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International Tax ADVISORY ■

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Tax Court Flexes Its Debt-Equity Muscle on "Unrelated" Parties

The Tax Court, in *American Metallurgical Coal Co.*, TC Memo 2016-139, recently held that financing of a sale of partnership interests by a foreign seller to a U.S. buyer was not debt, but equity. The court found that the parties failed to act consistent with an arm's-length creditor-debtor relationship, despite the obvious U.S. tax advantages of debt treatment to both sides—the portfolio interest exemption for the foreign seller and interest deductions for the U.S. buyer. As the Treasury and IRS work to finalize the expansive anti-earnings stripping regulations proposed in April under Code Section 385 (see our prior coverage here and here), this case should be a warning to taxpayers that the government is already willing and able to challenge financing arrangements they think run afoul of arm's-length debt standards.

The taxpayer was a U.S. consolidated group with significant net operating loss (NOL), and one of the subsidiaries was the buyer in the relevant sale of the partnership interests. While the seller, a Liberian corporation, was not related to the taxpayer, the court noted that the taxpayer had provided management services to the seller and acted as the seller's agent in the U.S. and that the parties had some common directors. The Liberian corporation had invested in a U.S. partnership, and after several years the investment made the corporation liable for U.S. branch profits tax. A common director approached the taxpayer to discuss how the partnership investment could be restructured to avoid "branch profits taxation problems." The taxpayer sought advice from a U.S. accountant, who worked with the parties to come up with an agreement.

The eventual agreement, dated December 1992, provided that the seller would transfer its partnership interests to the buyer in exchange for a note with principal ($5 million) due at maturity and fixed interest at 12% over a 10-year term. The agreement also provided for additional "interest" allowing the seller to participate in "excess cash flow" (i.e., earnings from the partnership investment that exceeded an amount defined in the contract). Further, pursuant to the agreement, the buyer was proscribed from liquidating, merging or consolidating, selling all or substantially all of its assets or engaging in any business other than ownership of the partnership interests.

The accountant advised in a memorandum that the transaction would qualify for installment sale treatment—allowing the seller to defer gain, which would be taxable under the Foreign Investment in Real Property Act until receipt of the note's principal—and that the buyer could use the NOLs to offset income from the partnership investment. In addition, the accountant concluded that the portfolio interest exemption could apply to interest paid to the seller under Code Section 881(c), so long as the seller furnished a Form W-8 before payment and the buyer properly filed U.S. withholding tax returns. The accountant also recommended that the parties get an independent appraisal of the partnership investment

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to support the $5 million selling price. The parties did not execute Form W-8, file withholding tax returns or obtain the independent appraisal.

In 2002, the parties extended the term of the note. The buyer failed to pay interest in 2003 and 2004, and the seller subsequently allowed those years' interest to accrue rather than finding the note in default. In 2006, the term of the note was extended again, and the parties agreed to reduced the fixed interest rate to 6% and prohibit prepayment of the principal. Despite the revised terms, the buyer continued to pay fixed interest at 12% rather than 6%.

Citing factors from the controlling precedent, *Estate of Mixon*, (5th Cir. 1972), the Tax Court concluded that the parties lacked "a genuine intention to create a debt, with a reasonable expectation of repayment … comport[ing] with the economic reality of … a debtor-creditor relationship." A significant factor was the buyer's lack, at the time of the transaction, of any assets to repay the putative debt (other than income from the purchased partnership interests). According to the court, the fact that repayment was completely contingent on the success of the partnership investment favored equity classification; the court also noted that the contingent "excess cash flow" interest part of the agreement suggested that the seller's position in the partnership investment had not significantly changed. The court further observed that there was no evidence that the agreement's terms were even negotiated and read the contract's conditions limiting the buyer's activities as giving the seller effective management of the buyer. In sum, the Tax Court found that the parties' actions—foregoing an appraisal, requiring no down payment, extending the note's term repeatedly, failing to pay interest timely or, later, at the agreed-upon reduced rate—spoke louder than the taxpayer's self-serving claim of intent to create debt.

The court also found that the taxpayer had not acted with reasonable cause and good faith in deducting interest payments to the seller, in spite of the taxpayer's argument that it had relied on competent professional advice. On this issue, the court observed that the accountant's advice was "informal"—not the form of advice subjected to the accountant's firm's strict standards and on which clients could rely. Moreover, the taxpayer had failed to follow the accountant's recommendations to get an appraisal of the partnership interests and to execute and file the relevant forms to support the portfolio interest exemption. As a result, the taxpayer was liable for substantial underpayment penalties for the interest deductions taken on the purported debt.

Treasury Cracks Down on FATCA Agreements "In Effect"

The IRS recently announced that, as of January 1, 2017, jurisdictions that have not brought their Foreign Account Tax Compliance Act (FATCA) intergovernmental agreements (IGA) into force will no longer "automatically" be treated as having an IGA in effect (as permitted under prior guidance). Rather, such countries have to furnish to the U.S. Treasury by December 31, 2016, a step-by-step plan (with anticipated dates) to sign an IGA (if not yet signed) and to bring the IGA into force. Treasury will then evaluate, based on the plan and a jurisdiction's prior conduct in IGA talks, whether the country shows "firm resolve" to bring the IGA into force. If so, the jurisdiction will continue to be treated as having an IGA in effect, though not indefinitely. A country's failure to adhere to the planned timeline could lead to a determination by Treasury that the jurisdiction should cease to be treated as having an IGA in effect.

Currently, foreign financial institutions (FFIs) in jurisdictions treated as having IGAs in effect are allowed to register on the FATCA registration system and to certify their IGA-based FATCA status to avoid FATCA withholding. If a jurisdiction ceases to be treated as having an IGA in effect, FFIs in that country would have to enter into and comply with FFI agreements unless they qualify for an exemption under the U.S. regulations. Otherwise, FATCA withholding will apply. To give such FFIs notice, a jurisdiction will not cease to be treated as having an IGA in effect until at least 60 days after the country's status is updated on the Treasury's IGA List.

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