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Memorandum

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to: Associate Area Counsel
(Large & Mid-Size Business)
Attn:

from: George R. Johnson
General Attorney, Branch 6
(Corporate)

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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Common Parent:

Sub 1:

Sub 2

Sub 3:

Taxpayer Group:

Promoter

Foreign Bank 1:

Foreign Bank 2:

Foreign Bank 3:

Foreign Bank Affiliate

SPV 1:

SPV 2:

SPV 3:

Collection Company:

City, State:

State 1

State 2

Country X:

Country Y:

Director 1:

Director 2:

Director 3:

Observer:

Managerial Company

Individual 1:

Transactions Document 1:

Transactions Document 2:

Transactions Document 3:

Transactions Document 4:

Transactions Document 5:

Transactions Document 6:

Transactions Document 7:

Transactions Document 8:

Charter:

Date 1:

Date 2:

Date 3:

Date 4:

Date 5:

Date 6:

Date 7:

Date 8:

Date 9:

Date 10:

Date 11:

Date 12

Date 13

Date 14

Date 15

Year 1:

Year 2:

POSTF-100070-07

Year 3:

Year 4

Year 5

Year 6

Year 7

Rate 1

Rate 2

<u>a</u>:

<u>b</u>:

<u>c</u>:

<u>d</u>:

<u>e</u>:

<u>f</u>:

<u>g</u>:

<u>h</u>:

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q

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aa

ISSUES AND RECOMMENDATIONS

ISSUE 1: Whether SPV 2, as the holder of the Class A Securities, should be treated either as a creditor or as a shareholder of SPV 1.

RECOMMENDATION 1: Even though we do not recommend challenging Common Parent's position that the two instruments should be viewed as one integrated instrument, we do recommend asserting that such combined instrument (the Class A Securities) be treated in substance as constituting secured debt, at least at the time it was issued and for the tax years, herein, at issue, as the Service's *alternative/secondary* position to that set forth in Recommendations 2, 3 and 4,. We believe that recasting the transaction as merely a loan between Foreign Bank 1 and Common Parent with SPV 1's role of that of a conduit provides a more satisfactory resolution of this case and better addresses the true substance of the Transaction.

ISSUE 2: Whether the "purported" sale of A/R's to SPV 1 was a true sale or a financing arrangement (loan) between SPV 1 and Common Parent.

RECOMMENDATION 2: SPV 1 never had the burdens and benefits of owning the A/R's because the A/R's were never, in substance, sold to SPV 1. The Transaction Document 1 established a factoring arrangement in name only. Sub 1 and Sub 2, Common Parent's two subsidiaries that were involved in the purported factoring arrangement with SPV 1, never delivered, and SPV 1 never received nor possessed, the A/R's (nor the related files) the two subsidiaries allege they sold to SPV 1. Although SPV 1 was purportedly in the factoring business, Sub 1 and Sub 2 factored these A/R's themselves. At most, the documents reveal that Sub 1 and Sub 2 gave SPV 1 a security interest in, but not dominion and control of, the A/R's at issue. Since SPV 1 received neither the A/R's nor their related files from Sub 1 and Sub 2 (the alleged Sellers), SPV 1 could not and did not factor the A/R's. Thus, SPV 1's role as a factor was nothing more than a disguise, and the true nature of this transaction was a loan between SPV 1 and the Taxpayer Group, or Foreign Bank 1 and the Taxpayer Group, with the Taxpayer Group's A/R's used as security for the loan.

ISSUE 3: Whether the factoring arrangement transaction had any practical economic effects other than the creation of income tax losses for the Taxpayer Group.

RECOMMENDATION 3: The factoring arrangement transaction had no business purpose other than tax avoidance, lacked economic substance, and, in fact and substance, constitutes an economic sham for federal income tax purposes.

ISSUE 4: Whether SPV 1 functioned merely as a conduit or nominee through which funds were transferred from the lender (Foreign Bank 1) to the borrower (the Taxpayer Group).

RECOMMENDATION 4: The loan proceeds and cash paid in repayment of such loans although transmitted through SPV 1 was never the property of SPV 1 (i.e., it was not owned by SPV 1). Rather, SPV 1, to the extent it held this cash, held the cash in trust for SPV 2, a special purpose vehicle established by Foreign Bank 1. SPV 1 thus acted as a mere conduit or nominee with regard to both the transfer of loan proceeds from Foreign Bank 1/SPV 2 to the Taxpayer Group and the repayment of the loan plus interest accruing thereon from the Taxpayer Group to Foreign Bank 1. Accordingly, SPV 1's role in this transaction should be ignored and the transaction recast as merely a loan between Foreign Bank 1 and the Taxpayer Group.

EXECUTIVE SUMMARY:

Common Parent in concert with Foreign Bank 1 (a Country Y corporation), and in furtherance of a tax strategy developed and marketed by Promoter, created SPV 1, a special purpose entity (SPE) which was incorporated in Country Y. SPV 1 was formed with funds of Common Parent and Foreign Bank 1. Those funds were funneled through their respective SPEs: SPV 1 and SPV 2. In exchange for a total contribution of $a (US dollars), Common Parent received an equal number of shares of preferred stock (the Class B Equity Certificates) and shares of common stock (the Class B Voting Shares); each share of preferred stock was stapled to each share of common stock, making a combined unit (referred to herein as the Class B Securities). The value of the preferred shares vis a' vis that of the common shares was highly disproportionate (1000:1 ratio). Foreign Bank 1 in exchange for $b (US dollars) received an equal number of Class A

Equity Certificates and Class A Voting Shares; each Class A Equity Certificates was stapled to each Class A Voting Share, making a combined unit (referred to herein as the Class A Securities). The value of the Class A Equity Certificates vis a' vis the value of the Class A Voting Shares was highly disproportionate (324:1 ratio). Taxpayer (Common Parent) takes the position that the Class A Securities held by SPV 2, a SPE of Foreign Bank 1, should be treated for federal tax purposes as an equity investment in SPV 1.

With the contributed funds, SPV 1 allegedly purchased certain account receivables ("A/R's") at a discount from Common Parent's three subsidiaries and transferred/assigned most of the remaining funds to Common Parent as a loan. According to the transactional documents, SPV 1 was to purchase monthly certain A/R's from the Taxpayer Group with the monies repaid monthly to it by Common Parent on the loan, and SPV 1 was to simultaneously relend the excess of the monthly loan repayments over the monthly purchase amounts to the Taxpayer Group. In reality: (1) SPV 1's purchase of the A/R's; (2) SPV 1's collection of the loan repayments; and (3) SPV 1's relending of the excess to Common Parent, never took place other than perhaps as book entries.

Common Parent asserts that SPV 1's two business activities were factoring A/R's and lending money. The simultaneous lending and alleged purchase activities between SPV 1 and Common Parent essentially operated: (a) with regard to the monies contributed by Common Parent to SPV 1, as a circular cash flow because those funds were immediately retransferred to the Taxpayer Group as loan proceeds and/or purchase monies; and (b) with regard to the monies contributed by Foreign Bank 1 to SPV 1, as loan proceeds (some amount of which was disguised as purchase money to buy the Taxpayer Group's A/R's). SPV 1 (the purported factor) had hired the Taxpayer Group to service and collect on the A/R's *that the Taxpayer Group allegedly sold to SPV 1*.

The Taxpayer Group used the monies collected from the A/R's SPV 1 purportedly purchased to repay some portion of the loan proceeds and the accrued interest. The loan repayments occurred on the same days that SPV 1's payments were due on the purchased A/R's, thus payment offsetting payment so that essentially little or no money did or was required to change hands. If the loan repayment amounts due on each payment date were insufficient to completely offset the amounts SPV 1 owed on the purchased A/R's, a provision in the Transaction Document 6 was triggered requiring Common Parent to make a mandatory loan prepayment of the shortfall to SPV 1. Conversely, if on a payment date Common Parent's required loan repayment amount was more than SPV 1 owed on the purchased A/R's, then the excess was automatically re-loaned to Common Parent without Common Parent ever having to transfer any monies to SPV 1 and SPV 1 ever having to take any action with respect to collecting on the loan and retransmitting such money to the Taxpayer Group for the purchase of A/R's. It appears that, except for the initial infusion of cash via Common Parent's and Foreign Bank 1's contributions (which contributions simultaneously flowed through SPV

1 to Common Parent), very little of these funds ever came to rest in SPV 1. Most, if not virtually all, of the funds remained with Common Parent and/or its subsidiaries.

We conclude that, when closely examined, SPV 1 did not in affect or in substance factor the Common Parent A/R's. SPV 1 never owned the A/R's. At no time did SPV 1 ever physically possess either the A/R files or any of the funds collected on the A/R's. The funds essentially stay with the Taxpayer Group and SPV 1 appears to have received only a security interest in the A/R's and the collections therefrom. SPV 1 was not given a present possessory interest in either the A/R's or the funds collected on those A/R's.

All steps involved in the Transactions occurring pursuant to the Tax Strategy, when stepped together, closely resemble, and have many of the same characteristics as, a revolving line of credit from Foreign Bank 1 to Common Parent, with Common Parent's A/R's being used as collateral for the loan. Common Parent and its subsidiaries maintained lockboxes[1] in their own names into which they put the monies collected in servicing the A/R's they allegedly sold to SPV 1. SPV 1 would acquire dominion and control over the content of these boxes *only on the occurrence* of a Termination Event[2]. Prior to the occurrence of a Termination Event (which apparently never occurred, at least not during the years at issue here), SPV 1 held *only* a security interest[3] in both the A/R's and the contents of these lockboxes.

The purported factoring transaction permitted Common Parent to deduct on its consolidated federal tax return both the (1) losses in the aggregate amount of the discounts arising from sale of the A/R's, and (2) the interest payments the Taxpayer Group made on the loans received from SPV 1. No U.S. income tax was paid on the interest or discount income earned by SPV 1. SPV 1 did not treat its discount and interest income as attributable to a U.S. permanent establishment, nor did Common Parent withhold 30% U.S tax on the interest and discount paid to SPV 1 under §§ 881(a)(1) and 1442. Further, Common Parent did not treat SPV 1 as its controlled foreign corporation.[4]

We conclude that, when viewed in substance, the above series of transactions constituted solely lending activities – monies loaned by Foreign Bank 1 to SPV 1 for the

[1] Lockbox - A facility offered by a financial institution for quickly collecting and consolidating checks and other funds from a party's customers. Black's Law Dictionary (8th ed. 2004). Another definition of lockbox is: A service offered by banks to companies in which the company receives payments by mail to a post office box and the bank picks up the payments several times a day, deposits them into the company's account, and notifies the company of the deposit. This enables the company to put the money to work as soon as it's received. http://www.investorwords.com/2868/lockbox.html
[2] See text on pages 14-16 for a list of termination events.
[3] Pursuant to one of the several contracts executed on Date 1, Common Parent's subsidiaries agreed to perfect first priority liens in the name of SPV 1 in the contents of the lockboxes. There are a substantial number of documents in the file evidencing that the Common Parent subsidiaries did in fact affect a security interest in the name of SPV 1 in the A/R's at issue here.
[4] This memo does not address any possible withholding, U.S. trade or business, U.S. permanent establishment or treaty issues.

purpose of having SPV 1 relend those same funds to Common Parent. SPV 1's main role in this series of transactions was merely that of: (1) a lender of monies to Common Parent; or (2) a conduit through which Foreign Bank 1 passed the loan proceeds to Common Parent and SPV 1 maintained a security interest for the benefit of Foreign Bank 1 in the Taxpayer Group's A/R's.

The Service may alternatively argue that either the loans were between SPV 1 and Common Parent or they were between Foreign Bank 1 and Common Parent with SPV 1 acting merely as a conduit though with the loan proceeds passed. Either way, Common Parent is not entitled to deduct the purported losses arising from the (nonexistent) factoring transactions, but should be allowed additional interest deductions resulting from any recharacterization of these tax items reported by Common Parent.

As an alternative position to recasting the transaction as a direct loan from Foreign Bank 1 to SPV 1, we recommend the Service assert that Foreign Bank 1's interest in SPV 1 is strictly a debt interest with an equity kicker, rather than a stock interest in SPV 1. In that case, Common Parent, a U.S. corporation, would be the sole shareholder of SPV 1. SPV 1 would be a controlled foreign corporation (CFC), within the meaning of Code section 957(a) if more than 50 percent of the total combined voting power of all classes of stock of SPV 1 entitled to vote is owned by United States shareholders (U.S. shareholder), or if more than 50 percent of the total value of the stock of SPV 1 is owned by U.S. shareholders. The significance of SPV 1 being a CFC is that, under Code section 951(a), if Common Parent is its U.S. shareholder, Common Parent would be required to include in gross income a pro rata share of the subpart F income of the CFC as well as any amount determined under section 956(a) with respect to such U.S. shareholder for such year.

Before SPV 1 can be determined to be a CFC, however, there needs to be a U.S. shareholder. We believe Common Parent would be a U.S. shareholder within the meaning of Code section 951(b). A U.S. shareholder is defined, in Code section 951(b), as a U.S. person who owns or is considered as owning 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. In this case, the Class A Securities of SPV 1, which are held by Foreign Bank 1 (through SPV 2), have the authority to appoint the three persons on SPV 1's board of directors. The Class B Securities of SPV 1, which are held by Common Parent (through SPV 3), have the authority to appoint an observer to the board of directors' meetings. Implicit in the determination that the Class A securities held by Foreign Bank 1 are debt instruments rather than equity, is that Foreign Bank 1 does not have the voting power associated with a class of stock. Further, as described in detail below, the transfer of decision-making authority by two of the board members of SPV 1 to the third, who is the managing director of both SPV 2 and SPV 3, indicate that the ability of the board to make independent decisions to further the stated corporate objectives of SPV 1 was illusory. Additionally, the provisions of the Transactions documents, the series of contractual agreements entered into between Foreign Bank 1, Common Parent and SPV 1, all entered into before this arrangement went into effect, severely restrict the decision-making abilities of the Board. Specifically, the normal board decisions relevant to SPV 1 were pre-determined before any of the parties to the transaction entered into the arrangement. Thus, we believe that the control of SPV 1 by Foreign Bank 1 is nonexistent and find Common Parent to be the U.S. shareholder of SPV 1. As such, because it owns 100 percent of the value of SPV 1, through SPV 3, it will pick up 100 percent of the subpart F income and section 956(a) amount.

Once the determinations are made that Common Parent is a U.S. shareholder of SPV 1 and that SPV 1 is a CFC, the subpart F income of SPV 1 and any amount under Code section 956(a) must be determined. Initially, we believe the following items are subpart F income of SPV 1 and thus, would be includible by Common Parent. Those items are interest amounts SPV 1 receives on loans made to Common Parent and the factoring discount realized by SPV 1 on the A/R's it acquires from Common Parent. To the extent that SPV 1 has earnings and profits that have not been included in gross income by Common Parent, Common Parent must include in gross income any investment of earnings by SPV 1 in United States property (U.S. property) as determined under section 956(a).

Specifically, section 954(a) defines subpart F income to include foreign personal holding company income (FPHCI). Under section 954(c)(1)(A), FPHCI includes interest income. The interest paid by Common Parent to SPV 1 on loans it receives from SPV 1 is subpart F income within the meaning of section 954(c)(1)(A).

The factoring discount is subpart F income by virtue of section 864(d)(2)(B).[5] Under section 864(d)(1), any person that acquires a trade or service receivable from a related person is required to treat the income realized from the receivable as if it were interest on a loan to the obligor under the receivable. Trade or service receivable is defined under section 864(d)(3) as any account receivable arising out of the disposition by a related person of property described in section 1221(a)(1) (stock in trade of a taxpayer or inventory). Related person is defined in section 864(d)(4)(B) as a U.S. shareholder (as defined in section 951(b)) and any person who is a related person (within the meaning of section 267(b)) to the U.S. shareholder. Because the alternative position would recharacterize Common Parent as the sole shareholder of SPV 1, thus creating a U.S. shareholder/CFC relationship, and the A/R's acquired by SPV 1 from Common Parent arise out of the disposition by Common Parent of property described in section 1221(a)(1) (stock in trade or inventory), the factoring discount realized by SPV 1 is treated as interest under section 864(d)(1), and thus, as subpart F income that is includible in gross income by Common Parent.

In general, the amount determined under section 956 with respect to any U.S. shareholder for the taxable year is the lesser of the excess of the U.S. shareholder's pro rata share of the average of the amounts of U.S. property held by the CFC as of the

[5] For the tax years in issue, § 864(a)(2)(B) was § 864(d)(2)(C). Pursuant to the American Jobs Creation Act of 2004, that section was redesignated as § 864(d)(2)(B) for tax years of the foreign corporation beginning after December 31, 2004.

close of each quarter of the taxable year, over the earnings and profits (E&P) described in section 959(c)(1)(A) of the CFC, or the shareholder's pro rata share of the applicable earnings of the CFC. Section 956(c)(1)(C) defines U.S. property to include an obligation of a related United States person. Section 965(c)(3) defines U.S. property to include certain trade or service receivables acquired from a related U.S. person.

In this case, SPV 1 loaned amounts to Common Parent, a related U.S. person. An obligation of a related U.S. person is a type of U.S. property described in section 956(c)(1)(C). Additionally, because the A/R's are acquired by SPV 1 directly from Common Parent, a related U.S. person, to the extent the obligors of the A/R's sold by Common Parent to SPV 1 are themselves U.S. persons, the A/R's are U.S. property as described in section 956(c)(3). After applying the formula set forth in section 956(a), Common Parent may have an inclusion in gross income under section 951(a)(1)(B) related to SPV 1's investments in U.S. property.

The Taxpayer Group contends that Foreign Bank 1's involvement in SPV 1 is that of a majority shareholder. If their position is correct, SPV 1 is not a controlled foreign corporation because Common Parent does not own more than 50 percent of the vote or value of SPV 1. Therefore, section 267 would not prevent Common Parent from reporting the loss on the sale of the A/R's to SPV 1 in the amount of the factoring discount.

Recharacterizing the Class A Securities as debt instruments, however, would effectively deny Common Parent's deduction for the factoring discount through the use of section 267. Such a re-characterization would result in SPV 3 being SPV 1's sole shareholder and thus the Common Parent being indirectly SPV 1's sole U.S. shareholder, as a result of Common Parent owning most of SPV 3. SPV 3 would then be treated as a partnership for federal tax purposes. The Taxpayer Group would thus be recognized as owning approximately 99.7% of the partnership interest in SPV 3 with SPV 1 owning the other approximately .3%. Common Parent would therefore be treated as (indirectly) owning 100% of the voting stock of and value in SPV 1.

We believe that recasting the transaction as merely a loan between Foreign Bank 1 and Common Parent with SPV 1's role of that of a conduit (instead of treating this as a real lending transaction between SPV 1 and Common Parent) provides the correct and most satisfactory resolution of this case. Recharacterizing the transaction in this way more accurately captures the true substance of this transaction. Such a recast would serve to eliminate any Section 267 issue, because under that recast no sale of A/R's between Common Parent and SPV 1 would be considered to have taken place and, therefore, Common Parent would not have realized any loss on a purported sale of the receivables.

FACTS

Parties to the Transactions.

Common Parent is the common parent of the Taxpayer Group, a domestic consolidated group filing Forms 1120. Common Parent, is headquartered in City, State 1. The consolidated group generally reports over $l in gross receipts and includes over m entities.

The group offers a wide variety of and services. Common Parent, Sub 1, Sub 2 and Sub 3, are the members of the Taxpayer Group involved in one or more of the transactions (the "Transactions") discussed in this memo. Common Parent, Sub 1, Sub 1 and Sub 3 are collectively referred to herein as the "Taxpayer Group" and at times simply as "Common Parent." Exam is currently auditing the taxpayers' fiscal tax years ended June 30, Year 1, June 30, Year 2 and June 30, Year 3.

Foreign Bank 1, Foreign Bank 2 (Foreign Bank 1's subsidiary), and SPV 2 (Foreign Bank 2's subsidiary) are corporations organized under the laws of a foreign jurisdiction. Foreign Bank 1 and Foreign Bank 2 are collectively referred to herein as the "Foreign Banks." SPV 2, a special purpose vehicle of the Foreign Banks, was formed to hold Foreign Bank 1's interest in SPV 1 in order to provide Foreign Bank 1 with a vehicle for participating in the Transactions. Foreign Bank 1, Foreign Bank 2 and SPV 2 are collectively referred to be hereinafter as the "Foreign Bank 1 Group." SPV 2 is sometimes hereinafter to be referred to in its capacity of: "the Holder of the Class A ECs," "the Holder of the Class A Shares," or "the Holder of the Class A Securities[6]." No member of the Foreign Bank 1 Group is related to Common Parent or any of its subsidiaries.

Two other corporations involved in the Transactions are SPV 1 and its wholly owned U.S. subsidiary, Collection Company. Both corporations have a central role in the Transactions and therefore are discussed in greater detail below.

SPV 1

SPV 1, a *societe anonyme*, was organized under the laws of Country Y on or around Date 14. SPV 1 was purportedly formed to engage in 2 businesses: factoring and lending. SPV 1's stated corporate objectives are: (a) to obtain, own and dispose of shares in, interests in, loans to and receivables originated by other corporations, partnerships or any other enterprises; and (b) to manage other corporations, partnerships or any other enterprises and to render services thereto.[7] Although broad, SPV 1's activities in furtherance of these purported corporate objectives are severely limited by the Date 1, resolutions of SPV 1's board of directors and by the provisions of

[6] For purposes of this memo, Class A Securities consist of the Class A Equity Certificates ("Class A ECs") and the Class A Voting Common Shares ("Class A Shares"), the latter two instruments are stapled together and must be transferred together.
[7] SPV 1's Charter Date 8, Article 2.

the Transaction Documents. As limited, SPV 1 may only (1) make loans to the Taxpayer Group, (2) purchase A/R's from the Taxpayer Group, (3) own shares in the Collection Company, (4) sell Defaulted A/R's to the Collection Company, and (5) make Permitted Investments[8].

SPV 1's asset base is limited by the Transaction Documents to: (1) A/R's it purchases from the Taxpayer Group; (2) intercompany loans it makes to the Taxpayer Group; (3) a limited amount of high-quality, highly-rated financial security assets; and (4) the stock of Collection Company, its wholly-owned subsidiary, to which it sells Defaulted A/R's.

SPV 2, by virtue of it holding the Class A Securities, has the authority to appoint, and has, in fact, appointed, all 3 of the directors to SPV 1's board. SPV 3, as holder of the Class B Securities, has the authority to appoint, and has, in fact, appointed, Observer[9] as an observer to the board of directors' meetings. The members of SPV 1's board of directors are Director 1[10], Director 2 and Director 3.[11]

Meeting for the first time on Date 1, the board of directors gave Director 1 full authority to act on their behalf and to sign all documents governing the Transactions, including making any changes to those documents which are agreeable to him. Shortly after the first board meeting, Director 2 gave full authority to Director 1 to represent him with regard to "acting in [his] capacity as designate Director of [SPV 1] in all and any transactions and/or matters, with regard to the transactions involving the Company, including the authority to, without limitation, execute contracts and/or agreements and/or all other documents however referred to, and perform (legal) acts necessary or desirable for purposes of representing Director 2."[12]

SPV 1 has no employees or officers. Transactional Documents indicate that its headquarters is in the Managerial Company's office in Country Y. SPV 1 does not perform any active management or operational duties.

Managerial Company purports to act as SPV 1's management and operational employee. On Date 1, SPV 1 entered into the following two Service Agreements with Managerial Company: (1) an administrative service agreement with an attached document entitled "Transaction Document 7," and (2) a management service agreement with an attached document entitled "Transaction Document 8."[13] These Agreements set

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[8] Permitted Investments means cash and cash equivalent investments, not to exceed in the aggregate at any time US $aa. Cash equivalent investments are high grade, low risk, and short-term investments. See Transaction Document 3, § 1, Definitions.
[9] Observer is Sub 1's Vice President of Taxes.
[10] Director 1 is also a director of SPV 2, the managing director of SPV 3, and the Vice-President of Foreign Bank 3 (another subsidiary of Foreign Bank 1).
[11] Director 3 is also a director of Managerial Company, which was hired by SPV 1 to provide managerial and operational services to SPV 1.
[12] Power of Attorney, dated Date 9, signed by Director 2.
[13] See Services Agreement between SPV 1 and Managerial Company with the attached Transaction Document 7 and the Management Agreement between SPV 1, Foreign Bank 2 and Managerial Company with the attached Transaction Document 8.

forth the following managerial and administrative services that SPV 1 hired Managerial Company to perform on SPV 1's behalf: (1) act as SPV 1's company director; (2) attend SPV 1's board of directors meetings and record the minutes of such meetings; (3) perform SPV 1's banking arrangements and sign checks on, withdraw and transfer funds from, and make deposits in SPV 1's bank accounts; (4) maintain SPV 1's books and financial records; (5) prepare SPV 1's annual accounts; (6) maintain all books required by law to provide a full record of all transactions undertaken by SPV 1; (7) monitor A/R data that Common Parent sends to SPV 1; (8) monitor A/R concentration limitations (e.g., to ensure that SPV 1 purchases only those A/R's with a low probability of default); (9) monitor A/R default triggers; (10) calculate new loan balances of the Taxpayer Group; (11) determine new, past-due A/R's; (12) calculate interest income on loans due from the Taxpayer Group; (13) determine if payment of yield on the Class B ECs is triggered; (14) pay SPV 1's operating expenses; (15) make quarterly distributions to the holders of the Class A ECs; (16) determine when distributions must be made to the holders of the Class B ECs; (17) inform SPV 1's board of directors of any Defaulted A/R's contributed by the Taxpayer Group to Collection Company, and (18) prepare SPV 1's tax returns.

SPV 1 purports to generate its earnings from a margin charged on the loans made to the Taxpayer Group and from factoring the A/R's it purchases from the Taxpayer Group. With regard to the factoring, SPV 1 purports that its earnings from factoring are based upon the difference between the face amount of each A/R and its purchase price (this difference is purported to constitute a discount fee charged for factoring the A/R's). SPV 1 filed a protective Form 1120-F, which included a Form 8833, Treaty Based Return Position Disclosure, which stated the following:

> SPV 1 qualifies for the portfolio obligation exemption with respect to any interest income it earns, and is not engaged in a U.S. trade of business. Notwithstanding the above, if SPV 1 were subject to U.S. taxation, under either section 881 or 882, it would be entitled to treaty relief, pursuant to articles 5, 7, and 12 of the U.S. – Country Y treaty.[14]

<u>Collection Corporation</u>.

Collection Corporation was organized under the laws of Delaware on or around Date 4. SPV 1 transferred to Collections $<u>n</u> cash in exchange for <u>m</u> shares of Collection Company's common stock. Collection Company purports to engage in the factoring of Defaulted A/R's purchased from SPV 1. Its two main corporate objectives are: (1) to purchase Defaulted A/R's from SPV 1 at a discount, Collection Company may borrow from SPV 1 to fund these purchases of defaulted A/R's; and (2) to engage in any activity or to exercise any power permitted to corporations under the laws of Delaware that are

[14] See footnote 4, supra.

incidental to, or connected with, the purchase of the Defaulted A/R's.[15] Foreign Bank 1 appointees serve as the directors of Collection Corporation.

SPV 1's Capital Structure.

SPV 1 was formed by (1) SPV 2 contributing $c and $d to SPV 1 in exchange for g Class A Equity Certificates[16] (par value $j/certificate) and g Class A Voting Common Shares[17] (par value $k/share), respectively; and (2) SPV 3 (a special purpose vehicle formed by the members of Taxpayer Group) contributing $e and $f to SPV 1 in exchange for h Class B ECs (par value $o/certificate) and h Class B Voting Common Shares[18] (par value $k/share), respectively. Later, on or about Date 2, SPV 2 contributed another $r to SPV 1, which increased the par value of its Class A ECs to $i or $s/certificate, increasing SPV 2's total aggregate investment in SPV 1 to $b[19]

SPV 1 issued an equal number of Class A ECs and Class A Shares to SPV 2 and an equal number of Class B ECs and Class B Shares to SPV 3. When they were issued, each Class A Share was "stapled together" with one Class A EC.[20] Likewise, each Class B Share was stapled together with one Class B EC. The stated purpose of such "stapling" is so that neither instrument can be transferred without the other.[21]

The Rights Afforded to SPV 2 as the Holder of the Class A Securities.

SPV 2 has certain rights as the holder of the Class A Securities. The Class A ECs and the Class A Shares (the two component parts of the Class A Securities) both provide SPV 2 with some rights in common, but each component part provides some unique rights which differ from those provided by the other. Since the instruments are stapled together and SPV 1's Constitution prohibits them from being unstapled[22], they are therefore legally treated as one security investment.[23]

Class A Securities.

SPV 1 issued the Class A Securities to SPV 2 on Date 1. The Class A EC component of the Class A Securities has a yield that accrues on (a) Date 1, (the day which they were issued) in an amount equal to 1.375 percent of the Par Value of the Class A EC,

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[15] Certificate of Incorporation of Collection Corporation, signed by Individual 1 on Date 4.
[16] Equity Certificates will hereinafter be referred to as "ECs."
[17] Class A Voting Common Shares will hereinafter be referred to as "Class A Shares".
[18] Class B Voting Common Shares will hereinafter be referred to as "Class B Shares".
[19] All monetary values in this memo are in U.S. dollars.
[20] SPV 1's Charter Date 8, Article 4 and Transactions Document 4, § 3.1.
[21] Transactions Document 4, page 2.
[22] Essentially, the Class A ECs are debt notes and, on their face at least, the Class A Shares appear to be preferred stock.
[23] Common Parent asserts that the stapled Class A ECs and the Class A Shares should be treated as one instrument. SPV 2 does not have the legal right to separate the two instruments. We do not take issue with Common Parent's assertion.

and (2) thereafter, quarterly at an annual stated yield of Rate 1 basis points[24]. The Date 1, accrued yield equals $p.[25] Unpaid yield is due and payable only if and to the extent (i) declared by SPV 1's board of directors, (ii) SPV 1 has sufficient retained earnings (without taking into account any accrued and unpaid Yield on the Class A or the Class B ECs); and (iii) SPV 1 is not insolvent immediately before the payment or made insolvent immediately after the payment (computing insolvency by considering the Class A ECs as obligations of SPV 1).

The Class A Securities afford its holders very little in the way of equity participation. The Class A EC component receives a Yield based on a market-rate of interest. Moreover, the Class A EC does not participate in corporate growth to any extent. The Class A Shares component of the Class A Securities, upon liquidation would receive in return no less than (their minimum amount of) $q in excess of their principal, and no more than (the maximum amount of) $d in excess of their principal[26]. This equates to a minimum of 3/100th of one percent to a maximum of 3/10ths of one percent of SPV 2's overall investment of $b in the Class A Securities. Regardless of whether SPV 2 receives the minimum or the maximum amount, that amount (and no more) will nevertheless be earned over a minimum of 5 and a maximum of 99 years (but may be shorter than 5 years if a Common Parent Reset Notice or a Termination Event[27] occurs earlier than Date 11).

The Class A Securities can be redeemed in two instances: (1) the Mandatory Redemption; and (2) upon SPV 1's liquidation.[28] The Mandatory Redemption occurs on Date 12. On the Mandatory Redemption date the yield on the Class A ECs ceases to accrue, the Class A ECs will be cancelled and all rights of the Holder (other than payment of all of the principal plus accrued and unpaid Yield) will cease.[29] On either redemption date, SPV 2 will be entitled to get a return of its principal ($i) plus receive any accrued and unpaid Yield.[30] However, if the Class A ECs are redeemed before the liquidation date, then SPV 2 will receive an additional 0.50% premium if SPV 1 has made a net profit; however, if SPV 1 has a net loss, there will be exacted a 0.50%

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[24] According to Taxpayer's documents, the determination of yield is based on the market rate on the date of issuance.
[25] Transactions Document 2, § 2.1.1. The $p amount equals 1.375% multiplied by $c, the par value of the Class A ECs on that date. Since this amount is paid on the day of issuance, it doesn't accrue. Thus, it amounts to nothing more than an upfront payment, akin to a lending or processing fee charged by lenders. Exam has obtained a Fee Letter from Foreign Bank 1 to Common Parent, dated Date 1, in which the stated lending fee was $p (on a principal loan amount of $c), the exact amount of the Date 1 return due on the Class A ECs.
[26] SPV 1's Charter Date 8, Article 5, Distributions.
[27] See list of Termination Events on pages 15–16.
[28] Transactions Document 2, § 3.1.
[29] Transactions Document 2, § 3.1.3.
[30] On the mandatory redemption date, the Class A EC redemption price will only be paid to the extent that (i) it does not exceed the sum of (a) the Distributable Amounts at such time and (b) the aggregate par Value of the Class A ECs, and (ii) the company is not both before and after insolvent as a result of the payment (treating neither the Class A ECs nor the Class B ECs as obligations of SPV 1).

discount.[31]. If the Class A ECs are redeemed, the Class A Shares are also required to be redeemed[32].

With respect to payment rights, redemption and rights of liquidation, winding up and dissolution, the Class A ECs rank prior the Class B ECs, the Class A Shares and the Class B Shares. SPV 2 has full creditor rights to enforce: (1) the payment of the Yield that has been declared and payable, and (2) the payment as of the maturity date of the principal amount of the Class A ECs.

SPV 2 has the right to accelerate the maturity of the Class A ECs by causing the liquidation of SPV 1 for nonpayment of Yield declared due and payable by SPV 1's board[33]. In the event of liquidation, dissolution or winding up of SPV 1's affairs, SPV 2, as holder of the Class A ECs, is entitled to an amount of cash equal to the sum of (1) the Par Value for each outstanding Class A EC plus (2) any unpaid Yield accrued through the date fixed for such liquidation, to the extent and in accordance with the priority of payments. SPV 2 also has a right to cause the liquidation of SPV 1 upon a breach of any provision of the following documents: (1) the Terms and Conditions of the Class A ECs document, (2) the Investors' Agreement, (3) Common Parent's five financial covenants, and (4) the covenants on the receivables portfolio. One document suggests that the exercise of this right to liquidate, however, would cost SPV 2 a penalty amount of $14 million (or 3.5% of its total investment in SPV 1).

<u>Class B Securities</u>.

SPV 1 issued the Class B Securities on Date 1. The Yield on the Class B Securities accrues on each quarterly date *after* Date 1[34] and equals the income SPV 1 receives on its Investments[35] minus the sum of (a) the quarterly Yield on the Class A ECs; (b) SPV 1's costs for that quarter; and (c) the net taxable profit required to be reported in Country Y for that quarter.[36] If the sum of (a), (b) and (c) above exceeds SPV 1's income on its Investments for the quarter, such excess shall be considered a "cost" incurred during the next following quarter.[37]

The Transactions Document 3 provides that the unpaid yield on the Class B ECs is due and payable on each payment date only if and to the extent (i) declared by SPV 1's

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[31] Transactions Document 4 § 5.1.
[32] Transactions Document 4 § 4.3.
[33] SPV 2 holds the Class A Securities and thereby has elected all three of members of SPV 1's board of directors. Thus, it is inconceivable that SPV 1 will not annually and consistently declare and pay dividends in the amount of the Yield owed on the Class A ECs.
[34] Note that, unlike the upfront fee accompanying the Class A Securities, there is no upfront fee for the Class B Securities.
[35] Investments means (a) purchased A/R's, (b) loans made to the Taxpayer Group; (c) shares of Collection Company capital stock and evidences of indebtedness issued by Collection Company, and (d) Permitted Investments. See footnote 5 for a definition of Permitted Investments.
[36] Transaction Document 3, § 2.1.1.
[37] See footnote 34.

board of directors, (ii) SPV 1 has retained earnings (without taking into account any accrued and unpaid Yield on the Class B ECs); and (iii) SPV 1 is not immediately before the payment insolvent or made insolvent immediately after the payment (computing insolvency by treating the Class A ECs as obligations of SPV 1).

Section 4.7 of the Investor's Agreement substantially limits the provision of the previous sentence by providing that NO YIELD WILL BE PAID ON THE CLASS B ECs; except that Yield will be paid: (1) on each payment date only in an amount necessary to ensure that the sum of the total Class B investment[38] will not exceed 97.5% of the amount of SPV 2's investment in the Class A Securities[39]; and (2) on the last business day of every April but only in an amount necessary to ensure that the sum of the loan value to the Taxpayer Group plus the aggregate value of SPV 1's Permitted Investments (maximum of $aa)[40] do not exceed 50% of the aggregate amount of all of SPV 1's investments.[41] SPV 1 is required to pay the Yield described in (1) and (2) above *only if and to the extent* the total Class B investment at that time is equal to or greater than $x and the Taxpayer Group prepays an amount of the outstanding loan balance, which amount will be used by SPV 1 to pay the amounts of (1) and (2).[42]

The Class B Securities are entitled to virtually all equity participation on liquidation, except for the possible $q or $d return on the Class A Securities. The Class B Securities, due to its Class B Share component, has the right to the remainder of the assets on liquidation after payment of (i) the entire principal plus all accrued but unpaid yield on the Class A ECs, and (ii) the return of capital on the Class A Shares, and (iii) a small return of equity on the Class A Shares of $q or $d.

The Transactions Document 3 describes two potential redemptions of the Class B Securities: (1) the Mandatory Redemption; and (2) the redemption upon SPV 1's liquidation. The Mandatory Redemption occurs on Date 13.[43] On the Mandatory Redemption date, the yield on the Class B ECs ceases to accrue, the Class B ECs shall be cancelled and all rights of the Holder (other than payment of the entire principal plus accrued and unpaid Yield) shall cease[44]. On either redemption date, Common

[38] The document defined this amount as accrued and unpaid yield on the Class B ECs plus the aggregate par value of the Class B Shares and Class B ECs. Taxpayer Group's initial investment in SPV 1 was $a and it remained $a throughout the entire period of the Transactions.
[39] The document defines this amount as accrued and unpaid yield on the Class A ECs plus the aggregate par value of the Class A Shares and Class A ECs. Foreign Bank 1's initial investment in SPV 1 was $w, which increased to $b on Date 2. It thereafter remained $b throughout the entire period of the Transactions.
[40] Permitted Investments is defined in footnote 5.
[41] See footnote 33, supra.
[42] There are two important points to note here. First, SPV 1 will pay a yield on the Class B ECs only if Taxpayer Group (the holder of the Class B ECs) increases its investment in SPV 1 from $a to more than $x. Second, Taxpayer Group will be the source of the funds SPV 1 uses to pay yield to the Taxpayer Group on the Class B ECs. Effectively, the Taxpayer Group (not SPV 1) will pay the yield to itself.
[43] It may be important to note that the mandatory redemption date for the Class A Securities is Date 12, whereas the mandatory redemption date for the Class B Securities is Date 13.
[44] Transactions Document 3, §§ 3.1.1 and 3.1.3.

Parent/SPV 3, as holder of the Class B Securities, will get a return of its principal (of $a) and accrued and unpaid Yield. On liquidation, Common Parent/SPV 3 will also get all remaining assets of SPV 1, after payment on the Class A Securities. In either case (1 or 2, above), if the Class B ECs are redeemed, the Class B Shares must also be redeemed.

With respect to payment rights, redemption and rights of liquidation, winding up and dissolution, the Class B ECs are ranked junior to the Class A ECs, but are ranked prior to the Class A Shares and the Class B Shares. Common Parent/SPV 3 has full creditor rights to payment on the maturity date of the principal amount of the Class B ECs.[45]

The Investors' Agreement restricts SPV 1 from issuing any additional Class A Shares, Class B Shares, Class A ECs, and Class B ECs. The Investors' Agreement also provides that no dividends will be declared on any Shares as long as both the (1) accrued and unpaid Yield, and (2) and the Par Value (i.e., the principal) on the ECs have not been paid.

Priority of Distribution on SPV 1's Dissolution or Liquidation.[46]

On dissolution or liquidation, SPV 1's assets or proceeds thereof will be distributed, in order of priority, as follows:

> First, payment in satisfaction of all of SPV 1's liabilities, not including payment on to the holders of the ECs or the shares;
>
> Second, payment to the Holder of the Class A ECs in satisfaction of the principal amount of these ECs and any accrued but unpaid Yield thereon;
>
> Third, payment to the Holder of the Class B ECs in satisfaction of the principal amount of these ECs and any accrued but unpaid Yield thereon;
>
> Fourth, payment to the Holder of the Class A Shares as a return of capital in amounts equal to the nominal value of these shares (i.e., $d);
>
> Fifth, payment to the Holder of the Class B Shares as a return of capital in amounts equal to the nominal value of these shares (i.e., $f);
>
> Sixth, payment to the Holder of the Class A Shares as an additional return in an amount equal to the nominal value of these shares (i.e., $d); and
>
> Seventh, payment of the remainder to the Holders of the Class B shares.

[45] SPV 1's Charter Date 8, Article 5.
[46] See footnote 43, supra.

Upon redemption of the Class A shares other than by liquidation of SPV 1, each Class A Share will receive an amount equal to its nominal value plus an amount of $ 0.20. This amount equates to $q.

Exchange and Remarketing.

SPV 1 can elect to require an exchange of the Class A ECs for one or more k-year convertible notes bearing a slightly lower yield (Rate k basis points). This election is available to SPV 1 on Date 11, and if it does not do so on this date, it may elect to require the exchange on Date 15, on the same terms and conditions as the Year 6 exchange. If SPV 1 makes the election on either date, SPV 2 must exchange the Class A ECs for Notes in an aggregate principal amount equal to the aggregate par value of the Class A ECs so exchanged plus an amount equal to the accrued and unpaid yield on those Class A ECs. Notes can be issued only to the extent that (i) the aggregate principal amount of the Notes does not exceed the sum of (a) SPV 1's retained earnings at that time, plus (b) the par value of the Class A ECs, provided that that SPV 1 is not insolvent both immediately before and after giving effect to such payment (computing, for this purpose, insolvency by treating neither the Class A ECs nor the Class B ECs as SPV 1's obligations). Upon conversion of the Class A ECs for Notes, (i) SPV 1 shall pay to the holders of the Class A ECs on the date of the redemption thereof an amount equal to 0.50% of all accrued but unpaid Yield on the Class B ECs and (ii) if the aggregate par value of the Class B ECs exceeds the aggregate fair market value of the Class B ECs, the aggregate principal amount of the Notes issued upon such conversion shall be reduced by an amount equal to 0.50% of such excess.[47] Note that upon the exchange of the Class A ECs for Notes (either in the Year 6 exchange or the Year 25 exchange), the Class A Shares must be redeemed for an amount equal to the nominal value of the Class A Shares plus U.S. $.20 per share.[48]

Once notified of SPV 1's election, Common Parent may elect to require that the Class A ECs be remarketed (the Year 6 Remarketing)[49]. The terms of the remarketing are that the Class A ECs will be remarketed for a price at least equal to 100.5 percent of the par value of the Class A ECs plus any accrued but unpaid yield on the Class A ECs plus an amount sufficient to compensate any holder of the Class A ECs for any loss, cost or expense (including losses resulting from the redeployment of funds) incurred as a result of a payment thereon being made on a day other than the date scheduled for such payment.[50] There is no provision for resetting the yield on the Class A ECs if the Year 6 Remarketing succeeds. No provision exists to prohibit Common Parent or any of its

[47] Transactions Document 4, § 5.1.
[48] At all times during the years at issue, SPV 2 maintained g shares of Class A stock, which stock had a nominal value of $k per share. Therefore, the redemption amount under this provision would be the $d nominal value of the Class A Shares plus $q ($.20 per share times g shares).
[49] It is called the Year 6 (or 25 year) Remarketing because if it occurs, it will occur in or around Year 4 (or Year 6), 6 or 25 years after the commencement of the Transactions (Date 1).
[50] This latter "cost" that the purchaser, if any, of the Class A ECs will pay SPV 2 appears to us to be a loan prepayment penalty.

affiliates from participating in the Year 6 Remarketing. If a purchaser is found, SPV 2 must sell and transfer to such purchaser the Class A Shares for a purchase price equal to the nominal value of the Class A Shares plus U.S. $0.20 per share. The sale of the Class A Shares is a condition precedent to the sale of the Class A ECs pursuant to the Remarketing.

If the Class A ECs are not sold pursuant to the Year 6 Remarketing, then the exchange of Class A ECs for Notes shall be affected on Date 5.

If the Class A ECs are not sold pursuant to the Year 6 Remarketing or if New Class A ECs are issued upon exchange of the Notes, Common Parent may elect to require a remarketing of the Class A ECs in Year 8 (the Year 8 Remarketing). The terms of this remarketing are that the Class A ECs will be remarketed for a price at least equal to 100.5 percent of the par value of the Class A ECs plus any accrued but unpaid yield on the Class A ECs plus an amount sufficient to compensation any holder of the Class A ECs for any loss, cost or expense (including losses resulting from the redeployment of funds) incurred as a result of a payment thereon being made on a day other than the date scheduled for such payment. Neither Common Parent nor any of its affiliates may participate in the Year 8 Remarketing. If the remarketing succeeds, the yield will be reset on all of the Class A ECs. Also, if a purchaser is found, the holder of the Class A Shares shall sell and transfer to such purchaser the Class A Shares for a purchase price equal to the nominal value of the Class A Shares plus U.S. $0.20 per share. The sale of the Class A Shares is a condition precedent to the sale of the Class A ECs pursuant to the Remarketing.

The parties have expressed, through the various agreements, their intent that the Class A ECs be treated as equity for US tax purposes and as debt for Country Y tax purposes. For US financial statement purposes, the Class A ECs and the Class A shares are to be considered debt, so that SPV 1's results will be consolidated for such financial purposes into Common Parent's results. For Country Y regulatory purposes, the Class A common securities have been determined to be debt. Common Parent's financial statement describes the Class A ECs as preferred variable debt securities.

For financial reporting purposes, Common Parent consolidates the financial statements of SPV 3, SPV 1 and Collection Company through its ownership of 99.9% of SPV 3's common interests and through its consolidation of SPV 1, which owns100% of Collection Company.

<u>Termination Events</u>[51]:

Except with respect to A/R's already sold to SPV 1, the Transaction Document 1 automatically terminates upon the earlier to occur of: (1) the insolvency of any of the three Common Parent subsidiaries, so long as the insolvency is accompanied by a

[51] Transaction Document 1 § 9.1.

legitimate insolvency or bankruptcy action as typically entered into by insolvent businesses; (2) Date 11 (unless extended by written agreement of the parties) or (3) the occurrence of any of the following events:

(a) The failure of the Seller to make any payment of amounts owed on the loan or amounts collected on the A/R's sold to SPV 1 when such amounts become due or fail to perform any of their obligations under the Transaction Document 1 or other Transaction Documents;

(b) the insolvency of any Seller, Servicer or Collection Agent;

(c) a default event occurs or one of the Common Parent subsidiaries becomes insolvent;

(d) the government places a lien on the assets of any Seller other than the A/R's sold to SPV 1;

(e) the termination of any lockbox agreement;

(f) the failure of the three Common Parent subsidiaries in the performance of duties as Servicer of the A/R's sold to SPV 1;

(g) if, due to some omission or commission of Common Parent or its subsidiaries, SPV 1 ceases to hold (i) valid title in any A/R it purchased, (ii) a first priority lien in such A/R, or (iii) a first priority, perfected lien in the Seller's collateral;

(h) the amendment of any Seller's constituent documents or its Credit and Collection policies;

(i) the principal amount of past due A/R's owing to SPV 1 and Collection Company exceeds 60% of the principal amount of all A/R's owing to SPV 1 and Collection Company;

(j) the average principal balance of all A/R's owing to SPV 1 and Collection Company that are past due by 30 days or more over any 3 month period, exceeds 55% of the average aggregate principal balance of all outstanding A/R's owing to SPV 1 and Collection Company;

(k) the average principal balance of all A/R's owing to SPV 1 and Collection Company that are past due by more than 60 days over any 3 month period, exceeds 25% of the average aggregate principal balance of all outstanding A/R's owing to SPV 1 and Collection Company;

(l) the average principal balance of all A/R's owing to SPV 1 and Collection Company that are past due by more than 90 days over any 3 month period, exceeds 20% of the average aggregate principal balance of all outstanding A/R's owing to SPV 1 and Collection Company;

(m) the average principal balance of all A/R's owing to SPV 1 and Collection Company that are past due by more than 180 days over any 3 month period, exceeds 10% of the average aggregate principal balance of all outstanding A/R's owing to SPV 1 and Collection Company;

(n) the excess of the average principal balance of all A/R's that are determined to be non-collectible during any 3 month period over the aggregate amount of collections of the A/R's during such period exceeds 1.125% of the aggregate gross revenues earned by the Sellers during such period from sales or services; and

(n) the excess of the average principal balance of all A/R's that are determined to be non-collectible during any 12 month period over the aggregate amount of collections of the A/R's during such period exceeds 0.50% of the aggregate gross revenues earned by the Sellers during such period from sales or services.

A credit report (entitled Credit Application), dated Date 3, processed by the State 2 branch office of Foreign Bank 1 discusses in detail the protections necessary to Foreign Bank 1 in order for it to agree to enter into the Transactions in the first place. Foreign Bank 1 was mainly concerned that, when SPV 1 terminates or the transaction unwinds, it (Foreign Bank 1) would receive its full investment plus an applicable rate of return. The Credit Report apparently was initiated by Taxpayer Group's request of Foreign Bank 1 to extend the above Tax Strategy beyond its contemplated termination date of Date 11. Parts of the Credit Application are set forth below:

The Credit Application notes that Common Parent had a Date 7 market capitalization of $v and that Common Parent made a number of covenants in order to obtain Foreign Bank 1's participation in this transaction. Common Parent made the following financial covenants to Foreign Bank 1 with regard to its status:

	Requirement	Actual 6/30/Year 3
Min. adjusted tangible net worth (TNW)	$t	u
Max total debt/EBITDA	2.0x	1.21x
Min funds from operations/total debt	30%	66.4%
Max total debt/capitalization	45%	23.4%
Min EBITDA/interest expense	6x	12.9x

The Credit Application also provided that there would be a "bullet" repayment (a single payment for the entire loan amount) of Foreign Bank 1's investment in SPV 1 at maturity, which the Credit Application lists for the Class A Equity Certificates (total investment $i) as Date 6 and for the Class A Common Shares (total investment of $d) as Date 5.

The Credit Application notes the following collateral protects Foreign Bank 1's investment:

- Asset base of SPV 1 consists of third party receivables and intercompany loans to Common Parent or guaranteed subsidiaries. Net coverage of Foreign Bank 1's $b investment by 3rd party receivables at 7/31/Year 3 (net of payables to Common Parent) totaling 1.75 times SPV 2's investment.
- Retained earnings of SPV 1 (as of 7/31/Year 3 - $y) enhanced preferred status of Foreign Bank 1's investment. SPV 1 generates approximately $z earnings monthly.
- Concentration limits on receivables portfolio: Non-investment grade or unrated: 2.5%; Investment grade: 3.5%.
- Monthly testing of receivables portfolio by an independent party (Managerial Company) against the following credit-quality covenants. Violation of any of these covenants constitutes an event of default and consequent unwinding of SPV 1.

Additionally, a letter, dated Date 8, from Foreign Bank Affiliate, an affiliate of Foreign Bank 1, to Common Parent mentions a "fee arrangement with respect to the SPV 1 transaction with Common Parent in which Foreign Bank 1 through its affiliate has contributed a total amount of $c." The letter states the amount of the fee as $p.[52] The initial dollar value of the Class A ECs purchased by SPV 2 on Date 1 was $c. The fee was calculated on this amount. The $p was referred to as a "structuring fee."[53]

There is documentation in the materials secured by Exam showing that the Taxpayer Group perfected security interests in all the A/R's they purportedly sold to SPV 1, the Sub 1 and Sub 2 lockbox accounts, as well as the contents of those lockbox accounts.[54] There is essentially no documentation or evidence demonstrating that the Taxpayer Group ever transferred title of the A/R's to SPV 1.

The Transactions.[55]

The Transactions commenced on Date 1, when SPV 1 made its first purchase of A/R's from and its first loan to the members of the Taxpayer Group. The Transaction

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[52] The fee of $p is the exact amount of the yield due by SPV 1 to SPV 2 two days later on Date 1. See the Transactions Document 2, § 2.1.1.
[53] We note that it is unusual for a prospective shareholder to charge a fee to another shareholder as a precondition to its making a purchase of equity in a common corporation.
[54] See, for example, the Uniform Commercial Code Financing Statements of Sub 3 (named "Debtor") in favor of SPV 1 (named "Secured Party"), which were filed with the Secretary of the State of Delaware.
[55] Transactions here means the entire series of transactions that satisfy the purposes of and implement the Tax Strategy developed by Promoter.

documents contemplate that every month thereafter for the next five years, SPV 1 would purchase A/R's from and make loans to the Taxpayer Group.[56] The documents also contemplate that the Transactions would terminate on Date 11[57], unless extended by written agreement of the parties or unless terminated earlier upon the occurrence of a Termination Event.[58]

As the A/R's are generated, the Taxpayer Group bundles certain A/R's and sells them to SPV 1, who buys them at a discount. The purchase price of each A/R equals the principal balance owing on the A/R minus the relevant factoring discount. The date set for SPV 1 to pay for the purchased A/R's is the earlier of: (1) the Value Date[59], or (2) when payment is received from the Account Obligor[60]. When an Account Obligor makes a payment on an A/R, the payment is automatically applied to and reduces the balance due on the purchase price.

Although all A/R sales are nonrecourse, SPV 1 does not choose the A/R's it will purchase. The first notice SPV 1 receives of the identity and number of A/R's it has purchased is on the Determination Date[61], which is defined as the 20th business day of the month following the month in which the Value Date occurs (the day SPV 1 is obligated to pay for the A/R's). On the Determination Date, the Sellers must notify SPV 1 of the identity of the A/R's SPV 1 purchased and the amount (principal balance) of those A/R's. Although SPV 1 is required to pay the balance of the purchase price by the Value Date, the amount that SPV 1 owes and must pay on the Value Date is determined later on the Settlement Date[62], a date occurring in the month <u>following</u> the month in which the Value Date occurs.[63] On both the Purchase Date (the date SPV 1 is required to Purchase the A/R's) and the Value Date (the date SPV 1 is required to fully pay for each A/R), SPV 1 has no knowledge of the identity, or the related purchase

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[56] Transaction Document 1 § 9.1; Transaction Document 5 § 6.1

[57] See footnote 23, which describes the Termination Events.

[58] References in the various documents, including the Credit Application, dated Date 3 and the Transaction Document 1 § 9.1, strongly infer that the parties contemplated that the Transactions not continue much beyond Date 11.

[59] The Value Date is the last business day of the calendar month in which the due date for such A/R occurs, unless the Value Date would precede the A/R due date, then the Value Date is the last business day of the next succeeding calendar month. If the A/R due date for any A/R sold to SPV 1 on Date 1, occurs on or prior to Date 1, then the Value Date for such A/R shall be Date 1. Transaction Document 1, Section 1, Definitions.

[60] Here, Account Obligor means a Common Parent customer whose purchase of goods or services created an A/R.

[61] Transaction Document 1, § 2.1(c).

[62] With respect to any date on which the Account Obligor makes a payment on the A/R before the Value Date, but only to the extent of collections received on such Payment Date, the Settlement Date is the last business day of the calendar month immediately following the calendar month during which such Payment Date occurs. With respect to any Payment Date occurring on the Value Date for any A/R, the Settlement Date is the last business day of the calendar month immediately following the calendar month during which such Value Date occurs. Transaction Document 1, §1.1, Definitions.

[63] Transaction Document 1, § 2.1(h).

price, of the A/R's sold to it. Only on the Determination Date[64] (generally the 20th day of the month following the Purchase Date and the Value Date) does SPV 1 learn of the identity and the price of each A/R sold to it because that is the day that each Seller is required to deliver to SPV 1 a schedule of A/R's sold to SPV 1 as well as a statement of the price for each A/R.

SPV 1 is not required to purchase any receivable if the purchase would cause SPV 1 to exceed its Maximum Purchase Limit.[65]

Seller has no right to repurchase any A/R's sold to SPV 1, except that SPV 1 may require a Seller to repurchase an A/R when (1) the Seller has breached any of its representations or warranties; (2) the Account Obligor returned any goods in connection with the A/R; or (3) SPV 1 receives a Common Parent Reset Notice[66]. In such an event, the Seller is required to repurchase the sold A/R for 100.55% of the Purchase Price[67].

SPV 1 does not have the right to reject any Eligible Receivable unless it determines that the Seller has breached any representation or warranty as to such receivable.[68]
The obligation to pay for the purchased A/R is represented on the balance sheet of SPV 1 as an account payable to Common Parent. This payable is senior to all other claims of SPV 1 including the Class A ECs.

Although the Sellers agree to transfer all rights, title and interest in the A/R's to SPV 1[69], the sale and transfer of the A/R's is only a paper entry. The Sellers never physically transfer the A/R's or the respective A/R files. The A/R files consist of documents evidencing the underlying customer transaction (e.g., the invoice), any security interest documentation, etc. The Sellers retain and possess the A/R files at all times "in a custodial capacity for SPV 1's benefit only"[70]. The Sellers are required to maintain for SPV 1's benefit a complete and accurate A/R file for each A/R sold to SPV 1[71]. They

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[64] Determination Date means, with respect to the Settlement Date, the 20th day of the calendar month during which such Settlement date occurs. Transaction Document 1 § 1.1 Definitions.
[65] Transaction Document 1. SPV 1's Maximum Purchase Limit means roughly the excess of SPV 1's total equity plus its retained earnings times 1.3 over the aggregate principal balance of all A/R's held at that time by SPV 1.
[66] A Common Parent Reset Notice means essentially a written notification by Common Parent to SPV 1 that a change in the tax law has occurred that will have a materially adverse change with respect to the business, financial statement, financial or tax consequences anticipated by Common Parent from these transactions. Transactions Document 4, §1. Definitions.
[67] Transaction Document 1, § 2.8(a), (b.
[68] Seller warrants as to all A/R's it sells to SPV 1 that each A/R is: (1) an Eligible Receivable; (2) the A/R has not been satisfied; (3) all information contained in the Schedule of Receivables regarding the A/R is accurate; (4) the Account Obligor has not raised any defenses against payment of the A/R; and (5) except as to the Sub 3 receivables, no default has occurred.
[69] Transaction Document 1, §2.1(a).
[70] Transaction Document 1, §2.4.
[71] Transaction Document 1, §§ 2.3 and 2.4.

are also required to document on their respective financial statements the transfer of the A/R's to SPV 1[72].

Other than the initial transfer of money from SPV 1 to the Taxpayer Group (which occurred on Date 1)[73], it appears that SPV 1 did not directly pay cash or make other forms of payment to the Sellers for the A/R's. Under the Transaction Document 1, SPV 1 pays the purchase price of the A/R's as follows: (1) all monies collected by the Taxpayer Group, as Servicers, on the A/R are automatically credited as a payment toward the purchase price of that A/R's; and (2) if, on the Value Date, collections on the A/R's are insufficient to cover the full purchase price of the A/R's sold to SPV 1 as of that date, then (A) the borrowers under the Transaction Document 6 are required to prepay all amounts borrowed under the Transaction Document 6, but only to the extent of the remaining balance of the aggregate purchase price owed by SPV 1 on the purchased A/R[74]; and (2) the amount of the loan prepayment is <u>automatically</u> applied to the amount SPV 1 owes.[75]

SPV 1 has the right to notify each Account Obligor that SPV 1 now owns the A/R. Except on the occurrence and continuation of a Termination Event, the Taxpayer Group is not required to notify the Account Obligors that their A/R's have been sold to SPV 1. The Sellers, in their role as Servicers, continue to receive payment on the underlying A/R's directly from the Account Obligors. The Sellers agree not to make any changes in the instructions to the Account Obligors regarding the deposit of collections on the A/R's.

To the extent not required to fund the purchase of A/R's, SPV 1 lends the excess of its cash to the Taxpayer Group on the Value Date, the same day it purchases the A/R's. The Transaction Document 6 provides that the loan balance on the Value Date fluctuates as a function of cash required to purchase the A/R's on that same date.

SPV 1 contracted with the Taxpayer Group for the Taxpayer Group to service and to collect on the A/R's that the Taxpayer Group sells to SPV 1. The Collection Company entered into a Servicing Contract with the Taxpayer Group to service the severely delinquent A/R's Collection Company purportedly purchases from SPV 1, which A/R's SPV 1 had initially purchased from the Taxpayer Group.

SPV 1 appointed Common Parent, to act as SPV 1's collection agent to hold and control each collection account and to supervise the deposit and distribution of all collections received with regard to the A/R's sold to SPV 1.

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[72] Transaction Document 1, § 23.
[73] On Date 1, except for the $<u>aa</u> (SPV 1's liquidity amount), SPV 1 transferred all of its paid in capital to Common Parent and its three subsidiaries in part as loan and in part as payment toward the purchase price of the Date 1, tranche of A/R's sold to SPV 1.
[74] Transaction Document 1, §2.1(g), which incorporates by reference Transaction Document 6 §§ 2.2(c) and 3.6(b).
[75] Transaction Document 6 §3.6(b).

Each Servicer has established and each one agrees to maintain one or more lockboxes in their own names.[76] Each Servicer agrees to deposit into the lockbox accounts all collections they receive on the A/R's sold to SPV 1. Each Servicer has instructed all existing Account Obligors to make payments with regard to the A/R to their respective lockbox accounts. Collections received by Sub 1 on the Sub 1 and Sub 3 A/R's are deposited in the Sub 1 lockbox account. Collections received by Sub 1 on the Sub 1 A/R's and the Sub 3 A/R's are deposited in the Sub 1 lockbox account.[77]

Sub 1 and Sub 2, in their role as Servicers, agree not to close any lockbox accounts, unless they receive SPV 1's written consent. Both Sub 1 and Sub 2 agree to take all necessary action as SPV 1 requires perfecting a first priority lien in such lockbox account. However, none of the Transactions documents prohibit Sub 1 or Sub 1 from withdrawing funds contained in the Lockbox Accounts, except that neither may withdraw any funds once SPV 1 takes exclusive dominion and control of the Lockbox Account. SPV 1 has the right to take exclusive dominion and control over the Sub 1 and Sub 2 lockboxes upon the occurrence of a Termination Event. Common Parent also is authorized under the Transactions documents to establish and maintain one or more Collection Accounts into which it will deposit all collections it receives on the A/R's sold to SPV 1.[78]

If a Termination Event occurs and is continuing, SPV 1 may establish one or more Collection Accounts in its own name over which it will have exclusive dominion and control. SPV 1 then may require all monies thereafter collected on its behalf be deposited into the SPV 1 Collection Accounts. SPV 1 may, on the occurrence and continuation of a Termination Event, take exclusive dominion and control of the Sub 1 Lockbox Accounts and the Sub 1 Lockbox Accounts and require that each Lockbox Bank transfer the contents of these Lockbox Accounts to any Collection Account SPV 1 establishes[79]. Noticeably absent is any provision in the Transaction Document 1 giving SPV 1 exclusive dominion and control over the Collection Accounts established by Common Parent; even though such accounts, like the Sub 1 and Sub 2 Lockbox Accounts, also hold collections received on the A/R's sold to SPV 1. On the occurrence

[76] The Transaction Document 1 § 6.1.
[77] In a letter dated Date 10, Sub 1 instructed Promoter how to handle the Sub 1 Lockbox Account. The letter refers to the Date 1 Transaction Document 1 and the reference contained therein to the A/R's Sub 1 purportedly sells to SPV 1. Promoter was instructed to charge Sub 1 (not SPV 1) for all service fees, overdrafts and any other charges related to the account. The letter notifies Promoter that Common Parent, guarantees Sub 1's performance under this letter. The letter further provided that "[u]ntil [Promoter] receives further written notice from [SPV 1], [Sub 1] may withdraw fund from the Account and otherwise give [Promoter] instructions with respect to the Account (including instructions to close the Account)." The letter goes on to instruct Promoter that only after Promoter receives SPV 1's written notice that a Termination Event has occurred and is continuing, "[Promoter] will restrict [Sub 1] from all use or control of the Account and will only follow [SPV 1's] written instructions (and [SPV 1] will have exclusive dominion and control over the Account)." Blocked Account Agreement dated Date 10, signed by Promoter, Sub 1, Common Parent, and SPV 1 S.A.
[78] Transaction Document 1 § 6.2.
[79] Transaction Document 1 § 6.3.

of a Termination Event, neither Common Parent nor any of its three subsidiaries may make any withdrawals from SPV 1's Collection Accounts.

Each member of the Taxpayer Group, as Servicer, agrees to: (1) collect all amounts due under all A/R's sold to SPV 1, including endorsing its name on checks and other instruments representing collections on such accounts; (2) monitor each such A/R and to participate in meetings and telephone conversations with representatives of the Account Obligors; (3) maintain adequate and complete A/R files; (4) provide SPV 1 with all information concerning defaulted A/R's and provide advice to SPV 1 as to whether or not SPV 1 should transfer such A/R's to Collection Company; and (5) notify each Account Obligor of a defaulted A/R of the fact that the defaulted A/R has been assigned to Collection Company and instruct the Account Obligor to make payment to Collection Company. Moreover, each Servicer agrees that it shall adopt a standard of care consistent with industry practice for the servicing of such A/R's, and will not amend such standard of care without SPV 1's written consent.

Each Servicer shall at its own expense maintain materials and equipment and employ the necessary number and quality of personnel to service and administer the sold A/R's. On each Determination Date, each member of the Taxpayer Group, as Servicer, agrees to deliver to SPV 1 a Schedule of Receivables, and to report to SPV 1 the identity of each A/R that has become a Defaulted Receivable.

SPV 1's board makes all decisions as to the settlement of delinquent receivables owned by SPV 1, except those that are severely delinquent. If any receivable remain outstanding for a period significantly beyond the original due date (termed a "severely delinquent receivables"), SPV 1 may sell that receivable to Collection Company. If SPV 1 determines to sell the A/R to the Collection Company, the Servicer of that A/R is required to contribute the Defaulted A/R to Collection Company[80].

LAW AND ANALYSIS

Issue 1: The stapled Class A Securities constitute either debt or debt with an equity kicker; they did not constitute equity.

Common Parent asserts that the Class A Securities should be treated as a preferred equity interest in SPV 1 and not as debt. We disagree. After application of the debt/equity factors to the characteristics of the Class A Securities (the combined characteristics of the two components), we conclude that the Class A Securities are more debt-like than equity-like in their characteristics.

A fundamental difference between a shareholder and a creditor is that while the "shareholder is an adventurer in the corporate business" who "takes the risk and profits from success", the creditor "in compensation for not sharing the profits, is to be paid

[80] Section 4, Transaction Document 7 attached to the Servicing Agreement entered into by SPV 1 and Managerial Company on Date 1.

independently of the risk of success, and gets a right to dip into the capital when the payment date arrives." Commissioner v. O.P.P Holding Corp., 76 F.2d 11, 12 (2d Cir. 1935). A significant factor for differentiating between a shareholder and a creditor is whether "the funds were advanced with reasonable expectations of repayment regardless of the success of the venture or were placed at the risk of the business." TIFD III-E, Inc., United States, 459 F.3d 220, 232 (2nd Cir. 2006) (a case commonly referred to as the "Castle Harbour" case)[81].

It is not enough when applying the facts to the debt/equity factors to test each factor for its presence or absence and then add up the total number of factors tending toward equity and compare that number to the total number of factors tending toward debt, one must also weigh each factor. Universal Castings Corp. v. Commissioner, 37 T.C. at 114.

The "classic debt" is said to be "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage of interest payable regardless of the debtor's income or lack thereof." Gilbert v. Commissioner, 248 F.2d 399, 402-03 (2d Circ. 1957). Courts not only look to the four corners of the instrument, they also will look beyond the face of the instrument to ascertain "whether the investment, analyzed in terms of its economic circumstances, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship." Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3d Cir. 1968).

Courts generally apply a varying list of as many as 16 criteria or factors to be considered in determining whether an financial instrument is debt or equity. The basic formula for testing for whether an instrument is debt or equity turns on the objective intent of the parties. The 16 factors are used for determining that objective intent. The utility of the criteria is limited, however, by the fact that these factors rarely all point in one direction and they have no established relative weights. William T. Plumb, Jr., *The Fed. Income Tax Significance of Corporate Debt: A Critical Analysis & A Proposal*, 26 Tax L. Rev. 369, 439-40 (1971).

Typically, the following factors are applied to the facts of the case to determine whether an instrument is debt or equity: (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a fixed maturity date; (3) the source of payments; (4) the right to enforce payment of what is purported to be principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest as between the creditors and

[81] The facts and circumstances of this case at issue are similar to those of Castle Harbour. In Castle Harbour, the Second Circuit Court of Appeals found the general debt/equity factors, which usually are applied where the equity holder asserts the instrument is debt, were equally applicable where the debt holder asserts the instrument is equity (as in Castle Harbour).

stockholders; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the purported debtor to repay on the due date or to seek a postponement. See Estate of Mixon v. United States, 464 F.2d 394, 406 (5th Cir. 1972)[82].

(1) *Names Given to the Certificates Evidencing the Indebtedness*. For purposes of this memo, the name "Class A Securities" was invented as an easy reference to the combined investment unit; SPV 1 had nothing to do with the name "Class A Securities." However, SPV 1 named each component of the combined unit as the Class A Equity Certificate and the Class A Voting Share. Common Parent's position is the combined unit is equity, not debt. We disagree.

The very debt-like instrument of the two was the Class A Equity Certificates. This name connotes an equity interest. Common Parent, in its financial statement, describes the Class A ECs as preferred variable debt securities; a name that strongly connotes debt. Foreign Bank 1, who held the Class A ECs through SPV 2, referred to its investment in SPV 1 as debt. Foreign Bank 1 treated this interest as debt both for financial accounting and taxation purposes. The name "voting shares" of the Class A Voting Shares connotes equity. Foreign Bank 1 also treated this interest as debt both for financial accounting and taxation purposes.

The fact that Common Parent asserts here that Foreign Bank 1's interest is one of equity should be afforded only the slightest probative value, given its strong self-serving interest in view of the large tax benefits that it expects to receive from this transaction. Hambuechen v. Commissioner, 43 T.C. 90, 104 (1964) (taxpayer's "self-serving statements that the advances were intended to be loans bear little weight in the face of the other facts of record"). Accordingly, this factor is entitled to very little weight in determining whether the Class A Securities constitute debt or equity.

(2) *The Presence or Absence of a Maturity Date*: The absence of an maturity date indicates that any redemption payment is tied to the long term fortunes of the business, and therefore serves as a strong indication of equity. The Transaction documents here are in conflict as to the true maturity date of the Class A Securities. One document provides a mandatory redemption date of Date 13 for the Class A ECs.[83] A Foreign Bank 1 document[84] indicates maturity dates for the Class A ECs and the Class A Shares of Date 6 and Date 5, respectively;[85]. Another document gives SPV 1 the power to force SPV 2 to redeem or exchange the Class A ECs for 5-year Notes in

[82] The IRS has also sets out a list of important debt-equity distinguishing factors in Notice 94-74, which lists 8 factors.
[83] Transaction Document 2 § 3.1.1.
[84] Credit Application dated Date 3.
[85] Interestingly, the divergent dates do not appear to follow the requirement set out in many of the Transaction documents (i.e., the Investor's Agreement) that when one of the instruments is redeemed, the other instrument must be redeemed also.

Year 6 of the transaction[86]; and another document provides that the Transactions will terminate on Date 11, thereby removing SPV 1's business purposes and its reasons for existence[87]. The existence of a maturity date is strong evidence of debt. This instrument clearly has a maturity date – many of them.

Moreover, Attachment C of the Credit Application states that the *transaction's* final maturity date is Date 6. Attachment C provides:

> On Date 11, or, at Common Parent's election, Date 5, the purchase of receivables by SPV 1 terminates and the $d of common shares held by SPV 2 is redeemed. Simultaneously, the $i Class A EC investment in SPV 1 converts into a two-year note, which incorporates all existing Common Parent financial covenants. For the final two years, the assets of SPV 1 will be almost entirely intercompany loans to Common Parent. Final repayment of Foreign Bank 1's funding will be effected by liquidation of the intercompany notes, thus this exposure is ultimately entirely Common Parent risk.

It is clear from the Credit Application that Foreign Bank 1 intended that its investment in the Class A Shares was to terminate on Date 11, 5 years after their issuance, or at the latest on Date 5, 6 years after their issuance. This strong inference is further enforced by Section 5.1 of the Investor's Agreement, which requires the Class A shares to be redeemed upon the exchange of the Class A ECs for Notes. Thus, Foreign Bank 1's total investment in SPV 1, in the form of the Class A ECs and the Class A Shares, was intended to be short term – 6 years at most. A short-term investment, which clearly this is, is more indicative of debt than equity.

(3) *The Source of Payments.* Generally, if the yield on the investment is not dependent on and does not vary with earnings, it indicates that funds were advanced with reasonable expectations of repayment and that such funds were not placed at the risk of the business. Thus, where payment of yield or interest on advanced funds is not dependent on the issuer's earnings, this indicates a creditor-debtor relationship and that debt rather than equity was issued. Conversely, where payment is dependent on and varies with the company's earnings, this indicates that the holder of the instrument is assuming the risks of the business venture so that he may enjoy a profit thereon. This suggests that the advanced funds resemble an equity interest.

Here, the Yield on the Class A EC is not dependent upon earnings. Although the quarterly Yield and Yield due on the mandatory redemption date (Date 12) are dependent on SPV 1 having Distributable Amounts (defined to mean retained earnings), the Yield due on liquidation of SPV 1 is not dependent on SPV 1's earnings.

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[86] Transaction Document 4 § 5.
[87] Transaction Document 1 § 9.1.

Section 3.2 of the Transaction Document 2, provides that "in the event of liquidation [of SPV 1] . . . the holders of the Class A ECs shall be entitled to amount in cash equal to the sum of (1) the Par Value for each outstanding Class A EC plus (2) unpaid Yield accrued through the date fixed for such Liquidation." On liquidation, Foreign Bank 1, through SPV 2, will receive both the principal amount of its investment and any accrued and unpaid yield thereon without regard to whether SPV 1 has any earnings.

Common Parent may argue, however, that, unlike a loan, which does not require the board's declaration as a precondition to payment, the board has to declare the yield before it will be paid to the Class A ECs. As a practical matter, however, the facts negate the force of this potential argument. Yield on the equity certificates was determined before the transaction ever went into effect, and therefore the payment of the Yield was not dependent on the earnings. The Transactions were prearranged so it was clear that Yield on the Class A ECs would be paid in all events. There was no discretion to declare dividends or the amount of the dividend, and there was no risk to Foreign Bank 1.

Even though the documents may suggest otherwise, (e.g., Foreign Bank 1 ostensibly owns 98% of the voting rights of SPV 1 and Director 1, an employee of one of the subsidiaries of Foreign Bank 1, was effectively the only active member of SPV 1's board), nevertheless, his power to control or run SPV 1 was illusory. This factor is indicative of debt.

(4) The Right to Enforce the Payment of Principal and Interest. Another factor is "whether the holders of instruments possess the right to enforce the payment of principal and interest." IRS Notice 94-47. The presence of an enforceable legal obligation to pay principal and interest supports a finding that the transaction more closely resembles debt. The issue is whether [Foreign Bank 1] had the right *to force* the payment of what is effectively its principal and interest. In Castle Harbor, the Second Circuit Court of Appeals found that the banks' interest was more like a creditor's interest than an equity holder's interest because, in part, the partnership agreements gave the banks the power to terminate and receive reimbursement of their $117.5 million investment at the agreed annual rate of return. TIFD III-E, 459 F.3d at 237.

Foreign Bank 1, through SPV 2, has the unconditional right to enforce payment of (a) yield that has been declared to be due and payable by SPV 1's board of directors; and (b) the payment at the maturity date of amounts due and payable upon a mandatory redemption of the Class A ECs. Transaction Document 2, § 6.2. Furthermore, Foreign Bank 1, through SPV 2, can force SPV 1 to liquidate and upon liquidation receive the aggregate par value of all outstanding Class A ECs plus unpaid Yield accrued through the date of liquidation. Transaction Document 2, § 3.2. Although § 6.2 of the Transaction Document 2 does not expressly give SPV 2 (and thereby Foreign Bank 1) the right to liquidate SPV 1 for nonpayment of Yield and principal, it does provide that nothing in the section "shall limit any rights . . . (ii) arising under, provided for in, or in respect of any separate agreement entered into by the [SPV 1]." It is clear from Foreign

Bank 1's statements in the Credit Application that "violation of any of [Common Parent's covenants] constitutes an event of default and consequent liquidation of SPV 1." Also, the Transaction Document 4, in its definition of "Specified Liquidation Condition", list as a liquidation event a breach of any provision (of the Transaction Document 4 or of the Transaction Document 2) that has an adverse material effect on the "rights and benefits available to the holder of the Class A Shares and the Class A ECs." Nonpayment of declared Yield is a breach of a provision that has an adverse material effect on the benefits available to the holder of the Class A Securities. Thus, Foreign Bank 1, through SPV 2, as the holder of the Class A Securities, has the right to liquidate SPV 1 for nonpayment of Yield and principal. This factor suggests that the Class A Securities are debt.

(5) *Participation in Management*. Whether the holder of the instrument is entitled to participate in corporate management or has voting rights as a result of the transaction, is a factor which tends, usually only slightly, to favor a conclusion that the interest resembles equity. Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, par. 4.03[2][h] (7th ed. 2002); Plumb, Jr., *The Fed. Income Tax Significance of Corporate Debt: A Critical Analysis & A Proposal*, 26 Tax L. Rev. 369, 447 (1971). In a footnote, Plumb cites several cases, among them Union Mut. Ins. Co. of Providence v. Commissioner, 46 T.C. 842, 845 (1966), aff'd, 386 F.2d 974, 978 (1st Cir. 1967), in which the court held the instruments in question to be debt even though the instrument holders had the right to designate as many as half the directors, even in the absence of default.

Here, the Class A Securities, in form, have most if not all of the voting rights with regard to SPV 1. However, this fact is not inconsistent with our position in this memo that SPV 2's right to elect the directors of SPV 1 served as additional security for the repayment of the amounts advanced to the Taxpayer Group as loans. It is not that unusual for Foreign Bank 1 to require an equity interest in an entity solely as security for a loan. In Enbridge Energy Company, Inc. v. United States, Nl. H-06-657, slip op. at 6 (S.D. TX, filed 3/31/2008) (opinion and order), the court noted that, as part of its protection for a loan it made to the debtor, Foreign Bank 1 required from the debtor a pledge of, among other things, a membership interest in a limited partnership that was the intermediary entity in an intermediary transactions tax shelter. Thus, in situations where Foreign Bank 1 enters into the transactions solely as a creditor, it is not out of character for it, for security reasons, to take on the appearance of a shareholder or partner.

SPV 2's participation in the management of SPV 1 has been severely limited by the Transactions documents. Those documents limit the assets SPV 1 can possess and thereby limit the business activities in which it may engage. The Transaction documents also prohibit SPV 1 from restructuring or creating new capital. SPV 1 cannot, without Common Parent's approval, borrow on or pledge its assets or elect to do anything that might change the structure or any of the terms of the agreements to Common Parent's detriment. Thus, SPV 2's control over SPV 1's board is anything but an exercise in conducting normal management functions. SPV 1 can do very little except follow the terms of the various Transactions documents. This suggests that Foreign Bank 1, through SPV 2, has just enough control appropriate to protect its interest as a creditor.

Also, it is not clear who controls SPV 1. Director 1, the only active member of SPV 1's board, wears two other hats: one as director of SPV 2 (Foreign Bank 1's SPV and wholly owned by Foreign Bank 1) and one as managing director of SPV 3 (Common Parent's SPV and wholly owned by Common Parent). Thus, it is unclear on whose behalf he is directing SPV 1. Furthermore, SPV 1 cannot take any major corporate actions without Common Parent's approval. SPV 1 cannot merge with another corporation; (2) it cannot purchase or sell any major assets; and (3) it cannot expend capital or dispose of assets, without Common Parent's approval. Common Parent also has a veto power over these major corporate decisions. This is a very significant power over the management of SPV 1. See Alumax v. Commissioner, 165 F.3d 822 (11th Cir. 1999).

Accordingly, although it superficially appears that SPV 2, as holder of the Class A Securities, possesses all the voting power and thereby all control over SPV 1; its voting power is power to not do anything significant. Mostly, SPV 2 has the power to force SPV 1 to declare Yield distributions with respect to the Class A Securities. This factor is a weak indicator of an equity-like interest. Other than the right to declare Yield on the Class A ECs, SPV 2's power appears to be limited to preserving the integrity of its security (the A/R's) on the loan. Thus, with respect to the facts here, this factor tends only slightly to favor a conclusion that the Class A Securities resembles equity.

(6) *A Status Equal or Inferior to that of Regular Corporate Creditors*. A factor to be considered in determining whether an interest is more akin to debt or equity is "whether the rights of the holders of the instruments are subordinate to the rights of general creditors." IRS Notice 94-47. Subordination to general creditors is indicative of equity. What is important here is not what the documents provide, rather it is what the realities of transaction are. TIFD III-E, Inc. v. U.S., 459 F.3d 220, 237 (2nd Cir. 2006). Here, the realities show that SPV 2's interests in SPV 1 were very well protected debtor-like protections. This factor therefore suggests that the Class A Securities resemble debt.

Although the Transactions documents provide that repayment of general creditors would take priority over payment on the Class A Securities, nonetheless, the payment of Foreign Bank 1's/SPV 2's interest was even more securely protected than by priority over the general creditors. SPV 1 was prohibited from issuing, without SPV 2's consent, "any securities having, with respect to payment rights, redemption rights and rights in respect of liquidation, winding up and dissolution, rights that are prior to or *pari passu* with the Class A ECs." Transactions Document 2, § 4. Thus, in reality, SPV 1 only has a few obligations that have priority over payment of Yield on the Class A Securities. Those obligations are: (1) payments to the Taxpayer Group for the purchased A/R's; (2) payment to Managerial Company for administrative, managerial, and accounting services; and (3) payments to Common Parent and its subsidiaries for collection services.

Moreover, repayment of Foreign Bank 1's/SPV 2's interest in SPV 1 was essentially guaranteed by Common Parent. Common Parent and SPV 1 entered into a Guarantee Agreement wherein Common Parent unconditionally guaranteed to SPV 1 (a) prompt payment of all amounts due under the Transaction Document 6; and (b) full performance of all duties, obligations and undertakings arising under the Transactions documents by Common Parent and its three subsidiaries to SPV 1. Guarantee Agreement, dated Date 1. Also, Common Parent provided Foreign Bank 1 with collateral arrangements (other than what appears in the Transactions documents) and the covenants securing Foreign Bank 1's investment in the Tax Strategy. The Credit Application shows the following collateral and covenants provided Foreign Bank 1 by Common Parent:

> (1) Asset base of SPV 1 consisting of third party receivables and intercompany loans to Common Parent or guaranteed subsidiaries. Such collateral coverage is now over 175% of the value of this Class A dual component instrument.
>
> (2) Concentration limits on receivables portfolio: Non-investment grade or unrated – 2.5%; Investment grade – 3.5%. Monthly testing of receivable portfolio by an independent party (Managerial Company) against credit-quality covenants. Violation of any of these covenants constitutes an event of default and consequent unwinding of SPV 1.
>
> (3) Financial covenants on Common Parent (maximum leverage, minimum, Tangible net worth, etc.).
>
> (4) USD r of Credit Default Swaps with maturity of November Year 5.
>
> (5) During the last two years of this transaction (i.e., Year 4-Year 5), the purchase of receivables terminates and the assets of SPV 1 will consist almost entirely of loans to Common Parent with projected 180% Common Parent note coverage of Foreign Bank 1's $b investment (excluding CDS hedges).

This makes it clear that Foreign Bank 1's/SPV 2's interest in SPV 1 is even more securely protected than would normally be the case where an interest expressly states it has priority over the general creditors. This factor strongly indicates debt.

(7). *The intent of the parties*. In the Sixth Circuit Court of Appeals (the circuit in which this case most likely will be litigated), the determination of the intent of the parties is a "critical" issue. Berthold v. Commissioner, 404 F.2d 119, 122 (6^{th} Cir. 1968). In

Berthold, the Sixth Circuit stated that the intention of the parties is the controlling factor in determining whether or not advances should be termed loans. See also Chism's Estate v. Commissioner, 322 F.2d 956 (9th Cir. 1963). The intention of the parties relates not so much to what the transaction is called, or even what form it takes, as it does to an actual intent that money advanced will be repaid. Berthold, 404 F.2d at 122; Commissioner v. Makransky, 321 F.2d 598 (3d Cir. 1963). Normal security, interest and repayment arrangements (or efforts to secure the same) are important proofs of such intent. Berthold, 404 F.2d at 122. In the present case, the parties intent as to whether the Class A Securities are debt or equity could not be clearer. The evidence that the objective intent of the parties is that Foreign Bank 1's entire investment was a loan is overwhelming: e.g., Common Parent's Guarantee of Foreign Bank 1's investment, and Foreign Bank 1 ensuring that SPV 1's asset base provided collateral coverage over 175% of the value of the Class A Securities. See Credit Application.

Common Parent asserts that the Class A Securities are equity. In form, the parties have expressed, through the various agreements, that the Class A ECs should be treated as equity for U.S. tax purposes and as debt for Country Y tax purposes. For U. S. financial statement purposes, Common Parent is treating the Class A securities as debt so that SPV 1's financials can be consolidated with Common Parent's financials. In Common Parent's financial statement notes, the Class A ECs are described as preferred variable debt securities (which name strongly indicates debt rather than equity). For Country Y regulatory purposes, SPV 1 treats the Class A Securities as debt. Because Common Parent's tax objective depends on successfully characterizing Foreign Bank 1's interest in SPV 1 as equity, it took pains to design these transactions to promote that characterization and thus maximize its tax benefits. It did this by attempting to give Foreign Bank 1's financial contribution the appearance of an equity investment. As such, Common Parent's statements of intent are to be viewed as self serving and should not be given much weight in determining whether the Class A Securities are debt or equity.

In the Credit Application, Foreign Bank 1 clearly indicates by its express language that it intended its investment in SPV 1 to be debt and that, at least from its viewpoint, SPV 1's role was merely to secure its $b loan to the Taxpayer Group. The Credit Application shows that Foreign Bank 1 took collateral, secured financial covenants from Common Parent, and purchased a CDS to hedge its investments. Especially harmful to Common Parent's position is the following provision in the Credit Application: "Monthly testing of receivables portfolio by an independent party (Managerial Company) against the following credit-quality covenants. *Violation of any of these covenants constitutes an event of default and consequent unwinding of SPV 1*" (emphasis added). This is strong evidence that Foreign Bank 1 viewed its entire investment in SPV 1, not as an investment in a factoring business, but only as a means of facilitating a lending transaction. Foreign Bank 1 is clearly stating here that if any of the multiple creditworthy covenants given by the Taxpayer Group to Foreign Bank 1 is violated, Foreign Bank 1 will cause an unwinding of the functions of SPV 1. It is noteworthy that in this provision of the Credit Application, there is no provision linking Foreign Bank 1's right to unwind SPV 1 to the latter's success or failure in either the factoring or lending business.

Furthermore, the Fee Letter from Foreign Bank Affiliate, an affiliate of Foreign Bank 1, to Common Parent discusses a "fee arrangement with respect to the SPV 1 transaction with Common Parent in which Foreign Bank 1 through its affiliate has contributed a total amount of $c." The letter states the amount of the fee as $p, which is exactly the yield due by SPV 1 to SPV 2 on the very next day Date 1. See Transactions Document 2, § 2.1.1. This shows that this "Yield" amount could have been nothing other than an upfront lender's fee. The Fee Letter clearly shows that the $p is in substance a lender's fee owed by Common Parent to Foreign Bank 1 for the $c loan, and not, as the Transactions Document 2, § 2.1.1 might otherwise indicate, owed by SPV 1 to SPV 2 as payment of yield on a purported equity investment. Note that the initial dollar value of the Class A ECs on Date 1 was $c, the exact amount cited in the Date 8, Fee Letter, which in the letter is called Foreign Bank 1's investment in SPV 1. It is clear that Foreign Bank 1's/SPV 2's intent in entering into these transactions was that of a creditor, and not as a shareholder, as the Transaction documents try to disguise it. This factor leans strongly toward characterizing Foreign Bank 1's entire investment in SPV 1 as debt.

(8) *"Thin" or Adequate Capitalization*. Thin capitalization prior to a purported loan to the issuer of the instrument would normally suggest an equity contribution. SPV 1 is not thinly capitalized. Here, however, Common Parent is not asserting that Foreign Bank 1's investment in SPV 1 is a loan; it is asserting that Foreign Bank 1's investment is equity. In such situations, this factor is a non-factor with regard to Common Parent's position. However, with regard to the government's position that Foreign Bank 1's investment is entirely debt, adequate capitalization typically is an important condition to a finding of debt. That SPV 1 is not thinly capitalized does not cause the government to reject its position that the Class A Securities are debt because adequate capitalization does not suggest that a purported equity instrument is in reality equity. Therefore, this factor is neutral.

(9) *The Ability of the Corporation to Obtain Loans from Outside Lending Institutions*. If a corporation is able to borrow funds from unrelated third parties, the transaction has the appearance of a bona fide indebtedness. The purpose of this inquiry is obviously to test whether shareholders/contributors acted in the same manner toward their corporation as ordinary reasonable creditors would have acted. If no reasonable creditor would have loaned funds to the corporation at the time of the advance, an inference arises that no reasonable investor would have been willing to take on this role as a creditor of such corporation. Estate of Mixon v. United States, 464 F.2d 394, 410 (5^{th} Cir. 1972).

Common Parent is not asserting that Foreign Bank 1's investment in SPV 1 is a loan; it is asserting that Foreign Bank 1's investment is equity. In such situations, this factor (like the prior factor) is a non-factor with regard to Common Parent's position. However, with regard to the government's position that Foreign Bank 1's investment is entirely debt, the fact that SPV 1 had the ability to obtain loans from outside lending institutions typically is an important condition to a finding of debt.

Although there are restrictions in SPV 1's contractual agreements which prohibit SPV 1 from borrowing funds, it is reasonable to expect that in the absence of such restrictions a lending institution would have loaned funds to SPV 1 (or Common Parent) on terms and amounts similar to that of the Class A EC's. The collateral and the financial covenants secured by Foreign Bank 1 prior to its investing in SPV 1, as well as Common Parent's guarantee of payment and performance to SPV 1, provides Foreign Bank 1 ample protection of its investment. It is clear that an outside lending institution may well have been willing to grant SPV 1 a loan *on the same basis and same terms* as that provided Foreign Bank 1/SPV 2. That SPV 1 could have obtained a loan from outside sources *on the same basis and same terms* as that provided Foreign Bank 1/SPV 2 supports the government's position. Thus, the terms and conditions defining Foreign Bank 1's/SPV 2's investment in SPV 1 strongly suggest a creditor-debtor, rather than a shareholder-corporation, relationship. This factor is indicative of debt.

(10) *The Extent to which the Advance Was Used to Acquire Capital Assets*. Using funds to purchase capital assets that are essential for the operations of a business suggests that the funds may represent equity. Estate of Mixon v. United States, 464 F.2d 394, 410 (5th Cir. 1972). Here, minimal capital assets, if any, are present. The funds received from Foreign Bank 1 were utilized to provide working capital for the day-to-day operations of SPV 1 and were in no way connected to any acquisition of capital assets. Id. The funds were used to purchase discounted trade receivables and to make loans to Common Parent. This factor lends only slight support the Service's position that the Class A Securities are debt.

(11) *Regular and timely payments by the Debtor to the Creditor are made consistent with the debt arrangement.* There appears to be no evidence that SPV 1 failed to make regular and timely payments of Yield on the Class A Securities. The very nature of the purchase of trade receivables activity -- the purchasing of the receivables at a discount and the anticipated payment of those receivables by unrelated third parties 30 days later -- lends an inference that the interest payments (the discount is equivalent to original issue discount on a bond) would have been made when due and so SPV 1 would have sufficient resources to make quarterly payments on the Yield. Furthermore, Common Parent, who was required to keep $t in tangible net worth and also who guaranteed the payment of the loans advanced to its subsidiaries, was financially secure enough to make payments on the loans made to it. Nonetheless, the field should look to see if payments were made when due. Where there appears to be no intent to repay a note, especially where repayment would jeopardize the financial condition of the borrower, this serves to favor characterizing a financial instrument as equity. Here, the financial condition of SPV 1, the borrower, was not in jeopardy. This factor is indicative of debt.

(12) *Lack of Participation in the Risks of the Business*. SPV 1 is nothing more than a conduit in the Transactions and therefore SPV 1 has no business in which Foreign Bank 1 risks its investment. Foreign Bank 1 took little or no risk whatsoever in this transaction. It completely protected its investment with a combination of collateral, financial covenants, and hedges. Page 10, Section III (captioned "Protection") of the Credit Application provides "Foreign Bank 1's protection in this transaction is considered strong. Foreign Bank 1's exposure is now covered 1.75 times with a diversified portfolio of third party receivables and by Common Parent notes. Including the USD r of credit default swap protection increases the total collateral coverage to over 2 times." This factor strongly indicates debt.

(13) *Payment of interest*. A true lender is concerned with interest income. Curry v. United States, 396 F.2d 630 (5th Cir. 1968). The failure to insist on interest payments ordinarily indicates that the payors are not seriously expecting any substantial interest income, but are interested in the future earnings of the corporation or the increased market value of their investment. Here, there are provisions for the payment of Yield on the Class A securities. The field should see if SPV 1 made timely and consistent payments of yield on the Class A ECs. If so, this would favor a finding that the advance to SPV 1 by Foreign Bank 1 was a loan.

(14) *Creditor Rights to Enforce Payment*. A debt is defined as an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable [to the creditor] regardless of the debtor's income or lack thereof. Portage Plastics Co. v. United States, 470 F.2d 308, 313 (7th Cir. 1972) (emphasis added). See also Nassau Lens Co., 308 F.2d at 47; Jewel Tea Co. v. United States, 90 F.2d 451, 453 (2d Cir. 1937) (L. Hand, J.). Foreign Bank 1 had the right to accelerate payment for its interest by forcing SPV 1 to liquidate. Acceleration of a debt is a creditor right. Foreign Bank 1's money is secure here. In the Credit Application, Foreign Bank 1 acknowledged that it was over-collateralized with respect to its investment. The mechanisms of the various agreements ensured that Foreign Bank 1 would receive an annual return at LIBO plus 76 basis points, regardless of whether SPV 1 was experiencing profits or losses. The trade receivables purportedly sold to SPV 1 served as security for the loan from Foreign Bank 1 through SPV 1 to Common Parent. Because Foreign Bank 1 has the right to accelerate this debt, this factor favors viewing the Class A ECs as debt.

(15) *Reasonableness of expectation of payment*. This factor concerns whether, at the time the instrument was issued, the debtor could reasonably be expected to meet interest and principal payments in accordance with the terms of the instrument. A true creditor wants principal repaid, plus interest and will lend money only when he has a reasonable belief that principal and interest will be paid to him. Features of the agreements in this case combined to provide Foreign Bank 1 with not only a reasonable expectation, but virtually an ironclad assurance that it would receive payment of its principal along with the Applicable Rate of return, regardless of whether SPV 1 was successful or not. These features include: (1) Foreign Bank 1's ability to liquidate SPV

1 in certain circumstances and receive reimbursement at the applicable rate of return; (2) the limitations on the assets SPV 1 may possess; (3) the substantial collateral that must be maintained; (4) Common Parent's financial covenants, which are required under the agreements; (5) Common Parent's personal guarantee of the obligations owed by its subsidiaries on the loans advanced to them by SPV 1; and (6) the $r CDS hedge. This factor favors viewing the Class A Securities as debt.

(16) *Whether there is an unconditional promise on the part of the issuer to pay a sum certain.* IRS Notice 94-47, 1994-19 I.R.B. 9 (Apr. 18, 1994).

If there is an unconditional promise on the part of SPV 1 to pay Foreign Bank 1/SPV 2 a sum certain at a reasonably close fixed maturity date, this would be indicative of debt. The Second Circuit Court of Appeals in Castle Harbour stated,

> While an obligation to pay a sum certain indicates debt, it does not follow that any insignificant deviation from a sum certain indicates equity. The purpose of the test is to determine as a practical matter whether the interest created is more akin to equity or debt. Thus, the closer the amount owed comes to being a sum certain, the more it would tend to indicate debt. Trivial or insignificant deviations from a sum certain would do little to argue against a finding of debt.

459 F.3d 220, 236. Here, the Credit Application provides that the Class A Equity Certificates yield 77 basis points or $5.005 million in gross revenue per annum. Foreign Bank 1 priced the transaction "to yield LIBOR plus 93 bpts overall, including upfront fees and internal equity funding. Moreover, Foreign Bank 1 expects to receive an additional, one-time return of approximately $2.750 million upon conversion of the Class A Equity Certificates to Unsecured notes of SPV 1 and $400,000 upon redemption of the Class A shares. Foreign Bank 1's expected "additional, one-time return" of $3.15 million is less than ½% of its overall investment in this transaction. Thus, Foreign Bank 1's upside potential in this transaction is insignificant and it has no downside potential. Foreign Bank 1 does not have a meaningful stake in the profits of SPV 1. Id. at 236 ("The possibility of a small share in extraordinary profits was not a significant feature of their investment"); O'Hare v. Commissioner, 641 F.2d 83 (2d Cir. 1981) (2nd Circuit affirmed the Tax Court's determination that the taxpayer's investment was in fact a loan, stating that the taxpayer had not become "sufficiently involved with the profitability of the venture to warrant treatment as a joint venturer," notwithstanding that the taxpayer was not indemnified against certain liabilities or losses). Here, this small degree of variability in the amount of the stated yield. It was a "sum certain" plus the possibility of an insignificant additional return. Thus, this "sum certain" is clearly more akin to a characteristic of debt rather than equity. Id. At 237.

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Other facts that lean heavily toward calling the Class A interests debt are:

1. Foreign Bank 1 doing a credit check on Common Parent;

2. Foreign Bank 1 charging Common Parent a $p upfront fee[88], referred to as a "structuring fee," for making a $c initial purported contribution to SPV 1;
3. Foreign Bank 1 requiring Common Parent to make 5 financial covenants to secure Foreign Bank 1's investment in the Transactions. One of the financial covenants required Common Parent to maintain $t in tangible net worth;
4. Fixed yield with regard to this investment;
5. The requirement that Common Parent, if it feels it is necessary, can request an extension of this transaction beyond its intended 5 year termination date;
6. Foreign Bank 1's significant over-collateralization of its investment;
7. Common Parent agreement in the Common Terms Agreement not to permit its Net Worth to be less than $2,550,000,000 at any time[89]; and
8. The Guarantee Agreement executed by Common Parent, the Date 3 Credit Application, and the Date 8 Fee Letter, show that *in form*, Foreign Bank 1 made a contribution to the capital of SPV 1, but, *in substance*, Foreign Bank 1 made a loan to Common Parent, not SPV 1. In Plantation Pattern, Inc. v. Commissioner, T.C. Memo 1970-182, *aff'd*, 462 F.2d 712 (5th Cir. 1972), the 5th Circuit Court of Appeals inferred that the loans made by the sellers of the old corporation to the new corporation and which were guaranteed by taxpayer-shareholder, were in substance loans from the sellers to the taxpayer-shareholder and not to the new corporation. The Court found that the sellers were in fact looking to the guarantee for repayment. In the present case, Foreign Bank 1 looked primarily to Common Parent's guarantee as the real source of repayment.

Common Parent asserts SPV 2's interest to be that of a shareholder and not of a creditor. However, when looked at objectively, the $d Foreign Bank 1 transferred in exchange for the Class A Shares is .5% of its total initial investment of $w, and about .31% of its ultimate investment of $b, in SPV 1. Thus, the $d purported equity Foreign Bank 1 had in SPV 1 is *de minimus*; that is, in relation to Foreign Bank 1's overall investment in the Transaction, the equity part of the Class A Securities is so insignificant that a court may overlook it in deciding this issue. This trifling amount tends to mislead if one were to focus on it to the exclusion of everything else. It is clear that, in entering into the Transactions, Foreign Bank 1 and Common Parent intended to engage solely in a loan; Foreign Bank 1 did not intend its investment to be an equity investment. Moreover, from all the facts detailed above, it is clear that Common Parent knew that Foreign Bank 1 intended to make a loan to it, and not a stock investment in SPV 1

We conclude, however, that Common Parent's characterization of the Class A Securities as equity is not entitled to be respected. The weight of the above factors leans overwhelmingly toward treating the Class A Securities as debt. SPV 2's

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[88] This "structuring fee" was disguised as "Yield" to be paid by SPV 1 to Foreign Bank 1. The "Yield" payment was due on SPV 1's first day of operations.
[89] Common Terms Agreement, § 3.16.

investment in SPV 1, analyzed in terms of its economic reality, clearly represents a strict debtor-creditor relationship. The factors demonstrate that SPV 2's investment does not constitute risk capital since, considering both the economic and legal realities, its investment return is overwhelmingly not tied to the fortunes of the corporate venture.

Issue 2. The "purported" sales of A/R's to SPV 1 were not a true sales, rather the "factoring" arrangement was merely a security arrangement for a loan from Foreign Bank 1 and the Taxpayer Group.

We must determine whether the A/R's were in fact sold to SPV 1 or whether SPV 1 just received a security interest in the A/R's from Common Parent so that Common Parent would receive a loan from Foreign Bank 1. Whether a sale has taken place for federal income tax purposes is determined by whether the benefits and burdens of ownership have been transferred to the purported purchaser. See e.g., Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1975), Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981); Frank Lyon v. United States, 536 F.2d 746 (8th Cir. 1976), rev'd, 435 U.S. 561 (1978). In this case, although a part of the Transactions *was structured* as a sale of A/R's from the Taxpayer Group to SPV 1, the Transactions was in fact nothing more than a secured loan between Common Parent and Foreign Bank 1 with SPV 1 serving merely as both a conduit through which the loan proceeds passed and as the holder of the security interest in the Taxpayer Group's A/R's (which served as collateral for the loan). The following facts establish that the Taxpayer Group never sold, and SPV 1 never owned, the A/R's and therefore SPV 1 could not and did not factor the A/R's the Taxpayer Group purportedly sold to it.

SPV 1 did not have an immediate right to possession of the A/R's. Immediate right to possession is a major incident of ownership. Tidewater Fin. Co. v. Moffett (In re Moffett), 288 B.R. 721, 728, 2002 Bankr. LEXIS 760 (Bankr. E.D. Va. 2002). During the relevant tax years at issue, Common Parent never delivered control of the A/R's it purportedly sold to SPV 1, and SPV 1 never took possession of the A/R's it purportedly purchased from the Taxpayer Group. Although the Transactions documents provide that the Taxpayer Group is to "sell, transfer, assign, set over and otherwise convey to SPV 1 . . . all rights, title and interest" it has in the A/R's, the documents never required that Common Parent transfer immediate possession or dominion and control of the A/R's to SPV 1. Possession of the A/R's always remained with the Taxpayer Group.[90] SPV 1 was only entitled to possession on the occurrence of: (1) a Termination Event[91]; or (2) SPV 1's written notification to Common Parent to turn over possession of the A/R's to SPV 1, which notification was premised on the Taxpayer Group no longer servicing the A/R's[92]. It appears that neither event occurred during the years at issue.

SPV 1 could not freely transfer or sell the A/R's it purportedly owned. Prior to the occurrence of a Termination Event, SPV 1 could not, without Common Parent's

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[90] Transaction Document 1, §§ 2.2(b), 2.3, 2.4, 2.6, 8.1(a).
[91] Transaction Document 1, §§ 2.6 and 8.1(a).
[92] Transaction Document 1, § 2.4.

consent, sell or transfer any A/R to any person other than to the Collection Company, Common Parent, Sub 1 or Sub 1[93]. Of significance, the transfer of the receivables on the date of purchase amounted to no more than a book entry on Common Parent's financial statements and records.[94] Common Parent never delivered physical possession of the A/R's to SPV 1; Common Parent was only required to deliver to SPV 1 a Schedule of Receivables.[95] In the case where the Taxpayer Group was no longer servicing the A/R's and if SPV 1 requested that the Taxpayer Group transfer possession of the A/R's to SPV 1, SPV 1 was only entitled to receive from Common Parent a copy of the A/R files; it was not entitled to receive the original files.[96] The original A/R files at all times stay in the possession of one or more members of the Taxpayer Group.[97]

SPV 1 could not exercise dominion and control over any funds collected on "its" A/R's. All collections on "its" A/R's were to be kept in Sub 1's and Sub 1's Lockboxes and Lockbox Accounts. Such collections were always under the exclusive dominion and control of Sub 1 and Sub 2. The Transaction documents grant SPV 1 dominion and control over these lockbox accounts and the funds held therein only on the occurrence of a Termination Event that is determined to be continuing.[98]

There is language in the Transactions documents suggesting that Sub 1 and Sub 2 may commingle funds collected on "SPV 1's" A/R's with funds collected on their own A/R's in these same lockboxes. The Taxpayer Group maintained responsibility for all service fees, overdrafts and any other charges related to these Lockbox Accounts99 even though such fees, overdrafts and other charges, if any, may arise from collections on "SPV 1's" A/R's.100 It is also noteworthy that, even on the occurrence of a Termination Event, SPV 1 was granted no dominion and control over funds *collected by Common Parent* with respect to "SPV 1's" A/R's that were put into a Collections Account established by Common Parent as Collection Agent[101].

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[93] Transaction Document 1, § 5.4
[94] See Transaction Document 1, §§ 2.3 and 4.2(b).
[95] Transaction Document 1, §§ 1.1 Definitions and 4.2(b).
[96] Transaction Document 1, § 2.2(b).
[97] Transaction Document 1, § 2.2(b); 2.3,
[98] The letter dated Date 10, from Sub 1 to Promoter provides evidence that SPV 1 never had dominion and control over the collections with respect to "its" A/R's. In the letter, Sub 1 informed Promoter that Sub 1 would be responsible for all service fees, overdrafts and any other charges related to the Sub 1 Lockbox Account. Sub 1 also stated that it [Sub 1] could continue to withdraw fund from the Account and can even give the Bank instructions with respect to the Account, including instructions to close the Account. Sub 1 goes on to state that SPV 1 will only take dominion and control over the lockbox and the contents of the lockbox upon the occurrence of a Termination Event, and only if SPV 1 delivers a written notice to Promoter that a Termination Event has occurred and is determined to be continuing.
[99] The evidence we have of his is Sub 1's letter to Promoter. We suspect, however, that there is a similar letter from Sub 1 to Promoter.
[100] See footnote 76, supra.
[101] Transaction Document 1 §§ 6.2(a) and 6.3(a) and (b). It is significant that these two provisions authorize SPV 1, upon a Termination Event, to take exclusive dominion and control over the Sub 1 and Sub 2 Lockbox Accounts and the contents therein, but do not authorize SPV 1 to do the same with regard to Common Parent's Collection Account(s) containing collections from A/R's purportedly sold to SPV 1.

SPV 1 did not have any control or discretion with respect to the determination of which A/R's it would purchase on the purchase date. The Taxpayer Group determined which A/R's were to be purchased by SPV 1. On the purchase date, SPV 1 did not know the identity of the A/R's it was purchasing, how many A/R's it was purchasing, or the creditworthiness of the Account Obligors. Nor did SPV 1 know how much it was to pay for the A/R's on the purchase date. SPV 1 only became aware of what it purchased, the size of the purchase, and the amount of the purchase price on the Settlement Date (a day well after the purchase day). Moreover, the account obligors were not notified that the A/R's were sold to SPV 1.

There is no evidence that SPV 1 received title to the A/R's. Significantly, the Transaction documents appear to give the Taxpayer Group the choice of whether to transfer title of the A/R's to SPV 1 or to perfect a security interest in the A/R's in favor of SPV 1[102]. There is ample evidence that SPV 1 received security interests in both the A/R's and the collections from such A/R's.[103] The fact that SPV 1 received a security interest in the A/R's is inconsistent with the notion that SPV 1 owned the A/R's. Accord Fidelity Mut. Life Ins. Co. v. Harris Trust & Sav. Bank, 71 F.3d 1306, 1309 (7th Cir. 1995) ("[a] security interest is not only not title; it is not a possessory interest; and so it does not entitle the lender to receive the rent or other income that the property throws off. An assignment of rents to the lender would thus be inconsistent with the character of the lender's interest in the property generating the rents, as it would give the lender a right associated with ownership").

Moreover, the Account Obligors mailed their payments with respect to "SPV 1's" A/R's to the lockboxes (mentioned above), which were maintained in the names of Sub 1 and Sub 2. Also, Exam should determine who actually made the determinations as to how the funds in Sub 1's and Sub 1's Lockboxes were invested. The Taxpayer Group apparently had decision power over whether and how to invest the collections on the A/R's prior to the Value Date.

For all the reasons stated above, we conclude that the A/R's were neither sold to SPV 1 nor ever owned by SPV 1. SPV 1 held only a security interest in the A/R's, which it held as collateral for the loan made by Foreign Bank 1 to the Taxpayer Group.

The fact that SPV 1 never owned or possessed the A/R's explains why, even in the form chosen by Common Parent, the factoring arrangement does not appear to be a true factoring arrangement. An overview of the entire transaction shows that SPV 1 (although purportedly entering as a factor into a nonrecourse factoring arrangement and taking upon itself the risk of loss upon the default of any of the A/R's) exhibited a conspicuous lack of concern over what are typically important concerns to factors who

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[102] Transaction Document 1, §§ 2.6, 8.1.

[103] Transaction Document 1, § 6.1(e)(iv); see also Uniform Commercial Code Financing Statements of Sub 3 (named "Debtor") in favor of SPV 1 (named "Secured Party"), which were filed with the Secretary of the State of Delaware.

enter into nonrecourse arrangements. Concerns such as (a) determining beforehand the identity of the A/R's that would be purchased; (b) computing how many A/R's that would be purchased, (c) checking the financial soundness of the Account Obligors, (d) calculating the aggregate purchase price of the A/R's, (e) notifying the Account Obligor that it would from this moment on be the collector of the funds on the A/R's, and (f) taking responsibility for collecting payments with respect to the A/R's. SPV 1 did not do any of these. On the other side, the Taxpayer Group also exhibited a lack of concern for (1) receiving immediate payment for the sale of the A/R's; (2) transferring the responsibilities for collections with respect to the A/R's to SPV 1, the ostensible factor; and (3) accepting responsibility for all of SPV 1's expenses.[104] The following facts show how unlike a factoring arrangement this arrangement truly was. They show that the factoring arrangement was a sham.

a. *The purported factoring arrangement is not a factoring arrangement in form or in substance.*

First, although the Taxpayer Group purports to sell its A/R's to SPV 1 (the purported factor), no A/R's were ever sold to SPV 1. SPV 1 received merely a security interest in the A/R's purportedly sold to it. Factors typically purchase the A/R's from their clients. They do not take security interests in the A/R's.

Second, the client here, the Taxpayer Group, did not receive quick cash. A client generally receives cash almost immediately upon the sale of the A/R to the Factor (and certainly well in advance of collection on the A/R from the Account Obligor). Here, the Taxpayer Group did not receive cash with respect to the A/R's sold to SPV 1 (the "factor") until the Value Date, which was defined as the last business day of the calendar month in which the due date for the A/R occurs.

On each purchase date, SPV 1 did not know the amount it owed to the Taxpayer Group for the purchased A/R's. Common Parent was only required to tell SPV 1 of the amount due on the Settlement Date (typically, a month after both the Purchase Date and the Value Date) when Common Parent was required to deliver to SPV 1 a Schedule of A/R's that were sold to SPV 1.

Third, SPV 1 did not confirm the legitimacy of the client's invoice before purchasing the A/R's. Typically with non-recourse factoring, the Factor provides credit checking of the Account Obligors. Before the Factor buys the invoice, it researches the client's customers to make sure they are creditworthy and that they historically pay their invoices on time. Here, on both the Purchase Date and the Value Date (the date SPV 1 is required to fully pay for each A/R), SPV 1 generally had no knowledge of: (a) the identity of the A/R's sold to it, (b) the purchase price of each A/R, (c) the identity of the Account Obligors, or (4) the creditworthiness of the Account Obligors. Common Parent

[104] The Taxpayer Group agreed to pay all costs incurred by SPV 1 in its business activities. It is certainly not typical in a nonrecourse factoring arrangement for the customer to agree to pay, in addition to the factoring discount, the costs incurred by the factor in collecting on the A/R's.

informed SPV 1 of the identity of the A/R's and the amount due for those A/R's at least a month after both the Purchase Date and the Value Date.

Fourth, SPV 1 did not provide collection services to the Taxpayer Group, even though the latter ostensibly paid for those services. Factors typically provide for a fee A/R's collection services to their clients. A Factor typically takes over the client's complete credit management services and employs its own resources to make sure the Account Obligors pay their invoices on time. Here, SPV 1 did not take over Common Parent's credit management services. The Taxpayer Group did its own credit management and collection activities with regard to the A/R's it purportedly sold to SPV 1.

Fifth, SPV 1 did not control the number of A/R's sold to it on the Purchase Date. The identity, the number, and the creditworthiness of A/R's purportedly purchased by SPV 1 was determined solely by the Taxpayer Group. SPV 1 had no right to choose the A/R's it would purchase. SPV 1 did not receive notice as to the identity and number of A/R's it purchased until well after the Purchase Date. This is unusual, if not at all practiced, with regard to nonrecourse factoring. As pointed out above, the Factor in a nonrecourse factoring arrangement bears the risk of nonpayment with respect of any A/R's it purchases. Therefore, the Factor in a nonrecourse arrangement carefully chooses which A/R's it will purchase and it takes full control of the A/R's it purchases. The Factor also controls the number of the A/R's and the total principal balance of A/R's it purchases. The Factor purchases only solid creditworthy invoices. Here, although Common Parent asserts that SPV 1 bears the risk of loss with respect to "SPV 1's" A/R's, SPV 1 has done nothing to protect itself from suffering the risk of loss with regard to these A/R's.

Sixth, SPV 1 does not have the right to reject any A/R's sold to it by Common Parent. SPV 1 may only reject an A/R if (1) it determines that Common Parent has breached any representation or warranty as to such receivable[105], (2) the A/R is not an Eligible Receivable[106], or (3) the purchase of the A/R would cause SPV 1 to exceed its Maximum Purchase Limit. This is contrary to typical factoring practices, especially nonrecourse factoring practices. A factor that enters into a nonrecourse arrangement always ensures it has the right to reject receivables by not purchasing them.

Seventh, the Account Obligors most likely were never notified that SPV 1 had purchased the A/R's and that they were to make their payments to SPV 1. Typically, the client is under a duty to notify the customers of the assignment of its A/R's to the Factor. Also, the Taxpayer Group received payment directly from its customers with respect to the A/R's it purportedly sold to SPV 1, put those payments into its own lockbox accounts, and possibly even commingled those funds with funds it received

[105] Seller warrants as to all A/R's it sells to SPV 1: (1) each A/R is an Eligible Receivable; (2) the A/R has not been satisfied; (3) all information contained in the Schedule of Receivables regarding the A/R's is accurate; (4) the Account Obligor has not raised any defenses against payment of the A/R; and (5) except as to the Sub 3 receivables, no default has occurred.

[106] Eligible Receivable is defined in the Transactions Document 1, § 1.1.

with respect to A/R's that were not sold to SPV 1. In a typical factoring arrangement, the client may not receive payment directly from its customers and then keep the funds so received. 32 American Jurisprudence 2d (2007), Factors and Commission Merchants, § 28 (citing Crocker Commercial Services, Inc. v. Davan Enterprises, Inc., 88 A.D.2d 877, 451 N.Y.S.2d 781, U.C.C. Rep. Serv. 328 (1st Dep't 1982)). Here, although SPV 1 had the right to notify each Account Obligor that it purchased the A/R's, the Taxpayer Group was not required to notify the Account Obligors that they sold the A/R's to SPV 1. Nor was the Taxpayer Group required to notify the Account Obligors to make future payments to SPV 1, except upon a Termination Event that is determined to be continuing. The field should ask Common Parent to produce evidence that the Account Obligors were notified by Common Parent that the A/R's were sold to SPV 1.

Finally, SPV 1 never possesses, even temporarily, the monies received on collection of the A/R's. A typical Factor collects on the A/R's for the client. The Factor purchases the A/R's and any monies collected thereon belong to the Factor. Here, all monies collected on the A/R's purportedly sold to SPV 1 were received by the Taxpayer Group and maintained in the Taxpayer Group's own lockboxes. Very little, if any, of the collected funds ever came to rest in SPV 1's possession.

We recognize that there are a variety of factoring arrangements prevalent in the market today and that some of those arrangements may differ significantly from the "typical" factoring arrangement. Here, however, Common Parent goes to great lengths to inject the "form" of a factoring arrangement into numerous, long, and very complex documents, yet it engaged in an illusory factoring arrangement in which form has no meaning. That the "form" of this factoring arrangement is so atypical of factoring arrangements in general, the form of Class A Securities in this Transaction is so atypical of debt in general leads us to conclude that the factoring arrangement here is a sham-in-fact. Common Parent simply paid SPV 1 a fee (the discount amount) for providing the "façade" of a factoring arrangement so that Common Parent could claim fictitiously generated losses.

Issue 3: The factoring transaction lacked economic substance.

We can anticipate Common Parent will argue that the transactions involved in the factoring arrangement complied in all respects with the Code. However, without agreeing that Common Parent complied, compliance with the Code is insufficient in and of itself for Common Parent to reap the tax benefits it claimed here: Coltec Industries, Inc. v. U.S., 454 F.3d 1340, 1355 (Fed. Cir. 2006). The transaction must also meet the economic substance test. In Coltec, the Federal Circuit Court of Appeals disregarded a transaction for tax purposes despite its literal compliance with the Code on the grounds that it lacked economic substance. The court stated:

> From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code

> by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit.

Coltec, 454 F.3d at 1353-54.

Taxpayers have the unquestioned right to decrease or avoid their taxes by means which the law permits, however, the law does not permit them to reap tax benefits from transactions that lack economic reality. Id., at 1355. "Transactions which do not vary control or change the flow of economic benefits are to be dismissed from consideration." Higgins v. Smith, 308 U.S. 473, 476 (1940).

Whether a specific transaction has economic substance is analyzed by many courts using a two-prong test: (1) the subjective intent of the taxpayer entering into the transaction, and (2) the objective economic substance of the transaction. The Sixth Circuit of Appeals, the circuit in which Common Parent has its principal place of business, does not determine economic substance by a rigid two-prong test. Instead, when considering the issue, the Sixth Circuit tends to view business purpose and economic substance as simply more precise factors to determine "whether the transaction had any practical economic effects other than the creation of income tax losses." Rose v. Commissioner, 868 F.2d 851 (6th Cir. 1989).

The transaction that gave rise to the tax benefit is the only transaction to be scrutinized under the economic substance doctrine. Coltec, 454 F.3d 1356 ("the transaction to be analyzed is the one that gave rise to the alleged tax benefit"); Jade Trading, LLC v. U.S., 80 Fed. Cl. at 119 (2007) ("It matters not whether Jade and its partners had the potential to earn pre-tax profits in all of their endeavors. What matters is whether the single transaction which gave rise to the tax benefits -- here the spread transaction contributed to Jade -- had the ability to earn pre-tax profits").

Here, the factoring arrangement is the transaction that gave rise to tax benefits at issue here and therefore it is the transaction to be scrutinized. Common Parent bears the burden of proof that the sale of the A/R's to SPV 1 had both business purpose and economic substance. Coltec, 454 F.3d at 1355; Jade Trading, LLC v. U.S., 80 Fed. Cl. 11, 115-16 (2007). We do not believe that Common Parent has met its burden in this case.

In order to satisfy the subjective component, the taxpayer must demonstrate that it was motivated by the opportunity to profit from the transaction, or at least had a valid business reason for entering into the transaction other than tax savings. In essence, the taxpayer must demonstrate that the transaction had what is commonly called a "business purpose." The subjective business purpose inquiry "examines whether the taxpayer was induced to commit capital for reasons only relating to tax considerations or whether a non-tax motive, or legitimate profit motive, was involved." Shriver v. Commissioner, 899 F.2d 724, 726 (8th Cir. 1990) (citing Rice's Toyota World v. Commissioner, 752 F.2d 89 (4th Cir. 1985)).

Business purpose.

The inter-company transfer of A/R's from Common Parent to SPV 1 should be ignored because: (1) the transfer was a sham in fact; and (2) if not a sham in fact, it lacked economic substance as it did not appreciably affect Common Parent's beneficial interest except to reduce its tax. See Ballagh v. U.S., 331 F.2d 874, 877-79 (Ct. Cl. 1964) (court disallowed interest expense deductions because the transaction which gave rise to the interest payments lacked economic substance as it did "not appreciably affect [Ballagh's] beneficial interest except to reduce his tax").

A transaction is not given effect for tax purposes unless it serves some purpose other than tax avoidance. Gregory v. Helvoring, 293 U.S. 465 (1935). Here, we conclude that Common Parent had no non-tax business purpose for transferring its A/R's to SPV 1. We can discern 5 possible purposes for a business entity to enter into a factoring arrangement that involves the selling of A/R's to a factor:

1. to get immediate cash by monetizing its assets;
2. to obtain financing because it is unable to obtain traditional forms of business financing (e.g., commercial bank loan);
3. to shift its collection function to someone else so it can concentrate on what it does best – its core business;
4. to shift the risk of loss on the collection of the A/R's; or
5. to generate tax deductions.

Numbers 1 to 4 are generally legitimate motives for federal income tax purposes. Number 5 is an illegitimate purpose. For the following reasons, we conclude that Common Parent, in entering into the factoring arrangement with SPV 1 and purportedly transferring some of its A/R's to SPV 1, was motivated only by the tax deductions that it could generate.

Except for the Date 1, sale of the Sub 3 A/R's, the structure of the factoring arrangement did not provide immediate cash to Common Parent. If Common Parent had never sold the A/R's to SPV 1, it would have received funds just as quickly. Except for the Sub 3 A/R's sale, SPV 1 was not required to provide funds to Common Parent in advance of the Value Date (the end of the month in which the due date of the A/R's occurred). Except for the Sub 3 A/R's, Common Parent almost always receives funds on the A/R's sold to SPV 1 only when payments were made by the Account Obligors with respect to the "sold" A/R's.

Common Parent did not enter into the factoring arrangement to shift its collection function to SPV 1 in order to concentrate on what it does best – its core business. Common Parent continued its collection function on the A/R's. SPV 1 performed no collection function with regard to these A/R's.

Nor did Common Parent enter into the factoring arrangement to shift the burden of risk with respect to the collection of the A/R's. Common Parent will most certainly argue that, since this was a nonrecourse factoring arrangement, the risk of loss was shifted to SPV 1. We conclude that the risk of loss was never shifted to SPV 1 because SPV 1 never owned the A/R's.[107] Even if it is determined that SPV 1 owned the A/R's and the risk of loss on default of such A/R's was borne by SPV 1, the ultimate risk of loss still did not shift away from Common Parent. The ultimate bearer of the risk of loss with regard to any defaulted A/R's remained with Common Parent as the equity shareholder of SPV 1. The Credit Application shows that Foreign Bank 1 ensured that sufficient collateral secured its $b investment. Moreover, Foreign Bank 1 could force the liquidation of SPV 1 if it determined that repayment of the loan to Common Parent was in jeopardy. Section 3.2 of the Transaction Document 2 ensures that Foreign Bank 1 would receive both its principal amount advanced and any accrued and unpaid yield thereon without regard to whether or not SPV 1 had sufficient earnings. Moreover, Foreign Bank 1 had Common Parent's guarantee that Common Parent would repay the loan proceeds and the yield accrued thereon. Foreign Bank 1 stood to lose nothing. Common Parent, on the other hand, as the sole owner of SPV 1's equity, always bore the entire risk of loss if the A/R's in SPV 1's hands defaulted.

Moreover, we found nothing in the documents provided by Common Parent that suggests that Foreign Bank 1, required, as a essential or necessary precondition to making the loan to Common Parent, that SPV 1 be established as an intermediary entity. The Credit Application and the Fee Letter (Date 8) strongly suggest that Foreign Bank 1 was willing to make a commercial bank loan of (at least initially) $w to Common Parent and that it was looking solely to Common Parent for repayment.

Even if Foreign Bank 1 did require the establishment of SPV 1, we do not believe that Foreign Bank 1 required or even sought to have SPV 1 enter into the factoring business with Common Parent. There is nothing in the Transaction documents suggesting that Foreign Bank 1 was truly interested in participating as a shareholder (and thereby assume the risk of profit or loss) of SPV 1 in the business of factoring. As we concluded above, Foreign Bank 1 entered into these Transactions with the intent of making a loan, not an equity investment. This is clearly borne out by the fact that its $d equity investment in SPV 1 (the Class A Shares) is only .5% of its total initial investment of $w, and about .31% of its ultimate investment of $b, in SPV 1. The design and strategy of forming SPV 1 as an intermediary entity was solely the brainchild of Promoter. If Foreign Bank 1 viewed SPV 1 as necessary, it viewed it as necessary only to secure an interest in Common Parent's assets to protect its loan to Common Parent.

[107] It is noteworthy that Common Parent recognized that there was a potential that a court may not find that title to the A/R's passed to SPV 1. Section 3.1(b)(xi)of the Transaction Document 1 provides in part that "in the event the transfer of any such Receivable does not constitute a sale of such Receivable, this Agreement will create in favor of SPV 1 a first priority perfected security interest in all of such Seller's right, title and interest in such Receivable."

There is no indication that Common Parent could not have obtained a $b loan from traditional financing methods. Common Parent was a very large company with assets worth billions. The Common Parent consolidated group generally reports over $l in gross receipts and includes over m entities. Common Parent covenanted with Foreign Bank 1 to maintain $t in tangible assets. Certainly, Common Parent did not have to resort to a factoring arrangement, generally a more expensive form of financing, to obtain a $b loan.

In conclusion, we can discern no legitimate business purpose for Common Parent purportedly selling its A/R's to SPV 1 except to generated tax losses. This is an illegitimate purpose. See Basic Inc. v. United States, 549 F.2d 740 (Ct. Cl. 1977) (court disregarded an inter-company transfer of stock because the transfer had no purpose other than to give the parent a transferred basis in the stock, so that the parent could report less taxable gain on its subsequent sale of the stock).

Economic Substance.

Taxpayer must also demonstrate that it satisfied an objective component of the Economic Substance doctrine. The courts have been willing to recognize the objective economic substance of a transaction if, in lieu of a reasonable possibility of profit, the taxpayer establishes that the transaction resulted in some other meaningful and appreciable enhancement in the net economic position of the taxpayer. Knetsch v. United States, 364 U.S. 361 (1960).

In the context of property dispositions, courts have applied the economic substance doctrine to disregard transactions which, although involving actual dispositions of property at a loss, had no net economic effect on the taxpayer's economic position, either because the taxpayer retained the opportunity to reacquire the property at the same price, or otherwise offset the economic risk of the disposition. ACM Partnership v. Commissioner, 157 F.3d 231 (3rd Cir. 1998), aff'g in part and rev'g in part, T.C. Memo 1997-115, cert. denied 526 U.S. 1017 (1999). It is not enough that the transaction occurred. The transaction must have appreciably changed the taxpayer's net economic position before it will be given effect for tax purposes. Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004).

In Richardson v. Commissioner, 509 F.3d 736 (6^{th} Cir. 2007), the Court affirmed the Tax Court's decision holding a couple liable for taxes on income received by trusts they created. The Tax Court had found that the trusts were shams that lacked economic substance. The Sixth Circuit stated, "If a transaction or entity has no valid, non-tax business purpose, nominally uses another person or entity as a conduit through which to pass title, or brings about no real change in the economic relation of the taxpayers to the income in question, the Commissioner of Internal Revenue has the authority to find that the transaction or entity lacks economic substance and disregard it for tax purposes." Id. at 741. Richardson is analogous to our case. Both cases involve the establishment of an entity to bring about no real change in the economic relation of the taxpayer to the income in question.

In Richardson, the taxpayers created two charitable trusts into which they had transferred all of their assets, including their personal residence, and all rights in their future income. Taxpayers maintained exclusive control of the funds of both trusts. The Court applied the following factors to determine whether the trusts had economic substance: (1) whether the relationship of the grantors to the transferred property changed materially; (2) whether any independent trustee exists to prevent the grantors from acting solely in their own interests; (3) whether any economic interests in the trust assets passed to other beneficiaries; and (4) whether the trust imposes any restrictions on the grantor's use of the assets. The Court held that the trusts lacked economic substance, finding the relationship of the taxpayers both to their physical assets and to their income-producing activities remained essentially unchanged after the formation of the trusts. Id. at 741.

Although Richardson involved trusts and this case involves a corporation, the holding and rationale of Richardson nonetheless applies to our case because Common Parent, just like the taxpayers in Richardson, ostensibly transferred assets to an entity that it formed, but in reality maintained exclusive control over those assets. Here, Common Parent created SPV 1, and similar to the actions of the taxpayers in Richardson, purportedly transferred title and control of its assets (i.e., its A/R's) to SPV 1. Applying the same factors (with some modification because the entity is a corporation, not a trust) used by the Richardson court, we conclude that the creation of SPV 1 for the purpose of factoring Common Parent's A/R's and loaning funds from Foreign Bank 1 to Common Parent lacked economic substance and that the relationship of Common Parent to the A/R's and their income-producing properties remained essentially unchanged after the formation of SPV 1. (We note that this argument looks a lot like the argument and analysis we set forth in Issue 2 above, and there is substantial overlap in the arguments and the facts marshaled in support of the arguments. We believe, however, that it has a slightly different focus here, keeping in line with the court's "economic substance" argument as set forth in Richardson).

Factors considered in Richardson applied to this case:

(1) *Whether the relationship of Common Parent to the A/R's changed materially*. Common Parent at all times maintained complete control over the A/R's files. It maintained the A/R's in its own physical possession. It continued to service the A/R's and to collect on the A/R's in the exact same way as it had done prior to purportedly transferring title to SPV 1. All collections on the A/R's came to the lockboxes Sub 1 and Sub 2 established in their own names. Sub 1 and Sub 2 maintained exclusive dominion and control of the funds in these lockboxes at all times during the three years in issue. SPV 1 merely received a security interest in the A/R's. Since no Termination Event occurred during this period, SPV 1

could not exercise dominion and control over the A/R's or the collections generated by those A/R's.

(2) *Whether any independent party existed to prevent Common Parent from acting solely in its own interest with regard to the A/R's*. Although in form, SPV 2 had control over SPV 1, SPV 1 never had control over the A/R's Common Parent purportedly sold to it. Because SPV 1 did not have a right to exercise dominion and control over the A/R's or the funds collected thereon until the occurrence of a Termination Event that was determined to be continuing, it could not effectively prevent Common Parent, Sub 1 or Sub 1 from acting solely in their own interest with regard to both the A/R's and the collections on those A/R's. For example, in the letter from Sub 1 to Promoter, Sub 1 informed Promoter that "[u]ntil [Promoter] receives further written notice from [SPV 1], [Sub 1] may withdraw fund from the Account." In the letter, Sub 1 also instructs Promoter that, at least until Promoter is notified by SPV 1 that a Termination Event has occurred, Sub 1 can close the account.[108]

(3) *Whether any economic interests in the A/R's passed to SPV 1 or to SPV 2, the other purported shareholder in SPV 1*. According to the Credit Application, SPV 1 generates earnings of approximately $<u>z</u> monthly. SPV 1's earnings are the sum of its interest income and (purportedly) factoring income. We believe that SPV 1 was used as a conduit for passing loan proceeds from Foreign Bank 1 to Common Parent and that the factoring transaction did not have substance -- that it was mere window dressing. The only true economic interest that passed to SPV 1 was the loan proceeds from Foreign Bank 1 to Common Parent.

(4) Whether SPV 1 imposes any restrictions on Common Parent's use of the assets. SPV 1 does not appear to impose any restrictions on Common Parent's use beyond SPV 1's security interest in the A/R's. The security interest in the A/R's was in place to secure repayment of Foreign Bank 1's loan to Common Parent. It appears that Common Parent dealt freely with the funds collected with respect to the A/R's purportedly sold to SPV 1.

In our case, like in the <u>Richardson</u> case, the purported factoring arrangement as well as the purported transfer of the A/R's had no valid, non-tax business purpose and no economic substance. We conclude from the facts that the factoring transaction generated only tax benefits through deductibility of the discount, with no meaningful and appreciable enhancement in Common Parent's net economic position other than to reduce its tax. The Transactions arrangement was just a way for Foreign Bank 1 to make a loan to Common Parent and to give Common Parent additional deductions at the same time. Part of the entire loan was dressed up to look like something else in an attempt to give Common Parent additional tax losses.

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[108] Note that the Transaction Document 1 provides that Sub 1 and Sub 2 cannot close the lockbox accounts without SPV 1's approval.

Finally, like the Richardsons, (although) Common Parent purportedly transferred the A/R's, Common Parent's business operations and dealings with the A/R's did not change. Like the trusts in Richardson, SPV 1 was used ostensibly to pass title of the A/R's, but not the beneficial interest in the A/R's. The factoring transaction brought about no real change in the economic relations of Common Parent to the A/R's purportedly sold to SPV 1. We therefore conclude that the Factoring Transaction had no practical economic effects other than the creation of income tax losses. See Rose v. Commissioner, 868 F.2d 851 (6th Cir. 1989).

ISSUE 4. SPV 1 functions as a mere conduit through which funds were transferred from lender (Foreign Bank 1) to borrower (the Taxpayer Group).

SPV 1 was merely a conduit in the entire transaction. Rev. Rul. 91-47, 1991-2 C.B. 16 held that the use of an entity to participate in a transaction may be disregarded when no substantial business purpose exists for its use even though the larger transaction has a business purpose. Here, Common Parent used SPV 1 as a conduit to pass a security interest in its A/R's to Foreign Bank 1.

The loan proceeds and cash paid in repayment of such loans ostensibly belonging to SPV 1 were actually not the property of SPV 1, but SPV 1 held such cash in trust for Foreign Bank 1/SPV 2.

SPV 1 at no time has any freedom of action with regard to the Transactions. Its discretion with regard to its own assets (i.e., its capital, the A/R's purportedly purchased, the loans it made to Common Parent, the discount and interest income it purportedly received, whether or not it contributes or sells A/R's to Collections Company, etc.) were totally circumscribed by the Transaction documents that were signed prior to SPV 1's formation.

As noted in the analysis of Issue 2, SPV 1 is not factoring the Taxpayer Group's A/R's. SPV 1 took what Foreign Bank 1/SPV 2 contributed to it and passed those funds through to the Taxpayer Group. Ostensibly, it passed a portion of those funds to the Taxpayer Group to purchase the Taxpayer Group's A/R's. However, we have concluded that SPV 1 was not engaged in "factoring," and there are no facts which would indicate that it was involved in any other activity aside from lending money to the Taxpayer Group. We conclude that the portion of the funds purportedly used by SPV 1 to purchase the A/R's were in fact lent to the Taxpayer Group.

The amount contributed by Common Parent/SPV 3 to SPV 1 in SPV 1's initial incorporation, which amount was purportedly used to purchase the Taxpayer Group's A/R's and as part loan proceeds transferred to the Taxpayer Group, should be deemed circular cash. That is, Common Parent contributed $a to SPV 1. SPV 1 in turn returned the virtually all of that money back to the Taxpayer Group. That money essentially stayed in the possession of the Taxpayer Group and did not return to SPV 1. Thus, it appears to be circular cash and can be ignored.

Most, if not all the funds contributed by Foreign Bank 1/SPV 2 to SPV 1 have flowed through SPV 1 and ultimately ended up with the Taxpayer Group. The fact that the amounts contributed to SPV 1 almost equal the amounts SPV 1 transferred to Common Parent, suggests that Foreign Bank 1, through SPV 2, is the real lender, not SPV 1. It suggests that SPV 1 is a mere conduit or nominee for the transfer of loan proceeds to Taxpayer Group and loan repayments to Foreign Bank 1. SPV 1 acted merely as a receiving and transmitting agent for the funds.

Further facts that suggest that SPV 1 is merely a conduit through which Foreign Bank 1 made a loan to Common Parent are:

1. The Yield due SPV 2 on Date 1, as holder of the Class A Securities was an upfront lending fee payment for a loan from Foreign Bank 1 to Common Parent.

2. SPV 2's will ultimately receive on liquidation of SPV 1 the principal amount of its investment and any accrued and unpaid Yield. It makes little sense for SPV 2 to loan the funds to SPV 1, who in turn, relends the same funds to Common Parent.

3. The Credit Application dated Date 3, strongly suggests that the Transactions were a disguise for a loan between Common Parent and Foreign Bank 1.

4. SPV 1 has no employees or officers and does not actively perform any management or operational duties.

5. Furthermore, the Taxpayer Group agreed to pay SPV 1's operating costs as well as any tax imposed on SPV 1.

For the reasons stated above, we conclude that SPV 1's sole role in the Transactions was as a mere conduit for the lending of funds by Foreign Bank 1 funds to Taxpayer Group. We further conclude that SPV 1 was used as a device for Foreign Bank 1 to ensure the loan to Taxpayer Group was adequately collateralized.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

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