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Memorandum

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to: Team Manager, HMP:Territory 2:Group 1653
(Large Business & International)

from: Chief, Branch 2
(International)

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subject: Application of section 267(a)(3) to certain claimed payments of interest made to related foreign persons and associated with related foreign person borrowings

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

LEGEND

Taxpayer =

Tax Years in Issue =

Year 1 =

Year 2 =

Industry A =

Industry B =

Country A =

Income Source A =

Events A =

Circumstances A =

$Amount A =

$Amount B =

$Amount C =

$Amount D =

$Amount E =

ISSUES

Whether, during the Tax Years in Issue, certain wire transfers of funds to related foreign persons that were treated by Taxpayer as payments of interest within the meaning of the cash method of accounting are deductible during those years under section 267(a)(3); alternatively, whether notes issued by Taxpayer to related foreign persons documenting advances associated with such wire transfers may be treated as payments includible in gross income by the recipient under the cash method of accounting and, Taxpayer asserts, deductible for that reason notwithstanding section 267(a)(3).

CONCLUSIONS

Under section 267(a)(3), the claimed payments of interest at issue, whether considered made by wire transfer or notes, are not deductible during the Tax Years in Issue.

FACTS

Taxpayer is the common parent of an affiliated group of corporations filing a consolidated return. Taxpayer's consolidated return group members are engaged in Industry A in locations across the United States. Its foreign parent, organized under the laws of Country A, and foreign affiliates organized and doing business in various other foreign countries, are engaged in or otherwise support similar operations.

Throughout the Tax Years in Issue, Taxpayer maintained a "general account" into which it deposited amounts derived from all sources, including, among others, advances from third party banks under lines of credit, active business income, Income Source A, and advances from its foreign parent. Taxpayer withdrew from this account amounts

necessary for the day-to-day operation of its business, including employee wages, capital expenditures including new physical plant, taxes, and so on.

Also throughout the Tax Years in Issue, Taxpayer claims to have made, out of this account, payments of interest to its foreign parent on certain advances, including a Year 1 advance of $Amount A (the “Year 1 Advance”). In each instance, funds sufficient to cover these “payments” (made via wire transfers) were obtained shortly before or shortly after a claimed payment of interest, either through additional loans from the foreign parent or pursuant to draw-downs on one or more lines of credit with the foreign parent that were similarly credited to the taxpayer’s general account.[1] These loans (collectively the “New Loans”), unless documented as advances pursuant to a pre-existing line of credit, were documented by notes (the “New Notes”). The principal amount of each New Note is payable only at maturity after several years, is subordinated to existing Taxpayer senior debt and also, we understand, is subordinated to any additional future senior debt that Taxpayer may choose to incur. The terms of the New Notes are such that any future senior debt may be incurred without obtaining the consent of any current or future holder(s). The New Notes are unfunded and unsecured. We understand that no New Note has ever been transferred to an unrelated third party for value.

Taxpayer treated each wire transfer to the parent described in the preceding paragraph as a payment of interest not subject to deferral under section 267(a)(3). Taxpayer has asserted, and the audit team has not contested, that if such amounts are properly treated as payments of interest within the meaning of the cash method of accounting that are not deferrable under section 267(a)(3), no withholding upon them is required by reason of an applicable income tax treaty (specifically, the income tax treaty between the United States and Country A).

Taxpayer’s business was impacted by Events A. Taxpayer’s deductions of the amounts here at issue increased or gave rise to net operating losses (NOLs) that were carried back to other tax years and generated refunds of taxes paid for those years.

Importantly, throughout the Tax Years in Issue, Taxpayer’s borrowings from its foreign parent substantially increased. In Year 1, according to Taxpayer, the amount borrowed

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[1] In fact, some of the new loans were made by one or more directly or indirectly wholly-owned foreign subsidiaries of the foreign parent. The audit team has concluded that such foreign subsidiaries are in essence “conduits” for loans from the foreign parent, and Taxpayer has not chosen to directly contest the team’s position that these foreign entities are stand-ins for the foreign parent which is the true “lender-in-substance” for all loans here at issue. Unless the context clearly requires otherwise, for purposes of this memorandum, the term “foreign parent” encompasses these subsidiaries as well as the parent.

Furthermore, in some instances loans were made to members of Taxpayer’s consolidated return group and not in form to the common parent of the U.S. consolidated group followed by a subsequent loan within the group to the member. Throughout this advice, where loans are referred to as made to “Taxpayer,” that term sometimes incorporates loans made in form to such subsidiaries.

from the foreign parent by members of Taxpayer's consolidated group, not including the Year 1 Advance, increased by $Amount B; in Year 2, such borrowings increased by $Amount C. Taxpayer asserts that it "paid" interest during the Tax Years in Issue equal to $Amount D and $Amount E, respectively.

This advice addresses the appropriate treatment of the bulk of the claimed interest payment transactions described above.[2] Taxpayer characterized these transactions as deductible payments of interest with respect to the Year 1 Advance and other loans from its foreign parent. Although the audit team has concluded that the Year 1 Advance should be characterized as equity, the team has not challenged the characterization of these other advances as debt for federal tax purposes in this audit cycle. Since the questioned "payments" of interest with respect to the Year 1 Advance raise the same issues and require the same analysis as claimed "payments" of interest with respect to other loans from the foreign parent, all these are considered collectively herein.

During audit, the team has identified three types of claimed interest payments made during the Tax Years in Issue. In the first type ("Category (1) Payments"), interest was "paid" to the foreign parent by directly netting a required interest "payment" against a foreign parent new advance. In the second ("Category (2) Payments"), documentary evidence (specifically, e-mail traffic) shows that portions of a new advance were "earmarked" to "pay" interest on a pre-existing debt even though the interest "payment" was not netted. In the third ("Category (3) Payments"), "payments" of interest were made close in time to new advances from the foreign parent.

Category (3) Payments constitute the bulk of claimed payments that the audit team concluded should be deferred under section 267(a)(3) in this audit. Because some of Category (3) advances were much larger than the amounts of the claimed interest payments here at issue, it is clear that significant portions of these advances funded *bona fide* Taxpayer operating expenses. The audit team has concluded that the substance of the Category (3) payment transactions requires that they be treated in the same manner as Category (1) and Category (2) payments to the extent that they funded claimed interest payments.

Taxpayer has not responded directly to the team's proposed treatment of the Category (3) payments by distinguishing among them based on any specific principled criteria (such as the length of time between a "payment" and a foreign parent loan during which the funds may have been available to the taxpayer or subject to the claims of third party creditors). Further, Taxpayer has not contended that any of its "payments" of interest were traceable to any specific advances under third-party lines of credit that were deposited into its general account.[3]

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[2] The treatment of the amount of Year 2 claimed interest payments in excess of $Amount E is not contested.

[3] To the extent that during the Tax Years in Issue advances under a third party line of credit were in fact used to fund payments of interest on foreign related party debt, these amounts already should be

Specific questions raised by Taxpayer's arguments regarding these facts

1. Taxpayer asserts that its use of a "general account" as described above renders it impossible "as a matter of law" to "trace" the New Loans (or new draw-downs on lines of credit from the foreign parent) to its "payments" of interest during the Tax Years in Issue. (This is referred to below as taxpayer's "anti-tracing argument".) Accordingly, Taxpayer contends, the "payments" here in issue must be treated as cash payments of interest received (within the meaning of the cash method of accounting) by the foreign parent and so not subject to deferral under section 267(a)(3). As a fallback position to its anti-tracing argument, Taxpayer contends that that if any of the "payments" here in issue should be "traced" or linked to a New Loan, then all new foreign parent advances for each taxable year should be treated as paying *pro rata* for all Taxpayer expenses paid out of the general account. Counsel has been asked to respond to this "anti-tracing" (or purpose-based) argument.

2. Taxpayer asserts that if it should be determined that any claimed payments of interest here at issue can be traced to New Loans, those questioned payments should be deemed made via the issuance of New Notes that are "cash equivalents" in the hands of the foreign parent. Counsel has been asked whether such notes are "cash equivalents" includible (absent a treaty) in the foreign parent's gross income when received.

3. Assuming that the New Notes are "cash equivalents" in the hands of the foreign parent, Taxpayer asserts that either their face amounts or fair market value (which Taxpayer implied during discussions would be identical) are deductible no later than when such note is received by the foreign parent. Taxpayer asserts, in a novel interpretation of the relevant provisions, that "the timing of the interest deductions here at issue depend on when the withholding tax would be imposed [absent a treaty exemption] on the interest, and does not depend on when the deduction would be allowed if the U.S. payor were on the cash method of accounting.".

Counsel has been asked to assess (if necessary) the merits of this contention, which is described below as Taxpayer's "regulatory construction argument."

Conclusions regarding Taxpayer's specific arguments

1. Under the facts here at issue, funds advanced to Taxpayer by its foreign parent via wire transfers to Taxpayer's general account and that are reflected in increased amounts owed to the foreign parent for the Tax Years in Issue were borrowed from the foreign parent for the purpose of paying interest to it on pre-existing loans. This is

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reflected as decreases in the total amounts owed by Taxpayer to its foreign parent and Taxpayer will have appropriately deducted or capitalized have interest on the unrelated party loans. Therefore, the existence and use of such lines of credit during the Tax Years in Issue should not alter the analysis herein.

equally the case with respect to New Loans associated with Category (1), (2), or (3) Payments, and whether made with respect to New Notes, the Year 1 Advance or amounts advanced pursuant to a pre-existing foreign parent line of credit. Taxpayer's anti-tracing argument is at odds with the economic realities of its relationships with both its foreign parent and with third parties.

2. Taxpayer's purported payments of interest to the lender with New Notes during the Tax Years in Issue are mere promises to pay in the future. Accordingly, they would not be includible under the cash method of accounting, even in the absence of an applicable income tax treaty, in determining the foreign parent's gross income.

3. Because Counsel has concluded that notes issued by Taxpayer and received by the foreign parent during the Tax Years in Issue are not includible in gross income by the foreign parent under the cash method of accounting, even in the absence of an applicable income tax treaty, it is not necessary here to address Taxpayer's regulatory construction argument.

LAW AND ANALYSIS

1. All three categories of interest "payments" at issue in this case should be treated as "traceable" to New Loans (or to draw-downs on pre-existing foreign parent lines of credit)

Taxpayer contends that the facts here preclude as a matter of law tracing any of its "payments" of interest to any borrowings from its foreign parent during the Tax Years in Issue. Its argument appears to flow from two different premises – first, that the facts here provide "no direct or indirect evidence that the purpose of the related party borrowings was to pay the interest payments; instead [Taxpayer] used the funds to pay all of its obligations" and second, that Taxpayer could either have "used" or "earmarked" amounts other than foreign parent advances that were deposited in its general account to "pay" interest on its pre-existing foreign parent debt, and (correspondingly) used foreign parent advances for other purposes. Accordingly, Taxpayer states, any correspondence between the times of the advances and its interest "payments" is unexceptional and not evidence of an economic linkage that could give rise to the deferral of a deduction under section 267(a)(3). Taxpayer does not meaningfully address in the context of these arguments its increasing indebtedness to its foreign parent during the Tax Years in Issue, including its asserted "leveraging up" through the Year 1 Advance transaction.

Taxpayer appears to contest the application of well-settled law in this area for two reasons. Taxpayer argues first that because *Battelstein v. Internal Revenue Service*, 631 F.2d 1182 (5th Cir. 1980) (*en banc*), *cert. denied*, 451 U.S. 938, *Davison v. Commissioner*, 107 T.C. 35 (1996), *aff'd*, 141 F.3d 403 (2nd Cir. 1998), and similar cases construe provisions of law other than section 267(a)(3), these cases have no bearing upon the construction of section 267(a)(3) or Treas. Reg. § 1.267(a)-3. In a

slightly different vein, Taxpayer contends that these cases are irrelevant to its situation because the cases involved small, unsophisticated businesses with a single lender and Taxpayer is a large corporation with a foreign parent and complex financial profile involving numerous sources of funds and expenditures.

Despite Taxpayer's apparent attempt to confine these precedents narrowly to their particular facts, *Battelstein*, *Davison* and other cases dealing with the taxation of lender-borrower circular cash flows stand for the proposition that a borrower's claimed payment of interest to its lender with funds borrowed for that purpose from the lender is not a payment within the meaning of the cash method of accounting. There is no reason to believe, or any authority to imply, that these holdings cannot be applied to make determinations regarding the cash method of accounting wherever that method is relevant, including under section 267(a)(3), or that the principles enunciated in these cases apply only to individual taxpayers with simple financial lives. The facts upon which Taxpayer relies to distinguish these cases – that they concern individual taxpayers using the cash method and (Taxpayer contends) with limited sources of funds – were not the basis for the courts' holdings in those cases, but the critical issue – whether "payments" of interest, within the meaning of the cash method of accounting, and with funds borrowed for that purpose from the same lender – is the same. After reviewing these cases, this advice will discuss why the principles set out in these cases support the audit team's proposed adjustments under section 267(a)(3).

Applicable case law regarding circular cash flows and the cash method of accounting in lender-borrower transactions

Battelstein holds that a circular transfer of cash from a lender to a borrower and back did not constitute a "payment" of interest within the meaning of the cash method of accounting. The taxpayers, individuals using the cash method of accounting, were engaged in real estate development and obtained loans from an unrelated lender (Gibraltar). Gibraltar agreed to make future advances of interest costs on the loan as they became due. The taxpayer agreed to issue a check to Gibraltar for the current interest due, and the lender agreed to issue the taxpayer a check in the identical amount. The court held that this "check exchange scheme" resulted in no interest being paid and disallowed a deduction under section 163. The court concluded that the checks, which were issued by the lender in the exact amount as the taxpayer's current interest obligations, had no purpose other than financing the taxpayer's interest obligations to the lender. This arrangement only served to defer the actual payment of interest and was a sham that should be ignored.[4]

[4] The court of appeals stated in part:

> It is well established . . . that [the] surrender of notes does not constitute the current payment of interest that Section 163(a) requires .. . . [P]ayment for tax purposes must be made in cash or its equivalent. *Don E. Williams Co. v. Commissioner*, 429 U.S. 569, 577-78, (1977) . . . . The 1977 decision explained that, "the reasoning is apparent: the note may never be paid, and if it is not

This principle and holding has been applied or echoed in a wide variety of contexts.[5] Taxpayer can cite no authority or valid reason why it does not apply in the context of purported “payments" of interest when those “payments” are part of lender-borrower circular cash flows that also may be subject to deferral under section 267(a)(3).

Davison signals the most recent (1996) detailed analysis by the Tax Court of lender-borrower circular cash flows. In *Davison*, a cash method partnership (White Tail) purchased farmland in 1979 and in 1980. Each acquisition was financed with loans obtained for that purpose from an unrelated insurance company (John Hancock) and made via wire transfers to the partnership’s account. The agreement with respect to the second (1980) loan required the partnership to use a portion of the second loan proceeds to retire the principal balance of first (1979) loan. Of the initial $19 million disbursement under that financing in May 1980, White Tail applied more than $6 million to retire the first John Hancock loan and $227,647 to “pay” accrued interest on that loan.

The second financing called for the partnership to make an interest payment of about $1.5 million January 1, 1981. Under the loan agreement, White Tail had the right to borrow up to one-half of the interest amount if it had insufficient funds from operations to make that interest payment.

> paid, 'the taxpayer has parted with nothing more than his promise to pay.”' *Don E. Williams Co. v. Commissioner*, 429 U.S. 578.

In rejecting the taxpayers’ reliance on the fact that actual checks were exchanged, the Court of Appeals in *Battelstein* viewed its holding as one rooted in basic principles of interpretation. It stated in part:

> In ignoring these exchanges, we merely follow a well-established principle of law, *viz.*, that in tax cases it is axiomatic that we look through the form in which the taxpayer has cloaked a transaction to the substance of the transaction. *See*, *e.g.*, *Republic Petroleum Corp. v. United States*, 613 F.2d 518, 524 (5th Cir.1980); *Redwing Carriers, Inc. v. Tomlinson*, 399 F.2d 652, 657 (5th Cir.1968) (citing cases). As the Supreme Court stated some years ago in *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 58 S.Ct. 393, 82 L.Ed. 474 (1938), “A given result at the end of a straight path is not made a different result because reached by following a devious path.” 302 U.S. at 613, 58 S.Ct. at 394. The check exchanges notwithstanding, the Battelsteins satisfied their interest obligations to Gibraltar by giving Gibraltar notes promising future payment. The law leaves no doubt that such a surrender of notes does not constitute payment for tax purposes entitling a taxpayer to a deduction. [Citation omitted.]

[5] Thus, for example, in the context of loss transactions, a taxpayer using the cash method of accounting may deduct any expenditures only in the taxable year in which they are paid. Treas. Reg. § 1.461-1(a)(1). No loss deduction may be reported until the taxpayer has satisfied the obligation arising from the transaction. *Helvering v. Price*, 309 U.S. 409 (1940). Payment occurs when the taxpayer suffers an economic detriment, i.e. an actual depletion of his money or property. *Jergens v. Commissioner*, 17 T.C. 806, 809 (1951), *acq*., 1952-1 C.B. 2. *See also P.G. Lake. Inc. v. Commissioner*, 148 F.2d 898, 900 (5th Cir.), *cert. den*., 326 U.S. 732 (1945) (describing payment as a liquidation of a liability in cash); *and Reynolds v. Commissioner*, 44 B.T.A. 342, 355 (1941), *acq*., 1941-2 C.B. 11 (deduction of expenses charged to personal account in year 1 that exceeded amount of funds in account should be disallowed since expenses not paid during taxable year 1); *and Shutly v. Commissioner*, T.C. Memo. 1968-24 (business expense incurred in 1963 could not be deducted that year in absence of payment).

By late 1980 it was clear that partnership revenue would not suffice to pay half the amount of interest due in January, 1981, and the parties agreed that John Hancock would advance to the partnership the full amount of the interest payment then due. It did so on by wiring the funds to the partnership on December 30, 1980. The following day, White Tail wired back those funds (plus a small additional payment). After these transactions, the partnership account had a negative balance.

On these facts, Judge Ruwe determined that "[f]undamental and significant factors" restricted White Tail's control over the funds that John Hancock wired to White Tail's account on December 30, 1980, because White Tail had specifically agreed to borrow this amount to satisfy its interest obligation in order to prevent a default. Use of the funds for any other purpose would have breached the terms of its agreement with John Hancock and would have resulted in White Tail's default and a likely end to its business operations.

In *Davison*, laying the foundation for his decision, Judge Ruwe described the Tax Court's evolving views on lender-borrower circular cash flows. In sustaining deductions under the cash method of accounting for later "payments" of interest to the lender, the earliest of these cases had applied formalistic tests to determine whether a taxpayer had "unrestricted control" over funds borrowed from its lender and deposited to its account.[6] The Tax Court's analysis in these cases was questioned and expressly rejected by two courts of appeals, which applied less mechanical tests in their analyses. Thus, in *Wilkerson v. Commissioner,* 655 F.2d 980 (9th Cir. 1981), *rev'g and remanding* 70 T.C. 240 (1978), the Ninth Circuit (relying on the Fifth Circuit's analysis in *Battelstein*) denied an interest deduction for a cash method taxpayer because a portion of borrowed loan proceeds was "specifically earmarked" for the purpose of paying the interest due. *See Davison*, at 47.

In subsequent cases the Tax Court expanded its analysis to consider factors beyond mere physical control over the borrowed funds. Thus, in *Menz v. Commissioner*, 80 T.C. 1174 (1983), the Tax Court considered significant, in concluding that the borrower did not enjoy unrestricted control over funds advanced from its lender that were later used to "pay" interest to the lender, that a wholly owned subsidiary of the lender was a 1–percent general partner of the borrower and possessed approval power over all the borrower's major transactions.[7]

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[6] *See Burgess v. Commissioner*, 8 T.C. 47 (1947), and other Tax Court cases discussed in *Davison*, at 43-46.

[7] Even though the 1-percent partner lacked signatory authority over the bank account into which the borrowed funds were deposited, the Tax Court found that the borrower lacked unrestricted control because that partner was itself controlled by the lender and could have terminated the borrower's existence if it had failed to use the borrowed funds to satisfy interest obligations owed to the lender. Thus, the court concluded, the "1-percent partner's control over the future of the partnership was too fundamental and significant to conclude that the partnership's control over the funds in its account was unrestricted." *Menz*, at 1192.

Against this background, Judge Ruwe concluded in *Davison* that:

> The issue before us arises when a borrower borrows funds from a lender and immediately satisfies an interest obligation to the same lender. In order to determine whether interest has been paid or merely deferred, it is first necessary to determine whether the borrowed funds were, in substance, the same funds used to satisfy the interest obligation. Whether the relevant transactions were simultaneous, whether the borrower had other funds in his account to pay interest, whether the funds are traceable, and whether the borrower had any realistic choice to use the borrowed funds for any other purpose would all be relevant to this issue. Once it is determined that the borrowed funds were the same funds used to satisfy the interest obligation, the purpose of the loan plays a decisive role.
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> In light of the foregoing analysis, we hold that a cash basis borrower is not entitled to an interest deduction where the funds used to satisfy the interest obligation were borrowed for that purpose from the same lender to whom the interest was owed. This test is consistent with our traditional approach of characterizing transactions on a substance-over-form basis by looking at the economic realities of the transaction. We agree with the Courts of Appeals in *Wilkerson* and *Battelstein* that there is no substantive difference between a situation where a borrower satisfies a current interest obligation by simply assuming a greater debt to the same lender and one where the borrower and lender exchange checks pursuant to a plan whose net result is identical to that in the first situation. In both situations, the borrower has simply increased his debt to the lender by the amount of interest. The effect of this is to postpone, rather than pay, the interest.

The decision was affirmed, and its analysis embraced, by the Second Circuit. *Davison v. Commissione*r, 141 F.3d 403 (2nd Cir. 1998) ("Where the agreed purpose and economic substance of the transaction is to capitalize and postpone, rather than extinguish, the debtor's interest obligation (through the device of 'paying' interest now owed using newly-borrowed principal from the same lender that will come due at a future date), a taxpayer should not be able to claim a tax deduction solely because, instead of changing places only on the lender's books, funds are temporarily placed under the debtor's control . . . . We adopt the reasoning, rationale, and holding of the Tax Court's opinion.")

Application of case law to the facts here at issue

Taxpayer dismisses *Battelstein* and *Davison* as irrelevant to the taxation of a complex multinational corporation's affairs. However, nothing confines the holdings of these

cases to individual taxpayers using the cash method or prevents their holdings from applying in the context of section 267(a)(3). Taxpayer's suggestion to the contrary is at odds with the consistent application of these principles elsewhere.

In the case at hand, Taxpayer's circled wire transfers accomplished nothing more than the Battelsteins' circling of checks: each assumed a greater debt to the same lender. The economic consequence also is the same: an effective postponement of payments due. The legal conclusion here must be identical: no "payment" of interest within the meaning of the cash method of accounting.

Taxpayer seeks to distinguish *Battelstein* on the basis that the debtor there had "limited sources [from which] to pay interest due." The facts of *Battelstein*, however, were otherwise. The Battelsteins had more than enough other assets with which to pay the interest due.[8] Similarly, subsequent case law has eroded any distinctions Taxpayer here would make based on the ordering of a borrowing from its lender and a payment of interest to that lender. Thus, in *Blitzer v. United States*, 684 F.2d 874 (Cl. Ct. 1982) the court stated, "[u]nder the *Battelstein* rationale a debtor is not recognized as having paid interest on a loan if he borrowed an equivalent sum from the creditor in a transaction closely linked to the payment of the interest, irrespective of the sequence. And it does not matter whether or not the borrower initially had funds of his own upon which he drew for the payment, nor whether or not he was given unrestricted control of the funds he received." *Blitzer*, at 885.

The thrust of relevant case law, as it has developed, is to focus on the underlying substance of the lender-borrower relationship to determine whether payments of interest purposefully are made via circular cash flows between lender and borrower. In *Battelstein* and similar circular cash flow cases, there were arms' length relationships between the borrowers and lenders, and the tensions between them were reflected in the facts addressed each case. Those fact patterns allowed courts to infer a taxpayer's purpose with respect to a given loan from the "ring-fenced" nature of a transaction that was largely in form and wholly in substance a circular cash flow.

Where a lender and borrower are related to one another, such ring-fencing is unnecessary to assure a lender that the funds it advances will be used to "pay" the borrower's pre-existing interest obligation to the lender. In related party cases, it is accordingly both necessary and appropriate to apply a heightened level of scrutiny to look past the form of the related parties' transactions with one another and to infer their private intentions from the objective economic hallmarks of their transactions *inter se*. *See, e.g., Matter of Uneco, Inc. v. United States*, 532 F.2d 1204, 1207 (8th Cir. 1976)

[8] *See Battelstein*, *supra* (Circuit Judge Politz, dissenting), at 1187 ("[I]n each of the [challenged] instances of payment . . . the Battelsteins had ample assets to cover taxes and interest payments independent of the subsequent loan proceeds. . . . It cannot be disputed that the Battelsteins had more than adequate funds to pay the quarterly interest, independent of any monies received on later advances from Gibraltar.")

(quoting _Cayuna Realty Co. v. United States_, 382 F.2d 298 (Ct. Cl. 1967) ("Advances between parent corporation and a subsidiary or other affiliates are subject to particular scrutiny 'because the control element suggests the opportunity to contrive a fictional debt'"). _See_ _also_ _P.M. Fin. Corp. v. Commissioner_, 302 F.2d 786, 789 (3rd Cir. 1962) (sole shareholder-creditor's control of corporation "will enable him to render nugatory the absolute language of any instrument of indebtedness") *and* _Fin Hay Realty Co. v. United States_, 398 F.2d 694, 697 (3rd Cir. 1968).

The Tax Court recognized this in *Davison*, formally repudiating the notion (already disavowed by two courts of appeals) that a taxpayer can exercise "unrestricted control" over funds merely by depositing funds borrowed from its lender into its bank account. *Davison* also makes clear that, in the Tax Court's view, in determining whether the purpose of a lender's advance is to fund a borrower's interest payment, it is necessary to consider the overall substance of the transactions at issue in their broad context, taking into account facts such as whether the failure to make interest payments on an existing obligation would have had significant economic consequences for the borrower (default), or highlighting the practical significance of *de facto* control exercised via the approval power of a 1-percent partner over the major financial decisions of a borrower-partnership. Where, as here, the borrower is wholly-owned subsidiary of the foreign parent, such control and with it the need for heightened scrutiny of the objective facts exists.

Taxpayer argues here that no specific loan from its foreign parent can be traced to a specific "payment" of interest here at issue – that the "purpose" of each foreign parent loan is obscure or must relate to all expenditures made by the borrower in a given taxable year. It makes this argument with respect to all three categories of payment identified by the audit team, asserting that in no case is there any verifiable nexus between a loan and a "payment" of interest. For all the following reasons, we conclude that nexus is clear with respect to all claimed payments of interest here at issue.[9]

In the case at hand, when funds are (in form) loaned by the foreign parent to the taxpayer and "paid" back via return wire transfers, the resulting "U-turn" transaction is one that changes neither the economic position of the lender or the borrower. Consider the following example. If, before a U-turn transaction, the taxpayer has an accrued interest obligation payable of $1X on a pre-existing loan of $20X from its foreign parent, it has at that time an economic liability to its parent of $21X dollars. After the taxpayer borrows, in form, an additional $1X at or about the time its interest payment on the pre-existing loan is due and "pays" the interest out of the proceeds of the New Note, the

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[9] Although the following analysis applies equally to all three categories of payments identified by the audit team in this matter, Counsel emphasizes that in the case of a Category (1) Payment (a "payment" made via a "netted" foreign parent advance) and a Category (2) Payment (in which a portion of a foreign parent advance was "earmarked" as relating to a subsequent interest "payment"), evidence of the "purpose" for such loans is beyond question. *See, e.g.,* the Ninth Circuit's consideration of "earmarking" in *Wilkerson v. Commissioner*, *supra*, and the Tax Court's discussion of that decision in *Davison*, at 47.

taxpayer still has a liability of $21X to the foreign parent. Correspondingly, the parent, too, has not changed its economic position vis-à-vis the taxpayer: It retains accounts receivable of $21X, now reflected by an old note for $20X and a new subordinated and long-term note for $1X. The taxpayer has in essence "paid" with an IOU. What it has not done is made a payment within the meaning of the cash method of accounting, since a promise to pay is not a payment within either the common-sense meaning of the term or the cash method of accounting.

In this case, Taxpayer, in each taxable year at issue, has identified various sources of cash for its varied types of expenses. Funds from all sources are pooled in its "general account" and all its expenses are paid therefrom. In both Year 1 and Year 2, Taxpayer's foreign parent borrowings substantially increased. To the extent of such increases, the Taxpayer's need for cash demonstrably exceeded its income from all sources.

It is equally clear that all of the expenses Taxpayer paid to unrelated persons from its general account – including its current obligations to third parties, employees, for equipment, physical plant and so on – were paid with cash. No third party here accepted scrip – IOU's – from the Taxpayer as "payment" for its services or products, and Taxpayer has not meaningfully suggested otherwise.[10]

On the facts here at issue, only the foreign parent accepted such Taxpayer promises to pay in the future in lieu of cash payments. In form foreign parent received wire transfers in "payment" of claimed interest expense but, because of the further advance of further funds to the taxpayer, in substance actually achieved no economic change in position. And only the foreign parent has a relationship with the debtor, by virtue of its equity

[10] Taxpayer observed that it had accrued (but not been required to pay in cash) interest expense with respect a line of credit from a third party lender during the Tax Years in Issue. Taxpayer appeared in so doing to imply that the acceptance of such interest "payments" amounted to "payments" to a third party with IOU's and that Taxpayer's "payments" to its foreign parent of interest with notes should be treated as deductible in the same manner as payments to third parties when accrued (but not paid).

Counsel notes that while the borrowings under third party lines of credit are inherently self-policing (because a third party creditor will not carry amounts that it suspects are unlikely to be repaid), amounts loaned by persons related to the borrower are subject to a heightened degree of scrutiny, and that the cash method of accounting must be used with respect to claimed interest to related foreign lenders, precisely because such self-policing is absent in the relationship between a foreign parent and its U.S. subsidiaries (among other relationships specified in section 267(b)).

Taxpayer may also have implied that it could have used such borrowings to "pay" (within the meaning of the cash method of accounting) such amounts to its foreign parent. As noted in footnote 3 above, all such cash method "payments" will have been fully reflected in the amounts by which the balances owed by the Taxpayer to its foreign parent at each year's end have risen; Taxpayer will already have received full credit to the extent that it has "borrowed from Peter" (i.e., by means of a third party loan, interest accruing on which is not subject to disallowance under section 267(a)(3)) "to pay Paul" (its foreign parent). The amounts here at issue accordingly are "net" of such third party borrowings.

interest, which reflects its willingness to indefinitely defer realization and recognition of the fruits of its investment in Taxpayer.[11]

The tracing of overall annual increases in debt owed by the Taxpayer to the foreign parent and Taxpayer's claimed "payments" of interest is, we believe, reflected in and evidenced by other facts here present and Taxpayer's overall pattern of conduct during the Tax Years in Issue. In particular, pertinent facts include evidence of specific loans that are unquestionably tied to specific claimed payments (Category (1) and Category (2) Payments). Such evidence lends weight to our conclusion that the Category (3) Payments here at issue are similarly closely linked to other foreign parent loans, as identified upon examination.

Also, we note that Taxpayer did not merely encounter shortfalls in its ability to make claimed "payments" of interest during the Tax Years in Issue only because of temporary and unforeseeable adverse business conditions, or because of Circumstances A. Rather, the artificiality of these transactions are demonstrated by foreign parent's decision to "leverage up" Taxpayer by an additional $Amount A during this audit cycle, which includes periods of substantially diminished demand for Taxpayer's core products. This additional leveraging was unaccompanied by any infusion of capital.[12] In assessing Taxpayer's ability to service such a large and significant advance, a third party lender would have closely considered Taxpayer's ability to make payments of interest thereon as an additional burden on Taxpayer's cash flow, which was already constrained by its obligation to pay interest on its other debts and also by diminishing demand for Taxpayer's core products. Taxpayer cannot, in light of such considerations, plausibly argue that the foreign parent's advances during the Tax Years in Issue were not meaningfully and "purposefully" related to its claimed payments of interest. Taxpayer and foreign parent both knew, or should have known, that Taxpayer might (and in the event, did) have insufficient cash available from all sources to make cash payments to its foreign parent all of the interest it was obligated to pay on the Year 1 Advance and otherwise during the Tax Years in Issue without incurring additional loans.

[11] Moreover, Taxpayer and its foreign parent alike were well aware that the failure to make timely interest payments on related party debt has led the Service to challenge the debt characterization of related party advances, and so was strongly motivated to make such payments, if only in form, to avoid falling into arrears and possible default on these obligations. These considerations must be taken into account in determining the underlying "purpose" of foreign parent advances used fund such "payments." *See Laidlaw Transportation, Inc., v. Commissioner*, T.C. Memo 1998-232, at 74 (evidence introduced at trial regarding the source of interest payments for purposes of a debt-equity analysis also relied upon by Commissioner to argue applicability of section 267(a)(3)).

[12] Because the characterization of Year 1 Advance is in dispute, consequential adjustments to the amounts of claimed deductions for interest expense that are the subject of this advice may be necessary if those payments are hereafter characterized in whole or in part as payments of dividends (not subject to deferral, if treated as paid, under section 267(a)(3)).

The foregoing evidence, in total, is compelling. Taxpayer's claimed interest "payments" at issue should be traced to increases in foreign parent debt during the Tax Years in Issue.

In each taxable year here at issue, claimed payments of interest that were formally and nominally cast as payments of "cash" via wire transfers, in substance were funded by foreign parent advances made in each such year. Under these circumstances and applying the Tax Court's analysis in *Davison*, we conclude that "the borrowed funds were, in substance, the same funds used to satisfy the interest obligation" and that the real and underlying "purpose of the loan[s]" here at issue was to substantiate (albeit superficially and in form only) a deduction for an amount claimed to be a "payment" within the meaning of the cash method of accounting. Thus, under these facts, Taxpayer may not claim a deduction for interest so "paid."

The logic of this conclusion applies equally with respect to all three categories of "payments" identified by Exam in this case. As noted above, Taxpayer has not argued, in response to the audit team's proposed adjustments, that the team has improperly linked one or more of the Category (3) Payments here in issue to a particular foreign parent advance or proposed specific criteria for doing so. In light of this fact and the nature of our analysis, Counsel believes that it is unnecessary to address here whether, under different circumstances or in response to different Taxpayer contentions, any particular purported Category (3) Payment of interest would be linked to a particular foreign parent loan under other grounds or analyses, or to address Taxpayer's arguments concerning the possible *pro rata* allocation of foreign parent loans during the Tax Years in Issue to all Taxpayer expenditures.

2. Taxpayer's notes are not cash equivalents that would properly be included in income by the foreign parent recipient under the cash method of accounting.

As explained above, Taxpayer did not pay interest to its foreign parent when it issued the New Notes to the foreign parent because in substance no payment, by cash or cash equivalent, was made at such times under the cash method of accounting. In light of Taxpayer's regulatory construction argument (discussed below), however, which implicates the appropriate construction of Treas. Reg. §§ 1.267(a)-3(b)(1) and 1.1441-2(e)(1), it is also necessary to address here whether the value of the notes issued by Taxpayer to its foreign parent would have been includible in gross income by the foreign parent (absent an exception pursuant to an applicable income tax treaty) under the U.S. tax principles governing the cash method of accounting.

Under the cash receipts and disbursements method of accounting, an amount is includible in gross income when actually or constructively received. Treas. Reg. § 1.451-1(a).

For a cash method taxpayer, "[t]he mere delivery of a promissory note to satisfy an interest obligation, without an accompanying discharge of the note, is a mere promise to

pay and not a payment in a cash equivalent." *Smoker v. Commissioner*, T.C. Memo 2013-56 (citations omitted). However, the issuance of a promissory note can be a payment of interest under the cash method if the note is a cash equivalent. A promise to pay is the equivalent of cash and taxable as if a cash payment had been made if (1) it is a promise of a solvent obligor, (2) is unconditional and assignable, (3) not subject to set-offs, and (4) is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money. *Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961).

Taxpayer has provided no evidence that the New Notes meet the four requirements of *Cowden* so as to be considered cash equivalent. They certainly do not appear to be of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the prevailing premium for the use of money. Therefore, the New Notes cannot be a cash equivalent includible in income when received by the foreign parent under *Cowden*.

As the New Notes are not cash equivalents, then the foreign parent did not receive payments includible in its income upon their receipt.

3. Taxpayer's regulatory construction argument

As described above, Taxpayer's claimed payments of interest via wire transfers from its general account, whether documented by New Notes or as advances pursuant to foreign parent lines of credit, should be disregarded as lender-borrower circular cash flows. The only appropriate tax treatment of these transactions is that Taxpayer did not "pay" interest due to its foreign lender by such wire transfers but rather evidenced its ongoing indebtedness in a series of new, long-term, unfunded and unsecured notes or other circular cash flows. Taxpayer's regulatory construction argument urges us to conclude that even if its wire transfers are disregarded as cash payments for federal income tax purposes, interest on Taxpayer's foreign related person debt nonetheless should be treated as paid, within the meaning of the cash method of accounting, by means of the such notes, which, Taxpayer critically asserts in advancing this argument, are "cash equivalents" received by the foreign parent during the Tax Years in Issue.

Counsel has concluded that notes issued by Taxpayer to the foreign parent and the subject of this advice are not includible in the foreign parent's gross income under the cash method of accounting. This conclusion fully disposes of the need to further address Taxpayer's regulatory construction argument in the present case.

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Please call if you have any further questions.

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