OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
May 30, 2001

Number: **200135011**
Release Date: 8/31/2001
CC:INTL:Br2
TL-N-2259-00, WLI #3
UILC: 385.01-00, 1273.00-00, 163.07-02

INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR Associate Area Counsel (LMSB), CC:LM:CTM:SJ
Attn.: Lloyd Silberzweig

FROM: Associate Chief Counsel (INTL)
CC:INTL

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated October 24, 2000. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Corporation X =

Corporation Y =

Association Z =

A =

B =

Country W =

Country X =

Country Y =

Country Z =

State M =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

$a =

$b =

$c =

c% =

ISSUES

1. Whether the note ("Note") issued by Corporation X to Association Z in exchange for approximately $a transferred from Association Z to Corporation X should be treated as valid indebtedness for Federal income tax purposes.

2. Assuming Association Z's investment in Corporation X is properly characterized as debt, are non-principal payments on the debt properly characterized as interest or original issue discount (OID) and when are such amounts deductible?

3. If the Note is valid indebtedness, whether Corporation X is required to withhold 30 percent of non-principal payments on the debt pursuant to § 881(a)(3)(B)?

CONCLUSIONS:

1. Although it is a close factual question, it appears on balance that the Note should be treated as valid debt. A key factor in debt-equity determinations is whether the debt has been paid off. In this case, the Note (or a successor note) is currently scheduled to be paid off, at the latest, by Date 4, which is in the current year and is less than 10 years from the time the debt was created. Failure to make payment by Date 4 (which is an extension beyond the original terms) would warrant serious consideration of the Note actually being equity.

We believe there are two important unanswered questions. First, as indicated above, whether the Note or successor is in fact paid off by Date 4. Second, can the $a received for the Note be traced back to A. If facts were developed showing that the $a originated with A (who, under § 318, constructively owns Corporation X), this would be an indication that the Note is not a valid debt. (A is a sibling of B who controls Association Z, so an indirect transfer of cash from A to Corporation X through B and Association Z is a possibility.)

2. Assuming that Association Z's investment in Corporation X is properly characterized as debt, the Note has OID that Corporation X is entitled to deduct when paid.

It is not clear, however, from the documents provided that, or to what extent, prepayments were made to Association Z under the Note. As a result, we were not able to determine whether the amount of OID deductible by Corporation X in each year was appropriate. We would be glad to assist you in making this determination. However, to do so, we would need the date and amount of each payment and a verification that interest accrued on any accrued but unpaid interest (under the terms of the Note) at the rate of c%, compounded annually.

3. This question was withdrawn and is not discussed below.

FACTS:

The taxpayer, Corporation X, a domestic corporation, was incorporated on Date 1 for the purpose of owning and operating commercial property in the United States. Corporation Y is incorporated under the laws of Country W. All of Corporation Y's issued and outstanding shares are owned by A, a citizen and resident of Country X. Throughout the taxable years in issue, Corporation Y owned all of the stock of Corporation X.

For United States income tax purposes, Association Z is an association taxable as a corporation; it is organized under the laws of Country Y and appears to be resident in Country Z. All of the interests in Association Z are owned by B, a sibling of A. B is related to A within the meaning of IRC § 267(b)(1). There is no evidence that Corporation X and Association Z are related persons within the meaning of § 871(h)(3) (dealing with the disallowance of portfolio interest treatment in connection with payments of interest received by 10% shareholders).

On or about Date 2, Corporation X appears to have issued the Note to Association Z in exchange for $a in cash. The terms of the Note provide for the repayment of $a plus the payment of interest at the rate of c%, compounded annually, in a single balloon payment on Date 3, a date 5 years from the date of issuance. The Note provides, however, that the principal and accrued interest, in whole or in part, may be prepaid at any time without premium or penalty and that "[a]ll prepayments shall be applied first to the then-remaining principal balance . . . and then to accrued interest."

At approximately the same time Corporation X issued the Note to Association Z, it borrowed $c from unrelated third parties. The c% rate of interest on the Note was identical to the rate of interest charged on the third party (secured) loans, which differed from the Note in requiring periodic payments of interest. The proceeds of both the Note and the secured loan were used to acquire real property in State M. The property so acquired was triple-net leased to an unrelated party. Rents from the lease have been used to service both the third party loans and to make prepayments on the Note.

Since their inception, Corporation X has paid its third party loans according to their terms out of lease payments, and it generally has made annual payments to Association Z in an amount slightly in excess of an amount equal to the interest that accrued on the Note at the rate of c%, compounded annually, for the period between prepayments. Prior to the end of its original 5-year term, the Note was extended for an additional 2-year period so that it is now required to be paid no later than Date 4. (During a portion of the extended term, the rate of interest on the Note is higher than originally provided.) All principal and accrued interest on the Note is now required to be paid at the end of this extended period.

LAW AND ANALYSIS

Debt-equity issues

A receipt of funds by a corporation is considered to result in a debt from the corporation to the transferor, rather than equity, if at the time the corporation receives the money the parties intend that it be repaid. *Crowley v. Commissioner*, 962 F.2d 1077, 1079 (1st Cir. 1992), *citing Alterman Foods, Inc. v. United States*, 611 F.2d 866, 869 (Ct. Cl. 1979), involving loans from a shareholder to a corporation. Courts typically determine whether the requisite intent to repay was present by examining available objective evidence of the parties' intentions, such as: the degree of corporate control enjoyed by the taxpayer; the corporate earnings and dividend history; the use of customary loan documentation, such as promissory notes, security agreements or mortgages; the creation of legal obligations attendant to customary lending transactions, such as payment of interest, repayment schedules and maturity dates; the manner of treatment accorded the distributions, as reflected in corporate records and financial statements; the existence of restrictions on the amount of the distribution; the magnitude of the distributions; the ability of the shareholders to repay; whether the holder of the debt undertook to enforce repayment; the repayment history; and the taxpayer's disposition of the funds received. *Crowley v. Commissioner*, *supra*. We discuss the relevant factors below.

The loan in this case is not subject to the same strict scrutiny that would be applied if the purported creditor (Association Z) and the purported debtor (Corporation X) were parent and subsidiary. Nonetheless, there is an indirect relationship (outside the scope of § 318) because individuals A and B are related to one another within the meaning of § 267(b). Thus, some scrutiny is warranted. *See Matter of Uneco, Inc. v. United States*, 532 F.2d 1204, 1207 (8th Cir. 1976) (quoting *Cayuna Realty Co. v. United States*, 382 F.2d 298 (Ct. Cl. 1967)) ("Advances between a parent corporation and a subsidiary or other affiliate are subject to particular scrutiny 'because the control element suggests the opportunity to contrive a fictional debt'"). *See also P.M. Fin. Corp. v. Commissioner*, 302 F.2d 786, 789 (3d Cir. 1962) (sole shareholder-creditor's control of corporation "will enable him to render nugatory the absolute language of any instrument of indebtedness") and *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968).

In addition, it should be noted that even in a parent-subsidiary situation other factors are required in order to find that purported debt is actually equity. There must be something more than just a relationship between the parties to support the inference that the parties did not intend to treat the money transferred as bona fide indebtedness. *See Piedmont Corp. v. Commissioner*, 388 F.2d 886 (4th Cir. 1968); *Liflans Corp. v. United States*, 390 F.2d 965 (Ct. Cl. 1968).

The Note has the formal indicia of indebtedness. It requires the payment of a sum certain ($a plus accrued interest) by a fixed maturity date. *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). *See also United States v. Title Guarantee & Trust Co.*, 133 F.2d 990 (6th Cir. 1943) (fixed maturity date one of most important factors in determining debt status). This factor supports treatment of the instrument as debt.

Since "actions speak louder than words," the parties' treatment of the Note is crucial in determining whether its characterization as debt should be respected. *See Yale Ave. Corp. v. Commissioner*, 58 T.C. 1062 (1972). *See also Waller v. United States*, 78-1 USTC ¶ 9394 (D. Neb. 1978) (failure to enforce outweighs formal indicia).

In this case, the critical question is whether Corporation X paid off the Note in accordance with its terms. Here, the Note was not paid off as required at the end of its initial term on Date 3, but was extended until Date 4. The fact that the creditor provided only a relatively short extension of time and required a higher interest rate for the latter portion of the extended term indicates the creditor intends to enforce its creditor rights.

In theory, payment of the debt is only one of several factors in debt-equity determinations. As a practical matter, however, even when the time for payment has been extended (provided the total period of time, including extension, is not unreasonable) courts generally find this single factor of payment-in-full compelling in reaching a determination that an item is debt.

Not only must the purported creditor expect repayment, the expectation must be reasonable. Repayments dependent on the fortunes of the business indicate equity. *Dixie Dairies Corp., supra; Estate of Mixon v. United States, supra.* In the present case, the corporation was newly created and had no accumulated reserves and little or no cash received from Corporation Y, its shareholder, therefore payment on the Note is dependent on the fortunes of the business. Generally, this factor would argue against respecting the characterization of the Note as debt. However, in the present case, there are two reasons why repayment may have seemed reasonable so that Association Z, the holder of the Note would not have felt at risk: (i) the relationship between A and B may have given B, and thus Association Z, a reasonable expectation of repayment; and (ii) Association Z knew that Corporation X was purchasing real estate so that Association Z perhaps reasonably viewed the real estate as being able to generate sufficient income to pay the c% interest and as having a fair market value sufficient to repay the Note's principal. A further development of the facts may show that because the money loaned was being used to buy real estate, an expectation of repayment was reasonable. See *Tomlinson v. 1661 Corporation*, 377 F.2d 291 (5th Cir. 1967).

OID deduction issues

The balance of this memorandum assumes that the Note represents valid indebtedness for federal income tax purposes and that the Note was issued in exchange for $a in cash.

Generally, OID means the excess of a debt instrument's "stated redemption price at maturity" over its "issue price." See § 1273(a)(1) and § 1.1273-1(a) of the Income Tax Regulations. The term "stated redemption price at maturity" includes interest and all other amounts payable under a debt instrument (other than any interest based on a fixed rate, and payable unconditionally at fixed periodic intervals of 1 year or less during the entire term of the debt instrument). See § 1273(a)(2) and § 1.1273-1(b). The issue price of a debt instrument that is not publicly offered and not issued for property is the price paid by the first buyer of the debt instrument. See § 1273(b)(2) and § 1.1273-2(a). The term "property" does not include money. Section 1273(b)(5).

In the instant case, Corporation X issued the Note in exchange for $a and the Note was not publicly offered. Therefore, the issue price of the Note equals $a. Because the Note's interest is not unconditionally payable at least annually, it does not constitute qualified stated interest within the meaning of § 1.1273-1(c)(1)(i), and, therefore, is included in the Note's stated redemption price at maturity. As a result, the Note's stated redemption price at maturity is the total amount of principal (that is, $a) plus the amount of interest that would accrue over the term of the Note at a rate of c%, compounded annually. Therefore, because the Note's stated redemption price at maturity exceeds the Note's issue price (by the amount of the accrued interest), the Note has OID.

Section 163(e)(1) allows as a deduction to the issuer for any taxable year that portion of the OID with respect to a debt instrument that is equal to the aggregate daily portions of the OID for days during such year. The daily portions of OID are determined under § 1272(a) (without regard to the rules for acquisition premium and de minimis OID). See §§ 1.163-7 and 1.1272-1. Because the Note has OID, under the general rule of § 163(e)(1), Corporation X would be able to deduct the OID on the Note as the OID (interest) accrues.

Section 163(e)(3)(A), however, provides that if any debt instrument having OID is held by a related foreign person, any portion of such OID shall not be allowable as a deduction to the issuer until paid.[1] A "related foreign person" means any person who (1) is not a United States person, and (2) is related within the meaning of § 267(b) to the issuer. Section 163(e)(3)(B). The term "United States person" includes a citizen or resident of the United States, a domestic partnership, a domestic corporation, and certain estates and trusts. Section 7701(a)(30)(C). For purposes of this memorandum, we have assumed that Corporation X is related to Association Z within the meaning of § 267(b). Based upon this assumption, any portion of OID accruing on the Note is allowable as a deduction when actually paid by Corporation X under § 163(e)(3)(A).

The Note provides that prepayments are applied first to the outstanding principal balance and then to accrued interest. This is contrary to the payment ordering rules found under the OID rules. Section 1.1275-2(a) provides that, except as provided in paragraph (a)(2) of this section (dealing with, for example, pro rata prepayments), each payment under a debt instrument is treated first as a payment of OID to the extent of the OID that has accrued as of the date the payment is due and has not been allocated to prior payments, and second as payment of principal. (See also § 1.446-2(e)(1), which provides that, except as otherwise provided in paragraphs (e)(2), (e)(3) and (e)(4) of that section, each payment under a loan (other than payments of additional interest or similar charges provided with respect to amounts that are not paid when due) is treated as a payment of interest to the extent of the accrued and unpaid interest.) Thus, for federal income tax purposes, the labels placed on the payments by the parties are generally ignored.

In this case, any payments on the Note are first treated as a payment of accrued but unpaid OID and then, to the extent of any excess payment, treated as a payment of principal. As a result, any portion of a payment treated as a payment of OID is deductible by Corporation X for the taxable year in which the payment is made.

---

[1] Section 163(e)(3) limits this provision to the extent that the OID is effectively connected with the conduct by such foreign related person of a trade or business within the United States unless such OID is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the United States. There is no evidence that Association Z was engaged in the conduct of a trade or business within the United States, and, for purposes of this memorandum, it is assumed that the OID is not effectively connected with the conduct by Association Z of such a trade or business.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

The Commissioner can apply or depart from the payment ordering rules of § 1.1275-2(a)(1) using its anti-abuse authority under § 1.1275-2T(g) if a principal purpose in structuring the Note, engaging in the transaction, or applying the regulations under section 163(e) or sections 1271 through 1275 is to achieve a result that is unreasonable in light of the purposes of the applicable statutes.[2] Whether a result is unreasonable is determined based on all the facts and circumstances. A result will not be considered unreasonable, however, in the absence of a substantial effect on the present value of a taxpayer's tax liability. Because the terms of the Note require that prepayments "shall be applied first to the then-remaining principal balance of this Promissory Note and then to accrued interest," it could be argued that the Note was structured to achieve a result that was unreasonable in light of the purposes of the OID rules. [redacted]

From the materials submitted, it appears possible that Corporation X issued the Note in exchange for $b in cash, which is slightly more than $a, or that the difference between $b and $a may represent the amount of one or more prior loans by Association Z to Corporation X, which may have been rolled-over into the Note. The analysis above, especially as regards OID, presumes that the Note was issued in exchange for $a. Different rules, not discussed herein, apply to determine OID where a note is issued in exchange for property (not money).

Please note also that the extension of the Note may raise additional issues not addressed in this Advice (e.g., whether the extension is a new "issuance" for purpose of the OID rules). These would pertain to years not under examination in the current cycle.

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

If you have any questions with respect to the OID issues discussed herein, please contact Christina Morrison at (202) 622-4429. Any questions regarding the debt-equity issues discussed herein should be directed to Michael Danbury at (202) 622-7750.

---

[2] For debt instruments issued on or after August 13, 1996, see § 1.1275-2(g).

Phyllis E. Marcus
Chief, Branch 2
Associate Chief Counsel (INTL)