

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

December 05, 2003

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Third Party Contact:
Index (UIL) No.: 385.01-00
CASE-MIS No.: TAM-144743-03, CC:CORP:B03

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

HOLDING =

F SUB =

State M =

Country N =

DATE 1 =

DATE 2 =

DATE 3 =

DATE 4 =

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FX =M =O =P =Q =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

ISSUE(S):

(1) Whether Holdings is precluded from re-characterizing the Notes as equity under section 385(c)(1) of the Internal Revenue Code for its taxable years ended Year 1, Year 2, and Year 3?

(2) Whether Holdings' schedule M-1 adjustment for "hybrid interest" on its Forms 1120 and its Schedule H net addition for "hybrid interest" on its Forms 5471 for the years at issue are sufficient disclosure such that it is excepted from the provisions of section 385(c)(1) (see section 385(c)(2))?

CONCLUSION(S):

(1) We find there is no violation of the consistency requirement under section 385(c)(1).

(2) Because we find the consistency requirement of section 385(c)(1) has not been violated in this case, we do not need to determine whether Holdings, the holder of the Notes, properly disclosed that it was treating the Notes in an inconsistent manner as provided in section 385(c)(2).

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FACTS:

Holdings is a State M corporation and the common parent of an affiliated group of corporations filing a consolidated federal income tax return.

On Date 1, Holdings and FX, a Country N corporation, formed F Sub, a Country N corporation, by contributing cash to F Sub in exchange for a 60-percent and 40-percent interest in F Sub, respectively. The interests received by Holdings and FX consisted of almost entirely F Sub debt. As of Date 2, F Sub had liabilities of \$ M and registered paid in equity of only \$ Q. On Date 3, Holdings and FX advanced additional funds to F Sub based on their original 60-percent/40-percent ownership basis in return for \$ P of F Sub instruments (the Notes), allocated 60-percent and 40-percent, respectively, that were formally designated as long term debt in Country N to avoid Country N capital flow restrictions and were registered with the Central Bank of Country N. Country N did not tax interest payments on foreign loans with terms longer than eight years. The Notes were unsecured and subordinated to all other debt of F Sub. The Notes did not restrict F Sub from further borrowings or require it to comply with any stated debt covenants. Neither principal nor interest was payable on the Notes until maturity in late Year 4, 8 ½ years after issuance. The Notes carried a fixed interest rate of Q percent, which accrued semi-annually. The Notes were replaced every six months and each replacement Note had the same terms and conditions as the previous Note, with the principal amount equal to the previous Note's principal plus any accrued interest.

Internally, Holdings booked its investment along with other capital contributions to F Sub in an account designated for investment in this subsidiary. In its worldwide financial reports, Holdings also treated the Notes as equity and did not report any accrued interest income on its Notes consistent with U.S. generally accepted accounting principles (GAAP). Specifically, because F Sub treated the Notes differently than Holdings treated them and because FX owned a minority interest in F Sub, Holdings was required to make adjustments, reclassifications, and eliminations to consolidate F Sub under GAAP. This included (1) booking interest income on Holding's books that was then eliminated by offset against F Sub's interest expense; (2) eliminating Holding's investment in F Sub by offset against F Sub's equity and the Notes; and (3) accounting for FX's minority interest.

In reporting taxable income for U.S. tax purposes, Holdings treated the F Sub Notes as equity. Holdings reversed from consolidated income the amount of accrued interest from F Sub as "hybrid interest" on Schedule M-1 of Form 1120 each year. Likewise, for information reporting purposes, Holdings increased F Sub's current earnings and profits each year for the amount of "hybrid interest" on Schedule H of Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations.

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In reporting taxable income for Country N tax purposes, F Sub treated the Notes as long-term debt. This Country N tax treatment had no U.S. tax effect. F Sub is not subject to U.S. tax on the Notes and has not filed a U.S. tax return treating the Notes as debt.

By Year 5, the Country N economy had improved and Country N lessened restrictions on foreign capital investment. Therefore, on Date 4, Holdings formally converted its F Sub Notes to F Sub stock. Because Holdings had structured the Notes so that interest and principal would not be paid until 8 ½ years after issuance, Holdings never received interest or principal payments on the Notes because it formally converted the Notes to equity on Date 4 (a date prior to late Year 4, the due date for principal and interest payments on the Notes).

LAW AND ANALYSIS:

ISSUE (1)

Holdings argues that the consistency requirement of section 385(c)(1) should not apply across borders where the foreign issuer is subject only to foreign tax on the instrument. While we do not necessarily agree that section 385(c)(1) cannot apply when the issuer is foreign, we believe that the requirement of consistent characterization between the issuer and holder imposed by section 385(c)(1) is satisfied in this case.

In 1992, Congress enacted section 385(c), which provides, in pertinent part, as follows:

(c) Effect of classification by issuer.

(1) In general. The characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness shall be binding on such issuer and on all holders of such interest (but shall not be binding on the Secretary).

(2) Notification of inconsistent treatment. Except as provided in regulations, paragraph (1) shall not apply to any holder of an interest if such holder on his return discloses that he is treating such interest in a manner inconsistent with the characterization referred in paragraph (1).

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Section 385(c) is concerned with inconsistent treatment by an issuer and holder that creates a potential for whipsaw for Federal income tax purposes. The legislative history under section 385(c) states that:

It has come to the attention of the committee that certain issuers and holders may be taking inconsistent positions with respect to the characterization of a corporate instrument as debt or equity. For example, a corporate issuer may designate an instrument as debt and deduct as interest the amounts paid on the instrument while a corporate holder may designate an instrument as equity and claim a dividends received deduction with respect to the amounts paid on the instrument. The committee believes that the fisc should be protected from this whipsaw of inconsistent debt equity classification. H.R. Rept. No. 102-716, 102nd Cong. 2d Sess., 4 (1992); Unofficial S. Rept. 138 Cong. Rec. 21-45, 21065 (1992).

F Sub's characterization of the instrument for purposes of County N's tax laws, or under other Country N laws, does not create a whipsaw problem for United States Federal income tax purposes. Accordingly, it is not relevant for purposes of section 385(c).

Section 385(c)(1) is concerned with the characterization of the issuer's instrument for United States Federal income tax reporting purposes. F Sub, the issuer, as a foreign entity not engaged in business in the United States, does not undertake any reporting of its characterization for Federal income tax purposes. However, Holdings, as the United States shareholder of F Sub, a controlled foreign corporation, is required to characterize the instrument for Federal income tax purposes, and reports that characterization on Form 5471 attached to its Federal income tax return.

In reporting taxable income for Federal income tax purposes, Holdings consistently treated the F Sub Notes as equity for all the tax years commencing with their issuance. Holdings deducted from consolidated income the amount of accrued interest from F Sub as "hybrid interest" on Schedule M-1 of Form 1120 for each of the tax years at issue. Likewise, for information reporting purposes, Holdings increased F Sub's current earnings and profits each year for the amount of "hybrid interest" on Schedule H of Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations.

Holdings had the obligation to report the United States tax consequences of F Sub, the issuer, on Form 5471 under section 385(c)(1). Holdings has been consistent in treating the Notes as equity both for F Sub, the issuer, on Form 5471, and for

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Holdings, the holder, on Form 1120. Therefore, based on the specific facts of this case, we find that there is no violation of the consistency requirement under section 385(c)(1).

ISSUE (2):

Because we find the consistency requirement of section 385(c)(1) has not been violated in this case, we do not need to determine whether Holdings, as holder of the Notes, properly disclosed that it was treating the Notes in an inconsistent manner as provided in section 385(c)(2).

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.