Transfer Pricing Thoughts: North America

By Patricia G. Lewis and Matthew W. Frank

Thoughts on Code Sec. 482 and Rising Standards of Proof

The standard of proof for taxpayers to defeat adjustments commonly made by the IRS under Code Sec. 482 is going up, according to the Internal Revenue Service's ("IRS") National Office. That is the message delivered by a recent IRS Field Service Advice ("FSA") memorandum[1] and the focus of this issue's column.

Code Sec. 482 and Cross-Border Advances

The FSA deals with the commonly encountered situation where a taxpayer advances funds to a related person in another country and documents those advances as interest-free loans rather than equity contributions. This characterization usually allows the taxpayer to avoid foreign taxes on capital investment and restrictions on repatriation of capital. This practice has been known to the IRS for years,[2] and we see it frequently in our work. Documenting advances as interest-free loans carries the obvious risk, however, that the IRS will invoke Code Sec. 482 to allocate interest to the domestic "lender" with respect to the interest-free advance. Historically, taxpayers have been able to defeat Code Sec. 482 adjustments in these cases by showing that the advance, though documented as an interest-free loan, was in substance equity rather than debt under the traditional multi-factor debt/equity analysis.

The FSA seeks to bolster the IRS' litigation position in these cases by imposing a "heightened standard of proof" on taxpayers seeking equity characterization for an advance documented as an interest-free loan.[3] The FSA asserts that if an advance is documented as a loan, the IRS may make a Code Sec. 482 adjustment notwithstanding that the advance is more like equity than debt and the taxpayer can defeat the allocation only by presenting "strong proof" (*i.e.*, proof greater than a simple preponderance) that the advance was equity in fact.[4]

While the FSA is definitely bad news for taxpayers, some comfort can be taken from the fact that its reasoning is weak and its conclusion is wrong. Treasury regulations, case law and prior IRS guidance all point the other way, so there is hope that the impact of the FSA will be slight and short-lived. In this column, we examine the FSA, explain why it is wrong and question whether making FSAs public was such a good idea after all.

Substance, Not Form, Is Controlling

The FSA's reasoning, and its conclusion, can be summarized as follows:

1) Treasury regulations under Code Sec. 482 permit the IRS to apply any "rule of law" in making an adjustment under Code Sec. 482;
2) it is a "rule of law" that taxpayers are normally bound by the form of their transactions and must meet a "heightened standard of proof" when arguing for tax treatment based on substance different from their chosen form;
3) therefore, any taxpayer who attacks a Code Sec. 482 adjustment by arguing that an "interest-free loan" is in fact equity must meet the heightened standard of proof.

This column will address the three principal deficiencies we see in the FSA's reasoning.

Patricia G. Lewis and Matthew W. Frank are members of Caplin & Drysdale, Chtd., in Washington, D.C.

©1999 **CCH** INCORPORATED

Treasury Regulations

The FSA seems willfully blind to the Treasury Regulations under Code Sec. 482. Contrary to the FSA's apparent view that the IRS is unconstrained by substance and can bind the taxpayer to the form of its advance (leaving the taxpayer to argue substance if it chooses to mount a defense), Treasury Regulations under Code Sec. 482 impose on the IRS an obligation to examine and adhere to substance, prohibiting it from elevating form over substance to allocate interest between related parties.

Treasury Reg. §1.482-2(a)(1)(ii)(B) provides that the IRS' authority to impute interest with respect to related-party loans or advances "*does not apply* to so much of an alleged indebtedness which is not in fact a bona fide indebtedness. . . ." By the very terms of this regulation, the IRS cannot allocate interest income between related parties on an *alleged* indebtedness that does not represent a bona fide indebtedness *in fact*.

Ironically, the FSA's reasoning is also defeated by the very regulation on which it relies. Treasury Reg. §1.482-2(a)(3)(i) coordinates Code Sec. 482 and other Code Secs. and states that if the interest rate on a bona fide indebtedness is subject to adjustment under Code Sec. 482 and also under other sections of the Internal Revenue Code, the order in which the different provisions shall be applied is as follows:

> First, the substance of the transaction shall be determined; for this purpose, all the relevant facts and circumstances shall be considered and any law or rule of law (assignment of income, step transaction, *etc.*) may apply * * *.

As noted, the FSA seizes on the indented language as permitting the IRS to apply any "rule of law" in making a Code Sec. 482 adjustment, then argues it is a "rule of law" that a taxpayer may not "disavow the form of its chosen transaction" without meeting a heightened standard of proof.

Rather than supporting the FSA argument, however, the regulation contradicts it. The regulation applies only to a bona fide indebtedness subject to adjustment under Code Sec. 482, which presupposes it is debt in substance and not just in form. Moreover, the regulation starts off by saying "First, the substance of the transaction shall be determined," and that it is "for this purpose" that any rule of law may apply. It is a perversion of the regulatory language for the IRS to assert that "for th[e] purpose" of determining the substance of a transaction, the IRS may apply a rule of law that elevates form over substance and raises the standard of proof on taxpayers trying to show the true substance of an advance.

It is a perversion of the regulatory language for the IRS to assert that "for th[e] purpose" of determining the substance of a transaction, it may apply a rule of law that elevates form over substance and raises the standard of proof on taxpayers trying to show the true substance of an advance.

Case Law and Prior Rulings

The FSA also fails adequately to explain how its approach can be reconciled with prior case law and IRS rulings. Courts have rebuffed past attempts by the IRS to rely on the form of the transaction to argue for debt classification. In one case, the IRS argued for such classification based "on the fact that the payments were denominated as loans in the various corporate documents and filings,"[5] and in another, it relied "almost exclusive[ly] . . . upon the formal *indicia* of indebtedness" in support of debt classification.[6] In each case, the court found that the advances were equity, applying the longstanding principle that "the decisive factor is not what the payments are called but what, in fact, they are . . . ."[7]

The IRS National Office, in a ruling which the FSA ignores, has likewise stated that the IRS cannot impute interest income under Code Sec. 482 simply by holding taxpayers to the form of their advances. In a 1970 private letter ruling, the National Office stated unequivocally that the IRS could not impute interest income under Code Sec. 482 to shareholders based on advances they made to a corporation where the advances, in substance, were more equity than debt notwithstanding that the parties intended to create debt and the advances were evidenced by written instruments titled "notes payable to shareholders."[8] The National Office acknowledged that the intent of the parties "might be the single most important ingredient in determining whether" a debt exists, but it continued, "It is the view of this office that a bare

intent, not adequately supported by facts, will not serve to convert a contribution to capital into a debt, or debt into capital." Twelve years later, in 1982, the National Office again ruled that interest income could not be allocated between a U.S. parent and its foreign subsidiary based on interest-free advances, because the advances, although cast in the form of loans and recorded in the subsidiary's books as loans, were in substance contributions to capital.[9]

The FSA distinguishes many of these cases on insubstantial grounds, typified by the argument that these cases do not count because the IRS did not raise the argument that the taxpayer should be subjected to a heightened standard of proof. While resourceful, this argument is not persuasive. Unless one believes the IRS litigation attorneys in those cases were simply being generous to taxpayers and handicapping themselves to make the litigation more of a sport, the failure of the IRS to argue in those cases for a heightened standard of proof is a pretty clear indication the IRS did not believe a heightened standard of proof applied. For good reason.

Policy Arguments

The FSA is just as weak when it tries to explain *why* a heightened standard of proof should apply to taxpayers arguing for U.S. tax treatment based on the substance of the advance. Some of its arguments are nothing more than non-sequiturs. For instance, the FSA says: "in the context of distinguishing debt from equity for federal income tax purposes, the application of a heightened standard of proof is particularly apt because…the intent of the parties…is a major factor under substantive law" and the form selected by the taxpayer is probative of such intent. Plainly, this confuses the weight assigned to a factor with the standard of proof. In the criminal context, fingerprints can be powerful evidence of guilt that obviously affect the quantum of proof, but no thinking person argues that it does, or should, affect the standard of proof. Similarly here, the fact that the intent of the parties is relevant to the debt/equity inquiry does *not* make it "particularly apt" to apply a heightened standard of proof.

Conclusion

In sum, the FSA is troubling because, without provocation, it threatens to increase costs for U.S. persons funding operations abroad by, in effect, forcing them to treat as debt for U.S. purposes advances that are equity in substance but documented as debt to avoid foreign capital registration requirements. As we noted at the beginning of this column, U.S. citizens have been making equity investments abroad and documenting them as interest-free loans for foreign law purposes for decades, with the IRS' knowledge and without objection. Why the IRS should take offense now is beyond us. The only comfort we take from the situation is that the FSA is unpersuasive and, therefore, (we hope) unlikely to be accepted by the courts.

The FSA is also troubling because its stubbornly one-sided analysis fails to reflect the candor and even-handedness required by the Internal Revenue Manual.[10] It suggests that the IRS may have been right when it warned that making FSAs public would tend to inhibit frank discussion of the strengths and weaknesses of competing arguments and turn FSAs, which are intended for internal guidance, into self-conscious pieces of advocacy for IRS positions.[11] It is too early to know whether this is happening. We hope it does not, but early signs are not encouraging.

ENDNOTES

1 FSA 199921002 (Jan. 29, 1999) (released May 28, 1999).

2 *See, e.g.*, Jenks, *Treasury Regulations Under Section 482*, 23 TAX LAW. 279, 294-95 (1970); LTR 8302015 (Sept. 30, 1982).

3 The FSA's "heightened standard of proof" is separate from (and in addition to) the heavy burden taxpayers have traditionally labored under in Code Sec. 482 cases. *See Eli Lilly & Co.,* 67-1 USTC ¶9248, 178 CtCls 666, 372 F2d 990, 997.

4 In the specific fact situation addressed in the FSA, the taxpayer not only documented the advances as loans but originally reported them as loans on its U.S. tax return. Although the FSA suggests at times that this was relevant to its analysis, little in the FSA suggests that its conclusion would have been different absent this fact.

5 *J.M. Segel*, 89 TC 816, 829 , Dec. 44,286.

6 *Inductotherm Industries, Inc.*, 48 TCM 167, Dec. 41,244(M), TC Memo 1984-281. Aff'd CA-3 (unplublished opinion), 770 F2d 1071 (1985).

7 *In re Lane*, CA-11, 84-2 USTC ¶9817, 742 F2d, 1311, 1315. Although neither of these cases arose under Code Sec. 482, cases under Code Sec. 482 also establish that the manner in which a taxpayer documents or books a transaction does not control its classification as debt or equity. In *J.A. Tobin Construction Co.*, 85 TC 1005, Dec. 42,548, for instance, the taxpayer transferred funds to its parent and reflected the transfers on its books as loans but did not charge interest. The court struck down the IRS' proposed Code Sec. 482 interest allocation, holding that Code Sec. 482 did not apply because, notwithstanding the book entries, the transfers were dividends, not loans.

8 LTR 7008201300A (Aug. 20, 1970).

9 LTR 8302015 (Sept. 30, 1982).

10 IRM XXXV(19)44(6)(f) (last amended 4-8-92).

11 *See Tax Analysts*, CA-D.C., 97-2 USTC ¶50,529, 117 F3d 607, 617-18.

©1999 **CCH** INCORPORATED