



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

FROM: Richard Fultz  
Field Service Special Counsel CC:INTL

SUBJECT:

This Chief Counsel Advice supplements the advice previously provided to you on August 30, 2001 and responds to your request for clarification of matters addressed in that Chief Counsel Advice. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Parent	=
Sub	=
Lenders	=
Country A	=
Amount 1	=
Amount 5	=
Amount 6	=
Amount 7	=
Period M	=
Year 2	=
S	=

ISSUE

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.

CONCLUSION

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The transaction may be bifurcated into a loan from the banks to Sub and an equity contribution from Parent to Sub. Based on the facts provided, we do not recommend pursuing the alternative characterizations of the transaction.

## FACTS

Our analysis is based on the facts as stated in your incoming request for Field Service Advice dated December 13, 2000.

## LAW AND ANALYSIS

The alternative characterizations of the transaction that we considered were a stripping transaction; a prepaid forward contract; and two forms of a conduit analysis. Under the first conduit analysis, Parent would be viewed as indirectly making an Amount 6 loan to Sub using Lenders as a conduit and Lenders would be viewed as providing separate financing of Amount 7, and under the second (a "partial recast"), Parent would be viewed as indirectly making an Amount 6 equity contribution to Sub, and Lenders as making an Amount 7 loan to Sub.

### A. Partial recast of the transaction as equity

As a convenience, we have restated our legal analysis which supports the partial recast of this 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 (4<sup>th</sup> 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 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 "genuine 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:

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- (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 (5<sup>th</sup> 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 transaction 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 enforce payment; (5) the securities are subordinated and unsecured; (6) in the event Lenders default on their obligation to deliver the Securities to Parent, Parent has the right to assign its interest in the Securities to Sub, with the result that Sub would offset its obligations to Lenders under the Securities with its rights under the assignment and make payments to

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Parent rather than 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. Alternative recharacterizations of the transaction

Of the remaining three alternatives considered, the first alternative treated the Lenders as "stripping" Sub's notes by retaining the cash flows represented by the semi-annual interest payments during Period M and selling the remaining cash flows on the Notes represented by principal together with interest following the turnover date. Under this analysis, Parent would become the immediate owner of a stripped instrument issued by Sub (but with a delay in possession equal to Period M). If this were the case, under I.R.C. section 1286, Parent would acquire a debt instrument with a principal amount of Amount 1 for Amount 6, and original issue discount of Amount 7 would accrete during Period M prior to the turnover date. However, characterizing Parent as having direct ownership during Period M of a debt instrument that automatically converts to an equity instrument on the turnover date would be difficult to sustain against the contrary assertion – and the approach we recommend above – that Parent has made an equity contribution at the outset. Accordingly, we advise against characterizing the transaction as a stripping transaction. Consequently, original issue discount would not accrete to Taxpayer under section 1286 during Period M.

For similar reasons, we advise against pursuing the second alternative considered, which characterized the transaction as a "prepaid forward," and the third alternative, which characterized this transaction as a conduit transaction where Lenders acted as a conduit for Amount 2 of Parent financing to Sub. Our opinions contained in this Chief Counsel Advice are based on the facts presented, which only support a partial recast (i.e., treating Parent as making an equity contribution to Sub at the outset). Because the facts only support this partial recast, characterizing the transaction as a prepaid forward (i.e., treating Parent as lending

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Amount 6 to Lenders and acquiring an ownership interest in Sub's notes on the turnover date), as well as a conduit transaction where Lenders acted as a conduit for an Amount 6 loan from Parent to Sub, are precluded.<sup>1</sup>

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



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Please call (202) 622-3830 if you have any further questions.

John Staples  
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<sup>1</sup> Because we conclude that Taxpayer's interest in the instrument at issue is not debt, there is no need to address the issue of whether this transaction should be challenged under section 446.