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

OFFICE OF
CHIEF COUNSEL

June 27, 2001

Number: **200146013**
Release Date: 11/16/2001
CC:INTL:B05/TL-N-3608-00
UILC: 163.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR CC:LM:FSH:HAR:B
Attn: Matthew Root

FROM: Jeffrey Dorfman
Chief, Branch 5, Office of Associate Chief Counsel (International) CC:INTL:B05

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated October 4, 2000. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =
Parent =
X and Y =
LLC =
State =
Country X =
Treaty =
Year 1 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Rate 1 =
Rate 2 =
Amount 1 =
Amount 2 =
Amount 3 =
Amount 4 =
Amount 5 =
Amount 6 =
Amount 7 =
Amount 8 =

ISSUES

1. Whether a U.S. subsidiary is entitled to deduct interest expense under section 163 when the recipient of the payment, a foreign corporation that owns all the stock of the U.S. subsidiary, reports the payment as a dividend on its foreign income tax return.

2. Whether the foreign corporation's transfer of an existing promissory note to its U.S. subsidiary, in exchange for a new note and the deemed issuance of stock of the U.S. subsidiary, causes the U.S. subsidiary to recognize income.

CONCLUSIONS

1. The inconsistent characterization of the payment by the U.S. subsidiary and its parent, while relevant, is not a controlling factor in determining whether the U.S. subsidiary may deduct the payment under section 163. Based on the facts provided, the U.S. subsidiary has not taken a position invoking the substance of a transaction that is contrary to its form, and thus has not disavowed the form of the transaction it has chosen. Further, at present, the doctrine of the duty of consistency does not apply because the U.S. subsidiary has not taken a position in one year and a contrary position in a later year, after the limitations period has run in that first year.

2. The foreign corporation's transfer of an existing promissory note to its U.S. subsidiary, in exchange for a new note and the deemed issuance of stock of the U.S. subsidiary, does not cause the U.S. subsidiary to recognize income or gain.

FACTS

Taxpayer is a domestic, wholly owned subsidiary of Parent, a Canadian corporation. During the year at issue, X and Y, two Canadian subsidiaries of Parent, formed LLC, a limited liability company under the laws of the state of New York and contributed Amount 1 to LLC. LLC's business was financing the operations of Taxpayer and Taxpayer's domestic subsidiaries. On or about Date 1 of Year 1, LLC loaned Taxpayer Amount 1. The note that Taxpayer gave to LLC ("Old Note") bore interest at Rate 1, which was compounded and payable semi-annually, and the principal amount was to be paid in full on or before Date 2, six years after Date 1.

Also on Date 1 of Year 1, Taxpayer loaned a total of Amount 1 to three of its subsidiaries, all of which executed notes with the same terms as the note between LLC and Taxpayer (except for the principal amount of each of the three loans.)

During Year 1, Taxpayer accrued interest payments of Amount 2 to LLC, and LLC accrued the same amount in interest income. During this year, LLC distributed Amount 3 to its partners, X and Y.

On Date 3 of Year 1, X and Y were liquidated into Parent. As a result, Parent owned a 100 percent membership interest in LLC. (The law of State permits the existence of single member limited liability companies.) The single member LLC did not elect to be treated as a corporation for U.S. tax purposes. According to LLC's final U.S. Partnership Return, the liquidation caused the technical termination of LLC, resulting in a deemed distribution of all of LLC's assets to Parent. Upon termination, LLC's assets, which consisted of the loan receivable (with a face amount of Amount 1) and a receivable for accrued but unpaid interest of Amount 4 were distributed to Parent.

On the same date, Parent contributed in a purported section 351 transaction its 100 percent ownership interest in LLC to Taxpayer in exchange for stock in Taxpayer with a fair market value of Amount 5 and a new note with a face value of Amount 6 ("New Note"), which was slightly less than the face value of the Old Note.[1] Except for the principal amount, many of the terms of the old and new loans were the same. For example, both notes accrued interest at Rate 1 per year, compounded and payable semi-annually; both matured in six years; and both had the same terms with respect to prepayment and events of default.

On an unidentified date after Taxpayer issued the New Note, Taxpayer paid Parent Amount 6, the note's face amount, of which Amount 4 was purportedly interest. (It is unclear whether Taxpayer's payment was made in Year 1 or a later taxable year.) Under the Treaty, Taxpayer withheld at Rate 2 on the interest payment.

On its Year 1 U.S. return, Taxpayer claimed an Amount 4 deduction. Parent, however, reported this payment as a deductible dividend rather than interest income for Country X tax purposes. Taxpayer stated that under Country X law, Parent cannot report on its Country X tax return interest income earned by a limited liability company. Rather, Parent is treated as having sold shares in LLC, and the excess of the selling price over basis is treated as a dividend up to the amount of the limited liability company's undistributed surplus. Taxpayer also stated that Parent was entitled to claim a deduction under a Country X provision similar to the U.S. dividends received deduction, to the extent that the dividend paid by a non-Country X payor (Taxpayer) and received by a Country X corporation (Parent) is

---

[1] The FSA request notes that Taxpayer has inconsistently identified the transferee of the LLC interest as Parent in some instances and Parent's foreign parent in others, and that Taxpayer has made varying representations concerning the value of the New Note. While the amount shown on the note itself was Amount 6, a Date 4 letter from Taxpayer represents that the amount was Amount 7, and Taxpayer's Year 1 return states that the note's fair market value was Amount 8.

paid out of "exempt surplus" and the Country X corporation owns at least Rate 2 of the voting stock of the non-Country X payor.

LAW AND ANALYSIS

A. Whether the Service may disallow Taxpayer's interest deduction based on the inconsistent characterization of the payment by Taxpayer and Parent.[2]

1. Disavowal of form

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). However, courts have long recognized that a taxpayer is free to structure his transactions as he chooses, but once having done so, must "accept the consequences of his choice, whether contemplated or not ... and may not enjoy the benefit of some other route he might have chosen to follow but did not." Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974) (citations omitted). The case law recognizes that taxpayers are advantaged by having both the power to structure transactions in any form they choose and the access to the facts that reflect the underlying substance. The Service, on the other hand, is disadvantaged because it does not have direct access to such facts. Accordingly, the Commissioner must be allowed to rely on representations made by taxpayers in their returns and to evaluate tax consequences based on such disclosures. For this reason, the courts have generally subjected taxpayers to a heightened standard of proof, among other requirements, before permitting them to disavow the form they chose and have the transaction taxed in accordance with substance. See, e.g., Spector v. Commissioner, 641 F.2d 376, 382 (5th Cir. 1981); Estate of Durkin v. Commissioner, 99 T.C. 561, 572-75 (1992); FNMA v. Commissioner, 90 T.C. 405, 426 (1988), aff'd, 896 F.2d 580 (D.C. Cir. 1990), cert. denied, 499 U.S. 974 (1991); Illinois Power Co. v. Commissioner, 87 T.C. 1417, 1431 (1986), aff'd, 896 F.2d 580 (D.C.Cir. 1990); Little v. Commissioner, T.C. Memo. 1993-281, 65 T.C.M. (CCH) 3025, 3032 (1993), aff'd, 106 F.3d 1445 (9th Cir. 1997).

You have asked us whether Taxpayer is subject to this heightened standard of proof. Based on the facts provided, Taxpayer has not disavowed the form it originally chose. It characterized the Amount 6 that it received from Parent as a loan (the New Note). Taxpayer treated the Amount 4 payment to Parent as interest, withholding at Rate 2 under the applicable treaty and claiming an interest expense deduction for such payment. (We do not know whether Taxpayer also treated the payment as interest for financial reporting purposes.) The fact that the counterparty, Taxpayer's parent, characterized for Country X tax reporting purposes

[2] The Field has not requested Chief Counsel Advice with respect to any issues regarding the application of section 163(j).

the same payment as a dividend, rather than interest, is not sufficient for us to conclude that Taxpayer disavowed its form. Thus, the heightened standard of proof does not apply here.[3]

2. Duty of Consistency

Related to the principle that a taxpayer cannot generally disavow its chosen form, the judicial doctrine of the duty of consistency prevents a taxpayer from taking one position in one year and a contrary position in a later year, after the limitations period has run in that first year. The duty of consistency applies when (1) the taxpayer made a representation or reported an item for U.S. income tax purposes in one year; (2) the Commissioner acquiesced in or relied on that representation or report for that year; and (3) the taxpayer attempts to change that representation or report in a subsequent year, after the statute of limitations has expired with respect to the year of the representation or report, and the change is detrimental to the Commissioner. Herrington v. Commissioner, 854 F.2d 755, 758 (5th Cir. 1988); Spencer Medical Associates, Automotive Ventures, Inc. v. Commissioner, T.C. Memo. 1997-130, 73 T.C.M. (CCH) 2309, aff'd, 155 F.3d 268 (4th Cir. 1998).

The first element is present as Taxpayer has characterized the payment to Parent as interest on its tax return. However, the second and third elements are absent. With respect to the tax years at issue, the Commissioner has not yet acquiesced or relied on Taxpayer's representation, and the statute of limitations has not yet expired without an audit of those tax years. Taxpayer has also not yet attempted to change this representation in a subsequent year after the statute of limitations has expired with respect to the year of the representation. Thus, the duty of consistency doctrine does not presently apply.

B. Whether Parent's transfer of an existing promissory note to Taxpayer, in exchange for a new note and the deemed issuance of stock of Taxpayer, results in taxable income or gain to Taxpayer.

1. Taxpayer does not recognize cancellation of indebtedness income from Parent's transfer of the Old Note to Taxpayer in exchange for the New Note and the deemed issuance of stock of Taxpayer.

Section 61(a)(2) of the Code provides that gross income includes income from the discharge of indebtedness. See United States v. Kirby Lumber Co., 284 U.S. 1 (1931). Generally, a debtor realized discharge of indebtedness income to the extent the fair market value of property or the amount of money given in satisfaction of a debt is less than the face amount of the indebtedness that is canceled, adjusted for unamortized premium or discount.

---

[3] We assume that the purported debt is debt in fact as we do not have facts represented that clearly suggest otherwise.

If a debtor discharges an unsecured liability by transferring appreciated capital assets, there is deemed to be a sale or exchange of the transferred property, and the debtor realizes capital gain or loss on this transaction measured by the difference between its adjusted basis in the property and the face amount of the liability discharged. However, if the debtor discharges its liabilities by issuing new stock or an obligation in place of the old obligation, an entirely different situation is presented. In substance, there has been no cancellation of the old obligation, but merely a continuation or substitution of the liability in a new form.

a. Use of a new debt instrument to discharge debt

Section 108(e)(10)(A) provides generally that for purposes of determining discharge of indebtedness income, a debtor is treated as having satisfied a debt with an amount of money equal to the issue price of a new debt where the debtor issues a new debt instrument in satisfaction of the old debt instrument. Section 108(e)(10)(B) provides that for purposes of section 108(e)(10)(A), the issue price is determined by applying sections 1273 and 1274. For purposes of determining issue price, section 1273(b)(4) is applied by reducing the stated redemption price of any instrument by the portion of the stated redemption price that is treated as interest. Where neither the new nor the old indebtedness is publicly traded and section 1274 does not apply, the issue price of a debt instrument issued for property, for purposes of determining whether there is original issue discount, is its stated redemption value at maturity. Section 1273(b)(4).

To the extent that a debtor corporation does not fully satisfy the debt with new debt, it will generally recognize income, even if the new debt and the cancelled debt constitute securities within the meaning of section 354, 355, or 356 and the exchange qualifies for nonrecognition treatment under one of these sections.

b. Use of debtor corporation’s stock to discharge debt

A solvent corporate debtor does not realize taxable cancellation of indebtedness income on the issuance of stock in exchange for its debt obligation unless there is a difference between the amount of debt discharged and the value of the stock. For transfers occurring after December 31, 1994, in determining the amount of cancellation of indebtedness income upon the exchange of qualified stock for debt, debt will be treated as having been satisfied with money equal to the fair market value of the stock. Section 108(e)(8).

If a debtor exchanges appreciated property to cancel debt, the debtor is generally subject to gain or loss recognition under section 1001. However, section 1032 provides an exception to the general recognition rule where “a corporation receives money or other property in exchange for [its own] stock.”

c. Taxpayer’s use of debt and stock to discharge debt

On Date 3 of Year 1, Taxpayer owed Parent Amount 1 of principal and Amount 4 of accrued but unpaid interest on the Old Note. On this date, Parent contributed this note to Taxpayer in exchange for a New Note with a face amount of Amount 6 (bearing the same interest terms as the Old Note) and a deemed issuance of common stock of Taxpayer.

If the Service accepts that there was a deemed issuance of stock of Taxpayer with a fair market value equal to the outstanding balance of the Old Note (taking into account the issuance of the New Note), the Old Note is repaid in full, and thus there is no cancellation of indebtedness income. If the Service does not respect the deemed issuance of stock, however, there would be cancellation of indebtedness income to the extend of the difference between the amount of the New Note (Amount 6) and the Old Note (Amounts 1 and 4).

2. Parent's transfer of the Old Note to Taxpayer in exchange for the New Note and the deemed issuance of stock of Taxpayer qualifies as a nonrecognition exchange under section 368(a)(1)(E).

The definition of a reorganization under section 368(a)(1)(E) includes a recapitalization, which refers to the readjustment of the financial structure of a single corporation. A recapitalization, and therefore a reorganization, takes place if "a corporation with $200,000 par value of bonds outstanding, instead of paying them off in cash, discharges them by issuing preferred shares to the bondholders." Treas. Reg. §1.368-2(e)(1). The transaction would similarly qualify as a recapitalization "if common stock were issued for the bonds or if the instrument given up were debentures, long-term notes or other securities." Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, 6th Ed. 1998 at p. 12.27[3][a] [hereinafter Bittker]. In addition, an exchange of debt of a corporation for debt of the same corporation qualifies as a recapitalization pursuant to section 368(a)(1)(E). Although section 368(a)(1)(E) does not require that the exchanged debt qualify as a "security," the operative nonrecognition provision for the debtholder in a section 368(a)(1)(E) transaction, section 354, does.

Under section 354(a)(1), both the old debt and new debt must be "securities." The term "securities" lacks a precise definition. The analysis is based on facts and circumstances, with term-to-maturity generally considered the most important element. Debt with a term of five years or more is generally a security; debt with a shorter term may not be. See generally Bittker at p. 12.41[3].

In an exchange of old securities for new securities where the principal amount of the securities received exceeds the principal amount of those securities surrendered, the fair market value of the excess amount is taxable boot under sections 354(a)(2)(A) and 356(d)(2)(B). §1.356-3(b), Exs. (4), (5), and (6). Thus, under sections 356(a)(1) and 356(a)(2), the taxpayer (e.g. Parent, if it were a U.S. taxpayer) would realize gain to the extent of boot. The gain would generally be capital gain if the securities are capital assets in the hands of the taxpayer since the transaction would not have the "effect of a distribution of a dividend." The term "principal amount," as used in section 356, does not necessarily refer to the face amount of the securities, but rather to the amounts that are treated as principal by the tax law for interest income and deduction purposes (i.e., the issue price of the new debt and the adjusted issue price of the old debt). Id. at p. 12.27[4][b].

If the excess principal amount is a method of discharging arrears in interest on the security, the security holder's gain is taxable separately as ordinary interest income.

Section 1032 generally provides that no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.

Here, Parent's exchange of the Old Note for a New Note and (the deemed issuance of) Taxpayer's stock qualifies as a reorganization pursuant to section 368(a)(1)(E). The principles of sections 368(a)(1)(E), 354, and 356, as discussed above, would apply to Parent if Parent were a U.S. taxpayer. Assuming Parent has no U.S. trade or business or permanent establishment, it would not be subject to U.S. tax on any capital gain under domestic law as well as the Treaty.

As to Taxpayer, to the extent that there is no cancellation of indebtedness income in connection with the section 368(a)(1)(E) reorganization (see discussion above in part B.1.c), Taxpayer does not recognize gain on the exchange. In addition, pursuant to section 1032, Taxpayer recognizes no gain or loss to the extent that it receives the Old Note in exchange for Taxpayer stock.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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) 622-3870 if you have any further questions.

John Staples
Associate Chief Counsel
(International)
By: JEFFREY DORFMAN
Chief, Branch 5
Office of Associate Chief Counsel
(International)