OFFICE OF
CHIEF COUNSEL

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

March 30, 1999

CC:INTL:BR2
TL-N-3564-98
UILC:482.03-04
1442.04-00

Number: **199926018**
Release Date: 7/2/1999

INTERNAL REVENUE SERVICE
NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR:

FROM:

SUBJECT:

This memorandum responds to your request for Field Service Advice dated October 6, 1998, on the above-captioned case. 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 =
B =
C =
P =
D =
X =
Z =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 10 =
Date 11 =

Date 12	=
Date 14	=
Date 15	=
Date 16	=
$a	=
$b	=
$c	=
$d	=
$e	=
$f	=
$g	=
$h	=

ISSUE(S):

Issue 1. Whether A is liable for the withholding tax under section 1442 with respect to any deemed payment(s) that result from the allocation of interest under section 482 from A, a domestic corporation, to its foreign parent, P, for Date 12 through Date 16.

Issue 2. In the alternative, for Date 14 or Date 14 and Date 15, whether A is liable for the withholding tax under section 1442 with respect to a constructive payment of interest pursuant to B's transfer of C stock to D and corresponding reductions of A's indebtedness to P.

CONCLUSION:

With respect to issue 1, we are unable to determine whether any allocation of interest under section 482 from A to P is appropriate. If such allocations are appropriate, as described below, the withholding tax liability under section 1442 may arise in connection therewith and A is liable for such tax under section 1461.

With respect to issue 2, assuming that there was no constructive payment of interest subject to withholding by virtue of a section 482 adjustment, we conclude that there may be a constructive payment of interest subject to withholding under section 1442 when A's indebtedness was canceled by P as characterized below and that A is liable for such tax under section 1461. Further, to the extent, if any, it is determined that there is a constructive U.S. source dividend from D (or any other corporation in the chain) to a foreign corporation (and the dividend is not effectively connected with a U.S. trade or business), the dividend may be subject to the 30 percent withholding tax under sections 881 and 1442 and D or another applicable corporation would be liable for the tax under section 1461.

FACTS:

A is a domestic corporation that is 100% owned by P, a corporation incorporated in Country Z. P is in turn indirectly owned by a unnamed Country X corporation (U). A owns 100% of B, a domestic corporation, and B owned 50% of C, a domestic corporation. A and B file a consolidated U.S. income tax return. U indirectly owns an unknown percentage of D, a domestic company. During the relevant periods, neither P nor U were engaged in a United States trade or business.

During the years at issue, A characterized itself as an investment holding company. From Date 1, through Date 2, P loaned $a to A. On Date 2, A accrued $e of interest payable to P. From sometime in Date 3, through Date 4, P loaned an additional $c to A. From Date 5 through Date 6, P loaned an additional $d to A. Beginning with date 3, A did not accrue any interest. Further, it is not known whether A took a deduction for the corresponding interest expense.

A has indicated that there were no notes representing the advances, but A reported these advances as loans on its Forms 1120 as well as on its Forms 5472.

On an unknown date, A loaned $f to B. B used the $f to acquire the 50% interest in C. A loaned an additional $g to B, which B then loaned to C.

During the taxable year ended Date 6, B transferred its interest in C to D. When the stock of C was transferred to D, P reduced A's indebtedness to it by $f. A booked this transaction on Date 10. A indicates that the debt to U was also reduced. P reduced A's indebtedness by an additional $g when D was substituted for A as the debtor for $g of the outstanding loans. This subsequent transaction was booked on Date 11.

The $f and $g loan reductions were reflected on A's Forms 1120 and 5472. The $f loan reduction was shown as a reduction in loans from shareholders on A's Form 1120 for the taxable year ended Date 6; and the $g loan reduction was reflected in the same manner on A's Form 1120 for the taxable year ended Date 7.

It is not currently known what particular events generated A's indebtedness to its parent, when the indebtedness was generated, the terms of the indebtedness, and the rate of interest accrued on Date 2.

LAW AND ANALYSIS:

Issue 1. Whether A is liable for the withholding tax under section 1442 with respect to any deemed payment(s) that result from the allocation of interest under section 482 from A, a domestic corporation, to its foreign parent, P, for Date 12 through Date 16.

Initially, we note that if the interest accrued on advances on Date 2 is determined to be at an arms length rate within the meaning of Treas. Reg. § 1.482-2(a)(2) and the advances provide for payment of interest at maturity, it is possible that no section 482 adjustment would be appropriate. Section 267(a)(3) puts the taxpayer on a cash basis with respect to this interest owed to P, so that even if its liability for interest properly were accrued for accounting purposes, no tax deduction for the interest would be allowable prior to its actual, constructive, or deemed payment. Because no documentation has thus far been produced, the balance of this memorandum assumes that no such documentation exists, and that a section 482 adjustment is appropriate for the period here in issue under the general rule set forth in Treas. Reg. § 1.482-2(a)(1).

In general, section 881 of the Code imposes a tax of 30 percent of the amount received from sources within the United States by a foreign corporation as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income ("FDAP"), but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.

The mechanism for collecting the tax imposed by section 881 is provided in sections 1441 and 1442. Section 1442 provides that, in the case of foreign corporations, there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in section 1441 a tax equal to 30 percent thereof. Section 1441 states, in part, that all persons, in whatever capacity acting, having control, receipt, custody, disposal, or payment of any items of income specified in [section 871] of any nonresident alien individual or of any foreign partnership shall deduct and withhold from such items a tax equal to 30 percent thereof. However, an applicable income tax treaty may reduce the rate of withholding or exempt amounts from withholding; *see* section 894, Treas. Reg. § 1.1441-6. The United States does not have a treaty with Country Z.

Section 1461 provides, in part, that every person required to deduct and withhold any tax under sections 1441 and 1442 is liable for such tax and is indemnified against the claims and demands of any person for the amount of any payments made in accordance with sections 1441 and 1442.

In the case of below-market or no interest loans between a corporation and its shareholder, sections 482 and 7872 are the two sections that could apply to impute interest income to the lender. Section 7872 provides that in the case of certain below-market gift loans or demand loans, the foregone interest is treated as transferred from the lender to the borrower and retransferred from the borrower back to the lender as interest. The transfer and retransfer are deemed to take place on the last day the calendar year in which the transaction occurred. Section 7872(c), which lists six categories of below-market loans to which the provision applies, includes corporation-shareholder loans. Corporation-shareholder loans are defined as "any below-market loans directly or indirectly between a corporation and any shareholder of such corporation." Section 7872(c)(1)(C).

Treas. Reg. § 1.7872-5T(b) lists below-market loans that are exempt from section 7872. Specifically, Treas. Reg. § 1.7872-5T(b)(10) exempts from section 7872 loans made to or from a foreign person that meet the requirements of Treas. Reg. § 1.7872-5T(c)(2). That regulation provides that section 7872 shall not apply to a below-market loan if the lender is a foreign person and the borrower is a U.S. person unless the interest income imputed to the foreign lender (without regard to this paragraph) would be effectively connected with the conduct of a U.S. trade or business within the meaning of section 864(c) and the regulations thereunder and not exempt from U.S. income taxation under an applicable income tax treaty.

Accordingly, because P and U have no U.S. trade or business to which the interest income would be effectively connected, section 7872 would not apply in this case to impute interest.[1] However, regardless of whether interest can be imputed under section 7872, interest can be imputed on certain loans that do not bear interest at a market rate under section 482.

Section 482 authorizes the Secretary of the Treasury to allocate gross income, deductions, credits, or allowances between controlled entities if he determines that such an allocation is necessary to prevent evasion of taxes or clearly to reflect the incomes of the controlled enterprises.[2] The purpose of section 482 is to prevent the artificial shifting of the true net incomes of controlled taxpayers by placing such taxpayers on a parity with uncontrolled, unrelated taxpayers. Commissioner v. First Security Bank, 405 U.S. 394, 400 (1972).

The Service has in the past argued that for purposes of implementing section 482, it is necessary and appropriate to treat a controlled entity as liable for sections 1441 and 1442 withholding taxes in respect of a constructive section 482 allocation of United States source FDAP to a foreign person. *See*, *e.g.*, R.T. French Co. v. Commissioner, 60 T.C. 836 (1973). In that case, a domestic brother corporation allowed its foreign sister corporations to use, without charge, certain intangibles. The Service imputed an arm's

---

1 Treas. Reg. § 1.7872-5T(a)(2) provides a possible alternative argument under which the loans at issue may be subject to section 7872. This regulation provides that transactions will not be exempt under Treas. Reg. § 1.7872-5T(b) if one of the principal purposes of structuring the transaction is the avoidance of Federal tax. The facts in the present case are not sufficiently developed to make this determination.

2 Section 482 provides in pertinent part as follows:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

length charge and reallocated approximately $19,000 in income from the foreign corporations to their domestic sibling under section 482. The Service also asserted that a $19,000 constructive dividend had been paid by the domestic brother corporation to the common foreign parent corporation, and sought to impose a withholding tax on this collateral adjustment (the deemed dividend distribution). However, the court determined that no constructive dividend had been paid to the common parent. Thus, it did not reach the question whether such a deemed or constructive payment would trigger section 1442 withholding liability.

Rev. Rul.82-80, 1982-1 C.B., modified, Rev. Proc. 91-23, 1991-1 C.B. 534, modified, Rev. Proc. 96-14, 1996-1 C.B. 626, in which the Service discussed the application of Rev. Proc. 65-17, 1965-1 C.B. 833,[3] to transactions involving a United States subsidiary and its foreign parent, also indicates the Service's position that a constructive, collateral adjustment required under section 482 may give rise to a section 1442 withholding tax liability.

Rev. Rul. 82-80 addresses a United States subsidiary whose taxable income was increased because of an allocation under section 482. The rulings states that if Rev. Proc. 65-17 treatment is granted, the original transaction will be treated, for tax purposes, as if the correct amount, as determined under section 482, had been paid. Thus, the ruling states, if a United States subsidiary pays more than arm's length consideration for services performed by its foreign parent, the parent corporation will not be considered to have received a dividend to the extent of the greater-than-arm's length amount, and the withholding tax provisions of section 1442 will be applied to the deemed flow of funds necessary to account for the amounts the foreign parent had, but should not have received, as payments for services.

---

[3] Rev. Proc. 65-17 describes the position of the Service, and the procedures to be followed, in cases in which a United States taxpayer, whose taxable income has been increased for a taxable year by reason of an allocation under section 482, requests permission to receive payment from, or to, which the allocation of income, or deductions, was made of an amount equal to a part or all of the amount allocated, without further income tax consequences. Note that the Service has proposed to update Rev. Proc. 65-17, and supercede Rev. Rul. 82-80, for future years. Announcement 99-1, 1999-2 I.R.B. 41.

The necessary and clear implication of Rev. Rul. 82-80 is that absent Rev. Proc. 65-17 treatment, a withholding tax liability under section 1442 would have arisen in connection with the deemed flow of funds from the United States subsidiary to its foreign parent, and that the tax imposed under section 1442 on such deemed payment would be collectible from the United States subsidiary, the withholding agent, under methods appropriate to that section. If a withholding obligation is deemed to arise under these circumstances (correlative or consequential adjustments arising in connection with section 482 allocations), it would appear certain that such obligations also should be treated as arising in connection with a primary adjustment under section 482 (*i.e.*, the allocation itself).

The precise issue of whether a section 482 allocation of U.S. source FDAP to a foreign entity is subject to section 1442 withholding has not been addressed by a court. There is, however, case law to support such an approach.

Interest imputed to a foreign related entity under section 7872 is subject to withholding. Climaco and Nakamura v. Internal Revenue Service, 96-1 USTC ¶ 50,153 (E.D.N.Y. 1996) (unpublished opinion, Jan. 24, 1996). In Climaco, one plaintiff was a shareholder of a foreign corporation who received a no-interest loan from the corporation; he used the no-interest loan to purchase a United States residence, apparently for himself and his wife (who appears to be the second named plaintiff in the case). Plaintiffs reported the imputed interest payments foregone by the foreign corporation on the loan pursuant to section 7872, and claimed a corresponding deduction for those payments. The plaintiffs also filed annual withholding tax returns pursuant to section 1442. Subsequently, however, the plaintiffs sought to have such withholding taxes refunded, asserting that in the absence of actual interest payments to a foreign payee, withholding was not required.

The District Court held that plaintiffs were required to withhold and pay a portion of the imputed interest under section 7872 despite the fact that the plaintiffs did not actually make any interest payments on their loan. The court could discern no reason why plaintiffs should not, on these facts, be required to make withholding payments. Had the foreign corporation lent money at the market rate, the court reasoned, the plaintiffs clearly would have been required to withhold at the appropriate rate on the stated interest under section 1442. To hold otherwise, the court reasoned, would mean that the foreign corporation, by structuring the transaction as an interest-free loan, could avoid payment of the tax altogether. In addition, the court found persuasive the Government's reliance on Casa de Jolla Park, Inc. v. Commissioner, 94, T.C. 384 (1990) and Central de Gas de Chihuahua v. Commissioner, 102 T.C. 515 (1994).

Casa de la Jolla addressed the following fact pattern. Petitioner, a domestic corporation, was organized by Marshall, a nonresident alien and citizen of Canada, to market condominium time-share units in a La Jolla (California) property. BankCal, a domestic (California) bank, collected the proceeds of condominium unit sales for petitioner. Marshall, petitioner's sole shareholder and director, held an interest-bearing promissory note from the petitioner.

Royal, a Canadian bank, had made substantial loans to Marshall, some in connection with the earlier acquisition and development of that property by a second domestic corporation wholly-owned by Marshall. As collateral for such loans, Royal held both Marshall's stock in the petitioner and his shares in another (Canadian) corporation, Blake Resources.[4]

When Blake Resources entered the Canadian equivalent of Chapter 11 bankruptcy proceedings, Royal sought further assurances of collection of Marshall's debts. Accordingly, Marshall, as sole shareholder and director of the petitioner, authorized BankCal to remit to Royal directly the proceeds from the sales of petitioner's time-share units that otherwise were due and payable to the petitioner. Royal immediately applied the payments it received pursuant to these arrangements to Marshall's personal loan accounts.

At issue was whether petitioner was responsible under section 1441 for withholding tax on Marshall's interest income.[5] Petitioner contended that it never possessed or controlled Marshall's interest income. Petitioner also argued that Marshall had never "received" any income from which petitioner could withhold. Respondent, in turn, contended that Marshall had *constructively* received the

---

[4] Additional collateral held by the bank is not described.

[5] Also at issue was whether such interest income was effectively connected with a United States trade or business, and so exempt from section 1441 withholding. The latter issue, resolved in the government's favor, is not discussed herein.

interest income, because pursuant to petitioner's instructions, the monthly net proceeds from condominium sales otherwise payable to it were applied to Royal's outstanding loans to Marshall. Respondent also argued that petitioner had control of the time-share proceeds from which withholdings could have been made.

The Tax Court concluded that petitioner did have control over funds from which withholding could be made. The court also rejected petitioner's contention that withholding responsibility under section 1441(a) requires *actual* payment and receipt, noting that "payment" is merely one of several terms (control, receipt, *etc.*) that are described in section 1441(a) in the disjunctive. Moreover, the court found that the doctrine of constructive receipt applies "*for purposes of section 1441.*" (Emphasis supplied.) This language may be read to support the view that whenever a payment of United States-source FDAP is constructively received by a foreign person, there is necessarily a corresponding deemed *payment* of the amount that may trigger withholding tax liability under section 1441(a).

Central de Gas de Chihuahua addressed the following fact pattern. Central, a foreign (Mexican) corporation, processed, transported, and distributed liquified natural gas throughout Mexico. Central rented a fleet of tractors and trailers to Hidro, a sister corporation (also Mexican), but did not receive any rental payments. The fleet was used to transport gas products within the United States and in Mexico. As here relevant, the Service imputed to Central the fair rental value of Hidro's use of the fleet, arguing that such income was taxable in its hands under section 881.

In responding to this argument, the taxpayer contended in part that in order for section 881(a) to apply, there must be an actual payment of the income item and that the allocation of rent to petitioner from Hidro under section 482 does not satisfy that requirement. The Service, in response, cited Casa de la Jolla Park for the proposition that there is no requirement of actual payment under section 881, and that the allocation of rent to petitioner under section 482 provides a sufficient basis for imposing the 30-percent tax under section 881.

The Tax Court held that an allocation under section 482 results in a deemed payment that constitutes "an amount received" under section 881. The court found that there is no requirement of actual payment under section 881 and that the allocation of rent to petitioner under section 482 provides a sufficient basis for imposing the 30 percent tax under that section.

The court in Central de Gas de Chihuahua expressly did not reach the issue of whether actual payment is required for withholding under sections 1441 and 1442. The court distinguished between section 881, which it found imposes a liability for tax, and sections 1441 and 1442, which provide the method for collecting that tax, commenting that the former section and the latter section serve distinctly separate purposes. However, the case is nonetheless support for imputing interest under section 482 and subjecting such interest to withholding. Because the case holds that a section 482 allocation amount is deemed to be received by the foreign entity, it follows that withholding is the collection mechanism for the section 881 tax liability. In our view, to separate the tax liability from the collection mechanism for the tax would render ineffective the triggering of the section 881 liability. The Tax Court touched on this concern when it observed that "[a] holding that actual payment is required could significantly undermine the effectiveness of section 482 where foreign corporations are involved. Such a view would permit such corporations to utilize property in the United States without payment for such use and thereby avoid any liability under section 881." Id., at 520. Similarly, Rev. Rul. 92-85, 1992-2 C.B. 69, holds that deemed dividend distributions under section 304(b)(2) by domestic acquiring or domestic acquired/issuing corporations to foreign controlling corporations give rise to tax under section 881(a)(1), and that the acquiring corporation (whether foreign or domestic) is responsible for withholding under section 1442 with respect of such deemed dividends.

Finally, we note that recently-issued final regulations under section 1441 (Treas. Reg. §1.1441-2(e)(2)) specifically provide that an allocation of income subject to withholding under section 482, as well as income arising as a result of a secondary adjustment made in conjunction with a reallocation of income from a foreign person to a related U.S. person, is subject to withholding under section 1441. While this regulation is not yet effective and hence does not apply to the taxable years here in issue, based on the foregoing and on the absence of any indication in this regulation and its preamble that it was intended to reflect a change of Service position, we view the new regulation as consistent with current applicable law on this point.

Issue 2. For Date 14 or Date 14 and Date 15, whether A is liable for the withholding tax under section 1442 with respect to a constructive payment of interest pursuant to B's transfer of C stock to D and corresponding reductions of A's indebtedness to P.

A. Proper characterization of the transaction.

It appears from the facts presented to us that B may have transferred its C stock (with an assumed FMV of $f) to D, and received zero consideration on the transfer. Generally, when the earnings of one controlled corporation are transferred to another for inadequate consideration, courts have recognized the appropriateness of imposing constructive dividend income on the common shareholder. Helvering v. Gordon, 87 F.2d 663 (8th Cir. 1937); Sammons v. Commissioner, 472 F.2d 449 (5th Cir. 1972). The rationale behind assigning constructive dividend income to the controlling shareholder is that when assets or monies are transferred between brother-sister corporations for less than adequate consideration, the real beneficiary of such transaction is the common shareholder. Accordingly, it is appropriate to treat such shareholder as if it received a dividend distribution from the transferor corporation[6] that the shareholder then contributes to the transferee corporation as a capital contribution. Sammons v. Commissioner, 472 F.2d 449 (5th Cir. 1972).

However, not all transfers of funds between related corporations will result in a constructive dividend to the common shareholder. Prior to imposing constructive dividend treatment, courts have required the satisfaction of a two-prong test. First, it must be shown that the transferred funds came under the control of the common shareholder. Second, courts have inquired whether the transfer was primarily for the benefit of the transferring corporation or rather for the benefit of the shareholder. Sammons, 472 F.2d at 451. Where there is no benefit to the transferor corporation, it is reasonable to assume that the common shareholder must have been the primary beneficiary of the capital transfer. Thus, in substance, the funds are truly available to the shareholder and must be accounted for by the shareholder for income tax purposes.

---

[6] Of course this assumes sufficient accumulated earnings and profits or current earnings and profits as required by section 316.

Keeping these principles in mind, we set forth our evaluation of the subject transaction for income tax purposes. First, the transfer of the C stock by B to D appears to have generated a reduction of $f of A's debt to P, followed by an additional $f debt reduction by U of the debt owed to it by P. B's debt to A does not appear to have been reduced. Thus, the transfer primarily benefitted A, not B. As such, under the principles set forth above, B's transfer of the C stock to D may appropriately be viewed as a constructive dividend of the C stock by B to A. However, because A and B are members of a consolidated group, and intercompany dividends are eliminated between members of such groups, the dividend would not generate income on the group's consolidated return. Former Reg. § 1.1502-14(a)(1).[7] The deemed distribution should give rise to a basis adjustment in A's B stock under Treas. Reg. § 1.1502-32. (This will be relevant when A is required to recognize gain or loss on its stock interest in B, but does not appear to have any tax consequence in the taxable years in question.) Note that if the C stock has appreciated in B's hands, (i.e., if the value of the stock that B owned in C is greater than the basis of the stock that B owned in C), there may be gain recognition under section 311(b).

As a result of this first constructive distribution, we view A as the constructive owner of the C stock. In order to determine the proper characterization of the next step of the transaction, further factual development must establish whether D's assumption of $g of A's liability was an integral part of the transaction in question. The facts presented to us indicate that the taxpayer booked the transfer of the C stock and D's assumption of A's liability six months apart. However, if it can be established that the substance of the transaction was such that the assumption of the liability was made, in part, in exchange for the C stock, then the assumption of the liability by D should be characterized as partial consideration for the transfer of the C stock. It would be helpful to have information documenting when D agreed to assume A's liability, and when the assumption legally occurred, as opposed to when the parties "booked it."

If the debt assumption were an integral part of the stock transfer, then we would view A as transferring $g worth of the C stock to D in exchange for the assumption of $g of A's debt to its parent. However, when the dust

---

[7] Treas. Reg. §1.1502-14 was removed by T.D. 8597 and is generally effective for transactions prior to July 12, 1995.

settles, D owns $f of C stock. This can be explained by viewing the transaction as if A transferred the additional $h worth of the C stock ($f of stock - $g assumption of liability = $h excess value received by D) to P as repayment of the $f debt, which P distributed to U in repayment of its debt of $f, and then that C stock was contributed down through the chain to D in successive capital contributions under section 118. Finally, to the extent P released A from $f of liability in exchange for stock worth $h, the $g difference would most likely be treated as a capital contribution from U, to P, and in turn to A, under section 118.

Briefly, if further factual development indicates D's assumption of A's $g debt to P was not in consideration for D's receipt of the C stock, then the tax ramifications are slightly different. Under this scenario, A would be viewed as transferring $f of C stock to P in repayment of its debt obligation, which P in turn would be viewed as transferring to U in repayment of its debt obligation, and then that C stock would be viewed as contributed down through the ownership chain to D in successive capital contributions under section 118. D's later assumption of $g of A's debt to P would then be viewed as a constructive dividend from D up the chain to U (assuming D received no additional compensation for the debt assumption). The cancellation of the debt vis-a-vis D would be treated as a capital contribution from U, to P, to A under section 118.

In the event the constructive "payment" to P for repayment of A's indebtedness has been established after a complete factual development, we believe there is little problem with deeming a portion of that payment to be interest. Gross income includes income realized in any form, whether in money, property, or services. Treas. Reg. § 1.61-1(a). Therefore, the transfer of stock can be an interest payment. Although there has been no apparent allocation between outstanding amounts of principal and interest on the loans in issue, we believe a finding that accrued interest was constructively paid out by virtue of either of the above-described characterizations of the transfer of the C stock by B to D is compelling. Consequently, Estate of Ratliff v. Commissioner, 101 T.C. 276 (1993) would appear to support allocating a portion of the payment to interest on the debt in issue here.[8] See

---

[8] Under Treas. Reg. § 1.446-2, except in circumstances not relevant here, "each payment under a loan . . . is treated as a payment of interest to the extent of the accrued and unpaid

also Commissioner v. National Alfafa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974); Nestle Holdings, Inc. v. Commissioner, 1998 U.S. App. Lexis 18161 (2d Cir. July 31, 1998); Estate of Durkin v. Commissioner, 99 T.C. 561 (1992). Autenreith v. Commissioner, 115 F.2d 856, 858 (3d Cir. 1940); Karme v. Commissioner, 73 T.C. 1163, 1185 (1980), aff'd, 673 F.2d 1062 (9th Cir. 1982).

To the extent the release by P of A’s liability is treated as a capital contribution, Fender Sales, Inc. v. Commissioner, 338 F.2d 924 (9th Cir. 1964), rev'g T.C. Memo. 1963-119, is relevant in determining whether the conversion of indebtedness into a capital contribution to the taxpayer constituted a constructive payment of interest to its foreign shareholder lender. In Fender Sales, a corporation was indebted for accrued but unpaid salaries to two individuals. It discharged that debt by issuing additional corporate shares to these individuals. The Ninth Circuit, in reversing, found that transaction constituted a payment of salary to the individuals. Although A in this case did not issue additional stock, by analogy, the change in the economic stake in the corporation from debt to equity in light of its purported accrued interest liability is similar to the salary payment made in Fender Sales.[9]

In rejecting taxpayers' claim that their positions had not changed as a result of the transaction, the Ninth Circuit said in Fender Sales, at 928:

> We are not prepared to hold that the voluntary surrender or forgiveness of a receivable which, if collected, would represent taxable income, is, in all circumstances, a non-taxable event. We believe the authorities are opposed to such a conclusion.

---

interest[.]" The indebtedness in issue here, however, predates the regulation's effective date. See Treas. Reg. § 1.446-2(j).

[9] Fender Sales accords with the Service's continued position, reflected in Rev. Rul. 67-402, C.B. 1967-2 135, that even where proportionate ownership by the employee/shareholders is unaffected by the stock issuance, there is still a payment and income. Sections 305 and 351 were held inapplicable in that context. The interests of the shareholders were made more valuable by the increase in value of the corporation's stock as a result of the concomitant decrease in corporate indebtedness.

The Ninth Circuit's view, however, was questioned and not followed by the Tax Court in the subsequent case of Putoma Corp. v. Commissioner, 66 T.C. 652 (1976), aff'd, 601 F.2d 734 (5th Cir. 1979). Nonetheless, we believe that Putoma should not preclude the successful application of a Fender Sales theory here, where the Golsen rule would compel the Tax Court to follow the Ninth Circuit holding in Fender Sales rather than the view suggested by the Fifth Circuit's affirmation of the Tax Court in Putoma Corp. See Golsen v. Commissioner, 54 T.C. 742 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971). In addition, the reissuance of stock certificates to reflect the changed proportionate interests in the taxpayer of its foreign corporate shareholders is a distinction that the Putoma court recognized was "an important part of [the] ratio decendi" of the Ninth Circuit in Fender Sales, notwithstanding the Tax Court's own position on the matter. In this case, although new stock was not issued, it is apparently uncontested that P's economic stake in A changed from debt to equity.[10]

Further, to the extent any amounts are treated as constructive dividends from a domestic corporation to a foreign corporation and those dividends are U.S. sourced and not effectively connected with a U.S. trade or business, those dividends may be subject to the 30 percent withholding tax under sections 881(a) and 1442. For example, in the second scenario described above, if D is treated as paying a constructive dividend to a foreign corporation, that constructive dividend may be subject to a 30 percent withholding tax and D would be liable for that tax under section 1461.

B. Section 304 discussion.

Pursuant to section 304(a)(1), if one or more persons are in control of each of two corporations, and in return for property, one corporation acquires the stock of the other corporation from the controlling party, then the property paid for the stock of the first controlled corporation by the second controlled corporation is treated as a distribution in redemption of the acquiring corporation stock. Section 304(c)(1) provides that the "control" test is met if the controlling party or parties own at least 50%

---

[10] Because P was the 100% owner of A, the issuance of additional stock certificates would be unnecessary to reflect any change in equity positions resulting from the conversion of the debt to equity.

of the total combined voting power of the corporation's stock, or at least 50% of the total value of shares of all classes of its stock. Section 304(c)(3) provides that the section 318 constructive ownership rules apply, with modifications, in determining control. Under section 304(c)(3)(B), a 5% threshold test is substituted for the 50% threshold in attributing stock ownership to and from corporations under sections 318(a)(3)(C) and 318(a)(2)(C). Additionally, in applying section 318(a)(3)(C) in a case where a shareholder owns between 5 percent and 50 percent of the stock in a corporation, such corporation shall be considered as owning only a corresponding portion of the stock owned by the shareholder.

In determining whether the transaction in question is a section 304 redemption through a related corporation, the control test outlined above (as well as the requirement that property must be exchanged for the acquired company's stock[11]) must be satisfied. In this case, assuming additional factual development indicates D acquired the stock of C from A in exchange for property, it must be established that A owns (directly, indirectly, or through attribution) at least 50% of the voting power or value of both C and D.

Under our understanding of the facts, it does not appear that A owns any stock of D directly. The question arises as to whether A owns, through attribution, sufficient amounts of each corporation. An exhibit provided by A suggests that it does not own sufficient amounts of D. Accordingly, there would be no section 304 transaction.

We are aware that there is further factual development to determine the ultimate parent of D and A, as well as whether A owns, through attribution, at least 50% of the voting power or value of D. However, until these facts are established, we believe it would be premature to analyze the subject transaction from the perspective of section 304.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATION:

---

[11] If further factual development establishes that the debt assumption was not integrally related to the transfer of the B stock, it may be that D did not acquire the B stock in exchange for property as required by section 304(a)(1)(B).

Further factual development is needed with respect to the nature and timing and specific characteristics of the debt obligations at issue. In particular, [redacted]. In addition, litigation hazards exist with respect to the undecided nature of the imputation of interest under section 482 where it may have been accrued on Date 2.

With respect to the proper characterization of the transaction, in several cases, the Service has asserted the argument that a constructive dividend results to the common shareholders. The results have been mixed for the Service. Cases in which the Service have prevailed include Sparks Nugget, Inc. v. Commissioner, 433 F.2d 631 (9th Cir. 1970); Sammons v. Commissioner, 433 F.2d 728 (5th Cir. 1970); Long v. Commissioner, 93 T.C. 5 (1989); Bell v. Commissioner, T.C. Memo 1982-660. Cases in which the taxpayer has prevailed include R.T. French Company v. Commissioner, 60 T.C. 836 (1973); White Tool and Machine Company v. Commissioner, 41 T.C.M. 117 (1980), aff'd, 677 F.2d 528 (6th Cir, 1982). Generally, the Service has only been successful when it could show a direct shareholder benefit from the transfer of capital from one controlled corporation to another.

There are a number of cases that have rejected the Service's constructive dividend argument even when no benefit to the transferor corporation was established. See White Tool and Machine Company v. Commissioner and R.T. French Company v. Commissioner. These courts seem to require that the common shareholder receive a greater benefit than the mere ability to transfer the capital of one controlled corporation to another. We emphasize that these decisions are not consistent with Service position. However, where it can be shown that the transferor corporation received a material economic benefit as a result of the transfer, the Service should not assert that the common shareholder received a constructive dividend as a result of the transfer. Although it still remains the Service's position that a transfer of capital between two commonly controlled corporations should result in a constructive dividend to the common shareholder (except in those rare instances when the intercompany transfer rises to the level of a nonshareholder capital contribution under section 118), [redacted].

If you have any further questions, please call (202) 622-3840.

_

PHYLLIS E. MARCUS
Chief, Branch 2
Office of Associate Chief

Counsel

(International)