DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL
CC:LM:MCT:CIN:1

FROM: Jeffrey Dorfman
Chief, CC:INTL:05

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated July 3, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =
Country A =
Branch A =
Sub A =
Sub B =
Sub C =
Date a =
Date b =
Amount a =
Amount b =
Amount c =
Amount d =
Rate a =
Rate b =
Rate c =
Rate d =
X year =

ISSUES

1. Whether the Sub A stock received by Branch A as an “interest payment” on the purported loan from Branch A to Sub A should be treated as § 305(a) stock and whether such payment is taxable under United States law.

2. Whether the Taxpayer can claim interest deductions for interest paid with respect to the loan to Taxpayer’s branch by the unrelated lenders and the loans to Taxpayer by Sub B and Sub C (as described below), under the assumption that such loans have economic substance.

CONCLUSIONS

(1) The Sub A stock received by Branch A as an “interest payment” on the purported loan from Branch A to Sub A should be treated as section 305(a) stock and is not taxable under United States law.

(2) Taxpayer can claim interest deductions for interest paid with respect to the loan to Taxpayer’s branch by the unrelated lenders and the loans to Taxpayer by Sub B and Sub C (as described below), under the assumption that such loans have economic substance. However, subject to the conditions identified in this memorandum, the interest income received by Sub B and Sub C with respect to the loan to Taxpayer is foreign base company income under section 954(c)(1)(A). For foreign tax credit limitation purposes, the amount included in Taxpayer’s income under section 951(a)(1)(A) is treated as income that is derived from sources within the United States pursuant to section 904(g)(2) and §1.904-5(m)(5)(i). If Taxpayer chooses the benefits of paragraph 3(a) of Article XXIV of the United States-Country A income tax treaty to treat the income as foreign source income, section 960 must be applied separately to such income under section 904(g)(10) and §1.904-5(m)(7).

FACTS

A. The Related Party Loans

1. Parties to the Transaction

Taxpayer is a domestic corporation which operates in Country A through a chain of controlled foreign corporations. Branch A is the Country A branch of Taxpayer. Sub A is a Country A controlled foreign corporation as defined in section 957 wholly owned by Taxpayer. Sub A has two wholly-owned lower-tier Country A

subsidiaries, Sub B and Sub C, both of which are controlled foreign corporations under sections 957 and 958.

2. Branch A/Sub A Loan

On Date a, Taxpayer caused Branch A to borrow Amount a U.S. dollars at an interest rate of Rate a from a group of three unrelated U.S. parties. Taxpayer acted as guarantor of the loans. On Date b, Branch A converted the Amount a proceeds of the loans into Amount b and re-loaned the proceeds to Sub A. The loan between Branch A and Sub A was unsecured, had a X-year term and an interest rate of Rate b per annum, with interest payable in the common stock of Sub A rather than in cash. Branch A simultaneously entered into a forward purchase agreement to buy shares of Sub A upon maturity of the loan equal to the loan's principal amount.

3. Sub A/Sub B and Sub C Loans

On the same date, Sub A entered into loan and forward purchase agreements with two of its lower-tier Country A subsidiaries. Sub A loaned Amount c to Sub B and Amount d to Sub C. Both loans had principal amounts totaling the Amount b to be received from Branch A under the Branch A/Sub A loan. The loans had X-year terms and annual interest rates of Rate c, with interest on the loans payable in the common stock of the two companies. The forward purchase agreements similarly provided that Sub A would "reinvest" the principal amount of the loans upon repayment in the stock of the subsidiaries.

4. Sub B and Sub C/Taxpayer Loans

Sub B and Sub C re-loaned the Amount b to Taxpayer through various loans spanning a twelve month period at Rate d interest for X-year terms.

B. Taxpayer's Tax Treatment of the Loans

For Taxpayer's previous reporting cycle, Taxpayer claimed interest deductions on its Country A tax return for the various related party loans. However, on its consolidated federal tax return, Taxpayer took the position that the loans and offsetting forward contracts should be integrated and treated the payments in stock received by Branch A and Sub A as stock dividends pursuant to section 305(a). Last cycle, the Field treated the loan and corresponding forward purchase arrangements between Branch A and Sub A, and the similar arrangement between Sub A and Sub B and Sub C as follows: (1) the payments in stock received by Branch A and Sub A resulting from the loans and offsetting forward contracts were treated as stock dividends pursuant to section 305(a); (2) the Sub B and Sub C loans to Taxpayer were treated as investments in U.S. property pursuant to section

956 for which an indirect foreign tax credit pursuant to sections 960 and 902 for Country A income taxes deemed paid by Taxpayer was allowed; (3) the field allowed Taxpayer interest deductions (subject to section 267(a)) for interest paid to Sub B and Sub C (apparently, Taxpayer did not claim an interest deduction for interest paid to the unrelated lenders); and (4) the field asserted a section 881 withholding tax of 10% (reflecting Article XI of the United States-Country A Income Tax Treaty) on the interest paid by Taxpayer to Sub B and Sub C. Taxpayer agreed with the foregoing adjustments. This cycle, Taxpayer agrees with the adjustments by the field set forth above but is claiming a deduction for the interest it paid to the unrelated third party lenders.

LAW AND ANALYSIS

A. Characterization of the Stock Received by Branch A

1. Taxpayer's Disavowal of Form

In order to disavow the form of a transaction and apply the principals of economic substance, Taxpayer must meet the standards set forth in Estate of Durkin v. Commissioner, 99 T.C. 561(1992), and Taiyo Hawaii Co., Ltd. v. Commissioner, 108 T.C. 590 (1997). These cases state that, normally, taxpayers may not use a substance over form argument to disavow their chosen form; however, in some circumstances, the disavowal will be permitted. Taxpayers will be permitted to assert the substance-over-form argument when the taxpayer's "tax reporting and other actions have shown an honest and consistent respect for … the substance of … [a transaction]." Taiyo Hawaii Co., Ltd., 107 T.C. at 602, quoting FNMA v. Commissioner, 90 T.C. 405, 426 (1988).

In addition, Estate of Durkin sets forth the following principals for disavowal of form: (1) The taxpayer must not be seeking to disavow its own tax return treatment for the transaction; (2) the taxpayer must show an honest and consistent respect for the substance of the transaction; (3) the taxpayer must not be unilaterally attempting to recast the transaction to obtain tax benefits with the perspective of hindsight; and (4) the taxpayer must not be unjustly enriched by disallowing the form of a transaction. Estate of Durkin, 99 T.C. at 574, 575.

Taxpayer must meet these standards to be permitted to integrate the loan and the forward purchase agreement. Taxpayer has shown a consistent respect for the treatment of the transaction and has reported the transaction on its tax return as though the transaction was integrated. Taxpayer is not using the benefit of hindsight to argue economic substance, nor has Taxpayer been unjustly enriched. Taxpayer has met the standards of Durkin and Taiyo and thus should be allowed to disavow the form of the transaction.

2. Whether the Branch A/Sub A Loan is Debt or Equity

Section 163 provides that periodic payments made with respect to an instrument are deductible as interest only if the instrument is a valid indebtedness of the payor. The characterization of an instrument as debt or equity for federal income tax purposes depends on all the facts and circumstances surrounding the issuance of a particular instrument. No one particular characteristic can be said to be decisive. John Kelly Co. v. Commissioner, 326 U.S. 521 (1946).

In resolving questions of debt versus equity, courts have identified and considered many factors. See e.g. Roth Steel Tube Company v. Commissioner, 800 F.2d 625, 630 (6th Cir. 1986) (11 factors); Stinnet's Pontiac Service, Inc. v. Commissioner, 730 F.2d 634, 638 (11th Cir. 1984) (13 factors); Estate of Mixon v. United States, 464 F.2d 394, 402 (5th Cir. 1972) (13 factors); Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712, (T.C. 1972) (11 factors). Among the factors that may be considered in making this determination are:

(1) the names given to the certificates evidencing the indebtedness;
(2) the presence or absence of a fixed maturity date;
(3) the source of payments;
(4) the right to enforce payment of principal and interest;
(5) participation in management flowing as a result;
(6) the status of the contribution in relation to regular corporate creditors;
(7) the intent of the parties;
(8) "thin" or adequate capitalization;
(9) identity of interest between creditor and stockholder;
(10) source of interest payments;
(11) the ability of the corporation to obtain loans from outside lending institutions;
(12) the extent to which the advance was used to acquire capital assets; and
(13) the failure of the debtor to repay on the due date or to seek a postponement.

In applying these factors, each case must be decided on its own facts, and no one standard is controlling.

The debt characteristics of this transaction include the unconditional promises to pay a sum certain on a fixed maturity date within the reasonably foreseeable future, the label placed on the instrument by the parties, and Branch A's ability to enforce payment of principal and interest.

The equity characteristics of the instrument include identity of interest

between creditor and stockholders, required payment of principal and interest only in stock, the source of payments and Branch A's increased ownership of Sub A flowing as a result of the payments of principal and interest.

The loan followed by the forward purchase agreement have the characteristics of an equity arrangement, rather than debt. In this case, Branch A made a loan to Sub A and then the parties entered into a forward stock purchase agreement, and Branch A agreed to accept stock of Sub A in exchange for the principal amount and interest due on the loan. Assuming the forward purchase agreement can be stepped together with the loan, the transaction indicates an equity contribution, rather than debt, because the funds are used to acquire the stock of Sub A. See Estate of Mixon v. United States, 464 F.2d at 410.

In addition, the principal and interest payments on the "debt" of Sub A are payable only in the stock of Sub A. According to Notice 94-47, 1994-1 C.B. 357, an instrument does not qualify as debt if it has terms substantially identical to promissory notes but with a provision that requires the holder to accept payment of principal solely in stock of the issuer.

3. Integration of the Loan and Forward Purchase Agreements under the Step Transaction Doctrine

Under the step transaction doctrine, a series of formally separate steps may be collapsed and treated as if they constitute a single integrated transaction. Three tests are used to determine if the doctrine applies. They are the binding commitment test, the mutual interdependence test, and the end result test. Under the binding commitment test, a series of formally separate transactions are stepped together or collapsed if, when the first step is taken, there is a binding commitment to take the later steps. Commissioner v. Gordon, 391 U.S. 83, 96 (1968), 1968-2 C.B. 148. Under the mutual interdependence test, a series of formally separate transactions are stepped together or collapsed if they are "so interdependent that the legal relations created by one transaction would be fruitless without completion of the series." See, e.g., American Bantum Car Co. v. Commissioner, 11 T.C. 397, 405 (1948), aff'd., 177 F.2d 513 (3d Cir. 1949), cert. denied, 339 U.S. 920 (1950). Finally, under the end result test, a series of formally separate transactions are stepped together or collapsed if they appear to be "prearranged parts of a single transaction intended from the outset to reach the ultimate result." Penrod v. Commissioner, 88 T.C. 1415, 1429 (1987).

In addition to the equity characteristics outweighing the debt characteristics, based on the facts above, it is likely that a court would apply at least one of the tests to this case to determine the actual substance of this transaction. The loan followed by the forward purchase agreement would be stepped together and treated as if Branch A contributed Amount a to Sub A in exchange for additional Sub A

stock as well as periodic distribution of Sub A stock by Sub A to Branch A.

Assuming the forward purchase agreement is stepped together with the loan, the transaction should be treated as an equity contribution by Branch A to Sub A for additional stock. In addition, the distribution of stock to Branch A from Sub A should be treated as if the distribution was made with respect to Branch A's stock in Sub A, and not as an interest payment. Section 305(a) states the general rule that, except as otherwise provided in § 305, gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock. Under § 305, a distribution made by a corporation to its shareholders in its own stock or in rights to acquire its own stock is not included in the shareholders' gross income. Accordingly, the Sub A stock received by Branch A as an "interest payment" on the purported loan from Branch A to Sub A should be treated as § 305(a) stock and is not taxable under United States law.

B. The Deductibility of the Interest Paid by Taxpayer to Sub B and Sub C

You have asked us to assume that the loans between Taxpayer and the unrelated lenders, and between Sub B and Sub C and Taxpayer, have economic substance in the context of the series of transactions at issue. Indeed, based on this premise the Field has treated the loans by Sub B and Sub C as investments in United States property under section 956 and imposed a withholding tax on interest payments made by Taxpayer to Sub B and Sub C under section 881.[1] Given this assumption, we see no basis for treating the loans inconsistently--that is, as bona fide for some purposes (e.g., determining investments in United States property under section 956 and withholding taxes under section 881) but as not bona fide for others (e.g., deducting interest expense under section 163). However, this conclusion is not the end of the analysis of this case.

C. Treatment of the Interest Income Received by Sub B and Sub C

1. Applicability of the Subpart F Provisions of the Code to the Interest

[1] We have not been asked to address the issue of whether the loans are investments in United States property under section 956. See section 956(c)(1)(C) and, with respect to the foreign tax credit limitation, section 904(d)(3)(G), section 904(g), and §§1.905-5(c)(4) and 1.904-5(m)(4). We also have not been asked to analyze whether the Service may properly impose a withholding tax on the interest paid to Sub B and Sub C by Taxpayer. However, see sections 881(a)(1) and (c)(3)(C) for the inapplicability of the portfolio interest exception. We assume the non-subpart F accumulated earnings and profits of Sub B and Sub C are sufficient to result in an inclusion of the loan principal amounts in Taxpayer's income under section 951(a)(1)(B). Finally, we have not been asked, and express no opinion on, the application of sections 985, 986, 987, and 988 to the facts presented.

Income

a. In general

The Field represents that all of the Country A subsidiaries of Taxpayer are controlled foreign corporations as defined in section 957 and that Taxpayer is a United States shareholder as defined in section 951(b).

b. Characterization of the interest income as subpart F income

Section 952(a)(2) defines subpart F income to include "foreign base company income." Section 954(a)(1) defines the term foreign base company income to include "foreign personal holding company income." Interest income constitutes foreign personal holding company income under section 954(c)(1)(A). Therefore, subject to certain exceptions[2], the interest paid by Taxpayer to Sub C and Sub B (after taking into account allocable expense, if any, as required by section 954(b)(5) and §1.954-2(a)(4)) is foreign personal holding company income of these CFCs and consequently foreign base company income. As foreign base company income of Sub C and Sub B, the interest (net of allocable expense, if any) paid by Taxpayer will constitute subpart F income under section 952(a)(2) and under section 951(a)(1)(A)(i) will be included in Taxpayer's income as a deemed dividend from such corporations. (We emphasize that we are assuming the interest income would not be eligible for any exception that would prevent the income being included in Taxpayer's income as foreign base company income. Further factual development is necessary to confirm this assumption.)

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[2] The exceptions referred to are the exclusions from foreign base company income set forth in sections 954(b)(3)(de minimis rule) and 954(b)(4)(high taxed income) as well as the limitations of section 952(c) (the earnings and profits limitations). Since we understand that Country A allows Sub B and Sub C a deduction for "interest expense" paid to Taxpayer, it is unlikely that the interest income would qualify for the high taxed exception of section 954. See §1.904-6 (foreign taxes are allocated to separate categories based on taxable income as computed under foreign law) and §1.954-1(d) (eligibility for the high taxed exception is based on computation of the section 960 credit that would be associated with the inclusion) and discussion below regarding the special foreign tax credit limitation rules applicable to the subpart F inclusions attributable to U.S. source income. For purposes of this analysis, we assume that the section 954(b)(3) and (4) exclusions do not apply and that Sub C and Sub B have sufficient earnings and profits to support taxation of the interest income under subpart F as well as of the 956 investments referred to above. We suggest further factual development on these issues.

D. Characterization of the Interest Income for Foreign Tax Credit Purposes

1. Entitlement to a Section 960 Deemed Paid Credit

Section 960(a)(1) allows a taxpayer who has a section 951 inclusion attributable to the earnings and profits of a foreign corporation which is a member of a section 902(b) qualified group to treat the section 951 inclusion as a dividend for purposes of determining the credit given under section 902. A qualified group is defined under section 902(b)(2) to mean: (1) a foreign corporation paying dividends in a taxable year to a domestic corporation which owns 10% or more of the voting stock of the corporation; and, (2) any other foreign corporation if the domestic corporation owns at least 5% of the voting stock of this other foreign corporation indirectly through a chain of foreign corporations connected through stock ownership of at least 10% of their stock, the foreign corporation who is the payor of the dividends is the first tier corporation in the chain, and the other foreign corporation is not below the sixth tier in the chain. Taxpayer had a section 951(a)(1)(A) inclusion attributable to Sub B and Sub C, who are members of a section 902(b) qualified group. Accordingly, under section 960(a)(1), Taxpayer may treat its subpart F income derived from its interest payments as a dividend to determine the credit given under section 902 for the foreign taxes of Sub B and Sub C deemed paid by Taxpayer.

2. Treatment of the Interest Income for Foreign Tax Credit Limitation Purposes

Pursuant to section 901(a), the deemed paid credit allowed under section 960 (section 960 credit) is subject to the foreign tax credit limitation of section 904. Under section 904(d)(1), the foreign tax credit limitation regarding the section 960 credit is applied separately to the categories of income listed in section 904(d)(1). The “look through” rules of section 904(d)(3), however, provide that any amount included in gross income under section 951(a)(1)(A) is treated as income in a separate category to the extent the amount so included is attributable to income in such category. See §1.904-5(c)(1). Section 904(g)(2) and section 1.904-5(m)(5)(i) provide that any amount included in the gross income of a United States shareholder of a controlled foreign corporation under section 951(a)(1)(A) is treated as income subject to a separate limitation that is derived from sources within the United States to the extent such amount is attributable to income of the controlled foreign corporation in the corresponding category of income from sources within the United States. See section 904(g)(2).[3]

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[3] To the extent that Sub A pays actual dividends to Taxpayer, see section 904(g)(4) and (5) and §1.904-5(m)(4).

However, if the taxpayer elects, section 904(g)(10) provides a special rule for sourcing section 951(a)(1) inclusions where the inclusion under a treaty obligation would be treated as arising from sources outside the United States if treated as an actual dividend. The regulation implementing section 904(g)(10), section 1.904-5(m)(7), provides as follows:

> (7) Coordination with treaties—(i) Rule. If any amount of income derived from a United States-owned foreign corporation, as defined in section 904(g)(6), would be treated as derived from sources within the United States under section 904(g) and this paragraph (m) and, pursuant to an income tax convention with the United States, the taxpayer chooses to avail itself of benefits of the convention that treat that amount as arising from sources outside the United States under a rule explicitly treating the income as foreign source, then that amount will be treated as foreign source income. However, sections 904(a),(b),(c),(d) and (f), 902, 907, and 960 shall be applied separately to amounts described in the preceding sentence with respect to each treaty under which the taxpayer has claimed benefits and, within each treaty, to each separate category of income.

Article X of the United States-Country A income tax treaty,(Convention Between the United States of America and Country A with Respect to Taxes and Income on Capital, entered into force August 16, 1984, TIAS 11087, 1987-2 C.B. 258), permits Country A to tax U.S. shareholders on dividends paid by Country A corporations. Paragraph 3(a) of Article XXIV of the treaty provides that:

> Profits, income or gains (other than gains to which paragraph 5 of Article XIII (Gains) applies) of a resident of a Contracting State which may be taxed in the other Contracting State in accordance with the Convention (without regard to paragraph 2 of Article XXIX (Miscellaneous Rules)) shall be deemed to arise in the other State.

Pursuant to §1.904-5(m)(5)(i), the interest income received by Sub C and Sub B from Taxpayer is treated as income subject to a separate limitation that is derived from sources within the United States because such amounts are included in the gross income of Taxpayer under section 951(a)(1)(A) and are attributable to interest income from sources within the United States. Under paragraph 3(a) of Article XXIV of the United States-Country A income tax treaty,[4] such amounts are treated as foreign source income (i.e., resourced). However, under section 904(g)(10) and §1.904-5(m)(7), if Taxpayer chooses to avail itself of the benefits the United States-Country A income tax treaty sections 904(a),(b),(c),(d) and (f),

[4] Section 904(g) is effective on July 18, 1984 and the Country A-United States treaty entered into force on August 16, 1984.

902, and 960 must be applied separately to the income included under section 951(a)(1)(A) attributable to the loans.

Finally, we note that Taxpayer's deduction for the interest it paid to Sub C and Sub B is subject to the interest allocation rules of §1.861-9T and may result in a reduction of Taxpayer's foreign tax credit limitation depending on the particular facts of this case.

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

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