

US Outbound Tax Newsalert

A Washington National Tax Services (WNTS)
Publication

May 17, 2012

Tax Court releases Hewlett-Packard opinion, addresses debt vs. equity issues

In brief

On May 14, 2012, the Tax Court released its memorandum opinion in *Hewlett-Packard Company and Consolidated Subsidiaries v. Commissioner* (T.C. Memo. 2012-135) addressing a complex structure that generated significant excess foreign tax credits. Although the IRS challenged the structure under several legal theories, including economic substance, the step-transaction doctrine, and debt/equity, the court held that the taxpayer's investment in a foreign corporation should be characterized as debt, thereby denying the taxpayer's claim of direct and deemed-paid foreign tax credits. The court did not address the other legal theories. The court also held that HP had not substantiated the capital loss it claimed that resulted from exiting the transaction.

The decision is significant since it represents the first of several expected court decisions addressing transactions labelled by the IRS as foreign tax credit generator transactions. While the non-precedential memorandum decision would appear to be of limited value in other so called generator cases with different facts, the case is noteworthy for its approach of considering the overall plan, structure, and tax posture of a taxpayer in the debt/equity analysis.

The decision is similar to those in *Castle Harbour (TIFD III-E, Inc. v. U.S., 459 F.3d 220 (2d Cir. 2006))* and *Schering-Plough (Schering Plough Corp. V. U.S., 100*



A.F.T.R.2d 2009-6157 (D. N.J. 2008), *aff'd Merck & Co., Inc. v. U.S.*, 652 F.3d 475 (3d Cir. 2011)) in that it pushed the boundaries of traditional debt/equity analysis to deny tax benefits in a highly structured transaction. In doing so, the decision has increased the uncertainty in characterizing financial instruments.

Facts

The transaction at issue was structured by AIG to arbitrage the difference between the accrual of income under the US and Dutch tax laws. AIG initially entered into the transaction in January 1996 and then sold its interest to HP in March 1996 at a \$15 million premium. In January 2004, HP exited the structure, claiming a capital loss of approximately \$15 million.

AIG entered into the transaction with ABN, a Dutch bank, each contributing notes or receivables to FOP, a foreign corporation, which then loaned the contributed amounts back to ABN and its affiliates, receiving four contingent interest notes (CINs) maturing in 2006. The CINs required the actual payment of base interest in Dutch guilders at a fixed rate but with reference to a US dollar amount, with contingent interest being payable only if the Dutch government bond rate exceeded 1%, as determined in 2006. The contingent interest on the CINs also was compounded each year, so that by 2004, the base interest would not cover FOP's Dutch taxes and expenses. Because of this, the parties expected HP would likely exit the structure at the end of 2003 through the exercise of a put option that alternatively could be exercised in 2007.

AIG held preferred and priority shares in FOP representing just over 20% of the voting power in FOP, while ABN held common shares with the remainder of the voting power. AIG also held warrants to subscribe to additional FOP shares, resulting in deemed ownership by HP in FOP over 50%, and purportedly making FOP a controlled foreign corporation (CFC).

AIG was entitled to 97% of the cash amounts that FOP received, less expenses and Dutch taxes, each year until 2003 (at which point the dividend rights would be reset).

Based on a ruling from the Dutch tax authorities, FOP recognized the base and contingent interest for Dutch tax purposes, and paid tax on that income. However, based on the dual-currency feature of the CINs, and the lack of rules addressing the accrual of such amounts under the US tax law at the time the transaction occurred, FOP only recognized the base interest (i.e., cash interest) in calculating its earnings and profits for US tax purposes.

Each year during the term, HP received 97% of the base interest received by FOP less the Dutch taxes paid as a dividend and claimed deemed-paid foreign tax credits for the Dutch taxes paid, as well as direct foreign tax credits for the 5% Dutch withholding tax imposed on such distributions.

HP entered into several interest rate and currency hedging transactions with AIG to minimize its exposure with respect to its fixed rate Dutch guilder dividend stream, and the fixed rate return embedded in the warrants.

The IRS's position

The IRS attacked the FOP transaction on three grounds: (1) that HP's investment was more appropriately characterized as debt, not equity, (2) that HP's investment was a sham under the economic substance doctrine, and (3) that FOP was a conduit entity

and the transaction should be recharacterized as a direct loan from HP to ABN. The Court held for the IRS on the first issue and declined to address the other two.

The Court's analysis

In ruling in the IRS's favor, the Court purported to apply a traditional debt/equity analysis, consisting of an examination of a series of court-developed factors to determine whether an instrument more appropriately constitutes debt or equity. The Court's analysis of several of these factors is questionable.

The courts have traditionally placed great weight on an instrument constituting stock under corporate law, and very few cases have characterized corporate stock as debt for US tax purposes. It had also been widely assumed that the IRS would generally not attempt to recharacterize stock as debt, because such a recharacterization could open the door to taxpayers creating hybrid instruments that create interest deductions for US tax purposes.

The Court justified equity treatment largely by integrating the taxpayer's put option with respect to its preferred shares with the preferred shares. It did so, even though the put right was enforceable against a shareholder and not the issuer of the shares. The Court distinguished cases cited by the taxpayer and relied on a rarely-cited 1940 9th Circuit case, *Commissioner v. Palmer, Stacy-Merrill*, 111 F.2d 809 (9th Cir. 1940). In that case, a new entity assumed pre-incorporation contracts obligating it to make predetermined periodic payments and to redeem shares. These factors were sufficient to characterize the payments in *Palmer* as interest. The Tax Court stated that, like the *Palmer* court, it would construe the put option and other agreements that were expressly listed in FOP's shareholders agreement as integrated pieces of one overall transaction.

Fixed maturity date

One factor courts consider important in determining whether an interest is debt is the presence of a fixed maturity date, as the absence of a maturity date is strongly indicative of equity. The Court conceded there was no mandatory redemption provision obligating FOP to purchase HP's interest, but found that the taxpayer's ability to exercise its put option in 2003 functioned as a maturity date. The Court noted that HP had an economic disincentive to stay in FOP after 2003 because after that year, FOP would have negative E&P as a result of Dutch taxes on the compounded contingent interest, and HP would not be able to claim deemed-paid foreign tax credits. The Court also found that the evidence suggested that both ABN and HP expected HP to exit the structure in 2003.

Observation: While the Court noted that no single factor in its analysis was controlling, it spent considerable space discussing the integration of the taxpayer's put option in the overall analysis, a point that appears critical for the court's later finding of an effective maturity date. From the Court's discussion, the finding of the fixed maturity date was important in its overall analysis.

In this context, the Court distinguished its decision in *Media Space v. Commissioner*, 135 T.C. 424 (2010), a case where a company granted its preferred shareholders redemption rights beginning in 2003, and the parties agreed to extend the redemption date in exchange for interest-like forbearance payments. The court in *Media Space* held that redemption

rights did not create the obligation to pay the redemption amount, but rather the exercising of the redemption rights creates the obligation to pay.

The Court distinguished *Media Space* because the agreements to extend the redemption dates in that case underscored the shareholders' efforts to uphold the business viability of the corporate entity. In addition, there was no predetermined date on which a significant portion of the transaction's economic benefits would terminate.

Creditor's rights

Courts have held that the ability of the person advancing the payments to enforce repayment is indicative of debt. While no traditional creditor's rights were present with respect to HP's preferred shares, FOP's articles of incorporation provided for certain events which would trigger a right of the preferred shareholders to call a meeting of FOP's shareholders, at which the shareholders could dissolve FOP or cause it to reduce its capital in order to redeem or repurchase the preferred shares. Although HP did not otherwise have voting control of FOP, in such a meeting HP would have held a majority of the votes of FOP pursuant to FOP's articles of incorporation. The Court concluded that these provisions "afforded HP an apparatus to enforce creditor rights."

Source of payments

Although a repayment that is contingent on earnings is generally indicative of an equity investment, the Court found that the transaction at issue was arranged in such a way that FOP's earnings were predetermined, that FOP was obligated to pay HP periodic, predetermined amounts, and that HP was assured to be repaid its investment at the end of the transaction. Therefore, the Court reasoned, the analysis of the source of payments favored debt characterization.

Participation in management

Generally, the right to participate in the management is indicative of equity. HP's preferred shares carried voting rights representing approximately 20 percent of the voting power in FOP. Moreover, as the Court previously discussed, in certain circumstances HP would have the ability to call a shareholder meeting at which it would hold a majority of the votes and could cause FOP to liquidate or to reduce its capital in order to redeem or repurchase the preferred shares. The Court ascribed HP's voting rights minimal importance in its analysis because it found HP itself did not view these rights as important. In this regard, the Court cited HP's lack of formal objection to an impermissible investment FOP made for a brief time and the lack of evidence that HP's representative attended board meetings. Further, the Court stated that the enhanced rights HP enjoyed in certain circumstances "did not meaningfully advance HP's participation in the management of FOP. Rather, they served as a means by which HP would be able to expediently exit the transaction..."

Observation: HP's voting rights in ordinary circumstances (20 percent) were proportional to the value of its investment in FOP. The Court's analysis appears to suggest that a court can discount the importance of the participation in management factor when the entity advancing funds has less than a controlling interest in the recipient of the funds. The Tax Court cited no authorities that supported this proposition, so it is unclear on what basis the Court's conclusion is premised.

Adequacy of capitalization

The parties did not address the adequacy of FOP's capitalization. In general, if a corporation is thinly capitalized, advances made to the corporation are more likely to be characterized as equity. Even though the parties did not argue this factor's relevance, the Court found that "ABN's substantial capital contribution was four times greater than HP's... ensuring that HP would be able to exit the transaction... with its investment repaid in full."

Observation: Although the Court qualified its analysis of this factor as favoring the IRS to the "extent this factor is pertinent," it is not clear why the Court addressed it at all or believed that it favored the IRS. The adequacy of capitalization is generally a factor that is only addressed where a taxpayer seeks to characterize an instrument as debt, but the purported debtor's capital structure may be too thin to support the debt. Adequate capitalization of a corporation is not indicative that purported equity is actually debt, because a corporation is not required to have debt in its capital structure.

Other factors

The Court also analyzed the parties' intent, as well as the ability to obtain outside financing. In addressing the parties' intent, the Court found that all relevant parties to the transaction were aware from the transaction's inception that it was in substance a limited term investment of HP's funds at a specified rate of return. The Court concluded that the factor analyzing the ability to obtain outside financing was not persuasive for either party under this case's circumstances.

Denial of capital loss

The Court denied HP a claimed capital loss associated with its exit from the transaction. With little analysis, the Court found that HP failed to substantiate its right to a capital loss deductible under section 165(a).

Observation: The Court's conclusion appears inconsistent with its findings of fact, which address HP's purchase price as well as sale price with its investment.

Conclusions

The IRS thus viewed this transaction as an inappropriate attempt to procure tax benefits, and the Court's decision considers that view. Because the decision is based on a fact intensive debt/equity analysis and is non-precedential in the Tax Court, it would appear to be of limited relevance in other so called foreign tax credit generator cases. More significant, however, the IRS victory in this case may create more uncertainty for taxpayers as they try to determine the characterization of financial instruments as debt or equity.

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