THE *HEWLETT-PACKARD* DEBT V. EQUITY CASE – REPLY BRIEF FILED

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INTRODUCTION

The focus of a debt-versus-equity inquiry generally narrows to 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. This determination has led various courts of appeals to identify and consider a multi-factor test for resolving such inquires.

In the typical debt-versus-equity case, the I.R.S. will argue for equity characterization whereas the taxpayer will endeavor to secure debt characterization to obtain an interest deduction. In some cases, the roles are reversed, but this does not require that courts apply different legal principles.[1] Some courts consider 10 factors, while others consider as many as 16 factors.[2] No matter how many factors are considered, the multi-factor test is the established, standard analysis used in such disputes.

While in the domestic context debt-versus-equity inquiries have been in dispute for decades, the examination of such disputes in the international context is relatively new. Two 2012 rulings by the United States Tax Court dealing with investment among related parties in the international arena went in different directions. In both cases, the taxpayers wanted the investments to be treated as equity for U.S. tax purposes. In *PepsiCo*,[3] the taxpayer prevailed and equity treatment was upheld. In contrast, the I.R.S. prevailed in the *Hewlett-Packard*[4] case, where the Tax Court was convinced that the transaction should be categorized as a loan rather than an equity contribution. In the *Hewlett-Packard* ("HP") case, the court did not limit the analysis to the investment instrument and the parties' rights and obligations under such instrument but rather looked to other documents it found integral to the transaction, including relationships with parties other than the issuer of the instrument.

THE HP CASE: SUMMARY OF FACTS

HP purchased preferred stock in a Dutch corporation ("FOP") from AIG. Additionally, HP assumed AIG's put and call option agreement with the other shareholder in FOP.

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1 *Segel v. Commr.*, 89 T.C. 816 (1987), citing Regland Inv. Co. v. Commr., 52 T.C. 867 (1969).

2 *Fin Hay Realty Co. v. United States*, 398 F.2d 694, (3rd Cir. 1968) discussing 16 factors; *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972) discussing 13 factors; and *United States v. Uneco, Inc.*, 532 F.2d 1208 discussing 10 factors.

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

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

The put agreement allowed HP to exit the investment for no cause on two specified dates (in January 2003 and January 2007). Exercising the put option without cause was to be made for a price equal to the fair market value of the preferred shares on the date the option was exercised. Eventually, the put option was extended, and HP exercised the option in January 2004. Under FOP's Shareholders Agreement, HP had a preferred entitlement to dividend distributions. FOP's Articles of Incorporation provided that the dividends shall be declared and payable to the holders of the preferred shares. Under the Shareholders Agreement, in certain circumstances, including the failure of FOP to pay any dividend when due and payable, the holders of the preferred shares had the authority to convene a shareholders' meeting at which the shareholders could (i) cause the other shareholder to redeem or repurchase the preferred shares or (ii) cause FOP to dissolve. As a major holder of the preferred shares, HP would have the majority vote in such shareholders' meeting. If the shares were redeemed, HP would receive proceeds that would compensate for the present value of the expected FOP dividends, plus an amount representing the present value of the expected foreign tax credits. Lastly, the Shareholders Agreement provided that the parties should take all actions that might be required to give effect to the dividend provision in the Articles of Incorporation and that the shareholders and FOP would undertake necessary or appropriate actions to implement the valid exercise of the put and call option agreement.

During the period that HP held the preferred shares of FOP, it claimed indirect foreign tax credits with respect to Dutch taxes paid by FOP, as a shareholder owning more than 10% of the voting stock. Additionally, HP claimed foreign tax credits with respect to the Dutch withholding tax that applied to dividend distributions it received from FOP. The I.R.S. disallowed the foreign tax credits on the basis that the investment was more appropriately characterized as debt, rather than equity.

THE TAX COURT'S DECISION

The Tax Court agreed with the I.R.S. position that HP's investment in FOP should be characterized as debt. The Tax Court recognized that the case would likely be appealed to the U.S. Court of Appeals for the Ninth Circuit and therefore applied the factors ordinarily considered by the Ninth Circuit. As a preliminary matter, the Tax Court noted that while the transaction was meticulously structured so that no action could be taken by FOP to undermine the put and call option agreement, the Shareholders Agreement nevertheless added an obligation for FOP and all its shareholders to undertake any necessary or appropriate actions to implement the valid exercise of the put and call option agreement. As a result, the Tax Court construed the put agreement and all agreements mentioned in the Shareholders Agreement as an integral part of the investment documents.

The Tax Court focused on the question of whether repayment was intended at the time of the investment, and determined that – when viewed in its entirety, taking into account all documents – HP never intended to assume the risk of the FOP venture. In applying all factors listed by the Ninth Circuit – even those not addressed by either of the parties – the Tax Court noted the following:

1. The put and call option agreement assured HP an exit option once the tax benefits of the transaction ended;
2. Based on the language of the Articles of Incorporation, the Board of Directors

lacked discretion to declare dividends payable to HP, thus making the payments to HP predetermined;

3. FOP's earnings, out of which dividend payments were to be made, were fixed and predetermined;

4. The only risk related to incoming cash was if the other shareholder defaulted on the agreement, which in the court's opinion was a low risk;

5. In the event that the other shareholder defaulted on its payments to FOP or that FOP did not pay dividends to HP, the Articles of Incorporation and the Shareholders Agreement worked in tandem to provide a mechanism by which HP would be made whole;

6. HP's tax benefit ceased in 2003, and therefore, HP had an economic disincentive to continue the transaction beyond 2003 (the initial put date), which should be interpreted to means that the 2003 option date was in essence a fixed maturity date; and

7. The Articles of Incorporation and the other agreements afforded HP a device to enforce creditor-like rights.

APPEAL

In October 2014, HP filed a notice of appeal to the Ninth Circuit and in January 2015 filed its opening brief. In its opening brief, HP argued that the Tax Court's finding that the investment "exhibited more qualitative and quantitative indicia of debt than equity" was based on misapplied established legal principles and was clearly erroneous.[5]

HP claimed that the debt-versus-equity dispute is to be resolved under an analysis of the multi-factor test that, in this case, was not even-handedly applied. HP noted that the facts do not support a claim that the transaction was a sham or that it lacked economic substance, and furthermore, the Tax Court did not address such alternative contentions by the I.R.S.

HP claimed that the debt-to-equity analysis should be based on the legal rights and obligations of the parties to the instrument, and nothing more.

REPLY BRIEFS

In April 2015, the I.R.S. filed its reply brief to the Ninth Circuit. The brief reiterated the earlier arguments and supports the Tax Court's decision.

On May 18, HP filed its reply brief stating its position that the Tax Court misapplied established legal principles when considering the multi-factor test. In the heart of the brief, HP claims that while Congress and the Treasury leave the resolution of debt-versus-equity questions to the long-standing judicial approach, and although the I.R.S. has consistently applied the judicial multi-factor test in its administrative rulings, in this case, the I.R.S. merely paid "lip service" to the multi-factor test and consistently invoked a vague "substance over form" principle whenever a factor indicated equity.

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[5] *Hewlett-Packard Co. v. Commr.*, 9th Cir., No. 14-73047, brief filed 4/12/15.

"HP's appeal rests on the premise that the Tax Court erred in reaching its decision. HP claims that the multi-factor test is the standard for debt-versus-equity disputes and that the Tax Court did not apply this test appropriately."

In HP's view, by adding an additional "substance over form" inquiry in analyzing each individual factor, the I.R.S. deviated from the proper application of that test. HP claims that applying the multi-factor test is the means to determine if a transaction has "substance" in a debt-versus-equity dispute. The I.R.S.'s deviation from such principles can enable courts to disregard the actual rights and obligations of the parties – which in HP's view is the "substance" of a debt-versus-equity dispute – and bypass any factor on the grounds that the relevant rights and obligations "do not fit the overall 'substance' of the transaction."

In HP's view, a court must faithfully apply the multi-factor test to examine whether the rights and obligations are more like debt or equity. To do otherwise departs from long-standing precedent and threatens to undermine the ability of taxpayers to engage in transactions with predictability.

With respect to the Tax Court's focus on the put agreement in deciding its case, HP claims that the put agreement should not be viewed to establish a fixed maturity date for the investment and should not be viewed to ensure HP's repayment of its investment for the following reasons:

- The put and call option was not exercisable for the first seven years, and indeed, HP ultimately only exercised it a year after the initial 2003 put date;
- The purchase price of the preferred shares under the put and call option agreement did not guarantee recouping the investment, as the counterparty could have had financial difficulties (and indeed did have significant difficulties a few years later), and such decline in fair market value would not have been offset by the dividend reset provision of the Articles of Incorporation;[6] and
- In any event, a fixed maturity date for preferred stock does not defeat equity treatment.

CONCLUSION

HP's appeal rests on the premise that the Tax Court erred in reaching its decision. HP claims that the multi-factor test is the standard for debt-versus-equity disputes and that the Tax Court did not apply this test appropriately. It claims that the "substance over form" principle is embodied in the multi-factor test and should not be an added layer to the analysis of each and every factor. Furthermore, HP claims that, by departing from the multi-factor analysis in favor of looking for the economic substance in the investment instrument, the Tax Court ignored certain rights and obligations of the instrument and bypassed certain significant factors.

The parties do not dispute the multi-factor test applied by the Tax Court, but rather the manner in which such factors are applied. HP argues that the analysis is that of the legal relationship created by the instrument; the I.R.S. claims that the economic relationship is what the factors seek to discover. In deciding this case, the Ninth Circuit will be required to determine how the debt-versus-equity factors are to be applied and whether a "substance over form" argument is embedded in the factors (argued by HP) or whether it is an implicit additional factor that must be considered.

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[6] The dividend reset provision provided a feature for the preference shares beginning in 2003 that would "cause the Shares B, insofar as possible, to have a market value that is equal to their par value."