DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR RANDALL P. ANDREOZZI
ATTORNEY ASSOCIATE AREA COUNSEL,
CC:LM:FSH:HAR:B

FROM: Associate Chief Counsel (CORP) CC:CORP

SUBJECT:

DISCLOSURE STATEMENT

This Chief Counsel Advice responds to your memorandum, dated December 9, 2000. In accordance with IRC § 6110(k)(3), Chief Counsel Advice should not be used or cited as precedent.

LEGEND

Taxpayer:
Corporation 1:
Sub 1:
Sub 2:
Sub 3:
Corporation 2:
Issuer:
City:
State:
Country:
Year 1:
Year 2:
Year 3:
Year 4
Year 5
Year 6:
Year 7:

Year 8:
Year 9:
Year 13:
Products:
Amount 1:
Amount 2:
Amount 3:
Amount 4:
Amount 5:
Amount 6:
Number:
Percent:
Date 1:
Date 2:
Date 3:
Advisors:
Chart:

ISSUE: Whether certain Perpetual Securities should be characterized as debt for federal income tax purposes, thereby triggering tax under former section 956A of the Internal Revenue Code.

CONCLUSION: The Perpetual Securities constituted equity and, therefore, the Service should not attempt to recharacterize the Perpetual Securities as debt.

FACTS: Corporation 1 is a publicly traded State corporation with its principal corporate office in City, State. It is also the common parent of the Taxpayer consolidated group (hereinafter “Taxpayer”). Corporation 1 filed a Year 3 consolidated return for the Taxpayer.

Corporation 1 manufactures, markets, and distributes Products. Sub 1, a domestic corporation, is a lower-tier, wholly-owned subsidiary of Corporation 1 and a member of Taxpayer. Sub 2 is a first-tier foreign subsidiary of Sub 1 and a controlled foreign corporation (“CFC”) as defined in section 957(a). Sub 3 is a first-tier foreign subsidiary of Sub 1 and a controlled foreign corporation (“CFC”) as defined in section 957(a).

Corporation 1’s many CFCs held a total of about Amount 1 in unrepatriated earnings and profits at the end of Year 2. Of this amount, Sub 2 held about Amount 2, of which a significant portion was invested in interest-yielding obligations. Corporation 1 held these funds in its foreign subsidiaries to facilitate possible expansion overseas and also because of the adverse tax consequences that would flow from their repatriation to the United States as dividends or loans.

During Year 2, the enactment of former sections 956A and 951(a)(1)(C) caused Corporation 1 to consider its disposition of these funds. Because these funds historically had been invested in assets producing "passive income" for purposes of the passive foreign investment company ("PFIC") passive income and passive asset tests under section 1297(b)[1], section 956A would, absent any changes in their investment policy by Corporation 1, trigger current taxation of all or part of Sub 2's non-subpart F current earnings and profits after those sections became effective.[2]

Acting in response to this concern, Corporation 1 decided to limit, if not eliminate, its exposure to this tax. Corporation 1's management met with Corporation 2 (an unrelated entity), who proposed that Corporation 1 purchase Amount 2 of "non-voting preferred stock" equivalent to at least a 25% equity stake (by value) in Issuer.[3]

Corporation 1 hired Advisors to review Corporation 2's proposal. Advisors, although not tax attorneys, stated in their report (hereinafter the "Advisors" report) that Sub 2's Amount 2 of unrepatriated earnings were "passive" assets under former section 956A. They concluded, among other things, that this asset potentially would subject the Taxpayer to taxation.

The Advisors recommended that Corporation 1 accept Corporation 2's proposal because, in their opinion, it was both a good tax decision and a good corporate policy decision. They noted that the proposal was a safe one financially, but that "buying a controlling interest in a foreign company would be perceived [in the financial markets] as expanding Corporation 1's risk taking." They also noted that

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[1]For the year at issue, section 1297(b) was designated 1296(b).

[2]See footnote 9 with respect to the effective dates of former sections 956A and 951(a)(1)(C).

[3]Sub 2 purchased the Perpetual Securities at issue in Year 3 and disposed of them during Year 8 and Year 9, when the last of the securities were redeemed. The Chief Counsel Advice request was submitted in connection with an ongoing examination of Taxpayer's Year 1 to Year 3 taxable years and, therefore, this advice directly pertains only to Taxpayer's Year 3 tax year. However, our resolution of the debt-equity issue will affect the treatment of the securities even as to subsequent years.

an investment in Issuer would achieve liquidity and safety, and Corporation 1 would retain sufficient financial flexibility. They reported that Issuer's current earnings and reserves of Amount 3 is "over ten times the required preferred dividend on the Corporation 1 investment." They stated that the proposal "sacrifices an acceptable amount of interest income." They also stated that under the proposal, Corporation 1 would receive "dividends" and that outsiders would consider that Corporation 1 was taking at least a "Percent equity position" (by value) in a single bank.

Acting in part on the advice of the Advisors, Corporation 1 agreed to Corporation 2's proposal, and on Date 1, Sub 2 and Issuer entered into a Subscription Agreement. The relevant portions of this agreement are set forth below:

> 2) Status
>
> The Securities constitute unsecured, subordinated obligations of [Issuer] neither payable upon demand nor having a fixed maturity and the Securities rank and will at all times rank pari passu without any preference among themselves and, subject to applicable laws, rank and will at all times rank (a) junior to the secured and unsecured liabilities of [Issuer] including any obligations of [Issuer] that are subordinated obligations and (b) senior to [Issuer]'s ordinary shares or any other class of shares issued or to be issued by [Issuer].
>
> Accordingly, payment of the Redemption Amount to Holders in the event of any voluntary or non-voluntary liquidation, bankruptcy or composition agreements of [Issuer] will be subject to the complete prior satisfaction of the claims of all creditors of [Issuer] that are senior to the Securities as provided for here above. The Securities will be neither set off against claims of [Issuer] nor secured by assets belonging to [Issuer].

The Agreement provided for a return on the investment at Number basis points under the 3-month U.S. currency LIBOR rate, adjusted quarterly. The yield amount was cumulative, but was payable only to the extent Issuer had "Distributable Profits" as of the close of the fiscal year. The Agreement provided that Issuer's "Board will decide and approve payment of the Yield Amount for each Yield Period."

Under the Agreement, if Issuer had no distributable profits as of the close of the prior fiscal year, it had the right to suspend payment of the yield amount. If Issuer suspended the yield amount for six consecutive yield periods, and Issuer's unencumbered capital was less than 90 percent of the total redemption amount (the "impairment threshold"), then Sub 2 had the right to give notice to Issuer. Issuer would then have 30 days to either satisfy all cumulative deferred yield amounts or increase its unencumbered capital above the impairment threshold. If Issuer failed to do this, Sub 2 had the right to have a special committee created by Issuer's Board of Directors. This special committee would consist of 1/4th of the Issuer Board members and its duty was to encourage actions by the Board that would protect Sub 2's interest in the securities. The special committee would continue to sit until: (1) Issuer's unencumbered capital was increased above the impairment threshold; (2) Issuer redeemed all the securities; or (3) Sub 2 no longer held the securities.

Sub 2 was entitled to redemption of both the unpaid principal amount and any accumulated yield amount upon the occurrence of the following events: (1) the "call" of the securities by Issuer, (2) the "put" of the securities by Sub 2,[4] or (3) the liquidation or dissolution of Issuer.[5] Payment of the redemption amount depended on whether Issuer had "unencumbered capital" sufficient to redeem the securities. *"Unencumbered Capital"* was defined as:

> [T]he excess of the total value of [Issuer]'s assets over the sum of [Issuer]'s Senior Liabilities and its subordinated liabilities, each as determined on the basis of [Issuer]'s audited consolidated financial statements for the Reference Fiscal Year (or, if applicable, the Alternative Fiscal Year) as approved by the shareholders' meeting of [Issuer] or, in the case of liquidation of [Issuer], on the basis of the most recent accounts of [Issuer] prepared by the liquidator of [Issuer]. For purposes of this definition, subordinated debt of [Issuer] does not include the Par Value Amount of [Perpetual] Securities outstanding.

Subscription Agreement, page 11, definitions. Under the Agreement, the Perpetual Securities were putable and callable, and had a return-on-investment rate reset feature. Sub 2 had the right to serially put these securities back to Issuer any time on or after Date 2 in exchange for the securities' par value. Issuer had the right to call (a right to buy) these securities from Sub 2 anytime on or after 3 calendar

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[4]The dates when Issuer could first exercise its "call" right and when Sub 2 could first exercise its "put" right are set out later in the facts.

[5]Issuer redeemed the entire investment at par in years Year 8 and Year 9.

months of the issue date, subject only to giving Sub 2 180-days written notice, for the par amount. In Year 13, the securities' contractual return-on-investment rate from that time forward would be reset to "ensure that the market value of the securities is equal to par value." The Perpetual Securities became freely transferable by Sub 2 in Year 13. There is no provision in the Subscription Agreement allowing Sub 2 to force payment of either the par amount or the Yield prior to Date 2. The Subscription Agreement terminates when: (1) either Issuer or Sub 2 fail to maintain confidentiality; or (2) Issuer fails to deliver to Sub 2 each year's financial records or other documents showing that (a) Issuer is meeting the criteria of an "active foreign bank"; and (b) the average amount of Issuer's "passive assets" do not exceed the relevant threshold for determining Issuer's "excess passive assets." Sub 2 had the right to pledge the Perpetual Securities immediately so long as it obtained Issuer's prior written consent. Finally, it appears that Sub 2 could borrow freely from Issuer up to the par value of the Perpetual Securities.

In Year 6, for reasons unknown to the Service, Sub 2 transferred all of these securities to Sub 3. In Year 8, Issuer redeemed Amount 4 of these securities at par over a 12-month period commencing on January 5, Year 8. In Year 9, Issuer redeemed the remaining Amount 5 of these securities at par over a 12-month period commencing on January 5, Year 9. Sub 3 held the securities in Year 8 and Year 9.

Corporation 1's post-transaction reporting of the character of the Perpetual Securities appears to have been somewhat inconsistent. The following shows how Corporation 1 treated these securities:

To its Year 3 consolidated tax return, Corporation 1 attached a Section 385(c) statement [6] that described the securities as follows:

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[6]Congress modified Section 385 to provide that when a corporation has identified an interest in the corporation as either stock or indebtedness, a holder of such an interest must disclose on its income tax return any inconsistent treatment of the interest. Section 385(c) (added by Energy Policy Act of 1992, Pub. L. No. 102-486, § 1936(a), 106 Stat. 2776, 3032). Inconsistent treatment of hybrid instruments is severely limited by Section 385(c), enacted in 1992 (Pub. L. No. 102-486, § 1936(a), 106 Stat. 2776, 3032), which provides that the issuer's characterization, at the time of issuance, of an instrument as stock or debt is binding on the issuer and on all holders except holders who disclose on their federal tax returns that they are treating the instrument in a manner inconsistent with the issuer's characterization. Section 385(c) applies to instruments issued after October 24, 1992.

> For US Tax purposes the Perpetual Securities are stock and are treated accordingly by [Taxpayer]. . . . It is understood that, as of the date of issuance, as issuer, Issuer intended to treat the Perpetual Securities under Country law as indebtedness. It is understood that Issuer has not characterized these securities as indebtedness for U.S. tax law purposes.

Corporation 1 had Securities and Exchange Commission (hereinafter "SEC") filings for years Year 3 up to and including Year 9. These filings generally referred to this investment as stock. [7]

Sub 2 recorded the Perpetual Securities on its consolidated financial statements as an unsecured and subordinated obligation of Issuer. You noted in your FSA request your belief that the Certified Financial Statements for Sub 2's Year 3 tax year indicated that the return on this investment was put under the category of "Interest Received." You based this belief on the statement in the Year 3 financial statement that Sub 2 in Year 3 received Amount 6 in currency and recorded it as "interest." Presently, you believe that part of that amount involves the payments Sub 2 received on the Perpetual Securities. However, we note that a separate section of this financial statement clearly makes the following direct reference to the Perpetual Securities:

You also note that Taxpayer appears to have reported income from its Issuer investment on Forms 5471 (Information Return of U.S. Persons with respect to

[7] Note, however, that at that time the Issuer had notified that it planned to call the Perpetual Securities pursuant to its call rights so that at that time these instruments had actually become "short term." We do not believe that this is inconsistent with the view expressed herein that the instruments were issued as equity, not debt.

Certain Foreign Corporations) filed with the Service in regard to Sub 2 and Sub 3[8] as interest. You state that the investment can be tracked throughout its life, and that the Issuer investment was consistently reported on all pertinent Forms 5471 as giving rise to interest income. You provided the following chart to us and set forth in bold the interest income in which you think Corporation 1 reported the yield amounts received on these securities:

Chart

LAW AND ANALYSIS

I. Section 956A.

Former sections 956A and 951(a)(1)(C) generally required the United States shareholder of a CFC to include in gross income an amount determined in part with reference to its CFC's earnings invested in “excess passive assets.”[9] For this purpose, “excess passive assets” was defined in former section 956A(c)(1) as the excess (if any) of the average of the amounts of “passive assets” held by the CFC as of the close of each quarter of the CFC’s taxable year, over 25 percent of the

[8]Because Sub 2 and Sub 3 constitute foreign corporations, neither qualify as part of Taxpayer for purposes of filing a consolidated U.S. Federal income tax return.

[9]Former sections 956A and 951(a)(1)(C) were adopted as part of the 1993 Revenue Reconciliation Act (Pub. Law 103-66, sec. 13231(b)); they generally were effective for taxable years of foreign corporations beginning after September 30, 1993, and to taxable years of United States shareholders within which or with which such foreign tax years ended. The provisions were repealed by the Small Business Jobs Protection Act, Pub. Law 104-188, sec. 1501(a)(2); the repeal was effective for taxable years of foreign corporations beginning after December 31, 1996, and to taxable years of United States shareholders within which or with which such foreign tax years ended.

average of the amounts of total assets held by the CFC as of the close of each quarter of the CFC's taxable year, and "passive assets" was defined with reference to the PFIC rules, as assets that produced "passive income" for purposes of the PFIC passive income and passive asset tests; see former section 956A(c)(2)(A) and section 1297(b). For this purpose, passive income included amounts that were defined as "foreign personal holding company income" (FPHCI) in section 954(c); see section 1297(b). Such income, in general, included both dividends and interest.

Two exceptions to that general rule, however, could possibly carve out in whole or in part from treatment as a passive asset, an investment in the stock of a foreign corporation engaged in the banking business, and result in the income derived from such activity being treated as nonpassive income for purposes of former section 956A. First, section 1297(c) provided a "look-thru" rule, under which, if a foreign corporation owned, directly or indirectly, at least 25% of the value of the stock of another corporation, then the foreign corporation was treated as if it held its proportionate share of the assets of the other corporation and received directly its proportionate share of the other corporation's income. That look-thru rule was expressly incorporated into former section 956A; see former section 956A(c)(3)(A).

Second, section 1297(b)(2)(A) excluded from the general definition of "passive income" any income derived in the active conduct of a banking business by an institution licensed to do business as a bank in the United States (or, to the extent provided by regulations, any other corporation). Although no final regulations have been promulgated, Notice 89-81, 1989-2 C.B. 399, describes the circumstances under which income derived in the banking business by a foreign corporation not licensed to do business as a bank in the United States is treated as active income for purposes of the PFIC passive asset and passive income tests. Neither section 1297(c), nor Notice 89-81, prohibits the use of the look-thru rule of section 1297(c) to determine whether a foreign corporation that directly or indirectly owns at least 25% of the value of another foreign corporation that is represented to be an active bank is a PFIC.

Notice 89-81 states that it is an "administrative pronouncement" that might be relied on by taxpayers until regulations are published, that such regulations will generally be effective for taxable years beginning after 1986, and that any modification of the rules in Notice 89-81 would be prospective. 1989-2 C.B. at 401.

Based on the cross-references in former section 956A to section 1297 discussed above, we conclude that for purposes of former section 956A, taxpayers were entitled to apply section 1297(c) and rely on Notice 89-81 throughout the years here in issue to determine whether, and to what extent, income derived by a foreign corporation not licensed to do business as a bank in the United States but engaged in the banking business should be treated as active income and thus, attributed to its foreign parent to determine if it is a PFIC. Thus, the application of section 1297(c) and the PFIC active banking rules are equally applicable to determine whether an asset is passive for purposes of former section 956A.

II. In Substance the Perpetual Securities Are Equity.

Usually, the often-litigated debt-equity issue, i.e., whether advances made by a shareholder to a controlled corporation should be characterized as debt or equity for Federal tax purposes, arises in the context in which the Service is contending for equity and the petitioner is contending for debt. That is not the case here. Corporation 1 contends that the Perpetual Securities are equity and you contend that they are debt. As noted by the Tax Court in Segel v. Commissioner, 89 T.C. 816 (1987); this "role reversal" in no way alters the applicable substantive principles. See also Wilshire & Western Sandwiches, Inc. v. Commissioner, 175 F.2d 718, 721 (9th Cir. 1949), revg. a Memorandum Opinion of the Tax Court, T.C. Memo. 1984-218; Georgia-Pacific Corp. v. Commissioner, 63 T.C. 790, 795-796 (1975); Ragland Investment Co. v. Commissioner, 52 T.C. 867, 875 (1969) , affd. per curiam, 435 F.2d 118 (6th Cir. 1970); J.A. Maurer, Inc. v. Commissioner, 30 T.C. 1273, 1289 (1958); Inductotherm Industries, Inc. v. Commissioner, T.C. Memo 1984-281.

We note that none of the decided cases in the debt-equity area lays down any comprehensive rule by which the question presented may be decided in all cases. The decision in each case turns upon its own particular facts and circumstances. In general, the resolution of the debt versus equity issue in the decided cases involves a comparison of the advances with a list of factors thought to be characteristic of true debt or equity. Some of the factors relied upon are: the intent of the parties, the name given the instrument, the presence or absence of a fixed maturity date, whether annual payments are dependent upon earnings, the credit status of the holders of the instruments (i.e., whether they are superior to or inferior to other creditors of the corporation), and whether the instrument carries with it any right to participate in the management of the company. None of the factors is necessarily controlling. In some cases one factor or another is said to be decisive and in other cases the determination is predicated upon a combination of them.

Initially, we note that traditional preferred stock has consistently been characterized as equity even though it often has a number of features in common with debt. As noted by one eminent commentator:

> Preferred stock is probably the most flexible of equity instruments, being limited in its terms and rights only by the imagination of the drafter. Thus, preferred stock can bear a fixed (or floating) dividend rate (although dividends typically have first preference on earnings), be cumulative (or not), participate with common (or not), have a fixed maturity date (or be "evergreen"), have a fixed (or variable) redemption price, be convertible (or exchangeable) into common (or into another class of preferred), be voting or nonvoting (or voting only in limited instances), and be callable, puttable (or both) at a fixed (or variable) redemption price; but it almost always has a preferred claim over common on dividends and upon liquidation (hence its label "preferred stock"). Thus, on a continuum, ranging from super-secure to highly risky, preferred stock can run the gamut of risk and rewards, depending on its particular terms, rights, and remedies under local corporate law.

Eustice, ’Debt-Like’ Equity & ’Equity-Like’ Debt: Treasury’s Anti-Hybrid Proposals, 71 Tax Notes, 1657, 1662 (June 17, 1996).

The 1st Factor – Intent of Parties

In determining whether an instrument appropriately is treated as debt, the intent of the parties is a highly significant, although not determinative, factor. Ragland v. Commissioner, 52 T.C. 867, 876 (1969), aff'd 435 F.2d 118 (6th Cir. 1970). A transfer will be characterized as a loan if at the time the funds were transferred, there was an unconditional intention on the part of the transferee to repay the money, and an unconditional intention on the part of the transferor to secure repayment. Geftman v. Commissioner, 154 F.3d 61 (3rd Cir. 1998); see also Groetzinger v. Commissioner, 87 T.C. 533, 542 (1986) ("In applying the substance-over-form doctrine, we are concerned with the intentions *at the time of the agreement* and economic realities as then perceived by the participants") (emphasis added). Thus, it is the intent of the parties *at the time of the transfer* that is most important.

You stress that one of the reasons Corporation 1 undertook this transaction was to avoid the imposition of the "excess passive assets" tax of I.R.C. § 956A. We note, however, that "a taxpayer has the right to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by any means the law permits." Goldstein v. Commissioner, 364 F.2d 734, 741 (2nd Cir. 1966) (citing Gregory v. Helvering, 293 U.S. 465, 469 (1935)). The fact that the issuance of preferred stock is motivated by tax considerations has been held to be insufficient in and of itself to support a finding of debt. See Ragland Inv. Co. v. Commissioner, 52 T.C. 867 (1969), aff'd per curiam, 435 F.2d 118 (6th Cir. 1970) (transaction deliberately structured to create preferred stock in order to qualify for § 243 dividends-received deduction; held successful under the circumstances of that case).

The proper inquiry therefore is not whether Taxpayer was trying to avoid tax but whether the Perpetual Securities that Sub 2 held constituted debt or equity. For all the reasons set forth below, we believe that Sub 2 principally intended the Perpetual Securities to constitute equity rather than debt, although we recognize that Sub 2's post-transaction manifestations were somewhat inconsistent in this regard.

Before entering into this transaction, Corporation 1 had financial advisors review Corporation 2's proposal. It is clear that Corporation 1 and the financial advisors viewed the Perpetual Securities as equity. Taxpayer clearly wanted the transaction to be treated as an equity investment in an active foreign bank. It is also clear that the financial advisors considered Corporation 2's Proposal as an offer by Issuer to sell Taxpayer an ownership interest in Issuer. The "Advisors" report provided the following: Issuer's current earnings and reserves amounted to "over ten times the required *preferred dividend* on the Corporation 1 investment"; if the proposal is accepted, Sub 2 would *sacrifice* "an acceptable amount of interest income." The report also provided: (1) Sub 2 would receive "*dividends*" under Corporation 2's proposal; (2) "outsiders would consider that Sub 2 was taking a "Percent *equity"* position; and (3) although Corporation 2's proposal was a safe one financially, Corporation 1 "would be perceived as expanding [its] risk taking."

What's most importance here is the terms of the Agreement because those terms indicate Sub 2's intent at the time it purchased the Perpetual Securities. The terms of the agreement are also important for determining the true nature of the underlying transaction. The Agreement strongly shows that the Perpetual Securities were intended by Taxpayer to be equity. It expressly provides that the securities: (1) have no fixed maturity date (hence the name, Perpetual Securities); (2) are unsecured; (3) are not payable upon demand; (4) are ranked junior to Issuer's secured and unsecured liabilities, including any obligations that are subordinated obligations; and (5) rank senior to Issuer's *other classes of stock*. It further provides that: (1) Issuer's board has the right to decide and approve payment of the yield amount for each yield period; (2) payment of the quarterly yield amount is subject to suspension if Issuer does not have "Distributable Profits"; (3) upon liquidation or bankruptcy, Taxpayer's claims are subject to the complete prior satisfaction of the claims of all creditors of the Company; (4) redemption of the securities is dependent on Issuer having "Unencumbered Capital";[10] and (5) Sub 2 had the right to be represented on Issuer's Board of Directors upon non-payment of the yield amount under certain conditions. Finally, there is no provision in the Agreement allowing Taxpayer the right to force a redemption of the securities or force payment of the yield amount prior to the Date 2.

You maintain that the Corporation 1's post-Agreement conduct shows that Corporation 1 intended the securities to be debt. In support of your position, you cite to the fact that Corporation 1 treated this investment inconsistently in the post-transaction period, treating it at times as if it were debt and at other times as if it were equity. See Gregg Co. of Delaware v. Commissioner, 239 F.2d 498 (2nd Cir. 1956) (the intent of the parties may be reflected by their subsequent acts; the manner in which the parties treat the instruments is relevant in determining their character). First, the Year 8 and Year 9 SEC 10-K filings filed by Taxpayer indicate

[10]Under the Agreement, "Unencumbered Capital" is defined as the excess of the total value of Issuer's assets over the sum of Issuer's senior liabilities and its subordinated liabilities.

that certain amounts of this investment (those Perpetual Securities that were to be redeemed that particular year) were being categorized as “short term.” Generally, the phrase “short term” is suggestive of debt, however, we do not think that here. As we noted in footnote 7, supra, Corporation 1 had legitimate reasons to label this investment as short term: Issuer had just notified Sub 2 that it was planning in that year to call the Perpetual Securities pursuant to its call rights. Thus, after that notification, Corporation 1’s investment had clearly become “short term.”

You also cite your belief that Sub 2, and later Sub 3, reported the yield from this investment in its “interest” totals on U.S. Forms 5471 for years Year 3 to Year 7. We have reviewed the documents you have submitted to support this conclusion. We can understand how the documents led you to that conclusion. While we believe this may be correct, the numbers do not jibe with this conclusion perfectly. Nevertheless, even assuming that Corporation 1 did consistently report the return on this investment as “interest” on Forms 5471, we do not think that is a sufficient basis for the Service to recharacterize this transaction as debt.

We note that Corporation 1 treated it as <u>equity</u> on other post-transaction documents.

Additionally, Sub 2's Certified Financial Statements for Year 3 state that the securities pay "*dividends*." What is clear is that Corporation 1’s post-transaction treatment of this investment may have been somewhat inconsistent: Sometimes it may have treated it as debt, although more often it refers to it in equity terms. Again, what is critical here is Sub 2’s intent <u>at the time it entered into this transaction</u>. Under the facts presented to us, we believe that the terms of the Subscription Agreement are the best indicator of Sub 2’s intent at that time and they support equity characterization.

<u>The 2nd Factor – Name of Instrument</u>

The next important factor in determining whether an instrument is debt or equity is the name given to the instrument. <u>Crawford Drug Stores, Inc. v. United States</u>, 220 F.2d 292, 295 (10th Cir. 1955) (a factor in determining debt versus equity is the intent of the parties, which would include the label the parties give to the instrument). Although this investment was not labeled either equity or debt, it was labeled “Perpetual Securities.” Generally, investments with long term maturities are suggestive of equity and investments with short term maturities are suggestive of debt. "Perpetual Securities" suggests a long term investment and, therefore, is indicative of equity. See Taiyo Hawaii Co. v. Commissioner, 108 T.C. 590 (1997) (descriptive terms on document such as "payment of principal is the priority" and that the rate of payment is "short-term prime," are indicative of debt and interest rather than equity or capital). Thus, we believe that this factor favors an equity characterization.

In this regard, we agree with your observation that mere labels cannot change debt to equity. You cite the following as indicative of debt: "[i]n implementing this transaction, taxpayer observed that outsiders might perceive the arrangement as an illiquid, risky equity venture of a Percent interest in a bank, *a perception that the company understood to be erroneous*" (emphasis added). We do not believe this statement from the "Advisors" report alters our view that the instruments in issue were equity. It could simply reflect the fact that these instruments were not risky and, in light of Sub 2's ability to borrow money on the strength of the security of these instruments, not illiquid. In any event, the other equity factors predominate.

The 3rd Factor – Fixed Maturity Date

The third important factor is the presence or absence of a fixed maturity date. The absence of a fixed maturity date would indicate that purported debt is equity for tax purposes, because a sum certain payable at maturity is the essence of debt for tax purposes. Crawford Drug Stores, Inc. v. United States, 220 F.2d 292, 295 (10th Cir. 1955). However, a fixed maturity date is common in preferred stock and its presence would not be cause for concluding that an instrument with other stock characteristics is debt for tax purposes. See Ragland Investment Co. v. Commissioner, 52 T.C. 867 (1969) , aff'd, 435 F.2d 118 (6th Cir. 1970). Here, the Subscription Agreement expressly stated that these securities had no fixed maturity date, yet it also gave Sub 2 the right to serially put the securities to Issuer in the Date 2. We do not think that a "put" option, exercisable for the first time, 87 years after issuance of the securities can be considered a fixed maturity date (or at least not the type of fixed maturity date – due to its distant "put" feature – that would indicate debt rather than equity). Thus, we believe that unlike typical debt, the Perpetual Securities essentially had no fixed or stated maturity date (or such a distant date, if any) that this is suggestive of equity. Parisian, Inc. v. Commissioner, 131 F.2d 394 (5th Cir. 1942) (where preferred stock did not have a fixed maturity with a right to enforce collection, "dividends" are accepted as "dividends," even though the preferred stock has redemption features); Zilkha & Sons, Inc. v. Commissioner, 52 T.C. 607 (1969).

The 4th Factor – Source of Yield Payments

The fourth factor is the source of the yield amounts; that is, whether the payments are dependent upon earnings. One general difference between equity and debt is that an equity holder's profit or loss depends on the success of the business venture, whereas a debt holder is entitled to his return without regard to the success of the business. Dividends on stock are normally payable only out of earnings or surplus of a corporation. Interest on debt, on the other hand, can be paid out of capital. When payments are made only out of the corporation's net earnings, as true dividends are, the return-on-investment more clearly resembles a preferred stock interest. Where such payments are made without regard to earnings, the return-on-investment more clearly resembles debt. See B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, para. 4.03 (5th ed. 1987); Crawford Drug Stores, Inc. v. United States, 220 F.2d 292, 295 (10th Cir. 1955) (another factor in determining debt versus equity is the source of the payments on the instrument, i.e., whether they are payable only out of earnings); Finance and Investment Corporation, 57 F.2d 444 (D.C. Cir. 1932) (dividends on preferred stock payable only out of earnings were held not to be deductible as interest). In this case, unlike debt, the holders of the Perpetual Securities had no right to receive yield payments on the securities unless and until declared by Issuer's Board and only if Issuer had distributable profits. “Distributable Profits” are defined as:

> [Issuer]’s after tax net profits . . . for such Fiscal Year plus carried forward profits plus distributable reserves constituted out of profit (less any carried forward loss) in each case on the basis of [Issuer]’s audited consolidated financial statements for such Fiscal Year as approved by the Board.

Subscription Agreement, page 11, definitions. It is therefore clear that the “yield amount” was not payable without regard to Issuer’s current or past profits. Unlike debt, the return on the Perpetual Securities has not payable in all events. This factor indicates that the Perpetual Securities resemble equity.

The 5th Factor – Subordination

A fifth factor is whether the investments are superior to or inferior to the right of creditors of the corporation. The Subscription Agreement clearly states that the Perpetual Securities rank junior to the secured and unsecured liabilities of Issuer, including any obligations of Issuer that are subordinated obligations, and senior to

Issuer's ordinary shares or any other class of shares issued or to be issued by Issuer. Thus, this factor favors equity characterization.

The 6th Factor – Right to Participate in Management

A Sixth factor is whether the instrument carries with it any right to participate in the management of the company. Charles L. Huisking & Co. v. Commissioner, 4 T.C. 595, 599 (1945) (the fact that an instrument does not confer upon the holder a voting right or any power of management suggests that the instrument is debt). Here, although Taxpayer does not have a right to elect members to Issuer's Board of Directors, the Subscription Agreement does provide Sub 2 a right to have its interests represented on the Board under certain conditions. On balance, however, this factor is not support for equity characterization.

The 7th Factor – Liquidation Proceeds

A seventh factor is whether the holders of the securities could share in the proceeds upon liquidation of Issuer equally with Issuer's creditors. The Subscription Agreement provides that payment of the redemption amount in the event of liquidation or bankruptcy is subject to the complete prior satisfaction of the claims of all creditors of Issuer. Thus, Sub 2 would recover its investment in the event of liquidation or bankruptcy of Issuer only after the creditors and other bondholders of Issuer had been paid. This indicates that the Perpetual Securities are equity, not debt. Ragland, 52 T.C. at 877; Charles L. Huisking & Co., Inc., 4 T.C. 595 (1945) (upon liquidation the claims of the holders of the preferred stock are subordinate to the claims of creditors. This indicates that the securities are stock rather than evidences of indebtedness). This factor supports equity characterization.

The 8th Factor – Enforcement Rights

An eighth factor is the right to enforce payment of principal and interest. There is no provision in the Subscription Agreement allowing Sub 2 to force payment of either the par amount or the yield amount. The Subscription Agreement does give Sub 2 the right to put the securities back to Issuer on or after Date 2 (87 years after the purchase of the Perpetual Securities) for par value plus accumulated yield. But we note that this redemption right is conditioned on Issuer having unencumbered capital. Thus, we do not think that Sub 2's "put" option here suggests that this is debt.

Of importance here, however, is the right of the instrument holder to force payment of the sum as a debt in the event of default. Parisian, Inc. v. Commissioner, 131 F.2d 394 (5th Cir. 1942) (of great significance is the complete absence of a most essential feature of a debtor and creditor, as opposed to a stockholder and corporation, relationship, the existence of a fixed maturity for a principal sum with the right to force payment of the sum as a debt in the event of default); Commissioner v. J. N. Bray Co., 126 F.2d 612 (5th Cir. 1942) (payments, though in form dividends, were in fact interest because the certificates contained a provision, not only for a fixed maturity with the right to sue on the certificates after one year's default, but for an acceleration of maturity with the right to sue where 4 consecutive semi-annual interest payments were defaulted). Here, Sub 2 had no right to force Issuer to pay the par amount of the securities or any unpaid yield in the event of default. Nor did Sub 2 have a right to liquidate Issuer in the event of default. Additionally, when it is considered the Issuer had Amount 2 at stake during the period that it held these did not obtain a security interest in any secured no assets of Issuer, it is quite clear that it did not contemplate at the time it entered into this transaction that it should be a creditor to the extent of Amount 2 with fixed maturities and the right to sue. Thus, the Amount 2 appears to be risk capital entirely subject to the fortunes of the corporate venture and, therefore, we think that this factor supports equity characterization.

III. I.R.C. § 385(c) Is Not Implicated Here.

The Service cannot look to § 385(c) for support to re-characterize these Perpetual Securities as debt. Under § 385(c), the issuer's characterization of an instrument as of the time of issuance as either debt or equity is binding on the issuer and on all holders of the instrument. This characterization, however, is not binding on the Service or on a holder that discloses to the Service on its return that it is treating the instrument in a manner inconsistent with the issuer's characterization. Corporation 1 informed the Service in its § 385(c) statement that Issuer, the issuer, would treat the Perpetual Securities under Country law as indebtedness but that Corporation 1 would report on its return Sub 2's treatment of the Perpetual Securities as equity for U.S. tax purposes. Moreover, we note that there is no evidence in the material that you sent us indicating that Issuer, the issuer, or any of its affiliates filed a U.S. federal tax return treating the Perpetual Securities as debt for U.S. tax purposes. Accordingly, we do not believe § 385(c) would be implicated here, even if the disclosure statement were not filed.

IV. Taxpayer's Treatment of this Investment is Not Inconsistent with Instruments' Form and Substance

Finally, we do not view Corporation 1 as taking a position contrary to the form or substance of the transaction. Therefore, the following cases, in which the court has held the taxpayer to the form of his transaction, are inapposite: Taiyo Hawaii Co. v. Commissioner, 108 T.C. 590 (1997); Comdisco, Inc. v. United States, 756 F.2d 569 (7th Cir. 1985); Norwest Corp. v. Commissioner, 111 T.C. 140 (1998); Estate of Durkin v. Commissioner, 99 T.C. at 561 (1992); Illinois Power Co. v. Commissioner, 87 T.C. 1417 (1986); Pinson v. Commissioner, T.C. Memo. 2000-208. In those cases, the taxpayer attempted to disavow the form of its transaction and argue the substance. Likewise, the rule of Estate of Weinert v. Commissioner 294 F.2d 750 (5th Cir. 1961) that the taxpayer must show an honest and consistent respect for the substance of the transaction in its tax returns and other documents is inapposite; it applies only where the taxpayer is seeking to disavow the form of the transaction. Corporation 1 is not seeking to disavow the form of the transaction, rather its position is consistent with both the form and the substance of the transaction.

In the following cases, the court (holding adverse to both taxpayers), found that the instrument was what its form and substance revealed it to be. Intergraph Corp. v. Commissioner, 106 T.C. 312, 323 (1996) , affd. per curiam without published opinion 121 F.3d 723 (11th Cir. 1997) (taxpayer argued that it, not its subsidiary, was the primary obligor on a loan; the Court, holding adverse to the taxpayer, found of the transaction showed in both form and substance the subsidiary as the primary obligor and taxpayer as the guarantor of a loan); Morgan Pacific Corp. v. Commissioner, T.C. Memo. 1995-418 (taxpayer alleged that transaction constituted a return of equity; the Court, holding for the Service, found that the transaction was in form and substance an interest payment by the subsidiary to a shareholder of the parent corporation). Our case is similar in that both the form and the substance suggest equity. Therefore, where the form and the substance are the same, the form and the substance will control our determination. We find Sub 2's purchase of Perpetual Securities was a purchase of equity in Issuer.

V. Conclusions.

We believe that under an analysis of all of the traditional debt versus equity factors, that the Perpetual Securities resemble equity, not debt. Section § 385(c) does not change that result, nor is it even implicated here. Furthermore, we believe that, both as a matter of form and of substance, the Perpetual Securities were equity.

We are convinced that Sub 2's intent at the time it purchased these securities was to create an equity interest in Issuer, a banking business. You do not dispute that this transaction was entered into at arm's length. Both Sub 2 and Issuer were independent of each other, there was no common control between them. Corporation 1 manifested a pre-transaction intent to obtain an Percent equity interest in an active foreign bank to protect Sub 2's unrepatriated earnings from taxation under former section 956A. The Advisors understood that Corporation 2 was proposing an equity interest in Issuer. The terms of the Subscription Agreement clearly manifested an equity, rather than a debt, investment. Corporation 1 expressed its intent to treat the Perpetual Securities as equity in its section 385(c) disclosure statement. Sub 2's Year 3 financial reporting statement indicated that the securities would pay "dividends." Corporation 1's SEC filings consistently indicated that the investment was equity.

There are two steps you need to take to confirm that former section 956A does not apply to Corporation 1 during the taxable years in issue. First, you should confirm that Sub 2's investment in Issuer was equal to at least 25% of the value of the latter corporation. Second, you should determine whether all or part of Issuer's income and assets are active and not passive by examining whether, and to what extent, Issuer's income and assets are active under the criteria set forth in Notice 89-81.

JASPER L. CUMMINGS, JR.
Assistant Chief Counsel (Corporate)

By: ALFRED C. BISHOP
Branch Chief
Associate Chief Counsel (Corporate)

cc: Bob Brazzil / Industry Director
Internal Revenue Service
Attn: Industry Director, Retailers, Food & Pharmaceuticals (LM:RFP)
1901 Butterfield Road, Suite 310
Downers Grove, IL 60515