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

FROM: STEVEN J. HANKIN
BRANCH CHIEF, CC:DOM:FS:CORP

SUBJECT: DEBT VERSUS EQUITY

This Field Service Advice responds to your memorandum dated September 22, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Conglomerate =

Ultimate Parent Company =

U.S. Parent Company =

U.S. Sub 1 =

U.S. Sub 2	=	
U.S. Sub 3	=	
F Sub 1	=	
F Sub 2	=	
F Sub 3	=	
Foreign Company 1	=	
F Entity	=	
L	=	
Instrument 1	=	
Instrument 2	=	
Instrument 3	=	
BBB	=	
FFG	=	
Type xx Preference Shares	=	

Type yy Preference Shares	=
Country 1	=
Country 2	=
Country 3	=
Country 4	=

$b	=
$c	=
$d	=
$e	=
$f	=
$g	=
$j	=
$k	=
$n	=
$p	=
$r	=
$s	=
$v	=
$x	=
Country 4 Currency Amount 1	=
Country 3 Currency Amount 1	=

b%	=
c%	=
p%	=
r%	=
s%	=
t%	=
u%	=
w%	=
x%	=
y%	=
z%	=

Year T	=
Year V	=
Year W	=
Year X	=
Year Y	=
Year Z	=

Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=

Date 8	=
Date 9	=
Date 10	=
Date 11	=
Date 12	=
Date 13	=

#AA	=
#BB	=
#CC	=
#DD	=
#EE	=
#FF	=
#GG	=
#JJ	=
#KK	=
#LL	=
#MM	=
#NN	=
#PP	=
#QQ	=
#RR	=
#SS	=
#TT	=
#VV	=
UUth	=

Document 1-A =

Document 1-B =

Document 1-C =

Document 1-D =

Document 1-E =

Document 1-F =

Document 2-A =

Document 2-B =

Document 2-C =

Document 2-D =

Document 2-E =

Document 2-F =

Document 3-A =

Document 3-B =

Document 3-C =

Document 4-A =

Document 4-B =

Document 4-C =

Document 4-D =

Document 5-A =

Document 5-B =

Document 5-C =

Document 5-D =

Document 5-E =

Document 5-F =

ISSUE(S):

Whether an instrument, with a term of #BB years, received by a member of the U.S. consolidated return group in exchange for the contribution of stock to a related foreign corporation is in the nature of stock that would qualify for tax-free treatment under I.R.C. § 351 or debt that would result in the recognition of substantial gain on the exchange.

CONCLUSION:

Based on the facts as we know them, the instrument received in the Date 4 transaction appears to be equity rather than debt.

FACTS:

A. Procedural Background

Your request seeks advice on whether Loan Stock 2 exchanged in the Date 4 transaction, as discussed below, is debt or equity. In the transaction on Date 4, a member of the U.S. consolidated group received Loan Stock 2 from a related foreign entity, which might be debt or equity. The U.S. consolidated group desires the non-recognition treatment accorded by section 351, which allows non-recognition of gain or loss where property is transferred to a corporation solely in exchange for stock in such corporation and immediately after the exchange such person is in control of the corporation. The transaction we are requested to review involves a series of complex steps which raises many issues. This memorandum responds to your question whether the instrument received should be treated as debt or equity and briefly addresses the taxpayer's compliance with section 367(a). In addition, we have noted other potential issues to consider in developing this case.

B. Background

Ultimate Parent Company, a foreign corporation organized under the laws of Country 4, is the parent of U.S. Parent Company, and its subsidiaries (the U.S. consolidated return group); and foreign subsidiaries F Sub 1, F Sub 2, and F Sub 3. U.S. Sub 1 and U.S. Sub 3 are wholly owned subsidiaries of U.S. Parent Company. U.S. Sub 1 and U.S. Sub 3 each own u% of U.S. Sub 2. Ultimate Parent Company owns the remaining t% of U.S. Sub 2.

U.S. Parent Company is the common parent of an affiliated group of corporations that provides BBB. U.S. Sub 1, the U.S. subsidiary that received the disputed security, became part of the consolidated group in Year X.

F Sub 1 has issued three sets of loan stock described in Instrument 1, Instrument 2 and Instrument 3. Your request seeks advice on the transaction that occurred on Date 4, in which U.S. Sub 1 reportedly received additional shares of Loan Stock 2, valued at $g, in exchange for F Sub 2 stock. F Sub 1 had a $c basis in the F Sub 2 stock exchanged.

1. Instrument 1

On Date 1 #JJ shares of Loan Stock 1 worth $j were issued by F Sub 1 according to the terms of Instrument 1. Of the $j of Loan Stock 1 issued and outstanding, U.S. Sub 1 owned $x and U.S. Sub 2 owned $d.

The rights of the holders of Loan Stock 1 were subordinated to the rights of all other creditors in the event of liquidation. The final redemption date for Loan Stock 1 was in Year V. The interest or "coupon" rate was fixed at r% per year and was made in two payments on June 30, and December 31, each year until the redemption date. The Loan Stock 1 was not convertible to any other security of F Sub 1 and was made redeemable at par plus any accrued interest. Upon the liquidation of F Sub 1, the Loan Stock 1 and arrears in interest were converted into Type yy Preference Shares for $b per share. Type yy Preference Shares received fixed preferential dividends of r% after payment of dividends to the Type xx Preference Shares. Upon liquidation, the assets were to be distributed (1) to Type xx Preference Shares, (2) to the Type yy Preference Shares, (3) $b to each Type xx Preference Share, (4) Country 4 Currency Amount 1 to each ordinary share, (5) $b to each Type yy Preference Share, and (6) the surplus to the ordinary shares. Type yy Preference Shares did not have rights to share in the profits of the company except for the r% interest and the liquidation amounts. Type yy Preference Shares did not have the right to vote at general meetings, except by resolution to allow them to vote or in the event the Type yy Preference Shares were proposed to be canceled. Shareholders with more than w% of the stock could convene a shareholders meeting provided there was a quorum of at least x% of the nominal amount of the stock. The rights of the shareholders could be modified by a y% majority.

Instrument 1 did not provide for creditor remedies in the event of default on payments such as the right to accelerate both principal and interest in the event of default. In addition, the instrument was not guaranteed by any party.

2. Instrument 2

On Date 3, #NN shares of Loan Stock 2 worth $n were authorized pursuant to Instrument 2 on Date 3. Instrument 2 provided for the redemption of all the outstanding Loan Stock 2 on Date 7.

According to the stock certificate attached to Instrument 2, all of the Loan Stock 1 worth $x owned by U.S. Sub 1 was re-executed and U.S. Sub 1 received $x worth of Loan Stock 2. According to Document 3-C, Instrument 1 was amended by Instrument 2[1].

The major differences between Instrument 1 and Instrument 2 are that:

a) F Sub 1 authorized #VV more loan stock worth $v more under Instrument 2;

b) the redemption due date was shortened from #CC to #BB years; and

c) the interest rate was increased to s%.

F Sub 1 purportedly created the Loan Stock 2 for the following stated reasons:

a) The date of redemption was shortened to allow F Sub 1 to continue to treat this as debt in Country 4 due to changes in Country 4 law;

b) To allow F Sub 1 to authorize more [loan stock] (See Document 3-C); and

c) To increase the interest rates from r% to s% for U.S. Sub 1 to recoup lost payments never received from F Sub 1 on Loan Stock 1 (See Document 3-C).

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[1]Document 3-C indicates that amendments were made to Loan Stock 1 on Date 11 to increase the interest rate, shorten the term date, increase the authorized amount of loan stock, and vary some of the coupon due dates. Documents 2-E and 4-B also indicate that the amendments occurred on Date 11 as well. However, Document 3-A indicates that Loan Stock 1 might not have been amended until Date 3 because the stock certificate for Loan Stock 1 was exchanged for a Loan Stock 2 certificate on Date 3 and not earlier. The available information does not explain these inconsistencies.

3. Date 4: The Transaction

According to the Conglomerate, on Date 4, U.S. Sub 1 contributed #QQ shares in F Sub 2 to F Sub 1 in exchange for $g of Loan Stock 2. The adjusted basis of F Sub 2 stock was $c. U.S. Sub 1 treated the transaction as a tax-free exchange of property under section 351 and thereby avoided a capital gain of approximately $f. F Sub 3 contributed #EE shares in F Sub 2 to F Sub 1. We are not certain what F Sub 3 received in exchange. According to Document 5-E, F Entity also transferred $c and #GG ordinary shares in Foreign Company 1 to F Sub 1 "[p]ursuant to the same plan." The underlying premise of U.S. Sub 1's position is that the Loan Stock 2 issued by F Sub 1 is stock rather than debt. As a result of the Date 4 transfer, U.S. Sub 1 held a total of #RR shares of Loan Stock 2 worth a total of $r (the original $x in addition to $g acquired on Date 4).

a) U.S. Sub 1's Position:

U.S. Sub 1 claims that the Loan Stock 2 traded on Date 4 was equity for U.S. tax purposes. U.S. Sub 1 in Document 4-D sets forth three reasons why the Loan Stock 2 possesses more equity than debt characteristics in three key areas:

- Subordination

Under the terms of the instrument, in the event of liquidation or redemption of F Sub 1, the rights of the holders of the instrument would be subordinated to the claims of all creditors. U.S. Sub 1 claims that the rights of the holders of Loan Stock 2 is subordinated to the ordinary share holders.

- Maturity

U.S. Sub 1 received an instrument that matured in #BB years. Long maturity dates have the indicia of equity.

- Thin Capitalization

In Document 4-D, U.S. Sub 1 claims that the debt to equity ratio is #TT to 1.

b) Events Prior to Date 4

As a prelude to the Date 4 transaction, a series of agreements between Ultimate Parent Company group affiliates were undertaken. According to Document 1-F, U.S. Sub 2 and F Sub 1 entered into an agreement on Date 10 whereby U.S. Sub 2, as the “beneficial owner” of #QQ F Sub 2 shares, “agreed to procure the sale” of F Sub 2 stock to F Sub 1. U.S. Sub 1 was identified in the document as the “registered owner” of the #QQ F Sub 2 shares. Consideration was to be satisfied by $g of F Sub 1’s Loan Stock 2. According to Document 1-F, the agreement was assignable by U.S. Sub 2.

According to Document 2-A, it was reported that U.S. Sub 2 had decided to sell, as beneficial owner, #QQ shares in F Sub 2 to F Sub 1. The consideration of Country 3 Currency Amount 1 “was to be satisfied by the issue to U.S. Sub 2 of $g in nominal amount of F Sub 1’s Loan Stock 2.” The minutes thereafter reflect that U.S. Sub 2’s chairman discussed the share sale agreement entered into between U.S. Sub 2 and F Sub 1 on Date 4, and a certificate for $g in nominal amount of the Loan Stock 2 “which had been issued to U.S. Sub 2 in satisfaction of the consideration payable by F Sub 1 to U.S. Sub 2” under the share sale agreement. Thereafter, U.S. Sub 2’s Board resolved to approve the share sale agreement and to “accept the Loan Stock 2 Certificate #LL issued by F Sub 1 and delivered to U.S. Sub 2 which was effective from Date 4 in full satisfaction of the consideration payable” by F Sub 1 to U.S. Sub 2 under the share sale agreement.

The facts provided this office do not include the share sale agreement or any copies of F Sub 1 Board meeting minutes or resolutions approving the purchase of F Sub 2’s shares and issuance of $g in nominal amount of Loan Stock 2 in consideration of such shares.

Also, according to Document 2-C, entered on Date 10, certain members of the Ultimate Parent Company Group and L, a citizen of Country 3, signed an agreement pursuant to which, inter alia, Ultimate Parent Company agreed to purchase, directly or indirectly, from U.S. Sub 1 #QQ shares in the capital of F Sub 2. In connection with Forms 926 and 8838 filed by U.S. Sub 1 on Date 8, U.S. Sub 1 stated that “on Date 4, U.S. Sub 1 contributed #QQ shares in F Sub 2 to F Sub 1 in exchange for $g of s% Loan Stock 2”.[2]

4. Treatment of the Loan Stock by F Sub 1 and U.S. Sub 1

[2]We note that these statements appear inconsistent with the information set forth in the agreement in Document 1-F, as well as U.S. Sub 2’s minutes as noted in Document 2-A.

According to the Conglomerate, F Sub 1 intended to treat the payments on Loan Stock 1 under Instrument 1 as debt for Country 4 tax purposes, and U.S. Sub 1 intended to treat the payments as dividends for U.S. tax purposes. When Loan Stock 1 was issued on Date 1, F Sub 1 was thinly capitalized. According to Document 2-F, there was $j in debt to approximately $p in equity.

After Loan Stock 1 was issued and up to Date 3, when Loan Stock 2 was issued, F Sub 1 never made any of the required semi-annual payments. U.S. Sub 1 never attempted to collect the payments. The available facts do not indicate whether U.S. Sub 1 accrued interest during this period.

At the time of the issuance of Loan Stock 2, there was also a high debt to equity ratio. According to Document 4-D, the debt to equity ratio was roughly #TT to 1. According to Document 5-F, after Loan Stock 2 and Loan Stock 3 were issued, the required semi-annual payments from F Sub 1 to U.S. Sub 1 were made on a regular basis. F Sub 1, a foreign entity, treated the payments as debt and deducted interest. U.S. Sub 1, part of the U.S. consolidated return filing group, treated the payments as dividend income. We are not certain if U.S. Sub 1 received foreign tax credits for the payments.

5. <u>Non-Recognition under Section 367</u>

On Date 8, U.S. Sub 1, as part of the consolidated return group, filed a Form 926 (Return by a U.S. Transferor of Property to a Foreign Corporation) together with Form 8838 (Consent to Extend the Time to Assess Tax and a Gain Recognition Agreement) under section 367 (see Document 5-A). Under the Gain Recognition Agreement, U.S. Sub 1 agreed to recognize gain under Treas. Reg. § 1.367(a)-3T(g)(3), if prior to the tenth taxable year following the transfer, F Sub 1 disposed of the F Sub 2 stock in any manner other than a liquidation. Under the Gain Recognition Agreement, U.S. Sub 1 agreed to extend the statute of limitations on assessment to the close of the UUth (Year W) after the year of the transfer (Year Z) under Treas. Reg. §1.367(a)-3T(g)(4). (See Document 5-D)

Along with the Gain Recognition Agreement, U.S. Sub 1 submitted disclosure statements under sections 385(c) and 351 for the tax year ending on Date 9. The section 385(c) statement disclosed that (1) U.S. Sub 1 is the holder of $k of Loan Stock 3, and U.S. Sub 2 is the holder of $s of the loan stock notes, (2) U.S. Sub 1 and U.S. Sub 2 treated these instruments as preferred stock for U.S. tax purposes, and (3) F Sub 1 treated the loan stock instruments as debt for Country 4 tax purposes. (See Document 5-D)

Document 5-E discloses that:

> U.S. Sub 1 contributed #QQ shares of F Sub 2 to F Sub 1 in exchange for $g of s% Loan Stock 2. The adjusted basis of the F Sub 2 shares in the hands of U.S. Sub 1 was $c.
>
> Pursuant to the same plan, F Entity transferred $c and #GG ordinary shares in Foreign Company 1 to F Sub 1.

LAW AND ANALYSIS

Debt Versus Equity

Whether a payment is equity or a debt is a question of fact to be decided on a case by case basis. See Gilbert v. Commissioner, 262 F.2d 512, 513 (2d Cir. 1959), aff'g. T.C. Memo. 1958-8. Courts have traditionally utilized a number of factors in determining whether an instrument is debt or equity. Under the facts of this case, Loan Stock 1, Loan Stock 2, and Loan Stock 3 are subject to strict scrutiny because the issuer (F Sub 1) and the holders (U.S. Sub 1 and/or U.S. Sub 2) are related parties. See Matter of Uneco, Inc. v. United States, 532 F. 2d 1204, 1207 (8th Cir. 1976) (quoting Cuyuna Realty Co. v. United States, 382 F.2d 298, 300-01 (Ct. Cl. 1967)).

Based on the facts as we know them, Loan Stock 2 more closely resembles equity than debt. Although no one factor or total number of factors are controlling, the available facts favor classifying Loan Stock 2 as equity in analyzing the Date 4 transaction.

1. Formal Indicia

The terms of an instrument are crucial in determining whether it should be characterized as debt or equity. Loan Stock 2 has some of the formal indicia of both debt and equity. Indeed the term "FFG" in the name of the instrument is itself inherently ambiguous, connoting both debt and equity. The provision in Instrument 2 for the repayment of a sum certain and a specified coupon rate is indicative of debt. See Commissioner v. O.P.P. Holding Co., 76 F.2d 11 (2d Cir. 1935) (provision for payment of a sum certain with fixed interest rate supports debt characterization). On the other hand, the absence of traditional creditor remedies for failure to make the required coupon payments is more characteristic of equity.

2. Treatment By the Parties

The available information indicates that U.S. Sub 1 treated the payments on Loan Stock 2 as dividends on preferred stock. The parties' treatment of the advances should, generally, be respected. See Yale Avenue Corp. v. Commissioner, 58 T.C. 1062 (1972). In the facts before us, the interest/ dividend payments were never made by F Sub 1 on Loan Stock 1, and U.S. Sub 1 never attempted to collect on the payments. The only action U.S. Sub 1 resorted to was to obtain an increase in the coupon rate of Loan Stock 2 to make up for these missed payments. It appears Loan Stock 2 dividends have been timely made by F Sub 1 and have been reported as dividends by U.S. Sub 1 for U.S. tax purposes.[3] F Sub 1, however, treats the payments made to U.S. Sub 1 as interest payments on debt and deducts them for Country 4 tax purposes.

3. Subordination

Upon liquidation of F Sub 1, Loan Stock 2 would be converted to Type yy Preference Shares and subordinated to other creditors and equity owners, such as the ordinary and Type xx Shares in F Sub 1. Subordination of Loan Stock 2 to other equity owners strongly suggests that Loan Stock 2 should be treated as equity. See P. M. Finance Corporation v. Commissioner, 302 F.2d 786 (3d Cir. 1962), where the Court held that subordination tended to wipe out the most significant characteristic of the debtor-creditor relationship.

4. Independent Creditor Test

Also, it is highly unlikely that any lender would lend money to F Sub 1. There are numerous factors to determine whether it is likely a creditor might lend money, including the capitalization, cash flow and profitability of a company. The high debt to equity ratio (discussed below) also suggests that no independent lender would loan money to F Sub 1. See Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir. 1968)

5. Debt to Equity Ratio

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[3]We note, however, that page #DD of Document 2-F indicates that on Date 5, the holders of the loan stock waived interest accrued on the loan stock amounting to $e, being all arrears of interest owed to them up to that date. We are not certain whether this amount relates to unpaid obligations on Loan Stock 1 or whether payments were also missed on Loan Stock 2. Compare this with Document 5-F which indicates that all coupon payments have been made on the loan stock.

A high debt to equity ratio suggests inadequate capitalization of F Sub 1, thus indicating that Loan Stock 2 was in the nature of equity. U.S. Sub 1 claims that the debt to equity ratio is #TT to 1. We point out that Documents 2-F, 4-B and 4-D contain inconsistencies on the reported capitalization. If, however, the debt to equity ratio is #TT to 1, as U.S. Sub 1 claims, F Sub 1 is more than thin, it is emaciated. See Ambassador Apartments, Inc. v. Commissioner, 50 T.C. 236 (1968), aff'd, 406 F.2d 288 (2d Cir. 1969) (equity found where debt/equity ratio in real estate corporation was 123:1). Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir. 1968) (equity found on 10:1 debt/equity ratio where debtor failed to repay at maturity and could not do so)). Regardless of the inconsistencies in the documentation provided, the capitalization of F Sub 1 is very thin.

6. Maturity

U.S. Sub 1 received an instrument that matured in #BB years. A long maturity date may be an indicium of equity. According to Notice 94-47, 1994-1 C.B. 357, the reasonableness of an instrument's term is determined based on all the facts and circumstances, including the issuer's ability to satisfy the instrument. According to the Notice 94-47, 1994-1 C.B. 357, a maturity date that is reasonable in one set of circumstances may be unreasonable in another if sufficient characteristics are present. There are cases which indicate that long term notes can possibly be considered as debt. See Monon Railroad v. Commissioner, 55 T.C. 345 (1970), acq., 1973-2 C.B. 3, (instrument with a 50-year term was treated as debt under the circumstances described). The Service takes the position in Notice 94-47, 1994-1 C.B. 357, that debt instruments over 50 years probably will not be respected as debt, depending on the facts and circumstances. However, Notice 94-47, 1994-1 C.B. 357, does not provide for a specific cutoff point under 50 years where an instrument is considered equity.

Under the facts in the present case, Loan Stock 2 has a term of #BB years. In and of itself, a term of #BB years, is not necessarily indicative of equity. However, #BB years, arguably, is a long maturity term, especially in light of F Sub 1's thin capitalization, poor payment history on Loan Stock 1, and Instrument 1 and Instrument 2's lack of traditional creditor remedies such as acceleration of principal and interest in the event of default.

Based on all of the available information, under a traditional analysis for distinguishing debt from equity, Loan Stock 2, exchanged on Date 4, appears to be equity.

Section 367 Compliance

Although not specifically included in your request, we have considered the application of section 367 with respect to the Date 4 transaction. The following discussion sets forth our preliminary views based on the facts that are currently available.

Section 367(a) generally denies tax-free treatment to certain otherwise tax-free transactions if the transferee is a foreign corporation. However, if the property transferred by the U.S. Sub 1 to the F Sub 1 is foreign stock (e.g., stock of F Sub 2), the U.S. transferor generally qualifies for nonrecognition treatment under section 367(a) if U.S. Sub 1 files a Gain Recognition Agreement and satisfies certain other procedural requirements. See, Notice 87-85, 1987-2 C.B. 395, modifying Temp. Treas. Reg. § 1.367(a)-3T. The Gain Recognition Agreement essentially requires F Sub 1 to retain the F Sub 2 stock during the term of the agreement. The Gain Recognition Agreement mechanism is only available if the transferred property is stock, not other property.

We assume for purposes of this advice, and based on the facts provided, that U.S. Sub 1's transfer of the F Sub 2 stock to F Sub 1 qualified as a section 351 exchange. Based upon this assumption, U.S. Sub 1's filing of the Gain Recognition Agreement with its Year Z tax return qualified for nonrecognition treatment under section 367(a) in the year of the transfer. Additionally, U.S. Sub 1 must continue to meet the requirements of Temp. Treas. Reg. § 1.367(a)-3T(g) during the Gain Recognition Agreement term in order to maintain such nonrecognition treatment.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

A. Section 311 Capital Gain for U.S. Sub 2

Your memorandum has relied on the assumption that U.S. Sub 1 was the beneficial and registered owner of the #QQ F Sub 2 shares prior to the Date 4 transaction. Whether U.S. Sub 1 owned the #QQ F Sub 2 shares just prior to the Date 4 transaction is unclear.

Documents 1-F and 2-A indicate that U.S. Sub 2 was the beneficial owner of the property (#QQ F Sub 2 shares) prior to the Date 4 transaction, in which U.S. Sub 1 purportedly transferred the property to F Sub 1 in exchange for Loan Stock 2. Beneficial ownership of the stock, as opposed to bare legal title thereto, is critical in determining who is a transferor in a section 351 transaction.

In order for U.S. Sub 1 to be the transferor of the F Sub 2 stock to F sub 1 in the Date 4 transaction, U.S. Sub 1 must have had full ownership of the F Sub 2 stock on Date 4. Thus, if U.S. Sub 2 previously held the beneficial ownership of the F Sub 2 stock, it must have transferred the beneficial ownership to U.S. Sub 1 prior to the Date 4 transaction. In the absence of facts to the contrary, it appears that U.S. Sub 2 may have transferred the beneficial ownership to U.S. Sub 1 in a distribution with respect to stock under section 301. To the extent that U.S. Sub 2's basis in the F Sub 2 stock was less than the fair market value of the stock, U.S. Sub 2 would recognize gain under section 311(b) equal to the difference between the fair market value ($g) and its basis in the F Sub 2 stock.

Depending on the facts as they are developed, section 311(b) gain would be recognized on Date 4 if U.S. Sub 1 disposed of the #QQ F Sub 2 shares. Under the circumstances, U.S. Sub 2's section 311(b) gain on the distribution of F Sub 2 shares would be deferred so long as the F Sub 2 shares were not sold or disposed of by U.S. Sub 1 outside of the consolidated group. <u>See</u> Treas. Reg. § 1.1502-13(c). However, it is our understanding, that on Date 4 U.S. Sub 1 exchanged the F Sub 2 shares for Loan Stock 2 which would result in immediate recognition of the deferred gain under Treas. Reg. § 1.1502-13(f)(1)(i).

B. Section 351 on Date 4 Transfer

U.S. Sub 1 claims that the transaction entered into on Date 4, where U.S. Sub 1 contributed #QQ shares in F Sub 2 to F Sub 1 in exchange for $g of Loan Stock 2, was a tax-free exchange of property under section 351. Document 5-E states that F Entity also transferred property to F Sub 1 as part of the same plan.

It is unclear from all of the documentation provided whether U.S. Sub 1 had “control”, under section 368(c), of F Sub 1 in the ordinary shares, Type xx Preference Shares, Type yy Preference Shares, on the Date 4 transaction.

According to Documents 3-C, 4-B and 4-D, there are #PP ordinary shares. We are not certain if these shares vote and who owned these prior to and after the Date 4 transaction.

According to Document 3-A, there are Type xx Preference Shares, Type yy Preference Shares, as well as Loan Stock 2 on Date 4. The Date 9 financial statements of F Sub 1, as noted in Document 2-F, indicate that U.S. Sub 1 owned p% of the Type xx Preference Shares on Date 9 and at the end of the reporting period, if not earlier. Document 2-F indicates that U.S. Sub 1 owned well over z% of the Loan Stock 2 on Date 13 but none as of Date 9. The available documents do not provide us information on what U.S. Sub 1 owned on Date 4.

Based on the limited information available, we are unable to determine whether the control requirement of section 368(c) was satisfied in the Date 4 transaction. For that reason, we cannot determine whether the Date 4 transaction qualified for non-recognition under section 351(a) even if the Loan Stock 2 is treated as equity.

C. Loan Stock 3

Although you did not request us to consider the classification of Loan Stock 3 as debt or equity, we note that the terms of Loan Stock 3, as set forth in Instrument 3, have certain features that may cause it to be treated as debt rather than equity.

On Date 6, Loan Stock 2 was exchanged for #NN shares worth a total of $n of Loan Stock 3 which has the same due date, interest/dividend rate, and interest/dividend coupon payment dates as Loan Stock 2 in Instrument 2. Loan Stock 3 is registered on the Country 2 Exchange. We do not have enough facts to determine why F Sub 1 created Loan Stock 3; however U.S. Sub 1 has informally indicated that F Sub 1 created Loan Stock 3 to comport with Country 4 law.

We note that, unlike Loan Stock 2, Loan Stock 3 contains the following features:

1. The terms in the event of "default" require acceleration of both the principal amount due as well as the interest accrued up to the date of repayment. Arguably, this acceleration feature is a traditional creditor remedy and makes Loan Stock 3 look more like debt (when compared with the prior instruments).

2. Ultimate Parent Company guarantees the amount due under Loan Stock 3 which would indicate a lender/borrower relationship. According to Document 4-B, Ultimate Parent Company is a very successful company with a lot of assets. Arguably, with Ultimate Parent Company’s guarantee, the holder of Loan Stock 3 would have a substantially greater expectation of repayment than a holder of Loan Stock 2 would have.

If Loan Stock 3 is debt, then the exchange of Loan Stock 2 for Loan Stock 3 may raise other issues. For example, it may have consequences in terms of the gain recognition agreement under section 367 since the exchange of Loan Stock 2 for Loan Stock 3 would probably not qualify as a recapitalization under section 368(a)(1)(E). Or, it may permit an additional argument that the exchange of the #QQ F Sub 2 stock for Loan Stock 2 was not a valid section 351 transaction because the subsequent exchange of the Loan Stock 2 for Loan Stock 3 soon after the Date 4 transaction.

D. Foreign Tax Credits

We do not know whether U.S. Sub 1 and U.S. Sub 2 have claimed foreign tax credits over the various tax years to present.

[redacted]

E. Section 385(c)

Our consideration in this memorandum of the characterization of Loan Stock 2 has focused on a traditional analysis for distinguishing debt from equity without taking into account section 385(c). Section 385(c) addresses instances, such as in the facts herein, where a corporate issuer of an instrument and holders of the instrument take inconsistent positions in their treatment of the instrument for tax purposes.

As noted, F Sub 1 characterizes payments made pursuant to the Loan Stock 1, Loan Stock 2, and the Loan Stock 3, as interest for Country 4 purposes. U.S. Sub 1 and U.S. Sub 2 claim to treat the payments as dividends for U.S. tax purposes. We don't know if their claim is accurate and for example, we refer to our comments above regarding the potential inconsistent treatment for purposes of foreign tax credits. We note, however, that U.S. Sub 1 and U.S. Sub 2 filed a statement pursuant to section 385(c) disclosing inconsistent treatment with respect to Loan Stock 3, but we are not aware of any such filing with respect to Loan Stock 2.

We take no position in this memorandum on the extent to which Section 385(c) may apply in this case. The Service has not yet issued regulations on this provision and has not yet taken a position on how this provision applies in the context of a foreign issuer- e.g., is the foreign issuer's characterization determined by reference to (1) foreign accounting purposes; (2) foreign tax purposes; or (3) U.S. tax purposes? However, if you ultimately conclude that the Date 4 transaction was a valid section 351 transaction, we recommend that Examination seek further guidance on the application of section 385(c) through a request for Technical Advice. See CCDM (35)274.

F. Factual Development

In the course of responding to your request, we have noticed a number of gaps and inconsistencies in the facts. Due to the number of inconsistencies found in the documentation provided by U.S. Parent Company and all other related parties, we suggest that all material facts be double checked for accuracy and that any inconsistencies be clarified.

In addition, we believe the following questions will help you develop the basic facts necessary in analyzing the issues discussed herein:

1. [redacted]

2. [redacted]

3. [redacted]

4. [redacted].

5. [redacted].

6. [redacted].

7. [redacted]

8. [redacted]

9. [redacted]

10. [redacted]

11. [redacted]

12. [redacted].

13. [redacted]

14. [redacted]

15. [redacted]

16. [redacted]

[redacted]

17. [redacted].

Please contact us if you have any questions.

cc: Assistant Regional Counsel (LC)
Assistant Regional Counsel (TL)