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
ASSOCIATE DISTRICT COUNSEL
ATTN:

FROM: DEBORAH A. BUTLER
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CC:DOM:FS

SUBJECT: Tax effect of a distribution of a note

This Field Service Advice responds to your memorandum dated September 9, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

FP =
FS =
DP =

Country X =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =

Year 1 =
Year 2 =
Year 3 =

Year 4 =

$a =
$b =
$c =
$d =
$e =
$f =

ISSUE:

Whether the rationale of *Kraft Foods Company v. Commissioner*, 232 F.2d 118 (2d Cir. 1956), applies to treat the distribution of notes from DP to its parent as a distribution with respect to stock (which would constitute a dividend to the extent of the earnings and profits of DP).

CONCLUSION:

Because the rationale of *Kraft Foods* does not apply (for the reasons stated below), the distribution would not be given any tax effect. Instead, the note would be treated as a statement by DP to make payments in the future (according to the terms of the note).

FACTS:

The taxpayer, DP, was the common parent of an affiliated group of corporations filing a consolidated Federal income tax return for Year 1, the tax year at issue. As of the date of the declaration of the promissory notes described below, DP owned all of the stock of several subsidiaries.

All of the stock of DP is owned by FS, all of whose stock is owned by FP, a Country X corporation. FP also owns all of the stock of several subsidiaries, some of which (including FS) are Country X corporations and some of which are domestic. However, because these domestic subsidiaries are not direct affiliates of DP, they are not members of the DP consolidated group.

On Date 1, subsidiaries of DP distributed interest-bearing, assignable, promissory notes, payable on Date 4, to DP in the aggregate amount of $b. DP in turn distributed these notes up the chain where they were assigned to various domestic subsidiaries of FP.

On Date 2, DP submitted its five-year corporate plan. This plan stated that DP, on behalf of the issuers, did not intend to pay the notes during such five-year period, even though the scheduled payment date occurred within this period. Subsequent five-year plans, through the end of Year 3, also stated that DP did not intend to pay the notes during such periods.

On Date 3, the issuer and holder of each note, both of which were affiliates of FP, each entered into an agreement postponing the payment of that note, which payment was due on Date 4.

On Date 5, the parties restructured the payment schedule of the notes, with principal payments scheduled to begin in Year 2 and continuing through Year 4.

The distribution of the notes by DP brought the total amount of its distributions during Year 1 to approximately $e, which was approximately $d in excess of the current and accumulated earnings and profits ("E&P") of DP. Thus, DP treated approximately $c of the distributions as dividends and approximately $d of the distributions as return of capital.

As a result of the disposition of certain assets of the DP group to unrelated parties in Year 1 (with the proceeds distributed to FS, as well as the distribution of other assets of the DP group to FS in Year 1), the value of the DP group declined from approximately $f to approximately $a. In addition, the debts for which the DP group were liable as of the end of Year 1, including the notes, contributed to a decrease in the retained earnings of the DP group from approximately $d to ($d).

LAW AND ANALYSIS

Case law:

DP argues that the distribution of the notes should be treated as a dividend. In support of its position, DP cites the case of *Kraft Foods Company v. Commissioner*, 232 F.2d 118 (2d Cir. 1956).

In *Kraft Foods*, National Dairy ("ND") purchased all of the assets of Kraft-Phenix Cheese Corporation (the "taxpayer") and issued a note in partial payment therefor. ND then transferred most of these assets to the taxpayer in exchange for all of its outstanding stock.

For several years, the taxpayer distributed most of its earnings to ND, which used such amounts to pay its debts, including its debt incurred to acquire the assets subsequently contributed to the taxpayer.

For several years following the acquisition, ND filed a consolidated return which included the taxpayer. However, when Congress abolished the privilege of an affiliated group of corporations to file a consolidated return, the taxpayer's board of directors declared a dividend of $30 million. The form of the distribution was 30 notes, each for $1 million at 6% interest per annum, payable in approximately 14 years. Simultaneous with this declaration, the taxpayer revalued its assets. As revalued, the taxpayer had a value in excess of the amount of the distribution. However, it could not have distributed such amount in cash without liquidating a substantial portion of the business.

For the first five years after the issuance of the notes (which were the years at issue), the taxpayer had sufficient earnings not only to pay ND the interest required by the notes, but also to distribute dividends to ND.

In determining the tax consequences of the distribution of the notes, the Court applied certain debt/equity factors: (1) the parent-subsidiary relationship, (2) the fact that an initial equity interest was converted into a purported debt interest, (3) the alleged thin capitalization resulting from the transaction, and (4) the lack of a business purpose other than tax avoidance.

After noting that transactions between a parent and its wholly owned subsidiary merit close scrutiny, the Court further noted that arm's-length transactions between a parent and a sub would nevertheless be respected. In this case, the Court concluded that, although the interest rate that ND charged the taxpayer was slightly higher than it had to pay for its own debt, such interest rate was neither unrepresentative nor uncompetitive. In addition, the Court concluded that, even though the debt was between a parent and a subsidiary, such debt would not necessarily be subordinated to debt owed by the taxpayer to outside parties. Thus, the Court refused to disregard the transaction at issue simply because it occurred between a parent and a subsidiary.

The Service argued that the distribution represented originally invested equity since the notes were not issued in exchange for additional funds nor against accumulated equity. The court rejected this argument noting that the tax law allow earnings to be distributed as a dividend, see Treas. Reg. § 1.301-1(d)(1)(ii), or in the form of a note (for example, following a recapitalization).

The Service argued that the debt/equity ratio was disproportionate (although the opinion did not state such ratio). However, the Court calculated the ratio as 10:13, relying on market values to determine the value of the taxpayer’s assets as opposed to relying on book values. The Court did not consider this ratio disproportionate.

Finally, the Court refused to disregard the transaction simply because the taxpayer had no business purpose other than tax avoidance. The Court noted that the transaction was only entered into because of the change in the treatment of consolidated returns, that the parties were separate entities and the transaction affected the legal rights and obligations of each party.

Analysis:

A transfer of funds from a corporation to a shareholder is considered debt, rather than equity, if at the time of the distribution the parties intended 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 corporation undertook to enforce repayment; the repayment history; and the taxpayer's disposition of the funds received from the corporation. *Crowley v. Commissioner*, *supra*. We discuss the relevant factors below.

**Related Party Debt**

The advances in this case are subject to strict scrutiny because each purported creditor and purported debtor are related parties (i.e., all are affiliates of FP). *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).

However, there must be something more than this to support the inference that the parties did not intend to treat the advances 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).

**Formal Indicia**

Each note has the formal indicia of indebtedness because it requires the payment of a sum certain (collectively $b) on a fixed maturity date (Date 3). *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).

However, the parties twice postponed the payment date of each note, eventually establishing a payment schedule (as opposed to one maturity date). Therefore, this factor does not favor respecting the characterization of the notes as debt.

**Treatment By the Parties**

Since "actions speak louder than words," the parties' treatment of the notes 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).

As noted above, the parties twice postponed the payment date of the notes. In addition, the five-year plans of DP issued for the period that included the scheduled payment date (as well as subsequent periods) stated that DP did not intend to pay the notes during such periods. By these actions, the parties did not evidence a serious intent to pay the notes in a timely fashion. See *Laidlaw Transportation Inc. v. Commissioner*, T.C.M. 1998-232, 75 TCM 2598. Therefore, this factor does not favor respecting the characterization of the notes as debt.

**Expectation of Repayment**

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.* You have indicated that it was not reasonable for the holder of the notes to expect that the issuers had the means to repay the debt.

First, the value of the DP group had been drastically reduced in size. This significantly reduced the amount of assets, and presumably as well the earnings, available to satisfy the debt. In other words, the ratio of the notes to the value of the assets increased substantially after these distributions.

Second, the parties twice postponed payment of the notes. However, DP cannot argue that unforeseen factors caused these postponements. The five-year plans of DP stated that it did not intend to pay the notes during the period covered by such plans. Thus, it is clear that there was no serious expectation of payment of the note. See *Laidlaw Transportation Inc., supra*. Therefore, this factor does not favor respecting the characterization of the notes as debt.

***Kraft Foods***

We agree that *Kraft Foods* is distinguishable. Based on the factors discussed above, the 30 $1 million note issued by the taxpayer to ND were clearly debt. First, the notes contained a formal indicia of debt. Second, the parties treated the notes as debt. The taxpayer made regular payments of interest (the principal was not due during the years at issue). In addition, the taxpayer made other distributions to ND. These payments and distributions were all out of the taxpayer's earnings. Third, the expectation of payment was reasonable considering the amount of earnings the taxpayer generated. Finally, the notes were issued only because Congress abolished the privilege of an affiliated group of corporations to file consolidated returns.

By contrast, based on the factors discussed above, it is not clear that the notes are debt. In fact, the factors discussed above argue strongly that the notes should be disregarded and treated merely as a statement by DP to make payments in the future.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

As a threshold matter, we note that the request for Field Service Advice does not state what the interest rate of each note was, whether each such rate was reasonable and whether interest payments on the notes were regularly made (although the request does hint in several places that such payments were made). Based on subsequent discussions, we have learned that the interest rate was reasonable and that payments were regularly made. In that case, this factor favors DP, although we do not think that it changes the underlying analysis. In other words, because of DP's statements in its various business plans that it did not intend to pay the notes and because of the repeated postponements of the maturity

date, based on the apparent inability to pay the notes, the parties did not treat the notes as debt, nor did the holder expect to be paid when due.

Second, we do not believe that *Kraft Foods* is as limited in scope as you suggest, nor as dispositive as DP asserts. *Kraft Foods* applies the same debt/equity principles as in the cases discussed above or as in the cases discussed in the prior Field Service Advice. For example, it has been recently cited for the proposition that a corporation can distribute its own note as a dividend (provided the note otherwise qualifies as debt). *See, e.g.,* Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders (6th Ed. 1998), S¶8.23[1], n. 389.1 (1999 Cumulative Supplement No. 1).

*Kraft Foods* has also been recently cited for the proposition that an arm's-length transaction between related parties will be respected. *See, e.g., Humana Inc. v. Commissioner*, 881 F.2d 247, 255 (6th Cir. 1989). Finally, it has been recently cited for the proposition that a transaction that affects the legal relations of separate (albeit related) corporations will be respected even though tax considerations were one motivation for the way the parties structured the transaction. See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d 231, 248 n.31 (3d Cir. 1989).

Moreover, none of these recent authorities have relied on the particular legal circumstances present in *Kraft Foods* (the abolition by Congress of the privilege of an affiliated group of corporations to file a consolidated return) to similarly limit its application

In any event, in this case, the parties did not consider their legal relations affected by the transaction. As noted above, the business plan stated that DP did not intend to pay the notes. In addition, the maturity date was repeatedly postponed. Thus, the issuance of the notes had no legal consequences to the parties.

Third, the transaction was clearly structured with tax considerations in mind. As you pointed out, the distribution of the notes in this case will allow DP to distribute its earnings tax-free. In other words, if DP had had earnings at the time of the distribution of the notes (and the other factors of the debt/equity test had been satisfied), such notes would have been treated as a dividend. Yet because DP distributed the notes after it distributed a substantial amount of other property, DP had no earnings by the time such notes were distributed. Thus, when the notes are paid, the earnings of DP will be distributed tax free.

Fourth, the agent argues that, in determining the value of DP's assets, book value and not fair market value should be used. We note that this argument is contrary to

the position adopted by the Second Circuit in *Kraft Foods*. It is also contrary to the position adopted by the Ninth Circuit. *See Miller's Estate v. Commissioner*, 239 F.2d 729 (9th Cir. 1956) (which cites to *Kraft* at p. 733), and *Bauer v. Commissioner*, 748 F.2d 1365 (9th Cir. 1984) (in which the Service in an AOD acquiesced in that court's calculation of the debt/equity ratio). Thus, we do not recommend that the agent pursue this argument.

Fifth, we note that a consequence of not treating the notes as debt will be to disallow the interest deductions claimed by DP in subsequent years. Instead, such amounts would be treated as dividends (ultimately distributed to a foreign corporation), for which there would be withholding. An additional consequence of not treating the notes as debt will be that the holder of the notes would be able to reduce its gross income for all such open years by such amounts.

Finally, assuming that the issuance of the new notes (either as a distribution or, as discussed below, in exchange for the old instrument) is treated as debt (because, for example, DP made principle and interest payments thereon), the notes would be treated as having been distributed in that year. Further assuming sufficient earnings and profits, the distribution of the notes would be treated as a dividend (for which there would be withholding).

Alternative Characterization

There is an alternative characterization to disregarding the notes (as described above). The Service could treat the notes as an equity interest by the holder in the issuers. Because the notes had (on their face) a limited term, they would likely be considered preferred stock. In that case, DP would still be denied interest deductions in subsequent years. However, because the amounts (now recharacterized as dividends) would be considered as paid to a domestic holder, there would be no withholding. Moreover, since the amounts received by the holder would be treated as dividends, instead of interest, the holder may be entitled to a dividends received deduction. Finally, when the issuers are treated as issuing the new notes (treated as debt), they would be treated as issuing these notes in redemption of the preferred stock.

Pursuant to I.R.C. § 302(a), this redemption would be tested under I.R.C. § 302(b) to determine if the proceeds should be taxed to the holder as an exchange under I.R.C. § 1001. If I.R.C. § 302(a) does not apply, then under I.R.C. § 302(d), the proceeds would be taxed to the holder as a dividend under I.R.C. § 301. Under I.R.C. § 302(c)(1), the constructive ownership rules of I.R.C. § 318(a) apply in making this determination. Under I.R.C. § 318(a)(3)(C), the holder of the notes, a direct affiliate of FP, would be treated as owning all of the stock owned, directly or

indirectly by FP. Such stock would include the stock of the issuers of the notes. Thus, both before and after the redemption, the holder would be treated as owning all of the stock of the issuers. Consequently, the redemption would not qualify under I.R.C. § 302(b). Therefore, the proceeds would be treated as a dividend to the holder.

[redacted]

Please call if you have any further questions.

By: _____
ARTURO ESTRADA
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cc: