DEBT VS. EQUITY: COMPARING HP APPEAL ARGUMENTS TO THE PEPSICO CASE

Authors
Galia Antebi
Nina Krauthamer

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INTRODUCTION

Historically, the I.R.S. and taxpayers often disagreed over whether a loan between related entities should be treated as equity rather than true debt. As a result, substantial case law has built up over the years, especially involving closely-held entities. One such case is *Mixon*,[1] which was discussed in our prior publication from April 2014[2] as the leading case law providing for the 13 factors to be considered in debt-equity cases. In recent years, the I.R.S. has begun to focus on the debt-equity issue in the cross border arena, and new decisions are being issued. Two 2012 cases, in the United States Tax Court (the "Tax Court" or "Court"), went in different directions. In *PepsiCo*,[3] the taxpayer prevailed and equity treatment was upheld. In contrast, the I.R.S. prevailed in *Hewlett-Packard*,[4] where the Tax Court was convinced that the transaction should be categorized as a loan rather than equity. In this case, the court looked beyond the instrument at issue and also examined agreements between the shareholders in the transaction.

Earlier this year, Hewlett-Packard ("HP") appealed its loss in the Tax Court to the U.S. Court of Appeals for the Ninth Circuit, arguing that the lower court's finding – that the investment displayed more "qualitative and quantitative indicia of debt than equity" – was "clearly erroneous."

HP CASE – FACTS AND TAX COURT DECISION

HP purchased an interest in a Dutch corporation, Foppingadreef ("FOP"), from AIG in 1996. The investment was originally structured by AIG as an equity investment in preferred shares. The other shareholder was a Dutch bank, ABN AMRO ("ABN"). FOP's Articles of Incorporation provide that it was organized for the purpose of investing its assets in contingent interest notes ("C.I.N.'s") and other approved debt instruments. FOP invested in C.I.N.'s issued by ABN which provided for interest consisting of a fixed element and a contingent element. The terms of the preferred shares, as structured by AIG, gave HP voting rights and preferred entitlement to dividend distributions. HP's vote was slightly more than 20%. However, if FOP was in default of its obligations, including failure to pay dividends when due and payable, HP was granted a majority vote and the authority to convene a shareholders meeting at which the shareholders could (i) cause the foreign corporation to redeem or repurchase HP's shares or (ii) cause the foreign corporation to dissolve.

1 *Estate of Mixon v. U.S.*, 464 F.2d 394, 402 (5th Cir. Ala. 1972).

2 See *Insights*, Vol. 1 No. 3, "Tax 101: Financing a U.S. Subsidiary – Debt vs. Equity."

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

4 *Hewlett-Packard Co. v. Commissioner,* T.C. Memo 2012-135 (5/14/12).

The dividends provision in the Articles of Incorporation provided that the FOP may distribute dividends out of profits from the preceding year, with the preferred stock receiving a dividend according to a specified formula before any dividends were paid to the common stockholders. FOP's Shareholders Agreement provided that the parties shall take "all such action as may be required to give effect" to the dividend provision in the Articles of Incorporation. HP received dividends each year from 1996 to 2003 from FOP, which reflected earnings from the fixed interest portion payable on the C.I.N.'s.

As part of the investment, and as originally agreed between ABN and AIG, HP entered into a put and call option agreement with ABN. This put option gave HP the right to compel ABN to buy its shares in FOP for fair market value on two specific dates, in January of 2003 and 2007, or upon the occurrence of particular events beyond the control of the parties. ABN had a call option on the same shares, giving it the right to purchase the shares from HP in the event of certain changes in Dutch or U.S. tax law or other financial institution regulatory regimes.

HP's investment was the result of outreach by AIG marketers, who approached HP because it was a global company with large international sales and, thus, was in an excess limitation position concerning its foreign tax credits. Prior to investing, HP calculated a pre-tax projection internal rate of return of 1.586% and an after-tax base case projection of a 9.1% internal rate of return. The worst-case scenario modeled the result of the FOP transaction with only a portion of the foreign tax credits and resulted in a 1.91% internal rate of return. Therefore, based on the creditworthiness of ABN and the very attractive after-tax return, HP made the FOP investment. Since HP treated the investment as equity, it claimed direct foreign tax credits for dividend withholding tax amounts paid to the Dutch authorities and an indirect foreign tax credit for the portion of Dutch income tax paid by FOP hoping to achieve the high after-tax rate of return calculated in its projections. The I.R.S. disallowed foreign tax credits and argued that (i) the investment is more appropriately characterized as debt rather than equity; (ii) the investment was a sham under the economic substance doctrine; and (iii) FOP should be treated as a conduit under the step-transaction doctrine and the transaction should be treated as a direct loan from HP to ABN.

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The Court reviewed the transaction documents and all relevant documents, including agreements between the parties, and found that the investment is more appropriately characterized as debt. This rendered the remaining issues as moot in the Court's opinion and thus these were not discussed.[5] In the debt versus equity issue, the Court reviewed the traditional factors. It ruled that the inquiry of a court in resolving the debt-equity issue is primarily directed at ascertaining the intent of the parties and the critical factor in finding that an investment is in substance a loan is to ask whether, when the funds were advanced, the parties actually intended repayment. The Court focused on the fact that HP had a put option and ruled that when HP's FOP investment is viewed in its entirety, it becomes clear that HP never intended to absorb the risk of the FOP venture; rather, it intended to have its investment repayable in any event. The Court determined that there were essentially no actions that FOP could initiate which would undermine the put agreement, and under these circumstances, the Court interpreted the Shareholders Agreement as

[5] While the HP court decision was based on the debt-equity analysis, HP's investment was challenged by the I.R.S. under two more theories: (i) economic substance and (ii) step transaction.

obligating FOP, either jointly or secondarily, to effect the put option. Further, the court viewed the dividend provision from the Articles of Incorporation as effectively negating the board's discretion on declaring dividends and the Shareholders Agreement commitment to act to its effect as providing HP with a legal remedy against the unrelated shareholder and FOP if ABN failed to perform as required under the agreement or did not pay the interest on the C.I.N. it issued. The Court's view was that while payment of dividends was contingent on FOP's earnings, the transaction was arranged so that FOP's earnings were predetermined and that the terms of the C.I.N.'s issued by ABN, which included a fixed interest element, assured that FOP would have sufficient earnings to make the aggregate periodic payments to HP. Additionally, the Court decided that the right under the put agreement to sell the shares in January of 2003 or 2007 effectively serviced as the investment's maturity date, which is generally a debt factor. While HP had 20% of FOP's voting power, allowing it to designate one of four board members, the Court did not give this factor much weight as indicative of equity treatment. In the Court's opinion, HP did not view these rights as important, being that no evidence was submitted to demonstrate that HP's representative ever attended any board meeting. The Court focused on its belief that HP never intended to absorb the risk of the FOP venture because the Shareholders Agreement and the put option demonstrated that HP sought a definite obligation, repayable in any event, and that HP always intended a seven-year exit from the transaction based on the option to sell its shares in FOP to ABN in 2003 when the tax benefit ceased.

PEPSICO – FACTS AND TAX COURT DECISION

In *PepsiCo*, PepsiCo Global Investments ("PGI"), a Dutch affiliate of PepsiCo, Inc. ("PepsiCo"), issued "advance agreements" to several PepsiCo domestic subsidiaries in exchange for certain outstanding indebtedness belonging to 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 being given the option to extend the maturity date for up to 15 additional years. However, PGI also had the right to prepay the principal amount and preferred return, in full or in part, at any time. The terms provided for a preferred return that accrued unconditionally at a defined rate payable on an annual basis out of "net cash flow," which was tied to income from the Indebtedness. Any accrued, but unpaid, preferred return would be capitalized and accrue compound interest. Furthermore, 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 by their negotiations with the Dutch tax authorities to receive a ruling confirming 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. The Court 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

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taxpayers' correspondence with the Dutch tax authorities. It also held that while the relatedness of the parties needs to be considered as a relevant 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 and concluded that the focus of such an 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 markets and those of other developing countries, and together with its ability to defer repaying the principal for up to 55 years, there was no expectation of repayment.

Although payment of the preferred return was linked to interest payments received on the Indebtedness and the instrument's was characterized as a debt instrument by the Dutch tax authorities, the Tax Court held that the advance payments were equity. This treatment was supported by the complete subordination of the advance agreements and the determination 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. The Court focused on the long term nature of the investment (which under certain circumstances could become perpetual) and the fact that the right to receive payments involved the issuer's discretion.

HP'S APPEAL

Label Given to the Instrument

The issuance of a stock certificate indicates an equity contribution, whereas the issuance of a bond, debenture, or note indicates a *bona fide* indebtedness.

Further to this concept, HP claims that there is no dispute it invested in preferred stock and thus, by the terms of the relevant documents, had an equity investment in FOP. It argues that the Court's decision to minimize the value of this factor in light of its review of the overall transaction is not supported by cogent reason. HP further claims that while the name of an instrument is not controlling, there is no basis for arguing that HP's preferred stock was a "gimmick of form" or that the underlying stock certificate was not meaningful whereas HP's rights under the terms of the preferred stock are those that normally are associated with stock ownership.

In *PepsiCo*, the Court ruled this factor to be neutral because the advance agreements, at least superficially, evinced the issuance of neither stock certificates nor debt instruments.

Presence or Absence of Fixed Maturity Date

The presence of a fixed maturity date indicates a fixed obligation to repay, a characteristic of a debt obligation. The absence of the same factor, on the other hand, would indicate repayment was in some way tied to the fortunes of the business, typical of an equity advance.

HP's preferred shares did not have a fixed maturity date. HP claims that the Tax Court's conclusion that the preferred shares should be treated as having an effective fixed maturity date due to the put option is flawed, as the put agreement is an agreement between HP and ABN and not with FOP, the issuer of the stock. Thus, it claims such an agreement does not shed light on the legal rights and obligations inherent in the investment. Additionally, HP claims that even if the put option were somehow relevant to the proper characterization of HP's investment in FOP, it is not unusual for preferred stock to have a fixed maturity date.

In *PepsiCo*, the advance agreements had a 40-year maturity date, which could be unilaterally extended by additional 15 years, and to the extent that any related party were to default on any loan receivables held by PGI, the terms of the advance agreements were to be voided, rendering the instruments perpetual. The I.R.S. argued that the maturity date was fixed and that the perpetual clause was meaningless, as there was an unrealistic possibility that the terms of the advance agreement would become void as the parties were all related and thus would never cause an involved party to default on any loan receivable held by PGI. However, the court rejected the I.R.S.'s arguments and ruled that under the circumstances the uncertainty of repayment of the principal amounts of the advance agreements at maturity was too great to conclude that PGI had an unqualified obligation to pay a sum certain at a reasonable fixed maturity date. The Court based its opinion on the fact that PepsiCo was reluctant to use domestic funds to further its global expansion and there was no assurance that the international investments would succeed as those involved unestablished markets.

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Source of Payments

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HP claims it is uncontested that FOP's Articles of Incorporation made preferred stock dividends payable only out of earnings and that this factor should point towards equity treatment. Furthermore, it claims that when the Court discussed this factor it strayed from the intended topic – the source of payments – and instead focused on the likelihood of repayment. HP claims that the Court erred in treating the dividend provisions as a debt-like feature simply because of the high likelihood that earnings would be available to make dividend payments.

In *PepsiCo*, the high likelihood of receiving payment also controlled the Court's decision with respect to this factor. The provisions of the advance agreements were meticulously structured to ensure that annual payments remained, effectively, discretionary. Additionally, PGI was required to make payments only to the extent "net cash flow" exceeded (i) accrued, but unpaid, operating expenses incurred and (ii) capital expenditures made or approved during the applicable year. Because board approval of expenses would result in no payments under the advance agreements, PepsiCo argued that payment likelihood was not uncertain. However, the I.R.S. argued that payments were never in doubt, as evidenced by PepsiCo's dialog with the Dutch tax authorities, which effectively obligated PGI to make payments in order to ensure debt treatment for Dutch tax purposes. The Court decided that payments on the advance agreements were largely linked to interest received on the notes from related parties and thus not speculative. Accordingly, the Court found this factor emphasized a debt characteristic.

Right to Enforce Payment

A definite obligation to repay an advance, including interest thereon, suggests a loan obligation.

HP claims that it had no right to demand the return of its investment if FOP failed to pay dividends. Instead, HP's recourse was to exercise its voting power to force FOP to redeem the preferred stock or to dissolve, a type of remedy typical to any preferred stock in support of equity treatment. HP claims that the Court's characterization of this right as an apparatus to enforce creditor rights lacks basis, as equity investors are entitled to try to protect their investment, and the mere fact that they have rights in case of failure to pay declared dividends does not make them "creditor rights."

In *PepsiCo*, the I.R.S. argued that while there was no mechanism providing the holders of the advance agreements with the right to demand immediate repayment for outstanding principal and interest in the event PGI defaulted, there was no real possibility that PGI would default because PepsiCo controlled all entities involved and would be economically disadvantaged if PGI were to default. The Court, however, rejected this claim and found that full repayment of principal and interest on the advance agreements was not unconditional due to the long-term nature of the advance agreements, which render the payments of principal speculative and the payment of the preferred return subject to business realities and uncertainties.

Participation is Management

The right of the entity advancing funds to participate in the management of the receiving entity's business demonstrates that the advance may not have been *bona fide* debt and instead was intended as an equity investment.

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HP's preferred stock carried with it management participation rights representing slightly more than 20% of FOP's voting power and the right to designate one of four members of the board of directors. Moreover, the Shareholders Agreement gave HP additional voting rights in the event of certain occurrences that threatened its investment, including failure to pay dividends when declared. HP claims that that voting power was meaningful because unanimity was required for many important board resolutions and that these rights represent substantial interest in the affairs of the corporation. The Court, however, determined that this factor is to be granted no weight, as in its opinion HP did not value those rights. The determination was based on the fact that evidence was not submitted to show that HP's representative ever attended any board meetings or formally objected to ABN's impermissible FOP investments. HP claims that the Court strayed from the relevant debt-equity analysis, which required examination of the objective characteristics of an investment as ascertained at the time the investment was made. HP continues to claim that what is relevant to the inquiry is the right to participate in management, which is fixed at the outset, not the extent to which the investor actually participates in said management, which can be determined only after the fact.

In *PepsiCo*, this factor was neutral, as PepsiCo commonly controlled the entities involved.

Borrower's Ability to Obtain Outside Loans

The touchstone of economic reality is whether an outside lender would have made the payments in the same form and on the same terms.

The lower court, in HP's case, examined the expected rate of return on the FOP investment and concluded that the availability of foreign tax credits was an important consideration in the rate-of-return analysis. It found that the expected rate of return would have been relatively unattractive to a prospective lender without those credits. However, because those credits are only available to owners and not lenders, the Court found that outside lenders would not have lent funds to FOP in the same form and on the same terms. Nevertheless, the Court found this factor to be neutral in light of concerns about allowing a taxpayer's tax-advantaged instruments to elude debt characterization.

In *PepsiCo*, the Court determined that since the terms of the advance agreements could not have been replicated in any reasonably similar manner by independent debt financing, this factor highlights equity characteristics.

Subordination to Regular Corporate Creditors

Whether an advance is subordinate to obligations to other creditors bears on whether the taxpayer advancing the funds was acting as a creditor or an investor.

HP's Articles of Incorporation provided that liquidation preference and any dividend right associated with FOP stock were junior to all FOP creditors. However, the Court concluded that since FOP's activities were sufficiently limited by its organizational documents, it would never do anything that would cause FOP to have a material creditor, and thus, HP's subordinate status gives it rights indicative of creditor.

In *PepsiCo*, the advance agreements were, on their face, unequivocally subordinate to any obligation of PGI to pay unpaid principal or accrued, but unpaid, preferred return to indebtedness of PGI and the rights of all creditors. The Court found this subordination to be meaningful and indicative of equity, in spite of the fact that all outstanding debts that ranked superior were related debt.

Intent of the Parties

The inquiry of a court in resolving the debt-equity issue is primarily directed at ascertaining the intent of the parties. The focus of the debt-versus-equity inquiry narrows to whether there was with a reasonable expectation of repayment and, if so, whether that intent comports with the economic reality of creating a debtor-creditor relationship.

HP claims that where the transaction was well-planned and the parties were counseled, this inquiry is likely to accord with the labels on the documents. The Tax Court, however, found that this factor pointed toward debt because it was of the opinion that HP intended to exercise the put option in 2003. Additionally, in evaluating this factor, the conclusion of the Court repeated some of the conclusions it reached in its analysis of other factors. These included the predictability of the cash flows and HP's additional voting right, which enabled it to protect its investment if dividends were not paid. HP claims that while it bore little risk because the FOP venture itself held little risk, its intention was to make an equity investment. Therefore, the Court's focus on the riskiness of the investment rather than on the legal rights and obligations attached to the instrument is erroneous. Additionally, HP claims that while it purchased a safe investment from AIG, there remained some risk in this investment because FOP's income depended upon ABN meeting its obligations.

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In *PepsiCo*, the Court found that the negotiations with the Dutch tax authorities emphasized the taxpayer's expectation that the advance agreements would be characterized as equity for U.S. tax purposes and as debt for Dutch tax purposes. It further found that the terms of the advance agreements also indicated that there was no intent to create debt, as evidenced by the long-term nature of the advance agreements and the speculative investments in undeveloped foreign markets to which repayment was effectively subject. The Court further concluded that the taxpayer's actions during the years were in accordance with legitimate tax planning and supported the taxpayer's intent to create a hybrid instrument.

CONCLUSION

It is not easy to predict the outcome of HP's appeal. While it makes very compelling arguments, the appellate court, like the Tax Court, may focus more on the expanded use of foreign tax credits by HP and less on traditional debt-equity factors.