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

MEMORANDUM FOR

FROM: Paul S. Epstein
Senior Technical Reviewer CC:INTL:BR5

SUBJECT:

This Field Service Advice responds to your memorandum dated September 11, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

USHC	=
Z Co.	=
Z Sub.	=
Z Parent	=
Country Z	=
State X	=
Y Circuit	=
US Sub.	=
X tax	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Year 1	=
$a	=

$b	=
$c	=
$d	=
$e	=
$f	=
$g	=
h	=
i	=
j	=
k%	=
m%	=
n	=
p	=
q	=

ISSUE(S):

(1) Should Taxpayer's notes, issued in exchange for some of its 100% foreign shareholder's shares, be respected as debt?

(2) If the notes are given tax effect, does section 163(j) or section 267(a)(3) limit Taxpayer's deduction for interest paid on the notes?

CONCLUSION:

Based on the facts presented, the Taxpayer's characterization of the notes as debt should be respected. In this regard, the instruments meet the necessary criteria to sustain debt characterization. We have evaluated the manner in which Taxpayer's stock was converted into debt and conclude that Taxpayer's creation and distribution of the debt instrument pursuant to a partial redemption of the stock of a one-hundred percent shareholder does not, in and of itself, prevent the controlling parent from acquiring valid debt. Under these circumstances, we believe that the transaction would not be defeated under sham or economic substance principles.

In addition, amounts of interest paid on the notes are currently deductible in the year paid and are not deferred under section 163(j) or section 267(a)(3). For purposes of the earnings stripping provisions of section 163(j), Taxpayer's adjusted taxable income exceeds 50% of adjusted taxable income for each year reviewed. The interest payments are not subject to deferral under section 267(a)(3) because the interest payments were actually made prior to the end of the taxable year in which the interest expense was accrued and deducted. There was no unpaid interest accrued at the close of the taxable year.

FACTS:

USHC (Taxpayer) is wholly owned by Z Co., a corporation established under the laws of, and doing business in, country Z. Z Co. is owned by Z Sub., which in turn is wholly owned by Z Parent, both of which are established under the laws of and do business in country Z. USHC owns all of the stock of US Sub., a subsidiary incorporated and doing business in the United States. US Sub. in turn owns the stock of various US subsidiaries. USHC is primarily a holding company, however, it does provide some management services. USHC's principal place of business is located in State X; therefore, Y Circuit or Court of Appeals for the Federal Circuit precedent is relevant.

Prior to Date 1, USHC's balance sheet showed a book value of approximately $a. As a result of a valuation of US Sub. and its subsidiaries, USHC's accountants determined that USHC's assets were worth approximately $b. The $c increase in value was attributed to goodwill. To reflect this increase in value, on Date 1, USHC made a $c revaluation surplus accounting entry on its books. Goodwill was debited $c, and retained earnings were credited $c. We understand that the purpose of the revaluation was to establish the value for which stock would be converted into debt. The valuation was performed incident to Taxpayer issuing the debt security in redemption of a portion of Z Co.'s stock in Taxpayer.

Prior to Date 2, the day following the revaluation, Z Co. owned all h shares of USHC outstanding common stock. Taxpayer had no other shares outstanding. On Date 2 Taxpayer entered into an Exchange Agreement with Z Co. Pursuant to the Exchange Agreement Taxpayer issued to Z Co. i identical notes (the notes) aggregating $c (face value) and approximately $d in cash in exchange for Z Co. tendering for redemption j of Taxpayer's h outstanding shares of common stock. Taxpayer has represented that the $d cash payment was made for rounding purposes so as to avoid the redemption of a fractional share. Of the approximately $c Taxpayer paid to Z Co. in exchange for Taxpayer's shares, $e, the full amount of Taxpayer's earnings and profits, was treated by the parties as a dividend, and the remainder was treated as a return of capital. Taxpayer withheld from the dividend at a rate of k%, the appropriate rate for dividend withholding under the US-Z tax treaty.

Taxpayer treated the notes as debt for tax purposes, as well as for financial accounting and regulatory purposes. Consequently, Taxpayer deducted the interest it paid on the notes in the taxable years in which it paid the interest. In addition, since under the US/ Country Z treaty no withholding is required on interest payments, Taxpayer did not withhold on the interest payments. Had the payments been characterized as dividends, Taxpayer would not be entitled to deduct the payments, which would be subject to withholding at a k% rate.

Following are the terms of the notes:

- The notes are dated Date 2.
- Each note has a face amount of $f, and pays interest at a rate of m%.
- The notes mature on Date 4.
- The notes may be prepaid on or after Date 3, i.e., on or after the sixth anniversary of the notes' issuance.
- At the holder's option, the notes can be converted at maturity into common stock of Taxpayer, at a per share conversion price based upon the fair market value of Taxpayer's shares at maturity.

The notes also contain a provision ("the extraordinary dividend provision") whereby if Taxpayer pays a dividend on its common stock, which dividend is not paid out of retained earnings, i.e., that the dividend is paid out of capital, Taxpayer must reserve the amount of the dividend which would be paid on the shares to which the notes are convertible, and pay that amount to the note holder upon maturity if the notes are converted. Taxpayer explained that this provision is meant to protect the note holder in the unlikely situation that all Taxpayer's retained earnings and a portion of Taxpayer's capital are distributed. In this manner, Taxpayer asserts that the note holder will obtain additional protection as to its right to collect the principal at maturity. This provision, however, will only protect the note holder if it chooses to take payment in Taxpayer's stock.

You have indicated that prior to the revaluation of Taxpayer's balance sheet, the redemption of Taxpayer's common stock, and issuance of the notes, Taxpayer had a debt to equity ratio of n:1. Had Taxpayer redeemed its stock and issued the notes without revaluing its balance sheet, it would have had a negative amount of equity. Due to the revaluation, Taxpayer's debt to equity ratio following the redemption and issuance of its notes was p:1.

You have also stated that Taxpayer is very profitable. Taxpayer claims that based on its very large amount of cash flow -- $g of cash flow for every $1 of interest owed -- that it would have been able to obtain loans in the amount of the notes from unrelated third parties for the purpose of repurchasing its shares. Taxpayer also claims that although it does not maintain any sinking fund or reserve to pay back the notes, it expects to be able to pay back the notes from its large amount of cash flow. However, Taxpayer has not provided a cash-flow projection or any similar document that would support Taxpayer's assertion of its ability to repay the notes at maturity.

The stated rate of interest on the note has been evaluated under the safe haven rules of § 1.482-2(a)(2)(iii)(B) and has been found to satisfy the requirements contained therein. Accordingly, the interest rate contained in the note is an arm's length rate. Taxpayer has paid the interest accruals as required by the notes in the years since their issuance. The interest payments were always made, and the interest expense was always deducted, in the taxable year in which the interest expense was accrued.

Taxpayer claims that the reason it issued the notes was to enable Z Parent to pay dividends at a lower Country Z tax cost, and lower its worldwide tax liability. Z Parent believes that due to the Country Z investor community sentiment, it is necessary for it to pay periodic dividends as evidenced by the fact it has continuously increased its annual dividend to its shareholders.

You have requested assistance as to whether the notes should be respected as debt, particularly since the conversion of stock into debt did not result in Z Co. investing any new capital into Taxpayer. You have also requested assistance as to whether the interest paid on the notes which Taxpayer deducted may be disallowed under another provision of the Code, e.g., sections 163(j), and 267(a)(3).

LAW AND ANALYSIS

I Debt Characterization Issue

As a threshold inquiry, you have questioned whether the Exchange Agreement, i.e., conversion of Taxpayer's equity into notes, should be given effect for federal tax purposes. You note that the Exchange Agreement has not effected any real change in Taxpayer, or in Z Co., its sole shareholder, and was only entered into in order to obtain federal tax benefits. No new capital was invested into Taxpayer as a result of issuing the notes. In addition, both prior and subsequent to executing the Exchange Agreement, Z Co. owned all of Taxpayer's shares. You believe that Taxpayer, in effect, has substituted deductible interest expense for non deductible dividend payments. In addition, the United States cannot impose withholding tax on interest payments made to Z Co., while the dividend payments would be subject to a dividend withholding tax under the U.S. tax treaty with Country Z.

Although the fact that debt is issued without the investment of new capital is a factor that tends to indicate that the purported debt instrument may in substance be equity, or otherwise ignored, this factor alone will not cause the debt instrument to be recharacterized as equity. See Sayles Finishing Plants, Inc. v. United States, 399 F.2d 214, 220 (Ct. Cl. 1968), which stated

> [c]onversion of equity interests into evidence of indebtedness does not necessarily defeat tax treatment of the resulting relationship between a stockholder or stockholders and the corporation as a bona fide indebtedness. Here again, all of the facts and circumstances of the particular case must be considered. Even the fact that no new money was invested in the business does not require a holding that issuance of corporate debentures was a capital transaction, but such debentures are to be allowed tax treatment as indebtedness when the other factors in the case establish a true indebtedness. However, in an appropriate case, lack of new money can be a significant factor in holding a purported indebtedness to be a capital transaction, particularly when the facts otherwise show that the purported indebtedness was merely a continuation of the equity interests allegedly converted.

[citations omitted].

Furthermore, in Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2d Cir. 1956), a case with facts very similar to the facts herein, the Second Circuit held that the debentures at issue were bona fide debt, notwithstanding that they were issued by the subsidiary to its parent as a dividend. The court held that the issuance of the debentures may not be disregarded if in fact the debentures were real, and created legal rights and duties. The debentures were given effect even though their distribution was only partially out of earnings and profits of the distributing subsidiary. A substantial return of capital was also associated with the distribution. Id at 121. See also § 1.301-1(d)(1)(ii); § 1.301-1(h)(2)(i) (contemplating that debt can be distributed to shareholders). Although in the present case Taxpayer issued the notes in exchange for its shares, while in Kraft Foods the taxpayer issued the debentures as a dividend, this distinction is immaterial since the redemption by a wholly owned corporation of its sole shareholder's shares is equivalent under the tax law to a distribution. See § 1.302-1(a). Furthermore, Taxpayer, its sole shareholder, and its creditors are in exactly the same position whether Taxpayer issued the notes to its sole shareholder in exchange for some of its outstanding shares of common stock, as it in fact did, or whether Taxpayer merely issued the notes as a distribution as was done in Kraft Foods.

We note that cases have cited the facts that no new capital was introduced as a result of the issuance of debt, and that the holders of the purported debt remained in the essentially the same position prior to and subsequent to the issuance of the debt, as reasons for determining that the debt should be recharacterized as equity. Nevertheless, in all the cases we have seen there were other factors involved which caused the courts to find that the debt in issue was not real. See, e.g., Wetterau Grocer Co. v. Comm'r, 179 F.2d 158 (8th Cir. 1950) (notes were not debt when interest was payable at the discretion of the taxpayer's directors, and the rate of interest was dependent upon taxpayer's earnings, the notes were subordinate to the claims of general creditors, and the notes were not negotiable); Rialto Realty Inc. v. United States, 366 F. Supp. 253 (E.D. Pa. 1973), aff'd in unpublished opinion (3d Cir. 1974) (bonds were held to be equity when (a) payment of the interest and principal could only be enforced by the trustee with the consent of 75% of the bondholders, which were also common stockholders, when the trustee was indemnified, (b) the bonds were subordinated to current mortgage debt and to any future mortgage lien which may be created for capital improvement purposes or for any reason, and (c) the taxpayer had a high debt to equity ratio); Sayles Finishing Plants, Inc. v. United States, 399 F.2d 214 (Ct. Cl. 1968) (bonds were not bona fide debt when as of the date of the trial, 28 years following the maturity of the bonds, the bonds had not been paid, nor had the creditors, which were also shareholders, made any attempt to collect payment).

In sum, we believe that the treatment of the instruments received in partial redemption of shareholder's stock should not be characterized as equity solely by reason of Taxpayer's redemption transaction and continued status as a sole owner of the distributing subsidiary.

Turning to traditional debt/equity principles, the Ninth Circuit has identified the following eleven factors to be considered in determining whether an interest should be characterized for tax purposes as debt or equity:

- The names given to the certificates evidencing the indebtedness;
- The presence or absence of a maturity date;
- The source of the payments;

- The right to enforce the payment of principal and interest;
- Participation in management;
- A status equal to or inferior to that of regular corporate creditors;
- The intent of the parties;
- “Thin” or adequate capitalization;
- Identity of interest between creditor and stockholder;
- Payment of interest only out of “dividend” money; and
- The ability of the corporation to obtain loans from outside lending institutions.

Bauer v. Comm’r, 748 F.2d 1365 (9th Cir. 1984).

In analyzing whether the notes should be characterized as debt using the above factors, we first look to whether the notes in form meet the requirements of debt. We then look to whether in substance the notes function as debt, rather than as risk capital.

The facts indicate that in form the notes contain all the indicia of debt instruments. The notes on their face are called notes. They contain a fixed maturity date, require the payment of principal and interest regardless of whether Taxpayer earns income, and are not subordinated to Taxpayer’s other creditors. The notes contain provisions under which the holder may enforce the payment of principal and interest through legal action if necessary. Finally, the notes by their terms were transferrable without restriction by the holder. Accordingly, Taxpayer appears to have observed the necessary formalities of creating bona fide debt instruments.

In addition, the parties consistently treated the notes as debt. The notes at all times were treated as debt in Taxpayer’s financial statements, and regulatory filings. Cf., Lundgren v. Comm’r, 376 F.2d 623 (9th Cir. 1967) (promissory notes evidencing advances made to the borrower corporation by the 60% shareholder were bona fide debt when the parties intended to create conventional debt, the borrower corporation’s SBA loan application and authorization referred to the advances as debt, and an offering circular filed with the SEC treated the advances as debt); Los Angeles Shipbuilding & Drydock Corp. v. United States, 289 F.2d 222 (9th Cir. 1961), vacating and rem’g 166 F. Supp. 914 (S.D. Cal. 1958) (the District Court’s characterization of advances made by Taxpayer’s predecessor to its wholly owned subsidiary as debt was not disturbed, since the record contained objective manifestations that the parties intended the advances to be loans). For Country Z tax purposes the notes were treated as debt, and the note payments as interest. Cf. Laidlaw Transp. Inc. v. Comm’r, T.C. Memo. 1998-232, 75 T.C.M. 2598, 2620

(1998) (in determining whether the parties intended to create debt, the Tax Court noted that Taxpayer represented to Canadian tax officials that the loans at issue were in the nature of capital contributions).

We next look at whether in substance the interest in Taxpayer that the notes represent are what they purport to represent, i.e., loans, rather than risk capital. This analysis is particularly important in cases when the purported lender and borrower are related. See, e.g., Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir. 1968); Laidlaw Transp. Inc. v. Comm'r, T.C. Memo. 1998-232 (1998). Generally, the courts have looked at whether the lender could reasonably expect to be repaid from anticipated cash flow or liquid assets, whether the borrower is adequately capitalized, and whether the borrower has made interest payments regardless of its earnings. A factor the courts ascribe importance to is whether the borrower could have obtained loans from outside sources.

First, courts have held that when the issuer never intended to pay back the debt upon its maturity, or could not have reasonably expected to be able to pay back the debt at its maturity, the purported debt would be recharacterized as equity. See, e.g., Brake and Electric Sales Corp. v. United States, 287 F.2d 426 (1st Cir. 1961); Gilbert v. Comm'r, 262 F. 2d 512 (2d Cir. 1959), cert. denied, 359 U.S. 1002 (1959); Gooding Amusement Co. v. Comm'r, 236 F.2d 159 (6th Cir. 1956), cert. denied, 352 U.S. 1031 (1957). To make this determination courts have looked at whether in fact the debt had been paid back at maturity, and if not, the reasons why the debt had not been paid back. See, e.g., Sayles Finishing Plants, Inc. v. United States, 399 F.2d 214 (Ct. Cl. 1968); Brake and Electric Sales Corp. In addition, the courts have looked to the use of the borrowed funds, and the possibility that the funds would be available for repayment, e.g., if the funds were used to acquire a non-liquid capital asset, they probably would not be available for repayment. See, e.g., Gilbert. Similarly, the courts have looked at whether the issuer of the debt had made provisions to pay back the debt, e.g., through the use of a reserve or sinking fund. See, e.g., Louisquisset Golf Club, Inc. v. Comm'r, T.C. Memo. 1962-297 (1962).

We are not in a position to determine whether Taxpayer will have the ability to pay the notes upon maturity. On one hand, Taxpayer is in the same economic position of having used borrowed funds to repurchase its stock, and has not set up a reserve or sinking fund to retire the notes. Both these factors tend to raise doubts as to whether Taxpayer will be able to pay back the debt at maturity. However, Taxpayer's historical results show that its taxable income before depreciation and amortization evidence Taxpayer's ability to repay the notes especially if Taxpayer chooses to refinance at maturity. We note, however, that these calculations do not take into account Taxpayer's capital expenditures during those years.

Based on the information you have submitted, it appears that Taxpayer was adequately capitalized. In determining Taxpayer's debt to equity ratio, we note that the purpose of the debt to equity ratio

> is to determine whether a corporation is so thinly capitalized that a business loss would result in an inability to repay the advance . . . . Essentially, we are concerned with the degree of risk the loan presents to the lender and whether an independent lender, such as a bank, would be willing to make the loan.

Bauer v. Comm'r, 748 F.2d 1365 (9th Cir. 1984), at 1369.

Therefore, generally when calculating a debt to equity ratio, the real values of the assets of the corporation, have been used, including goodwill and going concern values, rather than merely using the book values that appear on the corporation's balance sheet. In Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2d Cir. 1956), the Second Circuit held that the taxpayer was not thinly capitalized when, similar to the current situation, the taxpayer increased its book value by writing up the book value of its intangibles immediately prior to its issuing debentures to its parent as a dividend. See also Miller's Estate v. Comm'r, 239 F.2d 729 (9th Cir. 1956) (the corporate debtor on notes payable to the taxpayer, was not thinly capitalized when taking into account the real value of its capital stock, as reflected by an estate tax appraisal, rather than the amount shown on its books, which did not reflect the business goodwill). Therefore, assuming that in fact Taxpayer's appraisal and resulting book values are legitimate, Taxpayer would not be thinly capitalized.

Finally, we are unable to determine whether Taxpayer had the ability to borrow from unrelated financial institutions. There is information that Taxpayer is very profitable, and probably had the ability to borrow from unrelated financial institutions. Assuming that in fact Taxpayer had the ability to borrow from unrelated financial institutions for the purpose of redeeming its stock at terms similar to those of the notes, and that Taxpayer in fact has sufficient cash flows for servicing the debt, the notes would appear to have economic reality and in substance represent debt rather than risk capital.

You further ask whether the notes' convertibility should impact on our analysis. Generally, if the purported debt is convertible, and based on the terms of the debt it is clear at the time the debt was issued that at maturity the holders will in fact convert the debt, this may well dictate that in fact the debt should be treated as equity. See, e.g., Revenue Ruling 83-98, 1983-2 C.B. 40. This is particularly so when the debt is held by the issuer's sole shareholder since a significant issue would be raised as to whether the instrument is what it purports to be, i.e., debt, or whether the parties are merely structuring the transaction as an artifice used to obtain an interest deduction. Cf. Knetsch v. United States, 364 U.S. 361 (1960) (Supreme Court held that no indebtedness existed when taxpayer had no intent to repay its "loans" in a situation which merely involved a circular exchange of funds); Gregory v. Helvering, 293 U.S. 465 (1935) (taxpayer could not avail herself of the non recognition benefit of the reorganization provisions when within a period of three days she organized a corporation and then liquidated it for the sole purpose of avoiding dividend treatment on a transfer of assets from her wholly owned corporation to her). In Taxpayer's situation, however, the notes are convertible at Z Co.'s option at maturity with the exercise price being the fair market value of Taxpayer's stock at the notes' maturity. Therefore, the conversion option would not make it significantly more likely that an unrelated third party holder of the notes would convert the notes. In addition, since in fact Z Co. already controls Taxpayer without regard to the conversion option, and could choose to invest the proceeds from a hypothetical repayment of the notes in Taxpayer's stock regardless of the existence of the conversion option, the option is less relevant to the debt/equity analysis in this case. Consequently, the conversion option's presence does not make it any more likely that the notes will be converted than if the conversion option had not been issued.

In addition, unlike the situations in Knetsch and Laidlaw Transportation Inc. v. Commissioner, T.C. Memo. 1998-232 (1998), no constant circular flow of funds is involved in this case. Taxpayer first converted a portion of its equity to debt without any investment of new capital for the issuance of the debt and without any use of cash to redeem its equity. The interest payments on the notes were always made with (electronically wired) cash payments. The interest payments which Taxpayer made were never repaid to Taxpayer as capital contributions.

We also do not believe the extraordinary dividend provision described above is significant in determining whether the notes are debt or equity, since it apparently is only meant to protect the note holder in case Taxpayer distributes its assets in excess of its earnings to the shareholders to the detriment of the creditors. In addition, we consider it unlikely that this provision will ever become applicable, particularly in light of the fact that Taxpayer has never paid a dividend during its existence (other than when it issued the notes in partial redemption of its parent's stock).

In conclusion, we believe the notes should be characterized as debt under a traditional debt/equity analysis. We note, however, that this conclusion assumes that Taxpayer will be reasonably able to repay the notes upon maturity based upon its cash flow or liquid assets, and that Taxpayer would have been able to obtain loans of similar amounts from unrelated financial institutions at similar terms.

II Section 163(j) and Section 267(a)(3)

You also have asked us to determine whether Taxpayer's interest deduction may be limited by section 163(j) or section 267(a)(3).

For purposes of our case, under certain circumstances section 163(j) limits deductions for interest paid by a U.S. taxpayer to its foreign parent to the extent no withholding tax is imposed on the interest payment. Generally under section 163(j) the interest deduction is limited to the extent Taxpayer has excess interest expense and Taxpayer's debt to equity ratio as of the close of each taxable year, as determined under section 163(j)(2)(C), exceeds 1.5 to 1. § 163(j)(2)(A). Excess interest expense is measured by the corporation's net interest expense over 50% of its adjusted taxable income, and its excess limitation carryforward. § 163(j)(2)(B)(i). Adjusted taxable income is taxable income after adjusting for non cash deductions, i.e., generally net operating loss deductions and amortization and depreciation deductions, and net interest expense. § 163(j)(6)(A). Generally taxpayer may carry its excess limitation, i.e., the amount by which 50% of taxpayer's adjusted taxable income exceeded its net interest expense, to the three succeeding taxable years. § 163(j)(2)(B)(ii) and (iii).

Taxpayer submitted a schedule showing that for Year 1, 50% of its adjusted taxable income exceeded its net interest expense. In addition, taxpayer's schedule showed that it had excess limitation carryforward from its prior three years which exceeds the total amount of interest paid in Year 1. Therefore, it appears from the information provided that section 163(j) will not limit Taxpayer's interest deduction in Year 1.

In addition, section 267(a)(2) in effect states that if the payor and recipient are related at the close of the taxable year of the payor in which an amount of expense or interest would be deductible, and the recipient is a cash basis taxpayer, the payor may not deduct the amount until the date on which the recipient must include the amount in income. Section 267(a)(3) states that the Service by regulation shall apply the matching principle of section 267(a)(2) in cases in which the recipient is a foreign person. Regulation § 1.267(a)-(3)(b) implements section 267(a)(3) and requires taxpayer to use a cash method of accounting with respect to deducting interest or other fixed, determinable, annual, or periodical amounts which are owed to a related foreign person. Hence, § 1.267(a)-3(b) essentially defers a taxpayer's deduction for interest accrued to a related foreign party until the taxable year in which the interest expense is paid. See Tate & Lyle, Inc. v. Comm'r, 87 F.3d 99 (3d Cir. 1996).

However, based on facts provided, section 267(a)(3) and § 1.267(a)-3(b) will not limit Taxpayer's interest expense deduction in the years at issue, because before the close of each year, Taxpayer has in fact paid the amount of interest which accrued as of each respective year end.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

[redacted]

[redacted] there were no proceeds from the notes' issuance used in a traditional tax shelter type of transaction, i.e., where a taxpayer uses the proceeds of the borrowing for investments that are patently unprofitable other than for the tax benefits involved. Examples of traditional tax shelter activities are when the taxpayer borrows money at 4% to invest in notes paying 1½ %, Goldstein v. Comm'r, 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967), and when the taxpayer borrows money to purchase gold on the spot market, and simultaneously sold the gold on the futures market so as to get interest deductions, offset by capital gains, Lee v. Comm'r, 155 F.3d 584 (2d Cir. 1998). Applying the sham/lack of business purpose rationale to situations which merely involve converting a portion of Taxpayer's capital structure from equity to debt would require an extension of the case law in derogation of other sound principles.

If you have any further questions, please call (202) 622-3870.

By: ______________________________

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