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Tax Court opinion upholds taxpayer's debt characterization of US intercompany debt

On June 19, 2012, the Tax Court released a memorandum opinion in *NA General Partnership & Subsidiaries v. Commissioner* (T.C. Memo. 2012-172). The issue in the case was whether an advance made by the taxpayer's non-US parent to its US group constituted debt or equity and, therefore, whether the taxpayer was entitled to interest expense deductions. The Court, ruling in favor of the taxpayer, upheld the taxpayer's treatment of the advance as debt.

Although this case is a memorandum decision that does not serve as binding precedent, it is important since it shows the Tax Court's current approach to debt vs. equity determinations. In particular, at a time when the IRS has been aggressively challenging taxpayers' intercompany financing arrangements, this case demonstrates that the Tax Court continues to apply a principled approach based on traditional debt vs. equity factors as established by case law. Note that the debt vs. equity determination is based on a taxpayer's particular facts and circumstances.

Facts

Based on the court's description of the facts, the advances and accompanying loan notes at issue arose out of a transaction where Scottish Power, a UK company, acquired PacifiCorp, a publicly held US utility company. PacifiCorp provides electricity and energy-related services to retail customers in several US states and also owned interests in Australian companies. In 1998, Scottish Power and PacifiCorp decided to merge. The parties planned to sell the Australian companies after the merger.

To effect the merger, Scottish Power organized NA General Partnership (NAGP), a Nevada general partnership that elected to be treated as a corporation for US federal income tax purposes. NAGP formed a subsidiary corporation, which merged with and into PacifiCorp. At closing, PacifiCorp's common stock was cancelled and converted into the right to receive Scottish Power shares or American Depositary Shares (ADS) from Scottish Power. PacifiCorp issued new shares of common stock to NAGP. To compensate Scottish Power for issuing shares to the PacifiCorp

shareholders, NAGP issued its own loan notes to Scottish Power in an amount equal to 75 percent of the acquisition's value.

The loan notes consisted of \$4 billion of fixed-rate notes and \$896 million of floating-rate notes. The fixed-rate notes matured in 2011 and had an interest rate of 7 percent, and the floating-rate notes matured in 2014 and had an interest rate of London inter-bank offer rate (LIBOR) plus 55 basis points. The fixed- and floating-rate notes were issued under separate loan agreements, and generally contained identical terms with the exception of their maturity dates and interest rates. The notes called for quarterly interest payments in arrears, were secured by a pledge of PacifiCorp shares, were transferable, gave Scottish Power the right to accelerate the notes upon default, and were recorded as debt on the books and records of both NAGP and Scottish Power.

At the time the notes were executed, the taxpayer expected that PacifiCorp dividends would fund NAGP's interest payments. According to the court decision, and based in part on a change in US tax regulations that would impact the financing structure, NAGP delayed making the only interest payment due in its 2000 taxable year and its first payment due in its 2001 taxable year. In 2001, NAGP ultimately paid \$333 million of the \$355 million interest it accrued on the loan notes for the 2001 taxable year, funding the payments with PacifiCorp dividends.

In the 2002 taxable year, Scottish Power and NAGP separated PacifiCorp's regulated and non-regulated subsidiaries from each other. This required Scottish Power and PacifiCorp to seek consent from both the UK Treasury and US state regulators. While regulatory approval was pending, Scottish Power suspended dividend payments from PacifiCorp. To fund the first two interest payments for the 2002 taxable year, NAGP borrowed \$186 million from Scottish Power on a short-term loan. According to the court, actual funds were transferred with respect to the first interest payment, but the second payment was made through journal entries on the parties' books and records.

Additionally, NAGP entered into a \$360 million credit facility with Royal Bank of Scotland (RBS). The credit facility matured in March 2002 and subordinated Scottish Power's right to repayment of the loan notes to RBS. NAGP borrowed a total of \$357 million under the credit facility, which it used to pay off the \$186 million short-term loan to Scottish Power and to fund additional interest payments on the loan notes while PacifiCorp's dividends remained suspended. When the PacifiCorp dividend suspension ended, NAGP fully repaid the RBS credit facility in the 2002 taxable year after PacifiCorp distributed dividends and proceeds from the sale of PacifiCorp's Australian subsidiary. In the 2002 taxable year, NAGP made interest payments to Scottish Power exceeding accrued interest for that tax year (*i.e.*, it made payments in arrears for the 2000 and 2001 unpaid interest), with the result that NAGP was in arrears of approximately \$1 million of interest at the end of the 2002 taxable year.

According to the Court, in March 2002, NAGP and Scottish Power decided to effectively capitalize the floating-rate notes into equity. To that end, Scottish power made contributions to NAGP, which NAGP used to fully retire the floating-rate notes. NAGP recorded the elimination of the floating-rate notes on its books as additional paid-in capital.

Later in 2002 (but in NAGP's 2003 taxable year), the parties decided to partially capitalize and repay the fixed-rate notes as part of a NAGP US group restructuring. According to the Court, the restructuring was in response to proposed IRS regulations under section 894 (domestic reverse hybrid regulations) that would have recharacterized NAGP's interest payments as non-deductible dividends. NAGP paid

\$241 million of interest on the fixed-rate notes during its 2003 taxable year. Its interest payments were current at the end of its 2003 taxable year.

The Court's analysis

In ruling in the taxpayer's favor on the debt vs. equity issue, the Court applied a traditional debt vs. equity analysis, examining a series of factors developed by courts to determine whether an instrument is more appropriately characterized as debt or equity. Because appeal of the case would lie in the Ninth Circuit, the Tax Court focused on case law developed by the Ninth Circuit Court of Appeals, which considers the following factors relevant to determine whether an advance is debt or equity:

- (1) the name given to the documents evidencing the indebtedness;
- (2) the presence of a fixed maturity date;
- (3) the source of the payments;
- (4) the right to enforce payments of principal and interest;
- (5) participation in management;
- (6) a status equal 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 corporation's ability to obtain loans from outside lending institutions.

The Tax Court placed particular emphasis on the case of *Hardman v. United States* (827 F.2d 1409 (9th Cir. 1987)), a case in which the Ninth Circuit also found that an advance was debt. The Court's analysis of several of these factors is highlighted below.

Source of payments

Courts often consider the source of payments in analyzing whether an instrument is debt or equity. In particular, if repayment depends on earnings or is to come from a restricted source, equity characterization may be indicated. The Court noted that this factor is somewhat anomalous because *bona fide* loans are often repaid out of corporate earnings. In finding that this factor favored debt characterization, the Court focused on the conclusions of one of the taxpayers' expert witnesses, who determined that PacifiCorp had reasonably anticipated cash flows at the time the notes were originated to pay NAGP dividends sufficient for NAGP to timely service and retire the debt as it became due. The Court disagreed with the IRS expert's conclusions because he excluded proceeds from the expected sale of PacifiCorp's Australian operations from the repayment analysis, even though the parties had contemplated the sale at the time the loan notes were entered into.

Observation: The Tax Court's analysis of this factor affirms that courts generally look to whether the borrower has the ability to generate sufficient cash flows to service and repay the debt. Interestingly, the test is often applied by looking at *operating* cash flow, *i.e.* whether the borrower would have the ability to generate sufficient operating cash flows to service the debt without being forced to sell its assets. In this case, the Tax Court included the sale of PacifiCorp's Australian subsidiaries in the cash flow analysis. Key to this appears to be that the parties contemplated selling the Australian business when entering into the transaction.

Subordination

Another factor courts frequently consider is whether the relevant instruments are subordinated to creditors. Although the notes in this case were not initially subordinated, the IRS argued that the notes resembled equity because the instruments did not restrict NAGP from taking on more senior debt, and NAGP later subordinated the notes to the RBS credit facility during the period it was in place.

The Tax Court rejected both arguments. With respect to the argument that the instruments did not restrict NAGP from taking on more senior debt, the Court noted that certain creditor protections are not as important in a related party context. In this case, because Scottish Power wholly owned NAGP, it had the power to prevent NAGP from taking on any additional debt, including senior debt.

Moreover, the Court found that the later subordination of the notes to the RBS credit facility was insignificant under the circumstances because NAGP obtained the credit facility to pay interest to Scottish Power on the loan notes while PacifiCorp delayed paying dividends, but NAGP reasonably expected PacifiCorp to pay a dividend sufficient to repay the credit facility on or before its maturity.

Intent of the parties

Courts frequently consider objective indications of the parties' intent to determine whether they intended to enter into a debtor-creditor relationship. The IRS argued that the parties in this case did not have that intent. The IRS reasoned that NAGP was capitalized with the loan notes primarily to obtain interest expense deductions and thus had tax avoidance motives. This indicates that the advance was really an equity investment. The Court rejected the IRS's argument on this point, observing that tax considerations permeate the decision to capitalize a business with debt or equity. The Court concluded that the taxpayer's objective to obtain interest deductions did not show that the parties lacked the requisite intent to enter into a debtor-creditor relationship.

The IRS also argued that the parties' post-transaction conduct demonstrated no intent to form a genuine debtor-creditor relationship. The IRS focused on the delayed interest payments, the short-term loan from Scottish Power to NAGP to fund interest payments on the loan notes, and the subsequent capitalization of a portion of the fixed-rate notes and all of the floating-rate notes.

The Court concluded that the parties intended to form a debtor-creditor relationship. The Court noted that while a failure to insist on interest payments may indicate intent to create an equity relationship, strict insistence on payment when due is not expected and consistent with business realities in the related party context. In this case, the Court found that NAGP took seriously its obligation to pay interest by making regular timely payments.

The Court also cited several cases that held that an advance from a parent corporation to its subsidiary may be characterized as debt even though the parent makes subsequent re-advances to cover interest on the initial advance. However, where substantially all the interest payments on advances were made through circular cash flows and did not change the parties' financial positions, courts have found that the original advances resembled equity. The Court found this case to resemble the first fact pattern because the short-term loans were used to make the interest payments on the loan notes only because of a delay in dividend payments from PacifiCorp. NAGP entered into a credit facility with a third party to repay the short-term loans, and the net result for the taxable year was payment of all accrued

interest on the loan notes and no increase in NAGP's related party indebtedness. Additionally, the payment of interest did not result in circular cash flows and actually affected NAGP's financial position.

The Court discounted the IRS's argument that the capitalization of a portion of the fixed-rate loan notes and all of the floating-rate notes indicated that the parties never intended to create a genuine debtor-creditor relationship. While the Court noted that principal repayment is strong evidence of a debtor-creditor relationship, the capitalization of such notes into equity does not necessarily preclude a finding of debt. The fundamental question is whether the capitalization represents a change in the parties' intentions or the mere recognition of a longstanding intent that the purported debt be an equity investment. In this case, the court concluded that the decisions to capitalize the loan notes as equity did not show that the parties always intended the notes to be an equity investment.

Observation: The IRS has challenged intercompany debt arrangements by using hindsight evidence to assert that the behavior of the parties subsequent to the arrangement's inception reveals that the parties never truly intended to create a debtor-creditor relationship. In general, existing case law suggests that it is not appropriate to recharacterize debt as equity by using hindsight evidence that is based on circumstances that the parties reasonably did not anticipate at the onset. Here, the Court reviewed the parties' actions after the loan notes were entered into, and concluded that such actions did not indicate an intent to enter into an equity relationship at the onset. This included subsequent actions that were taken in response to circumstances that the parties reasonably could not anticipate at the onset (*e.g.*, the subsequent proposed domestic reverse hybrid regulations).

Inadequate capitalization

In general, if a corporation is thinly capitalized, advances made to the corporation are more likely to be characterized as equity. Courts generally focus their analysis of a corporation's capitalization on its debt-to-equity ratio.

The IRS expert witness in this case argued that the loan notes should be characterized as equity because NAGP's credit rating by an independent rating agency would likely have been below investment grade. The Court disagreed with the IRS's analysis. The Court found that, even assuming the accuracy of the IRS expert's rating analysis, the assigned rating did not establish that NAGP was so thinly capitalized that it would be unable to repay the intercompany debt.

Ability to obtain outside financing

Courts have held that evidence that a purported debtor could have obtained loans from outside sources on comparable terms points towards a debt characterization, whereas evidence that a debtor could not have obtained such loans points towards an equity characterization. The IRS's expert concluded that NAGP could not have obtained third-party financing on the same terms as under the fixed-rate notes. However, the Court gave little weight to the IRS expert's conclusions, observing that the proper analysis of this factor does not require a precise matching of terms. Courts recognize that a related party lender may offer more flexible terms than could be obtained from unrelated lenders. The Court relied on the taxpayer's expert's conclusions, based on information including comparable contemporaneous debt issuances, that the interest rate for the fixed-rate notes in the market would have been slightly higher, and that the transaction could have been sold in the debt capital markets to third-party investors. The Court accordingly concluded that this factor

avored debt characterization with respect to the fixed-rate notes. Significantly, the Court observed that “the record is void of any facts to persuade us that NAGP could have obtained financing from an unrelated party comparable to the terms of the \$896 million floating rate notes.” The Court nevertheless found that this lack of evidence was only a “neutral” factor in the characterization of the floating rate notes.

Conclusions

The Court’s analysis in this case follows the principled approach of applying debt-equity factors developed by case law to the particular facts and circumstance of the case. Although a memorandum decision, this decision serves as a useful roadmap of how courts and the Tax Court in particular currently analyze debt vs. equity determinations. In light of recent attempts by the IRS to extend the limits of existing case law, the opinion in this case is a welcome affirmation of well established principles. Nevertheless, the decision underscores the inherently factual nature of the inquiry that courts must undertake in characterizing financial instruments. The Court’s analysis demonstrates the importance of a taxpayer’s ability to establish the factual basis required for a debt characterization. As a result, taxpayers should consider preparing contemporaneous documentation to establish the parties’ intent and the borrower’s creditworthiness in order to satisfy this burden of proof.

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