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

OFFICE OF
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Number: **200003001**
Release Date: 1/21/2000
CC:INTL:Br.2 August 31, 1999
TL-N-6272-98

UILC: 482.08-00
482.08-04
1442.04-00

INTERNAL REVENUE SERVICE
NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR:

FROM:

SUBJECT:

This memorandum responds to your request for Field Service Advice dated November 30, 1998, on the above-captioned case. 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:

A =

B =
C =
Country X =
Country Y =
Year 1 =
Year 2 =
Year 3 =
Year 4 =

X =

ISSUE(S):

1. Whether A is precluded from recharacterizing advances it received from its foreign related entities as equity when it originally classified those funds as debt on its books and records and its tax returns.

2. Whether withholding pursuant to sections 1441 and 1442 may be imposed with respect to deemed interest payments that result from a section 482 allocation of interest income from A to its foreign related parties.

3. Whether interest should be imputed to foreign lenders pursuant to section 482 despite the fact that the debtor is financially distressed.

CONCLUSION:

1. A is subject to the “strong proof” rule articulated by the Tax Court when it takes a position invoking the substance of a transaction that is contrary to its form. Based upon the strong proof rule, it would be difficult for A to overcome its burden of proof in attempting to disavow the form of the transaction it has chosen. However, further factual development is recommended. Section 385(c) is further support that A should not be allowed to recharacterize its advances as equity.

2. At present, it cannot be determined whether any allocation of interest under section 482 from A to its foreign related entities is appropriate. If such allocations are appropriate, as described below, the withholding tax liability under section 1442 may arise in connection therewith and A is liable for such tax under section 1461.

3. The accrual rules of section 451 (including the doubtful collectibility exception) do not, as a matter of law, prevent the Service from making an adjustment under section 482. However, if it is determined that there is no reasonable expectation of collecting the imputed interest from A and that the reason for A’s inability to pay is not attributable to non-arm’s length actions by related parties, then section 482 should not be applied to impute interest on A’s trade payables.

FACTS:

The taxpayer, A, is a United States affiliate of a large business system operating in the United States, Country X, and Country Y. A is 87 percent owned by B, a Country X corporation. It is unknown who owns the remaining 13 percent.

A has consistently shown losses since its inception in Year 1. The net operating loss carryover to Year 2 was over $X. A is discontinuing its operations. A represents that it is thinly capitalized. Because A did not have sufficient cash to prepay for inventory, substantial funds have been advanced to A by B and C, a related Country X corporation, during year 2, year 3, and year 4. The advances to A arose from the purchase by A of inventory from the foreign related entities. A concedes that A and these foreign related entities are commonly controlled for purposes of section 482. The foreign related entities during the periods in issue did not engage in a United States trade or business. A recorded the advances as debt on its books and records and its tax returns. For example, on its trial balances, the amounts are reflected as trade payables to the foreign related parties. On its tax returns, the advances are reflected as “Loan from Shareholder”. Also, during the examination process, the taxpayer’s representative indicated that the shareholder of the foreign related entities instructed A to classify these advances as debt. No interest has been accrued or actually been paid with respect to these advances. No payments on these account payables have been made other than a single receivable in Year 2 and an adjusting journal entry in Year 3. Further, no promissory notes are known to exist pertaining to these trade accounts payable. The documentation referencing the intercompany transactions generally does not state an interest rate.

LAW AND ANALYSIS:

1. Whether A is precluded from recharacterizing advances it received from its foreign related entities as equity when it originally classified those funds as debt on its books and records and its tax returns.

A argues that the advances are, in substance, capital contributions, and as such, are not subject to imputed interest under section 482. You have requested assistance on whether a taxpayer is bound by the form in which it has chosen to structure the transaction, in this case as debt rather than equity.

In general, the substance rather than the form of a transaction governs for federal income tax purposes. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935). Thus, the Commissioner has been allowed to discount the form of a transaction, and determine the tax consequences based on its substance. See Gregory v. Helvering; Spector v. Commissioner, 641 F.2d 376, 381 (5th Cir. 1981), cert. denied, 454 U.S. 868 (1981); Laidlaw Transportation, Inc. v. Commissioner, T.C. Memo. 1998-232.

However, the Supreme Court has also long recognized that a taxpayer, although free to structure his transaction as he chooses, "once having done so, he must accept the consequences of his choice, whether contemplated or not . . . and may not enjoy the benefit of some other route he might have chosen to follow but did not." Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974) (citations omitted). Taxpayers have "less freedom than the Commissioner to ignore the form that they have adopted", and are ordinarily bound by the tax consequences that flow therefrom. Illinois Power Co. v. Commissioner, 87 T.C. 1417, 1430 (1986), aff'd 896 F.2d 580 (D.C. Cir. 1990). See also, Nestle Holdings, Inc. v. Commissioner, 152 F. 3d 83, 87 (2d Cir. 1998); Spector v. Commissioner, 641 F.2d at 381; Taiyo Hawaii Company, Ltd. v. Commissioner, 108 T.C. 590, 601-603 (1997); Estate of Durkin v. Commissioner, 99 T.C. 561, 572-75 (1992); Little v. Commissioner, T.C. Memo. 1993-281, 65 T.C.M. (CCH) 3025, 3032 (1993), aff'd, 106 F.3d 1445 (9th Cir. 1997). This rule seeks to avoid the uncertainty that would result from allowing the taxability of a transaction to depend on whether an alternative form exists under which more favorable tax consequences would result. National Alfalfa, 417 U.S. at 149; Television Indus., Inc. v. Commissioner, 284 F.2d 322, 325 (2d Cir. 1960).

The case law recognizes that taxpayers are advantaged by having both the power to structure transactions in any form they choose and the access to the facts that reflect the underlying substance. In contrast, the Commissioner is disadvantaged because he does not have direct access to the facts underlying a particular transaction. Hence, the Commissioner must be allowed to rely on representations made by taxpayers in their returns, and must be allowed to evaluate the resulting tax consequences based on such disclosures. This reliance is particularly appropriate in the context of a cross border transaction, such as the present case, where documents, information and witnesses are not readily available to the Commissioner.

"The Commissioner is justified in determining the tax effect of transactions on the basis in which the taxpayers have molded them ...." Television Industries, Inc. v. Commissioner, 284 F.2d at 325. See also, FNMA v. Commissioner, 90 T.C. 405, 426 (1988), aff'd, 896 F.2d 580 (D.C. Cir. 1990), cert. denied, 499 U.S. 974 (1991). To allow taxpayers to argue for alternative tax treatment of a transaction upon the examination of the returns would be tantamount to administering the tax laws based on a policy that tax consequences flow from the "transaction taxpayers have chosen or from any other form [of transaction] they might have chosen, whichever is . . . [more favorable]." City of New York v. Commissioner, 103 T.C. 481, 493 (1994) (quoting Television Industries, Inc. v. Commissioner, 284 F.2d at 325), aff'd, 70 F.3d 142 (D.C. Cir. 1995). For this reason, the courts have generally subjected taxpayers to a heightened standard of proof before they are permitted to contradict the form and have the transaction taxed in accordance with substance. Spector v. Commissioner, 641 F.2d at 382; Estate of Durkin v. Commissioner, 99 T.C. at 572-

75; FNMA v. Commissioner, 90 T.C. at 426; Illinois Power v. Commissioner, 87 T.C. at 1431; Little v. Commissioner, 65 T.C.M. (CCH) at 3032.

The courts have articulated this heightened standard of proof differently. See Spector v. Commissioner, 641 F.2d at 382. For example, in Commissioner v. Danielson, 378 F.2d 771 (3rd Cir. 1967), cert. denied, 389 U.S. 858 (1967), the court held that where taxpayers executed a contract containing specific terms, conditions and allocations, they may not alter or avoid the tax consequences of that agreement in the absence of fraud, duress, or undue influence.[1] In contrast, the court in Sonnleitner v. Commissioner, 598 F.2d 464 (5th Cir. 1979), determined that before a taxpayer may alter or avoid the tax consequences of a contractual arrangement, the taxpayer must come forth with strong proof that the agreement lacked economic reality. See also Little v. Commissioner, 65 T.C.M. (CCH) at 3031 (strong proof requires a showing beyond a "preponderance of the evidence that the terms of the written instrument do not reflect the actual intentions of the contracting parties"). The strong proof standard has also been adopted by the Tax Court in adjudicating matters involving debt-equity disputes. Miller v. Commissioner, T.C. Memo. 1989-153, 57 T.C.M. (CCH) 46, 50-51 (1989) aff'd in an unpublished opinion, (6th Cir. 1990) (where taxpayers chose to characterize the advances as debt, the court was unpersuaded by their argument that the substance was equity when the advances contained both debt and equity characteristics).

The Tax Court has adopted the strong proof standard and has refused to apply Danielson outside the circuits that recognize it. See, e.g., Meredith Corp. v. Commissioner, 102 T.C. 406, 440 (1994); Elrod v. Commissioner, 87 T.C. 1046, 1065-66 (1986). The "strong proof" rule, as applied by the Tax Court, requires a showing of somewhat more than a preponderance of the evidence and somewhat less than Danielson. Illinois Power Co. v. Commissioner, 87 T.C. at 1434, n.15 (1986), acq. in result, 1990-2 C.B. 1. The burden upon the taxpayer is "far heavier when his tax reporting positions and other actions did not consistently reflect the substance which he later argues should control the form." Miller v. Commissioner, 57 T.C.M. at 50-51 (citing Illinois Power Co. v. Commissioner, 87 T.C. at 1430).

The Tax Court in Estate of Durkin v. Commissioner, 99 T.C. at 574-575 held that, under either a "strong proof" or Danielson standard, the taxpayers could not disavow the form they chose where:

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[1] Only certain courts have adopted Danielson. See, e.g., Lane Bryant, Inc. v. United States, 35 F.3d 1570 (Fed. Cir. 1994); Schatten v. United States, 746 F.2d 319 (6th Cir. 1984); Bradley v. United States, 730 F.2d 718 (11th Cir. 1984), cert. denied, 469 U.S. 882 (1984); Spector v. Commissioner, supra.

(1) taxpayers were seeking to disavow their own tax return treatment of the transaction,
(2) the taxpayers' reporting position and other actions did not show "an honest and consistent respect for the substance of the transaction",
(3) the taxpayers were unilaterally attempting to have the transaction treated differently after it had been challenged, and
(4) the taxpayers would have been unjustly enriched if he were permitted to belatedly alter the transaction after well-informed negotiations were held with the other party to the transaction.

The taxpayers in Durkin did not prevail in establishing that the transaction, in substance, was different from that which was initially reported in the tax return as a purchase of coal properties from their corporation at a price below fair market value. Upon examination of the returns, the Commissioner determined that the taxpayers received a constructive dividend for the difference between the price paid and fair market value of the property. After their returns were challenged by the Commissioner, the taxpayers argued that their purchase of coal properties were in substance part of one integrated transaction in which they disposed of their stock ownership to another shareholder, and thus, the transaction should be taxed as a redemption. Based on the four factors discussed above, the Tax Court determined that the taxpayers did not carry their heightened burden to show a substance that is different than their reporting position. Furthermore, the taxpayers would have been unjustly enriched if they were permitted to avoid the tax consequences of a constructive dividend.

The Ninth Circuit, which governs the present case, has never adopted the Danielson rule and, as a result, the Tax Court has followed the "strong proof" rule there. See, e.g., Fountain Valley Transit Mix, Inc. v. Commissioner, T.C. Memo. 1996-244; Salyer Grain and Milling Co. v. Commissioner, T.C. Memo. 1986-165, aff'd, 815 F.2d 1265 (9th Cir. 1987).[2] These cases rely upon Schmitz v. Commissioner, 51 T.C. 306, 318 (1968), aff'd sub. nom., Throndson v. Commissioner, 457 F.2d 1022 (9th Cir. 1972) in which the Tax Court specifically applied the "strong proof" rule, and the Ninth Circuit affirmed without reaching the issue of the application of Danielson.[3]

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[2] In Salyer Grain and Milling Co. v. Commissioner, 815 F.2d 1265 (9th Cir. 1987), the Ninth Circuit simply adopts the Tax Court opinion.

[3] The Ninth Circuit has used a more stringent rule approaching Danielson. In Palo Alto Town & Country Village, Inc. v. Commissioner, 565 F.2d 1388, 1390 (9th Cir. 1977), the taxpayers were challenging provisions in their agreements regarding the purchase price of two contiguous parcels of land. The court held that taxpayers were bound by the agreements "knowingly and voluntarily made, with no suggestion of fraud." The court noted that "the tax consequences of such an agreement may be

Although the Danielson standard and the "strong proof" standard were both first applied in cases involving covenants not to compete, it is now clear that both standards cover a much broader range of circumstances. Estate of Robinson v. Commissioner, 101 T.C. 499, 513 (1993); Coleman, 87 T.C. 178, 202 (1986). Taxpayers have been held to their characterization of an amount as debt. See Taiyo Hawaii, Ltd. v. Commissioner, 108 T.C. 590 (1997); City of New York v. Commissioner, 103 T.C. 481 (1994); Litchfield v. Commissioner, T.C. Memo. 1994-585, aff'd in an unpublished order, 97-2 USTC ¶ 50, 536 (10th Cir. 1997); Miller v. Commissioner, T.C. Memo. 1989-153. Significantly, Taiyo Hawaii was decided under Ninth Circuit precedent.

The court in Taiyo Hawaii, in holding for the Commissioner that the advances were debt, found that it was unnecessary under the facts of that case to engage in a traditional debt-equity analysis. 108 T.C. at 601-604. Working from the fundamental rule of law enunciated in National Alfalfa that a taxpayer must accept the tax consequences of its choice of transaction, the court noted that taxpayers have been permitted to assert substance over form where their "tax reporting and other actions have shown an honest and consistent respect for" the substance. Id. at 602 (citing FNMA v. Commissioner, 90 T.C. at 426 and Illinois Power Co. v. Commissioner, 87 T.C. at 1430). The court found that Taiyo Hawaii failed this exception. The court stated:

> Petitioner has, for all purposes, treated the advances as loans and was instructed by its parent corporation to accrue interest. Under those circumstances, we reject petitioner's approach of testing its own choice of form with traditional debt versus equity considerations, such as the absence of a fixed payment schedule, maturity dates, enforcement, or formal debt instruments. We are likewise unpersuaded by petitioner's accountant's . . .

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challenged by the Commissioner, but not by the taxpayer." 565 F.2d at 1390 (citations omitted). Other Ninth Circuit cases have similarly held that, in an absence of fraud, a taxpayer could not challenge the form of its transaction. See Baxter, 433 F.2d 757, 759 (9th Cir. 1970). The Tax Court has recognized that the holding of Palo Alto indicates that the Ninth Circuit may apply a rule that is more stringent than the "strong proof" rule. See Huestis v. Commissioner, T.C. Memo. 1992-159, 63 T.C.M. (CCH) 2443, 2447 (1992); Chiapetti v. Commissioner, T.C. Memo. 1996-183, 71 T.C.M. (CCH) 2778, 2783 n.8 (1996). However, whether the Tax Court would ever apply the Palo Alto standard is questionable. In both Huestis and Chiapetti, the Tax Court determined that their conclusion would be the same under either the "strong proof" or Palo Alto standard. Huestis, 63 T.C.M. (CCH) at 2447; Chiapetti, 1996 RIA TC Memo ¶ 96, 183 at 1368 n.8. Further, after Palo Alto, the Tax Court has continued to apply the "strong proof" standard in cases appealable to the Ninth Circuit. See Salyer Grain and Milling Co, 51 T.C.M. (CCH) at 922 n.1.

> after-the-fact testimony that, in retrospect, he should have considered the advances as equity and reported them as such on petitioner's tax returns.

108 T.C. at 602-603 (citations and footnote omitted).

In the recent opinion of Norwest Corp. v. Commissioner, 111 T.C. 105 (1998), the Tax Court denied the taxpayer's attempt to have a transaction taxed in accordance with its substance, after it was initially reported on the return as a sale and lease-back of real property. The taxpayer argued that there had been no sale, and that the entire transaction, in substance, was merely a financing arrangement. After considering various approaches, the Tax Court concluded that the "taxpayers cannot elect a specific course of action and then when finding himself in an adverse situation extricate himself by applying the age-old theory of substance over form." Norwest Corp. v. Commissioner, 111 T.C. at 146. A taxpayer's ability

> to ignore the transactional form that he has adopted . . . is further curtailed if . . . [he] attempts to abandon his tax return treatment of a transaction . . . [W]hen a taxpayer seeks to disavow his own tax return treatment . . . by asserting the priority of substance only after the Commissioner raises questions with respect thereto, this Court need not entertain the taxpayer's assertion of the priority of substance . . . [Due to] the tremendous load he carries, [the Commissioner] must necessarily rely in the vast majority of cases on what the taxpayer asserts to be fact. The burden is on the taxpayer to see to it that the form of business he has created for tax purposes, and has asserted in his returns to be valid, is in fact not a sham or unreal. If in fact it is unreal, then it is not he but the Commissioner who should have the sole power to sustain or disregard the effect of the fiction since otherwise the opportunities for manipulation of taxes are practically unchecked. Id. at 145-146.

Further, the Tax Court adopted a heightened standard of proof when a taxpayer attempted to avoid the Commissioner's interest allocation pursuant to section 482 based on the argument of substance over form. Cayuga Service, Inc. v. Commissioner, T.C. Memo. 1975-4, 34 T.C.M. (CCH) 18 (1975). In response to the taxpayer's urging that the court disregard the form of intercompany advances as loans, and find that the advances were investments, the court stated, "[I]f a taxpayer asserts that the substance is different than the form he used, he must furnish strong proof that the substance was other than the form indicates," citing, *inter alia*, Ullman v. Commissioner. The court found that "petitioner has failed to meet its burden of persuading us that the advances were in fact investments and not loans." 34 T.C.M. (CCH) at 25.

The court decided Cayuga Service based on then existing Treas. Reg. § 1.482-2(a), T.D. 6952 (Apr. 16, 1968) and the decision is consistent with longstanding principles that the Commissioner is allowed to determine the tax consequences of a transaction based on its substance, while imposing a heightened standard of proof on taxpayers that argue for a substance different than the form. These principles are set forth in Treas. Reg. § 1.482-2(a), T.D. 8552 (Jul. 1, 1994), and, unlike the 1968 regulations, are confirmed in Treas. Reg. § 1.482-2(a)(3)(i), which provides that the substance of the transaction shall be determined, and that "all the relevant facts and circumstances shall be considered and any law or rule of law (assignment of income, step transaction, etc.) may apply."

We recognize that in some cases involving debt-equity disputes decided prior to Norwest and Taiyo Hawaii, courts chose to adjudicate the matter by testing the taxpayer's chosen form with traditional debt versus equity considerations. For instance, in Georgia-Pacific Corp. v. Commissioner, 63 T.C. 790 (1975), the Commissioner argued that the taxpayer was bound by the form in which affiliated corporations cast advances. The Tax Court, however, believed that such advances should be "characterized in terms of economic reality for the year at issue" and that "changing circumstances as time passes may alter the original character of an advance and transform it into equity." Id., at 795-796. It is worth noting that when applying the various debt-equity factors to reach the conclusion that the advances were debt, a recurring theme relied upon by the Court was the intent of the affiliates as evidenced by their contemporaneous actions prior to litigation - - the manner in which the affiliates characterized the advances on their books and records, reported the advances on their tax returns and reported the advances to unrelated third parties. Id., at 796-800. The Court concluded that the advances were "clearly loans at their inception" and the taxpayer had failed to present a "concrete demonstration of any changed intent." Id., at 800. In this sense, Georgia-Pacific, which was decided only one year after National Alfalfa, was a precursor to Norwest and Taiyo Hawaii. But, to the extent Georgia-Pacific reflects a court's willingness to indulge in traditional debt-equity considerations, the Tax Court in Taiyo Hawaii found the taxpayer's reliance on Georgia-Pacific unworthy of comment in light of National Alfalfa and its progeny. 108 T.C. at 601.[4]

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[4] The court in Taiyo Hawaii was likewise unimpressed with the taxpayer's reliance on J.A. Tobin Construction Co. v. Commissioner, 85 T.C. 1005 (1985) (imputation of interest under section 482 rejected, but the Commissioner did not argue that the taxpayer was held to the form of its transaction); J.A. Maurer, Inc. v. Commissioner, 30 T.C. 1273 (1958) (advances were contributions to capital); LDS, Inc. v. Commissioner, T.C.M. 1986-293 (the transfer of land in exchange for a note was nontaxable capital contribution because the objective factors overwhelmingly outweigh the taxpayer's subjective intent that the transaction was to be a sale of land); and Inductotherm Industries, Inc. v. Commissioner, 48 T.C.M. 167, 186-89 (1984), aff'd. without published opinion 770 F.2d 1071 (3d Cir. 1985) (advances characterized as equity but the Commissioner did not argue that the taxpayer was held to the form of its transaction for such advances) 108 T.C. at 601, n. 9.

In this case, we believe it would be difficult for A to overcome its burden of proof under the "strong proof" rule in attempting to disavow the form of transaction that it has chosen. A booked the advances as trade payables to the foreign related parties on its trial balances and recorded the advances as "Loan from Shareholder" on its tax returns. It is only after an examination by the Service of taxpayer's records that A is seeking to disavow its own tax return treatment for the advances it received. Clearly, A's financial reporting and tax reporting indicate an inconsistent treatment for these advances. Further, due to the imposition of additional tax liability, it appears that A is unilaterally attempting to have the transaction treated as a contribution to capital after the Service challenge. However, we have no knowledge how B and C treated the advances for financial reporting and for tax reporting purposes. For example, it is not known whether the advances were reflected in B or C's capital account. Thus, further factual development is necessary to finally determine whether A and the foreign related lenders took consistent positions with respect to the advances that A is seeking to disavow, and whether their reporting positions show "an honest and consistent respect for the substance of the transaction."

In the event it is necessary to consider whether the advances constitute debt or equity, the particular facts and circumstances must be examined. No single uniform approach has been adopted by the courts in analyzing this particular issue. The Tax Court looks to whether there was a "genuine intention to create a debt, with a reasonable expectation of repayment, and . . . [whether] that intention comport[s] with the economic reality of creating a debtor-creditor relationship." Nestle Holdings. Inc. v. Commissioner, T.C. Memo. 1995-441, 70 T.C.M. (CCH) 682, 700 (1995), vacated and remanded on another issue 152 F.3d 83 (2d Cir. 1998) (quoting Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 377 (1973). In this regard, the same facts concerning the tax and financial reporting of A, contemporaneous with the transaction, are very probative of the overall intent of the parties.

The courts have enumerated several other factors, in addition to intent, to be considered in resolving a debt-equity issue. While the following list is not exclusive and no single factor is determinative, the courts generally look to:

1. the name and presence of a written agreement demonstrating indebtedness,
2. the presence of a fixed maturity date,
3. the source of payments, e.g., whether there is anticipated cash flow to cover payments,
4. the right to enforce payment,
5. increased participation in management as the result of the advance,
6. subordination,
7. thinness of the capital structure in relation to debt,
8. the identity of interest between creditor and stockholder,

9. the source of interest payments, e.g., from earnings,
10. the ability of the corporation to obtain credit from outside sources,
11. the use of funds for capital assets or risk involved in making the advances, and
12. the failure of the debtor to repay.

See Laidlaw Transportation, Inc. v. Commissioner, T.C.M. 1998-232; Nestle Holdings, Inc. v. Commissioner, 70 T.C.M. at 700; Lansall Company v. United States, 512 F.Supp. 1178, 1180 (S.D.N.Y. 1981). See also I.R.C. § 385(b) (listing debt-equity factors which could be taken into account in regulations).

Although the taxpayer represents that the above factors have been satisfied, further factual development is necessary.

It is also your position that section 385(c) precludes A from recharacterizing the advances as equity.

In the instance case, A is a domestic corporation that consistently characterized the advances from related foreign parties as payables on their books and records and reported them as “Loans from Shareholder” on their federal tax returns. Only when faced with additional tax liability did A seek to recharacterize the advances as equity. Under these circumstances, we agree that section 385(c) is further support to preclude taxpayers from recharacterizing the advances from debt to equity.

2. Whether withholding pursuant to sections 1441 and 1442 (“withholding tax”) may be imposed with respect to deemed interest payments that result from a section 482 allocation of interest income from A to its foreign related parties.

Initially, we note that if there were any accounts receivable providing for interest, and if it is determined both that the accounts receivable’s stated interest is at an arms length rate within the meaning of Treas. Reg. § 1.482-2(a)(2) and the accounts receivable provided for payment of interest at maturity, it is possible that no section 482 adjustment would be appropriate. Section 267(a)(3) puts the taxpayer on a cash basis with respect to this interest owed to the foreign lender, so that even if its liability for interest were properly accrued for accounting purposes, no tax deduction for the interest would be allowable prior to its actual, constructive, or deemed payment. Because no documentation has thus far been produced, the balance of this memorandum assumes that no such documentation exists, and that a section 482 adjustment is appropriate for the period here in issue under the general rule set forth in Treas. Reg. § 1.482-2(a)(1), during which time no interest was paid or accrued by the taxpayer in respect of outstanding indebtedness.

In general, section 881 of the Code imposes a tax of 30 percent of the amount received from sources within the United States by a foreign corporation as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income ("FDAP"), but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.

The mechanism for collecting the tax imposed by section 881 is provided in sections 1441 and 1442. Section 1442 provides that, in the case of foreign corporations, there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in section 1441 a tax equal to 30 percent thereof. Section 1441 states, in part, that all persons, in whatever capacity acting, having control, receipt, custody, disposal, or payment of any items of income specified in [section 871] of any nonresident alien individual or of any foreign partnership shall deduct and withhold from such items a tax equal to 30 percent thereof. However, an applicable income tax treaty may reduce the rate of withholding or exempt amounts from withholding; see section 894, Treas. Reg. § 1.1441-6. The United States does not have a treaty with Country X. However, we do not know the lenders country or countries of residence to determine whether there is an applicable treaty.

Section 1461 provides, in part, that every person required to deduct and withhold any tax under sections 1441 and 1442 is liable for such tax and is indemnified against the claims and demands of any person for the amount of any payments made in accordance with sections 1441 and 1442.

Rev. Rul. 82-80, 1982-1 C.B., modified, Rev. Proc. 91-23, 1991-1 C.B. 534, modified, Rev. Proc. 96-14, 1996-1 C.B. 626, superceded, Rev. Proc. 99-32, 1999-34 I.R.B.1, in which the Service discussed the application of Rev. Proc. 65-17, 1965-1 C.B. 833,[5] to transactions involving a United States subsidiary and its foreign parent, also indicates the Service's position that a constructive, collateral adjustment required under section 482 may give rise to a section 1442 withholding tax liability.

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[5] Rev. Proc. 65-17 describes the position of the Service, and the procedures to be followed, in cases in which a United States taxpayer, whose taxable income has been increased for a taxable year by reason of an allocation under section 482, requests permission to receive payment from, or to, which the allocation of income, or deductions, was made of an amount equal to a part or all of the amount allocated, without further income tax consequences. Note that Rev. Proc. 65-17, and Rev. Rul. 82-80, have been superceded for future years. Rev. Proc. 99-32, 1999-34 I.R.B.1.

Rev. Rul. 82-80 addresses a United States subsidiary whose taxable income was increased because of an allocation under section 482. The ruling states that if Rev. Proc. 65-17 treatment is granted, the original transaction will be treated, for tax purposes, as if the correct amount, as determined under section 482, had been paid. Thus, if a United States subsidiary pays more than arm's length consideration for services performed by its foreign parent, the parent corporation will not be considered to have received a dividend to the extent of the greater-than-arm's length amount, and the withholding tax provisions of section 1442 will be applied to the deemed flow of funds necessary to account for the amounts the foreign parent had, but should not have received, as payments for services.

The necessary and clear implication of Rev. Rul. 82-80 is that absent Rev. Proc. 65-17 treatment, a withholding tax liability under section 1442 would have arisen in connection with the deemed flow of funds from the United States subsidiary to its foreign parent, and that the tax imposed under section 1442 on such deemed payment would be collectible from the United States subsidiary, the withholding agent, under methods appropriate to that section. If a withholding obligation is deemed to arise under these circumstances (correlative or consequential adjustments arising in connection with section 482 allocations), it would appear certain that such obligations also should be treated as arising in connection with a primary adjustment under section 482 (i.e., the allocation itself).

The precise issue of whether a section 482 allocation of U.S. source FDAP to a foreign entity is subject to section 1442 withholding has not been addressed by a court. There is, however, case law to support such an approach.

Interest imputed to a foreign related entity under section 7872 is subject to withholding. Climaco and Nakamura v. Internal Revenue Service, 96-1 USTC ¶ 50,153 (E.D.N.Y. 1996) (unpublished opinion, Jan. 24, 1996). In Climaco, one plaintiff was a shareholder of a foreign corporation who received a no-interest loan from the corporation; he used the no-interest loan to purchase a United States residence, apparently for himself and his wife (who appears to be the second named plaintiff in the case). Plaintiffs reported the imputed interest payments foregone by the foreign corporation on the loan pursuant to section 7872, and claimed a corresponding deduction for those payments. The plaintiffs also filed annual withholding tax returns pursuant to section 1442. Subsequently, however, the plaintiffs sought to have such withholding taxes refunded, asserting that in the absence of actual interest payments to a foreign payee, withholding was not required.

The District Court held that plaintiffs were required to withhold and pay a portion of the imputed interest under section 7872 despite the fact that the plaintiffs did not actually make any interest payments on their loan. The court could discern no reason why plaintiffs should not, on these facts, be required to make withholding payments. Had the foreign corporation lent money at the market rate, the court reasoned, the plaintiffs clearly would have been required to withhold at the appropriate rate on the stated interest under section 1442. To hold otherwise, the court reasoned, would mean that the foreign corporation, by structuring the transaction as an interest-free loan, could avoid payment of the tax altogether. In addition, the court found persuasive the Government's reliance on Casa de Jolla Park, Inc. v. Commissioner, 94, T.C. 384 (1990) and Central de Gas de Chihuahua v. Commissioner, 102 T.C. 515 (1994).

Casa de la Jolla addressed the following fact pattern. Petitioner, a domestic corporation, was organized by Marshall, a nonresident alien and citizen of Canada, to market condominium time-share units in a La Jolla (California) property. BankCal, a domestic (California) bank, collected the proceeds of condominium unit sales for petitioner. Marshall, petitioner's sole shareholder and director, held an interest-bearing promissory note from the petitioner.

Royal, a Canadian bank, had made substantial loans to Marshall, some in connection with the earlier acquisition and development of that property by a second domestic corporation wholly-owned by Marshall. As collateral for such loans, Royal held both Marshall's stock in the petitioner and his shares in another (Canadian) corporation, Blake Resources.[6]

When Blake Resources entered the Canadian equivalent of Chapter 11 bankruptcy proceedings, Royal sought further assurances of collection of Marshall's debts. Accordingly, Marshall, as sole shareholder and director of the petitioner, authorized BankCal to remit to Royal directly the proceeds from the sales of petitioner's time-share units that otherwise were due and payable to the petitioner. Royal immediately applied the payments it received pursuant to these arrangements to Marshall's personal loan accounts.

At issue was whether petitioner was responsible under section 1441 for withholding tax on Marshall's interest income.[7] Petitioner contended that it never possessed or controlled Marshall's interest income. Petitioner also argued that Marshall had never "received" any income from which petitioner could withhold. Respondent, in turn, contended that Marshall had constructively received the interest income, because pursuant to petitioner's instructions, the monthly net proceeds from condominium sales otherwise payable to it were applied to Royal's

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[6] Additional collateral held by the bank is not described.

[7] Also at issue was whether such interest income was effectively connected with a United States trade or business, and so exempt from section 1441 withholding. The latter issue, resolved in the government's favor, is not discussed herein.

outstanding loans to Marshall. Respondent also argued that petitioner had control of the time-share proceeds from which withholdings could have been made.

The Tax Court concluded that petitioner did have control over funds from which withholding could be made. The court also rejected petitioner's contention that withholding responsibility under section 1441(a) requires actual payment and receipt, noting that "payment" is merely one of several terms (control, receipt, *etc.*) that are described in section 1441(a) in the disjunctive. Moreover, the court found that the doctrine of constructive receipt applies "*for purposes of section 1441*." (Emphasis supplied.) This language may be read to support the view that whenever a payment of United States-source FDAP is constructively received by a foreign person, there is necessarily a corresponding deemed payment of the amount that may trigger withholding tax liability under section 1441(a).

Central de Gas de Chihuahua addressed the following fact pattern. Central, a foreign (Mexican) corporation, processed, transported, and distributed liquified natural gas throughout Mexico. Central rented a fleet of tractors and trailers to Hidro, a sister corporation (also Mexican), but did not receive any rental payments. The fleet was used to transport gas products within the United States and in Mexico. As here relevant, the Service imputed to Central the fair rental value of Hidro's use of the fleet, arguing that such income was taxable in its hands under section 881.

In responding to this argument, the taxpayer contended in part that in order for section 881(a) to apply, there must be an actual payment of the income item and that the allocation of rent to petitioner from Hidro under section 482 does not satisfy that requirement. The Service, in response, cited Casa de la Jolla Park for the proposition that there is no requirement of actual payment under section 881, and that the allocation of rent to petitioner under section 482 provides a sufficient basis for imposing the 30 percent tax under section 881.

The Tax Court held that an allocation under section 482 results in a deemed payment that constitutes "an amount received" under section 881. The court found that there is no requirement of actual payment under section 881 and that the allocation of rent to petitioner under section 482 provides a sufficient basis for imposing the 30 percent tax under that section.

The court in Central de Gas de Chihuahua expressly did not reach the issue of whether actual payment is required for withholding under sections 1441 and 1442. The court distinguished between section 881, which it found imposes a liability for tax, and sections 1441 and 1442, which provide the method for collecting that tax, commenting that the former section and the latter section serve distinctly separate purposes. However, the case is nonetheless support for imputing interest under section 482 and subjecting such interest to withholding. Because the case holds that a section 482 allocation amount is deemed to be received by the foreign entity, it follows that withholding is the collection mechanism for the section 881 tax liability. In our view, to separate the tax liability from the collection mechanism for the tax would render ineffective the triggering of the section 881 liability. The Tax Court touched on this concern when it observed that "[a] holding that actual payment is required could significantly undermine the effectiveness of section 482 where foreign corporations are involved. Such a view would permit such corporations to utilize property in the United States without payment for such use and thereby avoid any liability under section 881." Id. at 520. Similarly, Rev. Rul. 92-85, 1992-2 C.B. 69, holds that deemed dividend distributions under section 304(b)(2) by domestic acquiring or domestic acquired/issuing corporations to foreign controlling corporations give rise to tax under section 881(a)(1), and that the acquiring corporation (whether foreign or domestic) is responsible for withholding under section 1442 with respect of such deemed dividends.

Finally, we note that recently-issued final regulations under section 1441 (Treas. Reg. § 1.1441-2(e)(2)) specifically provide that an allocation of income subject to withholding under section 482, as well as income arising as a result of a secondary adjustment made in conjunction with a reallocation of income from a foreign person to a related U.S. person, is subject to withholding under section 1441. While this regulation is not yet effective and hence does not apply to the taxable years here in issue, based on the foregoing and on the absence of any indication in this regulation and its preamble that it was intended to reflect a change of Service position, we view the new regulation as clarifying currently applicable law on this point.

3. Whether interest should be imputed to foreign lenders pursuant to section 482 despite the fact that the debtor is financially distressed.

Assistance has been requested about whether interest should be imputed on A’s outstanding balances of intercompany obligations under section 482 because of doubtful collectibility. In particular, you have proposed to argue that the general accrual rules of section 451, including the “doubtful collectibility” exception, do not override the more specific rules of the section 482 regulations. Your request is in response to A’s argument that interest may not be imputed due to doubtful collectibility.

In Johnson v. Commissioner, T.C. Memo. 1982-517, 44 T.C.M. (CCH) 1076, 1083, the Tax Court held that a corporation did not have to accrue interest imputed under section 482 on an advance to a commonly controlled sister corporation, which originally characterized the advances as loans. Because the facts indicated that the corporation had no reasonable expectancy of collecting the advances or any interest on the advances, the court concluded that the corporation was not required to accrue interest imputed pursuant to section 482. The court based its conclusion on the "narrow exception" to the general rule of accrual for circumstances where "it is reasonably certain that the income will not be collected in the tax year or within a reasonable time thereafter . . . ." 44 T.C.M. at 1083, citing Corn Exchange Bank v. United States, 37 F.2d 34 (2d Cir. 1930).

Notwithstanding the application in Johnson of the "doubtful collectibility" exception to the general rule of accrual, you have suggested that the Service can challenge the Johnson decision based on a rationale analogous to a secondary rationale underlying the conclusion in TAM 9538007.

TAM 9538007 considered whether the "doubtful collectibility" exception to the general accrual rules should apply in the case of original issue discount ("OID") interest accrual under section 1272. The TAM pointed out that the accrual of OID differs from the accrual of non-OID interest in advance of receipt because OID is included in income in lieu of receipt. The OID interest is deemed paid to the holder, who in turn is deemed to lend the same amount back to the issuer. At the same time, the holder's basis in the instrument increases by an equivalent amount. In addition, the TAM cited Weis v. Commissioner, 94 T.C. 473 (1990), and Williams v. Commissioner, 94 T.C. 464 (1990), which held that the general interest accrual rules of sections 446 and 461 do not trump the more specific imputed interest rules of section 483. The TAM concluded that to extend the doubtful collectibility exception to the accrual of OID would contravene the legislative intent of the OID rules by (1) failing to respect the principle that OID is "deemed" paid as accrued; (2) creating a mismatch of issuer deductions and holder inclusions; and (3) elevating general accrual principles over specific statutory provisions. Thus, taxpayers must continue accruing OID for as long as they hold the instruments, regardless of the financial condition of the issuer.

We generally agree that the "doubtful collectibility" exception does not necessarily preclude the Service from imputing interest under section 482. The general rule of Treas. Reg. § 1.482-2(a)(1) authorizes the district director to make appropriate allocations to reflect an arm's rate of interest on a loan or advance from one member of a group of controlled entities to another member of the same group. This rule applies only to bona fide indebtedness between members of a group of controlled entities and expressly does not apply to an alleged indebtedness that is in fact a contribution to the capital of a corporation or a distribution by a corporation with respect to its shares. Payments with respect to an alleged indebtedness are treated according to their substance. Treas. Reg. § 1.482-2(a)(1)(ii).

Neither section 482, nor the regulations thereunder, explicitly provide any exception for a debtor that is unable to pay interest imputed under section 482. We recognize, however, that the Tax Court applied the exception in Johnson v. Commissioner, supra, in holding that the lending corporation was not required to accrue interest income imputed under section 482. In that case, the Service did not dispute, and the Tax Court did not discuss, whether that the exception applied to the imputation of interest under section 482. The Service argued that the taxpayer in that case had not established the lack of any reasonable expectation of collecting the interest.

The Service's position in Johnson is similar to its position in the earlier case of Pitchford's, Inc. v. Commissioner, T.C. Memo. 1975-75, 34 T.C.M. (CCH) 384. There, the Service expressly conceded that an accrual basis taxpayer need not report otherwise accrued interest income where there is not a reasonable expectancy of repayment. In addressing this issue, the court stated:

> We express no views on the question whether allocation of interest income under section 482 is indeed precluded where there would not have been a reasonable expectancy of collection of such interest. For purposes of this case only, we accept respondent's concession on this point.

34 T.C.M. at 386.

Although the Service conceded in Pitchford's that the doubtful collectibility exception would preclude the accrual of interest imputed under section 482, the accrual rules of section 451 (including the doubtful collectibility exception) do not, as a matter of law, prevent the Service from making an adjustment under section 482. One of the factors to be weighed in determining whether to make a discretionary adjustment under section 482 should be the financial condition of the related debtor. However, once it has been determined that a section 482 allocation is proper, section 451 and the case law thereunder cannot frustrate such an allocation.

In Procacci v. Commissioner, 94 T.C. 397, 415-417 (1990), the Tax Court considered whether an allocation of rental income to a lessor under section 482 is precluded where the lessee lacks available funds after payment of other expenses to pay the rent. The court began its analysis with the acknowledgment that a determination under section 482 is "intensely factual" and focuses on "what would have transpired between uncontrolled parties dealing at arm's length." 94 T.C. at 412-413. In discussing the holdings in Pitchford's and Johnson, the court explained that those cases did not establish a per se rule, as urged by the petitioners in Procacci. Rather, the court viewed each case as having been decided on its own peculiar facts and explained the significance of the cases as follows:

> At best these cases merely apply a practical, facts and circumstances approach to the question of whether the amounts of interest income imputed under section 482 would have actually been paid in an arm's-length situation. That is the import of the "reasonable expectancy" exception to the general rule of accrual accounting.

> Finding that a taxpayer has no reasonable expectancy of receiving a payment means that the taxpayer would not have received the payment from an unrelated party in the same condition as the controlled one.

94 T.C. at 417. The court summarized its view of the application of section 482 as follows:

> Thus, section 482 requires that we trace a hypothetical arm's-length path, using as parameters the facts and circumstances of the particular case as shown by the record and determine its consequences. And, because the determination is so fact-specific, prior cases with materially different facts are of limited guidance to us. In other words, in a case like this, there are no per se rules or bright-line tests.

94 T.C. at 420.

In our view, the doubtful collectibility exception to the general accrual rules does not per se preclude an allocation of interest under Treas. Reg. § 1.482-2(a). However, we believe the Procacci court's explanation of the interaction between section 482 and the doubtful collectibility principle points out a practical limitation inherent in the overall purpose of section 482. Although the doubtful collectibility exception to the accrual rules does not control whether the Service can make a section 482 adjustment imputing interest on related-party debt, the debtor's ability to pay is a factor to consider in determining whether such an adjustment is appropriate. As suggested by the Procacci court, the underlying goal of section 482 is to place related parties in the same position as unrelated parties acting at arm's length. Because an unrelated creditor may be able to invoke the doubtful collectibility rule where the facts demonstrate the debtor's total inability to pay interest, a related creditor can be expected to argue that section 482 should not place it in a worse position than an unrelated creditor under an arm's-length transaction.

Accordingly, in light of Procacci, we would expect the Tax Court not to permit imputed interest under section 482 where an unrelated creditor would not have to accrue such interest under the doubtful collectibility exception. However, even if facts indicate that a controlled debtor is unable to pay interest to a related creditor, the totality of the facts surrounding the lending transaction may establish that the reason for controlled debtor's inability to pay is attributable to other non-arm's length actions by the related parties. Accordingly, after consideration of all the relevant facts, the court may conclude that imputed interest under section 482 is appropriate. Therefore, further factual development is necessary in this case.

[redacted]

If you have any further questions, please call Kate Y. Hwa at (202) 622-3840.

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