



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

OFFICE OF
CHIEF COUNSEL

Number: **200238022**
Release Date: 9/20/2002
CC:INTL:6
POSTF-160376-01
UILC: 482.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

June 13, 2002

MEMORANDUM FOR JUNE Y. BASS, ASSOCIATE AREA COUNSEL (LMSB)
CC:LM:CTM:LN

FROM: John M. Breen, Senior Technical Reviewer, CC:INTL:6

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated January 28, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be used or cited as precedent.

LEGEND

<u>a</u>	=
<u>b</u>	=
<u>c</u>	=
<u>d</u>	=
<u>e</u>	=
<u>f</u>	=
<u>g</u>	=
<u>h</u>	=
<u>i</u>	=
<u>j</u>	=
<u>k</u>	=
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POSTF-160376-01

<u>n</u>	=
<u>o</u>	=
<u>p</u>	=
<u>q</u>	=
<u>r</u>	=
<u>s</u>	=
<u>t</u>	=
<u>u</u>	=
<u>v</u>	=
<u>w</u>	=
<u>x</u>	=
<u>y</u>	=
<u>z</u>	=
<u>aa</u>	=
<u>bb</u>	=
<u>cc</u>	=
<u>dd</u>	=
<u>ee</u>	=
Corp A	=
Corp B	=
Country 1	=
Country 2	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Period A	=
Period B	=
Product	=
Taxable Year 1	=
Taxable Year 2	=
Taxable Year 3	=

ISSUES

- (1) Whether the facts support reclassifying a portion of certain accounts payable to a controlled party as equity.
- (2) As an alternative to reclassifying a portion of accounts payable as equity, whether the IRS may apply section 482 to impute payments of interest on those accounts payable.

POSTF-160376-01

- (3) Whether the IRS has a policy of excluding foreign-owned companies as potential uncontrolled comparables under the Treas. Reg. § 1.482-5 comparable profits method.

CONCLUSIONS

- (1) Insufficient facts are available to determine whether to reclassify a portion of the accounts payable as equity.
- (2) Interest may be imputed with respect to a portion of the accounts payable pursuant to Treas. Reg. §§ 1.482-2(a)(1). However, imposition of interest under that provision would require a corresponding reduction in the amount of accounts payable subject to the balance-sheet adjustment under the Treas. Reg. § 1.482-5 comparable profits method.
- (3) Pursuant to Treas. Reg. §§ 1.482-1(d)(2) and 1.482-5(c), the IRS evaluates the comparability of potential uncontrolled comparables under the comparable profits method, by considering all factors that could affect profits or prices in arm's length dealings, without regard to foreign ownership.

FACTS

Corp A is a domestic calendar-year taxpayer and a wholly-owned subsidiary of Corp B, a corporation organized under the laws of Country 1. The taxable years of Corp A subject to examination by the IRS correspond to Taxable Years 1, 2, and 3.

Corp A's principal business during the years at issue was the distribution of Corp B brand Product in the United States and Country 2. Corp A also provided repair and maintenance services for the Products and performed marketing activities typical of a wholesale distributor.

Corp A purchased Products exclusively from Corp B and Corp B affiliates pursuant to an agreement dated Date 1 (Agreement). Article 8.1 of the Agreement required Corp A to pay Corp B an agreed-upon purchase price for the Products. The Agreement, however, did not specify the terms of payment between the parties or the interest rate (if any) applicable to outstanding balances. Payables arising under the Agreement were identified as accounts payable in Corp A's financial records. Analysis during the course of the examination indicated that these

POSTF-160376-01

accounts payable were outstanding for an average of Period A before the underlying amounts were paid to Corp B. The Forms 5472 (Information Return of a 25% Foreign-Owned U.S. Corporation Engaged in a U.S. Trade or Business) filed by Corp A indicate that Corp A did not pay any interest to Corp B for the tax years under audit, which is consistent with the conclusion that no interest was paid on the intercompany accounts payable.

The examination conducted by the IRS considered, among other issues, whether the transfer prices for purchases of tangible property by Corp A from Corp B were arm's length within the meaning of section 482 and the regulations thereunder. Corp A reported the following amounts of taxable income for the years in question:

<u>Year</u>	<u>Net Operating Income/(Loss)</u>
Taxable Year 1	<u>\$a</u>
Taxable Year 2	<u>(\$b)</u>
Taxable Year 3	<u>(\$c)</u>
Total	<u>(\$d)</u>

Source: IRS Economist Report dated Date 2 at 8.

The IRS economist determined that the comparable profits method (CPM) constituted the best method for evaluating transfer prices between Corp A and Corp B. Under the CPM, the operating profit earned in the tested party's controlled transactions (the relevant business activity) is evaluated by reference to the operating profit that would have been earned if performance in the relevant business activity were based on the profit level indicator (PLI) in the comparable controlled transactions. See Treas. Reg. § 1.482-5(a). In testing the operating profit of Corp A, the IRS economist identified and analyzed six uncontrolled comparables that engaged in transactions comparable to the controlled transactions between Corp A and Corp B. The operating margin (ratio of operating profits to sales) was selected as the PLI.

The IRS economist considered one potential comparable company that was wholly-owned by foreign interests during Period B. Consistent with the comparability factors under Treas. Reg. §§ 1.482-1(d)(2) and 1.482-5(c), the IRS economist excluded this potential comparable company for reasons unrelated to its foreign ownership.

The IRS economist made adjustments to the uncontrolled comparables and the tested party for differences in certain assets and liabilities (hereinafter, balance-

POSTF-160376-01

sheet adjustments), pursuant to Treas. Reg. § 1.482-5(c)(2)(iv). First, the IRS economist determined the net trade assets held by each party, using the following formula:

$$\text{Net Trade Assets} = \text{Accounts Receivable} + \text{Inventory} - \text{Accounts Payable}$$

Second, the IRS economist applied a short-term interest rate to each party's net trade assets to calculate a notional carrying cost with respect to the balance-sheet items. Third, the IRS economist subtracted the resulting amount from operating profit, in order to restate each party's operating profit on a hypothetical "zero net trade assets" basis. If net trade assets were positive, the adjustment reduced operating profit; if net trade assets were negative, the adjustment increased operating profit.¹

Because Corp A's accounts payable in Taxable Years 1-3 substantially exceeded the total of its accounts receivable and inventory, Corp A's net trade assets were negative in each year. Consequently, a balance-sheet adjustment based on Corp A's balance-sheet items as reported would have increased Corp A's reported operating profits.

The IRS concluded that Corp A's accounts payable were in substance equity, because Corp A's open-account debt with Corp B under the CPM was excessive in comparison to that of the uncontrolled comparable companies. Consequently, the IRS economist reclassified a portion of Corp A's accounts payable as equity, and excluded that portion from Corp A's net trade assets before performing balance-sheet adjustments to operating profit pursuant to Treas. Reg. § 1.482-5(c)(2)(iv).

The portion of Corp A's accounts payable reclassified as equity was calculated as follows. First, the ratio of equity to total assets was calculated for each of the uncontrolled comparables used in the CPM. Second, Corp A's accounts payable were adjusted to a level that would give Corp A an equity-to-assets ratio equivalent to the median of the equity-to-assets ratios of the uncontrolled comparables. The adjustments to Corp A's accounts payable were as follows:

¹ For simplicity, we refer to a downward adjustment of this type as reducing operating profit, although in a particular year such an adjustment may increase operating loss.

POSTF-160376-01

<u>Year</u>	<u>Accounts Payable Per Financials</u>	<u>Amount Reclassified As Equity</u>	<u>Adjusted Accounts Payable</u>
Taxable Year 1	\$ <u>e</u>	\$ <u>i</u>	\$ <u>m</u>
Taxable Year 2	\$ <u>f</u>	\$ <u>j</u>	\$ <u>n</u>
Taxable Year 3	\$ <u>g</u>	\$ <u>k</u>	\$ <u>o</u>
Total	\$ <u>h</u>	\$ <u>l</u>	\$ <u>p</u>

Source: IRS Economist Report dated Date 2 at 7 and Exhibit 4. Note: Individual-year data for accounts payable and amount reclassified do not add exactly to the adjusted accounts payable, as the IRS used annual-average accounts payable at year-end to derive the latter amounts.

When the IRS economist adjusted Corp A's operating profits to a hypothetical "zero net trade asset basis," pursuant to Treas. Reg. § 1.482-5(c)(2)(iv), by applying a short-term interest rate to Corp A's net trade assets, the adjustments to Corp A's operating profit were as follows:

<u>Year</u>	<u>Reported Operating Profit/(Loss)</u>	<u>Balance-Sheet Adjustment (Reduction)</u>	<u>Adjusted Operating Profit/(Loss)</u>
Taxable Year 1	\$ <u>a</u>	\$ <u>q</u>	\$(<u>u</u>)
Taxable Year 2	\$(<u>b</u>)	\$ <u>r</u>	\$(<u>v</u>)
Taxable Year 3	\$(<u>c</u>)	\$ <u>s</u>	\$(<u>w</u>)
Total	\$(<u>d</u>)	\$ <u>t</u>	\$(<u>x</u>)

Source: IRS Economist Report dated Date 2 at 8. Thus, over the three-year period, the adjustment reduced Corp A's reporting operating profit by a total of \$t.² Similar adjustments were made to the uncontrolled comparables, based on their respective (unadjusted) accounts receivable, inventories, and accounts payable.

For each of Taxable Years 1 through 3, Corp A's adjusted operating profits fell outside the interquartile range of the comparable operating profits indicated by the PLIs of the uncontrolled comparables under the CPM. In calculating the section 482 adjustment, the IRS adjusted Corp A's profits for each year to the median of

² If the IRS had used the reported amount of Corp A's accounts payable, the balance-sheet adjustment would have increased operating profits for the three-year period by \$y. Thus, IRS's re-characterization of a portion of Corp A's accounts payable as equity had the following effect: \$t (reduction in operating profit) + \$y (foregone increase in operating profit) = \$z (net impact on reported operating profit).

POSTF-160376-01

the interquartile range of the comparable operating profits, pursuant to Treas. Reg. § 1.482-1(e)(3). The resulting adjustments under the CPM were \$aa, \$bb, and \$cc in Taxable Year 1, Taxable Year 2, and Taxable Year 3, respectively. See IRS Economist Report dated Date 2 at 9. The total section 482 adjustment under the CPM for the three-year period was \$dd.

On Date 3, the IRS issued a thirty-day letter containing a Form 886-A (Explanation of Items) with respect to the above issues. On Date 4, Corp A submitted a Protest and Request for Competent Authority Assistance and Simultaneous Appeals procedure. As of the issuance date of this advice, Examination has jurisdiction over this case.

LAW AND ANALYSIS

INTRODUCTION

The comparable profits method (CPM) under Treas. Reg. § 1.482-5 “relies on the general principle that similarly situated taxpayers will tend to earn similar returns over a reasonable period of time.” T.D. 8552, 1994-2 C.B. 93, 109. The reliability of the results under the CPM depends on the comparability between the tested and the uncontrolled parties. Consequently, Treas. Reg. § 1.482-5(c)(2)(iv) provides for adjustments for differences between the tested and uncontrolled parties that “materially affect the profits determined under the relevant [profit level indicator (PLI)].” Thus, the regulations provide:

In some cases, the assets of an uncontrolled comparable may need to be adjusted to achieve greater comparability between the tested party and the uncontrolled comparable. In such cases, the uncontrolled comparable’s operating income attributable to those assets must also be adjusted before computing a profit level indicator in order to reflect the income and expense attributable to the adjusted assets. In certain cases it may also be appropriate to adjust the operating profit of the tested party and comparable parties. For example, where there are material differences in accounts payable among the comparable parties and the tested party, it will generally be appropriate to adjust the operating profit of each party by increasing it to reflect an imputed interest charge on each party’s accounts payable.

Treas. Reg. § 1.482-5(c)(2)(iv) (emphasis added). See also Treas. Reg. § 1.482-5(e), Example 5 (adjustment for differences in accounts receivable), Example 6 (adjustment for differences in accounts payable). Although the regulation refers to

POSTF-160376-01

distinct adjustments for accounts receivable and accounts payable, in this case the IRS performed a single adjustment for balance-sheet items by reference to net trade assets, which combined accounts receivable, accounts payable, and inventory in a single calculation.

The question presented is what, if any, action the IRS may take when a tested party's open-account debt with a related party under the CPM appears excessive as compared to the open-account debt of uncontrollable comparable companies. The existence of substantial, interest-free payables to a foreign parent may give rise to a balance-sheet adjustment under Treas. Reg. § 1.482-5(c)(2)(iv) that increases the tested party's reported operating profit. Such an adjustment will reduce the amount of the section 482 adjustment (if any) that is necessary to reach an arm's length result under Treas. Reg. § 1.482-1(e)(3)

The balance-sheet adjustments to the tested party's operating profits specified by Treas. Reg. § 1.482-5(c)(2)(iv) are based on the classification of items under general Federal income tax principles. Thus, for example, if the status of a particular item as debt is in question, the item is subject to analysis under applicable judicially-developed principles, including economic substance. The results of that analysis form the basis upon which a section 482 analysis is made.

We consider first whether a basis exists for reclassifying a portion of the accounts payable in this case under general Federal income tax principles. We then turn to the alternative proposal, that Corp A's operating profit be adjusted for imputed interest payable to Corp B on overage accounts payable, and that withholding tax be collected on that amount under I.R.C. § 1442.

Issue 1: Whether the facts support reclassifying a portion of certain accounts payable to a controlled party as equity.

In general, the substance rather than the form of a transaction governs for Federal income tax purposes. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935). Thus, in appropriate cases, the IRS is empowered to disregard the form of a transaction, and determine the tax consequences based upon its substance. See Gregory v. Helvering; Spector v. Commissioner, 641 F.2d 376, 381 (5th Cir. 1981), cert. denied, 454 U.S. 868 (1981); Laidlaw Transportation, Inc. v. Commissioner, T.C. Memo. 1998-232, 75 T.C.M. (CCH) 2598 (1998).

The IRS generally applies a substance-over-form analysis to determine whether advances of funds constitute debt or equity. See Laidlaw Transportation; Nestle Holdings, Inc. v. Commissioner, T.C. Memo. 1995-441 (1995), vacated and

POSTF-160376-01

remanded on another issue, 152 F.3d 83 (2d Cir. 1998) (quoting Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 377 (1973)).³ Numerous judicial decisions analyze whether intercompany advances of funds constitute debt or equity. No single or uniform approach has been adopted by the courts in addressing this particular issue. The Tax Court generally examines 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, *supra*. This case, however, is appealable to the Ninth Circuit, and thus the Tax Court will follow the governing precedent in the Ninth Circuit. Golsen v. Commissioner, 54 T.C. 742 (1970).

The Ninth Circuit has enumerated specific factors that may be considered in resolving a debt-equity issue. Hardman v. United States, 827 F.2d 1409 (9th Cir. 1987). Although the following list is not exclusive and in general no single factor is determinative, the Ninth Circuit generally analyzes the following:

- (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 payments;
- (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;

³ Section 385(a) also authorized the Secretary to prescribe regulations to determine whether an interest in a corporation is to be treated as equity or indebtedness. However, to date, no regulations have been issued under section 385.

POSTF-160376-01

- (9) The source of interest payments, e.g., from earnings;
- (10) The ability of the corporation to obtain credit from outside sources; and
- (11) The intent of the parties.

Hardman, 827 F.2d at 1412.

In applying the Ninth Circuit debt-equity factors, the facts surrounding the transaction are of primary importance. The facts currently available in this regard are at best ambiguous. For example, although Corp A recorded the advances as accounts payable on its books, it is unclear how Corp B treated the advances. Further, no information is available regarding the repayment schedule, maturity dates, or remedies in light of a default on repayment. Nevertheless, because Corp A consistently classified and accounted for the advances as debt, and because Corp A actually made repayments on the accounts payable (albeit after an extended period of time), the facts developed so far would not support reclassifying a portion of Corp A's accounts payable as equity.

We emphasize that the analysis needed to determine whether an advance of funds constitutes debt or equity is fact-intensive. We stress that if additional facts were available, the IRS might conclude, based on the factors enumerated above, that a portion of Corp A's accounts payable should be reclassified as equity.

Absent a basis under general Federal income tax principles for reclassifying Corp A's accounts payable as equity, the balance-sheet adjustments under Treas. Reg. § 1.482-5(c)(2)(iv) should have been based on the unadjusted accounts payable reported by Corp A.

Issue 2: As an alternative to reclassifying a portion of accounts payable as equity, whether the IRS may apply section 482 to impute payments of interest on those accounts payable.

You asked whether, as an alternative to reclassifying a portion of Corp A's accounts payable as equity, it may be appropriate to make a section 482 adjustment for imputed interest on a portion of Corp A's accounts payable, and to collect withholding tax on deemed interest payments arising under that provision.

POSTF-160376-01

Imputing interest on Corp A's accounts payable pursuant to Treas. Reg. § 1.482-2(a)(1) may be an alternative to reclassifying a portion of the accounts payable as equity. If such an adjustment were made, however, the accounts payable subject to imputed interest pursuant to Treas. Reg. § 1.482-2(a)(1) would be excluded from the amounts subject to balance-sheet adjustments to Corp A under the CPM.

For purposes of our analysis, we assume, consistent with the resolution of Issue 1 above, that no reclassification of Corp A's accounts payable as equity is appropriate. We also assume that Corp A paid no interest on its accounts payable, consistent with the information on Forms 5472 for Taxable Years 1-3. Under Treas. Reg. § 1.482-2(a)(1)(i), when one member of a controlled group makes an interest-free loan or a loan at less than an arm's length rate of interest, the IRS may make appropriate allocations to reflect an arm's length interest rate for the loan or advance. Debt arising in the normal course of business between members of a controlled group, including an extension of credit, is generally considered a loan or advance to which Treas. Reg. § 1.482-2(a)(1) applies.⁴

Section 1.482-2(a)(i) of the Treasury Regulations generally defines an arm's length interest rate as the rate that was charged, or that would have been charged, at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances. Because it does not appear that interest was charged on the intercompany payables in this case, the IRS may impute an arm's length interest rate as defined in Treas. Reg. § 1.482-2(a)(i). In the case of intercompany trade payables or receivables generated in the ordinary course of business, interest generally need not be charged until the first day of the third calendar month after the month in which the receivable or payable arose. See Treas. Reg. § 1.482-2(a)(1)(iii)(B). This interest-free period may be longer under certain circumstances. See Treas. Reg. § 1.482-2(a)(1)(iii)(C)-(E). Thus, some portion of Corp A's accounts payable would probably not be subject to imputed interest under Treas. Reg. § 1.482-2(a)(1)(iii)(B).

⁴ If the stated rate of interest on the loan or advance between two controlled entities is subject to adjustment under section 482 and is also subject to adjustment under another provision, Treas. Reg. § 1.482-2(a)(3) provides that the other Code provision (e.g., sections 467, 483, 1274 or 7872) applies to the indebtedness before the Service applies section 482 to determine whether the rate of interest charged on the indebtedness (as adjusted by the other Code section) is equal to an arm's length interest rate. In the present case, because any imputed interest adjustment would be pursuant to the authority of section 482, the coordination rule is inapplicable.

POSTF-160376-01

Having determined that an imputed interest adjustment under Treas. Reg. § 1.482-2(a) may be appropriate, we consider the effect of such an adjustment on the analysis of Corp A's transfer prices under the CPM.

An adjustment for imputed interest with respect to a portion of Corp A's accounts payable under Treas. Reg. § 1.482-2(a) would require a corresponding reduction in the amount of Corp A's accounts payable that are subject to the balance-sheet adjustments under Treas. Reg. § 1.482-5(c)(2)(iv). Stated differently, the CPM balance-sheet adjustment under Treas. Reg. § 1.482-5(c)(2)(iv) would properly take into account only those accounts payable that were not subject to imputed interest under Treas. Reg. § 1.482-2(a)(1). Furthermore, although the imputed interest adjustment under Treas. Reg. § 1.482-2(a)(1) would not be taken into account directly under the CPM,⁵ the imputed interest would constitute an additional deduction to which Corp A may be entitled in determining its taxable income for the years in question.⁶ Reclassifying a portion of the overage accounts payable as interest-bearing, and excluding those reclassified accounts payable from the CPM balance-sheet adjustment calculation, would generally result in a larger CPM adjustment, but would not affect the net amount of taxable income reported by Corp A.

If the IRS collected imputed interest on a portion of Corp A's accounts payable under section 482, withholding tax under section 1442(a) would apply to imputed interest payments from Corp A to Corp B.⁷ See Central de Gas de Chihuahua, S.A. v. Commissioner, 102 T.C. 515 (1994) (withholding tax applied to deemed payment of rent under section 482). See also Climaco v. Internal Revenue Service, 96-1 USTC (CCH) ¶ 50,153 (E.D.N.Y. 1996) (unpublished opinion, Jan. 24,

⁵ Interest expense, whether actual or imputed, does not constitute an operating expense under Treas. Reg. § 1.482-5(d)(3). Nor would the provision allowing adjustment of the tested party's reported operating profit for "finally determined" section 482 adjustments apply to the imputed interest adjustment. Treas. Reg. § 1.482-5(d)(5).

⁶ This imputed interest expense could, however, negatively impact Corp A's section 904(a) limitation. See Treas. Reg. § 1.861-9T.

⁷ The final regulations under section 1441, effective for payments made after December 31, 2000, specifically provide that an allocation of income under section 482, reallocation of income from a foreign person to a related U.S. person, is subject to withholding under section 1441. See Treas. Reg. § 1.1441-2(e)(2). Although this regulation was not in effect for the taxable years at issue, based on case law and in absence of any indication in this regulation and its preamble that it was intended to reflect a change of IRS position, we view the final regulation as clarifying the applicable law for the years at issue.

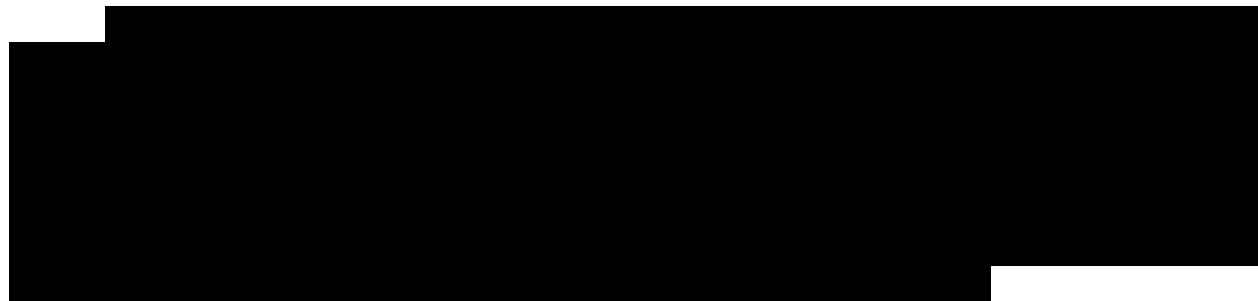
POSTF-160376-01

1996) (withholding tax applied to deemed payment of interest pursuant to section 7872) and Casa de la Jolla Park, Inc. v. Commissioner, 94 T.C. 384 (1990). The rate of withholding tax on any imputed interest payment would likely be ee%,⁸ pursuant to the Country 1-United States Income Tax Treaty.

Issue 3: Whether the IRS has a policy of excluding foreign-owned companies as potential uncontrolled comparables under the Treas. Reg. § 1.482-5 comparable profits method.

Pursuant to Treas. Reg. §§ 1.482-1(d) and 1.482-5(c), the IRS evaluates the comparability of potential uncontrolled comparables under the CPM by considering all factors that could affect profits or prices in arm's length dealings, without regard to foreign ownership.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



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.

Please call (202) 874-1490 if you have any questions.

JOHN M. BREEN
Senior Technical Reviewer, Branch 6
Office of Associate Chief
Counsel (International)

⁸ Because Corp A also purchased Products from Corp B affiliates in countries other than Country 1, the applicable treaty rate may differ depending on the country of incorporation of the Corp B individual affiliates.