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DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR:

FROM:

SUBJECT:

This Field Service Advice responds to your memorandum dated October 18, 1999. 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

FC1 =
US1 =

Country X =

Date 1 =

Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Year 7 =
Year 8 =

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

$g =
$h =
$i =
$j =
$k =
$l =
$m =
$n =
$p =
$q =
$r =
$s =

x% =

ISSUES

(1) Whether the amounts purportedly loaned by FC1 to US1 should be respected as debt.

(2) Whether US1 is liable for withholding under § 1442 on payments made to FC1.

CONCLUSIONS

(1) The limited information available favors debt characterization. However, in order to fully analyze this evidence we would need more information on Year 1 through Year 4.

(2) Assuming that the amounts purportedly loaned by FC1 to US1 are characterized as debt, US1 is not liable for withholding under § 1442 on payments made to FC1.

FACTS

FC1 is a government owned Country X corporation that owns all of the stock of US1, a domestic corporation. US1 was incorporated on Date 1. As of the end of Year 2, FC1 had invested approximately $b in US1. From Year 1 through Year 8, FC1 loaned money to US1 at x% interest. The amounts purportedly loaned by FC1 to US1 were either loaned to or invested in unrelated parties. The chart below shows the amount of advances for each year at issue, the repayments (if any) and the balance. A portion (and in some cases a significant portion) of the repayments constituted interest. US1's tax returns for each of the years at issue reported net operating losses.

Year	Advances	Repayments	Balance
1	$a	$0.00	$a
2	$0.00	$0.00	$a
3	$f	$0.00	$h
4	$m	$0.00	$n
5	$l	$g	$r
6	$c	$j	$q
7	$i	$e	$s
8	$d	$k	$p

Note that the loan from shareholder account balance increased each year from $a in Year 1 to $r in Year 5. However, most of this increase occurred in Year 4. By Year 8, the balance was $p, which was less than the balance for Year 5 of $r and only slightly more than the balance for Year 4 of $n. Note also that in both Year 6 and Year 8, the amount of the repayments exceeded the amount borrowed.

The Field proposes to treat the advances as contributions to capital and to disallow US1's interest deductions for each of Year 5, Year 6, Year 7 and Year 8. The payments that US1 characterized as interest and principal would then be recharacterized as dividends to the extent of US1's earnings and profits. To the extent the distributions are dividends, US1 is responsible for withholding under I.R.C. § 1442.

LAW AND ANALYSIS

Debt vs. Equity

A transfer of funds from a corporation to a shareholder is considered debt, rather than equity, if at the time of the distribution the parties intended that it be repaid. Crowley v. Commissioner, 962 F.2d 1077, 1079 (1st Cir. 1992) (corporation loaned money to an individual shareholder), citing Alterman Foods, Inc. v. United States, 611 F.2d 866, 869 (Ct. Cl. 1979), (shareholder corporation loaned money to a subsidiary corporation). Courts typically determine whether the requisite intent to repay was present by examining available objective evidence of the parties' intentions, such as: the degree of corporate control enjoyed by the taxpayer; the corporate earnings and dividend history; the use of customary loan documentation, such as promissory notes, security agreements or mortgages; the creation of legal obligations attendant to customary lending transactions, such as payment of interest, repayment schedules and maturity dates; the manner of treatment accorded the distributions, as reflected in corporate records and financial statements; the existence of restrictions on the amount of the distribution; the magnitude of the distributions; the ability of the shareholder to repay; whether the corporation undertook to enforce repayment; the repayment history; and the taxpayer's disposition of the funds received from the corporation. Crowley v. Commissioner, supra. Although, unlike Crowley, this case involves a loan from the shareholder corporation to a subsidiary corporation, the analysis is the same. We discuss the relevant factors below.

Related Party Debt

The advances in this case are subject to strict scrutiny because the purported creditor (FC1) and the purported debtor (US1) are related parties (i.e., FC1 owns all of the stock of US1). See Matter of Uneco, Inc. v. United States, 532 F.2d 1204, 1207 (8th Cir. 1976) (quoting Cayuna Realty Co. v. United States, 382 F.2d 298 (Ct. Cl. 1967)) ("Advances between a parent corporation and a subsidiary or other affiliate are subject to particular scrutiny 'because the control element suggests the opportunity to contrive a fictional debt'"). See also P.M. Fin. Corp. v. Commissioner, 302 F.2d 786, 789 (3d Cir. 1962) (sole shareholder-creditor's control of corporation "will enable him to render nugatory the absolute language of any instrument of indebtedness") and Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir. 1968).

However, there must be something more than this to support the inference that the parties did not intend to treat the advances as bona fide indebtedness. See Piedmont Corp. v. Commissioner, 388 F.2d 886 (4th Cir. 1968); Liflans Corp. v. United States, 390 F.2d 965 (Ct. Cl. 1968).

Formal Indicia

Since there was no repayment schedule in the case of the transfer, there was apparently no fixed maturity date for the note. See Tyler v. Tomlinson, 414 F.2d 844, 849 (5th Cir. 1969) ("While [the notes] did contain a provision for repayment on demand, such a provision cannot be realistically considered manifesting a genuine interest in repayment in view of the financial condition of the corporation and the complete identity of shareholders and noteholders.") and Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir. 1968). Cf. Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972) (repayment of demand notes contemplated within a short time supported ultimate finding of bona fide debt); J.S. Biritz Construction Co. v. Commissioner, 387 F.2d 451, 459 (8th Cir. 1967) ("The demand feature is also one of convenience and is of limited significance in this case"). Therefore, the note is in form a demand note.

Demand notes are recognized as debt where other factors indicate debt. See J.S. Biritz, supra. In this case, the interest rate of the note was x%, a reasonable rate of interest. Therefore, this factor supports characterizing the demand note as debt. However, in the absence of a repayment history, demand notes are peculiarly subject to attack because they may evidence a casual attitude towards repayment. See Tyler v. Tomlinson, supra and Fin Hay Realty Co., supra. See also Plumb, "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 Tax Law Review 369, 418 - 419 (1971) (Plumb).

In this case, the shareholder loan balance account indicates that US1 made no payments (of either principal or interest) from Year 1 through Year 4. Nevertheless, US1 made payments of both principal and interest from Year 5 through Year 8 and the loan balance decreased from $r to $p. Further, in both Year 6 and Year 8, the repayments exceeded the amount borrowed.

Treatment By the Parties

Since "actions speak louder than words," the parties' treatment of the notes is crucial in determining whether its characterization as debt should be respected. See Yale Ave. Corp. v. Commissioner, 58 T.C. 1062 (1972). See also Waller v. United States, 78-1 USTC ¶ 9394 (D. Neb. 1978) (failure to enforce outweighs formal indicia).

On the one hand, the parties characterized these transactions on their books as debt. In addition, US1 made payments of principal and interest in Year 5 through Year 8. Moreover, the loan balance at the end of Year 8 was less than at the end of Year 5. Finally, US1's repayments in Year 6 and Year 8 exceeded the amount borrowed during each respective year. On the other hand, FC1 continued to loan money to US1 in Year 1, Year 3 and Year 4, even though US1 made no payments in those years.

Expectation of Repayment

Not only must the purported creditor expect repayment, the expectation must be reasonable. Repayments dependent on the fortunes of the business indicate equity. Dixie Dairies Corp., supra; Estate of Mixon v. United States, supra. In analyzing this factor, you should determine why US1 did not make any payments in Year 1 through Year 4. We note that, even in the absence of any payments by US1 in those years, FC1 continued to loan money to US1, increasing the loan balance from $a to $n, with most of that increase occurring in Year 4. Nevertheless, as noted above, after Year 4, US1 made payments of both principal and interest on the balance and reduced the balance from $r to $p. Moreover, in both Year 6 and

Year 8, US1's repayments during each year exceeded the amount borrowed for that year.

Withholding

Section 881(a) imposes for each taxable year a tax, except as provided in subsection (c), 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.

Section 1442(a) provides that, in the case of foreign corporations subject to taxation under this subtitle, there shall be deducted and withheld at the source in the same manner and on the same items of income as provided in § 1441 a tax equal to 30 percent thereof.

Section 1441(a) provides that, except as otherwise provided in § 1441(c), all persons in whatever capacity acting, having control or payment of any of the items of income specified in § 1441(b), to the extent that any of such items constitute gross income from sources within the United States, of nonresident aliens shall deduct and withhold from such items a tax equal to 30%. The items of income described in § 1441(b) include wages, compensation, and other fixed or determinable annual or periodical income.

Section 1461 provides in part that every person required to deduct and withhold tax under § 1442 is liable for such tax.

Treas. Reg. § 1.1441-6(a) provides, in general, that the rate of 30 percent or 14 percent shall be reduced as may be provided by a treaty with any country. In the case of dividends, the regulation provides that the withholding agent shall determine the applicable rate pursuant to the appropriate tax treaty and the regulations issued thereunder. Finally, Treas. Reg. § 1.1441-6(c) requires that in order to secure the reduced rate of, or exemption from, U.S. income tax at source in the case of interest, the recipient shall file Form 1001 (Ownership, Exemption, or Reduced Rate Certificate) with the withholding agent.

Section 894 states the provisions of this title shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer.

Consequently, the applicability of United States income tax and withholding obligations, depends upon the characterization of the payments from US1 to FC1 as interest or dividends, and the application of the provisions of the Income Tax Treaty between the United States and China, signed on April 30, 1984

(Convention). The key question is whether the payments from US1 to FC1 are principal and interest or dividends. If the payments are principal and interest, the interest payments are subject to a 30 percent withholding tax, unless that rate is modified by Article 10 of the Convention. If the payments are dividends, then they are taxable under Article 9 of the Convention at a rate of 10 percent and subject to withholding under I.R.C. § 1442 at the 10 percent rate.

The Convention, provides for the taxation of Dividends in Article 9 and Interest in Article 10.

Article 9(2) of the Convention entitled "Dividends," provides that dividends may be taxed in the Contracting State of which the company paying the dividends is a resident, and according to the laws of that Contracting State, but if the recipient is the beneficial owner of the dividends the tax so charged shall not exceed 10 percent of the gross amount of the dividends.

Article 10(2) of the Convention provides that interest may be taxed in the Contracting State in which it arises and according to the laws of that Contracting State, but if the recipient is the beneficial owner of the interest, the tax so charged shall not exceed 10 percent of the gross amount of the interest.

Article 10(3) of the Convention provides that notwithstanding the provisions of paragraph 2, interest arising in a Contracting State and derived by the government of the other Contracting State, a political subdivision or local authority thereof, the Central Bank of that other Contracting State or any financial institution wholly owned by that government, or by any resident of the other Contracting State with respect to debt-claims indirectly financed by the government of that other Contracting State, a political subdivision or local authority thereof, the Central Bank of the other Contracting State or any financial institution wholly owned by that government, shall be exempt from tax in the first-mentioned Contracting State.

The U.S. Senate Committee on Foreign Relations' explanation of the proposed income tax treaty between the US and China explains the above provision by stating that since China's economy is socialist, the effect of this treatment will be to exempt most interest paid to Chinese recipients from U.S. tax without a general reciprocal exemption. Because FC1 is wholly owned by the Chinese government, the advances can be viewed as indirectly financed by the government of China. Therefore, the interest paid by US1 to FC1 will be exempt from U.S. tax pursuant to Article 10(3) of the Convention. Consequently, if the payments are exempt from U.S. taxation, no withholding is required.

Therefore, assuming that the amounts purportedly loaned by FC1 to US1 are characterized as debt, US1 is not liable for withholding under I.R.C. § 1442 on payments it made to FC1. However, if those amounts are characterized as equity then the payments from US1 to FC1 will be dividends, subject to taxation at a 10 percent rate and also subject to withholding at the 10 percent rate under I.R.C. § 1442.

Finally, the application of the I.R.C. § 6651, failure to file penalty, the I.R.C. § 6656 failure to deposit penalty, and the I.R.C. §§ 6721, 6722 penalties for failure to file information returns and correct payee statements depend on whether the payments are properly characterized as principal and interest or dividends. If the payments are properly characterized as principal and interest and those payments are exempt from tax under the Convention, US1 will not be liable for the the I.R.C. § 6651 penalty because there was no tax due. The I.R.C. § 6656 penalty may apply if there is no Form 1001 on file with the withholding agent. The I.R.C. § 6721 and 6722 penalties would apply in the amounts of $50 per year. However, if the payments are properly characterized as dividends US1 will be liable for each of the penalties under I.R.C. §§ 6651, 6656, 6721, and 6722.

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If you have any questions, please call Robert Laudeman on (202) 622-3840.

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