OFFICE OF
CHIEF COUNSEL

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

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INTERNAL REVENUE SERVICE
NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: Northern California District Counsel
CC:SF:TL
Attn: Kevin Croke

FROM: Steven A. Musher, Chief
CC:INTL:Br6

SUBJECT:

This Field Service Advice responds to your memorandum dated September 23, 1997. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

**LEGEND:**

| | |
|---|---|
| A Group | = |
| B | = |
| C | = |
| D Group | = |
| E Group | = |
| Counsel F | = |
| Country X | = |
| Country Y | = |
| Country Z | = |
| Year 1 | = |
| Year 2 | = |

| | |
|---|---|
| Year 3 | = |
| Year 4 | = |
| Year 5 | = |
| Year 6 | = |
| Year 7 | = |
| Year 8 | = |
| $ j | = |
| $ k | = |
| $ m | = |
| $ n | = |
| $ o | = |
| $ p | = |
| $ q | = |
| $ r | = |
| $ s | = |
| $ t | = |
| $ u | = |
| $ v | = |

**ISSUE:**

Whether, pursuant to Treas. Reg. § 1.482-2(a), the Commissioner may allocate interest income to B with respect to B’s advances to C in order to reflect an arm’s length transaction, when B asserts upon examination that its treatment of the advances as debt was a mistake and that the advances were equity?

**Conclusion:**

The Commissioner, pursuant to Treas. Reg. § 1.482-2(a), proposes to allocate interest income to B with respect to B's advances to C in order to reflect an arm's length transaction. B’s assertion upon examination that its treatment of the advances as debt on its tax returns and financial statements was a mistake, and that the advances were equity, subjects B to a heightened standard of proof under the rule of law enunciated in Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974) and its progeny. In order for B to sustain its position, B must come forth with sufficient evidence to satisfy the heightened standard of proof by demonstrating that B and C consistently respected and reported the advances as equity and that the other facts and circumstances justify treating the advances as equity. Based on the facts presented, there is no evidence to support that B and C consistently respected the advances as equity, and other circumstances herein do not justify treating the advances as such.

**FACTS:**

B is a wholly-owned domestic subsidiary of A Group and it was incorporated to hold and manage investments. In Year 1, B organized C, a wholly-owned foreign subsidiary, in Country X, to act as the holding company for its foreign ventures, and to make equity investments in start-up companies.

To finance the foreign joint ventures, B advanced a total of $ j to C over a five year period (Years 2 through 6). Of this amount, $ k were transferred before January 1, Year 4, and the remaining balance of $ m were advanced during the taxable years at issue (Years 4 through 6). B recorded these advances on its books under the intercompany receivable account titled “Due From C”.

The Board of Directors minutes for Years 3 through 6 indicated that B advanced the following amounts as equity investments in C:

| Board of Directors Minutes | Advance For Equity Investment |
|---|---|
| Year 3 | $ n |
| Year 4 | $ o |
| Year 5 | $ p |
| Year 6 | $ q |
| Total | $ v |

Thus, out of the total advances of $ j, $ v (28.2%) appears related to common equity investments in C. Although B declared these advances as equity investments, such amounts could not be traced, or matched, against the actual cash tranfers that were made to C during the respective tax years.

B’s books also contained a separate asset account titled “Capital Investment - C” that was used to reflect B’s equity investment in C. Throughout Year 4, that account had a consistent balance of $ u. Due to a change in B’s accounting system in Year 5, and the resulting consolidation of certain accounts, no information is available concerning the subsequent balance in “Capital Investment - C”. However, the aforementioned advances of $ v that were allegedly equity contributions to C does not appear to have been recorded in that account.

In connection with B’s Year 3 federal and state income tax returns, B prepared a memorandum dated May 21, Year 4 addressing its concerns about the current and future treatment of the advances to C for both book and U.S. tax purposes. The memorandum stated that B originally planned to have the advances

> treated as equity contributions for U.S. purposes and 85% as interest-free debt for [Country X's] purposes ... If the planning was implemented for all of [Year 3], the transfers to [C] should be booked as capital contributions, for U.S. tax and GAAP, rather than as debt. The debt classification invites the question of whether interest has been paid or imputed under U.S. tax rules. I hope to get your consent to ... book a reclassification of the debt to equity for [Year 3] and future years. This assumes the corporate resolutions are not inconsistent ... [T]he debt classification helped [B's] foreign exchange position by having a debt (which moves with exchage rates) rather than equity ...

There is no indication that B acted in accordance with this memoradum by reclassifying the advances as equity in Year 3, or subsequently classifying the advances as equity in Years 4 through 6, for book and U.S. tax purposes.

To memorialize some of the advances that were made during Years 4 through 6, B and C executed two written agreements dated December 31, Year 3 and October 1, Year 6. Each advance agreement contained the following:

<u>December 31, Year 3 Advance Agreement</u>

Effective December 31, Year 3, B has advanced $ r to C for funding C's interest in a foreign joint venture with D Group in Country Y. The parties agreed that the terms and conditions set forth below shall apply to 85% of B's present, and all future, advances to C.

1. Maturity date: The advances shall be repaid no later than 25 years after December 31, Year 3, and shall be repaid upon first demand by B if C is given 10 days written notice. Any repayment shall be subordinated to any claims made by general creditors.

2. Stated interest: The advances bear no interest.

3. Prepayment rights: C has the right to prepay all or any part of the advances at any time, provided 14 days prior written notice is given.

4. Acceleration clause: In the event C (a) becomes insolvent, (b) admits in writing that it is unable to pay its debts as they mature, (c) undertakes any proceeding pursuant to bankruptcy or insolvency laws, or (d) undertakes, or is subject to, dissolution or liquidation

proceedings, then the advances shall become immediately due and payable.

5. Payment: All payments due under this Agreement shall be made by C in freely transferable and convertible currency.

6. Withholding Reimbursement: If C is required to withhold a tax, levy, duty or charge from any payment made under this Agreement, C shall reimburse B by way of indemnification, the amounts so withheld.

<u>October 1, Year 6 Advance Agreement</u>

Pursuant to the Share Acquisition Agreement dated June 27, Year 6, C agreed to purchase a 51% ownership interest in E Group, a Country Z company, for $ s. B will advance $ t to C for purposes of this acquisition under the following terms and conditions.

1. Maturity date: The advances shall be repaid no later than 25 years after October 1, Year 6, and shall be repaid upon first demand by B if C is given 10 days written notice. Any repayment shall be subordinated to any claims made by general creditors.

2. Stated interest: The advances bear no interest.

3. Prepayment rights: C has the right to prepay all or any part of the advances at any time, provided 14 days prior written notice is given.

4. Acceleration clause: In the event C (a) becomes insolvent, (b) admits in writing that it is unable to pay its debts as they mature, (c) undertakes any proceeding pursuant to bankruptcy or insolvency laws, or (d) undertakes, or is subject to, dissolution or liquidation proceedings, then the advance shall become immediately due and payable.

5. Payment: All payments due under this Agreement shall be made by C in freely transferable and convertible currency.

6. Withholding Reimbursement: If C is required to withhold a tax, levy, duty or charge from any payment made under this Agreement, C shall reimburse B, by way of indemnification, the amounts so withheld.

For U.S. financial statements and tax reporting purposes, B reflected the advances as loans to C, and booked the respective amounts as intercompany receivable due from C. Consistent with B's reporting, C then recorded a corresponding intercompany payable in its financial statements and Country X tax returns. Footnote "5" of C's financial statements, titled "Subordinated Loan from Shareholder", stated that C obtained a subordinated loan from B on an interest-free basis, and that "repayment is not expected within 5 years." This repayment period appears to coincide with the time period in which B projected a profitable net return on C's investment in D Group.

B submitted a twenty-two page position letter dated January 7, Year 8, claiming that (1) the advances were mistakenly classified as debt, (2) the Advance Agreements were executed for purposes of foreign tax planning in Country X, and (3) the advances in substance constitute equity contributions to C. In support of point "1", B argues that the advances were mistakenly classified as debt by outside compliance professionals who failed to consider the actual nature of the advances while preparing B's income tax returns.

As for point "2", B claims that the advances to C were documented by Advance Agreements for purposes of minimizing C's Country X tax liabilities. In particular, B wished to reduce the amount of Country X's capital tax on the advances made to C, qualify for a participation exemption on dividends received with respect to C's investments in D Group and E Group, and reduce the dividend withholding tax imposed by Country X. To explain the foreign tax planning objectives, B submitted a letter from Counsel F dated May 20, Year 7, which addressed Country X's law on capital and withholding taxes.

For Country X's purposes, B used a debt-equity allocation of 85%-15% because that ratio would allow C to limit its Country X tax liabilities for three reasons. First, under Country X's law, there are two separate tax regimes (e.g. capital tax and corporate tax) with their own distinct debt-equity characterization rules. Advances that may be categorized as loans under the capital tax regime can be considered equity contributions for purposes of the corporate tax system. Under the capital tax system, a 1% tax is imposed on equity contributions received by C. Equity is defined as "risk-carrying capital", and any funds that are provided to an entity on credit, that gives rise to a claim against the entity, generally do not constitute "risk-carrying capital". By apportioning 85% of the advances as loans, C limited its 1% capital tax exposure to 15% of the advances received from B.

In addition, a contribution of informal capital may result from interest-free debt obligations. Because a debtor benefits from not having to incur interest expense related to interest-free loans, the capital tax regime treats the forgiven interest expense as informal capital contributions to the corporation, and imposes the 1% capital tax on the foregone interest. Commencing with Year 5, C imputed a contribution to its capital equal to the amount of the forgiven interest and paid the 1% capital tax thereon to Country X.

Counsel F also stated that in order for “debt” to exist based on Country X’s civil law,

> the debtor is under an obligation to repay the amount advanced. Apart from this feature, there is no other determining characteristic of a loan. In fact, a loan is not required to be in any particular form, and may bear high interest or not interest at all ... Since the Advance Agreements must be repaid on demand (upon 10 days notice) and in any event no later than 25 years, the Advance Agreements are properly characterized as a loan rather than capital under Country X’s civil law.

Secondly, Country X has determined that a debt-equity ratio of 85%-15% satisfies its requirement of adequate capitalization. Country X informally adopted these percentages as a safe harbor debt-equity ratio to avoid issues of thin capitalization, and thereby allowing Country X corporations to receive a participation exemption by obtaining a deduction for dividends received from equity investments. Country X has denied the participation exemption to corporations that were thinly capitalized. By using the safe harbor debt-equity ratio, C avoids the issue of thin capitalization, and thus qualify for a deduction related to dividends received from its equity investments in D Group and E Group.

Lastly, Country X also imposes a withholding tax on dividends paid to non-Country X shareholders. By classifying 85% of the advances as debt, C can avoid the dividend withholding tax because any payment to B must first be applied against the outstanding debt. Counsel F’s letter states that based on Country X’s jurisprudence

> the civil law ‘form’ in which funds are provided is generally determinative. Yet, for purposes of Country X’s corporate tax (and withholding tax), debt may be recharacterized as equity ... in the event of a sham transaction. That is, when parties present something as a loan which, in reality, determined under civil law, should be characterized as capital ... [the] debt [will be] recharacterized as equity, [and] distributions to the shareholder ... may nevertheless be subject to withholding tax.

With respect to point “3" above, B argues that interest income under section 482 may only be imputed with respect to bona fide indebtedness. To determine if an advance is bona fide debt, the substance, and not the form, controls its determination. B cited numerous cases in support of the position that debt-equity determinations are based on substance, including TAM 8302015 on the issue of imputed interest under section 482. Based on the case law, and the TAM, B claims that the subject advances are not characteristic of debt due to (1) the extended maturity date of 25 years, (2) the expectation of repayment is dependent upon the success of C Corp.'s investments, (3) the mere contractual right to enforce repayment is insufficient when "the lender takes none of the customary steps to guaranty repayment in the event the purported borrower's business fails", (4) the advances were subordinated to the interest of other creditors, (5) the intent of the parties to treat the transaction as equity, (6) the thin capitalization, and (7) the inability of C to obtain funds from independent lenders. Further, the resolution of debt-equity issues under U.S. law does not depend on 'debt' characterization pursuant to Country X's rules.

**LAW AND ANALYSIS:**

The Commissioner's proposed interest adjustment under section 482 is predicated on treating the advances made by B to C as debt. Section 482 allows the Commissioner to "distribute income or deductions between or among commonly controlled taxpayers as may be necessary in order to prevent" distortion of income and expenses, and to clearly reflect the true tax liability of the taxpayers. B. Forman Company v. Commissioner, 453 F.2d 1144, 1150 (2nd Cir. 1972), *cert. denied*, 407 U.S. 934 (1972). An allocation to reflect an arm's length rate of interest may be made under section 482 with respect to bona fide indebtedness between controlled taxpayers.

Treas. Reg. § 1.482-2(a)(1), *Interest on bona fide indebtedness*, provides in pertinent part:

> (i) *In general.* Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group and either charges no interest, or charges interest at a rate which is not equal to an arm's length rate of interest (as defined in paragraph (a)(2) of this section) with respect to such loan or advance, the district director may make appropriate allocations to reflect an arm's length rate of interest for the use of such loan or advance.
>
> (ii) *Application of paragraph (a) of this section*–(A) *Interest on bona fide indebtedness.* Paragraph (a) of this section applies only to determine the appropriateness of the rate of interest charged on the principal amount of a bona fide indebtedness between members of a group of controlled entities, including–

(*1*) Loans or advances of money or other consideration (whether or not evidenced by a written instrument); and

(*2*) Indebtedness arising in the ordinary course of business from sales, leases, or in rendition of services by or between members of the group, or any other similar extension of credit.

(B) *Alleged indebtedness.* This paragraph (a) does not apply to so much of an alleged indebtedness which is not in fact a bona fide indebtedness.... For example, paragraph (a) of this section does not apply to payments with respect to all or a portion of such alleged indebtedness where in fact all or a portion of an alleged indebtedness is a contribution to capital of a corporation or a distribution by a corporation with respect to its shares.... Payments made with respect to alleged indebtedness (including alleged stated interest thereon) shall be treated according to their substance. *See* § 1.482-2(a)(3)(i).

Treas. Reg. § 1.482-2(a)(3), *Coordination with interest adjustments required under certain other Code sections*, provides the order in which different provisions of the Code shall be applied in determining the interest adjustment under section 482. Subdivision (i) of this regulation states:

> First, the substance of the transaction shall be determined; for this purpose, all the relevant facts and circumstances shall be considered and any law or rule of law (assignment of income, step transaction, etc.) may apply ....

Treas. Reg. § 1.482-2(a)(4), *Examples*, provides that the principles of Treas. Reg. § 1.482-2(a)(3) may be illustrated by, inter alia:

> *Example 1.* An individual, A, transfers $20,000 to a corporation controlled by A in exchange for the corporation's note which bears adequate stated interest. The district director recharacterizes the transaction as a contribution to the capital of the corporation in exchange for preferred stock. Under paragraph (a)(3)(i) of this section, section 1.482-2(a) does not apply to the transaction because there is no bona fide indebtedness.

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, the Commissioner has been allowed to discount the form of a transaction, and determine the tax consequences based on its substance. *See* Gregory v. Helvering, 293 U.S. 465; 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). This substance over form approach provided to the Commissioner constitutes a rule of law within the meaning of Treas. Reg. § 1.482-2(a)(3)(i), as exemplified by the district director's recharacterization of a note as a contribution to capital set forth in *Example 1*, supra.

The Supreme Court has also long recognized the rule of law that a taxpayer, although free to structure his transaction as he chooses, "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). Taxpayers have less freedom than the Commissioner to ignore the transactional form that they have adopted, and are ordinarily bound by the tax consequences that flow therefrom. Illinois Power Co. v. Commissioner, 87 T.C. 1417, 1430 (1986). *See also*, Nestle Holdings, Inc. v. Commissioner, 152 F. 3d 83, 87 (2d Cir. 1998); Harris v. United States; 902 F.2d 439, 443 (5th Cir. 1990); Spector v. Commissioner, 641 F.2d at 381; Taiyo Hawaii Company, Ltd. v. Commissioner, 108 T.C. 590, 601-603 (1997); Estate of Durkin v. Commissioner, 99 T.C. 561, 572-75 (1992); 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). This rule of law, which limits a taxpayer's ability to disavow the form of its chosen transaction, seeks to avoid the uncertainty that would result from allowing the taxability of a transaction to depend on whether an alternative form exists under which more favorable tax consequences would result. National Alfalfa, 417 U.S. at 149; Television Indus., Inc. v. Commissioner, 284 F.2d 322, 325 (2nd Cir. 1960).

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. In contrast, the Commissioner is disadvantaged because he does not have direct access to the facts underlying a particular transaction. Consequently, the Commissioner must be allowed to rely on representations made by taxpayers in their returns, and must be allowed to evaluate the resulting tax consequences based on such disclosures. This reliance is particularly appropriate in the context of a cross border transaction, such as the present case, where documents, information and witnesses are not readily available to the Commissioner.

"The Commissioner is justified in determining the tax effect of transactions on the basis in which the taxpayers have molded them ...." Television Industries, Inc. v. Commissioner, 284 F.2d at 325. *See also,* 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). To freely allow taxpayers to argue for alternative tax treatment of a transaction upon the examination of the returns would be tantamount to administering the tax laws based on a policy that tax consequences flow from the "transaction taxpayers have chosen or from any other form [of transaction] they might have chosen, whichever is ... [more favorable]." City of New York v. Commissioner, 103 T.C. 481, 493 (1994) (quoting Television Industries, Inc. v. Commissioner, 284 F.2d at 325), *aff'd,* 70 F.3d 142 (D.C. Cir. 1995). *See also*, Harris v. United States; 902 F.2d at 443 ("taxpayers may not in hindsight recast the transaction as one that they might have made in order to obtain tax advantages"). For this reason, the courts have generally subjected taxpayers to a heightened standard of proof before they are permitted to contradict the form and have the transaction taxed in accordance with their alleged substance. Spector v. Commissioner, 641 F.2d at 382; Estate of Durkin v. Commissioner, 99 T.C. at 572-75; FNMA v. Commissioner, 90 T.C. at 426; Illinois Power v. Commissioner, 87 T.C. at 1431; Little v. Commissioner, 65 T.C.M. at 3032. Moreover, in the context of distinguishing debt from equity for federal income tax purposes, the application of a heightened standard of proof is particularly apt because (as discussed below) the intent of the parties, at the time of creation of the arrangement, is a major factor under substantive law. A taxpayer's treatment of an instrument as debt or equity on its federal income tax return is probative of such intent.

The courts have articulated this heightened standard of proof differently. *See* Spector v. Commissioner, 641 F.2d at 382. For example, in Commissioner v. Danielson, 378 F.2d 771 (3rd Cir. 1967), *cert. denied*, 389 U.S. 858 (1967), the court held that where taxpayers executed a contract containing specific terms, conditions and allocations, they may not alter or avoid the tax consequences of that agreement in the absence of fraud, duress, or undue influence.[1] In contrast, the court in Sonnleitner v. Commissioner, 598 F.2d 464 (5th Cir. 1979), determined that before a taxpayer may alter or avoid the tax consequences of a contractual arrangement, the taxpayer must come forth with strong proof that the agreement lacked economic reality. The Tax Court has adopted the strong proof standard and has refused to apply Danielson outside the circuits that recognize it. *See, e.g.*, Meredith Corp. v. Commissioner, 102 T.C. 406, 440 (1994); Elrod v. Commissioner, 87 T.C. 1046, 1065-66 (1986). The strong proof rule, as applied by the Tax Court, requires a showing of somewhat more than a preponderance of the evidence and somewhat less than Danielson. *See* Illinois Power Co. v. Commissioner, 87 T.C. at 1434, n.15. The burden upon the taxpayer is "far heavier when his tax reporting positions and other actions did not consistently reflect the substance which he later argues should control the form." Miller v. Commissioner, 57 T.C.M. at 50-51 (citing Illinois Power Co. v. Commissioner, 87 T.C. at 1430).

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[1] Only certain courts have adopted the Danielson rule. See, e.g., Lane Bryant, Inc. v. United States, 35 F.3d 1570 (Fed. Cir. 1994); Schatten v. United States, 746 F.2d 319 (6th Cir. 1984); Bradley v. United States, 730 F.2d 718 (11th Cir. 1984), *cert. denied*, 469 U.S. 882 (1984); Spector v. Commissioner, supra.

The Tax Court in Estate of Durkin v. Commissioner, 99 T.C. at 574-575 held that, under either a strong proof or Danielson standard, the taxpayers could not disavow their chosen form where: (1) taxpayers were seeking to disavow their own tax return treatment of the transaction, (2) the taxpayers' reporting position and other actions did not show "an honest and consistent respect for the substance of the transaction", (3) the taxpayers were unilaterally attempting to have the transaction treated differently after it had been challenged, and (4) the taxpayers would have been unjustly enriched if he were permitted to belatedly alter the transaction after well-informed negotiations were held with the other party to the transaction.

The taxpayers in Durkin did not prevail in establishing that the transaction, in substance, was different from that which was initially reported in the tax return as a purchase of coal properties from their corporation at a price below fair market value. Upon examination of the returns, the Commissioner determined that the taxpayers received a constructive dividend for the difference between the price paid and fair market value of the property. After their returns were challenged by the Commissioner, the taxpayers argued that their purchase of coal properties were in substance part of one integrated transaction in which they disposed of their stock ownership to another shareholder, and thus, the transaction should be taxed as a redemption. Based on the four factors discussed above, the Tax Court determined that the taxpayers did not carry their heightened burden to show a substance that is different than their reporting position.

In the recent opinion of Norwest Corp. v. Commissioner, 111 T.C. 105 (1998), the Tax Court again denied the taxpayer's attempt to have a transaction taxed in accordance with its alleged substance, after it was initially reported on the return as a sale and lease-back of real property. The taxpayer argued that there had been no sale, and that the entire transaction, in substance, was merely a financing arrangement. After considering various approaches, the Tax Court concluded that the "taxpayers cannot elect a specific course of action and then when finding himself in an adverse situation extricate himself by applying the age-old theory of substance over form." Norwest Corp. v. Commissioner, 111 T.C. at 146. A taxpayer's ability

> to ignore the transactional form that he has adopted ... is further curtailed if ... [he] attempts to abandon his tax return treatment of a transaction ... [W]hen a taxpayer seeks to disavow his own tax return treatment ... by asserting the priority of substance only after the Commissioner raises questions with respect thereto, this Court need not entertain the taxpayer's assertion of the priority of substance .... Id. at 145-146.

Most notably for purposes of the present case, taxpayers have been held to their characterization of transactions as debt despite their attempts to invoke traditional debt versus equity, or other substance considerations . *See* Taiyo Hawaii, Ltd. v. Commissioner, 108 T.C. at 602-603 (debt versus equity); City of New York v. Commissioner, 103 T.C. at 493 (debt versus partial debt, partial grant); Litchfield v. Commissioner, T.C. Memo. 1994-585, 68 T.C.M. (CCH) 1291 (1994), *aff'd in an unpublished order*, 97-2 USTC ¶50,536 (10th Cir. 1997) (debt versus equity); Miller v. Commissioner, 57 T.C.M. at 50-51 (debt versus equity).

For instance, in Taiyo Hawaii v. Commissioner, the U.S. taxpayer received advances from its foreign parent that were not evidenced by a promissory note, had no fixed maturity date or stated rate of interest, and were unsecured. In the financial statements and tax returns, the taxpayer respected the advances as intercompany loans. Further, at the instruction of the parent, the taxpayer accrued interest expense on the advances, and deducted said interest on its tax returns. Upon examination, the Commissioner determined that the taxpayer was liable for excess interest tax under section 884(f). To avoid this tax, the taxpayer attempted to disavow its characterization of the advances as debt, and argued that notwithstanding the "labels originally attached to the advances, they were, in substance capital contributions." Id. at 601-602.

In support of its argument, the taxpayer cited a past line of cases where the Tax Court previously resolved debt versus equity disputes by applying the traditional debt versus equity considerations.[2] The Tax Court, in holding for the Commissioner that the advances were debt, found that it was unnecessary under the facts of the case to engage in a traditional debt versus equity analysis, and relegated the cases relied upon by the taxpayer to a footnote. 108 T.C. at 601-602, n. 9 and 10. Instead, working from the fundamental rule of law enunciated in National Alfalfa that a taxpayer must accept the tax consequences of its choice of transaction, the Tax Court noted that taxpayers have been permitted to assert substance over form where their "tax reporting and other actions have shown an honest and consistent respect for the substance." Id. at 602 (citing FNMA v. Commissioner, 90 T.C. at 426 and Illinois Power Co. v. Commissioner, 87 T.C. at 1430). Taiyo Hawaii, however, failed to demonstrate an honest and consistent respect for what it contended after the fact was the substance of the transaction. Relying on cases such as Estate of Durkin v. Commissioner and Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959), *aff'g* 29 T.C. 129 (1957), the Tax Court stated:

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[2] J.A. Tobin Construction Co. v. Commissioner, 85 T.C. 1005 (1985); Georgia Pacific Corp. v. Commissioner, 63 T.C. 790 (1975); J.A. Maurer, Inc. v. Commissioner, 30 T.C. 1273 (1958); LDS, Inc. v. Commissioner, T.C. Memo. 1986-293, 51 T.C.M. (CCH) 1433 (1986); Inductotherm Industries, Inc. v. Commissioner, T.C. Memo. 1984-281, 48 T.C.M. (CCH) 167 (1984), *aff'd without published opinion*, 770 F.2d 1071 (3rd Cir. 1975).

> Petitioner has, for all purposes, treated the advances as loans and was instructed by its parent corporation to accrue interest. Under those circumstances, we reject petitioner's approach of testing its own choice of form with traditional debt versus equity considerations, such as the absence of a fixed payment schedule, maturity dates, enforcement, or formal debt instruments. We are likewise unpersuaded by petitioner's accountant's . . . after-the-fact testimony that, in retrospect, he should have considered the advances as equity and reported them as such on petitioner's tax returns.
>
> Petitioner’s approach does not show that the substance of the advances was not loans. It merely illustrates that the parties to the transactions did not follow all the formalities that might be considered probative that the advances were debt rather than equity. In that regard, petitioner has not shown that the form of the transaction did not comport with its substance ... Accordingly, we hold that petitioner has not carried its burden of showing that the substance of the transaction was different from its form.

108 T.C. at 602-603 (citations and footnote omitted).

Further, the Tax Court adopted a heightened standard of proof when a taxpayer attempted to avoid the Commissioner’s interest allocation pursuant to section 482 based on the argument of substance over form. Cayuga Service, Inc. v. Commissioner, T.C. Memo. 1975-4, 34 T.C.M. (CCH) 18 (1975). In response to the taxpayer’s urging that the court disregard the form of intercompany advances as loans, and find that the advances were investments, the court stated, “[I]f a taxpayer asserts that the substance is different than the form he used, he must furnish strong proof that the substance was other than the form indicates,” citing, *inter alia*, Ullman v. Commissioner. The court found that “petitioner has failed to meet is burden of persuading us that the advances were in fact investments and not loans.” 34 T.C.M. at 25.

The court decided Cayuga Service based on then existing Treas. Reg. § 1.482-2(a), T.D. 6952 (Apr. 16, 1968) and the decision is consistent with longstanding judicial principles that the Commissioner is allowed to determine the tax consequences of a transaction based on its substance, while imposing a heightened standard of proof on taxpayers that argue for a substance different than the form. Unlike the 1968 regulations, these judicial principles are presently set forth in Treas. Reg. § 1.482-2(a), T.D. 8552 (Jul. 1, 1994), and confirmed in subdivision (3)(i) thereof, that the substance of the transaction shall be determined by considering “all the relevant facts and circumstances ... and any law or rule of law (assignment of income, step transaction, etc.) may apply.”

Although there exist a past line of cases in which some courts were willing to adjudicate debt versus equity disputes raised by taxpayers without expressly subjecting the taxpayers to a heightened standard of proof for determining the substance, the court in Taiyo Hawaii v. Commissioner, as mentioned above, was unpersuaded as to the relevance of these cases and found them unworthy of comment in light of National Alfalfa and its progeny. 108 T.C. at 602, n. 9 and 10. Further, were another court to be persuaded otherwise, these cases are factually or legally distinguishable from the present case.

For instance, in J.A. Tobin Construction Co. v. Commissioner, 85 T.C. 1005, the Commissioner sought to impute interest pursuant to section 482 on funds paid by a subsidiary to its parent and reflected by the subsidiary as loans on its books and financial statements. The subsidiary subsequently declared substantial dividends during the years in question, which it credited against the recorded balances rather than paid in cash. There were no written debt instruments and the subsidiary's financial statements contained a footnote noting its intention to declare dividends if its parent were unable to repay the loaned amounts. The Commissioner relied upon then existing Treas. Reg. § 1.482-2(a)(1), T.D. 6952 (Apr. 16, 1968), for authority to allocate the interest. The taxpayer, in turn, argued that the transfers were corporate distributions, and relied upon then existing Treas. Reg. § 1.482-2(a)(3), which stated that the subparagraph relied upon by the Commissioner "does not apply to alleged indebtedness which was in fact a contribution of capital or a distribution by a corporation with respect to its shares." Both parties argued numerous cases to support their respective characterizations of the funds transferred as loans or corporate distributions. The Tax Court held that the transferred funds were not loans, placing emphasis on the fact that the transferred funds, which appeared only as accounting entries, "were treated as satisfying the obligation of Tobin Construction to pay the dividends declared." Id. at 1019-1021.

Before conducting its analysis of whether the transfers were loans or distributions, the Tax Court in J.A. Tobin Construction Co. noted the principle that "a taxpayer is generally not allowed to argue that the substance of a transaction was other than the form he chose," citing In re Steen v. United States, 509 F.2d 1398, 1402-1403, n. 4 (9th Cir. 1975). However, the court did not subject the taxpayer to a heightened standard of proof in this case, for several reasons. First, the court noted that the regulation relied upon by respondent placed "no express restriction on a taxpayer's (as distinguished from respondent's) ability to challenge the bona fide nature of the loan and nothing in the regulation suggests that only respondent can make that argument." Second, respondent did not argue that the taxpayer, "as a matter of law, is held to the form of the transaction." And finally, the court found that under the circumstances, both the form and substance were in dispute, and after considering all the facts, the advances were dividends in form and substance.

Id. at 1021-1023. Post Corp. v. United States, 640 F.2d 1296 (Cl. Ct. 1981), is equally distinguishable on similar grounds.

In sum, J.A. Tobin Construction Co. is distinguishable from the present case because the taxpayer did not disavow its initial tax return position, and the Commissioner did not argue that the taxpayer was held to the form of the transaction as a matter of law. Whatever doubt the court may have had about the Commissioner's ability to invoke the rule of law enunciated by National Alfalfa and its progeny within the purview of an interest allocation under section 482, had the Commissioner so chosen, would now be alleviated by the language of the present regulation which makes clear that the Commissioner may determine the substance of the transaction, and that "for this purpose, all the relevant facts and circumstances shall be considered and any law or rule of law ... may apply."

The Tax Court was also willing to consider the debt versus equity issue in Georgia-Pacific Corp. based on the substance of the transaction due to the exceptional circumstances involved in that case. The taxpayer in Georgia-Pacific acquired the assets of Colortype Co., which included a receivable for advances made by Colortype to its subsidiary. The Commissioner argued that since the taxpayer was Colortype's transferee, the taxpayer was bound by the form in which Colortype characterized the advances. Prior to the acquisition, Colortype executed a note agreement containing stated interest and maturity date. Both Colortype and its subsidiary accrued interest income, and corresponding expense, on their financial statements and tax returns. The taxpayer argued that, as of the year in question, there had been a change in the economic circumstances of the business, and the advances made by Colortype had been transformed into equity. The court opined that:

> [w]hile a taxpayer must in other contexts normally accept the tax consequences of the way in which he deliberately chose to cast his transaction, advances of the type here involved must be characterized in terms of economic reality for the year at issue ... Changing circumstances as time passes may alter the original character of an advance and transform it into equity ... Therefore, the taxpayer was not bound by the form in which it cast this transaction.

Id. at 795-96. The court in any event determined that the character of the advances were debt.

The Georgia-Pacific opinion is distinguishable in that the transaction was created by the taxpayer's predecessor. Moreover, the court obviously weighed the taxpayer's historic evidence of intent, including statements noted on the returns, as significant factors in its decision. As such, the opinion does not support the proposition that when faced with a taxpayer seeking to disavow its form and argue debt versus equity considerations, a court would feel compelled to take a different tack than that in Taiyo Hawaii.[3]

With respect to the present case, B should be subject to the heightened standard of proof when it attempts to argue substance by rebutting its own tax return treatment of the advances that were originally reported as debt. Under these circumstances B must demonstrate that B and C consistently recognized and respected the advances as capital contributions. B's initial federal income tax return position is probative of B's and C's intent to treat the advances as debt. The numerous documents (e.g. internal memorandum, corporate resolution, Advance Agreements and C's foreign tax disclosures) demonstrate that B's tax reporting position and other actions do not show an honest and consistent respect for what it now claims to be, in substance, equity contributions to C.

The memorandum dated May 21, Year 4 indicates that B realized that its classification of the advances as debt raises the issue of whether interest has been imputed under U.S. tax rules. It was recommended that if the advances were intended to be equity investments in C, they should be reclassified from debt to equity, provided that such reclassification is not contrary to B's corporate resolutions. By recategorizing the advances, it would eliminate any concerns regarding imputed interest. However, B did not reclassify any of the advances for U.S. tax purposes, and the corporate resolutions, for Years 3 through 6, only authorized a portion of the advances ($ v) to be treated as equity investments in C. As such, B's inaction, coupled with the corporate resolutions, exemplify that B neither respected, nor intended, for the entire advance of $ j to be treated as capital

[3] The other cases cited by the taxpayer in Taiyo are also distinguishable from the present matter. In J.A. Maurer, Inc. v. Commissioner, 30 T.C. 1273 (1958), the Commissioner determined that the taxpayer had forgiveness of indebtedness income, but the Tax Court found that the advances in questions were contributions to capital. The Commissioner did not argue that the heightened standard of proof should apply, and the case predated the Supreme Court's 1974 opinion in National Alfalfa. Furthermore, it is not clear that the taxpayer disavowed any prior return position. As for the decision in LDS, Inc. v. Commissioner, 51 T.C.M. 1433, although the court analyzed the substance of the transaction by applying the traditional debt-equity factors, it determined that the taxpayer proved the substance by proffering strong proof that all factors, taken collectively, weighed in favor of equity. Furthermore, in Inductotherm Industries, Inc. v. Commissioner, 48 T.C.M. at 186-89, the court allowed advances to be characterized as equity, but the Commissioner did not argue that the heightened standard of proof applies when a taxpayer argues for substance different from its reporting position.

contributions. Consequently, B's conduct negates its argument that the advances were mistakenly classified as debt by outside compliance professionals since B was cognizant of the issues surrounding the manner in which it reported the advances.

In cases involving cross border transactions, the Tax Court will take into account the global structure of the transaction, including foreign tax disclosures. For instance, in Coleman v. Commissioner, 87 T.C. 178, 200-204 (1986), the Tax Court examined all the facts surrounding the cross border leasing transaction between the U.S. lessee and U.K. lessor in determining whether the former had a depreciable interest in the leased equipment. Prior to the lease arrangement, the U.K. lessor transferred its title, and ownership interest, in the equipment to the lenders. Hence, the U.S. lessee could not acquire a depreciable interest in the equipment since his interest flows from that of the U.K. lessor. By claiming depreciation deductions, the U.S. lessee was in fact attempting to disavow the form of the transaction that was originally structured between the U.K. lessor and the lenders. The Court stated:

> [t]he fact that the purpose underlying the form of the transaction between [the U.K. lessor] and the lenders was to take advantage of U.K. rather than U.S. tax laws does not, in our opinion, provide a sufficient foundation for permitting petitioners to disavow that form in order to obtain the benefits of U.S. tax laws...
>
> Moreover, there is ... [no established judicial principles] which compels us to ignore the form of a transaction structured to obtain tax benefits in one jurisdiction and to restructure the transaction, at the insistence of the taxpayer, in order to confer tax benefits in another jurisdiction – in short, to enable the taxpayer to play both ends against the middle.

Like Coleman, the Tax Court in Laidlaw Transportation, Inc. v. Commissioner, 75 T.C.M. at 2600-16, also reviewed the structure of the advances on a global basis. The dispute in Laidlaw involved the characterization of cross border advances that were made between controlled taxpayers and classified as debt. The Commissioner challenged the substance of the transactions arguing that the advances constituted equity. In holding for the Commissioner, the Tax Court noted that the advances were structured in a manner that ultimately created a "double deduction" to the Canadian parent on a global basis. Id. at 2602. The Canadian parent borrowed funds from an independent lender and transferred these funds, as capital contributions, to a wholly-owned Netherlands subsidiary. The Netherlands subsidiary in turn loaned those funds, with stated interest, to U.S. sister companies that were also wholly-owned by the Canadian parent. Under this structure, the Canadian parent deducted interest on its loan with the outside lender, and the U.S. subsidiaries deducted interest on its borrowings from the Netherlands subsidiary.

During an examination of the parent's returns, the parent represented to the Canadian tax authorities that the advances were capital contributions to the subsidiaries. Id. at 2615-16. The Tax Court viewed this representation as a significant factor in establishing the parent's intent that the advances were equity investments. Id. at 2620.

In light of Coleman and Laidlaw, the Advance Agreements, and C's Country X tax reporting, are likely to serve as further corroboration that B did not honestly and consistently respect the substance of the advances as alleged equity. The Advance Agreement dated December 31, Year 3 states that B structured 85% of all present, and future, advances to C as debt. C's position is that the advances qualify as debt, pursuant to Country X's law, because C acknowledges that it "is under an obligation to repay" the funds to B in accordance with the terms of the Advance Agreements. Hence, both B and C respected the advances as debt, and reported the transactions as such in their respective tax returns. Although C did not deduct any interest expense on these non-interest bearing advances, the amount of the foregone interest has nevertheless been indirectly recognized by C as additional informal capital contribution under Country X's capital tax regime. Accordingly, C accrued and paid the 1% capital tax with respect to the foregone interest. Recognizing the foregone interest and reporting the advances as loans in the financial statements and tax returns of both jurisdictions are probative of an intent that the advances were debt. Hence, these facts do not establish that B and C respected the advances as capital contributions.

B's inconsistent conduct also shows that it is unilaterally disavowing the outbound aspect of the advances as equity to avoid U.S. tax consequences, while maintaining C's corresponding treatment of the same advances as non-interest bearing debt in order to obtain Country X's tax benefits. In transactions involving controlled taxpayers (as in this case where C is wholly-owned by B), it is reasonable to expect that the parties would accord consistent, and reciprocal, characterization on intercompany transactions. However, B's position is that the advances may be given disharmonious characterization for purposes of obtaining tax benefits in both United States and Country X. That is, B treats the advances as an investment in C, without the expectation of repayment, but C views the advances as a loan, with the intent to fully repay B within 25 years. This categorization results in a transaction that requires particular scrutiny, particularly when it involves related parties. Like the taxpayer in Coleman, supra, B is attempting to "play both ends against the middle" by disavowing the advances that were consistently recognized as debt in both jurisdictions, and restructuring the U.S. aspect of the advances as equity for purposes of avoiding the tax consequences of section 482. In light of the foregoing, we do not believe that B has sustained its heightened burden to establish that in substance, it respected the advances as capital contributions to C when in fact the parties themselves did not honestly and consistently respect the character of the advances as such.

In considering whether B can produce sufficient evidence to demonstrate that B and C consistently respected and reported the advances as equity, and that the other facts and circumstances justify treating the advances as equity, we note that no single uniform approach has been adopted by the courts in analyzing the debt versus equity factors. The courts analyze whether there was a "genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship." Litton Business Systems, Inc. v. Commissioner, 61 T.C. at 377. Courts generally look to: (1) the names given to the certificates evidencing the indebtedness, (2) the presence or absence of a maturity date, (3) the source of the payments, (4) the right to enforce payment of principal and interest, (5) participation and management, (6) a status equal to or inferior to that of regular corporate creditors, (7) the intent of the parties, (8) "thin" or adequate capitalization, (9) identity of interest between creditor and stockholder, (10) payment of interest only out of "dividend" money, and (11) the ability of corporation to obtain loans from outside lending institutions. Hardman v. United States, 827 F.2d 1409, 1412 (9th Cir. 1987) (citing Bauer v. Commissioner, 748 F.2d 1365, 1368 (9th Cir. 1984); A.R. Lantz Co. v. United States, 424 F.2d 1330, 1333 (9th Cir. 1970); O.H. Kruse Grain & Milling v. Commissioner, 279 F.2d 123, 125-26 (9th Cir. 1960)). *See also* Laidlaw Transportation, Inc. v. Commissioner, T.C. Memo. 1998-232; Nestle Holdings, Inc. v. Commissioner, T.C. Memo. 1995-441, 70 T.C.M. (CCH) 682 (1995); Morgan Pacific Corp. v. Commissioner, T.C. Memo. 1995-418, 70 T.C.M. (CCH) 540, 546 (1995).

The limited facts herein show that the Advance Agreements contain some indicia of debt, as well as equity, for the following reasons:

1. *The names given to the certificates*. The "issuance of a stock certificate indicates an equity contribution, and the issuance of a bond, debenture or note indicates a bona fide indebtedness." Hardman v. United States, 827 F.2d at 1412. Where the document lacks a name, or the assigned name is ambiguous, the court look to the language expressed in the document. For instance, phrases such as "in consideration of", or "hereby agrees to pay" is typical language associated with a promissory note. Id. *But see* Laidlaw Transportation, Inc. v. Commissioner, 75 T.C.M. at 2617 (notwithstanding how the document is labeled, this factor carries less weight as compared to others). While the title describing the documents herein are ambiguously labeled "Advance Agreements", the language contained therein appears indicative of a promissory note since B and C are acknowledging C's

obligation to repay the advances on ten days' notice, and no later than 25 years from the date of their original issuance.

2. *The presence or absence of a maturity date.* "The absence of a fixed maturity date indicates that repayment is tied to the fortunes of the business". Hardman v. United States, 827 F.2d at 1413. In contrast, the existence of a fixed maturity date generally indicates that the advance was debt. Laidlaw Transportation, Inc. v. Commissioner, 75 T.C.M. at 2617. Demand instruments with no fixed maturity date, or postponing and amending maturity dates for prolonged periods, suggests "that the lender does not intend to require repayment and that the transfers are equity." Id. *But see* B. Forman Company v. Commissioner, 453 F.2d 1144 (rolling over the notes upon maturity did not transform the advances that were treated as debt into equity for purposes of section 482 imputed interest). B's Advance Agreements are not strictly demand instruments given the existence of a fixed maturity date of "no later than 25 years". As such, these Advance Agreements are different from the instruments discussed in Laidlaw. That is, the agreements herein contain the absolute latest time in which C must repay the advances. Further, there is no evidence that B either postponed or amended the original maturity date set forth in the Advance Agreements. The maturity term of 25 years may not be deemed excessively long since the Tax Court has upheld related party debt instrument with a term of 20 years. *See* Nestle Holdings, Inc. v. Commissioner, 70 T.C.M. at 690.

3. *The source of payments*. If the recipient of the advances does not have "liquid assets or reasonably anticipated cash-flow from which to repay," then the advances are likely to be equity. Laidlaw Transportation, Inc. v. Commissioner, 75 T.C.M. at 2618. Repayments that are dependent upon earnings and profits of the corporation are indicative of equity. Hardman v. United States, 827 F.2d at 1413. The facts presented to date do not establish whether C has sufficient liquid assets or reasonably anticipated cash-flow to repay the advances to B. To determine C's liquidity, consideration should be given to C's cash position, including any other asset that can be readily converted to cash, such as marketable securities. Further, if C's investment in D Group and E Group are publicly traded, then such investment will also qualify as marketable securities. As for determining anticipated cash-flow, C's business plan and financial projections ascertaining the expected cash-flow in connection with C's operations are also relevant.

4. *The right to enforce payment of principal and interest*. "The presence of an enforceable obligation" to repay the funds suggests that the advances are debt. Hardman v. United States, 827 F.2d at 1413. This factor distinguishes

a contractual right from an equity interest, associated with stock ownership, in which there is no right to enforce payment of dividends. Id. *See also* Estate of Mixon v. United States, 464 F.2d 394, 405 (1972) (repayment cannot be contingent upon the success of the business). The key consideration here is the reservation of contractual right to enforce payment, and not the exercise of such right. Laidlaw Transportation, Inc. v. Commissioner, 75 T.C.M. at 2619. However, when the maturity dates are repeatedly extended, then the right to enforce payment becomes meaningless, and such conduct could infer that the advances are equity. Id. at 2612-19.

The acceleration clause noted in the Advance Agreements establish that not only did B reserve the right to enforce full repayment, but that such repayment was not contingent upon the success of C's business. Even if C were to experience financial difficulties or insolvency, and undertake dissolution or liquidation proceeding, B nevertheless had the right to compel full repayment of the advances. B is not taking the risks associated with an equity contribution, whose return on investment is generally subject to the fortunes, or misfortunes, of the corporation. Given that B has not repeatedly extended the maturity date, the acceleration clause weighs the Advance Agreements in support of debt.

*5.* *Participation in management*. Where there is an increase in the ownership interest of the corporation, or an increase in voting rights, as a result of the advances, then the transaction weighs in favor of equity. Hardman v. United States, 827 F.2d at 1413. However, this factor is irrelevant in B's case since it wholly owns all the outstanding stock of C. *See* Laidlaw Transportation, Inc. v. Commissioner, 75 T.C.M. at 2619. Therefore, this factor is deemed neutral.

6. *A status equal to or inferior to that of regular corporate creditors*. "Whether an advance is equal or subordinate to the claims of regular corporate creditors affects whether the taxpayer was dealing as a shareholder or creditor." Id. The Advance Agreements contained a statement whereby C's repayments are subordinated to the claims of general creditors. Hence, this factor is indicative of equity.

7. *The intent of the parties*. As discussed above, B's and C's conduct manifested the intent that the advances were loans. (*See* pp. 17-19 of this memorandum).

8. *Thin or adequate capitalization*. A high debt to equity ratio "tends to show that the obligation is unrealistic or beyond the corporation's ability to

perform." Hardman v. United States, 827 F.2d at 1414. The courts have not articulated a particular debt to equity ratio which would be considered as adequate capitalization, and hence, we cannot determine whether a debt to equity ratio of 85% to 15% would be deemed adequate.

9. *Identity of interest between creditor and stockholder*. "If advances by shareholders are proportionate to their stock ownership, the advances are more likely to be equity." Laidlaw Transportation, Inc. v. Commissioner, 75 T.C.M. at 2621. This factor favors equity since C is wholly-owned by B, but such factor is seldom decisive.

10. *Payment of interest only out of dividend money*. When advances are without stated interest, such suggests that the provider of funds is "interested in the future earnings of the corporation or the increased market value of [its] interest." Estate of Mixon v. United States, 464 F.2d. at 409. Hence, non-interest bearing advances tend to indicate equity investment. However, an advance that otherwise qualifies as debt will not be transformed into equity simply because there is a lack of stated interest, or it carries inadequate interest. The purpose of Treas. Reg. § 1.482-2(a) is to allow the Commissioner to impute interest in non-interest bearing related party advances. *See* Kerry Investment Company v. Commissioner, 500 F.2d 108 (9th Cir. 1974) (upholding Commissioner's imputed interest under section 482 on non-interest bearing related party advances)*;* Kahler Corp. v. Commissioner, 486 F.2d 1 (8th Cir. 1973) (imputing interest income on non-interest bearing related party advances with no maturity date). Therefore, this factor is neutral in determining whether B's advances are debt or equity.

11. *The ability of the corporation to obtain loans from outside sources*. "If a corporation is able to borrow funds from outside sources, the transaction has the appearance of a bona fide indebtedness and indicates that the shareholder acted in the same manner toward the corporation as 'ordinary reasonable creditors would have acted'." Hardman v. United States, 827 F.2d at 1414. Further development with this issue is required given that we have no facts concerning whether an independent creditor would agree to lend funds to C under the same conditions as provided in the Advance Agreements. Hence, we cannot determine whether this factor would weigh in favor of debt or equity.

Based on the foregoing analysis, the Advance Agreements contain certain indicia of debt that is supported by B's and C's subsequent conduct manifesting their intent that the advances were loans. The debt characteristics in these instruments create a further burden for B, under the heightened standard of proof, that the advances in question are equity.

As a final matter, we note that TAM 8302015, Notice 94-47 and the cases[4] cited by B are distinguishable from the instant case. First, the TAM cannot be cited as precedent, and most notably, the facts therein are different from B's case. In the TAM, the parent corporation made advances to its subsidiary that was evidenced by an unsecured subordinated demand note. Subsequent to the issuance of the note, the subsidiary experienced poor financial condition resulting in an inability to repay the advances. The parent's board of directors adopted a resolution to convert the advances that were initially treated as debt, and thereafter, the parent recognized the advances as equity for book and tax purposes. In concluding that the parent was not subject to imputed interest under section 482, we cited Georgia-Pacific Corp. v. Commissioner, 63 T.C. 790, for the proposition that "while a taxpayer must normally accept the tax consequences resulting from the deliberate structuring of a transaction, advances between a parent corporation and a subsidiary must be characterized in terms of economic reality for the year at issue."

The conclusion in the TAM adopts the principles set forth in Georgia-Pacific that recognize "[c]hanging circumstances as time passes may alter the original character of an advance and transform it into equity." Georgia-Pacific Corp. v. Commissioner, 63 T.C. at 796. Due to a change in the subsidiary's financial condition which resulted in its inability to repay, it was appropriate to change the character of the advances given that the economic reality of the transaction no longer resembled debt. However, since C is not experiencing any poor financial condition, and has not expressed an inability to repay the advances to B, there is no justifiable basis for B to claim that the advances should be converted to equity. Thus, the circumstances underlying the TAM differs from the instant case. Further,

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[4] John Kelly Co. v. United States, 326 U.S. 521 (1946); Hardman v. United States, 827 F.2d 1409 (9th Cir. 1987); Goldberg v. United States, 789 F.2d 1341 (9th Cir. 1986); Roth Steel Tube Co. v. Commissioner, 800 F.2d 625 (6th Cir. 1986); Stinnett's Pontiac Service, Inc. v. Commissioner, 730 F.2d 634 (11th Cir. 1984); In re Lane v. United States, 742 F.2d 1311 (11th Cir. 1984); Bauer v. Commissioner, 748 F.2d 1365 (9th Cir. 1984); A.R. Lantz Co. v. United States, 424 F.2d 1330 (9th Cir. 1970); Berkowitz v. United States, 411 F.2d 818 (5th Cir. 1969); Fin Hay Realty Co v. United States, 398 F.2d 694 (3rd Cir. 1968); United States v. Snyder Brothers Co., 367 F.2d 980 (5th Cir. 1966); American-La France-Foamite Corp. v. Commissioner, 284 F.2d 723 (2nd Cir. 1960); Estate of Miller v. Commissioner, 239 F.2d 729 (9th Cir. 1956); Snitzer v. Commissioner, 183 F.2d 70 (9th Cir. 1950); Post Corp. v United States, 640 F.2d 1296 (Cl. Ct. 1981); Georgia Pacific Corp. v. Commissioner, 63 T.C. 790 (1975); J.A. Maurer v. Commissioner, 30 T.C. 1273 (1958); Kadlec v. Commissioner, T.C. Memo 1996-119; Deja Vu, Inc. v. Commissioner, T.C. Memo. 1995-234; Ginsburg v. Commissioner, T.C. Memo. 1992-372; LDS, Inc. v. Commissioner, T.C. Memo. 1986-293; Inductotherm Industries, Inc. v. Commissioner, T.C. Memo. 1984-281; McHenry v. Commissioner, T.C. Memo. 1978-300.

the underlying theme in determining the outcome in Georgia-Pacific was the intent of the parties, and in the present case, the intent of the parties is best evidenced by their treatment of the advances as debt until the time the Service proposed an adjustment pursuant to Treas. Reg. § 1.482-2(a)(i).

Notice 94-47, 1994-1 C.B.357, is irrelevant to the present analysis. The Notice did not address the Commissioner's position regarding taxpayers who take inconsistent tax reporting positions by disavowing the character (debt or equity) that was initially adopted in their related party advances. The Notice's principal purpose was to inform the public that the Commissioner intends to scrutinize instruments that have been categorized as debt for tax purposes, but treated as equity for regulatory, rating agency, or financial accounting purposes. In this respect, the Notice discussed the (1) traditional debt versus equity analysis, (2) instruments that are payable in stock and (3) treatment of instruments with extended maturities in light of Monon Railroad v. Commissioner, 55 T.C. 345 (1970).

In response to the case law cited by B in support of its contention that debt versus equity disputes are resolved based on the substance of a transaction, it should be noted that those cases did not involve taxpayers who were attempting to disavow their tax return position. The taxpayers therein maintained a consistent tax position regarding the form and substance of the transaction, and argued that both the form and substance of the advances were debt in order to claim either a bad debt or interest expense deduction. It was the Commissioner who challenged the claimed deductions on the grounds that the substance of the advances were not bona fide debt, but rather equity. Consequently, B's cases do not support the proposition that the traditional debt versus equity analysis should trump other relevant judicial principles reflective of the heightened standard of proof.

**CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:**

Please consider that cases of this nature always involve a weighing of all facts and circumstances, and that a court may be more inclined to find that a taxpayer has met its heightened standard of proof upon disavowing the form of its transaction if the debt versus equity considerations overwhelmingly favor the taxpayer, particularly in light of the language of Treas. Reg. § 1.482-2(a)(3), which arguably could be read to require a substance analysis only under section 482. *See* Tobin v. Commissioner; Inductotherm Industries, Inc. v. Commissioner. Notwithstanding the fact that there is considerable evidence and judicial support to subject the taxpayer to a heightened standard of proof upon the Commissioner's proposed allocation of interest, consideration of going forward with the adjustment should also include the overall strengths and weaknesses of the case in terms of the traditional debt versus equity approach.

If you have any further questions, please call (202) 874-1490.

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