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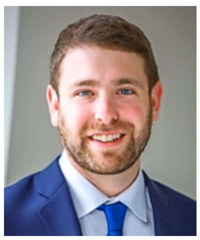
INSIGHT: Evolution of Common Law Factors Characterizing Intercompany Debt



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This article explains the evolution of U.S. common law regarding debt characterization through a brief chronology and considers the common law standards in the context of recent regulatory change.

Today, the fate of the final Section 1.385 Regulations (385 Regulations) is unclear given recent reports from Treasury and the subsequent passage of the Tax Cuts and Jobs Act (TCJA). Nonetheless, it is clear that the reliance on case law in the U.S. in the context of debt characterization is unlikely to change, regardless of that fate. This is because the 385 Regulations include a general rule that ''effectively implements the common law factors'' such that the minimum documentation requirements, which apply to instruments issued on or after January 1, 2019, should include the application of, and where appropriate, the weighting of, common law factors.

Even if there are changes to or a repeal of the 385 documentation and distribution rules, as has been contemplated in Treasury reports (e.g., Second Report to the President on Identifying and Reducing Tax Regulatory Burdens dated October 2, 2017), there is no evidence that the reliance on common law in the context of debt characterization would change. In fact, less regulatory guidance might make taxpayers more reliant on common law, and the common law factors, when supporting debt characterization as was common prior to introduction of the proposed 385 Regulations in April of 2016.

While the TCJA introduced rules that limit the benefits of earnings stripping using intercompany financing, most notably the interest deductibility cap (e.g., revised 163(j)), the IRS may nonetheless continue to pursue debt characterization challenges to combat earnings stripping, similar to past high-profile cases such as the Scottish Power Case (NA General Partnership v. Commissioner, T.C. Memo. 2012-172).

As such, taxpayers should consider the precedents set by U.S. court cases, which represented the prevailing standards before the 385 Regulations were finalized, and will likely continue to serve as prescriptive guidance regardless of the ultimate fate of the 385 Regulations.

The following subsequent case summaries provide an overview of some of the important debt characterization court cases in the U.S. This summarized list is not intended to be exhaustive, but rather illustrative of the evolution of present common law standards. The key takeaways from these cases, including the common law factors relied upon, should be considered in conjunction with the facts and circumstances of a specific case, as well as the legal jurisdiction in which a specific case would be litigated (e.g., circuit court).

Important Debt Characterization Court Cases

John Kelley Co. v. Commissioner, 1946, U.S. Supreme Court Background: This is the sole example of the U.S. Supreme Court ruling on debt characterization. The Supreme Court reviewed both John Kelley Co. v. Commissioner and Talbot Mills v. Commissioner (Talbot Mills v. Commissioner of Internal Revenue, 146 F.2d 809 (1st Cir. 1944)) in conjunction with one another because the cases were focused on similar issues and occurred around the same time. Both cases were ruled upon by the Tax Court (deeming payments interest in 'Kelley' and dividends in 'Talbot'). Subsequently, the cases were considered by Appeals Courts (with a reversal to 'Kelley' and an affirmation to 'Talbot', such that in both instances, the payments were considered dividends).

Ruling: The Supreme Court affirmed the rulings made by the Tax Court, or rather, affirmed the Talbot decision (in which the Court of Appeals had agreed with the Tax Court) and reversed the Kelley decision (in which the Appeals Court disagreed with Tax Court). The Supreme Court's opinion referred to the ''Dobson Rule,'' a precedent established in Dobson v. Commissioner, 320 U.S. 489, that stated that ″...Congress intended to leave to the final determination of the Tax Court all issues which were not clear-cut questions of law,'' meaning that the Supreme Court was holding on judging the debt characterization question and instead just clarifying that based on precedent, the Tax Court's decision should be final (a precedent which was abolished two years later by Congressional Statute).

Key Takeaways: Although the primary conclusion reached in the case pertained to a question of jurisdiction, given the weight of the Supreme Court's opinion, practitioners have clung to commentary in Justice Reed's opinion that seems to imply the importance of certain criteria in considering debt characterization. For example, his comment that ″...we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure,'' appears to support a thin capitalization assessment as a debt characterization criterion. As such, this case can be seen as influential in implying that thin capitalization assessments should be considered when assessing characterization (despite the fact that the Supreme Court had not intended to opine on such matters).

Kraft Foods Company v. Commissioner, 1956, U.S. Court of Appeals for the Second Circuit Background: This case was an appeal of Tax Court's judgment that an intercompany dividend in the form of debentures between a Kraft subsidiary and its parent should be considered equity and not debt. The Tax Court concluded that there was no intent to create a genuine debtor-creditor relationship between the taxpayer and its parent, and that the so-called interest payments constituted non-deductible dividend distributions.

Ruling: The Court of Appeals reversed the decision noting that if the transaction was otherwise reasonable, the instrument should not necessarily be disqualified as debt just because it was between a parent and a subsidiary, issued as a dividend (and as such, there was no cash or asset in return) and with no business purpose besides tax minimization. The judge noted, ''Since the acts were real and the taxable entities cannot be characterized as sham entities, the transaction should not be disregarded merely because the transaction was entered into in response to a change in governing tax law.''

Key Takeaways: This case affirmed that intercompany lending aimed at tax minimization and/or not issued for cash does not in and of itself require recharacterization as equity.

O. H. Kruse Grain & Milling v. Commissioner, 1960, U.S. Court of Appeals for the Ninth Circuit Background: The IRS determined that the taxpayer's company had claimed interest on non-bona fide debt. The Tax Court agreed and the case was ultimately sent to the U.S. Court of Appeals for the Ninth Circuit.

Ruling: The Court of Appeals affirmed the decision on the basis of an eleven factor test: ''They are (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a maturity date; (3) the source of the payments; (4) the right to enforce the payment 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 ability of the corporation to obtain loans from outside lending institutions.''

Key Takeaways: This is the first court opinion to formally list key factors often cited in subsequent cases.

Fin Hay Realty Co. v. United States of America, 1968, U.S. Court of Appeals for the Third Circuit Background: This case looked at a situation where two individual taxpayers contributed debt and equity capital into a corporation (Fin Hay Realty Co.) which was used to purchase apartment buildings. In 1962, the IRS declared that the payments on the notes were no longer allowable as deductible interest, so the corporation went to District Court. When it was denied there, the case was appealed and sent to the U.S. Court of Appeals for the Third Circuit.

Ruling: The Court of Appeals upheld the decision to deem the instruments equity. The opinion listed sixteen factors that had been raised by courts and commentators to address the debt vs. equity dilemma (citing J. S. Biritz Construction Co. v. Commissioner of Internal Revenue, 387 F.2d 451 (8 Cir. 1967); Tomlinson v. 1661 Corporation, 377 F.2d 291 (5 Cir. 1967); Smith v. Commissioner of Internal Revenue, 370 F.2d 178 (6 Cir. 1966); Gilbert v. Commissioner of Internal Revenue, 262 F.2d 512 (2 Cir. 1959); and 4A Mertens. Law of Federal Income Taxation, § § 26.10a, 26.10c (1966)). The Court also stated that ''It still remains true that neither any single criterion nor any series of criteria can provide a conclusive answer in the kaleidoscopic circumstances which individual cases present.'' The opinion noted that while the emphasis of prior cases has been on lists of factors, they are ″...only aids in answering the ultimate question of whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of a corporate venture or represent a strict debtor-creditor relationship.'' The court explained that the economic reality of the notes was that they did not constitute debt, noting the absence of a genuine debtor-creditor relationship (as evidenced by the fact that their claim to their assets was never at risk despite the notes going unpaid for years) and the fact that a rational third-party lender would not have agreed to the terms of the loan (″It is difficult to escape the inference that a prudent outside businessman would not have risked his capital in six percent unsecured demand notes in Fan Hay Realty Co. in 1934″).

Key Takeaways: This case established frequently cited language stating that the oft-used lists of factors are aids through which to determine the ultimate question of whether the economic reality of an instrument truly represents genuine debt, and it applied a framework for considering whether a third-party lender would enter into the debt transaction as constructed by the taxpayer.

Jean C. Tyler and Dolly Ann Tyler v. Laurie W. Tomlinson, 1969, U.S. Court of Appeals for the Fifth Circuit Background: Neal and Jean Tyler operated a partnership that distributed beer, but ultimately formed a corporation known as Neal Tyler & Sons, Inc., to which it transferred all the assets of their partnership in exchange for stock and promissory notes. The corporation separately issued new notes to Neal and Jean Tyler in subsequent years, which were specifically subordinated to all corporate creditors. The Commissioner denied the deductibility of the interest on the promissory notes, and when the issue went to court, the District Court ruled that the evidence was deemed so overwhelmingly in favor of the Commissioner that the Court granted the government's motion of a directed verdict. The corporation appealed against the directed verdict.

Ruling: The Court of Appeals ruled against the taxpayer and affirmed the directed verdict. The case referred back to the eleven factors introduced in O. H. Kruse Grain & Milling, Petitioner, v. Commissioner of Internal Revenue, Respondent, 279 F.2d 123 (9th Cir. 1960), but also added to the list 1) the extent to which the initial advances were used to acquire capital assets, and 2) the failure of the debtor to pay on the due date or to seek a postponement. When these criteria were applied, the courts found, for example, that the corporation was inadequately financed and that there were no realistic creditor safeguards, specific maturity dates, or expectations of repayment.

Of note, the opinion stated, ''The object of the inquiry is not to count factors, but to evaluate them. No single factor can be controlling.''

Key Takeaways: This case added to the ''Kruse Factors'' to create the list of thirteen factors more famously used in Estate of Travis Mixon, Jr., Plaintiff-appellee, v. United States of America, Defendant-appellant, 464 F.2d 394 (5th Cir. 1971), and it reinforced the thinking found in Fin Hay Realty Co., Appellant, v. United States of America that the factors are not a checklist to be counted against one another but rather a means to make a holistic assessment on a case-by-case basis. This has been frequently quoted in subsequent court cases in describing how the courts use the lists of factors to make a determination.

Estate of Travis Mixon, Jr. v. United States of America, 1971, US - Court of Appeals for the Fifth Circuit Background: Travis Mixon was President and one of five Directors of the Bank of Graceville, Florida. The office of the Florida Commissioner of Banking determined that due to embezzlement and the write-off of improperly secured loans within the bank, the Directors or stockholders needed to make $200,000 available for the bank to be adequately capitalized. Due to the large number of small shareholders with pre-emptive rights, it was determined that rather than issuing stock, the $200,000 would come in the form of debt from three of the Directors (including Travis Mixon). In handling the payment of interest on the $200,000, it was necessary to determine whether this constituted interest or a dividend, as the treatment would impact the income tax paid.

Ruling: The Appellate Court ruled in favor of the taxpayer. The opinion listed the thirteen criteria in Jean C. Tyler and Dolly Ann Tyler, Appellants, v. Laurie W. Tomlinson, District Director of Internal Revenue, Appellee, 414 F.2d 844 (5th Cir. 1969), which are now referred to in shorthand as the ''Mixon Factors.'' The courts noted that not all criteria of legitimate indebtedness were present, but that enough of the factors were met to affirm the advance as a bona fide loan.

Key Takeaways: Though this case did not introduce any new factors (interestingly, all thirteen factors were included two years earlier in Jean C. Tyler and Dolly Ann Tyler, Appellants, v. Laurie W. Tomlinson, District Director of Internal Revenue, Appellee, 414 F.2d 844 (5th Cir. 1969)), it was the first to list these factors in a row and as such is commonly considered the baseline case for debt/equity analyses in the modern era. The thirteen ''Mixon Factors'' are still commonly referred to in debt characterization discussions.

Rudolph A. Hardman, Frances N. Hardman and Hardman, Inc. v. United States of America, 1987, U.S. Court of Appeals for the Ninth Circuit Background: The IRS assessed deficiencies against Rudolph A., Frances N. Hardman, and their corporation Hardman Inc. after they counted a payment resulting from the resale of land as capital gains tied to the sale of real property rather than a dividend. The Hardmans filed suit, but the district court ultimately agreed with the IRS that payment was a dividend taxable as ordinary income. As such, the case was appealed.

Ruling: The Appellate Court ruled in favor of the taxpayer. The opinion referred to Gregory v. Helvering, 293 U.S. 465, 469-70, 55 S. Ct. 266, 267-68, 79 L. Ed. 596 (1935) (which is not directly related to debt characterization) stating that ''[s]ubstance, not form, controls the characterization of a taxable transaction,'' and then applied the eleven factors listed in O. H. Kruse Grain & Milling, Petitioner, v. Commissioner of Internal Revenue, Respondent, 279 F.2d 123 (9th Cir. 1960) to evaluate the transaction under review.

The opinion concluded ''. . .that the lack of formalities in the instrument executed by Hardman, Inc., raises the suspicion that the transaction was a disguised attempt to extract earnings and profits from the corporation at favorable capital gains tax rates'', but ultimately found that ''. . .the trial court erred in relying on this sole factor and neglecting to consider fully the several other factors, all of which point to the opposite conclusion.''

Key Takeaways: This case applied the precedent that substance is more important than form to determining the characterization of a transaction, noting ''Courts will not tolerate the use of mere formalisms solely to alter tax liabilities.'' That said, the opinion also highlights that many transactions are structured specifically for purposes of tax optimization, and that this does not in itself disqualify the form of the transaction, provided the substance is valid. The decision also reinforced the usage (within the Ninth Circuit) of the eleven-factor test previously applied in O. H. Kruse Grain & Milling, Petitioner, v. Commissioner of Internal Revenue, Respondent, 279 F.2d 123 (9th Cir. 1960 and later applied in NA General Partnership v. Commissioner, T.C. Memo. 2012-172.

NA General Partnership v. Commissioner, 2012, U.S. Tax Court Background: Scottish Power, a UK company, acquired PacifiCorp, a publicly held US utility company. The IRS challenged interest deductions taken by Scottish Power on billions of dollars in notes issued between company units. The IRS argued the debt should be treated as equity, which would nullify the tax breaks.

Ruling: The Tax Court ruled in favor of the taxpayer and considered the interest to be deductible. Given that an appeal would have gone to the Court of Appeals for the Ninth Circuit, the Tax Court applied Ninth Circuit precedents and applied the eleven-factor test first used in O. H. Kruse Grain & Milling, Petitioner, v. Commissioner of Internal Revenue, Respondent, 279 F.2d 123 (9th Cir. 1960) and also used in Rudolph A. Hardman, Frances N. Hardman and Hardman, Inc., plaintiffs-appellants, v. United States of America, Defendant-appellee, 827 F.2d 1409 (9th Cir. 1987). The Tax Court noted that some factors pointed to debt and others equity, but that substance is more important than form and that when viewed holistically, the instrument was ultimately more akin to debt than equity.

Key Takeaways: Prior to this case, the IRS had been relatively inactive with regards to debt characterization questions and focused more on instruments owned by individuals and relating to closely held organizations. This case was one of multiple cases since 2012 which represented a trend of the IRS increasingly using case law to challenge interest deductions claimed by multinational corporations. Further, these cases reinforced that in this new era of increased debt characterization scrutiny, the factor tests established in precedent were aids for holistically assessing the substance and economic reality of an issuance.

Conclusion

As detailed above, early cases generally dealt with closely held corporations where the question under review was whether an individual's income should be taxed as interest or dividends, whereas the flurry of cases since 2012 (e.g., Scottish Power, PepsiCo, HP, Dow Chemical) are aimed at corporate tax issues and often earnings stripping using deductible intercompany interest.

Despite this shift in scope, when viewed chronologically the rulings build towards a relatively consistent and applicable framework for debt characterization. Specifically, U.S. courts have generally concluded that lists of common law factors such as the Mixon Factors serve as a lens for determining whether the economic reality of an issuance better represents debt or equity. These common law factors provide insight into the interpretation and application of the 385 Regulations and will likely inform the specific characteristics that the IRS and/or courts will look for. As such, companies would be wise to keep those factors in mind when structuring intercompany loans.

When structuring intercompany debt, companies should also confirm that their arrangement is reflective of market terms. For example, per the Fin Hay Realty Co. ruling, taxpayers should consider whether an independent third party would be placated by the upfront terms and ongoing fulfilment of the loan. As such, well-documented issuances that have clear terms and fixed interest obligations that are actually met should be relatively more defensible than ''looser'' arrangements where interest and principal obligations are treated as optional.

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