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

OFFICE OF
CHIEF COUNSEL

February 19, 2002

Number: **200227006**
Release Date: 7/5/2002
CC:INTL:5
POSTF-145506-01
UILC: 881.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ACTING ASSOCIATE AREA COUNSEL(LMSB)

FROM: Paul Epstein
Senior Technical Reviewer CC:INTL:5

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated November 21, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =
Parent =
Country A =
Country B =
Country C =
Sub 1 =
Sub 2 =
Sub 3 =
Seller =
Acquisition =
Finance Company =
Asset A =
Amount A =
Amount B =
Amount C =
Amount D =
Amount E =
Amount F =
Amount G =
Amount H =
Amount I =
Date 1 =

Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =
Date 10 =
Date 11 =
Date 12 =
X Percent =

ISSUES

1. Whether the multi-party financing arrangement should be recharacterized under the "anti-conduit" regulations under section 881.

2. Whether an Amount A loan between the Taxpayer and an affiliated finance company should be ignored or recharacterized under case law principles of substance over form.

3. Whether the substance of the Amount A loan was equity instead of debt.

CONCLUSIONS

1. Based on the facts submitted, Taxpayer did not enter into a financing transaction under the "anti-conduit" regulations. As such, the multi-party financing arrangement in this case should not be recharacterized as a loan from Parent to Taxpayer under Treas. Reg. § 1.881-3.

2. Based on the facts submitted, the Amount A transaction between Finance Company and Taxpayer should not be recharacterized as a loan from Parent to Taxpayer under case law principles of substance over form.

3. The Amount A transaction between Finance Company and Taxpayer should be characterized as debt. The facts indicate that Taxpayer was a fully solvent financial institution. Moreover, Taxpayer adhered to the terms of the instrument, which, in form, had debt characteristics. The subordination feature of the debt should not recast the instrument as equity.

FACTS

Parent is a corporation established under the laws of Country A. Taxpayer is a wholly owned U.S. subsidiary of Parent. Taxpayer, a U.S. bank holding company, owns all of the stock of Sub 1 and Sub 2, both U.S. corporations.

On Date 1, Sub 2 signed an agreement to purchase Asset A from Seller (the "Acquisition"), an unrelated party. The closing date for the Acquisition was Date 2. To finance the Acquisition, Parent established a subsidiary, Finance Company, in Country B on Date 3, the purpose of which was to provide financing to the U.S. operations of Parent, including the funding of the Acquisition. Prior to investing in Finance Company, Parent was required to obtain permission from the regulatory authorities in Country A, who required Parent to sign an undertakings letter limiting Finance Company's activities to intercorporate dealings with Parent's controlled entities located outside of Country A. Parent obtained the necessary approval on Date 4.

On Date 3, Parent contributed Amount A to Finance Company in exchange for ordinary shares of Finance Company's stock. The origin of the funds contributed by Parent to Finance Company has not been determined. Also on Date 3, Finance Company lent Taxpayer Amount A and received a subordinated debenture in exchange. There were no face-to-face negotiations between Taxpayer and Finance Company, and the terms of Finance Company's loan to Taxpayer were established by Sub 2. Additionally, there were no negotiations with entities outside of Parent's related entities to secure funds to finance the Acquisition. The debt instrument is an unsecured 10-year note with principal due on Date 5. The interest rate on the loan was fixed at 6-7/8% until Date 6. Thereafter, the note bore a floating interest rate of 50 basis points over six-month LIBOR. Interest is payable to Finance Company semi-annually. The note is subordinated to prior payment in full of all senior indebtedness of Parent. The note is not guaranteed by Parent.

Taxpayer initially stated to the Revenue Agent that the business purpose for the loan from Finance Company was to avoid withholding taxes on interest paid under the applicable income tax treaty between the U.S. and Country A. This treatment would be unavailable had the loan been made directly by Parent to Taxpayer. In contrast, the Taxpayer claimed in a written response that the business purpose for making the loan with Finance Company was to partially fund the Acquisition.

Finance Company considered hedging its loan to Taxpayer in the event of a change in the tax laws. Specifically, Finance Company considered purchasing a put option from a U.S. branch of Parent that would enable Finance Company to put the note to that U.S. branch in the event that the tax law changed in such a manner as to impose U.S. taxation on the interest payable to Finance Company by Taxpayer. The cost of the contemplated put option would not have exceeded Amount B. The put option was never purchased.

On Date 3, Taxpayer contributed Amount C to Sub 1 in exchange for preferred stock, a subordinated debenture, and a credit to its capital surplus account. Also on Date 3, Sub 1 contributed Amount C to Sub 2 in exchange for a subordinated debenture and a credit to its capital surplus account. All of these transactions were approved by U.S. regulatory authorities.

Taxpayer deducted Amount D and Amount E for amounts paid to Finance Company for the taxable years ended Date 7 and Date 8, respectively. Exemption from U.S. tax withholding was claimed on these payments under the United States-Country B Income Tax Treaty in effect during the years at issue. The interest payments from Taxpayer were deposited in the bank account of Finance Company at Parent's branch office in Country C. Finance Company has paid no dividends to Parent.

Finance Company's only business activity during the years under examination was the loan to Taxpayer, and its only income was interest income from that same loan. Finance Company therefore had no independent credit standing outside of its loan to Taxpayer and income accrued and received thereon. Finance Company's assets consisted solely of the Amount A note, interest deposits received from Taxpayer, and accrued interest receivable from Taxpayer. Finance Company's directors were related to or appointed by Parent, and Finance Company had no employees during the years at issue.

On Date 9, Finance Company entered into a lease for office space located in Country B. The lease was guaranteed by Parent. On Date 10, the lease was assigned to Sub 3, a wholly owned subsidiary of Parent located in Country B.

On Date 11, Finance Company entered into an agreement with Parent under which Parent would provide support services to Finance Company in exchange for an annual payment of Amount F. On Date 12, Finance Company assigned this agreement to Sub 3.

LAW AND ANALYSIS

I. Applicability of "Anti-Conduit" Regulations

Under section 881, foreign corporations are required to pay a 30% tax on U.S. source interest income that is not effectively connected with a U.S. trade or business. Under sections 1441 and 1442, certain persons must deduct and withhold the 30% tax from interest payments made to foreign corporations. The 30% tax rate may be reduced or eliminated by treaty. In the present case, the applicable income tax treaty between the U.S. and Country A provides that interest payments made by U.S. taxpayers to Country A corporations are subject to an X Percent rate of withholding. The applicable income tax treaty between the U.S. and Country B exempts interest payments made by U.S. taxpayers to Country B corporations from withholding tax.

Regulations promulgated under section 881 provide special rules limiting the ability of taxpayers to reduce or eliminate withholding tax obligations through the use of conduit entities established in jurisdictions for which the applicable withholding tax rate is reduced or eliminated by treaty. When multi-party financing arrangements are recharacterized under these regulations, intermediate entities or conduits are disregarded for U.S. tax purposes, and financing arrangements are generally recharacterized as transactions directly between the financed and the financing entity.

Treas. Reg. § 1.881-3(a) provides that the Service may disregard, for purposes of section 881, the participation of one or more intermediate entities in a financing arrangement where such entities are acting as conduit entities. Treas. Reg. § 1.881-3(a)(2)(i) defines a financing arrangement as two or more financing transactions through which one party (the financing entity) advances property or money to another party (the intermediate entity), and the intermediate entity then advances property or money to a third party (the financed entity).

Treas. Reg. § 1.881-3(a)(2)(ii)(A) defines a financing transaction to mean debt, certain types of stock in a corporation, leases and licenses, and certain other transactions where a person advances money or property to a transferee who is obligated to repay or return a substantial portion of the money or other property advanced, or the equivalent in value. Treas. Reg. § 1.881-3(a)(2)(ii)(B)(1) provides that stock in a corporation will constitute a financing transaction only if one of the following conditions is satisfied:

(i) The issuer is required to redeem the stock at a specified time or the holder has the right to require the issuer to redeem the stock or to make any other payment with respect to the stock;

(ii) The issuer has the right to redeem the stock, but only if, based on all of the facts and circumstances as of the issue date, redemption pursuant to that right is more likely than not to occur; or

(iii) The owner of the stock has the right to require a person related to the issuer (or any other person who is acting pursuant to a plan or arrangement with the issuer) to acquire the stock or make a payment with respect to the stock.

Treas. Reg. § 1.881-3(a)(2)(ii)(B)(2) provides that for purposes of Treas. Reg. § 1.881-3(a)(2)(ii)(B), a person will be considered to have a right to cause a redemption or payment if the person has the right to enforce the payment through a legal proceeding or to cause the issuer to be liquidated if it fails to redeem the interest or to make a payment. However, a person will not be considered to have a right to force a redemption or a payment if the right is derived solely from ownership of a controlling interest in the issuer in cases where the control does not arise from a default or similar contingency under the instrument.

In the present case, the facts indicate that Parent contributed Amount A to Finance Company in exchange for stock that satisfies none of the conditions described in Treas. Reg. § 1.881-3(a)(2)(ii)(B)(1). Accordingly, such stock is not a financing transaction within the meaning of Treas. Reg. § 1.881-3(a)(2)(ii)(A), and no financing arrangement is present within the meaning of Treas. Reg. § 1.881-3(a)(2)(i)(A).

Treas. Reg. § 1.881-3(a)(2)(ii)(B) provides a special rule for determining whether a financing arrangement exists in the context of related parties. Specifically, Treas. Reg. § 1.881-3(a)(2)(ii)(B) provides that if two or more financing transactions involving related persons would form part of a financing arrangement but for the absence of a financing transaction between the related persons, the Service may treat the related persons as a single intermediate entity if it is determined that one of the principal purposes for the structure of the financing transactions is to prevent the characterization of such arrangement as a financing arrangement. If the facts of the present case were to show that Parent borrowed all or part of the Amount A it contributed to Financing Company from a foreign lender, Treas. Reg. § 1.881-3(a)(2)(ii)(B) could apply to treat Parent and Financing Company as a single intermediate entity so long as it could be shown that one of the principal purposes for the structure of the financing transactions was to prevent the characterization of such arrangement as a financing arrangement. Under such facts, Taxpayer would be liable for any taxes required to be withheld with respect to interest payments made to the foreign lender.

II Recharacterization of Transaction on General Economic Substance Grounds

As an alternative to applying the “anti-conduit” regulations, you have raised the issue as to whether case law principles of substance over form apply in this case. We agree that such principles can be used as an alternative basis for addressing conduit financing transactions; however, we do not believe that the facts, as currently developed, support the use of that approach in this case.

Case law principles of substance over form focus on the “objective realities of a transaction rather than the particular form the parties employed.” Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978). The courts have applied substance over form principles to disregard the use of intermediaries and conduits that were imposed for the avoidance of Federal income taxes. See, e.g. Del Commercial Properties, Inc. v. Commissioner, T.C. Memo. 1999-411, aff’d, 251 F.3d 210 (D.C. Cir. 2001), cert. denied, 2002 U.S. LEXIS 418 (2002); Gaw v. Commissioner, T.C. Memo. 1995-531, aff’d without published opinion, 111 F.3d 962 (D.C. Cir. 1997). See also Aiken Industries, Inc. v. Commissioner, 56 T.C. 925 (1971), *acq. on other* *issue,* 1972-2 C.B. 1; Rev. Rul. 84-152, 1984-2 C.B. 381, Rev. Rul. 84-153, 1984-2 C.B. 383 (both limited by Rev. Rul. 95-56, 1995-2 C.B. 322, following issuance of anti-conduit regulations); Tech. Adv. Mem. 9133004 (May 3, 1991).

In Del Commercial Properties, the taxpayer, a fourth-tier subsidiary of an affiliated group of corporations, leased industrial real estate it owned in the U.S. In order to improve properties, the common parent of the affiliated group arranged for financing through a lower-tier subsidiary incorporated in the Netherlands. First, a Canadian bank loaned $18 million to an upper-tier Canadian subsidiary. Second, $14 million was contributed by the upper-tier Canadian subsidiary through a series of middle-tier subsidiaries located in Canada, the Cayman Islands, and the Netherlands Antilles, and finally to the lower-tier Netherlands financing subsidiary. Third, the taxpayer received the $14 million from the Netherlands financing subsidiary. The taxpayer guaranteed repayment of part of the upper-tier Canadian subsidiary's loan from the Canadian bank and authorized the bank to place a mortgage on its real property. Additionally, the taxpayer agreed to provide the bank with annual financial statements, to insure its real property and assign any insurance proceeds to the bank, and to use the proceeds from any sales of real property to make payments on the $14 million loan. The taxpayer made payments to the Netherlands financing subsidiary for a year and a half, and then began making payments directly to the upper-tier Canadian subsidiary. Under the United States-Netherlands tax treaty, interest payments made by U.S. taxpayers to Netherlands corporations were exempt from taxes in the United States, but under the United States-Canada tax treaty the withholding tax rate was 15%.

The Tax Court applied the step-transaction doctrine in concluding that the substance of the financial transactions was a loan from the upper-tier subsidiary directly to the taxpayer and that the funds passed through the Netherlands financing subsidiary to avoid the withholding tax. The court noted that the Netherlands financing subsidiary had minimal assets, minimal business activity, no officer with substantive duties, and only transitory possession over the funds. Additionally, the interest rates and payment schedules of the two loans corresponded closely. In affirming the opinion of the Tax Court, the D.C. Circuit Court of Appeals concluded that the Tax Court did not err in holding that the payments to the Netherlands financing subsidiary were in substance payments to the upper-tier Canadian subsidiary. As such, the payments were subject to 15% withholding under the United States-Canada tax treaty and were not exempt from withholding under the United States-Netherlands tax treaty.

In Gaw, a U.S. corporation made interest payments to a Dutch corporation that was a subsidiary of a Hong Kong corporation. The Tax Court held that the payments were subject to U.S. taxes because in substance they were directed to the Hong Kong corporation. The Tax Court explained that under the substance over form doctrine, "although the form of a transaction may literally comply with the provisions of the Code, that form will not be given effect where it has no business purpose and operates simply as a device to conceal the true character of that transaction." Id., T.C. Memo. 1995-531 at 124. Applying this standard, the court concluded that the taxpayer had not carried his burden of proving that the loans had been structured for any nontax business reason. Accordingly, the court treated the loan as if it had been made by the Hong Kong corporation and ruled that the interest payments were subject to U.S. withholding tax.

Certain facts developed by the field suggest that a recharacterization of the transactions among Taxpayer, Finance Company and Parent under general economic substance principles would be potentially appropriate, but only if certain additional evidence is developed. For example, Finance Company's only business activity during the years under examination was the loan to Taxpayer, and its only income was interest income from that same loan. Finance Company's assets consisted solely of the Amount A note, interest deposits received from Taxpayer, and accrued interest receivable from Taxpayer. Finance Company's directors were related to or appointed by Parent, and Finance Company had no employees during the years at issue. Finance Company leased office space in Country B, but the lease was guaranteed by Parent and ultimately assigned to Sub 3, a wholly owned subsidiary of Parent located in Country B. Finally, Taxpayer initially acknowledged that the purpose for the loan from Finance Company to Taxpayer was the avoidance of withholding taxes on interest paid under the applicable income tax treaty between the U.S. and Country B -- treatment that would have been unavailable had the loan been made directly by Parent to Taxpayer. The tax motivation behind the transaction is also demonstrated by the fact that Finance Company researched the hedging of its loan to Taxpayer in the event of a change in the tax laws. Specifically, Finance Company considered purchasing a put option from a U.S. branch of Parent that would enable Finance Company to put the note to that U.S. branch, and therefore eliminate any further payments subject to withholding, in the event that the tax law changed in such a manner as to impose U.S. taxation on the interest payable to Finance Company by Taxpayer. Nevertheless, no evidence suggests that Finance Company either made or was required to make payments to Parent. In the absence of such evidence, Finance Company cannot be said to be acting as a conduit or that it lacks dominion and control over the payments it received from Taxpayer. Accordingly, Finance Company should not be disregarded as a conduit without further factual development.

III. Recharacterization as Equity

Section 385(b) provides five non-exclusive factors for distinguishing a transaction between debt and equity. However, the statute is subject to the issuance of regulations. At this time, there are no promulgated regulations under the statute. Accordingly, the distinction between debt and equity must be determined under principles derived by case law, and, in limited circumstances, by Treasury rulings and other specific transactional guidance.[1]

The essence of a debt is an unconditional, legally enforceable obligation to repay a sum certain on demand or on a specified date. A. Finkenberg's Sons, Inc. v. Commissioner, 17 T.C. 973 (1951). The less resemblance an instrument bears to such an unconditional promise to pay, the more likely it is to be characterized as equity. The characterization of an instrument as debt or equity for United States federal income tax purposes depends on the terms of the instrument and all surrounding facts and circumstances. See generally Gilbert v. Commissioner, 262 F.2d 512 (2nd Cir. 1959). Among the factors that may be considered in making such a determination are the following:

1. The name and presence of a written agreement demonstrating indebtedness;
2. The presence of a fixed maturity date;
3. The source of payments, i.e., whether the borrower owns sufficient assets or anticipates sufficient cash flow to make payments;
4. The right to enforce payment;
5. Increased participation in management as a result of the advance;
6. Whether the rights of the holders of the instrument are subordinate to rights of the issuer's general creditors;
7. Thinness of the borrower's capital structure in relation to debt;
8. The identity of interest between creditors and stockholders;
9. The ability of the borrower to obtain credit from other sources;
10. The use of advanced funds for capital assets; and
11. The failure of the debtor to repay amounts owed.

[1] For example, Treas. Reg. § 1.882-5(c)(5), Ex. 1, classifies a perpetual subordinated debt of a foreign bank as equity under U.S. tax principles for purposes of determining a foreign bank's worldwide liability-to-assets ratio in the interest expense allocation formula. See also Notice 94-47, 1994-1 C.B. 357.

See Laidlaw Transportation Co. v. Commissioner, T.C. Memo. 1998-232; Nestle Holdings, Inc. v. Commissioner, T.C. Memo. 1995-441.

Based on the facts submitted, we conclude that the transaction between Taxpayer and Finance Company should be treated as debt. The instrument, in form, has all of the features of a debt instrument including a reasonable stated interest rate and an unconditional promise to pay a sum certain on a fixed maturity date. The instrument at issue in this case does not have the equity features of a perpetual subordinated note as previously discussed. Cf. Treas. Reg. § 1.882-5(c)(5), Ex.1. Although Finance Company's rights are subordinated to the rights of Taxpayer's general creditors, regulated financial institutions may ordinarily issue subordinated notes to meet regulatory capital reserve requirements with no consequence to the debt treatment of such notes. See Jones v. United States, 659 F.2d 618 (5th Cir. 1981); Rev. Rul. 85-119, 1985-2 C.B. 60. Further, no facts have been presented to suggest any curtailment of Finance Company's legal rights to enforce the payment of principal and interest. Moreover, the facts indicate that Taxpayer has sufficient liquid assets and/or reasonably anticipated cash flow from which to repay the loan, and that Taxpayer has made all payments in a timely fashion in accordance with the terms of the instrument. In sum, the weight of the relevant factors, including Taxpayer's timely observance of the terms of the instrument, indicates that the instrument issued by Taxpayer to Finance Company should qualify as indebtedness.

IV. Disallowance of Interest Deduction Under Section 267(a)(3)

The facts set forth in the field's memorandum of November 20, 2001 suggest that a discrepancy of Amount G may exist between the amount of interest expense deducted by Taxpayer (Amount D in 1996 and Amount E in 1997, or a total of Amount H) and the amount of interest actually received and deposited by Finance Company (Amount I). Under section 267(a)(3) and Treas. Reg. § 1.267(a)-3(b), a taxpayer is required to defer the deduction of accrued interest payable to a related foreign person until such interest is actually paid. Accordingly, further consideration should be given as to whether Taxpayer deducted accrued interest payable to Finance Company in any tax period in which such interest was not actually paid.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

By: ______________________________
PAUL EPSTEIN
Senior Technical Reviewer