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

**OFFICE OF CHIEF COUNSEL**

May 15, 2002

Number: **200235004**
Release Date: 8/30/2002
UILC: 385.01-00

CC:CORP:1
POSTF-150520-01

INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR David N. Brodsky
Associate Area Counsel, (LMSB) Area 1

FROM: Mark S. Jennings
Branch Chief, CC:CORP:1

This Chief Counsel Advice responds to your memorandum dated <none specified>. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

<u>LEGEND</u>

Corporation A =

Corporation B =

Corporation C =

Country X =

Country Y =

Year 1 =

Date 2 =

Date 3 =

Year 4 =

Date 5 =

Date 6 =

Date 7 =

Business R =

Accounting Firm =

$m =

$n =

$p =

$q =

$s =

$t =

$v =

g% =

Document =

Nominal Amount =

ISSUES

1. Whether certain advances of cash from a parent to a wholly owned subsidiary constitute debt or equity for federal income tax purposes.

2. Whether a parent is entitled to a bad debt deduction under I.R.C. Section 166 when the parent forgives a debt owed to it by one of its foreign subsidiaries.

3. Whether a parent is entitled to a worthless stock deduction under I.R.C. Section 165 on the sale of the stock of its foreign subsidiary.

4. Whether I.R.C. Section 482 may apply to the sale of a foreign subsidiary to another member of a controlled group.

CONCLUSIONS

1. On balance, we believe that the factors are heavily weighted towards characterizing the advances, evidenced by certain converted notes, as equity for federal income tax purposes.

2. A bad debt deduction is not allowed when the purported debt has the characteristics of equity, and such forgiveness would constitute a contribution to capital between related parties.

3. A worthless stock deduction is not allowed when the stock sold relates to a solvent corporation that has future value.

4. Section 482 may apply to the sale of a subsidiary within a controlled group in order to clearly reflect income.

FACTS

Corporation B, a U.S. corporation, is the wholly owned subsidiary of Corporation A, a Country Y corporation. Corporation B was acquired by Corporation A in Year 1. Corporation B, in turn, owns 100% of the stock of several foreign subsidiaries, including Corporation C, a Country X corporation. Corporation C was acquired by Corporation B during a period in which Corporation B aggressively expanded its international businesses and investments.

Corporation B and its subsidiaries, including Corporation C, engage in multiple phases of Business R. However, pursuant to the Country X constitution, foreign entities such as Corporation B are not allowed to directly own Business R facilities in Country X. At the time of Corporation B's investment in Country X, there was a belief that the Country X government was becoming more accepting of the privatization of business and that such change would result in foreign persons being able to directly own and/or operate a Business R facility. In addition, it was believed that the rate of reimbursement for Business R services would be increased. As such, Corporation B invested in Business R entities in Country X through franchise, management, and purchase option agreements that would allow Corporation B to acquire direct ownership of such entities in the event of a change in the constitution of Country X and the creation of a more favorable business environment for foreign ownership and investment. Corporation B invested in this manner in anticipation of such changes in the constitution and in the reimbursement rate. However, these expectations proved incorrect, and the venture quickly lost value.

On Date 2, Corporation B sold Corporation C (and eleven other foreign subsidiaries) to Corporation A. The sale of Corporation C was for its fair market value on Date 3, as determined by Accounting Firm in its independent valuation report. As part of the sale agreement, Corporation A required that Corporation C (and the other foreign subsidiaries) be debt-free when it was acquired by Corporation A.

Immediately prior to the sale, Corporation C owed Corporation B $m. Beginning in Year 4, Corporation B advanced money to Corporation C in the form of third party payments of obligations incurred in obtaining Business R equipment and other Business R expenses. Promissory notes (the "Notes") were issued that called for g% simple interest payable with principal at maturity. The Notes were to mature on Date 5. Prior to maturity, Corporation B converted the Notes (the “Conversion”) into two new notes (the "Converted Notes"). As such, no interest or principal payments were made on the Notes prior to the Conversion. At the time of the Conversion, the cumulative ledger balance, representing outstanding interest and principal, was equal to $n. A Corporation B Document indicates that the Conversion occurred on Date 6. Corporation C was insolvent at the time of the Conversion.[1]

There are entries in Corporation B’s books for two separate Converted Notes, one for a principal amount of $p ("Note 1") and the second for a principal amount of $q ("Note 2"). Note 1 bore a g% interest rate; Note 2 did not provide for the payment of interest. The Converted Notes provided for the payment of principal and interest on Date 7 and precluded prepayment. Further, interest was only payable to the extent of Corporation C’s annual net profits. In years in which the net profits exceeded the interest payable, the excess interest amount was carried forward to the following year. This carryforward of interest was also subject to the annual net profit limitation. Further, the Converted Notes not only provided for a contingent interest payment, but also for a contingent principal amount. Under the terms of the Converted Notes, for years in which Corporation C realized losses, the repayment amount was to be reduced until the "full amount of the principal is exhausted." The Converted Notes were subordinate to all non-subordinated debt and given preference to shareholders upon liquidation or bankruptcy. At the time of the Conversion, steps had been taken to sell Corporation C to Corporation A. As

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[1] It should be noted that we have not received sufficient information to make a determination regarding the structure of the Conversion and its related tax consequences. It appears that the Conversion may have been effectuated as an exchange under § 1001. A § 1001 transaction would require the recognition of gain or loss, and would therefore require more factual development regarding the valuation of the notes exchanged in the Conversion. However, if the Conversion was structured as a recapitalization under Section 368(a)(1)(E), the tax result would differ. As such, further investigation regarding the structure of the Conversion should be undertaken so that any impact on the Conversion or the discussion herein can be assessed.

noted above, at the time of the sale of Corporation C, the outstanding principal and interest on the Converted Notes was $m.

The sale of Corporation C was effected as follows: (1) Corporation A loaned $s (less a Nominal Amount) to Corporation C; (2) Corporation C transferred the borrowed funds to Corporation B in complete cancellation of its debt; (3) Corporation A purchased the Corporation C stock from Corporation B for a Nominal Amount. This transaction was effected by bookkeeping entries; no cash was exchanged.

Corporation B has claimed a § 165 worthless stock deduction in the amount of $t (the book value of Corporation C's common stock as of the date of the sale less a Nominal Amount) and a § 166 worthless debt deduction in the amount of $v (the $m outstanding interest and principal less the $s repayment).

## LAW AND ANALYSIS

### *Debt vs. Equity*

When attempting to ascertain the nature of advances of cash from a shareholder to a corporation, debt-versus-equity issues are resolved by comparing the "debt" to a list of common law factors developed over the years. See generally, Plumb, "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 Tax L. Rev. 369 (1971) (provides a comprehensive list of factors for consideration); see also, Fin Hay Realty v. U.S., 398 F.2d 694 (3d Cir. 1968). Factors such as the relationship of the parties, the formal indicia of the instrument, and the intent of the parties are all considered. These factors attempt to provide a framework for analyzing the facts of a situation and making a determination as to whether an instrument is bona fide debt or if it is more appropriately classified as an equity interest similar to a shareholder's interest in stock. No one factor is determinative, and each case must be evaluated based on all its facts and circumstances. Estate of Mixon v. U.S., 464 F.2d 394, 402 (5th Cir. 1972). The nature of the purported debt is redetermined on a tax year by tax year basis. That is, an instrument that was once bona fide debt does not necessarily remain bona fide debt into perpetuity.[2] Plante v. Comm'r, 168 F.3d 1279, 1281 (11th Cir. 1999).

*Relationship of the parties/Proportionality*

[2]Here, we focus on the nature of the Converted Notes and do not consider whether the Notes were debt or equity prior to the Conversion.

When hybrid debt[3] exists between related parties, the instrument is subject to special scrutiny. Section 385(b)(5); In re Uneco, 532 F.2d 1204,1207 (8th Cir. 1976). Generally, when the shareholders hold “debt” in proportion to their equity interests, it indicates that the instrument is equity-like. Gooding Amusement Co. v. Comm’r, 236 F.2d 159 (6th Cir. 1956), Fin Hay Realty at 698. In this case, Corporation C is a wholly owned subsidiary of Corporation B; the parties are related and the “debt” held by Corporation B is per se proportional, since Corporation B is the only shareholder. These two factors weigh against the characterization of the Converted Notes as debt.

*Formal indicia /Name of the instrument*

Facially, the Converted Notes are debt-like. They provide creditors rights to Corporation B and provide for a maturity date. However, the ‘cast’ given an instrument is not determinative of the economic substance of the instrument, especially in the case of related parties. See Fin Hay Realty at 697. The fact that the Converted Notes are not necessarily debt-like is further supported by the fact that Corporation B recorded the post-conversion “debt” on its records as “quasi-equity.”

A true debt instrument requires a debtor to have "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor’s income or the lack thereof." Gilbert v. Comm’r, 248 F.2d 399, 402 (2d Cir. 1957); see also Treas Reg. § 166-1(c). A fixed maturity date is a strong indication that an instrument is debt,[4] but is not necessarily dispositive. Huisking & Co. v. Comm’r, 4 T.C. 595, 599 (1945); Utility Trailer Mfg. Co. v. U. S., 212 F. Supp. 773, 786 (S.D. Cal. 1962). However, when the creditor extends the maturity date significantly, it weighs against characterization as debt and may indicate that the creditor is not operating as an arms length lender. Burr Oaks v. Comm’r, 43 T.C. 635, 643 (1965), aff’d, 365 F.2d 24 (7th Cir. 1966); Charter Wire v. U.S., 309 F.2d 878, 881 (7th Cir. 1962). Corporation B, through the Conversion, extended the maturity date of the Notes shortly before any payment was due. This is indicative that the instruments are equity.

Generally, debt calls for an amount of interest to be paid as compensation to the holder for the use of the money. The failure to provide for a rate of interest generally serves a shareholder interest (e.g., enhancing earnings), and not a third-

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[3] Hybrid debt is purported debt with one or more equity features.

[4] See Treas. Reg. § 385(b)(1); U.S. v. Title Guarantee & Trust Co., 133 F.2d 990, 993 (6th Cir. 1943).

party lender interest. See Plumb at 433. The Supreme Court has said, albeit in dicta, that a loan that does not provide for interest is "identical, except in name, with contributions of capital." Nat'l Carbide Corp. v. Comm'r, 336 U.S. 422, 435 fn.16 (1949); See also, Curry v. U.S., 396 F.2d 630, 633 (5th Cir. 1968). As noted above, Note 2 ($q) did not provide for the payment of interest, and although Note 1 ($p) bore a g% interest rate, interest was only payable to the extent of Corporation C's annual net profits. These facts indicate that both Note 1 and Note 2 should likely be characterized as equity.

*Intent of the parties*

Courts have often looked to the intent of the parties as manifested by their actions. When the purported creditor obtains collateral or otherwise securitizes the advanced funds, it is evidence of indebtedness. Lack of security does not necessitate a finding of equity, but it tends to suggest equity when other factors indicate debt, when the company has consistently had losses, and when an unrelated creditor would have demanded security.

Arm's length debtor relationships generally require the regular payment of interest. Contingent interest on a purported loan indicates that the "loan" is equity. Courts have found that when a corporation paid "interest" based on profits, the nature of the payments (if made) were more closely akin to dividend distributions. Bakers' Mut. Coop. Ass'n of New York, N.J. v. Comm'r, 40 B.T.A. 656, 662 (1939), aff'd, 117 F.2d 27 (3rd Cir. 1941). Corporation C's interest payments were wholly based on their profits, which indicates that the Converted Notes were equity.

There was a significant risk that no interest would be paid on the Converted Notes based on the formula provided for in the promissory notes. Moreover, there was a significant chance that the principal amount would be reduced to zero. The fact that the holder of the Converted Notes was an active participant in the downside of the corporation indicates that the interest was equity-like because true creditors are entitled to receive a sum certain irrespective of the performance of the corporate venture. Cuyura Realty Co v. U.S., 382 F.2d 298, 300 (Ct. Cl. 1967); Knollwood Memorial Gardens, 46 T.C. 764, 780-81(1966); Gooding Amusement Co. at 163; see also, Bercaw v. Comm'r, 165 F.2d 521 (4th Cir. 1948). Further, Corporation C took no measures to ameliorate this problem by, for example, establishing a sinking fund. Roth Steel Tube v. U.S., 800 F.2d 625, 631(6th Cir. 1986). The contingencies placed on the interest and principal significantly increased the risk experienced by Corporation B. These factors weigh heavily towards the characterization of the Converted Notes as equity.

*Bad Debt Deduction*

A bad debt deduction may only be taken for a bona fide debt. Treas. Reg. § 1.166-1(c). As discussed immediately above, based on an analysis of the available facts, the Converted Notes should be properly characterized as equity. Although notes were issued at the time of the Conversion, the totality of the circumstances surrounding the issuance of the Converted Notes indicate that the Converted Notes were contributions to capital rather than a bona fide debt. See, for example, Wildes v. Comm'r, T.C. Memo 1980-298, in which the court looked to the economic reality test of a bona fide debt as set forth in Fin Hay, supra, and concluded that even though the formal criteria of an obligation were met (i.e., the execution of a note payable within one year from the date of execution), the totality of the circumstances indicated that an equity investment rather than a bona fide debt existed. Thus, the Converted Notes, when properly classified as equity, could not give rise to a bad debt deduction.

In the event that the Converted Notes were found to constitute a bona fide debt, a bad debt deduction would not be available due to the shareholder relationship existing between Corporation B and Corporation C. Section 61(a)(12) provides that, except as otherwise provided, gross income means all income from whatever source derived, including income from the discharge of indebtedness. Treasury Regulation 1.61-12(a), however, provides that, in general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the debt. Corporation B, the sole shareholder of Corporation C, forgave the debt owed to it by Corporation C and received no consideration in exchange for such forgiveness. Therefore, even if the Converted Notes were classified as debt, the forgiveness of such debt would constitute a contribution to the capital of Corporation C and no bad deduction would be available.

*Worthless Stock Deduction*

Section 165(a) provides that taxpayers can deduct losses for which they are not otherwise compensated or reimbursed. No limit is placed on losses deducted by corporations, but the losses must be sustained during the taxable year and must be evidenced by a closed and completed transaction fixed by an identifiable event. Treas. Reg. § 1.165-1(a) and (b). Section 165(g)(1) provides that if any security which is a capital asset becomes worthless during the taxable year, the loss will be treated as a capital loss. However, § 165(g)(3) provides that if stock of a foreign or domestic corporation affiliated with the taxpayer becomes worthless, the loss is deductible as an ordinary loss. As a wholly owned subsidiary, Corporation C is considered affiliated with Corporation B.

Morton v. Comm'r, 38 B.T.A. 1270 (1938), set forth a worthlessness standard that is often relied upon by the courts. Essentially, a two prong test of worthlessness must be satisfied. First, the stock must cease to have liquidating value (i.e., the corporation has an excess of liabilities over assets). Second, the stock must lack potential value. In order for Corporation C to be insolvent, the Converted Notes must be considered bona fide debt. As discussed herein, the Converted Notes are not bona fide debt, and as a result, Corporation C was solvent on the date of its sale to Corporation A. In addition, Corporation C brought in substantial revenue prior to the claimed worthless stock deduction, and continued to operate as a business after its acquisition by Corporation A. Thus, the facts indicate that Corporation C was not worthless at the time of its sale to Corporation A due to its solvency and the existence of future value.

*Section 482*

In analyzing this transaction, the Field should consider whether the amount paid by Corporation A for Corporation C reflects an arm's length result as required by § 482. Section 482 gives the Service broad authority to redetermine the terms of transactions between related parties. Specifically, § 482 provides that "[i]n the 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 in indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions . . . 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."

The purpose of § 482 is to insure that taxpayers that are part of a controlled group clearly reflect income attributable to controlled transactions. The ownership structure of Corporation A, Corporation B, and Corporation C would constitute a controlled group, and as a result, the sale of Corporation C to Corporation A is a controlled transaction to which § 482 applies. See Treas. Reg. §§ 1.482-1(a)(1), -1(i)(6), and -1(i)(8). The regulations under § 482 provide that a controlled transaction is deemed to clearly reflect income if the results of the controlled transaction are consistent with the results that would have been obtained had the parties not been under common control. Treas. Reg. § 1.482-1(b)(1). Because the total consideration paid for Corporation C was considerably less than the purported indebtedness owed by Corporation C to Corporation B (and, as discussed above, properly classified as contributions to capital), this raises the question of whether the consideration paid would meet the arm's length standard.[5]

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[5] The § 482 regulations provide a variety of methods to determine the arm's length result. However, we do not have sufficient facts to determine which of the methods discussed in the regulations would be the most appropriate to apply in the instant case or what the arm's length result would be.