TAX 101 – INTRODUCTORY LESSONS: FINANCING A U.S. SUBSIDIARY – DEBT VS. EQUITY

Authors
Galia Antebi
and Nina Krauthamer

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INTRODUCTION

When a foreign business contemplates operating in the U.S. through a U.S. subsidiary corporation, it must take into account the options available for funding the subsidiary. As a practical matter, a foreign-owned subsidiary may encounter difficulty in obtaining external financing on its own, and thus, internal financing is often considered. It is a common practice for a foreign parent corporation to fund its subsidiary through a combination of equity and debt.

Using loans in the mixture of the capital structure is often advisable from a tax point of view. Subject to the general limitations under the Internal Revenue Code (the "Code"),[6] financing the operations with debt will result in a U.S. interest expense deduction, often with a meaningful reduction of the overall tax rate applicable to the operation. (It should be noted that the U.S. has one of the highest corporate tax rates in the world.) Additionally, repayment of invested capital (in the form of debt principal) will be free of U.S. withholding tax if the investment qualifies as a debt instrument for U.S. tax purposes. If the lender is a resident of a treaty jurisdiction and eligible for treaty benefits, the interest payments will be subject to a reduced rate of taxation – or a complete elimination of taxation[7] – under the treaty.[8] Another reason multinational entities use debt to finance their subsidiaries is the possibility for tax arbitrage resulting from the differing treatment in various countries of debt and equity.

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6 E.g., the "earning stripping" rules of Code §163(j) and the "matching rule" of Code §267(a).

7 E.g., under Article 11 of the treaty between the U.S. and the Russian Federation no U.S. tax will be imposed on U.S. source interest paid to a Russian resident eligible for treaty benefits.

8 Interest payments qualifying for the "portfolio interest exemption" are not subject to U.S. withholding tax. To qualify, the indebtedness instrument must be in registered form, the foreign lender must not own 10% or more of the voting power of the borrower (after application of constructive ownership and attribution rules), and the interest must not be contingent on the business performance of the borrower or a related party. Intercompany indebtedness generally does not qualify.

In certain circumstances debt treatment may be re-characterized by the I.R.S. as equity. As a general proposition, the classic criteria for debt requires that a loan be repaid on maturity and bear interest payable at certain events during the term of the loan, no later than on maturity. For that reason, financing a U.S. subsidiary with an interest-free debt is problematic, resulting in a risk that the investment be re-characterized as equity.

If the I.R.S. re-characterizes the loan as equity, any interest deduction taken will be disallowed and any interest payment made to the creditor will be treated as an equity distribution, which will be considered as a dividend to the extent of the earnings and profits of the borrower. Additionally, when an interest deduction is disallowed, the subsidiary could be found to have a higher tax obligation and could be subject to interest and penalties with respect to the possible underpayment of taxes. Further, the subsidiary would be required to withhold tax on payments treated as distributions (at a rate of 30% or less if a treaty is applicable), and because it has not done so in a timely manner, this could result in additional penalties.

DEBT OR EQUITY?

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Code §385 was enacted in 1969, authorizing the Treasury (I.R.S.) to issue regulations to determine whether an instrument is to be treated as debt or equity. The factors to be considered are: (i) whether there is a written unconditional promise to pay on demand or on a specified date a certain sum of money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest; (ii) whether there is subordination to or preference over any indebtedness of the corporation; (iii) the ratio of debt to equity of the corporation; (iv) whether there is convertibility into the stock of the corporation; and (v) the relationship between holdings of stock in the corporation and holdings of the interest in question. Following the authorization, Treasury regulations were proposed, finalized, re-proposed and finally withdrawn. One commentator described the regulatory project as a "fiasco."[9]

Over the years, however, the U.S. courts established several factors to determine when capital investment will be treated as debt or equity. The treatment of debt or equity in a non-arm's-length setting is heavily influenced by the facts and circumstances. The courts look to the genuineness of the parties' intention to create a debtor-creditor relationship and to the reasonableness of that intention. This is generally determined based on the credit-worthiness of the borrower. This is done under two approaches: (i) an objective analysis of the borrower's financial conditions as of the time the loan was first made, or (ii) a subjective analysis that looks for hallmarks of a true debt.

Under the objective approach, key financial ratios are reviewed to determine if the borrower objectively fits within an independent lender's paradigm. These factors

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[9] Federal Income Taxation of Corporations and Shareholders (Thomson Reuters/WG&L, 7th ed. 2013 with updates through March 2014) (accessed on Checkpoint (www.checkpoint.riag.com) [4/11/14]).

include the company's earnings before interest, tax, depreciation and amortization ("E.B.I.T.D.A."), debt to equity ratio, current assets to current liabilities ratio, and E.B.I.T.D.A. to interest ratio.

Under the subjective approach the courts deemed several factors as important when a shareholder makes loans to a company. The controlling case law is *Mixson*[10] and it provides the following factors:

1. <u>The names given to the certificates evidencing the indebtedness</u> – if no documentation exists, the informality may suggest that intent to repay was not present at the time the loan came into existence;

2. <u>The presence or absence of a fixed maturity date</u> – the absence of a fixed maturity date may suggest that intent to repay was not present at the time the loan came into existence;

3. <u>The source of payments</u> – in general, a purported debt can be repaid from three possible sources: (i) the liquidation of the corporation's assets, (ii) profits and cash flow from the corporation's business, and (iii) refinancing the debt. If the only reasonably assured source of funds for repayment of the debt is the liquidation of the debtor's assets, then the investment resembles an equity investment. Conversely, a purported debt will be recognized as debt if the projected cash flow is adequate to repay the obligation;

4. <u>Increased participation in management</u> – if as a result of granting the loan the lender has an increased right to participate in management, this may suggest that the instrument has indicia of equity;

5. <u>The right to enforce payment of principal and interest</u> – although junior to a secured creditor, a general creditor typically has rights to enforce repayment on demand. Lacking this right may suggest indicia of equity;

6. <u>The intent of the parties</u> – in seeking the intent, focus is placed on how the parties treated the instrument. While not conclusive, a relevant consideration in addition to the preceding factors includes the accounting treatment of the loan on the company's books;

7. <u>"Thin" or inadequate capitalization</u> – the adequacy of a borrower's capital structure at the onset of the purported debtor-creditor relationship may indicate the creditor's intent to be repaid in accordance with the terms of the instrument. The equity capitalization provides a cushion to protect the creditor from the borrower's business losses and a decrease in the value of its assets. Thus, inadequate capitalization at the time the relationship was established may be an indication of whether or not a reasonable expectation of repayment existed;[11]

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[10] *Estate of Mixson v. U.S.*, 464 F.2d 394, 402 (5th Cir. Ala. 1972).

[11] The withdrawn proposed regulations under Code §385 provided a safe harbor rule which would have assured debt classification if the total debt-to-equity ratio

8. Identity of interest between creditor and stockholder – if debt is provided by stockholders in proportion to their respective stock ownership, it may indicate that the investment is an equity contribution;

9. Interest payments – the lack of provisions for the payment of interest indicates that the funds loaned were intended as a contribution to equity rather than an arm's-length debt obligation. The failure to insist on interest payments ordinarily indicates that the lender is not expecting interest income but is interested in the future earnings of the corporation or the increased market value of its interest;

10. The ability of the corporation to obtain loans from outside lending institutions – if a corporation is able to borrow funds from outside sources, the shareholder loan would appear to be a bona fide indebtedness;

11. The extent to which the loan was used to acquire capital assets – courts have held that purported debt should be treated as equity if the funds advanced are used to acquire the essential assets of a business;[12] and

12. The failure of the debtor to repay on the due date or to seek a postponement – repayment of the loan under its terms and conditions is an indication of a true debt instrument.

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RECENT CASE LAW

In the last five years, the I.R.S. has begun to focus on the debt-versus-equity issue. It is said to be in dispute in many of the Large Business and International Division's cases. New decisions on debt-to-equity cases were recently issued. Two cases in which the taxpayer prevailed are: *ScottishPower*,[13] which resulted in debt treatment, and *PepsiCo*,[14] which resulted in equity treatment.

In *ScottishPower*, ScottishPower plc ("ScottishPower"), a U.K. company, entered into negotiations to acquire PacifiCorp & Subsidiaries ("PacifiCorp"), a publicly held U.S. utility company with domestic and foreign subsidiaries. To affect the acquisition, ScottishPower organized NA General Partnership ("NAGP"), which elected to be treated as a U.S. corporation. NAGP formed a special purpose subsidiary to merge into PacifiCorp. Shareholders of PacifiCorp received either ScottishPower shares or depositary shares ("ADS shares") in exchange for their

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(including both outside and inside debt) did not exceed 10:1 and if the inside debt-to-equity ratio did not exceed 3:1 at the end of the taxable year in which the purported debt instrument was issued.

[12] Since most real estate holding corporations incur mortgage debt that can only be paid at maturity by selling (or refinancing) the assets, it seems that financing the entity with a loan is a standard practice of the real estate industry and a legitimate business reason, which should not, on its own, affect the characterization of the investment as debt or equity.

[13] *NA General Partnership and Subsidiaries v. Commissioner*, T.C. Memo. 2012-172 (6/19/12).

[14] *PepsiCo Puerto Rico, Inc. v. Commissioner*, T.C. Memo. 2012-269 (9/20/12).

PacifiCorp shares. NAGP issued notes to ScottishPower in consideration for the transfer of its ADS shares and common shares (on behalf of NAGP) to PacifiCorp shareholders in connection with the merger (representing 75% of the acquisition value of PacifiCorp). The loan notes consisted of $4 billion of fixed-rate notes and $896 million of floating-rate notes. The fixed and floating rate notes were issued under separate loan agreements and generally contained identical terms, other than the date of maturity and the interest rates. The notes: (i) called for quarterly interest payments, (ii) were secured by a pledge of PacifiCorp shares, (iii) were transferrable, (iv) gave the creditor the right to accelerate the notes upon default, and (v) were recorded as debt on the books and records of both parties. At the time the notes were executed, the creditor, ScottishPower, expected that PacifiCorp dividends would fund the borrower's (NAGP's) interest payments. NAGP did not always pay interest on time but eventually repaid all interest. The I.R.S. argued that ScottishPower's investment in NAGP was not debt but equity.

The Tax Court ruled in favor of the taxpayer based on an analysis of the eleven factors used by the Court of Appeals for the Ninth Circuit (to which an appeal would lie). These factors comprise: (1) the name given to the documents evidencing the indebtedness, (2) the presence of a fixed maturity date, (3) the source of the payments, (4) the right to enforce payments of principal and interest, (5) participation in management, (6) a status equal to or inferior to that of regular corporate creditors, (7) the intent of the parties, (8) "thin" or adequate capitalization, (9) identity of interest between creditor and stockholder, (10) payment of interest only out of "dividend" money, and (11) the corporation's ability to obtain loans from outside lending institutions. The Tax Court noted that no one factor is decisive. The Tax Court's stated objective was not to count the factors, but rather to evaluate them. In holding for the taxpayer, the Tax Court found:

> We recognize that there are features in this case pointing to both debt and equity. Nevertheless, in view of the record as a whole, we find that the advance was more akin to debt than equity. We did not rely on any single overriding factor. Rather, we find that the whole of this case is more reflective of the true relationship between the parties than the individual parts. We therefore hold that the payments of interest made with the respect to the loan notes are deductible as interest for each year at issue.

In *PepsiCo*, PepsiCo Global Investments ("PGI"), a Dutch affiliate of PepsiCo, Inc. ("PepsiCo"), issued so-called "advance agreements" to several PepsiCo domestic subsidiaries in exchange for certain outstanding indebtedness of PepsiCo and members of its consolidated group (the "Indebtedness"). PepsiCo intended the advance agreements to be treated as equity for U.S. tax purposes and as debt for Dutch tax purposes. In other words, the interest income on the Indebtedness would be offset for Dutch income tax purposes by an interest expense deduction with respect to the preferred return payable to the U.S. affiliates on the advance payments. The terms of the advance agreements were 40 years maturity with PGI's option to extend maturity date for up to 15 additional years. However, PGI had the right to prepay principal amount and preferred return in full or in part at any time. The terms also provided for a preferred return that accrued unconditionally at a defined rate, payable on an annual basis out of cash flow with respect to the Indebtedness. Any accrued but unpaid preferred return would be capitalized and accrue compound interest. Lastly, the holder of an advance agreement was subordinated to all other creditors.

The I.R.S. contended that the advance agreements were in substance debt and that the parties' intention was demonstrated in their negotiations with the Dutch tax authorities to receive a ruling that the agreements be treated as debt for Dutch purposes. The I.R.S. also argued that the terms of the agreements were not relevant because of the common control of the parties. The Tax Court ruled in favor of the taxpayer, stating that the form of a transaction often informs its substance. It explained that the characterization of the advance agreements as debt or equity must be considered by examining the relevant terms of the instruments in light of the surrounding facts and circumstances, including but not exclusive to the taxpayers' correspondence with the Dutch tax authorities, and that while the relatedness of the parties needs to be considered as a factor and closely scrutinized for substance, an otherwise legitimate transaction will not be disregarded merely because it represents a related party agreement.

The Tax Court followed a traditional analysis of the debt-versus-equity factors, listing thirteen factors: (1) names or labels given to the instruments, (2) presence or absence of a fixed maturity date, (3) source of payments, (4) right to enforce payments, (5) participation in management as a result of the advances, (6) status of the advances in relation to regular corporate creditors, (7) intent of the parties, (8) identity of interest between creditor and stockholder, (9) "thinness" of capital structure in relation to debt, (10) ability of the corporation to obtain credit from outside sources, (11) use to which advances were put, (12) failure of debtor to repay, and (13) risk involved in making advances. It concluded that the focus of a debt-versus-equity inquiry is generally whether there was intent to create a debt with a reasonable expectation of repayment and, if so, whether that intent comports with the economic reality of creating a debtor-creditor relationship. The Tax Court found that PGI was exposed to eastern European and other developing countries' markets and that together with its ability to defer repaying the principal for up to 55 years, there was no expectation of repayment.

Despite the fact that the payment of preferred return was linked to interest payments received on the Indebtedness and that the Dutch tax authorities characterized the instrument as a debt instrument, the Tax Court held that the advance payments were equity. Pointing toward equity treatment was the complete subordination of the advance agreements and the finding that an independent creditor would not have loaned funds in the amount of the advance agreements to PGI under any reasonably similar financial terms. Those factors, together with the lack of repayment expectation, led the Tax Court to the conclusion that the risk involved in making the advances revealed its equity characteristics.

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CONCLUSIONS

Using indebtedness as part of a U.S. subsidiary's capital structure is often advisable from a tax point of view. In determining the capital structure of the U.S. subsidiary, it is important that the factors described above are considered carefully. Taxpayers should prepare supporting documentation to demonstrate to the taxing authorities and the courts that under an analysis of the factors, a debt instrument should be characterized as debt for U.S. tax purposes in case of an I.R.S. challenge.