg. § 1.956-1T(b)(4)(i).

ANALYSIS

Bank M’s plan called for a complex structure that would disguise Corp A’s true purpose, which was to repatriate cash from its foreign subsidiaries and avoid the consequences of section 956. This plan required Corp A to enter into a basis swap with an unrelated party and then to assign a portion of its right to receive income under the swap to several of its foreign subsidiaries in exchange for an upfront cash payment. Corp A argues that the tax accounting rules in existence at the time of the transaction allowed it to defer recognition of the payment until a period beginning five years after the year in which it received the payment. In effect, Corp A is arguing that it is entitled to complete tax free use of the payment for the first five years of the basis swap and substantial deferral for the remaining 15 years. Corp A’s position is dependent on full recognition being given to all parts of the transaction that generated the upfront cash payment. This recognition is not warranted, since the facts indicate that no tax-independent considerations underlay the plan. Corp A has acknowledged that a principal purpose of the transaction, and the sole purpose of the assignment portion of the transaction, was to repatriate cash tax-free from its foreign subsidiaries. As will be discussed below, several theories support recharacterization of the transaction as a set of loans from the foreign subsidiaries to the U.S. parent on the ground that the transaction lacks economic substance.

A. The Transaction Lacks Economic Substance.

It appears from the facts currently available that the transaction was not a factual sham. Fund transfers actually occurred, and the transaction cannot be characterized as fictitious. The next step, therefore, is to determine whether the transaction lacked economic substance. As the Third Circuit noted in ACM, 157 F.3d at 247, a transaction must have either a subjective non-tax purpose or objective economic consequences in order to survive a challenge on the ground of a lack of economic substance. Corp A concedes that the basis swap transaction was tax motivated, particularly the assignment portion of the transaction. However, it argues that it entered into the swap portion of the transaction for a legitimate business purpose, namely the hedging of its short term domestic debt. Corp A's claim cannot be sustained under either the subjective prong or the objective prong of the economic substance analysis. Moreover, the transaction is subject to step transaction principles.

1. Lack of Non-Tax Purpose.

Corp A claims that it entered into the swap portion of the transaction specifically to hedge its short-term domestic liabilities. According to Corp A, historical differences between the LIBOR rates earned on its overseas cash and the commercial paper rates paid by it on its domestic liabilities had provided consistent positive arbitrage opportunities for Corp A. In the years immediately preceding the taxable years in issue, however, these rates had been narrowing and, in Corp A's view, were in danger of becoming reversed. Corp A claims that it entered into the basis swap in order to hedge its liabilities in the event the spread turned negative.

Corp A's arguments are contestable on several grounds. First, and most significantly, Corp A's argument is belied by the fact that any hedging benefit achieved by Corp A as a result of entering into the basis swap was effectively nullified by the mirror swaps between it and Bank M, the promoter of the basis swap transaction. Thus, the swap, once fully hedged, became a meaningless product with no economic substance, much like a riskless straddle. "That would clearly be the case where the broker guaranteed the investor that the only consequences of the straddles would be tax consequences; there would be no market risks, downside or upside. Straddles that involve no market risks are not economically substantial straddles and hedges; they are artifices created by accomplices in tax evasion, the brokers." Yosha v. Commissioner, 861 F.2d at 500.

Another factor contradicting Corp A's purported hedging motivation is Corp A's choice of a long-term (*i.e.*, 20-year) instrument to hedge short-term liabilities. Such a mismatch between instruments effectively exposed Corp A to potential interest rate risk once the hedged liabilities expired or were disposed of. This potential for such market risk was further exacerbated by the absence of a liquid secondary trading market for derivative instruments like the basis swap, a fact that Corp A knew before it entered into the transaction.

Third, all of the promotional material prepared by Bank M, as well as documentation prepared by Corp A during its consideration of Bank M's proposal, were directed at achieving a single goal -- the tax-free repatriation of cash -- and ignored other aspects of the swap, such as its potential hedging benefits. See Heltzer v. Commissioner, 62 T.C.M. 518 (1991) (promotional materials focused only on tax benefits, and taxpayer did not investigate brokerage firm's profit record). For example, the schedules prepared by Corp A, which were circulated among key members of the accounting and treasury departments, only analyzed the impact of the repatriation of the cash, not the "hedging" potential of the swap. In these studies, the impact of the differing legs of the swap was assumed away.

Fourth, every aspect of the transaction (*i.e.,* the basis swap portion, the assignment portion, and the offsetting hedges) was meticulously pre-arranged to avoid subjecting any of the participants to economic risk and to ensure that the only change to any of their economic positions was either the payment of fees (in the case of Corp A), the receipt of fees (in the case of Bank M, Bank N and Bank O), or the cash flows from Sub C and Sub D (in the case of Corp A). The intentional elimination of all economic risk strongly supports the proposition that Corp A lacked any non-tax purpose for this transaction.

Finally, some documentation exists that suggests Corp A and Bank M may at one time have discussed basing a portion of Bank M's fee on the expected tax savings derived by Corp A from the proposed swap transaction. Such a fact, if established, strongly suggests that Corp A's sole purpose in entering into the transaction was tax-related.

2. Lack of Objective Economic Consequences.

In general, courts have declined to recharacterize or otherwise disregard a transaction on the ground of lacking economic substance if the transaction had real and practical economic effects other than the creation of income tax benefits. See, e.g., ACM, 157 F.3d at 248-252. From the facts presented, the basis swap transaction entered into by Corp A had no real and practical economic effects other than the creation of income tax benefits. As described above, the swap between Corp A and Bank N was fully hedged resulting in an economic nullity. Indeed, when the substantial transaction costs of sum U are taken into account, the transaction lacked, from the outset, any reasonable prospect of profit. Moreover, while the dynamic nature of the hedges might generate some fortuitous gain, such amount would likely be de minimis relative to the tax benefits achieved by the transaction overall. In this regard, any such gain would not materially affect this analysis. Sheldon, 94 T.C. at 768. Accordingly, the basis swap transaction fails the objective prong of the economic substance analysis.

3. Step-Transaction.

Corp A followed a prearranged plan to reach its stated goal of repatriating Sub C's available cash. It disguised a self-amortizing loan from Sub C as a notional principal contract, the economic impact of which it hedged, through an assignment of the receiving leg of years 6 through 20 of the swap to Sub C in exchange for a lump sum payment from Sub C in year 1 of the swap. Bank N became the accommodation party through which the principal and interest payments from Corp A were routed. To further disguise its tax planning, part of the receiving leg of the swap was assigned to Sub D rather than Sub C, the affiliate that held the cash. To make its lump sum payment to Corp A, Sub D had to obtain the needed cash from Sub C. In this case, therefore, Bank N was acting as the accommodation party for the principal and interest payments from Corp A, while Sub D was acting as the accommodation party that received the loan principal on behalf of Such C. These unneeded steps were added to disguise the true substance of the transaction and must be ignored.

The facts presented indicate that the various steps of the transaction at issue were entered into as part of an overall plan for Sub C to make a self-amortizing loan to Corp A. The facts presented suggest that the parties were committed to this overall plan from the outset. Thus, it appears that the binding commitment test could be met. However, further factual development is necessary.

"[T]he end result test is flexible and bases tax consequences on the real substance of the transactions, not on the formalisms chosen by the participants." Penrod, 88 T.C. at 1430. The facts reflect that the parties had a single goal, a single end result, in mind. All the steps of these transactions were planned in order to reach Corp A's stated goal to repatriate Sub C's cash and avoid subpart F. The series of formally separate steps – the swap, the assignment to Bank O, the assignment to Sub C and Sub D – were pre-arranged parts of a single transaction intended from the outset to reach the ultimate result sought after. See Penrod, 88 T.C. at 1429-1430, and cases cited therein.

The charts from the various presentations made by Bank M focused on a single goal: the repatriation of the cash held by Sub C. If the primary purpose of the swap was to hedge an interest rate risk, the presentation would have focused on those particular rates. Instead, the presentation assumed away the economic impact of changes in interest rates by assuming each leg of the swap paid the same rate. The number of confirmations for the swap confirm the intent of the parties. Rather than a single swap confirmation, several were prepared, each in the amount of the anticipated assignments to Bank O, Sub C and Sub D. Finally, the fact that Corp A and Bank N hedged the positions resulting from the swap establishes that nothing other than the repatriation of cash from Corp A's foreign subsidiaries was contemplated.

An analysis under the interdependence test, which looks to the relationship between each of the steps of the transaction, also supports its recharacterization. Each step in the transaction, by itself, would have been meaningless. If the assignment of years 6 through 20 had not been made, the entire swap would have been an economic sham with no substance. This is because the entire swap was hedged, and thus its potential economic impact was nullified. Moreover, the assignment of Notional Amount P of years 6 through 20 of the swap to Bank O was to be quickly nullified through the exercise of the options granted to the parties. Similarly, the advances from Sub C to Sub D were not meaningful: Sub D did not need the cash. Rather, that step was merely an intermediate step, and was to be immediately followed by the transfer of the cash to Corp A.

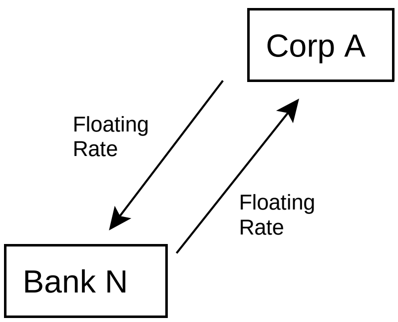
The participation of third parties does not affect the conclusions reached herein. The transactions cannot be characterized as "genuine multi-party transaction[s]", as was done Frank Lyons, supra. Here, the third parties participated in the tax avoidance promotion in exchange for a fee. They did not have a stake in the transaction's outcome and were fully insulated from risk. The courts have repeatedly held that the insertion of a third-party straw man that acts as a conduit between related parties can be ignored under the step-transaction doctrine. Del Commercial Properties, Inc. v. Commissioner, T.C. Memo 1999-411 (1999); Gaw v. Commissioner, T.C. Memo. 1995-531, aff'd without published opinion 111 F.3d 962 (D.C. Cir. 1997); Kuper v. Commissioner, 533 F.2d 152 (5th Cir. 1976).

It should also be noted that, while the cases such as Mapco, supra, that examine the difference between sales of future cash flows and loans support the economic substance theories, an analysis under the doctrines described herein is more appropriate. This is because, rather than attempting to sell a genuine future cash flow, the parties created a cash flow from a transaction lacking economic substance and assigned part of it to foreign related parties. Under these circumstances, it is appropriate to ignore the components of the transaction that are properly characterized as economic shams and eliminate the unnecessary steps undertaken by the parties under the step-transaction doctrine. The application of these principles reveals the true nature of the transaction: a self-amortizing loan.

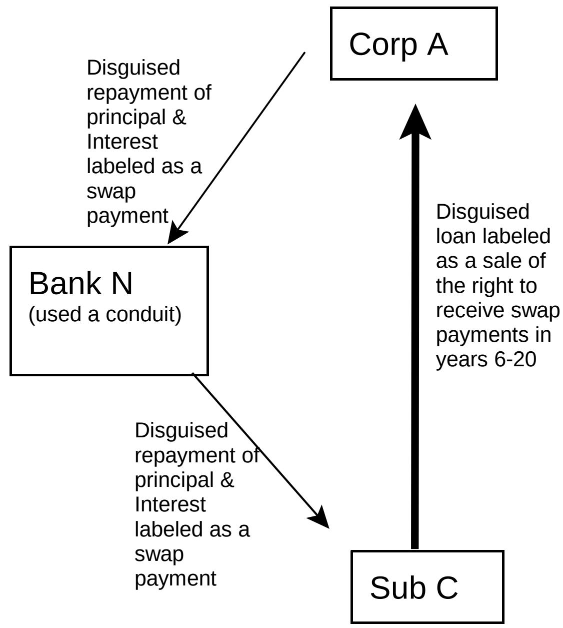
B. Because the Transaction Lacks Economic Substance, It Can Be Recharacterized as a Series of Loans from the Foreign Subsidiaries to the U.S. Parent.

Under economic substance and step transaction principles, the transaction at issue should be recharacterized to reflect its true economic nature. The swap followed by the assignment of portions of the receiving leg to Subs C and D effectively resulted in a self-amortizing loan disguised as the purchase price for the sale of the swap leg. In other words, Corp A borrowed sums Y and Z from Subs C and D, respectively, when it “sold” its right to receive payments under the swap. To repay this loan, a third-party intermediary (*i.e.,* Bank N) was engaged to receive periodic principal and interest payments from Corp A (disguised as swap payments) and to forward such payments to Subs C and D based on their “purchase” of the swap cash flows. Although the transaction was structured to hide the loan through the use of different floating rates in the basis swap, the use of hedges to negate this difference reveals the true nature of the transaction. Specifically, the use of the hedges enabled Bank N to effectively convert the amount of cash it received from Corp A under the basis swap to equal the amount of cash it was obligated to pay Subs C and D under the assignment. Thus, the differing interest rates set forth in the swap agreement does not negate the use of economic substance principles to recharacterize this transaction as a loan.

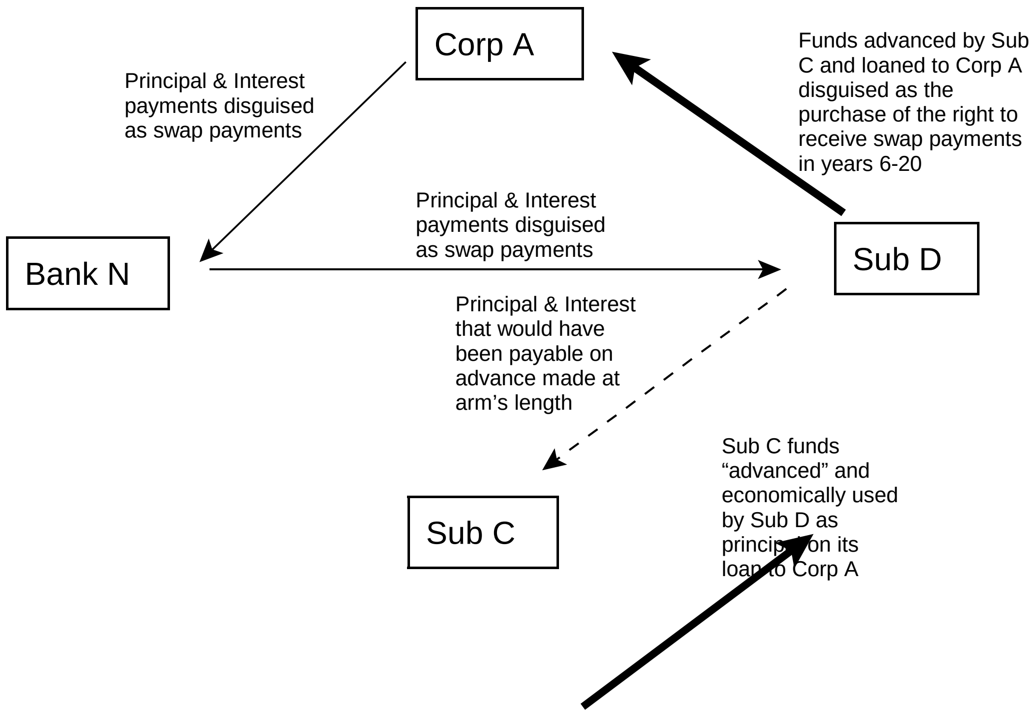
① Original swap payments



② Economic effect of the planned structure



Presumably to further disguise the source of the funds for the loans from Sub C to Corp A, Sub D was inserted as a second entity through which the loans were made. This was accomplished through the "advance" of substantially all of Sub C's non-PTI cash to Sub D through the accounts of Sub E (which were used by Sub D to "purchase" its portion of the assignment). Such advances had no economic substance as they were not evidenced by any notes, no interest was paid and they were not disclosed on Schedule M of the Forms 5471 filed by Corp A. The diagram below shows that if (1) the parties were required to made periodic payments on an arm's length basis and (2) if the unnecessary intermediaries were eliminated, the transaction was nothing other than a loan from Sub C to Corp A.



C. The Loans from the Foreign Subsidiaries to the U.S. Parent Constitute Investments in U.S. Property under Section 956.

1. General.

If the transaction is recharacterized as a loan from Sub C to Corp A, the next issue that arises is whether such "loan" is an investment in U.S. property under section 956. Corp B is a United States shareholder within the meaning of section 951(b), since it is a domestic corporation that owns directly 100% of the stock of Sub C. Sub C is a CFC within the meaning of section 957(a), since 100% of its stock was owned by Corp B, a U.S. shareholder, during all of the tax years at issue. Accordingly, if Sub C's loan to Corp A constitutes U.S. property within the meaning of section 956(b)(1). Corp B will be required to include in income currently its pro rata share of Sub C's increase in earnings invested in that U.S. property.

Because Sub C's loan to Corp A constitutes indebtedness of Corp A, a domestic corporation, such loan constitutes U.S. property within the meaning of section 956(b)(1) unless it falls within the exception in section 956(b)(2)(F). That section provides that the term "U.S. property" does not include obligations of domestic corporations that are unrelated to the CFC making the investment. For purposes of this rule, a domestic corporation is considered unrelated to the CFC making the investment if it is neither a United States shareholder of the CFC, nor a corporation 25 percent or more of whose total combined voting power of all classes of stock entitled to vote is owned or is considered as owned (within the meaning of section 958(b)) by a United States shareholder of the CFC. Treas. Reg. § 1.956-2(b)(1)(viii). This definition thus requires that a domestic corporation must meet two requirements if it is to be considered unrelated to a CFC holding its obligation: it must not be a U.S. shareholder with respect to the CFC, and no more than 25% of its total combined voting power of all classes of its stock entitled to vote can be owned by a United States shareholder of the CFC. For purposes of the application of the exception in section 956(b)(2)(F), Corp A is considered to own 100% of Sub C's voting stock. See Treas. Reg. § 1.958-2(c)(1)(iii). Thus, it qualifies as a United States shareholder with respect to Sub C for purposes of section 956(b)(2). See section 951(b). Accordingly, for each of the tax years in issue, Corp B is required to include in its income currently its pro rata share of Sub C's earnings invested in United States property.

2. Sub D's "Loan" to Corp A

In an apparent effort to hide the fact that Sub C was the originator of the cash to be repatriated, Corp A assigned a large portion of the receiving leg of the swap (Notional Amount R) for years 6 through 20 to Sub D. Sub D in turn obtained the funds it needed to purchase Notional Amount R from Sub C through an advance from Sub C that was booked as an increase in Sub D's accounts payable to Sub C. Corp A now seeks to recharacterize these transfers as equity contributions to Sub D .

Corp A's attempt to recharacterize as an equity contribution the amount received from Sub C and used to purchase Sub D's assignment does not affect the analysis under section 956. As described above, Temp. Reg. §1.956-1T(b)(4) provides that a CFC (such as Sub C) will be considered to hold indirectly investments in U.S. property acquired by another foreign corporation controlled by the CFC (such as Sub D) if the funding (whether through capital contributions or debt) for such investment originated from the CFC and was designed to avoid the application of section 956. Sub D is controlled by Sub C, since Sub C owns 100% of Sub D's stock. Temp. Reg. § 1.956-1T(b)(4)(i). Moreover, as was the case with Sub C's loan to Corp A, Sub D's loan to Corp A constitutes an investment in U.S. property within the meaning of section 956(b)(1) and Treas. Reg. § 1.956-2T(d)(2) by Sub C. The various bookkeeping entries indicate that the ultimate source of the funds used by Sub D to purchase its share of the assignment was Sub C, an entity that generated substantial non-subpart F revenues. Whether Sub C transferred these funds to Sub D as either equity or debt is irrelevant, since Treas. Reg. § 1.956-1T(b)(4) expressly contemplates both types of funding. Accordingly, Sub C will be considered to hold indirectly Sub D's investment in U.S. property if a principal purpose for transferring the funds to Sub D was to avoid the application of section 956. Such a purpose need not comprise the sole purpose for engaging in the transaction as long as it is one of the principal purposes. See The Limited v. Commissioner, 113 T.C. 169 (1999). The facts, as developed thus far, strongly suggest that such a purpose was present. In particular, Corp D had no earnings and profits while Corp C had substantial non-PTI earnings and profits. If Corp C had made a loan directly to Corp A, such a loan would clearly have qualified as an investment in U.S. property under section 956. In contrast, if Corp D had made the loan, there would have been no investment in U.S. property because Corp D had no earnings and profits. The documents underlying this transaction are replete with references to accomplishing the tax-free repatriation of Sub C's revenues to Corp A. In an attempt to accomplish this goal, Sub D was interposed into the transaction in order to make it appear that the funds were derived from an entity with no earnings and profits.

D. Inapplicability of Notice 89-21.

Corp A relies upon Notice 89-21, 1989-1 C.B. 651, to support its treatment of the basis swap transaction. The notice addresses the proper method of accounting for a notional principal contract with respect to the years at issue. Because we believe that the basis swap substantively is not a notional principal contract, we believe that Notice 89-21 does not apply to the transaction.

Economic substance and step transaction principles apply before application of any technical rules in the Notice. It is well established that compliance with the literal terms of a statute or regulation will not insulate a taxpayer from the requirement that its transactions have economic substance. A transaction must have a bona fide commercial purpose as a condition precedent to the receipt of any tax benefits associated with the transaction except in the rare instance where a tax motivated transaction is "unmistakably within the contemplation of Congressional intent." Fox v. Commissioner, 82 T.C. 1001, 1020-1021 (1984). Thus, as with statutes and regulations, an economic substance and step transaction analysis precedes consideration of the technical rules in Notice 89-21.

As the Third Circuit stated in Weller v. Commissioner:

> Thus, the principle laid down in the Gregory case is not limited to corporate reorganizations, but rather applies to the federal taxing statutes generally. The words of these statutes which describe commercial transactions are to be understood to refer to transactions entered upon for commercial purposes and "not to include transactions entered upon for no other motive but to escape taxation."

270 F.2d 294, 297 (3d Cir. 1959), aff'g. 31 T.C. 33 (1958). This principle was recently confirmed by the Tax Court in ACM, which held that "[o]nly after we conclude that a transaction has economic substance will we consider the transaction's tax consequences under the Code." 73 T.C.M. at 2217. See also Leema Enterprises Inc. v. Commissioner, T.C. Memo 1999-18 (January 28, 1999).

[redacted]

If you have any questions, please call (202) 622-3870 or (202) 622-3840.

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