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 ACTING ASSOCIATE AREA COUNSEL, CC:LM:MCT:WAS
Attn: Karen Chandler

FROM: Jeffrey Dorfman
Chief, Branch 5 CC:INTL:BR5

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated December 13, 2000. In accordance with I.R.C. ' 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Parent =
Sub =
Target =
Promoter =
Lenders =
Country A =
Date 1 =
Date 2 =
Date 3 =
Date 4
Date 5
Date 6
Amount 1
Amount 2
Amount 3
Amount 4
Amount 5

=
=
=
=
=
=
=
=

Amount 6	=
Amount 7	=
Amount	=
a%	=
b%	=
Period M	=
Period N	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
X Transaction	=
S	=
T	=
U	=

ISSUES

1. Whether the transaction, in which Parent purchased through a prepaid purchase agreement a security issued by its Country A subsidiary to two unrelated foreign banks, may be recharacterized for federal income tax purposes.

2. Whether the Service is estopped from challenging the transaction in the current audit when, in an audit of prior years, the Service did not challenge the transaction.

CONCLUSIONS

1. The transaction may be bifurcated into a loan from the banks to Sub and an equity contribution from Parent to Sub.

2. The Service is not estopped from challenging the transaction in the current audit.

FACTS

Sub is a wholly owned Country A subsidiary of Parent, a U.S. corporation. On Date 1, Sub acquired Target, a Country A corporation. Sub=s acquisition of Target was originally financed by a loan from Parent, which had obtained the funds through a series of short term loans from unrelated persons. That same month, Promoter made an initial presentation to Parent, soliciting its interest in a particular transaction that Promoter called the X Transaction. Promoter had marketed this transaction to other companies prior to approaching Parent.

According to Promoter=s marketing material, the proposed X Transaction consisted of two transactions executed simultaneously: the issuance of a note with no fixed maturity (a perpetual debt instrument) by a Country A subsidiary to foreign banks, and a purchase contract between the banks and the U.S. parent under which the banks were obligated to transfer the note to the U.S. parent after Period N in exchange for Amount 5, paid on the date the X Transaction was entered into. The marketing material described the note as treated as equity for U.S. tax purposes after the transfer to the U.S. parent, Awith the result that the US bifurcates the transaction for tax-analysis purposes.@ Promoter identified two Aexit strategies@ after the U.S. parent acquired the note from its U.K. subsidiary. First, the parent could redeem the note with no Country A corporate or withholding taxes. The gain from the redemption would be treated as a dividend to the parent if the Country A subsidiary had earnings and profits, which would not be subject to U.S. tax if sufficient foreign tax credits were available. Second, the U.S. parent could contribute the note as equity to the Country A subsidiary, which also would have no U.S. or Country A tax consequences. According to Promoter=s marketing material, the transaction=s benefit arose from the asymmetrical U.S. and Country A tax treatment of the perpetual debt instrument, specifically Ain the form of annual deductions for payments of principal, and a redemption gain either free of tax in the US and [Country A] if contributed, or sheltered by sufficient foreign tax credits if redeemed.@

Parent, Sub, and Promoter executed a letter of understanding dated Date 2 setting forth some of the terms of the transaction, such as the Amount 1 aggregate principal amount of Sub=s notes, and Promoter=s fee, which was a% of the principal amount of the notes. After Promoter made a second presentation and provided additional materials to Parent, the Board of Directors of Parent approved Parent=s guarantee of Amount 1 in connection with the X Transaction on Date 3. According to the minutes of the meeting, the purpose of the X Transaction was to Afinance the acquisition of [Target] and to partially fund anticipated capital expenditures in [Country A].@

Promoter subsequently solicited potential lenders to participate in the transaction with Taxpayer and Sub. Included in the marketing materials was a cash flow summary that indicated that the investor bank would loan Amount 1, which consisted of the Amount 3 prepayment plus a loan of Amount 2. Each of the payments made by Sub to the bank during Period M contained an interest element and a principal element so that by the turnover date, the bank would receive Amount 4 of interest and repayment of the Amount 2 principal amount. After factoring in transaction costs, the bank would earn a projected b% return. Two foreign banks, Lenders, agreed to participate in the X Transaction.

On Date 4, the directors of Sub formally authorized it to execute the X Transaction, which occurred nine days later. According to the transaction documents, Sub issued two unsecured notes A(ASecurities@) with no fixed maturity to Lenders. The principal amount of each Security was Amount 5 (equal to half of Amount 1). For Period M, when each Security is outstanding, <u>i.e.</u>, the period in which the Securities are held by Lenders, the Securities have certain characteristics of debt for U.S. tax purposes, although they have no maturity date. During Period M, Sub must make two purported interest payments to each lender annually, which are guaranteed by Parent. These amounts are payable unconditionally, with any failure to pay being a default that will trigger traditional creditors= rights (<u>e.g.</u>, the rights to repayment of par plus unpaid interest, sue for payment of a matured claim, and join with other creditors to force Sub into bankruptcy). The Securities also rank senior to all claims of unsubordinated creditors of Sub and junior to all secured obligations of Sub. Sub is not required to redeem, nor has the option of redeeming, the Securities during this period, and Lenders do not have any right to put the Securities to Sub at any time. The only circumstance under which Sub may redeem the Securities is in the event that, due to a change in law occurring after the Securities are issued, a foreign withholding tax is imposed on payments on the Securities to Lenders. In such case, or in the event that the Securities are repaid following default by Sub prior to the turnover date, Lenders must pay Parent an amount equal to the redemption or repayment proceeds of the Securities, less the present value of the remaining payments up to the turnover date. In the event that certain events affecting Lenders= credit ratings occur prior to the turnover date, Parent has the right to accelerate Lenders= obligation to deliver the Securities to Parent, in exchange for payment of an amount equal to the present value of the remaining payments up to the turnover date.

On the same date as the Securities were issued (Aissue date@), Parent entered into a forward purchase agreement with Lenders to purchase the Securities with a combined nominal principal amount of Amount 1. Under this agreement, Lenders were obligated to deliver the Securities to Parent after Period M expired (i.e., on the Aturnover date@), and in exchange, Parent paid Lenders Amount 6 on the issue date. Parent financed its prepayment through commercial paper financing.

On the turnover date, the Lenders are obligated to transfer ownership of the Securities to Parent. Also on the turnover date, the terms of the Securities will change, resulting in more equity characteristics. Stated interest will only be payable to the extent that, immediately after such payment, Sub would remain solvent, and Sub will not be required to make payments of stated interest if it has not declared or paid dividends on any class of its share capital. Stated interest payments not made as a result of such limitations will accumulate and become payable when such limitations cease to apply, but failure of Sub to make payments as a result of such limitations will not give holders of the Securities any traditional creditors= rights. Also on the turnover date, the Securities will no longer rank senior to all unsubordinated claims and will rank junior to all senior and secured claims of creditors. Payments on the Securities during this period are not guaranteed. In the event of the winding-up of Sub, the holder of the Securities (i.e., Parent) will rank as if the Securities had been converted into a notional class of preference shares ranking ahead of all issued shares on the day before the winding-up commences. In the event Lenders default on their obligation to deliver the Securities to Parent, Parent may assign its rights under the forward purchase agreement to Sub, in consideration for Sub agreeing to make payments to Parent as if Parent were the holder of the Securities. By doing so, Sub would not need to make such payments to Lenders because under Country A law, Sub=s rights under the forward purchase agreement would offset Sub=s obligation to make payments to Lenders. Sub would thereafter make payments to Parent rather than Lenders notwithstanding the fact that Lenders continue to hold the Securities.

Two law firms and an accounting firm had reviewed and provided written opinions on the proposed transaction for U.S. and Country A tax purposes and U.S. and Country A accounting purposes. S provided an opinion dated Date 5, of the U.S. tax consequences of the proposed transaction. The opinion stated that for U.S. tax purposes, the issuance of the Securities and Lenders= simultaneous obligation to transfer the Securities to Parent under the forward purchase agreement should be integrated and treated as the issuance by Sub of two separate securities: the front-end Security (under which Sub makes payments to Lenders during Period M) and the back-end Security (obligating Sub under certain conditions, to make payments to Parent after the turnover date). Accordingly, for U.S. tax purposes, the opinion concluded that:

1) Prior to the turnover date, the instrument would be characterized as debt, so that payments by Sub to Lenders during Period M would be treated as interest and not as dividends;
2) Parent would be entitled to deduct interest or original issue discount accrued on the debt it incurred to make the prepayment on the forward purchase agreement;
3) Parent would not be required to include in income any payments with respect to the Securities in these years;
4) After the turnover date, the Securities would be characterized as equity, so that to the extent payments are made by Sub to Parent, such payments will be foreign source dividends that potentially entitle Parent to indirect foreign tax credits.

T, a Country A law firm, provided Promoter two opinions, both dated Date 6, of the Country A tax consequences of the proposed transaction. It concluded that for Country A purposes, the

Securities would be treated as perpetual debt. While Lenders hold the Securities (i.e., until the turnover date), the periodic payments on the Securities would be deductible as interest for Country A tax purposes. However, to the extent Sub makes subsequent payments on the Securities after the turnover date, these payments would be treated as nondeductible equity distributions for Country A tax purposes, rather than interest, because these amounts were paid to a holder (Parent) that is not subject to Country A tax on such payments.

According to a memo dated the same month as T=s Date 6 memoranda, U, an accounting firm, reviewed the transaction and concluded that it was acceptable for Parent to net (in consolidation) its asset, i.e., the amount it prepaid on the forward purchase agreement to Lenders, against Sub=s liability to Lenders on the notes, and to account for this net liability Aas if it were the principal on an amortizing notes, the payments of which are the interest payments@ made during years prior to the turnover date.

In the years at issue (Year 3 and Year 4), for Country A tax purposes, Sub deducted interest accrued on the Amount 1 principal amount of the Securities. For U.S. GAAP financial consolidated reporting purposes, Taxpayer did not show Amount 1 as outstanding third party debt because it netted the Amount 6 prepayment amount against Amount 1. As a result, under GAAP, Taxpayer booked interest income of approximately Amount 8 as a U.S. financial reporting consolidation entry in each of these years. (The Year 1 amount of book interest income flowed through line 1 of Schedule M and was the subject of a Schedule M-1 adjustment in Year 1, but the Year 2 amount was reported in the tax return in retained earnings, which did not require a Schedule M-1 adjustment.) For U.S. tax purposes, however, Parent reported no interest income. It treated the Amount 6 payment as having no U.S. tax consequences since it characterized the forward purchase agreement as any other forward or option contract for the purchase of securities by a non-dealer. Parent asserts that the Securities should be treated as equity as of the turnover date under Notice 94-47, 1994-1 C.B. 357, because (1) the Securities have no maturity date; (2) the holder of the Securities on the turnover date, i.e., Parent, has no traditional creditors= rights; (3) interest payments are made only to the extent that immediately after such payment Sub would remain solvent; (4) the Securities do not require interest payments unless Sub declared or paid dividends; (5) the Securities are subordinated and unsecured; and (6) they will be held by Sub=s sole shareholder.

LAW AND ANALYSIS

A. Partial recast of the X Transaction as equity

The substance of a transaction and not the form controls, especially where the parties to the transaction are jointly controlled. Road Materials Inc. v. Commissioner, 407 F.2d 1121, 1124 (4th Cir. 1969). Where related entities occupy both sides of the bargaining table, the form and labels do not necessarily correspond to economic reality because the parties can mold the transaction at their will. Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3d Cir. 1968). Form and labels lose their significance particularly where a shareholder who advances funds to a corporation can treat those funds as corporate obligations instead of contributions to capital without affecting his proportionate equity interest. Id.

In determining whether the X Transaction constitutes debt or equity, the particular facts and circumstances must be examined. No single uniform approach has been adopted by the courts in analyzing this particular issue. The Tax Court looks to whether there was a Agenuine intention to create a debt, with a reasonable expectation of repayment, and ... [whether] that intention comport[s] with the economic reality of creating a debtor-creditor relationship.@ Nestle Holdings, Inc. v. Commissioner, T.C. Memo. 1995-441, 70 T.C.M. (CCH) 682, 700 (1995), vacated and remanded on another issue, 152 F.3d 83 (2d Cir. 1998), quoting Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 377 (1973). In addition to intent, the courts have enumerated several other factors to consider in resolving a debt-equity issue. While no single factor is determinative, John Kelley Co. v. Commissioner, 362 U.S. 521 (1946), and the following list is not exclusive, the courts generally look to:

(1) the name and presence of a written agreement demonstrating indebtedness;
(2) the presence of a fixed maturity date;
(3) the source of payments, e.g., whether there is anticipated cash flow to cover payments;
(4) the right to enforce payment;
(5) increased participation in management as the result of the advance;
(6) subordination;
(7) thinness of the capital structure in relation to debt;
(8) the identity of interest between creditor and stockholder;
(9) the source of interest payments, e.g., from earnings;
(10) the ability of the corporation to obtain credit from outside sources
(11) the use of funds for capital assets or risk involved in making the advances; and
(12) the failure of the debtor to repay.

See Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972); Laidlaw Transportation, Inc. v. Commissioner, T.C.M. 1998-232; Nestle Holdings, Inc. v. Commissioner, 70 T.C.M. at 700; Lansall Co. v. United States, 512 F. Supp. 1178, 1180 (S.D.N.Y. 1981). See also I.R.C. section 385(b) (listing debt-equity factors which may be taken into account in regulations).

Based on the facts presented, the Securities may be recharacterized as in part a net loan of Amount 7 from Lenders to Sub that Sub repays (with respect to principal and interest) during Period M, and in part an equity contribution of Amount 6 from Parent to Sub on the issue date. Facts supporting the treatment of Lenders= advance to Sub as a loan are: (1) a written agreement relating to an amount 5 loan between each lender and Sub; (2) a cash flow summary included in Promoter=s marketing materials for potential lenders indicated that the lenders would make a net loan to Sub (of an Amount 1 notional principal amount less the Parent=s Amount 6 payment) that Sub would repay by the turnover date; (3) Sub was unconditionally obligated to make payments to Lenders; (4) Parent guaranteed Sub=s payments to Lenders in Period M; (5) Lenders had traditional creditors= rights to enforce payment; and (6) the Securities (during Period M) ranked senior to the claims of Sub=s unsubordinated creditors.

Facts supporting the characterization of Parent=s prepayment as an equity contribution are (1) the Securities have no fixed maturity date, (2) Parent is not entitled to nor receives any economic return from Sub in the form of interest or otherwise during Period M; (3) Parent is entitled to payment after Period M only subject to the solvency and dividend payment conditions described above; (4) Parent lacks traditional creditor rights to enforcement payment; (5) the Securities are subordinated and unsecured; (6) Parent has the right to assign its interest in the Securities, with the result that, in the event Lenders defaulted on their obligation to deliver the Securities, Sub would make payment to Parent instead of Lenders; and (7) Parent, the sole shareholder of Sub, holds the Securities. Characterizing Parent=s interest in the Securities as equity is consistent with the opinion issued by S. We disagree, however, that Parent does not have an equity interest until the turnover date. The facts indicate that, in substance, Parent made an Amount 6 equity contribution on the issue date. Parent was effectively guaranteed to receive the Securities on the turnover date: Lenders were obligated to deliver the Securities to Parent on the turnover date (if not earlier in the event of bank insolvency), the chance of Sub=s default on the Securities was remote because of Parent=s guarantee, and Parent=s interest in the Securities was recorded on Sub=s books at or around the issue date.

Beginning with Sub=s first payment on the notes to Lenders in Year 2, Sub reduced its earnings and profits by an amount equal to the deductible interest it paid on the Amount 1 notional principal amount of the Securities. As a result of recharacterizing a portion of the transaction (Amount 6) as equity and not debt, Sub=s earnings and profits should be adjusted to reflect that a corresponding amount of Sub=s claimed interest deductions should be treated as nondeductible distributions to Parent.

B. <u>Issue of estoppel</u>

We understand that the examination for Year 1 (the year the transaction was entered) and Year 2 (the first year in which Sub purportedly paid interest) was closed without challenging this transaction. It is well-settled that the Service=s failure to make an assessment upon a prior audit does not estop the Service from making an otherwise appropriate assessment at some later date. <u>See</u> <u>Knights of Columbus Council No. 3660 v. United States</u>, 783 F.2d 69, 73 (7th Cir. 1986) (Service=s failure to assess the wagering tax against taxpayer in two earlier audits in 1960 and 1972 does not prevent assessment of tax in 1972 following 1977 audit that found such assessment appropriate); <u>Hawkins v. Commissioner</u>, 713 F.2d 347, 351-52 (8th Cir. 1983). The Service is not estopped from changing an earlier interpretation of law even if the taxpayer detrimentally relied in good faith on the Service=s erroneous position in the prior year. <u>Dickman v. Commissioner</u>, 465 U.S. 330, 343 (1984); <u>Dixon v. Commissioner</u>, 381 U.S. 68, 73 (1965). Accordingly, although the Service did not challenge the X Transaction during an earlier audit, the Service is not estopped from challenging the X Transaction in the current audit that includes Year 3 and Year 4.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Under section 482, since Parent and Sub are Aowned or controlled directly or indirectly by the same interests,@ the Service may allocate gross income between Parent and Sub to prevent evasion of taxes or clearly to reflect the income of these entities. Thus, it may be possible to allocate a fee from Sub to Parent for guaranteeing Sub=s payments to Lenders on the note This allocation should reflect an arm=s length charge for Parent=s provision of a guarantee of Sub=s payments to Lenders. Whether the controlled transaction produces an arm=s length result is evaluated by comparing the results of those transactions to results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances. See '1.482-1(d)(1). Accordingly, section 482 may provide another basis for challenging the X Transaction if supported by additional factual development.

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

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