

# *US Outbound Tax Newsalert*

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*Tax Court releases PepsiCo opinion,  
upholding taxpayers' equity  
characterization of hybrid  
instruments*

## *In brief*

In recent years, the IRS has increased its scrutiny of cross-border intercompany financing arrangements, challenging the economic realities of such arrangements. These challenges continue to make their way through IRS exam, appeals, and to the judicial level.

Following on a recent taxpayer favorable Tax Court memorandum opinion in the debt/equity area (*NA General Partnership & Subsidiaries v. Commissioner (Scottish Power)*, T.C. Memo. 2012-172, (see [June 25, 2012, US Inbound Newsalert: Tax Court opinion upholds taxpayer's debt characterization of US intercompany debt](#))), the Tax Court again ruled in this area when, on September 20, 2012, the court issued a memorandum opinion in *PepsiCo Puerto Rico, Inc. v. Commissioner and PepsiCo, Inc. & Affiliates v. Commissioner (PepsiCo)*, T.C. Memo. 2012-269. *PepsiCo* involved a US multinational company that treated certain intercompany advances (advance agreements) from the US to a foreign affiliate as equity investments for US federal income tax purposes, thereby characterizing the payments received by the advancing party as equity distributions. The IRS challenged the treatment of the advance agreements. The Tax Court, ruling in favor of the taxpayers, upheld the taxpayers' treatment of the advance agreements as equity and not as debt for US federal income tax purposes.



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Although this decision is a memorandum opinion that does not serve as binding precedent, the decision provides important insight into the Tax Court's current approach to handling ongoing IRS challenges to cross-border intercompany financing arrangements. The court emphasized that it has previously articulated a list of 13 factors important in determining whether a transaction is characterized as debt or equity for US federal income tax purposes and that the factors identified by the IRS in Notice 94-47, 1994-1 C.B. 357, are 'subsumed within the more discerning inquiry espoused' by the Tax Court in previous debt versus equity analyses.

### **What does the court's decision mean for multinational companies with intercompany financing arrangements?**

There are several important points that multinational companies with intercompany financing arrangements can take away from the court's analysis in the *PepsiCo* decision and its recent decision in *Scottish Power*. *PepsiCo* confirms, like *Scottish Power*, that a taxpayer's decision as to how to capitalize its affiliates with debt or equity is best left with the taxpayer (so long as the capitalization decision is consistent with the substance) and not the courts, as such inquiries generally are not subject to successful attack on grounds of tax motivation, or lack of business purpose or economic substance. However, the court may determine different outcomes depending on whether the court views the arrangement in connection with legitimate tax planning of an underlying business transaction as compared with the facilitation of what it might view as more structured transactions (*Cf. Hewlett-Packard Co. v. Commissioner*, T.C. Memo. 2012-135 (see [May 17, 2012, US Outbound Tax Newsalert: Tax Court releases Hewlett-Packard opinion, addresses debt vs. equity issues](#))).

In addition, the court's analysis in *PepsiCo* supports the principle that structuring a cross-border intercompany financing arrangement that results in different tax treatment for US and foreign tax purposes is not, by itself, determinative of how the instrument is properly characterized for US federal income tax purposes. Moreover, the *PepsiCo* decision recognizes that although related party arrangements are subject to special scrutiny, related parties are generally presumed to act at arm's length when assessing debt-equity factors in the intercompany debt context, and their intent to create equity or debt will not necessarily be determined based on precise matching of unrelated party terms or actions.

Further, *PepsiCo* provides helpful insight with respect to a taxpayer's ability to assert the relevance of substance and form for US tax purposes. In *PepsiCo*, the Tax Court rejected the IRS's attempt to disregard the form in the related-party context, as well as the broader substance of the transaction, on the basis of the intended treatment for Dutch tax purposes and the facts underlying that treatment. Such a determination by the court stands for the notion that the purpose of an arrangement for foreign tax purposes will not, itself alone, dictate the appropriate treatment for US tax purposes, although the facts that are essential for foreign tax treatment will likely be accepted as facts for US tax purposes, but not to the exclusion of other facts.

Finally, it is important to note that while *PepsiCo* provides helpful guidance for any US multinational that desires to structure an intercompany arrangement as debt for foreign tax purposes but as equity for US tax purposes, it does not necessarily follow that the analysis of debt-equity factors in *PepsiCo* would be adopted by a court in the context of a foreign multinational that desires to structure an intercompany arrangement with its US subsidiary as debt for US tax purposes. Foreign multinationals desiring debt treatment are well advised to seek guidance primarily from cases in which intercompany debt owed by a subsidiary to its parent and another subsidiary was upheld as debt for US tax purposes, such as *Scottish Power*.

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## *In more detail*

### **What did the opinion address?**

The principal issue in these consolidated cases was whether advance agreements issued by PepsiCo, Inc.'s (PepsiCo's) Netherlands subsidiaries to certain PepsiCo domestic subsidiaries and PepsiCo Puerto Rico, Inc. (PPR) constituted debt or equity. Below is a summary of the court's findings of fact.

In the mid-1990s, PepsiCo began to consider large-scale investments in emerging, unestablished markets. In addition, PepsiCo sought to organize its international holdings to allow for a more effective use of overseas earnings and to avoid using cash from the United States to fund its overseas operations. As a result, PepsiCo undertook a global restructuring of its international operations. Pursuant to its global restructuring, and influenced by changes to the US-Dutch treaty, PepsiCo transferred ownership of some of its foreign partnerships from various Netherlands Antilles holding companies to Netherlands holding companies.

In 1996, the interests in the foreign partnerships were ultimately contributed to newly formed subsidiaries, PepsiCo Worldwide Investments (PWI) and PepsiCo Global Investments (PGI). Both PWI and PGI were besloten vennootschaps (private limited liability companies) organized under Dutch law. By having PWI and PGI each hold an interest in each foreign partnership, the foreign partnerships continued their status as partnerships for US federal income tax purposes. PepsiCo would eventually cause PWI to merge into PGI and thereafter file check-the-box elections to treat the foreign partnerships as disregarded entities for US federal income tax purposes.

In September 1996, a US related party contributed certain pre-existing notes to PGI and PWI in exchange for advance agreements having similar face amounts. Subsequently, in May 1997, PGI issued an advance agreement to PPR, a Delaware corporation that elected the benefits of sections 936 and 30A, in exchange for pre-existing notes held by PPR. Similarly, these pre-existing notes had an aggregate principal face amount equal to the face amount of the advance agreement.

The advance agreements issued by PGI and PWI to the US related parties were carefully drafted by PepsiCo and thoroughly reviewed by the Dutch Revenue Service. It was PepsiCo's intent for the advance agreements to be classified as debt in the Netherlands and as equity in the United States. PepsiCo contemplated that the tax treatment of these instruments would reduce PGI's Dutch corporate taxable income from accrued interest from the pre-existing US related party notes by the amounts accrued under the advance agreements. From a US tax perspective, the taxpayers anticipated that payments to the US entities pursuant to the advance agreements would be treated as distributions on equity and that the taxpayers were unlikely to be subject to subpart F income or dividend treatment on the distributions, as PGI's earnings and profits were predicted to be reduced or eliminated by the foreign partnerships' losses in the foreseeable future.

In order to obtain the intended treatment of the advance agreements for Dutch tax purposes, the taxpayers, their Dutch tax counsel, and the Dutch Revenue Service participated in a lengthy and detailed negotiation process to create instruments capable of securing a Dutch tax ruling. The negotiations included significant discourse between the parties; in particular, intercompany communications as well as representations and other dialogue with the Dutch Revenue Service. One issue of particular importance throughout the negotiations was the Dutch Revenue Service's position that amounts paid on the advance agreements should at least be equal to the

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interest received by PGI on the US related party notes. The taxpayers stressed their reluctance to include such language in the advance agreements, as such a specific obligatory link between PGI's receipt of interest payments relating to the US related party notes and PGI's payments pursuant to the advance agreements would undoubtedly be susceptible to the IRS recharacterizing the arrangement as debt for US federal income tax purposes. The taxpayers eventually assured the Dutch Revenue Service that each payment of interest on the US related party notes to PGI would be used to fund payments relating to the advance agreements, and as a result, the Dutch Revenue Service approved the tax ruling.

The final advance agreements incorporated many of the initial provisions, but also included several provisions that were tailored to address the concerns of the Dutch Revenue Service. The advance agreements provided for payments of principal amounts after initial terms of 40 years, with PGI (and PWI) having unrestricted options to renew the advance agreements for a period of 10 years and, if these options were exercised, the ability to exercise a separate option delaying payment of principal for an additional 5 years. If, however, a related party defaulted on loan receivables held by PGI (or PWI), the advance agreements would become perpetual.

The advance agreements provided that a preferred return would accrue on any unpaid principal amounts. The preferred return accrued semiannually and consisted of two components, a base preferred return and a premium preferred return. The preferred return unconditionally accrued pursuant to the advance agreements, but the instruments required that PGI (and PWI) make payments of accrued preferred return only under certain specified circumstances, which included making such payments only to the extent that 'net cash flow' exceeded 'accrued but unpaid operating expenses incurred' and 'capital expenditures made or approved' by PGI during the applicable year. The provision further provided that in no event would the amount of net cash flow be less than the aggregate amount of all interest payments and payments of capitalized interest received from related parties during such year. In the event any accrued preferred return was not paid when due, such amounts were to be capitalized. The payment of capitalized base preferred return was required annually and the payment of capitalized premium preferred return was required only when the principal amount of its corresponding advance agreement was paid in full. Both were subject to "net cash flow" restrictions similar to the payment of accrued preferred return.

Furthermore, the advance agreements provided that PGI (and PWI) could pay in full or in part at any time unpaid principal, accrued but unpaid preferred return, any unpaid capitalized base preferred return amount, and any unpaid capitalized premium preferred return amount. The obligation to pay any of these amounts was subordinated to all the indebtedness of PGI (and PWI). In addition, the rights of all PGI (and PWI) creditors to receive payments from PGI (and PWI) were 'superior and prior to' the rights of the holders of the advance agreements. The advance agreements did provide the holders the right to declare unpaid principal and preferred return immediately due and payable upon dissolution, insolvency, or receivership of PGI, but such rights were subject to the 'net cash flow' restrictions and remained subordinated to all indebtedness of PGI and the rights of all creditors.

During the years at issue (1998 through 2002), PGI, preferring to borrow cash from PepsiCo affiliates rather than from third-party lending institutions because of the higher costs of external borrowing, had outstanding indebtedness to related parties that ranged from approximately \$437 million to more than \$937 million. During that same period, PGI made loans and equity investments in affiliates of approximately \$1.415 billion.

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From 1997 through 2009, nearly all of the amounts received by PGI under the US related party notes were paid out to the holders of the advance agreements, with each preferred return payment being made on the same day that interest due on the US related party notes was paid to PGI. On their US federal income tax returns, the taxpayers treated the payments of preferred return as distributions on equity and claimed as a deduction the interest due to PGI on the US related party notes. The payments of interest to PGI on the US related party notes were, pursuant to the Dutch tax treaty, exempt from US withholding tax. PepsiCo included the interest on the US related party notes as subpart F income on its consolidated US federal income tax returns, but only to the extent of PGI's earnings and profits. PPR did not report any subpart F income during the years at issue.

### **What was the IRS's position?**

The IRS asserted that the substance of the transactions, as revealed primarily through the taxpayers' dialogue with the Dutch Revenue Service during negotiations to secure a Dutch tax ruling, evidenced the taxpayers' clear intentions in structuring the advance agreements and underscored that the instruments manifest a creditor-debtor arrangement for US federal income tax purposes.

### **What was the taxpayers' position?**

The taxpayers disputed the assertion that the advance agreements should be characterized as debt, contending that the form of the advance agreements, together with the risks assumed by the holders of the advance agreements, justified their characterization as equity instruments for US federal income tax purposes.

### **What did the court decide?**

In ruling in favor of the taxpayers with respect to the appropriate characterization of the advance agreements, the Tax Court applied a traditional debt versus equity analysis, examining 13 factors developed by the court to aid in resolving debt versus equity issues. The Tax Court focused on factors developed by its own case law because the Court of Appeals for the Second Circuit, the court to which appeal in these cases would lie, has not explicitly adopted a specific factor test; rather, the Second Circuit has implied that a thorough inquiry would include factors designated by Notice 94-47, supplemented with additional, pertinent factors generally considered by other courts. The Tax Court, citing *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476, 493 (1980) and stating that the factors identified by Notice 94-47 'are subsumed within the more discerning inquiry espoused in *Dixie Dairies Corp.*', explained that it considers the following factors as germane to debt versus equity inquiries:

- names or labels given to the instruments
- presence or absence of a fixed maturity date
- source of payments
- right to enforce payments
- participation in management as a result of the advances
- status of the advances in relation to regular corporate creditors
- intent of the parties
- identity of interest between creditor and stockholder
- "thinness" of capital structure in relation to debt;
- ability of the corporation to obtain credit from outside sources
- use to which advances were put
- failure of debtor to repay

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- risk involved in making advances.

The court further stated that the various factors are merely aids in determining “whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship.”

The advance agreements contained certain equity-like terms, including the subordination of payments to all other debt; restrictions on use of net cash flows received from related party to make payments; lack of sufficient default remedies; and long, possibly perpetual, terms. The court’s analysis of the factors relating to these terms is highlighted below.

#### *Status of the advances in relation to regular corporate creditors*

One factor courts frequently consider in making debt versus equity determinations is whether an advance is subordinated to obligations of other creditors. The advance agreements, by their own terms, unequivocally subordinated any obligation of PGI under the agreements to all indebtedness of PGI and the rights of all its creditors.

The IRS argued that this feature was not dispositive of equity characterization and that irrespective of the subordination provision the practical likelihood of it affecting payments was nonexistent. The court acknowledged that the IRS was correct in asserting that this feature is not dispositive, but explained that the same is true for all other factors. In finding that this factor weighed in favor of equity treatment, the court focused on terms described above as well as the impact of PGI’s outstanding indebtedness to affiliates (i.e., \$980 million) and its exposure to liabilities of its foreign investments, all of which ranked superior to any rights engendered in the advance agreements.

#### *Source of payments*

Courts often consider the source of payments in analyzing whether an instrument is debt or equity. In particular, if a taxpayer is willing to condition the repayment of an advance on the financial well-being of the receiving company, then the taxpayer is acting more as a classic capital investor, and not as a creditor. The Tax Court noted that in considering this factor, it must discern whether certain discrete terms of the advance agreements reflect the transaction’s substance.

Despite the restrictions on the use of net cash flows with respect to payments under the advance agreements, which alone may be indicative of equity treatment, the court found that this factor favored debt characterization. In reaching this conclusion, the court weighed heavily on the taxpayers’ intercompany memos and representations to the Dutch Revenue Service that uniformly expressed an intent that PGI’s receipt of interest on the US related party notes would in turn be used to fund payments of base preferred return on the advance agreements. Furthermore, the court found that PGI’s payment of nearly all amounts received under the US related party notes to the holders of the advance agreements during the years at issue exemplified PGI’s commitment to make payments on the advance agreements from a reasonably certain stream of revenue.

The court was not persuaded that the express language in the advance agreements made such payments too speculative and subject to PGI’s unfettered discretion at least during the five-year period of the Dutch tax ruling. Furthermore, the court noted that payments on the advance agreements generally were made on the same date that interest due on the US related party notes was paid to PGI, and in



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substantially similar amounts. The court also found that PGI could, and did, deviate from the intended payment schedule and that, under Dutch law, it could treat the advance agreements as debt for Dutch law purposes, even if it could no longer rely on the Dutch tax ruling. Overall, the court concluded there was a connection between the payments of interest on the US related party notes to PGI and the payments by PGI on the advance agreements. This, however, was only one factor in the overall facts and circumstances analysis considered by the court.

### *Right to enforce payments*

Courts have held that the ability of a party to enforce repayment is indicative of debt. While there was no mechanism that provided the holders of the advance agreements with the right to demand immediate repayment of outstanding principal and interest in the event PGI defaulted, the IRS contended that there was no real possibility that PGI would default because PepsiCo controlled all the entities involved and would be economically disadvantaged if PGI were to default. The court rejected this contention, reiterating that there was no basis in fact or in law for the argument that the taxpayers could ensure the timely payment of intercompany obligations based solely on the subsidiaries' inter-relatedness.

The IRS further argued that PGI intended to, and was, internally committed to make payments on the advance agreements. The court rejected this assertion and found that full repayment of principal and interest on the advance agreements was not unconditional, as the long and perhaps perpetual terms of the advance agreements rendered payment of principal speculative and the payments of base preferred return were subject to the business realities and uncertainties of the taxpayers' global expansion throughout the long term of the investment.

The IRS alternatively argued that the advance agreements provided other legitimate creditor safeguards, such as the provision which allowed holders to declare unpaid principal and preferred return 'immediately due and payable' upon dissolution, insolvency, or receivership of PGI. The court, rejecting this assertion, stated that pursuant to the provisions of the advance agreements the subordination of any such payments to all indebtedness of PGI and the rights of all creditors would be meaningful and significant in light of PGI's \$980 million in outstanding indebtedness to affiliates in addition to other exposures during the years at issue. The court concluded that the absence of any legitimate creditor safeguards afforded to the holders of the advance agreements was a significant factor weighing in favor of an equity characterization.

### *Presence or absence of a fixed maturity date*

Another factor courts consider important in determining whether an instrument constitutes debt or equity is the presence of a fixed maturity date. The absence of a fixed maturity date is strongly indicative of equity, as this would indicate that repayment was in some way tied to the fortunes of the business. The Tax Court highlighted that the advance agreements had terms of 40 years which could be unilaterally extended by the holders an additional 15 years, but that to the extent a related party were to default on any loan receivables held by PGI, such terms were to be voided, rendering the instruments perpetual.

The IRS argued that the maturity dates of the advance agreements were fixed and that the perpetual clause was meaningless, as there was an unrealistic possibility that the terms of the advance agreements would become perpetual presuming that the taxpayers, through their own control of all involved entities, would never cause a related party to default on any loan receivables held by PGI. The court rejected these

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arguments as well as the IRS's assertion that the court should consider PepsiCo's entire business operations in determining the reasonableness and likelihood of repayment.

Instead, the court determined that under the circumstances the uncertainty of repayment of the principal amounts of the advance agreements at maturity was too great to conclude that PGI had an unqualified obligation to pay a sum certain at a reasonable fixed maturity date. The court based its conclusion on the taxpayers' uncontested reluctance to use domestic moneys to further its global expansion and their desire to create a more self-sustaining international business component. The court found that this accentuated the uncertainty of repayment because there was no assurance that the international investments would succeed and that the extended maturity date of the advance agreements effectively subjected the principal amounts of the instruments to an uncertain international economic climate for an inordinate period. The court further emphasized that, given that PGI made a significant amount of loans to its affiliates during the years in issue and that repayment of those loans was subject to the success of the taxpayers' speculative new investments in unestablished foreign markets, PGI could not be certain that its foreign affiliates would be able to fulfill all their payment obligations.

### *Other factors*

The Tax Court also analyzed the parties' intent, the thinness of PGI's capital structure in relation to debt, and PGI's ability to obtain credit from outside sources.

With respect to the parties' intent, the court found that the negotiations with the Dutch Revenue Service underscored the taxpayers' expectation that the advance agreements would be characterized as equity for US federal income tax purposes and as debt under Dutch tax law. The terms of the advance agreements also indicated that there was no intent to create traditional debt. The advance agreements had long, and possibly perpetual, terms; the repayment of principal was effectively subject to PGI's speculative investments in undeveloped foreign markets; and the realistic possibility that a US related party might default on a receivable held by PGI, which would cause the advance agreements to become perpetual instruments, further dissipated any reasonable expectation of repayment of principal. In addition, the court found that the taxpayers' actions during the years at issue were in accordance with legitimate tax planning and further supported the taxpayers' intent to create a hybrid instrument. Accordingly, the court concluded that the taxpayers' intentions comport with the substance of the transaction, as they did not intend to create a definite obligation, repayable in any event.

In analyzing PGI's capital structure, the court examined PGI's debt-to-equity ratio and relied on the taxpayers' uncontested expert report and expert testimony, which provided that PGI's debt-to-equity ratio was untenable according to industry standards if the advance agreements were treated as debt. In analyzing PGI's ability to obtain credit from outside sources, the court again relied on the taxpayers' uncontested expert, who asserted that no reasonable commercial lender would have issued a loan to PGI in similar amounts and under any reasonably similar terms to those of the advance agreements.

### *Actions to consider*

Given the inherently factual nature of this inquiry, taxpayers with cross-border financing arrangements should consider preparing contemporaneous analysis and documentation to clearly establish the parties' intent and the substance with respect



to the desired characterization of the arrangement for US federal income tax purposes.

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