OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

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

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated August 21, 2000. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

USP	=
FS	=
Country 1	=
FC	=
Product 1	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=
Year 9	=
Year 10	=
Year 11	=
Year 12	=
Year 13	=

Month # 1	=
Month # 2	=
Month # 3	=
Month # 4	=
Date # 1	=
Amount # 1	=
Amount # 2	=
Amount # 3	=
Amount # 4	=
Amount # 5	=
Amount # 6	=
Amount # 7	=
Amount # 8	=
Amount # 9	=
Amount # 10	=
Amount # 11	=
Amount # 12	=
Amount # 13	=
Amount # 14	=
Amount # 15	=
Amount # 16	=
Amount # 17	=
Amount # 18	=
Amount # 19	=
Amount # 20	=
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Amount # 22	=
Amount # 23	=
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Amount # 25	=
Amount # 26	=
Amount # 27	=
Amount # 28	=
Amount # 29	=
Amount # 30	=
Amount # 31	=
Amount # 32	=
Amount # 33	=
Amount # 34	=
Amount # 35	=
Amount # 36	=
Amount # 37	=

Amount # 38 =

ISSUE

May USP or FS deduct a currency loss under § 1.988–2(b)(13) when certain payables/ receivables are capitalized into the equity of FS ? Since § 1.988-2(b)(13) only applies when a debt instrument is acquired by the obligor in exchange for its stock, a threshold issue is whether the purported payables/ receivables are debt under the facts presented.

CONCLUSION

The accounts receivable are not characterized as indebtedness; accordingly no exchange loss is allowable under § 1.988-2(b)(13) on the capitalization of the accounts receivable since they are characterized as equity in the first instance.

FACTS

USP (“USP”) is a U.S. corporation, which manufactures Product 1. It distributes its product overseas through the use of subsidiaries which purchase USP’s inventory, and sell the inventory in the subsidiaries’ markets. FS (“FS”), a Country 1 corporation, is a wholly owned Country 1 subsidiary of USP, with a Country 1 FC functional currency. FS is included in the USP group consolidated return as a section 1504(d) corporation.

FS was trying to gain market share in a growth market, and was experiencing cash flow problems. USP financed FS’s growth by selling its inventory to FS on credit. The resulting accounts receivable/ payable are the subject of this advice.

FS incurred accounts payable to USP in the years Year 2-Year 11. The accounts payable were not evidenced by notes, had no loan amortization schedule, and did not accrue interest.

During the years Year 2-Year 8 the accounts receivable/ payable[1] were denominated in U.S. dollars, due to hyperinflationary conditions in Country 1. Accordingly, FS was subjected to the exchange risk regarding the payables. In Year 9-Year 11 the receivables were denominated in FCs, so that USP carried the exchange risk.

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[1] For convenience, these accounts payable from FS to USP generally will be referred to as accounts receivable or as advances.

The accounts receivable were converted into capital stock of FS on Date # 1, Year 11. As a result of converting the accounts receivable to capital, the USP group deducted foreign currency losses on the accounts receivable under § 1.988-2(b)(13). For the accounts receivable incurred during the period Year 2-Year 8, FS realized the foreign currency loss, since the accounts receivable were denominated in dollars. For the accounts receivable incurred during the period Year 9-Year 11, USP realized the foreign currency loss, since the accounts receivable were denominated in FCs.

During the period Year 2-Year 11 FS made partial payment on the accounts receivable. During the period Month # 4 Year 3 through Month # 2 Year 8, FS made full payment on the accounts receivable incurred during those years, by the end of each year. USP and FS accounted for the repayment by first applying the repayment to those advances accrued in the year of payment. Accordingly, the receivables in issue are those that were incurred prior to Month # 4 Year 3, or after Month # 2 Year 8, and which were not repaid. During each year or partial year in which the accounts receivable in issue described in the preceding sentence were accrued, the balance of the accounts receivable increased before taking into account any fluctuations due to changes in foreign currency rates, i.e., during the periods in issue, FS did not pay off any of its old accounts receivable due.

You have included information regarding FS's balance sheet for the end of the years Year 1-Year 11.[2] From the information provided, it appears that FS's relevant financial history can be broken down into three periods. During the whole period Year 1-Year 11, FS had negative retained earnings.

During the first period, Year 1 through Year 2, FS had a mere investment in common stock of $Amount # 1. It had negative retained earnings in the amounts of $Amount # 2 and $Amount # 3 respectively, and negative stockholder equity in the amounts of $Amount # 4 and $Amount # 5 respectively. The liabilities outstanding during those years were $Amount # 6 and $Amount # 7 respectively. FS incurred a loss of $Amount # 8 in Year 2.

The second period, in which FS generally earned moderate amounts of income, was from Year 3 through Year 9. In Year 3, although stockholder equity remained negative, it increased significantly (to negative $Amount # 9) due to capitalizing a $Amount # 10 note payable to USP, and income of $Amount # 11. During the period Year 3 through Year 9, FS earned income in all years other than Year 5. (In Year 5, FS incurred a loss of $Amount # 12.) During the years in which

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[2] Although FS's functional currency is FCs, the information supplied to us was converted to U.S. dollars.

FS earned income, its income ranged from $Amount # 13 in Year 7, to $Amount # 14 in Year 4. The average income earned during the years Year 3-Year 9 (including the loss in Year 5) was $Amount # 15. During the period Year 4 through Year 9, FS had positive stockholder's equity ranging from $Amount # 16 to $Amount # 17. Notwithstanding FS's income during these years, FS continued to have negative retained earnings.

On the balance sheet for taxable year ending ("TYE") Year 2, FS's liabilities were $Amount # 7. In Year 3, a $Amount # 10 note payable was capitalized, so that at the end of Year 3 FS's liabilities were $Amount # 18. In Year 4, the liabilities decreased by $Amount # 19, while in the years Year 5-Year 7 the liabilities increased by amounts ranging from $Amount # 20 to $Amount # 21. For TYE Year 7, the balance sheet shows liabilities of $Amount # 22. In Year 8, the liabilities increased $Amount # 23 to $Amount # 24. In Year 9, FS's liabilities increased $Amount # 25 to $Amount # 26. The vast majority of the liabilities consist of the accounts receivable owing to USP.

During the third period, in Year 10 and Year 11, FS incurred losses of $Amount # 27, and $Amount # 28 respectively. It is not clear how much of Year 11's loss was incurred prior to Date # 1, Year 11. In addition, FS's liabilities increased significantly during this period. As previously stated, in Year 8 the liabilities increased $Amount # 23 to $Amount # 24. In Year 9, FS's liabilities increased $Amount # 25 to $Amount # 26.[3] FS represents that on Date # 1, Year 11, its accounts payable to USP were exchanged for capital of FS. The balance sheet for TYE Year 11 (following the exchange) shows liabilities of $Amount # 29.

In Year 12 and Year 13, FS continued to have cash flow problems, and consequently, USP converted the accounts receivable, which were denominated in FCs, to capital stock on an annual basis. In both Year 12 and Year 13, the FC depreciated against the dollar, so that USP attempted to recognize a loss on the conversion of accounts receivable into capital stock.

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[3] In Year 10, FS's liabilities decreased by $Amount # 30. This decrease was not due to a decrease in the balance of accounts receivable due to USP. You stated that the Year 10 decrease in liabilities appears to be due to changes in exchange rates.

LAW AND ANALYSIS

Section 1.988-2(b)(13) generally requires holders and obligors of debt instruments denominated in a nonfunctional currency to recognize foreign currency gain or loss when the debt instrument is exchanged for stock of the obligor; however, the foreign currency gain or loss recognized may not exceed the total economic gain or loss realized on the exchange. Since § 1.988-2(b)(13) only applies when a debt instrument is acquired in exchange for its stock, the facts presented raise a preliminary question as to whether the accounts payable/ receivable were debt or equity.

The Tax Court has stated that since in debt-equity cases there are many combinations of factual circumstances, precedents are generally of little value, and each debt-equity case must be decided based on its own facts. Segel v. Commissioner, 89 T.C. 816 (1987). Nonetheless, in determining whether an instrument is characterized as debt or equity, courts generally consider the following factors:

- The names given to the certificates evidencing the indebtedness;
- The presence or absence of a fixed maturity date;
- The source of the payments;
- The right to enforce the payment of principal and interest;
- Participation in management;
- A status equal to or inferior to that of regular corporate creditors;
- The intent of the parties;
- “Thin” or adequate capitalization;
- Identity of interest between creditor and stockholder;
- Payment of interest only out of “dividend” money;
- The ability of the corporation to obtain loans from outside lending institutions;
- The extent to which the advance was used to acquire capital assets;
- The failure of the debtor to repay on the due date or to seek a postponement.

Bauer v. Commissioner, 748 F.2d 1365 (9th Cir. 1984) (listing all but the last two factors); Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972) at 402. The factors are not of equal significance, and no one factor is controlling. Bauer, 748 F.2d at 1368; Laidlaw Transportation, Inc. v. Commissioner, T.C. Memo 1998-232 (1998) at 75 T.C.M. 2598, 2616. We first consider the above factors seriatim, and then based on the factors, conclude that the accounts receivable should be characterized as equity.

The names given to the certificates evidencing the indebtedness
The presence or absence of a fixed maturity date

The receivables were called "accounts receivable" or "accounts payable," by the parties, and were recorded as such in their corporate books. This supports debt characterization. However, courts have often held that this factor, which looks to the label which the taxpayers affix to the financing, is less important than those factors which look to the substance of the instrument. See, e.g., A.R. Lantz Co. v. United States, 424 F.2d 1330, 1334 (9th Cir. 1970) ("[I]n resolving a debt-equity question we must deal with substance and reality and not mere form") (citations omitted); Tyler v. Tomlinson, 414 F.2d 844 (5th Cir. 1969) ("To hold [that the advances were debt] would be to ignore the plain facts and to elevate form over substance. Tax law requires that creditorship have genuine existentiality. This requires more than a declaration of intention to create an indebtedness and more than the existence of corporate paper encrusted with the appropriate nomenclatural captions.") (citations omitted).

The receivables, however, were not evidenced by written notes. In addition, the receivables contained no maturity date, had no amortization schedules, and interest was not paid or accrued on the receivables for either book or tax purposes. Generally, these factors would indicate that the financing was equity. However, courts have held that short term advances or accounts receivable were characterized as indebtedness notwithstanding the absence of these formal indications of debt. See Malone & Hyde v. Commissioner, 49 T.C. 575 (1968), acq., 1968-2 C.B. 2 (1968); Petersen v. Commissioner, T.C. Memo. 1965-145 (1965); Erickson v. Commissioner, T.C. Memo. 1956-256 (1956).

The source of the payments

This factor concerns whether repayment is only possible out of the issuer's corporate earnings. If so, the issuance appears to be equity. Gilbert v. Commissioner, 262 F.2d 512 (2d Cir. 1959) (court held that indebtedness was a capital contribution when the creditor could not expect the debtor to repay the indebtedness unless there was a substantial improvement in its financial affairs and its business was successful), cert. denied, 359 U.S. 1002 (1959).

In the instant case, the advances were unsecured, and were not guaranteed. Accordingly, USP could only look for payment to the assets of FS. To the extent the assets are necessary for use in FS's business, USP would not have required repayment of the assets, since it would hurt its equity interest in FS. See, e.g., Brake & Electric Sales Corp. v. United States, 185 F. Supp. 1 (D. Mass. 1960) (court found that notes were not indebtedness since the noteholder, who was also the debtor's sole shareholder, could not have realistically expected the corporation to repay the notes without putting itself into a disadvantageous financial position), aff'd, 287 F.2d 426 (1st Cir. 1961). In addition, since FS had negative stockholder's equity in many years, and only a small positive stockholder's equity in the other years, USP could not look to the value of FS's assets for repayment of its receivables.

Consequently, USP must have expected to be repaid (if at all) from the earnings of FS. Although every creditor to some extent looks to the earnings of the debtor for payment, the real issue is whether the debtor currently has earnings, and whether it is reasonable to assume that those earnings will continue, or whether the creditor is expecting repayment based on the hope of success of an untried business. See, e.g., Jack Daniel Distillery v. United States, 379 F.2d 569, 583 (Ct. Cl. 1967)("To say that the advances were placed at the risk of the business does not help the Government. All unsecured loans involve more or less risk. On all available information, the risk here was a good one."); Burr Oaks Corp. v. Commissioner, 365 F.2d 24, 27 (7th Cir. 1966) ("[i]f payment to the transferor is dependent solely upon the success of an untried, undercapitalized business, the prospects of which are uncertain, the transfer of property raises a strong inference that it is, in fact, an equity contribution."), cert. denied, 385 U.S. 1007 (1967). In the instant case, we do not have sufficient information to determine whether FS's income stream was reasonably forseeable when the accounts receivable at issue were created. We note, however, that other than Year 8 and Year 9, in the years in which the accounts receivable at issue were created, FS either incurred losses, or had incurred losses in the previous years.[4] In addition, FS had negative retained earnings during the whole ten year period. Accordingly, this factor tends to support equity characterization.

The right to enforce payment of principal and interest

Debt generally requires an unconditional promise to repay the principal, and the creditor has the right to enforce that promise. A stockholder, however, has no right to enforce its right to dividends or redemption of the stock. See Revenue Ruling 90-27, 1990-1 C.B. 50. We assume in the instant case that under applicable commercial law, payments on the accounts receivable could have been enforced. Accordingly, this factor generally would support debt characterization.

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[4] In Year 2, FS incurred a loss of $Amount # 8; in Year 3, FS realized income of $Amount # 11. The accounts receivable from Month # 4 Year 3 through Month # 2 Year 8 were paid in full, and accordingly are not in issue. In Year 8 and Year 9, FS earned income of $Amount # 31 and $Amount # 32 respectively. In Year 10 and Year 11, FS incurred losses of $Amount # 27 and $ Amount # 28 respectively.

However, even if the holder had the legal right to enforce payment on the purported debt, courts have held that the purported debt was in fact equity when from the surrounding circumstances it appeared that it was unlikely that the holder of the debt would in fact enforce payment on the debt. See, e.g., Gooding Amusement Co. v. Commissioner, 23 T.C. 408 (1954) (court held that loans from shareholders were not debt, since shareholders had no intent to enforce payment on the loans to the extent it meant not paying outside creditors), aff'd, 236 F.2d 159 (6th Cir. 1956), cert. denied, 352 U.S. 1031 (1957); A.R. Lantz Co. v. Commissioner, 283 F. Supp. 164 (C.D. Cal. 1968) (court held that advances were not debt when although there was a right to enforce payment, the right would not be exercised under normal circumstances), aff'd, 424 F.2d 1330 (9th Cir. 1970); Brake & Electric Sales Corp. v. United States, 185 F. Supp. 1 (D. Mass. 1960) (court held that loans from shareholders were not debt, since shareholders had no intent to enforce payment on the loans to the extent the corporate debtor would be required to raise the funds by borrowing from another source), aff'd, 287 F.2d 426 (1st Cir. 1961); Laidlaw Transportation Inc. v. Commissioner, T.C. Memo. 1998-232 (1998) at 75 T.C.M. 2598, 2619 ("[t]he fact that the agreements may have been legally binding counts for little if, as here, the parties understood that they would never be enforced."); but cf. Wilshire & Western Sandwiches, Inc. v. Commissioner, 175 F.2d 718 (9th Cir. 1949) ("The same strict insistence on payment on [the] due date as would be the case if the bank would be the creditor, should not be expected."). Accordingly, in this case in which the debtor's parent corporation held the accounts receivable at issue for a long period without attempting to enforce payment, this factor supports equity characterization.

Participation in management

The accounts receivable do not give USP any rights to participate in management; generally, this would support debt characterization. However, USP owns all the stock of FS, and consequently, completely controls FS. The fact that the accounts receivable do not vest in USP any additional rights to participate in FS's management is unimportant. Accordingly, this factor is neutral.

A status equal to or inferior to that of regular creditors

Subordination is an important equity characteristic. United States v. Snyder Brothers Co., 367 F.2d 980 (5th Cir. 1966), cert. denied, 386 U.S. 956 (1967). In the instant case, the accounts receivable were not by their terms subordinated to other creditors. Accordingly, this factor supports debt characterization. It should be noted, however, that since the vast majority of outstanding debt was owed to USP, this factor loses its importance. See Midland Distributors, Inc. v. United States, 481 F.2d 730, 734 (5th Cir. 1973) ("[subordination] is not important here because there were no other substantial creditors.").

Intent of the parties

In the Ninth Circuit, the circuit in which appeal in this case would lie, this factor concerns whether the parties intended that the advance be debt rather than equity, i.e., whether the advance was intended to be paid in any event, or whether the advance was intended to be placed at the risk of the business. This intent is not determined merely from what the parties decided to call the advance; rather it is determined by analyzing all the debt/ equity factors. Hardman v. United States, 827 F.2d 1409 (9th Cir. 1987); A.R. Lantz Co. v. United States, 424 F.2d 1330 (9th Cir. 1970). As we discuss below, we conclude that the parties must have intended that the accounts receivable would be at the risk of the business, due to the relatively small investment in common stock, the relatively large amount of intercompany liabilities already outstanding, and the negative shareholder's equity when the accounts receivable were created. In addition, the fact that the accounts receivable already outstanding were not paid in a timely manner leads to the conclusion that the parties did not intend that the accounts receivable would be paid in all events. Rather, the accounts receivable must have been intended as investments in equity capital.

"Thin" or adequate capitalization

Thin capitalization is a factor supporting equity characterization. Bauer v. Commissioner, 748 F.2d 1365 (9th Cir. 1984). Unlike an equity investor, a creditor does not intend to place its funds at the risk of the business. Slappey Drive Industrial Park v. United States, 561 F.2d 572, 581 (5th Cir. 1977). If the business is thinly capitalized, the creditor's funds in essence are being placed at the risk of the business, in that a business loss would result in an inability to repay the loan. Bauer v. Commissioner, 748 F.2d 1365 (9th Cir. 1984). Consequently, if the debtor is thinly capitalized, the debt may be recharacterized as equity.

In the instant case there are two classes of accounts receivable at issue: those which were accrued in Year 2 and Year 3, and those that were accrued from Month # 3 Year 8 through Month # 1 Year 11. During Year 2 and Year 3 (prior to the capitalization of a $Amount # 10 note payable to USP) FS had a mere investment in common stock of $Amount # 1. FS had negative retained earnings at the end of Year 1, Year 2, and Year 3 of $Amount # 2, $Amount # 3, and $Amount # 33 respectively, and negative stockholder's equity in Year 1, Year 2, and Year 3 of $Amount # 4, $Amount # 5, and $Amount # 9. FS had liabilities at the end of Year 1, Year 2, and Year 3 of $Amount # 6, $Amount # 7, and $Amount # 18 respectively. (FS's liability and negative stockholder's equity figures significantly improved in Year 3 because it capitalized a $Amount # 10 note payable.) Accordingly, during this period FS had a negative capitalization, i.e., no equity. Consequently, this is a strong factor for equity characterization of the accounts receivable which were accrued during this period.

During the period Month # 3 Year 8 through Month # 1 Year 11, FS had an investment in common stock of $Amount # 34, and constant negative retained earnings. Its stockholder's equity increased (due to earnings during this period) from $Amount # 35 at the end of Year 7, to $Amount # 17 in Year 9. In Year 10, its stockholder's equity decreased to negative $Amount # 36.[5] The amount of liabilities increased from $Amount # 22 at the end of Year 7 to $Amount # 26 at the of Year 9. The total amount of liabilities decreased in Year 10 to $Amount # 37, apparently due to changes in exchange rates. Consequently, when computing debt to equity ratios, using the total liabilities and stockholder's equity, the ratio runs from a low 7.2 in the end of Year 7, to 12.9 in Year 8, and 16.9 in Year 9. In Year 10, FS had a negative stockholder's equity. Accordingly, for those accounts receivable issued in Year 9, Year 10 and Year 11, this factor supports an equity characterization. For the accounts receivable accrued in Month # 3 through December Year 8, this factor is neutral since the 7.2 debt equity ratio of Year 7 is reasonable. In addition, we do not have information as to how FS's financial information changed from January Year 8 through Month # 2 Year 8.

It should be noted, however, that when calculating debt equity ratios, courts have often looked to the real values of the taxpayer's assets, rather than merely using the values shown on taxpayer's books. This is particularly so when taxpayer's business is profitable, and has large amounts of goodwill. <u>See</u>, <u>e.g.</u>, <u>Estate of Miller v. Commissioner</u>, 239 F.2d 729 (9th Cir. 1956); <u>Kraft Foods Co. v. Commissioner</u>, 232 F.2d 118 (2d Cir. 1956). We have no information as to the amount of unrealized appreciation, if any, which is not reflected in taxpayer's book values. However, unlike the cases mentioned above, taxpayer realized losses in Year 2 and Year 5, and in Year 10 and Year 11 taxpayer realized very large losses.

<u>Identity of interest between creditor and stockholder.</u>

In a situation where all stockholders lend money to the corporation in the same proportion as their stockholdings, there is a strong indication that the purported debt is in fact equity. This factor is inconclusive when a parent corporation lends money to its wholly owned subsidiary, since it is undisputed that a parent can lend funds to its wholly owned subsidiary. <u>Slappey Drive Industrial Park v. United States</u>, 561 F.2d 572 (5th Cir. 1977) at 581. Accordingly, this factor is neutral.

<u>Payment of interest only out of dividend money.</u>

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[5] The stockholder's equity figures for Year 11 are not meaningful since they take into account the capitalization in Month # 1 Year 11, and reflect the condition of FS at a period Amount # 38 months after the last account receivable in issue was accrued, during a period in which FS incurred a large loss.

The payment of interest only when the issuer has income, tends to support an equity characterization of the instrument. In this case, no interest was payable on the accounts receivable, although they were outstanding for long periods of time. Accordingly, this factor supports an equity characterization. See, e.g., Slappey Drive Industrial Park v. United States, 561 F.2d 572, 582 (5th Cir. 1977) ("When a corporate contributor seeks no interest, it becomes abundantly clear that the compensation he seeks is that of an equity interest: a share of the profits or an increase in the value of his shareholdings.").

The ability of the corporation to obtain loans from outside lending institutions.

If the borrower cannot obtain loans on similar terms from outside lending institutions, the inference is that a reasonable shareholder would not make the loan, and that in reality the notes are equity. Estate of Mixon v. United States, 464 F.2d 394, 410 (5th Cir. 1972); Segel v. Commissioner, 89 T.C. 816 (1987).

Since the credit at issue is accounts receivable on purchases of inventory, in this factor we primarily consider whether an unrelated supplier would have continued supplying inventory to FS on similar terms as the credit extended by USP. Although we have no direct information on this issue, for the following reasons we do not believe an independent supplier would have continued supplying FS with inventory on credit. First, in Year 2 and Year 3, and from Month # 3 Year 8 through Month # 1 Year 11, FS's accounts receivable were constantly increasing, i.e., it had not yet repaid USP for the inventory USP had previously supplied, and was purchasing more inventory on credit. We do not believe an independent supplier would have continued supplying inventory under those conditions.

In addition, in Year 2 and Year 3 FS had a negative capitalization, and significant negative retained earnings, i.e., losses in the previous years. Furthermore, although FS realized income in Year 3, it had incurred a loss during Year 2, the year immediately prior to its Year 3 extension of credit.[6] Consequently, we do not believe an independent third party would have lent funds to FS in Year 2 and Year 3.

During the period Month # 3 Year 8 through Month # 1 Year 11, the balance on FS's accounts receivable were constantly increasing. Furthermore, the amounts of FS's total liabilities were significantly increasing in each year other than Year 10, in which the amount of liabilities decreased due to fluctuations in the exchange rates. Other than the period of Month # 3 through December Year 8, FS had high debt equity ratios. Lastly, although FS was still earning income in Year 8 and Year 9, its liabilities were increasing in vastly greater amounts, so that for Year 7, its

[6] We have no information as to whether FS earned income in Year 1.

income was equal to 11% of its increase in liabilities. In Year 8 and Year 9, FS's income was equal to 3.3 % and 1% respectively of its increase in liabilities. Finally, in Year 10 and Year 11, FS suffered very large losses (in comparison to the income it had earned in all the previous years Year 3-Year 9 combined). Accordingly, we do not believe an independent third party would have supplied credit or otherwise lent funds during this period to FS.

The extent to which the advance was used to acquire capital assets.

In the instant case the advances were created through purchase of inventory from USP. Since inventory is generally sold (or used in the production of inventory which in turn is sold) for cash or accounts receivable (which are turned into cash), this factor supports a debt characterization. Malone & Hyde v. Commissioner, 49 T.C. 575 (1968), acq., 1968-2 C.B. 2 (1968); J. Hofert Co. v. United States, 23 A.F.T.R. 2d 69-845, 69-1 U.S.T.C. par. 9220 (C.D. Cal. 1969).

The failure of the corporation to repay on the due date.

Generally, the fact that a loan was not paid when due supports equity characterization, since unlike an equity investor which places its money at the risk of the business, the debt holder is only interested in the timely repayment of its money with interest. Slappey Drive Industrial Park v. United States, 561 F.2d 572 (5th Cir. 1977). In the instant case, the accounts receivable had no maturity date. However, accounts receivable are short term debt which is generally expected to be repaid upon sale of the inventory, and collection of the proceeds. In the instant case, the accounts receivable which were accrued during Year 2 and Year 3 were outstanding for an average of eight years. The accounts receivable which were accrued from Month # 3 Year 8 through Month # 1 Year 11 were outstanding for an average of 1.25 years. Accordingly, this factor supports equity treatment.

It must be noted that FS repaid in full its accounts receivable which were accrued between Month # 4 Year 3 and Month # 2 Year 8. Since those accounts receivable were accrued subsequent to the receivables of Year 2 and Year 3, payment on those accounts receivable have no bearing on the characterization of the Year 2 and Year 3 receivables. In fact, the longer the period of nonpayment on the Year 2 and Year 3 accounts receivable, the more likely the receivables are going to be characterized as equity, even if they originally would have been characterized as debt. Sayles Finishing Plants, Inc. v. United States, 399 F.2d 214 (Ct. Cl. 1968).

As pertains to the accounts receivable accrued from Month # 3 Year 8 through Month # 1 Year 11, the payment of the earlier accounts receivable is a factor which supports debt characterization. Of course, since the receivables themselves were not timely paid, this supports equity characterization.

Analysis of Debt Equity Factors

When analyzing the above factors, we first look at whether the form of the advances correspond to indebtedness. Although the advance was not evidenced in writing, contained no maturity date, and did not require the payment of interest, we do not believe the absence of these formalities is fatal in accounts receivable or other advances which are generally intended to be short term, as long as they were recorded in the books of the parties as debt. See Rowan v. United States, 219 F.2d 51 (5th Cir. 1955); Malone & Hyde v. Commissioner, 49 T.C. 575 (1968), acq., 1968-2 C.B. 2 (1968); Petersen v. Commissioner, T.C. Memo. 1965-145 (1965).

We next look at whether, from the objective facts, it appears that the parties intended to create debt. This issue attempts to look at the substance of the financing. When the parties to the financing are related, the substance of the financing will be carefully scrutinized, since in fact the taxpayer occupies both sides of the bargaining table. Fin Hay Realty Co. v. United States, 398 F.2d 694, 698 (3d Cir. 1968). The intent to create debt involves an intent to repay the principal, generally with interest. Slappey Drive Industrial Park v. United States, 561 F.2d 572 (5th Cir. 1977); A.R. Lantz Co. v. United States, 424 F.2d 1330 (9th Cir. 1970); Tyler v. Tomlinson, 414 F.2d 844 (5th Cir. 1969). The fact that the debt was not repaid, or that interest was not paid on the debt generally undermines the debt characterization of the instrument. Slappey Drive Industrial Park v. United States, 561 F.2d 572 (5th Cir. 1977); A.R. Lantz Co. v. United States, 283 F. Supp. 164 (C.D. Cal. 1968), aff'd, 424 F.2d 1330 (9th Cir. 1970). However, as stated above, short term advances have been held to be debt, although interest was not charged on the advances. Malone & Hyde v. Commissioner, 49 T.C. 575 (1968), acq., 1968-2 C.B. 2 (1968).

Regarding most of the accounts receivable at issue, it appears that the parties must have intended that the receivables would be placed at the risk of the business, i.e., that the receivables would be equity, since FS was generally incurring losses when the receivables were accrued, and was not repaying the receivables previously accrued. However, regarding some of the accounts receivable accrued in Year 3, when FS started to become profitable, and the accounts receivable accrued shortly after Month # 2 Year 8, when FS stopped paying its accounts receivable, it could be argued that the parties originally may have intended to create short term accounts receivable. However, the accounts receivable at issue were not repaid, and indeed, the balance of the accounts receivable had risen over the years, without the accounts receivable being converted to a long term debt instrument, and without the charging of interest. This and the other facts described above indicate that the parties intended the advances to be equity.

Finally, if it is determined that the parties intended to create a debt instrument, the issue is whether the economic realities support characterizing the advances as debt. We believe the economic realities of the accounts receivable at issue are that they were extended as risk capital, i.e., equity. First, as we discussed above, an unrelated supplier would not have extended credit to FS in Year 2 through Month # 4 Year 3, and Month # 3 Year 8 through Month # 1 Year 11, based on the fact that prior to Year 2 and through the Year 2 - Year 3 period, FS had not repaid its outstanding accounts payable. Similarly, in the period of Month # 3 Year 8 through Month # 1 Year 11, FS had not been repaying its outstanding accounts payable. In addition, other lenders would not have extended credit to FS during those periods based on FS's negative or thin capitalization, and its history of losses.

Since we conclude that the accounts receivable are properly characterized as equity, section 988 does not apply with respect to the Year 11 recapitalization of the accounts receivable. See section 988(c)(1). Section 1.988-2(b)(13) generally requires the holder and obligor of a nonfunctional currency denominated debt instrument to recognize exchange gain or loss on the exchange of the debt instrument for stock of the obligor, notwithstanding that the gain or loss would not otherwise be recognized. Taxpayer argued that USP and FS should each recognize their exchange loss under § 1.988-2 (b)(13). However, since we determine that the accounts receivables in substance are not debt, § 1.988-2(b)(13) would not apply. In addition, since the accounts receivable are in substance equity, the disposition of the accounts receivable is not a section 988 transaction, as defined in section 988(c)(1), and § 1.988-1(a), and accordingly not subject to section 988.

No opinion is expressed as to whether the accounts receivable accrued and paid that are not at issue in this memorandum are properly characterized as indebtedness.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

You should consider whether FS was qualified to make a section 1504(d) election. See section 1504(d); Kohler Co. v. United States, 124 F.3d 1451 (Fed. Cir. 1997); U.S. Padding Corp. v. Commissioner, 865 F.2d 750 (6th Cir. 1988). If FS did not properly make the election, it will not be an includible corporation as defined in section 1504(b). Section 1504(b)(3). It then would not be a member of USP's affiliated group, section 1504(a)(1)(A), and would not be included in USP's consolidated return. Consequently, its income, deductions, gains and losses would not be included in USP's consolidated return. § 1.1502-11(a).

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Please call if you have any further questions.