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

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT: Treatment of Inter-company Debt

This Field Service Advice responds to your memorandum dated September 27, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Corp U =

Corp C =

Corp B =

Corp S =

Corp D =

Corp X =
Corp R =

Year 1 =

Year 2 =

Year 3 =

ISSUES

1. Whether the taxpayer's purported inter-company "loans and advances" lack economic substance and business purpose and constitute substantive shams.

2. Whether certain advances made by Corp U (through journal entries) purporting to be advances for indebtedness to its indirect subsidiaries relating to dividends distributed by them qualify as indebtedness for Federal income tax purposes.

3. Did advances made by Corp U to the same subsidiaries relating to their expenses represent valid indebtedness, or did those advances represent contributions to their capital?

CONCLUSIONS

1. The taxpayer's inter-company "loans" and most of the "advances" lack economic substance and business purpose and constitute substantive shams.

2. The advances relating to dividends should be disregarded for Federal income tax purposes because they did not create a bona fide debtor-creditor relationship. If they had created a bona-fide debtor-creditor relationship, these transactions had the net effect of the payment of dividends with notes of the subsidiaries (assuming adequate earnings and profits). We note that the distribution of obligations of a distributing corporation can be a dividend. Treas. Reg. § 1.301-1(d). Moreover, a distribution can be a dividend whether or not it has a business purpose. However, since no principal payments were ever made on the notes deemed distributed and interest was merely accrued and added to 'principal,' the notes (and the underlying 'loan' receivables) should be disregarded in this case.

3. Likewise, the 'advances' to account for operating expenses were not intended to be repaid because among other factors, none were ever repaid over the history of these advances (which spanned several years). In addition, the advances were more than three times what an outside lender might have advanced. Moreover, the 'creditor' took no actions to enforce its rights to collect any of the advances. Consequently, none of the advances constituted valid indebtedness when made (through journal entries).

Thus, the advances to the subsidiaries for their operating expenses were contributions to capital. Assuming the booked advances represented real expenditures to defray expenses of the operating subsidiaries, they would be contributions to capital (as we have concluded they were not indebtedness). In such case, the expense advances would be considered successive contributions to capital down the corporate chain to the operating member whose expense was defrayed.

FACTS

The taxpayer consists of Corp U and a group of affiliated corporations with which it files consolidated returns on a calendar year basis. During the first half of Year 3, Corp B, a holding company, was wholly owned by Corp C, a holding company directly and wholly owned by Corp U.

During mid to late Year 1, Corp U acquired Corp D, Corp S, and Corp X. Corps D, S and X were involved in the building materials and supplies business. Ownership of Corps D, S and X was established directly or as tiered subsidiaries through Corp B. Corp B distributed building supplies and materials over a multi-state area.

Soon after acquisition of Corps D, S and X, Corp U decided to “get their earnings and profits out of them.” To this end, Corp U made a series of “loans” to Corps D, S and X followed immediately by “dividend” distributions back to Corp U. Corp U did not report these “dividends” in reliance on the dividend received deduction rules.

No cash or checks actually changed hands in any of these transactions, nor were there any transfers between or among bank accounts. They were completed exclusively through journal entries. Promissory notes were executed for at least some of the “loans.” These notes describe a stated interest rate, and interest was accrued on the “loans.” However, the interest was not paid. The interest due was characterized as an advance to the subsidiary and rolled into an inter-company account.

In addition to the “loans” and accrued interest, Corp U made other advances to the subsidiaries for daily cash needs, including utilities, salaries, etc. Again, there were no actual cash advances or transfers into bank accounts. The entire family of corporations utilized a single “Cash Management Account” for these purposes. “Transfers” into and from this account were accomplished on a daily basis through journal entries. If a subsidiary had excess cash on its books, it was “transferred” into the account. If the subsidiary had insufficient cash on its books to cover expenses, the account was charged with an “advance” to the subsidiary. This inter-company accounting resulted in balances which changed daily.

The subsidiaries did not make any principal repayments on the “loans.” The subsidiaries often did not generate enough income to pay accrued interest and other expenses. Accordingly, their negative balances in the inter-company Cash Management Account generally increased over time.

During Year 2 and Year 3, Corp U and Corp B management decided that the continued ownership and operation of the building supply businesses was no longer a part of its strategic plan. The subsidiaries of Corp B were suffering decreased operating revenues, eroding gross income and diminished profits. Accordingly, Corp U sought a buyer and entered into purchase negotiations with Corp R.

At this point in time, total inter-company indebtedness from Corp B and its subsidiaries to Corp U exceeded $100 million, including principal loan balances exceeding $75 million and advances in an aggregate amount of over $25 million.

Corp R did not want to acquire Corp B and its subsidiaries encumbered with enormous debt. It offered to purchase Corp B and its subsidiaries in a stock deal for several million dollars, but only if the inter-company debt was canceled or otherwise retired. To this end, during June of Year 3, the board of directors of Corp U executed a corporate resolution contributing its entire interest in all inter-company indebtedness of Corp B and its subsidiaries to the capital of Corp C. Immediately thereafter, the board of directors of Corp C adopted a resolution contributing its interest in the debt acquired from Corp U to the capital of Corp B. These resolutions had the effect of extinguishing the debt at the Corp U and the Corp C level, leaving the Corp B stock unencumbered as Corp R required. Less than one week later, the taxpayer sold 100 percent of the shares of Corp B to Corp R for the offered amount.

The accounting firm who was advising the taxpayer about the divestiture prepared an estimated valuation of Corp B and its subsidiaries. This valuation concluded that Corp B and its subsidiaries were insolvent at the time of the sale because their liabilities exceeded their asset values. The taxpayer treated the debt cancellation transactions as being the equivalent of a write-down of the debt to fair market value. The taxpayer took a bad debt deduction for the difference between the amount of the inter-company indebtedness and the purchase price. The taxpayer attributed 2/3 of the amount of bad debts to Corp D and 1/3 to Corp S.

Subsequently, the accounting firm provided a more complete appraisal study. Based on the appraisal, the taxpayer claimed a worthless stock loss from Corp D and Corp S. Approximately 1/10 of the claimed loss was attributed to Corp D. The remaining 9/10 of the claimed loss was attributed to Corp S. To exemplify, for Corp S, the claimed worthless stock loss was computed by taking the taxpayer's investment in Corp S, plus Corp S's earnings and profits including dividends, less the dividends paid.

LAW AND ANALYSIS

1. Sham Transactions

I.R.C. § 165(g) allows a deduction for worthless securities. Section 166 allows a deduction for any debt which becomes worthless during the tax year. However, the incidence of taxation depends upon the substance of a transaction. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impede the effective administration of the tax policies of Congress. Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945); Bealor v. Commissioner, T.C. Memo. 1996-435.

If a transaction is devoid of economic substance, it is not recognized for federal taxation purposes, for better or for worse. This denial of recognition means that a sham transaction, devoid of economic substance, cannot be the basis for a deductible loss. United States v. Wetzlar, 31 F.3d 117, 122 (3d Cir. 1994).

A taxpayer is generally free to structure its business transactions as it pleases, though motivated by tax reduction considerations. Gregory v. Helvering, 293 U.S. 465 (1935). However, it is well settled that the substance of a transaction and not the form will control its tax consequences. Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978); 3-Koam Co. v. Commissioner, T.C. Memo. 1997-148. Where a taxpayer, cognizant of potential tax benefits, enters into a transaction of questionable economic worth, the tests developed under the sham transaction doctrine are applied to determine whether a threshold level of business purpose and economic substance is present. Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184, 196 (1983), aff'd in part, rev'd in part, 752 F.2d 89 (4th Cir. 1985).

The Tax Court stated the principle as follows:

> The freedom to arrange one's affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the Internal Revenue Service and the courts will play along. The Commissioner and the courts are empowered, and in fact duty-bound, to look beyond the contrived forms of transactions to their economic substance and to apply the tax laws accordingly.

COMPAQ Computer Corporation v. Commissioner, 113 T.C. No. 17 (Sept. 21, 1999), citing Saviano v. Commissioner, 765 F.2d 643, 654 (7th Cir. 1985).

Thus, in order to be able to deduct its claimed bad debt and worthless stock losses, the taxpayer must establish that it had a business purpose in entering into the purported loans and that the loans had economic substance. See Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. No. 21 (Oct. 19, 1999).

Economic substance is determined by objective evaluation of changes in economic position of the taxpayers (economic effects) aside from tax benefits. Kirchman v. Commissioner, 862 F.2d 1486, 1492 (11th Cir. 1989), aff'g, Glass v. Commissioner, 87 T.C. 1087 (1986). Economic substance depends on whether, from an objective standpoint, the transaction was likely to produce economic benefits aside from tax deductions. Bail Bonds by Marvin Nelson, Inc. v. Commissioner, 820 F.2d 1543, 1549 (9th Cir, 1987).

There appears to be no objective evidence that the taxpayer's purported "loans" from Corp U to Corps D, S and X and the reciprocal payment of dividends from Corps D, S and X to Corp U had any economic effect. These transactions were strictly inter-company. No cash changed hands. There were just offsetting journal entries with no real economic change to the company as a whole. The purported loans were not used for business expenses or assets. Rather, there was a circular flow of money that existed only on paper.

These journal entries did not create a bona fide debtor-creditor relationship.
If the tax consequences depend on representations regarding changes in legal rights and if those changes simply did not occur, the reported 'transaction' is a sham. A case illustrating this kind of sham because a debtor-creditor relationship was not established is Goodstein v. Commissioner, 267 F.2d 127 (1st Cir. 1959), aff'g, 30 T.C. 1178 (1958). The Tax Court determined that Goodstein was entitled to no deduction because the series of transactions was pursuant to a preconceived plan that lacked economic substance and should be ignored for tax purposes. 30 T.C. at 1188. On appeal, the First Circuit did not comment upon the asserted lack of economic substance and instead decided that the legal relationship that existed between Goodstein and Lender was not that of borrower and lender, so that payments from one to the other could not be interest. See 267 F.2d at 131. It is just this lack of a purported legal creditor-debtor relationship between the taxpayer and its indirect subsidiaries here that is a sham. Here the "distribution" of notes left the parties where they began because the notes were not respected by the parties as obligations. Thus, no debtor-creditor relationship arose.

Because the loans had no validity, for federal income tax purposes, the journal entries for advances for the interest expense attributable to these sham loans should also be disregarded.

However, some of the advances were for expenses which Corps D, S and X could not pay out of their net income. These advances have an economic effect and cause a change in the overall financial picture of the taxpayer.

The lack of an economic effect due to the purported loans is highlighted by the fact that a commercial bank indicated that loans would usually be made based on earnings before interest, taxes, depreciation and amortization. The amount lent would usually be between 1.5 and 2.5 times earnings. The amount lent by Corp U to Corps S and D was at least three times the maximum that would have been lent by a commercial bank.

The Tax Court examined whether a bona fide debt existed in Booker v. Commissioner, T.C. Memo. 1996-261. The court noted that in determining whether a debtor-creditor relationship represented by a bona fide debt existed it had to consider all facts and circumstances. The test is whether the debtor was under an unconditional obligation to repay the creditor and whether the creditor intends to enforce repayment of the obligation. The existence of notes or other indicia of indebtedness, the existence of security or collateral, the demand for repayment, records that may reflect the transaction as a loan, and the borrower's solvency at the time of the loan are all factors that can be considered in making this determination.

The facts and circumstances in this case demonstrate that there was no valid debt. The effect of the loan/dividend transactions was to take the equity out of Corps D and S and transfer it to Corp U. The transfers were entirely via journal entries, there was no actual cash transfer and no overall economic outlay or effect on the company. Because there was no "genuine indebtedness," there can be no deductions/losses arising therefrom. See Shirar v. Commissioner, 916 F.2d 1414 (9th Cir. 1990); Sheldon v. Commissioner, 94 T.C. 738 (1990); ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998).

In determining whether a transaction should be respected for tax purposes, the courts also look at whether the taxpayer had a valid business purpose for engaging in the transaction other than tax avoidance. See Frank Lyon Co. v. United States, 435 U.S. 561, 583-84 (1978); Winn-Dixie, supra.

No apparent business purpose was served by Corp U draining the equity from Corps S and D by making purported loans to them and then taking those proceeds back as dividends. This is especially the case where there were no adverse tax consequences because the taxpayer did not pay taxes on these dividends in reliance on the dividends received deduction. Interest was accrued on these purported loans [and presumably deducted on the tax returns]. When Corps D and

S could not pay the accrued interest, more “advances” were made to them for the interest obligation. There was no real flow of monies, only journal entries that did not effect the overall economic condition of the companies - everything owed/paid was inter-company.

Moreover, the so called interest accruals were circular to the extent they simply increased prior ‘loan’ balances. A case where payment of ‘interest’ by the recipient of disregarded loans among related corporations was held circular and disregarded is Laidlaw Industries, Inc. & Subsidiaries v. Commissioner, T.C. Memo. 1998-232 75 TCM 2598, 2622 (CCH). There in substance, the ‘borrower’ paid alleged ‘interest’ at most sporadically because funds flowed in a carefully orchestrated circle. Such payments failed to change the taxpayer’s financial position because the vast majority of the funds were immediately returned as ‘interest reinvestment loans’. Thus, the Tax Court found that in substance no interest had been paid. This supported its finding that the advances to related companies were capital contributions rather than loans. In this case, the fact that interest was never paid over a number of years, but was added to ‘principal’ further illustrates that the notes were a sham.

Thus, the effect of these purported loans was tax motivated. The taxpayer was able to claim interest deductions each year. The taxpayer is presently claiming a bad debt loss and a worthless stock loss. In the meantime, there was no objective economic outlay. There was no valid business purpose for the loan/dividend transactions.

Thus, the loan transactions should be disregarded for tax purposes. The loans should not be considered in determining the amount of any bad debt loss. “Advances” for interest on these sham loans should also be disregarded for purposes of determining the bad debt. The interest should also be disregarded in determining the earnings and profits for Corps D and S.

Once a transaction is determined to be a sham, it should be disregarded. Therefore, the dividends that were made from the loan proceeds should also be disregarded in determining if there is a worthless stock deduction.

2. Whether Either Advance (Relating To Dividend Or Expense) Was Valid Debt

For the following reasons, neither kind of purported debt qualified as valid because the relevant facts indicate there was no intention to pay the amounts of purported indebtedness.

A. Dividend - 'Debt' The 'creditor' of the claimed indebtedness never received payments of principal or interest on the notes (or the bare advances, if any). Interest although accrued was never paid but rolled over into additional purported debt. These advances (perhaps only some of which were evidenced by notes) were not respected by the parties as debt. The facts indicate that there was no intention to honor them by payment. None were paid over the entire history of these advances which spanned several years. In addition, the advances were more than three times what an outside lender might have advanced. Significantly, the purported creditor took no actions to enforce its rights to collect any of the advances. Consequently, none of the advances relating to dividends was valid indebtedness when made (either through journal entries or via the deemed distribution of the notes).

As was previously noted, the Tax Court examined whether a bona fide debt existed in Booker v. Commissioner, T.C. Memo. 1996-261. The Tax Court noted that in determining whether a debtor-creditor relationship represented by a bona fide debt existed it had to consider all facts and circumstances. The test is whether the debtor was under an unconditional obligation to repay the creditor and whether the creditor intends to enforce repayment of the obligation. The existence of notes or other evidence of indebtedness, the existence of security or collateral, the demand for repayment, records that may reflect the transaction as a loan, and the borrower's solvency at the time of the loan are all factors that can be considered in making this determination. For the afore-described reasons, there was no valid debt created by the purported loans or the advances.

An additional argument for disregarding the dividend indebtedness is that, although the distribution of a corporate obligation can be a dividend of property, the nature of the instrument will determine whether it is an actual obligation or only a promise to pay a future dividend. In the case of the declaration of a future dividend, the future payment is the distribution and there is no preliminary distribution of a debt obligation. See, e.g., Vinnell v. Commissioner, 52 T.C. 934 (1969); Stephens v. Commissioner, 60 T.C. 1004 (1973), aff'd , 506 F.2d 1400 (6th Cir. 1974) (installment payment held to be mere open account debt, not a distribution of a corporate obligation). Accordingly, this purported obligation with regard to the dividend can be disregarded as constituting merely a promise to pay future dividends and not a current obligation.

B. Advances Related To Expenses

For the same reasons the advances relating to dividends were disregarded as failing to create a debtor-creditor relationship as discussed above, the advances related to expenses also did not establish indebtedness. The notes and or entries provided for ‘interest’ which was accrued but unpaid. That is, no journal entries reduced the ‘borrowers’ balance in the Cash Management Account to fund the interest accruals. The ‘payment’ history of these arrangements shows that during the years of the taxpayer’s ownership of the subsidiaries, no principal payments were ever made, and their purported indebtedness only grew.

3. The Advances Relating To Expenses As Equity - Contribution to Capital

A debt-equity issue arises with respect to the advances relating to the expenses. With respect to the debt-equity issue, generally, if an instrument denominated as ‘debt’ in fact represents an investment in the corporation, in the sense that the return on, and of , the investment is dependent on corporate success, the instrument will be treated as ‘equity’ for tax purposes. The determinant of tax liability is not the ‘form’ of the instrument but the ‘substance’ of the legal rights created therein. Here some of the purported loans were documented with promissory notes of unknown maturity (perhaps payable upon demand). The notes provided for ‘interest’ which was accrued but unpaid. That is, no journal entries reduced the ‘borrowers’ balance in the Cash Management Account to account for the interest accruals. As stated above, the ‘payment’ history of these arrangements shows that during the years of the taxpayer’s ownership of the subsidiaries, their purported loan balances only grew. Indeed, no payments were ever made to defray the principal or interest on the purported indebtedness. However, because they represent outlays for actual expenditures of the subsidiaries, they must be recognized for tax purposes. As they were clearly dependent for repayment upon the success of the subsidiaries, they must be regarded as equity contributed to capital. Thus, assuming the booked advances represented real expenditures to defray expenses of the operating subsidiaries, they would be contributions to capital down the corporate chain to the operating member whose expense was defrayed.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We believe determination of the basis of stock for purposes of determining any worthless stock deduction must be carefully considered in light of the investment basis adjustment rules of Treas. Reg. § 1.1502-32 and section 1503. For example, any worthless stock deduction with respect to Corp D and Corp S would have to have been taken by Corp B, the shareholder. If such a deduction were utilized on the group’s return, it should contribute to a reduction in Corp C’s basis in the stock of Corp B prior to its sale. The basis result will vary depending upon whether we prevail on the amount of bona fide debt, if any. As the taxpayer contends that Treas. Reg. § 1.1502-20 does not disallow its loss, the field should consider requesting our assistance with regard to the proper application of the loss disallowance rules. Finally, you may wish to consult further with us for elaboration on any of the foregoing issues or other questions that may arise.

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By: ______________________________

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