Structuring Foreign Investments in U.S. Corporations Using Portfolio Debt Guaranteed by the Issuer’s Foreign Affiliate

by Toby Cozart†

INTRODUCTION

Under sections 871(h) and 881(c) of the Internal Revenue Code [hereinafter I.R.C. or Code], a nonresident alien individual or foreign entity [hereinafter Foreign Person] can qualify for a complete exemption from U.S. federal income taxation on “portfolio interest” income from a U.S. debtor, provided such income is not effectively connected with the conduct by such Foreign Person of a trade or business in the United States.¹ Two types of instruments may qualify for the portfolio interest exemption — nonregistered instruments (such as bearer instruments) and registered instruments. Without the exemption, portfolio interest is subject to a U.S. federal withholding tax equal to thirty percent of the gross amount paid (except as reduced under a bilateral income tax treaty between the United States and the creditor’s country of residence).²

† Partner, Lillick McHose & Charles, San Francisco, California; J.D. Duke Law School, 1978; L.L.M. New York University School of Law, 1981. The author thanks Benjamin Berk and Helen Conroy for their assistance in preparing this article, and Renato Beghe for his elucidation of debt-equity principles.


This article addresses various federal income tax issues pertaining both to registered and bearer debt instruments sold by or on behalf of a U.S. corporate debtor [hereinafter U.S. Issuer] on foreign securities markets that qualify for the portfolio interest exemption [hereinafter Portfolio Debt] and are made attractive to foreign investors [hereinafter Foreign Holders or Holders] by virtue of a guarantee by a foreign affiliate [hereinafter Affiliated Foreign Guarantor] of the U.S. Issuer of the payment of such instruments upon their maturity.

Portfolio Debt investments can be used to avoid the Foreign Investment in Real Property Tax Act of 1980 [hereinafter FIRPTA] as well as the thirty percent withholding tax on interest. Generally, under FIRPTA, gain or loss realized by a Foreign Person from the disposition of a U.S. real property interest is taxed at domestic rates as U.S. source income effectively connected with a U.S. trade or business.\(^3\) Under the relevant regulations, amounts that are treated as principal and interest payments on a debt obligation are not taxable under FIRPTA.\(^4\) Therefore, an investment in a U.S. real property interest will receive more favorable income tax treatment if it is structured as debt, rather than as equity.

A right to receive contingent payments with respect to a Portfolio Debt investment from a U.S. Issuer based on its profits or appreciation of its assets (i.e., contingent interest) may be especially attractive. If the investment is treated as debt for U.S. federal income tax purposes, contingent interest payable on the investment will qualify as portfolio interest. The Foreign Holder therefore would share in appreciation of U.S. property while minimizing exposure to U.S. taxes, including those under FIRPTA.\(^5\) Indeed, contingent interest may be attractive enough to persuade investors not to seek an indemnity against taxation of their interest payments by the United States.\(^6\)

Part I below places the portfolio interest exemption within the context of other methods to obtain exemption from the thirty percent withholding tax—

---

3. I.R.C. § 897(a) (1986). A U.S. real property interest [hereinafter USRPI] is defined as a direct interest in U.S. real property or an interest in a U.S. real property holding corporation, i.e., a U.S. corporation fifty percent or more of the assets of which are USRPIs. Id. § 897(c)(1).


5. Although contingent interest payable on an investment that qualifies for the portfolio interest exemption [hereinafter Portfolio Debt] is exempt from U.S. federal income taxation under the Foreign Investment and Real Property Tax Act of 1980 [hereinafter FIRPTA], gain from sale of the investment is not. Gain on the sale of an obligation is taxable under FIRPTA if the obligation constitutes an interest other than solely as a creditor. Id. Whether an obligation is considered debt for U.S. tax purposes is not relevant to whether such interest is that solely of a creditor. Id. § 1.897-1(d)(1). A right to share in appreciation in real property or in the assets of an entity is treated as an interest in real property other than solely as a creditor. Id. § 1.897-1(d)(2), (3).

6. Such indemnities typically increase (i.e., "gross-up") the amount of interest paid to a foreign investor [hereinafter Foreign Holder or Holder] in order to produce the same amount after deduction of the withholding tax as the Holder would realize in the absence of such tax.
namely, reduced withholding under a bilateral income tax treaty, and the exemption for short-term obligations. Part II reviews the requirements for the portfolio interest exemption, with particular emphasis on the rule that excludes from the exemption loans made by foreign banks in the ordinary course of their banking business. Part III discusses the circumstances in which the Internal Revenue Service [hereinafter IRS] may seek to recharacterize Portfolio Debt as equity, with the result that interest payments would be subject to the withholding tax as dividends and could not be deducted by a U.S. Issuer. Part IV explores whether guarantee fees paid to an Affiliated Foreign Guarantor by either the U.S. Issuer or a Foreign Holder would be subject to the thirty percent withholding tax. In addition, Part IV discusses the authority of the IRS under sections 162(a) and 482 to disallow deductions by a U.S. Issuer of the guarantee fees even when such fees are equivalent to amounts charged for guarantees in arm’s length transactions between unrelated parties.

I. RELATIVE ADVANTAGES OF PORTFOLIO DEBT

A. International Finance Subsidiaries

Under prior law, in order to avoid the thirty percent withholding tax on interest, a U.S. debtor would form an affiliated finance corporation [hereinafter International Finance Subsidiary or IFS] in a favorable treaty jurisdiction such as the Netherlands Antilles. The IFS would issue bonds to Foreign Persons (e.g., on the Eurobond market) and, in turn, would lend the bond proceeds to the U.S. debtor.7 Interest income derived by an IFS formed in the Netherlands Antilles would be exempt from the thirty percent withholding tax under article VIII of the United States-Netherlands Income Tax Convention (as extended to the Netherlands Antilles) [hereinafter Netherlands Antilles Treaty].8 Furthermore, interest paid by the IFS to its foreign bondholders would not be subject to the thirty percent withholding tax; such payments would be treated as foreign source income that is not effectively connected with a U.S. trade or business.9 The interest earned by the IFS would be subject to such taxation in the Netherlands Antilles, but only after deducting from such income interest owed to the foreign bondholders.10

10. Gelinas, supra note 7, at 240. Typically, an International Finance Subsidiary [hereinafter IFS] realizes net income of one percentage point. The Netherlands Antilles taxes the income at a rate of about thirty percent. Id. at 241.
After the enactment of the portfolio interest exemption in 1984, the IRS attacked the use of an IFS to avoid the thirty percent withholding tax in cases where the foreign bondholders do not reside in the IFS's host country. In two companion revenue rulings, the IRS held that the interest paid to a Netherlands Antilles IFS by a U.S. corporation was subject to the thirty percent withholding tax as U.S. source income.\textsuperscript{11} It reasoned that the IFS's debt was in substance that of the U.S. debtor because the IFS acted merely as a conduit for lending the borrowed funds to the U.S. debtor.\textsuperscript{12} Thus, the interest paid by the U.S. debtor to the IFS was not "derived" by the IFS for purposes of invoking the treaty exemption. As provided in subsequent legislation, these rulings only affect bonds issued by an IFS on or after June 22, 1984.\textsuperscript{13}

The viability of IFSs formed in the Netherlands Antilles was cast in further doubt on June 29, 1987, when the United States unilaterally terminated all but one article of the Netherlands Antilles Treaty, effective January 1, 1988.\textsuperscript{14} Under article VIII, the only provision of the Treaty to survive the termination notice (as clarified in a subsequent announcement by the U.S. government on July 10, 1987\textsuperscript{15}), interest paid by a U.S. debtor to an IFS

\textsuperscript{11} Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383. These rulings hold that interest paid by a U.S. subsidiary of a Swiss or U.S. parent corporation, respectively, to a Netherlands Antilles subsidiary was not exempt under article VIII of the United States-Netherlands Income Tax Convention. \textit{See also} Gen. Couns. Mem. 37,940 (Apr. 24, 1979).


\textsuperscript{13} Deficit Reduction Act of 1984, Pub. L. No. 98-369 § 127(g)(3), 98 Stat. 494, 652-53 (1984). \textit{See also} Rev. Rul. 85-163, 1985-2 C.B. 349 (providing that Revenue Ruling 84-152 and Revenue Ruling 84-153 will not be applied retroactively prior to October 15, 1984. This grandfather rule applied to interest payments to a controlled foreign corporation [hereinafter CFC] provided: (1) the CFC was in existence on or before June 22, 1984; (2) the principal purpose of the CFC on the date of an interest payment was issuing its obligations, holding short-term obligations, and lending proceeds of such obligations to commonly-controlled affiliates; (3) the obligations on which the interest is paid are obligations of a U.S. affiliate that were issued before June 22, 1984; and (4) on the date on which interest is paid, the CFC satisfies the requirements (particularly, the debt-equity requirements) of four revenue rulings: Rev. Rul. 69-377, 1969-2 C.B. 231; Rev. Rul. 69-501, 1969-2 C.B. 233; Rev. Rul. 70-645, 1970-2 C.B. 273; and Rev. Rul. 73-110, 1973-1 C.B. 454. \textit{See infra} note 57 for the definition of a CFC.

\textsuperscript{14} \textit{See} 124 \textit{DAILY TAX REP. (BNA)} at G-5 (June 30, 1987). The Netherlands and Netherlands Antilles unilaterally accepted the partial termination on September 14, 1987. 178 \textit{DAILY TAX REP. (BNA)} at G-2 (Sept. 16, 1987).

formed in the Netherlands Antilles remains exempt from the thirty percent withholding tax. However, companies that continue to rely on this exemption face a risk that the exemption will be terminated, possibly even retroactively, if legislation that has been proposed by the Treasury Department is enacted. The legislation would provide a statutory withholding exemption for interest paid by a U.S. corporation to certain Netherlands Antilles affiliates with respect to Eurobonds issued prior to October 15, 1984. The Treasury Department has indicated that it may seek termination of article VIII if the proposed legislation is enacted.

Portfolio Debt investments avoid each of the risks applicable to loans made through an IFS because such investments are exempt from the thirty percent withholding tax without regard for whether a reduction of such tax is available under an income tax treaty.

B. Commercial Paper

Short-term obligations that mature in 183 days or less [hereinafter Commercial Paper] also are exempt from the thirty percent withholding tax. Unlike Portfolio Debt, Commercial Paper need not be targeted at Foreign Persons in order to qualify for exemption from the thirty percent withholding tax, but must be targeted at Foreign Persons in order to avoid information reporting and backup withholding taxes when the foreign holder does not wish to be identified to the IRS.

16. Rev. Rul. 87-79, 1987-35 I.R.B. 7. An exemption is available, however, only if the IFS is able to avoid treatment as a conduit pursuant to Revenue Rulings 84-152 and 84-153. See supra note 11.


20. In order to avoid information reporting and backup withholding taxes on Commercial Paper interest (including original issue discount), (1) the instruments must satisfy the foreign targeting requirements applicable to bearer debt, (2) interest and principal must be paid outside the United States (and may not be paid to a U.S. address whether by mail or electronically), (3) the face amount of the instrument must not be less than $500,000, (4) the instrument must contain a special legend described in the regulations, and (5) if in registered form, the instrument must be registered in the name of an exempt recipient described in Treasury Regulation section 1.6049-4(c)(1)(ii) (corporations, governments, securities dealers, custodians and nominees, certain financial institutions, certain brokers). Temp. Treas. Reg. § 35a.9999-4 Q&A-5, Q&A-6 (as amended 1986). As in the case of bearer and foreign-targeted registered Portfolio Debt instruments, the use of a paying agent that is a dual status custodian can trigger an obligation to report but not to withhold. Id.; Temp. Treas. Reg. § 35a.9999-4T Q&A-5 (ii) (as amended 1986). See infra notes 76-94 and accompanying text. In addition, payments of principal upon the retirement
In contrast to Portfolio Debt, Commercial Paper is subject to restrictions on its use as long-term financing. Recent private letter rulings and a General Counsel Memorandum address arrangements that have been made with underwriting banks to ensure continuous reissuance of short-term notes over a period of years. These arrangements attempt to give substance to the stated maturities of the notes, in order to qualify the notes as exempt Commercial Paper, notwithstanding the obligations of the underwriters and/or their affiliates to extend some form of additional credit to the issuer upon the maturity of each series of notes.

Although the IRS has respected arrangements that use the Commercial Paper exemption to provide longer-term financing, in certain cases it has refused to rule or has ruled adversely. The IRS Chief Counsel took the position in General Counsel Memorandum 39,301 that short-term notes purchased by underwriters were not exempt from the thirty percent withholding tax where the underwriters were committed to purchase unsold notes of the issuer in a future series, since there was a possibility that the proceeds of a future series would be applied to repay the notes purchased by the underwriters. However, in Private Letter Ruling 86-47-003, the IRS determined that only those notes that continue to be held by the underwriter would be tainted by the underwriter's obligation to purchase unsold notes in future series. Of course, the underwriter may not wish to take on a resale risk and, thus, might require interest on the notes it is unable to sell to be "grossed up" to reflect any U.S. withholding tax.

In order to avoid the objections raised by the IRS in these rulings, underwriters have used related corporations to prevent the underwriter's commitment to purchase future series of notes from effectively extending the stated maturity of an outstanding series. In Private Letter Ruling 86-34-060, the IRS respected the stated maturities of short-term notes, where the members of a "tender panel" of underwriters (who were entitled to purchase the notes from the issuer) were contractually prohibited from holding the notes for their own account. However, affiliates of the underwriters were permitted to purchase the notes for their own account provided that they were not lenders under the ancillary credit facilities. Tender panel members had no obligation of Commercial Paper are not subject to information reporting or backup withholding. I.R.C. § 3406(b)(3)(C) (1986); Temp. Treas. Reg. § 5f.6045-1(c)(3)(vi)(C) (1984). Proposed regulations would alter these rules by imposing information reporting and backup withholding upon Commercial Paper interest paid by a dual status custodian to a customer unless the custodian had the requisite documentary evidence that the customer is a Foreign Person. Prop. Treas. Reg. § 1.6049-5(c)(5), 1.6049-5(f), 53 Fed. Reg. 6003, 6004 (1988).

24. Id. See also Priv. Ltr. Rul. 87-39-042 (June 30, 1987).
to purchase the notes, but were obligated to extend credit to the issuer to cover the amounts of any notes in future series that could not be sold.

Unfortunately, it is unclear whether the Commercial Paper exemption can be preserved by having an affiliate of the committed underwriter purchase the issuer's notes. When an issuer of Commercial Paper has obtained a separate line of credit from a lender that is neither related to nor under common control with the purchasers of the Commercial Paper, the credit line arguably should not affect the exempt status of the notes. An interpretation of the statute having that result would overly restrict the scope of the Commercial Paper exemption. When the committed lender and the holders of the Commercial Paper are under common control, however, there is a potential for abuse. The validity of Private Letter Ruling 86-34-060 is therefore uncertain. An obligation to make a loan to the issuer upon the maturity of Commercial Paper held by an affiliate arguably is equivalent, in substance, to a required purchase and rollover of the notes as they fall due. Accordingly, if the underwriter commits to advance funds upon the maturity of a Commercial Paper series, it may be unwise for the issuer to issue Commercial Paper to an affiliate of that underwriter without first obtaining a favorable ruling from the IRS.

In contrast to Portfolio Debt, there is no statutory restriction against the purchase of Commercial Paper by a person who is related to the issuer. In such cases, however, the IRS is likely to disregard the stated maturity of a Commercial Paper note if there is a plan or practice of repaying the note with the proceeds of a contemporaneous issuance of a new note between the parties. A variation on this rollover theme involves issuing the subsequent note to an affiliate of the purchaser of the initial instrument. As discussed above, that arrangement may be questionable even when the purchaser is not related to the issuer.


27. The Internal Revenue Service [hereinafter IRS] recently announced, however, that it would not issue private rulings on the question of whether a Commercial Paper instrument will be respected as exempt from the thirty percent withholding tax when "such debt instrument is issued by a domestic corporation and is purchased by its controlled foreign corporation." Rev. Proc. 87-6, § 3.01(1), 1987-1 I.R.B. 45.

28. In several private letter rulings, the IRS has treated Commercial Paper instruments issued by a U.S. parent corporation to a foreign subsidiary as exempt from the thirty percent withholding tax. Priv. Ltr. Rul. 85-38-034 (June 21, 1985), withdrawn by Priv. Ltr. Rul. 86-12-023 (Dec. 18, 1985); Priv. Ltr. Rul. 85-34-070 (May 29, 1985), withdrawn by Priv. Ltr. Rul. 86-12-019 (Dec. 18, 1985). In each case, the rulings were premised on representations that, upon maturity of a Commercial Paper instrument, the subsidiary would reinvest the proceeds in a new instrument of the parent only upon an exercise of its "independent judgement." The IRS subsequently withdrew these rulings because it believed that the issue was "too dependent on subsequent facts" to be the subject of a ruling.
II. THE PORTFOLIO INTEREST EXEMPTION

A. Overview

Congress enacted the exemption for portfolio interest from the thirty percent withholding tax in the Deficit Reduction Act of 1984. The exemption applies only to interest on obligations issued after July 18, 1984, received in taxable years ending after that date. In order to qualify for the exemption, an instrument must meet certain requirements that are summarized below. If these requirements are not met, the paying agent must withhold taxes from interest paid to the holder of the instrument at a rate of thirty percent (except as reduced under a treaty).

The primary impetus for the portfolio interest exemption was a perceived need to attract foreign capital to the United States. By eliminating the withholding tax on the debt obligations of U.S. persons, U.S. businesses would become more efficient. Faced with competition from foreign lenders, U.S. interest rates also would decrease and come more into equilibrium with foreign interest rates, particularly Eurobond rates. Thus, securities markets, including secondary markets, would become more integrated and efficient.

A secondary impetus was a perceived need to eliminate the use of tax treaties, such as the Netherlands Antilles Treaty, as a means of eliminating the withholding tax on interest paid to foreign investors. Favorable treatment for International Finance Subsidiaries was thought to conflict with the basic U.S. tax policy discouraging the use of treaties by third country residents to obtain benefits not otherwise available. Moreover, IFSs were considered inefficient for several reasons. First, IFSs were too costly and complicated to be used by small businesses. Second, foreign tax credits available under...

---

30. Id. § 127(g)(1).
34. Id. at 33-34 (statement of Ronald Pearlman of the Treasury Department).
35. 1984 Senate Print, supra note 31, at 420. After the issuance of Revenue Rulings 84-152 and 84-153, see supra note 11, and the ensuing market outrage over the Treasury Department's attack on IFSs, Ronald Pearlman, Assistant Secretary for Tax Policy, stated that the repeal of the thirty percent withholding tax on portfolio interest had removed policy impediments to IRS attacks on IFSs. Letter from Ronald Pearlman to Congressmen, reprinted in 28 Tax Notes 1105 (Sept. 2, 1985).
36. 1984 Senate Print, supra note 31, at 420; 1984 Hearings, supra note 33, at 42-43 (statements of Rep. Sam Gibbons); 1983-84 Misc. Tax Bills VI: S. 1066, S. 1550, S. 1557 and S. 1666: Joint Hearings before the Subcomm. on Savings, Pension & Investment Policy and Subcomm. on...
then existing law for taxes paid to an IFS's host country effectively trans-
ferred tax revenues from the U.S. treasury to the host country.37

1. Bearer Instruments

Historically, the Eurobond market has largely been composed of bearer
securities,38 due to investors' desires for anonymity. Under I.R.C. sections
871(h)(2) and 881(c)(2), interest payments on bearer instruments are eligible
for the portfolio interest exemption only if the following requirements are
met:39 (1) the instrument is sold under arrangements [hereinafter foreign
targeting requirement] reasonably designed to ensure its initial sale (and re-
sales in connection with its original issuance) either to Foreign Persons or to
certain financial institutions;40 (2) interest on the instrument is payable only

---

37. 1984 Joint Comm. Print, supra note 7, at 17 (describing provisions of H.R. 4170 and
H.R. 2163 recharacterizing interest income of IFSs as U.S. source income, thereby reducing or
eliminating the foreign tax credit for host country taxes).

38. Baxter, International Financial Markets and Loans: An Introduction to the Legal Con-
text, 10 CAN. BUS. L.J. 198, 203 (1985). In some cases, foreign investors seek anonymity because
of fear of governmental confiscation. 1984 Hearings, supra note 33, at 253.

revised temporary regulations were issued, T.D. 8111, 51 Fed. Reg. 45,464 (1986), the IRS also
took the position that debt eligible for the portfolio interest exemption had to: (a) have a matur-
ity of more than one year, (b) be issued by a corporation or other entity (other than a natural
person), and (c) be of a type ordinarily offered to the public. T.D. 7967, 1984-2 C.B. 329, 331

40. The foreign targeting requirement may be satisfied in one of three ways. First, this
requirement is met if securities law counsel provides a written opinion that the obligation is
exempt from registration under the Securities Act of 1933 [hereinafter 1933 Act], because it is
intended for distribution only to persons who are not U.S. persons, and the obligation is offered
for sale or resale only outside the United States and is delivered only outside the United States.

Second, the foreign targeting requirement is met if the obligation is registered under the
1933 Act, the obligation is exempt from registration under section 3 or 4 of the 1933 Act, or the
obligation does not constitute a security under the 1933 Act, provided each of the following
additional requirements is met: (1) the obligation is offered for sale or resale and only delivered
on original issuance, outside the United States; (2) the issuer and its underwriters offer (and
coventant that they will offer) the obligation only to Foreign Persons and certain financial institu-
tions [hereinafter Qualified Financial Institutions]; (3) the issuer (or an underwriter) sends a
confirmation to each purchaser stating that the purchaser represents that it is either a Foreign
Person or a Qualified Financial Institution, and, if the purchaser is a dealer, that it will send
similar confirmations to whomever purchases from it; (4) before the obligation is released in
definitive form, the issuer (or an underwriter) receives a signed certificate from the person enti-
tled to physical delivery stating that the obligation is being acquired by a Foreign Person or
Qualified Financial Institution; and (5) the issuer and its underwriters do not have actual knowl-
dge that the certificate received is false. Id. § 1.163-5(c)(2)(i)(B).

Third, the foreign targeting requirement also is met if the obligation is issued only outside
the United States by an issuer that does not significantly engage in interstate commerce with
respect to the issuance of such obligation, either directly or through its agent or underwriter. In
the case of an issuer which is a U.S. person, the issuer must be engaged, through a branch, in the
active conduct of a banking business outside the United States and the obligation must be issued
outside the United States and its possessions, and (3) the instrument is legended to inform U.S. holders of certain tax penalties imposed upon its acquisition by them.

If any one of these three requirements applicable to bearer instruments is not observed, the issuer of the obligation will be precluded from claiming interest deductions (as well as reductions to its earnings and profits). The issuer also will incur an excise tax equal to one percent of the principal amount of each instrument failing to meet the requirements, multiplied by the number of years between the instrument's issuance and maturity. Finally, unless the issuer is required to pay the one percent excise tax (and except as provided under regulations), a U.S. person holding a bearer instrument must treat gain on the sale or disposition of the instrument as ordinary income and is denied a deduction for any loss sustained with respect to the instrument.

2. Registered Instruments

Registered instruments qualify for the portfolio interest exemption if the U.S. payor receives a statement that the beneficial owner of the instrument is a Foreign Person. The statement must identify the name and address of the beneficial owner and must be made either by the beneficial owner or by a specified financial custodian, including a securities clearing organization, by the branch in connection with that trade or business. Other requirements also apply. Id. § 1.163-5(c)(2)(i)(C).

A Qualified Financial Institution is a financial institution which holds the obligation in connection with a trade or business outside the United States, or as a broker dealer (registered under U.S. federal or state law) for sale to customers in the ordinary course of its trade or business, or which complies with reporting requirements specified under the regulations with respect to ownership, transfers, and payments. I.R.C. § 165 (j)(3)(A)-(C).

1. The requirement that interest on an obligation be payable outside the United States is considered satisfied if payment of interest can be made only upon presentation of a coupon or upon making of any other demand for payment outside the United States to the issuer or its paying agent. Generally, interest will not be considered to be payable outside the United States if paid into an account maintained by the payee in the United States or mailed to an address in the United States. Treas. Reg. § 1.163-5(c)(2)(v) (1987). An exception is made for interest paid to:

1. a Qualified Financial Institution (see supra note 40 for definition); or (2) any financial institution as a step in the clearance of funds, provided such interest is promptly credited to an account maintained outside the United States for such institution or for persons for whom such institution has collected such interest. Id. § 1.163-5(c)(2)(v)(B)(2) (1987).

2. Unless the obligation qualifies under the interstate commerce exception referred to supra in note 40, or is a temporary global security, the following statement must appear on the face of the obligation and on any detachable interest coupons: "Any United States person who holds this obligation will be subject to limitations under the United States income tax laws, including the limitations provided in section 165(j) and 1287(a) of the Internal Revenue Code." Treas. Reg. § 1.163-5(c)(1)(ii)(B) (1987). The statement need not appear on a temporary global security, which is defined as a security held for the benefit of the purchasers of the obligations of the issuer and interests that are exchangeable for a security in definitive form prior to the security's stated maturity. Id.


4. Id. § 4701(2).

5. Id. §§ 165(j), 1287.

6. Id. §§ 871(b)(2)(B), 881(c)(2)(B).
An instrument is in registered form if the rights to principal and interest may be transferred by issuance of a new instrument, by reissuance of the old instrument by the issuer, or through a book-entry system maintained by the issuer.

The regulations create a special category of foreign-targeted registered instruments that are subject to less onerous certification requirements. These requirements were promulgated to facilitate access to the Eurobond market by government-owned or sponsored agencies after the Treasury Department, in response to concerns over potential tax evasion, promulgated regulations prohibiting such agencies from issuing bearer instruments. An instrument falls within this special category if it is a registered instrument, and, except when sold at a public auction, is targeted at foreign markets in the same manner as a bearer instrument. When the withholding agent makes interest payments to the beneficial owner of the instruments, the certification requirements are similar to those for registered instruments. If the registered owner is a financial custodian and the interest is paid to the custodian at an address outside the United States, however, then the withholding agent need only obtain an annual certification from the custodian that the beneficial owner—who need not be identified—is a Foreign Person.

If the withholding agent does not receive the required statement, it generally must withhold tax on the interest payment under I.R.C. sections 1441(a) and 1442(a), even if the payment otherwise qualifies for the portfolio interest exemption. Temp. Treas. Reg. § 35a.9999-5 Q&A-10 (1984) (two exceptions specified).
B. Exceptions to the Portfolio Interest Exemption

1. Prohibited Relationships

Code sections 871(h)(3)(B) and 881(c)(3)(B) provide that the portfolio interest exemption does not apply to interest paid to a person who directly or indirectly owns ten percent or more of the stock of the issuer. Presumably, Congress imposed this restriction in order to prevent related corporations from converting taxable dividends into tax-exempt portfolio interest by characterizing, as debt, investments that could easily be made as equity.

Absent a default by a U.S. Issuer, an Affiliated Foreign Guarantor will not be treated as owning a Portfolio Debt instrument by virtue of its guarantee. In cases where an Affiliated Foreign Guarantor is treated as primarily liable through its guarantee for payment of a Portfolio Debt instrument, the ten percent shareholder exception would not apply because, as between the U.S. Issuer and the Affiliated Foreign Guarantor, the investment would be treated as equity rather than as debt.

In many cases, a U.S. Issuer will be able to prevent its affiliates from inadvertently acquiring its Portfolio Debt instruments. Nonetheless, it is possible for the ten percent shareholder rule to be violated inadvertently when overlapping indirect ownership of the Foreign Holders and the Affiliated Foreign Guarantor is acquired. Proposed regulations would remedy this problem in the case of publicly traded corporations. Under the IRS proposal, a shareholder owning five percent or less of the total value of a publicly traded corporation's stock would not be treated as owning any stock owned by the corporation in other companies.

Under section 881(c)(3)(C), the portfolio interest exemption also does not apply to interest received by a controlled foreign corporation [hereinafter CFC] from a related person. This exception for CFCs will not apply to a

53. For purposes of this exception, ownership of stock by a partnership, trust, estate, or corporation is attributed to the partners, beneficiaries, or shareholders in proportion to their interests in any such entity. Conversely, ownership of stock by a partner, estate, trust beneficiary (other than the holder of a "remote contingent interest"), or shareholder is attributed to the relevant partnership, estate, trust, or corporation. (In the case of a shareholder who owns less than fifty percent of a corporation, only a portion of the stock owned by him in another corporation is attributed to the first corporation, determined by the shareholder's proportionate interest by value in the first corporation.) I.R.C. §§ 318, 871(h)(3) (1986). In addition, a person is considered to own any stock that he has an option to acquire. Id. § 318(a)(4). This rule precludes the portfolio interest exemption from applying to convertible debentures that the holder has a present right to convert into ten percent or more of the issuer's stock. See Rev. Rul. 68-601, 1968-2 C.B. 124.


55. See infra notes 122-25 and accompanying text.


57. A CFC is defined as any foreign corporation in which more than fifty percent of (a) the total combined voting power of all classes of voting stock or (b) the total value of the corporation, is owned, on any day during the taxable year of such corporation, directly or constructively by one or more U.S. persons each of whom owns ten percent or more of the combined voting power of the corporation. I.R.C. §§ 951(b), 957(a) (1986).
Foreign Holder if U.S. persons do not own more than fifty percent in voting power or value of the stock of the Foreign Holder, whether directly or by attribution. Portfolio interest received by a CFC that is not subject to these rules regarding prohibited relationships and therefore is exempt from withholding, nonetheless will be taxed currently to the CFC's U.S. shareholders.\footnote{58}{For this purpose, a related person includes: (a) an individual owning directly or indirectly more than ten percent in value of the stock of the CFC; (b) a corporation that is a member of the same controlled group as the CFC (as defined in I.R.C. section 267(f)); (c) a partnership, if the same persons own more than fifty percent in value of the stock of the CFC and more than fifty percent in value of the capital or profits interest in the partnership; (d) an S corporation, if the same persons own more than fifty percent in value of the stock of the S corporation and the CFC; (e) generally, a U.S. citizen, domestic partnership, domestic corporation, estate, or trust (other than a foreign estate or trust) that owns or is considered as owning ten percent or more of the total combined voting power of all classes of the voting stock of the CFC; and (f) any party who is related, under I.R.C. section 267(b), to any of the parties listed in (e). Id. §§ 267(b), 864(d)(4), 881(c)(3).}

Apparently, the practical inability of a paying agent to determine whether interest is subject to the thirty percent withholding tax because it is paid to a ten percent shareholder, or by a related person to a CFC, led the IRS to promulgate amendments to the temporary regulations on December 19, 1986\footnote{59}{See id. §§ 881(c)(4), 951(a)(1), 952(a)(2), 954(c)(1)(A).} that would effectively limit the use of bearer instruments to cases where the instrument is publicly issued,\footnote{60}{T.D. 8111, 51 Fed. Reg. 45,464 (amending Temp. Treas. Reg. § 35a.9999-5 (1986)).} or the issuer and holder are publicly traded corporations. These amendments were suspended on February 13, 1987, but retain their status as proposed regulations.\footnote{61}{An instrument is treated as publicly issued under the regulations if it: (a) is listed on an exchange; (b) is not subject to any U.S. federal securities law restrictions on its offering, sale, or resale, other than as to citizenship, nationality, residence, or jurisdiction of the purchaser's incorporation; and (c) is initially offered for sale through an underwriter on a best efforts basis, sold to an underwriter for resale, or is part of an issue that is sold to more than thirty-five purchasers. Temp. Treas. Reg. § 35a.9999-5 Q&A-25 (1986).} If reinstated, the courts might overturn these amendments in cases where the issuer could prove that the instruments were not being held by ten percent shareholders or related CFCs.

2. **Prohibited Loans**

Under section 881(c)(3)(A), the portfolio interest exemption does not apply to interest received on an "extension of credit" by a foreign bank (directly or through an intermediary)\footnote{62}{I.R.S. Notice 87-24, 1987-9 I.R.B. 9.} pursuant to a loan agreement entered into in the ordinary course of its banking business [hereinafter ordinary bank...\footnote{63}{The Conference Committee for the Deficit Reduction Act of 1984 clarified that in appropriate cases the IRS should attack attempts to "circumvent the foreign shareholder/bank rule ... by entering into 'back to back' loans, wherein a foreign affiliate of a U.S. taxpayer (or a bank) lends money to an unrelated foreign party that renews that money at discount to the U.S. taxpayer." H.R. REP. No. 861, 98th Cong., 2d Sess. 937-38 (1984), reprinted in 1984 U.S. CODE CONG. & ADMIN. NEWS 1625-26, as Pub. L. No. 98-369. See also Rev. Rul. 87-89, 1987-37 I.R.B. 9.}
Credit].

Interest paid by the U.S. government on its obligations to foreign banks is not included in this exception.

The legislative history of the ordinary bank credit exception may indicate that Congress sought to draw a distinction between ordinary bank credit and Eurobond-type investments. In its General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, the Staff of the Joint Committee on Taxation described a loan as ineligible for the portfolio interest exemption if that loan performs the "function" of ordinary bank credit. It then stated: "[I]nterest on an obligation that does not perform that function — for example, a Eurobond held by a foreign bank as an investment asset — may be eligible for the exemption."

As explained by the staff of the Joint Committee on Taxation, 

As explained by the staff of the Joint Committee on Taxation, "[i]n addition to addressing a Federal Reserve concern regarding reserve requirements, the foreign bank exception was intended to prevent U.S. banks, which are subject to U.S. tax on interest income, from suffering a competitive disadvantage vis-à-vis foreign banks that make loans to U.S. persons." Apparently, the Federal Reserve Board was concerned that if the thirty percent withholding tax were not imposed on this type of portfolio interest, foreign banks would make loans to U.S. persons from abroad, rather than through U.S. branches, as a means of avoiding the three percent reserve requirement applicable to U.S. banks with respect to nonpersonal time deposits and Eurodollar investments used to support U.S. lending. Consequently, the Federal Reserve Board reportedly opposed repeal of the thirty percent withholding tax "on interest paid to banks domiciled abroad, pursuant to a loan agreement entered into in the normal course of their banking business."

Although the statutory language may suggest otherwise, a marketable obligation should not be treated as ordinary bank credit in cases where it is difficult to apply the distinction between the two. If the instrument can be traded on a foreign securities market, then its purchase by a foreign bank does not cause the sort of diversion of ordinary loans from domestic to foreign banks or bank offices that Congress sought to prevent. Many ordinary

---

64. This exception applies only to banks that are considered to be corporations under U.S. federal income tax law. Compare I.R.C. § 871(h) (1986) (portfolio interest exemption for "individuals").

Although a "banking business" is not defined in the statute or regulations for this purpose, the same term is used in I.R.C. section 871(i)(1)(3)(A), which exempts interest on deposits with persons carrying on a banking business from the thirty percent withholding tax. I.R.C. § 871(i)(1)(3)(A) (1986). See generally 1 R. Rhoades & M. Langer, supra note 2, § 2.23(2)(C) (1987).


66. Id.


68. Id.
U.S. bank credit transactions can be restructured as a sale of debt securities in a public offering on a foreign market. If the portfolio interest exemption were denied whenever an investment could be characterized as ordinary bank credit, however, publicly-offered instruments would be vulnerable and the statute would be unworkable.

If an instrument's marketability is not determinative of whether it constitutes ordinary bank credit, then other factors become relevant, such as the extent to which the Foreign Holder conducts a thorough credit review of the U.S. Issuer. This interpretation would conflict with the purpose of the portfolio interest exemption of giving U.S. borrowers greater access to foreign lenders. Without a sensible means of distinguishing between market obligations and ordinary bank credit, issuers would have to exclude foreign banks arbitrarily from the class of eligible purchasers in order to avoid indemnifying foreign banks against the potential inapplicability of the exemption. There are two practical solutions to this problem. One is to allow the exemption whenever the instrument is demonstrably marketable and the other is to deny the exemption unless the instrument has been offered to the public in a specific way. The first solution is more consistent with the statute because the second would require imposing specific procedures and would promise exemption from withholding taxes, two provisions which cannot currently be found in the statute or regulations.

Although the distinction between a Eurobond investment and ordinary bank credit is elusive, the crux of the matter is whether the instrument in question is marketable on a foreign securities market. However, only the marketability of the instrument upon its initial offering should be relevant. The competitive concerns raised by the Federal Reserve Board and others apparently are fully satisfied in the case of a particular transaction upon the initial offering and sale of the instrument to Foreign Persons. Thereafter, the instrument logically cannot compete with lending by U.S. banks. Accordingly, if a particular obligation does not constitute ordinary bank credit upon its issuance, it should retain that characterization thereafter (whether or not it continues to be held as an investment asset).

---

69. A similar argument has been made that "it would stretch the [statutory] language considerably to treat a purchase of a debt security pursuant to an underwriting or selling group agreement (and, a fortiori, any purchase as a secondary market investor) as an 'extension of credit' pursuant to a 'loan agreement.'" Taylor, supra note 1, at 44-5.


72. Congress and the courts have developed a distinction, or set of distinctions, between securities that are held as investments and those that are held primarily for sale or use in the ordinary course of the taxpayer's business. See Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955); I.R.C. § 1236 (1986). (The Supreme Court recently narrowed its Corn Products holding in Arkansas Best Corp. v. Commissioner, 56 U.S.L.W. 4229 (March 7, 1988).)
In order to enhance the likelihood that a privately-offered debt investment held by a bank will be treated as Portfolio Debt, it may be desirable to obtain confirmation from a qualified investment banker that the debt instrument is marketable on the relevant foreign securities market. In this regard, an Affiliated Foreign Guarantor’s guarantee agreement with a foreign bank could affect the eligibility of a Portfolio Debt instrument for exemption from the thirty percent withholding tax. If the guarantee is not readily transferable with the instrument, for example, that fact could be evidence that the instrument is not marketable but is more in the nature of ordinary bank credit.

The authors of a recent article indicate that the “similarity between bank credit and bank investment is uncomfortable in the context of unlisted, short-term and quasi-privately offered instruments” and recommend that “prospective investors should not rely on the portfolio interest exemption for [any such instruments] anticipated to be held at maturity by banks.” While the authors’ point is well taken, it is less relevant to the risk of longer-term instruments that are easily traded on the relevant foreign securities market. In that case, qualifying for the exemption for Commercial Paper from the thirty percent withholding tax may not be feasible for the reasons explained in Part I.B above.

There are ways to reduce the risk to a U.S. Issuer of falling within the ordinary bank credit exception. A U.S. Issuer may be able to avoid indemnifying Foreign Holders against this risk by offering additional financial incentives, such as contingent interest. In addition, when the Foreign Holders are expected to be banks, the U.S. Issuer may be able to enhance the likelihood of obtaining an exemption from the withholding tax by structuring the offering so that the instruments may qualify both as Portfolio Debt and as Commercial Paper.

C. Information Reporting and Backup Withholding

Under section 3406(a)(1), a twenty percent backup withholding tax is imposed on payments of interest (including original issue discount) and principal in certain cases, such as when the recipient has not furnished a taxpayer...
identification number to the payor or has furnished an incorrect number.\textsuperscript{75}

In general, backup withholding is imposed on such payments only if they are subject to information reporting pursuant to sections 6041, 6045, or 6049.\textsuperscript{76}

Under sections 6041, 6045, and 6049, payors must report interest payments to the IRS and brokers (including certain obligors\textsuperscript{77}) must report to the IRS proceeds of sales effected on behalf of a customer, including payments to redeem or retire an obligation.\textsuperscript{78} This requirement does not apply to exempt recipients\textsuperscript{79} which include, among others, domestic and foreign corporations, governments, securities dealers, custodians and nominees, specified financial institutions and specified brokers.\textsuperscript{80} As applied to Portfolio Debt, the information reporting and backup withholding rules are complex and only their principal features are summarized below.

To obtain an exemption from information reporting and backup withholding for interest payments on Portfolio Debt instruments, generally the payor must not have actual knowledge that the payee is a U.S. person\textsuperscript{81} and the instrument must qualify for exemption from regular withholding.\textsuperscript{82} Subject to these conditions, interest on registered Portfolio Debt instruments, including foreign-targeted registered instruments, is generally exempt from information reporting and backup withholding.\textsuperscript{83}

In the case of Portfolio Debt instruments that are registered but not foreign-targeted, all foreign brokers are required to report and withhold upon the proceeds of sale or retirement of an instrument.\textsuperscript{84} In the case of foreign-targeted registered instruments, however, brokers that collect funds on behalf of a customer and which have a "dual status" are subject to information reporting and backup withholding upon the sale or retirement of an obligation.\textsuperscript{85} A dual status custodian is defined as: (a) a foreign office of a U.S.

\textsuperscript{75} I.R.C. § 3406(a)(1) (1986).
\textsuperscript{76} Id. § 3406(b).
\textsuperscript{77} Treas. Reg. § 1.6045-1(b) Ex. (1)(ii) (1983) ("an obligor that regularly issues and retires its own notes").
\textsuperscript{78} See id. § 1.6045-1(a)(9), (c)(2) (1983) (the term "sale" means "any disposition of securities . . . and includes . . . retirements of indebtedness . . . "). Issuers and their agents are not required to report payments made to retire "registered form obligations as to which the relevant books and records indicate that no interim transfers have occurred." Temp. Treas. Reg. § 5f.6045-1(c)(3)(s) (1984).
\textsuperscript{82} Id.
person; (b) a controlled foreign corporation (within the meaning of section 957(a)); or (c) a foreign person fifty percent or more of the gross income of which was effectively connected with its conduct of a U.S. trade or business during the most recent three year period. Finally, whether or not a registered instrument is foreign-targeted, a broker is not required to report a sale of the instrument to the IRS if the broker has received a statement from the recipient during the calendar year or either of the preceding two calendar years, signed under penalties of perjury, that the recipient is a Foreign Person who is not subject to U.S. federal income taxation with respect to the transaction. If promulgated, proposed regulations would make significant changes to these rules.

In the case of Portfolio Debt instruments in bearer form, temporary regulations generally exempt interest on such instruments from information reporting and backup withholding provided the payor does not have actual knowledge that the payee is a U.S. person. Payments made to redeem or retire such instruments (but not other sales proceeds) also are exempt from information reporting and backup withholding if they are not made to a U.S. address, either by mail or electronically.

There is an important exception to these rules under which the identity of the paying agent can subject the Foreign Holder to information reporting of interest under section 6049 and of redemption and retirement payments under section 6045. The regulations provide that the payment or collection outside the United States of U.S. source portfolio interest by a dual status custodian is subject to information reporting under section 6049 if such custodian is “otherwise required to report amounts paid to or collected on behalf

---

86. Id.
87. Treas. Reg. § 1.6045-1 (g)(1) (1983). The recipient must state that it is a Foreign Person who: (a) has not made an election under I.R.C. section 6013(g) or (h) to be treated as a U.S. resident by reason of marriage to a U.S. person; (b) is not subject to the provisions of I.R.C. section 877 relating to former U.S. citizens; (c) is not, and does not reasonably expect to become, subject to tax under I.R.C. section 871(a)(2) on capital gains derived from U.S. sources due to a presence in the United States for a period aggregating 183 days or more during the taxable year; and (d) is not, and does not reasonably expect to become, subject to taxation with respect to the transaction under I.R.C. section 1 or 11 by reason of engaging in a trade or business in the United States during the taxable year. Id. See also Temp. Treas. Reg. § 35a.9999-3 Q&A-33 (1983).

A dual status custodian, see supra note 86 and accompanying text, has a special right under temporary regulations to treat a customer as an exempt Foreign Person without the benefit of the sworn statement described above, if it has documentary evidence that the customer is a Foreign Person, including, for example, a written indication of such status on an account application form. Temp. Treas. Reg. § 35a.9999-4T Q&A-1, Q&A-2 (1984).

88. Foreign brokers who are not dual status custodians would be exempted from information reporting and backup withholding with respect to sales effected outside the United States, and no foreign broker would be required to report or withhold upon the proceeds of a redemption or retirement of either a foreign-targeted registered obligation or a bearer obligation. Prop. Treas. Reg. § 1.6045-1(g)(1)(i)(B), 53 Fed. Reg. 5997 (1988).
90. Id. § 35a.9999-5 Q&A-7.
of the payee."  

A similar exception overrides the exemption (described above) from information reporting and backup withholding with respect to the redemption or retirement of a bearer instrument. These exceptions apply if the custodian is required to report payments to its customer with respect to other transactions and investments. Dual status custodians are not required to report the relevant payments, however, if they have the requisite documentary evidence that the payee is a Foreign Person, such as a written indication from the payee on an account application form.

Although payments that dual status custodians are required to report under the regulations are not presently subject to backup withholding, backup withholding may be applied on a prospective basis in future regulations. To avoid indemnifying Foreign Holders against backup withholding by a dual status custodian, if possible the U.S. Issuer should insist that Foreign Holders assume that risk.

III. DEBT VS. EQUITY

This Part identifies the U.S. federal income tax principles which govern the characterization of Portfolio Debt investments as debt rather than as corporate equity. If an investment were not recognized as debt, it ordinarily would be treated as equity in the U.S. Issuer, and payments to the Foreign Holder of principal and interest on the investment (including contingent interest) would be treated as distributions to the Affiliated Foreign Guarantor, or its parent corporation in the chain of control. Such distributions would

91. Id. § 35a.9999-4T Q&A-5(ii), 35a.9999-5 Q&A-2, 35a.9999-5 Q&A-16.
92. Id. § 35a.9999-5 Q&A-7.
93. Id. § 35a.9999-4T Q&A-1, Q&A-2 (redemption or retirement payments), Q&A-5(iii) (interest).
94. Id. § 35a.9999-4T Q&A-5(iv). The IRS has recently proposed regulations which, if adopted, would impose information reporting and backup withholding upon payments of portfolio interest by a dual status custodian unless the custodian has the requisite documentary evidence that the payee is a Foreign Person. Prop. Treas. Reg. § 1.6049-5(f), 53 Fed. Reg. 6005 (1988).
95. According to one commentator, issuers have not entirely succeeded in shifting this withholding tax risk to holders when the instrument provides for a fixed, nonfloating, interest rate. In this case, the issuer is required to call the instrument prematurely in order to avoid paying a "gross-up" indemnity. See generally Taylor, supra note 1, at 44-15.
96. Alternatively, the investment could be treated as equity contributed to a partnership with a U.S. corporate debtor [hereinafter U.S. Issuer], particularly if contingent interest is used to give the Foreign Holder an interest in the U.S. Issuer's profits. In that case, each Foreign Holder would be treated as engaged in the business of the partnership in the United States under section 875 and would be taxed at domestic rates on a share of the partnership's income allocated to it under section 704(b), without regard to whether it receives distributions from the partnership in the current taxable year.

According to one case, Allison v. Commissioner, 35 T.C.M. (CCH) 1069, 1076-77 (1976), the four basic attributes of a partnership are: "a contract, express or implied, that a joint venture be formed; the contribution of money, property and/or services by the partners; an agreement for joint proprietorship and control; and an agreement to share profits." See generally W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners §3.02.
be subject to the thirty percent withholding tax as dividends (except as reduced by a treaty) to the extent of the U.S. Issuer’s earnings and profits.97

The discussion below focuses both on “straight” debt instruments, which provide for fixed interest payments, and “hybrid” debt instruments, which provide for contingent interest payments. Generally, if an instrument does not provide for contingent payments, it will be respected as representing debt rather than equity, provided that the debtor may be expected to repay the instrument as it matures. The IRS has sometimes sought to impose another condition—with mixed acceptance by the courts—that recharacterizes debt as equity whenever the debtor’s debt-equity ratio (i.e., the ratio of the debtor’s debt to the net value of its assets) is too high. The requirements applicable to hybrid debt instruments are less certain, as indicated by cases that have bifurcated loans with contingent interest into separate debt and equity components. Finally, since an Affiliated Foreign Guarantor’s guarantee of an instrument may cause the instrument to be treated as equity, the circumstances in which this result may occur are also discussed.

In 1969, Congress added section 385 to the Code, which authorizes the Treasury Department to issue regulations for determining whether an interest in a corporation should be treated as equity or debt. After issuing proposed regulations on this subject in 1980 [hereinafter Originally Proposed Regulations], the Treasury Department modified and promulgated them in final form [hereinafter Final Regulations]. However, the Treasury Department then postponed their effective date, issued a second set of proposed regulations [hereinafter Subsequently Proposed Regulations], and finally abandoned the regulation project altogether in 1983.98 As a result, the standards applied in decided cases remain the controlling authority in this area, although many practitioners still refer to the section 385 regulations for informal guidance. It may be noted that loans to Foreign Persons were not expressly treated in

---

97. I.R.C. §§ 301(c), 316, 861(a)(2), 881(a)(1), 1441(b), 1442(a) (1986).

the final version of these regulations. It was anticipated, however, that the Treasury Department would expand the regulations to apply to such transactions.

Indebtedness generally has been defined for U.S. federal income tax purposes as an unqualified obligation to pay: (i) a sum certain at a reasonably close fixed maturity date or on demand; and (ii) a fixed percentage rate of interest, payable whether or not the debtor has any earnings. The provision of a floating rate tied to some index or other external standard does not prevent interest from being definitely determinable for this purpose.

Courts have identified a wide variety of other factors as bearing on the characterization of debt. In one case, a federal circuit court of appeals summarized the factors to be used in testing an instrument for equity or debt classification as including the following: (1) the name given to the instrument and the intentions of the parties; (2) the presence or absence of a maturity date; (3) enforceability by the holder of the payment of principal and interest; (4) participation by the holder in management; (5) priority of the holder's interests compared to those of other corporate creditors; (6) presence or lack of sufficient capital to enable the corporation to obtain loans from outside lending institutions; (7) the relationship between the holder and the stockholders; and (8) the use of the investment to provide capital upon the organization of the corporation.102

99. Farley Realty Corp. v. Commissioner, 279 F.2d 701, 704 (2d Cir. 1960); Gilbert v. Commissioner, 248 F.2d 399, 402 (2d Cir. 1957).

100. Foresun, Inc. v. Commissioner, 41 T.C. 706, 714 (1964), aff'd per curiam, 348 F.2d 1006 (6th Cir. 1965); see also Roth Steel Tube Co. v. Commissioner, 800 F.2d 921 (6th Cir. 1986) (eleven factors); In re Lane, 742 F.2d 1311 (11th Cir. 1984) (thirteen factors); Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir. 1968) (sixteen factors); I.R.C. § 385(b) (1986).

101. The intent of the parties is manifested, in part, by the form of the transaction and the labels used. Gooding Amusement Co. v. Commissioner, 236 F.2d 159, 166 (6th Cir. 1956), aff'd, 348 F.2d 1006 (11th Cir. 1964). To gain recognition, the instrument should be designated as debt and treated as such in the issuer's books and records, in its financial statements, in any representations to regulatory agencies and for all other purposes. Any intent on the part of the holder not to enforce the debt in accordance with its terms could cause the debt to be treated as equity.

102. Courts have sometimes treated a loan as equity when the corporation uses the funds as working capital or to purchase other assets that are essential to the operation of its business. See, e.g., Gustin v. Commissioner, 27 T.C.M. (CCH) 186, 192 (1968), aff'd, 412 F.2d 803 (6th Cir. 1969); Snitzer v. Commissioner, 13 T.C. 43, 61-62 (1949). But see, e.g., Santa Ana Consolidated, Inc. v. Commissioner, 50 T.C. 536, 551 (1968); Morgan v. Commissioner, 30 T.C. 881, 892 (1958); Brown v. Commissioner, 27 T.C. 27 (1956), acq. 1957-2 C.B. 4; see also cases cited infra note 171. Many of the cases that treat such loans as equity can be distinguished on the grounds that other indicia of equity are present. E.g., Slappey Drive Industrial Park v. United States, 561 F.2d 572, 583 (5th Cir. 1977) (failure to repay upon maturity); Joseph Lupowitz Sons, Inc. v. Commissioner, 497 F.2d 862, 867 (3d Cir. 1974) (independent lender would not lend funds); Fin Hay Realty Co. v. United States, 398 F.2d 694, 698 (3d Cir. 1968) (same); Covey Investment Co. v. United States, 377 F.2d 403, 404 (10th Cir. 1967) (failure to repay upon maturity); Dobkin v. Commissioner, 15 T.C. 31 (1950), aff'd per curiam, 192 F.2d 392 (2d Cir. 1951) (inadequate capitalization).

One commentator has suggested that the essentiality of the corporation's assets merely "narrows the sources from which repayment may reasonably be expected, and places the burden on the taxpayer to show that the debt can be paid at maturity out of expendable assets, soundly anticipated cash flow, or other sources not unduly dependent upon the uncertain success of the..."
The cases indicate that no one of these factors is conclusive; all are considered together, with no particular factor outweighing any other.\textsuperscript{103} Whether an investment constitutes equity or debt for tax purposes is also considered primarily a question of fact. As a result, the IRS ordinarily will not issue a private ruling on the question.\textsuperscript{104}

\subsection{A. Excessive Debt}

In \textit{John Kelley Co. v. Commissioner},\textsuperscript{105} the U.S. Supreme Court indicated that "an obviously excessive debt structure" would require recharacterization of a corporation's debt as equity. Despite the extensive factual inquiry that this principle implies, many lower courts subsequently focused on the debtor's debt-equity ratio\textsuperscript{106} as critical to the analysis, without regard to the debtor's ability to pay its obligations as they fall due and the creditor's reasonable expectations of repayment.\textsuperscript{107} This emphasis was misleading.

The courts have apparently never recharacterized as equity an obligation that has all the formal indicia of debt and which is held by an independent creditor with no direct or indirect stock interest in the debtor. This preference for debt characterization was reflected in the Final and Subsequently Proposed Regulations, which allowed any straight debt instrument held by an

\begin{itemize}
\item business." Plumb, \textit{The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal}, 26 \textit{TAX L. REV.} 369, 522-23 (1971). Another has suggested that the IRS does not enforce this requirement because to do so would undermine the financing methods typically used in industries such as the real estate industry, "since most realty-holding corporations incur mortgage debt that can be paid at maturity only by selling or refinancing the mortgaged property." B. Bittker \& J. Eustice, \textit{Federal Income Taxation of Corporations and Shareholders} § 4.04, at 4-25 (5th ed. 1987).
\item Rev. Proc. 88-3 § 4.02(1), 1988-1 I.R.B. 29. Prior to June 30, 1974, when the Interest Equalization Tax [hereinafter IET] was in effect, it was possible to obtain a ruling from the IRS that an IFS would be treated as an independent entity if the IFS's debt-equity ratio was no greater than five to one. After the IET expired, the IRS stated that it would no longer rule on the independent status of such IFSs and revoked prior published rulings approving the five to one standard. Rev. Rul. 74-464, 1974-2 C.B. 46; Rev. Rul. 74-620, 1974-2 C.B. 380; Rev. Rul. 77-178, 1977-1 C.B. 43.
\item 326 U.S. 521, 526 (1946).
\item Under the Final and Subsequently Proposed Regulations, debt-equity ratios were to be computed by excluding trade accounts payable, accrued operating expenses, taxes, and other similar items from the debt factor (but not the equity factor), and by using the adjusted basis of the issuer's assets, rather than their fair market value, in the equity factor. Subs. Prop. Reg., \textit{supra} note 98, § 1.385-6(h); Final Reg., \textit{supra} note 98, § 1.385-6(g). (Under Subsequently Proposed Regulation section 1.385-6(h)(6), the adjusted basis for depreciable property was to be computed by using the depreciation method for earnings and profits purposes.) In the case of an issuer which is a member of an affiliated group, these ratios were to be computed by taking into account the issuer's proportionate share of the assets and liabilities of each subsidiary in its affiliated group. Subs. Prop. Reg., \textit{supra} note 98, § 1.385-6(j); Final Reg., \textit{supra} note 98, § 1.385-6(h).
\end{itemize}
independent creditor\textsuperscript{108} to be treated as debt. Such favorable treatment was allowed even when the corporation's debt was excessive, the debt was held proportionately, the interest rate was reasonable, and the terms of the instrument were not diligently enforced.\textsuperscript{109}

Nor does the existence of a virtually infinite debt-equity ratio require a different conclusion.\textsuperscript{110} In \textit{Truschel v. Commissioner},\textsuperscript{111} the Tax Court held that mortgage bonds issued to independent creditors by the corporate subsidiary of an educational institution were debt, even though the subsidiary's resulting debt-equity ratio was 22,000:1. In so holding, the court made the point that the thin capitalization of the debtor was not significant. "In the ordinary thin capitalization case, the alleged bondholders or noteholders and stockholders are the same persons."\textsuperscript{112} These parties hold their stock and debt interests proportionately, thereby creating a presumption that they have no incentive to act like independent creditors.

Although not determinative, the fact that debt is owned in proportion to stockholdings has invited special scrutiny by the courts. Conversely, a substantial disproportion in holdings of debt and stock has helped to establish debt characterization, but does not prevent a court from treating an investment as equity.\textsuperscript{113} According to the Final and Subsequently Proposed Regulations, straight debt instruments\textsuperscript{114} issued proportionately to the debtor's shareholders ordinarily were to be treated as indebtedness, even though the

\textsuperscript{108} Subs. Prop. Reg., \textit{supra} note 98, § 1.385-6(a)(3)(ii); Final Reg., \textit{supra} note 98, § 1.385-6(a)(3)(ii). Under the Final and Subsequently Proposed Regulations, whether a creditor is independent was to be determined by taking all relevant facts and circumstances into account. Subs. Prop. Reg., \textit{supra} note 98, § 1.385-6(b)(1); Final Reg., \textit{supra} note 98, § 1.385-6(b)(1). Under a safe harbor test in the Subsequently Proposed Regulations, an independent creditor was defined to include a creditor who owned less than five percent of the debtor's stock (or stock owned by the issuer), either directly or under attribution rules, and whose percentage ownership of the debtor's debt was at least twice its percentage interest in the voting power or value of the debtor's stock. Subs. Prop. Reg., \textit{supra} note 98, § 1.385-6(b)(2).

\textsuperscript{109} Subs. Prop. Reg., \textit{supra} note 98, § 1.385-6(a)(3)(ii); Final Reg., \textit{supra} note 98, § 1.385-6(a)(3)(ii). The regulations also provided the same treatment when "a corporation's stock and instruments are widely held and the instruments are separately traded and readily marketable." Subs. Prop. Reg., \textit{supra} note 98, § 1.385-6(a)(3)(i); Final Reg., \textit{supra} note 98, § 1.385-6(a)(3)(i).

\textsuperscript{110} Under the Originally Proposed Regulations, an instrument was to be treated as stock per se (regardless of who held it) if the issuer's debt-equity ratio exceeded ten to one at the end of the taxable year in which the instrument was issued, based on asset values (rather than basis). Orig. Prop. Reg., \textit{supra} note 98, § 1.385-8. After much criticism, this rule was omitted in the Final Regulations. T.D. 7747, 1981-1 C.B. 141, 144-45.

\textsuperscript{111} 29 T.C. 433 (1957).

\textsuperscript{112} \textit{Id.} at 439.

\textsuperscript{113} See Indian Lake Estates, Inc. v. Stewart, 448 F.2d 574 (5th Cir. 1971); Foresun, Inc. v. Commissioner, 348 F.2d 1006 (6th Cir. 1965); Old Dominion Plywood Corp. v. Commissioner, 25 T.C.M. (CCH) 678 (1966); Merlo Builders, Inc. v. Commissioner, 23 T.C.M. (CCH) 185 (1964).

\textsuperscript{114} The regulations would have treated an instrument evidencing an obligation as a "straight debt instrument" if the obligation is treated as indebtedness under applicable nontax law and is neither convertible into stock nor provides for any contingent payment to the holder (other than a call premium). Subs. Prop. Reg., \textit{supra} note 98, § 1.385-3(b)-(e); Final Reg., \textit{supra} note 98, § 1.385-3(c)-(f); Orig. Prop. Reg., \textit{supra} note 98, § 1.385-3(d)-(g).
Treasury Department observed in promulgating the Final Regulations that there is little economic difference (other than tax consequences) between proportionate investments made as debt and those made as equity.\footnote{115} Under the Final and Subsequently Proposed Regulations, however, a debt instrument issued proportionately to shareholders was to be treated automatically as stock if the corporation's debt was excessive, i.e., if the debtor's "financial structure," together with all the terms and conditions of the instrument, would not satisfy an independent creditor.\footnote{116}

Due to the ten percent shareholder exception, Portfolio Debt instruments can be held proportionately, as that concept was developed under the Subsequently Proposed Regulations,\footnote{117} only, if the instruments are held, directly or indirectly, by six or more investors, none of whom own ten percent or more of the issuer's stock directly or by attribution. In determining a disproportion under the case law, however, any "economic" solidarity between the creditor and the debtor has been taken into account.\footnote{118}

The use of a corporation's debt-equity ratio as a standard that may be relied on by either taxpayers or the IRS is obsolete. As a practical matter, however, it is frequently assumed that a debt-equity ratio of three to one is likely to withstand attack.\footnote{119} Nonetheless, whether or not the obligations in question are held proportionately, the modern standard is whether there is a

\footnote{115} T.D. 7747, 1981-1 C.B. 141, 144.
\footnote{116} Subs. Prop. Reg., \textit{supra} note 98, § 1.385-6(g); Final Reg., \textit{supra} note 98, § 1.385-6(f).
\footnote{117} See Subs. Prop. Reg., \textit{supra} note 98, § 1.385-6(a). Proportionality exists under the Subsequently Proposed Regulations when there is more than a fifty percent "total overlap factor" with respect to the class of instruments in question. \textit{Id.} § 1.385-6(a)(2)(i). Instruments were to be treated as in the same class when issued under a single plan or if not, treated differently (e.g., no priority in the payment of interest). \textit{Id.} § 1.385-6(a)(4), (5). The total overlap factor is the sum of the overlap factors of each person who holds (actually and constructively) both some of the class of instruments and of the stock of the issuer. Each holder's overlap factor is the lesser of such holder's percentage ownership (taking into account constructive ownership) of (a) the stock or (b) the class of instruments. \textit{Id.} § 1.385-6(a)(2)(i). In addition, a particular instrument was to be treated as held proportionately if (i) it is held by a person who owns (actually and constructively) at least twenty-five percent of the value or voting power of the issuing corporation's stock and (ii) the issuing corporation's debt-equity ratio exceeds ten to one. \textit{Id.} § 1.385-6(a)(2)(vi). The test for proportionality in the Final Regulations was less mechanical, based on a determination of "all relevant facts and circumstances." \textit{Final Reg., supra} note 98, § 1.385-6(a)(2)(i).

\footnote{118} See, \textit{e.g.}, Liflans Corp. v. United States, 390 F.2d 965, 971 (Ct. Cl. 1968); P.M. Financial Corp. v. Commissioner, 302 F.2d 786, 788-89 (3d Cir. 1962); Wilbur Security Co. v. Commissioner, 279 F.2d 657, 662 (9th Cir. 1960); C.M. Gooch Lumber & Sales Co. v. Commissioner, 49 T.C. 649, 659 (1968).

\footnote{119} See B. BITTKE\& J. EUSTICE, \textit{supra} note 102, § 4.04, at 4-24. As of 1983, one commentator reported that the most commonly accepted debt-equity ratio for international financing subsidiaries was three to one. See Sarafopoulos, \textit{supra} note 7, at 405 n.27. Another stated that it was common practice for the debt-equity ratios of international financing subsidiaries to vary from 3:2 to 2:1. See Povell, \textit{International Finance Subsidiaries Under Attack}, \textit{FOREIGN TAX PLANNING} 9, 22 (Practicing Law Institute Course Handbook No. 179, 1983).

Under the Final and Subsequently Proposed Regulations, a safe harbor rule would have assured debt treatment for straight debt held proportionately by shareholders if the "outside" debt-equity ratio did not exceed ten to one and if the "inside" debt equity ratio (i.e., determined without taking into account liabilities to independent creditors) did not exceed three to one at the
reasonable expectation, on the basis of available assets and assured cash flows, that the instrument will be paid in accordance with its terms.\textsuperscript{120} Courts have recognized that an amount of equity capital which is adequate in one industry may be insufficient in another and that, within an industry, the standard may vary with the type of operation involved.\textsuperscript{121}

\section*{B. Affiliate Guarantees}

The IRS has argued successfully in court that, when a shareholder has guaranteed a corporate obligation, the obligation should be treated both as the shareholder’s debt and as an equity investment in the issuer by the guarantor shareholder.\textsuperscript{122} If an Affiliated Foreign Guarantor were treated as the primary obligor with respect to an instrument issued by a U.S. Issuer, interest paid on the instrument would be treated as distributions from the U.S. Issuer to the Affiliated Foreign Guarantor, or its parent in the chain of control. The distributions could not be deducted by the U.S. Issuer and, to the extent of the U.S. Issuer’s earnings and profits, would be subject to the thirty percent withholding tax as dividends (except as reduced under a treaty).

Although the IRS has won several of the shareholder guarantee cases, no court has held that a shareholder guarantee, by itself, is sufficient to give rise to a deemed equity investment in the debtor. In \textit{Plantation Patterns, Inc. v. Commissioner},\textsuperscript{123} the leading case in this area, the court held that a shareholder guarantee of corporate debts resulted in an equity investment in the debtor by the shareholder and substituted the shareholder as the primary obligor on the guaranteed debt, because: (1) a substantial proportion of the guaranteed debt was used to acquire capital assets of the corporation; (2) the meager capital of the corporation (it had a 125:1 debt-equity ratio) indicated that the shareholder guarantee was “the real undergirding for the deal” because creditors would not otherwise have lent money to the debtor; (3) the end of the taxable year in which the instrument was issued. Subs. Prop. Reg., \textit{supra} note 98, § 1.385-6(g)(3); Final Reg., \textit{supra} note 98, § 1.385-6(f)(3).

\begin{itemize}
\item \textsuperscript{120} \textit{E.g.}, Bradshaw v. United States, 683 F.2d 365, 374 (Ct. Cl. 1982); Piedmont Corp. v. Commissioner, 388 F.2d 886 (4th Cir. 1968); Rowan v. United States, 219 F.2d 51, 55 (5th Cir. 1955); Byerlite Corp. v. Williams, 286 F.2d 285 (6th Cir. 1960); Lots, Inc. v. Commissioner, 49 T.C. 541, 548 (1968), \textit{aff’d per curiam on other grounds} \textit{sub nom. Christie v. Commissioner}, 410 F.2d 759 (5th Cir. 1969), \textit{acq.} 1968-2 C.B. 2; Baker Commodities, Inc. v. Commissioner, 48 T.C. 374, 398 (1967), \textit{aff’d on other grounds}, 415 F.2d 517 (9th Cir. 1969), \textit{cert. denied}, 397 U.S. 988 (1970). \textit{See generally} Plumb, supra note 102, at 530-35.
\item \textsuperscript{121} \textit{See Plumb, supra} note 102, at 510.
\item \textsuperscript{122} \textit{Plantation Patterns, Inc. v. Commissioner}, 462 F.2d 712 (5th Cir. 1972), \textit{cert. denied}, 409 U.S. 1076 (1972); Murphy Logging Co. v. United States, 239 F. Supp. 794 (D. Ore. 1965), \textit{rev’d}, 378 F.2d 222 (9th Cir. 1967); Rev. Rul. 79-4, 1979-1 C.B. 150; \textit{see also} Selfe v. United States, 778 F.2d 769 (11th Cir. 1985); Casco Bank & Trust Co. v. United States, 544 F.2d 528 (1st Cir. 1976), \textit{cert. denied}, 430 U.S. 907 (1977). Taxpayers seeking to use this principle to their advantage have frequently been unsuccessful. \textit{E.g.}, Blum v. Commissioner, 59 T.C. 436 (1972); Schneiderman v. Commissioner, 54 T.C.M. (CCH) 1007 (1987); Bader v. Commissioner, 52 T.C.M. (CCH) 1398, 1401 (1987); \textit{see also} Leavitt Estate v. Commissioner, 90 T.C. No. 16 (1988) (declining to apply \textit{Plantation Patterns} to S corporations).
\item \textsuperscript{123} 462 F.2d 712 (5th Cir. 1972), \textit{cert. denied}, 409 U.S. 1076 (1972).
\end{itemize}
guaranteed creditors agreed to subordinate their rights to those of other corporate debtors; and (4) the debtor's business prospects were dubious without the guaranteed financing. The court used the same factors to determine who was primarily liable for the corporation's debts as are applied generally in determining whether a loan constitutes debt or equity for tax purposes.

When an instrument is guaranteed by the debtor's parent, in keeping with debt-equity principles, courts have attached a great deal of importance to the availability of assets and cash flows of the debtor. An investment generally will be recognized as debt provided that the debtor can reasonably be expected to make payments on the instrument out of its own assets and assured cash flows. So long as the Affiliated Foreign Guarantor's guarantee affects only the interest rate payable on a Portfolio Debt investment, rather than the viability of any loan at all, then the Plantation Patterns result can be avoided.

C. Shared Appreciation Loans

The fact that interest is payable currently is an important factor tending to establish that an instrument represents debt. "[I]t is a common attribute of a debt that the holder thereof is entitled to interest thereon even though there are no net earnings." Conversely, it is characteristic of an equity investment that the holders' right to receive income thereon is dependent not only on the existence of corporate earnings or surplus, but also upon the discretionary action of the board of directors. In order to increase the likelihood that payments on a shared appreciation loan are at least partially treated as interest for income tax purposes, such loans typically have two components—a fixed interest portion (at below market rates) and a "contingent" interest portion calculated as a percentage of the appreciation in an underlying asset (often the asset securing the loan).

The courts have long held that a typical debt instrument which provides for interest equal to the debtor's net earnings up to a fixed percentage of the original principal amount, will not be treated as equity unless factors other

124. 462 F.2d at 722.
125. See, e.g., Murphy Logging Co. v. United States, 378 F.2d 222 (9th Cir. 1967) (debt characterization despite debt-equity ratio of 160:1); Ackerson v. United States, 277 F. Supp. 475, 477 (W.D. Ky. 1967) (collateral held adequate where "the expectation of success was unchallenged"); Santa Anita Consolidated, Inc. v. Commissioner, 50 T.C. 536, 553 (1968) (corporation suffered losses, but cash flows to make payments reasonably expected).

The Originally Proposed Regulations provided that a shareholder guarantee would not affect the characterization of a corporate loan if it is "reasonable (at the time of the guarantee) to expect that the loan can be enforced against the corporation according to its terms." Orig. Prop. Reg., supra note 98, § 1.385-11(a). The preamble to the Final Regulations clarified that this provision (then incorporated in section 1.385-9) was "essentially a restatement of existing case law." T.D. 7747, 1981-1 C.B. 141, 148. In order to prevent any possible confusion in this regard, the provision was omitted from the Subsequently Proposed Regulations. Notice of Proposed Rulemaking, 47 Fed. Reg. 164, 169 (1982).
than participation in the debtor's profits indicate otherwise.\footnote{127} The IRS confirmed this principle in Revenue Ruling 68-54,\footnote{128} which treated subordinated ten year debentures as debt even though the debentures provided, in addition to fixed interest of seven percent per annum, for interest contingent upon net profits to be paid up to an additional one percent per annum. The holders of these instruments had no voting or management powers, did not own any stock in the debtor, and could (the IRS concluded) reasonably anticipate payment of interest and principal in accordance with the terms of the instruments.

The IRS also has extended recognition to debt instruments that provide for limitations on contingent interest other than a maximum interest rate. Revenue Ruling 76-413\footnote{129} applied debt-equity principles to recognize contingent interest on real estate mortgages as interest for purposes of qualifying real estate investment trusts under the income tests of section 856(c). The five year mortgages provided for fixed annual interest of eleven percent and additional contingent interest upon the sale of the real estate equal to the greater of 1.75 percent of the debtor's gross receipts or $300 per acre. The IRS has not been willing, however, to recognize as debt shared appreciation loans that provide for contingent interest based on appreciation in the value of the security when the loan proceeds are used for commercial or business purposes.\footnote{130}

In contrast to the miserly views of the IRS, courts have been willing to treat an instrument as debt even when contingent interest is equal to a percentage of net profits and there is no limitation on the contingent payment to

\footnote{127} See, e.g., Lansing Community Hotel Corp. v. Commissioner, 14 T.C. 183, 189-90 (1950), aff'd, 187 F.2d 487 (6th Cir. 1951) (interest limited to five percent, payable out of net operating income; debentures matured in ten years, apparently were not subordinated to general creditors, and were issued as dividends to approximately 298 shareholders); New England Lime Co. v. Commissioner, 13 T.C. 799, 804 (1949) (fixed interest at three percent with an additional three percent payable out of net earnings; debentures matured in twenty-five years, were not held proportionately by shareholders, were not subordinated to general creditors, and court was satisfied with issuer's capital). Cf. Hale-Justis Drug Co. v. Commissioner, 2 T.C.M. (CCH) 39 (1943) (two percent fixed interest, with additional interest up to eight percent payable out of income, held equity; debentures were subordinated, matured in fifty years, and had voting rights). Some courts weigh a provision for cumulative interest as an additional factor favoring debt treatment. See Commissioner v. H.P. Hood & Sons, 141 F.2d 467, 470 (1st Cir. 1944); Sabine Royalty Corp. v. Commissioner, 17 T.C. 1071, 1077 (1951).

\footnote{128} 1968-1 C.B. 59.

\footnote{129} 1976-2 C.B. 213.

\footnote{130} In Revenue Ruling 83-51, 1983-1 C.B. 48, the IRS examined three fact patterns in which a shared appreciation loan was used to finance the purchase of a personal residence. The taxpayer (mortgagor) executed a mortgage note agreeing to pay fixed interest, and contingent interest equal to forty percent of the appreciation in the value of the residence over the term of the loan. The IRS held in each instance that both the fixed and contingent interest payments were deductible as interest under section 163. The IRS reasoned that a lender need not necessarily calculate interest as a percentage of the loan principal. The ruling cautions, however, that its holdings should not be considered to apply when the loan proceeds are used for commercial or business activities or when the debtor is a corporation. Further, the ruling states that contingent payments may not be deductible as interest when the creditor has a greater interest in the equity of the property than that contemplated in the ruling.
make it resemble interest. In *Foster v. Commissioner*, the Tax Court recently held that a commercial lender's "bonus" was interest even though it was equal to 100 percent of the amount of the loan, was paid in addition to market-rate interest, and was payable (before the debtor waived this provision) only out of fifty percent of the profits of the real estate development project over a five year term. In other similar cases upholding debt characterization, it apparently has not mattered whether the contingent payment was characterized as interest or, instead, as a distributive share of the income of a partnership between the debtor and creditor. In *Foster*, however, which of these two characterizations applied made a difference both to the timing of the creditor's income and to its character. Indeed, the debtor had promised to structure the loan bonus to obtain, for the creditor, the advantage of lower tax rates applicable to capital gains.

Although the courts tend to be more accommodating than the IRS in respecting loans with contingent interest, the holdings have not always been predictable. In particular, two cases have bifurcated debt with contingent interest into separate debt and equity components.

In *Farley Realty Corp. v. Commissioner*, the Second Circuit was confronted with a purported real estate loan in the amount of $70,000 that matured in ten years and which provided for fixed annual interest payments of fifteen percent for the first two years and thirteen percent over the remainder.

---

131. 80 T.C. 34 (1983), aff'd on this ground and rev'd and vacated on other grounds, 756 F.2d 1430 (9th Cir. 1985), cert. denied, 474 U.S. 1055 (1986).
132. 80 T.C. at 197-211.
133. See, e.g., Dorzback v. Collision, 195 F.2d 69 (3d Cir. 1952) (husband agreed to pay wife twenty-five percent of net income from business in lieu of fixed interest; contingent payments held to be interest, although court noted that tax consequence might be the same if wife held to be a partner); Erwin de Reitzes-Marienwert v. Commissioner, 21 T.C. 846 (1954) (son agreed to pay mother interest equal to forty percent of his net profits from a partnership business; court allowed son interest deduction even though it stated same result would follow if mother were treated as a partner); Kena, Inc. v. Commissioner, 44 B.T.A. 217 (1941) (corporation received, in lieu of interest, eighty percent of the net profits of the shareholder of its parent corporation from trading stocks; held, payments were interest for purposes of the personal holding company tax, but same result would have followed if payments were treated as distributive share of capital gains). See also Farley Realty Corp. v. Commissioner, 279 F.2d 701, 705 (2d Cir. 1960) (distinguishing *Dorzback*); Portage Plastics Co. v. United States, 301 F. Supp. 684, 689 (W.D. Wis. 1969), rev'd on other grounds, 470 F.2d 308 (7th Cir. 1972), aff'd on rehearing, 486 F.2d 632 (7th Cir. 1973) (en banc) (distinguishing *Dorzback*, *Erwin de Reitzes-Marienwert*, and *Kena*). But see Commissioner v. Williams, 256 F.2d 152 (5th Cir. 1958) (debtor promised to pay one-half of his profits—including capital gains—to his wife, the creditor's daughter; held, profits interest did not make wife a partner). The facts in three other similar cases upholding debt instruments are not sufficiently clear to determine whether the holding made a difference to the creditor's tax liability. See Wiggin Terminals, Inc. v. United States, 36 F.2d 893 (1st Cir. 1929) (in addition to six percent interest, creditors entitled to a bonus of 100 percent of principal amount; held, deductible as interest); Mayer v. Commissioner, 13 T.C.M. (CCH) 391 (1954) (creditor entitled to one-third or one-half of the profits of various businesses); Astoria Marine Construction Co. v. Commissioner, 4 T.C.M. (CCH) 278 (1945) (creditor entitled to one-third or one-half of profits upon completion of construction of a boat; borrower held entitled to deduct losses from venture). For a discussion of the potentially different consequences of a loan and a partnership interest, see Feder, supra note 96, at 192-97.
134. 279 F.2d 701 (2d Cir. 1960).
of its term. In addition, the taxpayer-debtor was obligated to pay to the creditor fifty percent of the property's appreciation upon its sale, whether the sale occurred before or after the loan's maturity. After the creditor's death, his estate settled its claim to the property's appreciation for $50,000. The Second Circuit held that although the taxpayer could deduct the fixed interest payments (which the IRS had not challenged), the $50,000 payment could not be deducted because the creditor's right to the taxpayer's profits constituted an equity interest separate from the original loan.135

In the second case, Richmond, Fredericksburg & Potomac Railroad Co. v. Commissioner,136 the Fourth Circuit held that contingent interest paid by the taxpayer on “guaranteed stock” issued in 1856 could not be deducted. The instruments had a fixed maturity and full voting rights, provided for “guaranteed dividends” at an annual rate of seven percent irrespective of earnings, were secured by first mortgages on the taxpayer's property, and, upon dissolution, would share ratably in the corporation's assets after payment of the par value of the common stock. In addition, the instruments were entitled as a class to half of the corporation's profits, to the extent that such share exceeded the aggregate amount of fixed interest. In a previous decision made thirty-eight years earlier, the Fourth Circuit had held that the fixed interest was deductible by the taxpayer as interest.137 In the subsequent case, the taxpayer sought to deduct as interest its payments in excess of the seven percent interest amounts. This time the taxpayer lost; the court held that the excess payments were dividends, but still allowed the taxpayer to deduct the fixed interest.138

Arguably, neither of these two cases bears on the characterization of a properly structured shared appreciation loan. The approach of these cases does not properly reflect the principle of many of the other cases in this area of the law that an instrument is either debt or equity but not both.139 Moreover, the obligations in these cases are distinguishable. The contingent right to appreciation in Farley did not mature upon repayment of the loan, but continued indefinitely until sale of the underlying property. This feature suggests that the contingent right was not given as consideration for the use of the creditor's funds. In Richmond, Fredericksburg & Potomac Railroad Co., the instruments had many of the features of stock that can be avoided in structuring a shared appreciation loan, including voting rights, an indefinite maturity, and equal priority with common stock in the assets of the corporation upon its dissolution. Moreover, the bifurcation approach of these cases

135. Id. at 704.
136. 528 F.2d 917 (4th Cir. 1975).
137. Helvering v. Richmond, F. & P.R. Co., 90 F.2d 971, 974-75 (4th Cir. 1937).
138. 528 F.2d at 920.
139. See Feder, supra note 96, at 208; Plumb, supra note 102, at 603 n.1387; Taylor, Debt/Equity and Other Tax Distinctions: How Far Can We Go?, 62 Taxes 848, 857 (1984). For a recent article arguing that the bifurcation approach is correct as a matter of policy, see Madison, The Deductibility of “Interest” on Hybrid Securities, 39 Tax L. 465 (1987).
was in part necessitated by their procedural histories. In neither case did the IRS seek to disallow deductions for the fixed interest payments. Nonetheless, these cases raise a spectre of bifurcation that should not be overlooked.

The withdrawn section 385 regulations departed significantly from case precedents in dealing with loans providing for contingent interest. The Final and Subsequently Proposed Regulations defined a "hybrid" instrument as one which is convertible into stock or which provides for contingent payments to the holder of the instrument.\textsuperscript{140} A proportionately-held hybrid instrument generally was to be treated as equity.\textsuperscript{141} A hybrid instrument that is not held proportionately also was to be treated as equity, but only if, on the date of its issue, the fair market value of the straight debt payments was less than fifty percent of the fair market value of the instrument.\textsuperscript{142} Otherwise, the instrument was to be analyzed under the rules applicable to straight debt instruments (described above) under which loans by independent creditors were treated as debt. Straight debt payments generally were defined to include fixed payments of principal or interest and contingent payments of either, assuming that such payments are made in the smallest amounts and at the latest dates.\textsuperscript{143} Examples under the regulations indicated that payments of interest out of the net profits of a company were to be treated as contingent payments.\textsuperscript{144}

Although supporting authorities are sparse, a Portfolio Debt instrument that provides for the payment of contingent interest should be treated as debt in appropriate cases, particularly if the Foreign Holder does not own any stock in the U.S. Issuer directly or by attribution. In order to distinguish

\textsuperscript{140} Subs. Prop. Reg., supra note 98, § 1.385-3(d); Final Reg., supra note 98, § 1.385-3(e).

\textsuperscript{141} Final Reg., supra note 98, § 1.385-6(c). Under an exception added by the Subsequently Proposed Regulations, however, if independent creditors owned at least twenty percent of the instruments in a class, then such instruments would have been tested under the rules applicable to nonproportionately-held hybrid instruments: any instrument in the class was to be treated as a straight debt instrument if fifty percent or more of the fair market value of the instrument was attributable to straight debt payments; otherwise, the instrument was to be treated as equity. Subs. Prop. Reg., supra note 98, § 1.385-5(a), 1.385-6(d)(2).

\textsuperscript{142} Subs. Prop. Reg., supra note 98, § 1.385-5(a); Final Reg., supra note 98, § 1.385-5(a). Under the Subsequently Proposed Regulations, the fair market value of the straight debt payments was deemed equal to the sum of the present value of each of the straight debt payments, using as a discount rate a reasonable rate of interest for an instrument in the amount of the straight debt payments, payable under the same terms and conditions. Subs. Prop. Reg., supra note 98, § 1.385-5(d)(3), (4).

\textsuperscript{143} Subs. Prop. Reg., supra note 98, § 1.385-5(c), (d)(ii); Final Reg., supra note 98, § 1.385-5(d). Under Subsequently Proposed Regulation section 1.385-5(c)(5), a fixed payment was not to be treated as a contingent payment merely because: (a) the holder's rights under the instrument are impaired by the federal bankruptcy laws or the insolvency of the debtor; (b) the obligation is nonrecourse; or (c) local law limits payments on the instrument to amounts payable out of earned surplus. In addition, the Final and Subsequently Proposed Regulations clarified that a principal sum was not contingent merely because it was in the debtor's control to prepay all or a portion of the principal amount. Subs. Prop. Reg., supra note 98, § 1.385-5(b)(4); Final Reg., supra note 98, § 1.385-5(d)(4).

\textsuperscript{144} See, e.g., Subs. Prop. Reg., supra note 98, § 1.385-5(f) Ex. (1).
contingent interest from a profits interest, it is desirable to limit the contingent interest payments to a reasonable percentage of either (i) the appreciation in the U.S. Issuer's assets or (ii) the original loan principal. Moreover, the instrument should have a fixed maturity date, and the contingent interest should be determined and paid upon maturity. It is unclear, however, how large the percentage used to calculate contingent interest may be before treatment of the instrument as debt is jeopardized.

The use of contingent interest to pay profits to foreign persons free of U.S. withholding taxes has recently come under congressional scrutiny. During October of 1987, the House Ways and Means Committee considered incorporating into its version of the Omnibus Reconciliation Act of 1987 a proposal to eliminate "tax reductions that apply to [such contingent] interest." The Committee subsequently rejected this proposal.

IV. TREATMENT OF GUARANTEE FEES

This Part addresses whether guarantee fees paid by the U.S. Issuer or Foreign Holders to an Affiliated Foreign Guarantor are eligible for exemption from the thirty percent withholding tax as foreign source income. Alternatively, when the Affiliated Foreign Guarantor has provided financial guarantees in the recent past, in transactions for which it has received fees, exemption from the thirty percent withholding tax also may be available if the Affiliated Foreign Guarantor is a resident of a country which has entered into a bilateral income tax treaty with the United States. Such business activities support the position that the guarantee fees are "industrial or commercial profits" or "business profits" of the Affiliated Foreign Guarantor, which generally may not be taxed by the United States under a treaty unless the Affiliated Foreign Guarantor has a permanent establishment in the United States.

If a Foreign Holder agrees to pay a guarantee fee to the Affiliated Foreign Guarantor in connection with the initial offering of Portfolio Debt instruments, the IRS may treat the arrangement as a constructive payment by the U.S. Issuer to the Affiliated Foreign Guarantor, with the Foreign Holder acting as a mere conduit or agent. This characterization affects whether the fee is subject to the thirty percent withholding tax and, if the fee is subject to withholding, could result in the U.S. Issuer being liable for such taxes as a

146. STAFF OF THE JOINT COMM. ON TAXATION, 100TH CONG., 1ST SESS., DESCRIPTION OF ADDITIONAL TAX PROPOSALS SUBMITTED BY MEMBERS FOR WAYS AND MEANS COMMITTEE REVENUE RECONCILIATION CONSIDERATION (JCX-13-87) 60 (Comm. Print 1987).
148. Cf. Aiken Industries, Inc. v. Commissioner, 56 T.C. 925 (1971), acq. on another issue, 1972-2 C.B. 1; H.R. REP. No. 861, supra note 63, at 937-38 (back-to-back loans cannot be used to avoid ten percent shareholder and ordinary bank credit exceptions to portfolio interest exemption); Rev. Rul. 87-89, 1987-37 I.R.B. 16; Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153,
withholding agent. As recharacterized, the guarantee fee would not constitute portfolio interest, because it would not be treated as paid to a Foreign Holder. Inasmuch as the parties would have characterized the payment as a guarantee fee, the IRS could require that it be treated as a guarantee fee paid by the U.S. Issuer—even if the fee exceeds a commercially reasonable amount. This conduit treatment also frames the issues discussed below concerning the source of the guarantee fees and whether they are exempt from the thirty percent withholding tax under a treaty. A payment that originates from a U.S. Issuer is at least superficially more likely to be U.S. source income than one from a Foreign Holder.

A. Taxation of Guarantee Fees as Dividends

If a U.S. Issuer pays or is deemed to pay the guarantee fees directly to an Affiliated Foreign Guarantor, then there is authority under which the fees would be viewed as distributions with respect to the stock of the U.S. Issuer, even if the fees were arm's length in amount. Accordingly, the fees would not be deductible by the U.S. Issuer, would be treated as U.S. source income, and, if paid or deemed paid to a foreign corporation, would be subject to the thirty percent withholding tax (except as reduced under a treaty) to the extent of the U.S. Issuer's earnings and profits. The ability to avoid dividend characterization may determine whether guarantee fees will be paid as part of the transaction. In many instances, a U.S. Issuer will prefer that an Affiliated Foreign Guarantor provide its guarantees without compensation, rather than incur withholding taxes on guarantee fees treated as dividends. In order to realize the potentially favorable treatment of guarantee fees discussed in Part IV.B below, the possibility of dividend treatment must first be eliminated.

There are two separate lines of reasoning under which the IRS could recharacterize arm's length guarantee fees as dividends. The first examines whether the fees are deductible under section 162(a) as ordinary and necessary business expenses. The second applies section 482, which permits the IRS (but not the taxpayer) to allocate gross income and deductions among commonly controlled entities "in order to prevent evasion of taxes or clearly

1984-2 C.B. 383. For criticism of Revenue Rulings 84-152 and 84-153, see the articles cited supra in note 11.

The risk that this conduit analysis may be upheld by a court is sufficiently great to warrant an assumption by the parties that it would succeed. Nonetheless, the transactions can be structured to reduce the risk somewhat if, in connection with the offering of Portfolio Debt instruments, the Affiliated Foreign Guarantor merely offers to provide a guarantee, with each Foreign Holder having a truly independent choice to reject the offer or accept it by paying a fee. If the guarantee offer is so attractive that no Foreign Holder could reasonably decide to reject it, however, then the conduit analysis is likely to succeed on the ground that the Foreign Holder's choice lacks economic reality.


150. The discussion in Part IV of this article assumes that the U.S. Issuer's immediate parent in the chain of common control is a foreign corporation that is not engaged in the conduct of a trade or business in the United States.

151. I.R.C. §§ 301(c), 316, 861(a)(2), 881(a)(1), 1442(a) (1986).
to reflect the income" of any such entity. Under either of these approaches, the IRS would attempt to treat fees that are not deductible as dividends to the extent of the payor's earnings and profits. Although in many instances these approaches will reach the same result, the principles involved are different. In addition, a taxpayer may bear a heavier procedural burden in contesting a disallowance under section 482, because to succeed in that appeal the taxpayer must prove that the IRS's determination was "unreasonable, arbitrary, or capricious."

I. Disallowance under Section 162(a)

Under section 162(a), expenses incurred in carrying on a trade or business are deductible if they are "ordinary and necessary" and reasonable in amount. Clearly, a guarantee fee that does not exceed the amount that an unrelated party would charge in an arm's length transaction is reasonable in

152. Id. § 482.  

Although these precedents would support a determination that guarantee fees that are not deductible under either section 162(a) or section 482 constitute a constructive distribution to the Affiliated Foreign Guarantor, or to the U.S. Issuer's immediate parent in the chain of common control, this is arguably not the correct result when the fees are arm's length in amount.

In general, a shareholder is deemed to receive a distribution with respect to a corporation's stock whenever the corporation makes payments primarily for his or her benefit that are not bona fide loans. E.g., Ireland v. United States, 621 F.2d 731 (5th Cir. 1980); Loftin & Woodard, Inc. v. United States, 577 F.2d 1206, 1214-19 (5th Cir. 1978); Sachs v. Commissioner, 277 F.2d 879 (8th Cir. 1960), cert. denied, 364 U.S. 833 (1960); Knott v. Commissioner, 67 T.C. 681 (1977).

When the payments in question are made to a sister corporation, rather than to the payor's shareholder, the analysis is similar. If the payments do not constitute bona fide loans, they are treated as constructively distributed by the payor to the common shareholders of the two entities, to the extent: (a) the common shareholders are directly benefited by the payments; and (b) the payments do not serve valid business needs of the payor. See Sammons v. Commissioner, 472 F.2d 449 (5th Cir. 1972); Gulf Oil Corp. v. Commissioner, 87 T.C. 548 (1986); Dean v. Commissioner, 57 T.C. 32 (1971); Rushing v. Commissioner, 52 T.C. 888 (1969), aff'd on other grounds, 441 F.2d 593 (5th Cir. 1971). See generally McCawley, Section 482 Allocations, 230-3d TAX MGMT. PORTFOLIOS (BNA) A-102 to A-107 (1986).

If the guarantee fees paid to an Affiliated Foreign Guarantor are equivalent to arm's length amounts, such fees may in fact serve a valid business purpose of a U.S. Issuer. For example, a U.S. Issuer might otherwise have to pay a higher interest rate on the Portfolio Debt. Cf. Gulf Oil Corp. v. Commissioner, 89 T.C. No. 70 (1987) and Mobil Oil Corp v. United States, 8 Ct. Ct. 555 (1985) (insurance premiums paid by affiliates to captive insurance company not constructive dividends, although not deductible, because affiliates received insurance protection). In addition, the common shareholders arguably are not directly benefited by the payments; rather they realize a benefit indirectly and from the successful business activity of the Affiliated Foreign Guarantor. Thus, although there may be ample authority for the IRS to disallow a U.S. Issuer's deductions for guarantee fees that are equivalent to arm's length amounts, there is substantial uncertainty that the IRS would be able to prevail in characterizing such fees as dividend income.

amount for purposes of section 162(a). A guarantee fee is also "necessary," in the sense generally required under section 162(a) that the expense be "appropriate and helpful" in furthering the taxpayer's business.\textsuperscript{155} Finally, the requirement that the expense be "ordinary" is used to distinguish between capital expenditures and expenses that are currently deductible.\textsuperscript{156} When paid by a cash method taxpayer, a fee for a guarantee that does not extend substantially beyond the close of the taxable year in which such fee is paid or incurred is fully deductible.\textsuperscript{157} In all other cases, the fee must be amortized over the term of the guarantee, or possibly, of the debt instrument.\textsuperscript{158}

The courts have modified these principles in cases involving shareholder guarantees, where it is perceived that guarantee fees have been used to avoid dividend taxation. In\textit{Tulia Feedlot, Inc. v. United States}\textsuperscript{159} (\textit{Tulia I}), the Fifth Circuit held that an annual fee paid to the taxpayer's shareholders for guarantees routinely made in proportion to stockholdings, was not "ordinary and necessary" because the taxpayer failed to establish that it was customary in its industry to pay shareholders a guarantee fee.\textsuperscript{160} No evidence was presented "to show what fees, given the risk involved, would be reasonable in the circumstances."\textsuperscript{161} The fees were paid during a period when the taxpayer had earnings and profits but was not paying dividends.\textsuperscript{162} The fees were equal to three percent of the maximum amount of the guaranteed credit line and did not, in the court's view, reflect a calculation of the guarantors' risks.\textsuperscript{163} In another factually similar case,\textit{Olton Feed Yard, Inc. v. United States},\textsuperscript{164} the Fifth Circuit reached the same result, but also inquired "whether it was necessary for the taxpayer to pay shareholders a fee in order to get them to sign guarantees for the loan."\textsuperscript{165}

Taxpayers have not always lost the shareholder guarantee cases, however. In a sequel to \textit{Tulia I} involving the same taxpayer but a later year,
Tulia Feedlot, Inc. v. United States (Tulia III), the Claims Court was persuaded that it had become customary in the taxpayer's industry for corporations to pay fees of three percent to five percent to shareholders guaranteeing corporate loans and that the taxpayer's shareholders were unwilling to provide any guarantees unless they received fees of three percent. Several additional factors were important: the taxpayer had, over the preceding three-year period, consistently paid dividends, the fees were based on the average annual outstanding guaranteed indebtedness, rather than the maximum amount of the guaranteed credit line, and the amounts guaranteed were not proportional to stockholdings. As indicated in two recent Technical Advice Memoranda, the IRS is likely to deny the deductibility of shareholder guarantee fees if the corporation has not consistently declared dividends, even if all of the other elements of Tulia III are present.

The criteria developed by the courts in the shareholder guarantee fee cases are arguably too stringent in the light of the general principles governing deductibility under section 162(a). The requirement that shareholders be unwilling to provide guarantees unless they receive a fee has little or no basis in prior law. A guarantee is "appropriate" and "helpful," (i.e., necessary) if it is required by the lender or otherwise enhances the marketability of a debt instrument. When the amount that an unrelated guarantor would charge in an arm's length transaction can be reasonably ascertained, a guarantee should not be treated differently from any other shareholder asset, which the shareholder has the option for income tax purposes of either contributing to the corporation's capital in a nontaxable transaction or transferring to the corporation for taxable arm's length consideration.

---

166. 3 Cl. Ct. 364 (1983), 83-2 U.S. Tax Cas. (CCH) ¶ 9516, 52 A.F.T.R.2d (P-H) 5702. See also A.A. & E.B. Jones v. Commissioner, 19 T.C.M. (CCH) 1561 (1960) (shareholder-guarantee fees reasonable in amount compared to those customarily charged in similar circumstances). In Tulia Feedlot, Inc. v. United States (Tulia II), 231 Ct. Cl. 971 (1982), 82-2 U.S. Tax Cas. (CCH) ¶ 9587, the Claims Court held that collateral estoppel based on Tulia I did not prevent the taxpayer from relitigating the shareholder guarantee fee issue in regard to a different tax year.

167. 3 Cl. Ct. at 369, 372, 83-2 U.S. Tax Cas. (CCH) ¶ 9516 at 87,838.

168. 3 Cl. Ct. at 368-72, 83-2 U.S. Tax Cas. (CCH) ¶ 9516 at 87,837.


171. See, e.g., Bradshaw v. United States, 683 F.2d 365 (Ct. Cl. 1982); Gyro Engineering Corp. v. United States, 417 F.2d 437 (9th Cir. 1969); Piedmont Corp. v. Commissioner, 388 F.2d 886 (4th Cir. 1968); Murphy Logging Co. v. United States, 378 F.2d 222 (9th Cir. 1967); Sun Properties v. United States, 220 F.2d 171 (5th Cir. 1955); Woolley Equipment Co. v. United States, 268 F. Supp. 358 (D. Tex. 1966); Adams v. Commissioner, 58 T.C. 41 (1972); Brown v. Commissioner, 27 T.C. 27 (1956), acq. 1957-2 C.B. 4; Perrault v. Commissioner, 25 T.C. 439 (1955), acq. 1956-1 C.B. 5, aff'd per curiam, 244 F.2d 408 (10th Cir. 1957), cert. denied, 355 U.S. 830 (1957). These cases generally respect a transfer of property to a corporation, in exchange for an installment payment obligation, as a sale when the parties treat the transaction as such, they have a business purpose for the transaction, and the installment obligation is true indebtedness.
In some cases, a U.S. Issuer will be able to prove that its Affiliated Foreign Guarantor would not have provided a guarantee without a fee. Courts may be willing to imply this fact from evidence that the Affiliated Foreign Guarantor is in the business of providing guarantees for a fee, especially to unrelated parties, but no decision has so indicated. Finally, in *Tulia III*, the guarantees were necessary to the conduct of the taxpayer's cattle feedlot business, which had insufficient capital to finance its cyclical expenses. In contrast, it is unclear whether a court would view an affiliate's guarantee fee as a necessary expense when the guarantee is merely one of several corporate financing alternatives.

In many cases, the U.S. Issuer will have difficulty proving that the payment of guarantee fees to affiliated guarantors is customary in the U.S. Issuer's industry. The requirement that an expense be "ordinary" has sometimes been used to limit deductibility under section 162(a) to expenses that are customary industry practice.\(^\text{172}\) This interpretation of section 162(a) arguably is mistaken to the extent that it is used to deny deductions for non-capital expenses.\(^\text{173}\) In any event, this interpretation does not entail treating guarantee fees paid to affiliates differently from guarantee fees paid to unrelated parties. Guarantee fees paid to an affiliate should typically be viewed as "ordinary" because guarantees are a customary practice in nearly every industry.

*Tulia I* and its progeny may best be understood as cases in which the courts have been suspicious that guarantee fees were disguised dividends. Under these precedents, a U.S. Issuer is more likely to avoid a recharacterization of its guarantee fees as dividends if it regularly pays dividends to its shareholders in amounts that represent a reasonable return on their investments. In addition, the U.S. Issuer should not be undercapitalized. In theory, a guarantee fee paid to an affiliate in an arm's length amount should be deductible if, under the debt-equity principles discussed in Part III, the issuer could deduct interest on a loan from the affiliated guarantor having terms similar to the guaranteed obligation. A fee paid to an affiliate for a loan guarantee should by itself be no more or less suspect, as disguised dividends, than interest paid for the use of its funds. The difficulty in using this point against *Tulia I* is that an arm's length charge for interest generally may be easier to ascertain than an arm's length charge for a guarantee. The use of money is worth something, but a guarantee may not be.


\(^{173}\) Bertolini Trucking Co. v. Commissioner, 736 F.2d 1120 (6th Cir. 1984), rev'g 45 T.C.M. (CCH) 44 (1982); see also Car-Ron Asphalt Paving Co. v. Commissioner, 758 F.2d 1132 (6th Cir. 1985).
2. Disallowance under Section 482

If an Affiliated Foreign Guarantor is not engaged in the business of providing guarantees and the guarantee fee exceeds the cost (which ordinarily would not be significant) of providing the guarantee, the IRS also could apply section 482 to treat the excess as a dividend to the Affiliated Foreign Guarantor, or to the U.S. Issuer's immediate parent in the chain of control.\(^{174}\) As under section 162(a), this risk exists even if the fee is an arm's length amount, regardless of whether the fee is paid directly by the U.S. Issuer or by the Foreign Holders pursuant to guarantees made in connection with the initial offering.

Prior to judicial acceptance of revised regulations promulgated under section 482 in 1968, a number of courts held that section 482 authorized the IRS to reallocate income and deductions between a group of commonly controlled entities, but only with respect to income or deductions realized or incurred in transactions with third parties.\(^{175}\) In the case of a guarantee fee paid to an Affiliated Foreign Guarantor, this interpretation meant that a U.S. Issuer's deduction for the fee could not be disallowed under section 482 because the disallowed deduction could not be allocated to another member of its controlled group. When the regulations were revised in 1968, they extended the IRS's authority to make adjustments to reflect the true taxable income of a controlled entity, "notwithstanding the fact that the ultimate income anticipated from a series of transactions [culminating with a third party] may not be realized or is realized during a later period."\(^{176}\) After some false starts,\(^{177}\) the revised regulations have been upheld by the courts.\(^{178}\)

Although the revised regulations under section 482 arguably are silent on the validity of adjustments made by the IRS that may prevent the full amount of an expense from being deducted, as compared to those that create income which might never be recognized,\(^{179}\) courts have upheld the IRS's

---


\(^{176}\) Treas. Reg. § 1.482-1(d)(4) (as amended 1968).


\(^{179}\) See Treas. Reg. § 1.482-1(d)(4) (as amended 1968).
authority to reduce or disallow deductions under section 482 when one member of a controlled group has charged another more than an arm's length price for goods or services.\textsuperscript{180}

Generally, the regulations provide that the true taxable income of each controlled taxpayer will be determined based on the standard "of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."\textsuperscript{181} Accordingly, if a guarantee fee is equal to the amount that an unrelated party would charge in an arm's length transaction, the payor's deduction for that expense and an inclusion in the payee's income in the same amount will be respected.\textsuperscript{182} The regulations specifically apply the arm's length standard to interest, compensation for services, rent for the use of tangible property, and payments to secure the transfer or license of intangible property.\textsuperscript{183}

In the case of compensation for certain services a different standard applies. Except in the case of services "which are an integral part of the business activity of either the member rendering the services or the member receiving the benefit of the services," arm's length compensation is presumed to equal the "cost or deductions" incurred by the renderer.\textsuperscript{184} This presumption can be overcome, but only when the taxpayer establishes "a more appropriate" measure pursuant to the arm's length standard.\textsuperscript{185}

Accordingly, the risk of an Affiliated Foreign Guarantor's fee being recharacterized as a dividend in whole or in part under section 482 is limited to the risk that the IRS and the courts will treat the fee as compensation for services, and that they will deem an arm's length charge for such services to

\textsuperscript{180}. U.S. Gypsum Co. v. United States, 452 F.2d 445 (7th Cir. 1971) (dictum); Challenger, Inc. v. Commissioner, 23 T.C.M. (CCH) 2096 (1964).
\textsuperscript{181}. Treas. Reg. § 1.482-1(b)(1) (as amended 1968).
\textsuperscript{182}. Id. § 1.482-1(a)(6).
\textsuperscript{183}. Id. § 1.482-2(a)-(d). In the case of the transfer to, or use of intangible property (as defined in I.R.C. section 936(h)(3)(B)) by, an affiliate, the Tax Reform Act of 1986 amended section 482 to require that, with respect to such transfer or use, income which is "commensurate with the income attributable to the intangible" be allocated to the affiliate. Tax Reform Act of 1986, Pub. L. No. 99-514 § 1231(e)(1), 100 Stat. 2085, 2562-63 (1986). This provision was intended to "make it clear that industry norms or other unrelated party transactions do not provide a safe-harbor minimum payment for related party intangible transfers" and that payments made for an intangible should be "adjusted over time to reflect changes in the income attributable to the intangible." H.R. REP. NO. 426, 99th Cong., 2d Sess. 425-26 (1986).

It is unclear how the 1986 amendment to section 482 could be used to allocate less income to the guarantee provided by an Affiliated Foreign Guarantor than the amount of its guarantee fee, when the fee is otherwise an arm's length amount. One of the factors that the Ways and Means Committee believed should be taken into account is "the extent to which the transferee bears real risks with respect to its ability to make a profit from the intangible." Id. at 426. A U.S. Issuer will use the guarantee to make a profit only in the sense of using it to raise funds from Foreign Holders. The Affiliated Foreign Guarantor continues to bear liability as a guarantor for the U.S. Issuer's use of the guarantee. Accordingly, the Affiliated Foreign Guarantor should at least be treated as receiving arm's length compensation for its efforts.
\textsuperscript{184}. Treas. Reg. § 1.482-2(b)(3) (as amended 1983).
\textsuperscript{185}. Id.
be the Affiliated Foreign Guarantor's "out of pocket" costs.\textsuperscript{186} Although the regulations do not specifically refer to guarantees, one of the examples in the regulations implies that arranging for financing is a service.\textsuperscript{187} Citing this example and other authority, the IRS has determined in several Technical Advice Memoranda and a General Counsel Memorandum that guarantees constitute services for purposes of section 482.\textsuperscript{188} In each of the cases under review, the IRS concluded that the guarantor had performed services of enabling the guaranteed debtor to secure financing, to pay a reduced rate of interest, and to forego having to obtain an independent credit rating.\textsuperscript{189}

The IRS most clearly articulated its informal position that guarantees are services in Technical Advice Memorandum 77-12-2289960A,\textsuperscript{190} which involved guarantees of foreign subsidiaries' indebtedness by a domestic U.S. parent corporation. In lieu of a service characterization, the IRS considered—and then rejected—treating the guarantees as a transfer or use of intangible property. The IRS concluded that a literal reading of the intangible property definition in section 1.482-2(d)(3) of the regulations does not encompass guarantees. This interpretation certainly is not obvious; the definition specifically includes "franchises, licenses, contracts and other similar items" that have substantial value "independent of the services of individual persons."\textsuperscript{191} Alternatively, the memorandum acknowledged that guarantees have been viewed as insurance in several authorities involving other issues,\textsuperscript{192} but concluded that "the undertaking of risk is merely a function of the service benefiting the subsidiaries."\textsuperscript{193}

The determination in Technical Advice Memorandum 77-12-2289960A that guarantees are services under the section 482 regulations is poorly reasoned and has been partly (if not completely) undermined by the decision of the Court of Claims in Bank of America v. United States.\textsuperscript{194} In Bank of America, the Court of Claims rejected the government's argument that a bank's assumption of risk upon acceptance of a letter of credit constitutes, or

\textsuperscript{186} See id. § 1.482-2(b)(4), (6) (including as costs wages, travel, materials, utilities, and other overhead charges). In Technical Advice Memorandum 77-12-289960A (Dec. 28, 1977), the IRS determined that "costs or deductions" for this purpose includes only "out of pocket" costs and does not include any "risk factor" with respect to a guarantee, whether theoretical or actual. See also Tech. Adv. Mem. 78-22-005 (Feb. 23, 1978).

\textsuperscript{187} Treas. Reg. § 1.482-2(b)(7)(v) Ex. (9) (as amended 1983).


\textsuperscript{191} Treas. Reg. § 1.482-2(d)(3) (as amended 1983).

\textsuperscript{192} Bowers v. Lawyers Mortgage Co., 285 U.S. 182, 189 (1932); United States v. Home Title Insurance Co., 285 U.S. 191, 195 (1932). These cases held that mortgage loan guarantees constituted insurance contracts for purposes of the capital stock tax then in effect.


\textsuperscript{194} 680 F.2d 142 (Ct. Cl. 1982).
is merely incidental to, the performance of services to the bank issuing the letter. 195

Although a guarantor's liability is only secondary (since the creditor looks primarily to the debtor for repayment of the loan), as compared to the primary liability of an accepting bank under a banker's acceptance, a guarantor typically involves no less of an assumption of financial risk and no more of a performance of services than does a banker's acceptance. 196 These considerations suggest that a guarantee is similar to insurance. Moreover, there is no authority for the conclusion in the memorandum that a guarantee may not be treated as a transfer or use of intangible property. In particular, a guarantor could be viewed as a license of the guarantor's creditworthiness or even a mere contract right, each of which is literally described under the regulations as "intangible" property. 197 In one recent case, the Tax Court implied that a guarantee of a service contract constituted the provision of an intangible asset for purposes of section 482, although this characterization was not directly at issue. 198

Assuming, arguendo, that a guarantee is a service for purposes of section 482, section 1.482-2(b)(7) of the regulations sets forth various rules for determining when an arm's length charge will be deemed to equal the guarantor's costs. These rules are complex and their application in a particular case must be examined carefully. Generally, to avoid a section 482 allocation based on the guarantor's costs, the guarantee would have to be considered an "integral part" of the business activity of the guarantor or the debtor, pursuant to one of four exceptions: (1) the guarantor is engaged in the trade or business of providing guarantees to one or more unrelated parties; 199 (2) the guarantor provides guarantees to the debtor as one of the guarantor's principal activities, which are presumptively defined as excluding any activity the cost of which is equal to or less than twenty-five percent of the total costs or deductions of the guarantor for the taxable year; 200 (3) the guarantees are a "principal element" in the operations of the debtor and the guarantor is "peculiarly capable" of providing guarantees to the debtor—e.g., it makes use of its special skill and reputation, an influential relationship with customers, or its intangible property; 201 or (4) the debtor has received the benefit of a

195. Id. at 149.
196. For a more detailed analysis of Bank of America v. United States, see infra notes 224-27 and accompanying text.
197. The characterizations considered in the text are discussed at greater length in the context of the sourcing rules infra at notes 238-43 and accompanying text.
198. See Hospital Corp. of America v. Commissioner, 81 T.C. 520, 599 (1983). In that case, the Tax Court upheld an allocation of income under I.R.C. section 482 from a foreign subsidiary to its U.S. parent corporation. In describing the various services rendered, and the intangible assets made available to the subsidiary by the parent, the court mentioned the parent's guarantee of a management contract between the subsidiary and a third party in the part of its opinion which dealt with intangible assets.
200. Id. § 1.482-2(b)(7)(ii).
201. Id. § 1.482-2(b)(7)(iii).
"substantial" amount of guarantees from the guarantor during the debtor's taxable year, which is presumptively defined as including cases in which the guarantor's costs or deductions in providing guarantees to the debtor exceed twenty-five percent of the total costs or deductions of the debtor during its taxable year.202

Ordinarily only the first and second exceptions will be applicable. With respect to the third exception, any unrelated guarantor can provide the same service to a debtor provided that it has a sufficient credit rating and the inclination to assume the debtor's credit risk. Therefore, the guarantor normally will not be "peculiarly capable" of providing guarantees to the debtor.203 The fourth exception typically will not apply because the guarantor's expenses ordinarily will not be substantial enough when compared to those of the debtor.

The first exception requires that the guarantor be engaged in a trade or business that provides guarantees. The IRS and U.S. courts have used four principal criteria to determine if a taxpayer is engaged in a trade or business:204 (a) a good faith intention of making a profit or producing income; (b) extensive activity over a substantial period of time;205 (c) activity that has actually begun; and (d) the taxpayer holding himself out "to others as engaged in the selling of goods and services" in connection with the activity.206

The fourth criterion has been particularly controversial. Following Justice Frankfurter's concurrence in Deputy v. DuPont,207 the IRS has consistently taken the position that, in order to be engaged in a trade or business for tax purposes, it is necessary for the taxpayer to hold himself out to others as selling goods and services. This position led to a split among the federal circuit courts in cases involving gambling losses.208 The Supreme Court recently resolved this issue in the gambler's favor in Commissioner v. Groetzinger.209 Although the Court rejected Justice Frankfurter's gloss, it

202. Id. § 1.482-2(b)(7)(iv).
203. The IRS reached this conclusion in General Counsel Memorandum 38,499 (Sept. 19, 1980).
204. See Boyle, What is a Trade or Business?, 39 TAX LAW. 737, 739 (1986).
205. U.S. courts analyzing whether an activity is extensive enough to be a trade or business have focused on whether the activity is continuous and regular. See Commissioner v. Groetzinger, 107 S. Ct. 980 (1987); Stanton v. Commissioner, 399 F.2d 326, 329 (5th Cir. 1968); Wiles v. United States, 312 F.2d 574, 576 (10th Cir. 1962); McDowell v. Ribicoff, 292 F.2d 174, 178 (3d Cir. 1961); Fischer v. Commissioner, 50 T.C. 164, 171 (1968). Some cases indicate that the amount of time spent in the activity is not determinative, but that the degree of personal effort and skill is the key. See, e.g., Fackler v. Commissioner, 133 F.2d 509 (6th Cir. 1943).
206. See Boyle, supra note 204.
207. 308 U.S. 488, 499 (1940).
did not attempt to formulate a substitute “trade or business” definition, and, thus, it is unclear whether the fourth criterion will reemerge in another context.

In order to fall within the first exception to the rule which presumes that an arm’s length charge for services equals the costs of providing such services, an Affiliated Foreign Guarantor would have to render services as a guarantor to unrelated parties. To the extent this exception is based upon Justice Frankfurter’s gloss, it is arguable that Groetzinger has implicitly overturned this requirement. The requirement apparently is not based on a determination that guarantee fees paid to affiliates are so inherently suspect that they should be disregarded even if they are demonstrably equivalent in amount to fees paid in arm’s length transactions. Such a determination would be inconsistent with the basic principles of the section 482 regulations, which generally respect transactions between commonly controlled entities if they are made at arm’s length,210 as well as with cases that have allowed taxpayer corporations to deduct guarantee fees paid to shareholder guarantors.211 Furthermore, the requirement that guarantees be provided to unrelated parties cannot be defended on the ground that a guarantee of an affiliate’s obligation always should be treated as a capital contribution to the affiliate, because the regulations do not go that far.

A critical issue posed by Groetzinger and the section 482 regulations may be whether guarantees that merely enhance an investment should be counted towards the conduct of a business.212 Guarantees issued to third parties to accommodate transactions involving affiliates could properly be attributed to the affiliates and their separate activities, particularly when the Affiliated Foreign Guarantor is not in the business of providing guarantees. This distinction could be viewed as resurrecting in a different (and possibly more supportable) context Justice Frankfurter’s belief that a taxpayer must hold himself out to unrelated persons as selling goods or services in order to be engaged in a trade or business. Accordingly, in order to avoid recharacterization of guarantee fees as dividends, it would be prudent to use an Affiliated Foreign Guarantor that provides similar guarantees to unrelated persons.

212. Compare the cases pertaining to the deductibility of shareholder guarantee fees under section 162(a) discussed supra at notes 155-73 and accompanying text. In Olton Feed Yard, Inc. v. United States, 592 F.2d 272, 275 (5th Cir. 1979), the court held that shareholder guarantee fees were nondeductible because, among other reasons, there was evidence to establish that the shareholders signed the guarantees “in order to protect and enhance their investment in the corporation.”
B. Taxation of Guarantee Fees As Business Profits

When the guarantee fees are "industrial or commercial profits" or "business profits" of an Affiliated Foreign Guarantor within the meaning of a bilateral income tax treaty between the United States and the Affiliated Foreign Guarantor's country of residence, the United States generally is prohibited from taxing the fees unless they are attributable to a permanent establishment of the Affiliated Foreign Guarantor in the United States. In determining whether the guarantee fees are exempt from U.S. federal income taxation under such treaty provisions, U.S. courts would apply the standard of whether such fees are attributable to the conduct of a trade or business by the guarantor. The criteria employed under the Code for determining the existence of a trade or business are described in Part IV.A.2 above. Generally, if an Affiliated Foreign Guarantor is treated as engaged in the trade or business of providing guarantees for purposes of section 482, it will also be treated as so engaged for purposes of applying the treaty provisions.

When the guarantee fees do not qualify as "industrial or commercial profits" or "business profits" of Affiliated Foreign Guarantor under an applicable bilateral income tax treaty, the U.S. government imposes a withholding tax (generally at a thirty percent rate) upon the fees if they are U.S. source income. Inasmuch as there is no statutory rule expressly categorizing the source of guarantee fees, the source of such income turns on which statutory source rule provides the best analogy. In applying the source rules in uncertain cases, two policy considerations have been influential: (a) the rules should not be so flexible as to allow a taxpayer to manipulate tax consequences without affecting the substance of a transaction; and (b) the rules


214. See Di Portanova v. United States, 690 F.2d 169, 177 (Ct. Cl. 1982).

215. I.R.C. section 863(a) provides that income which is not covered by any of the categories described in I.R.C. sections 861(a) and 862(a) is to be allocated or apportioned between U.S. and foreign sources pursuant to regulations adopted by the Treasury Department. I.R.C. § 863(a) (1986). Regulations adopted under section 863(a) have dealt only with natural resources (Treas. Reg. § 1.863-1(b) (1975)), transportation services (Treas. Reg. § 1.863-4 (1975)) and telegraph and cable communication services (Treas. Reg. § 1.863-5 (1975)).


must be consistent enough to provide an adequate degree of certainty in their application to the taxpayer.\textsuperscript{218}

There are at least five possible characterizations of the guarantee fees under the sourcing rules. In each case, Congress has provided a somewhat arbitrary rule for determining the location of the economic activity that generates the specific type of income. These characterizations are: (1) as interest income, sourced to the country of the debtor’s residence;\textsuperscript{219} (2) as compensation for labor or personal services, sourced to the country where the services are performed;\textsuperscript{220} (3) as proceeds from the sale of an intangible asset (e.g., a contractual right of recourse against the guarantor), sourced generally to the seller’s country of residence;\textsuperscript{221} (4) as royalties received for the privilege of using the guarantor's creditworthiness, sourced to the place where this intangible asset is used;\textsuperscript{222} and (5) as insurance underwriting income, sourced (in this case) to the location of either the property insured or the activity in which the insured-against liability may arise.\textsuperscript{223}

The source of the guarantee fees depends on which of the five characterizations is deemed most appropriate. In order to establish that the source of the guarantee fees is outside the United States, it could be argued that the fees were most like proceeds from the sale of an intangible asset outside the United States or income from the insurance of property located outside the United States. If the IRS were so inclined, however, it could argue that the fees were most like interest and, therefore, would qualify as U.S. source income because the payor—U.S. Issuer—has its residence in the United States. It is not immediately apparent what treatment would result from drawing analogies between guarantee fees and service income or royalties. Ordinarily, a Portfolio Debt instrument would be enforced in U.S. courts and, thus, the income from the guarantee fee is arguably generated in the United States where the guarantor’s service is performed or its creditworthiness is used.

None of the reported cases appear to provide controlling precedent for the sourcing issue. The principal authority in this area is \textit{Bank of America v. United States},\textsuperscript{224} which addressed, among other things, the source of commissions earned by a U.S. bank in providing banker’s acceptances for letters

\begin{verbatim}
218. See Green Export Co. v. United States, 284 F.2d 383 (Ct. Cl. 1961) (upholding title passage rule for source of income from sale of exported goods by a Western Hemisphere Trade Corporation).
220. Id. § 861(a)(3). “Personal services” refers to services performed by corporations as well as by individuals. Commissioner v. Hawaiian Philippine Co., 100 F.2d 988, 991 (9th Cir. 1939), cert. denied, 307 U.S. 635 (1939).
221. I.R.C. § 865(a)(1986). Under the Tax Reform Act of 1986, a special rule applies to the sale of goodwill, the proceeds from which are sourced to the country in which the goodwill was generated. Id. § 865(d)(3). These provisions generally apply to transactions by foreign persons after March 18, 1986. Tax Reform Act of 1986, supra note 183, § 1211(c)(2).
223. Id. § 861(a)(7); Treas. Reg. § 1.953-2(a) (1980).
224. 680 F.2d 142 (Ct. Cl. 1982), aff’d 47 A.F.T.R.2d (P-H) 81-652 (1981); see also Helvering v. Stein, 115 F.2d 468 (4th Cir. 1940); Doyle, Dane, Bernbach, Inc. v. Commissioner, 79 T.C.
\end{verbatim}
of credit drawn on foreign banks as payment to U.S. sellers for goods sold to foreign customers. Such letters of credit become negotiable instruments upon acceptance, payable at maturity by the accepting bank. The government argued to both the trial judge and, upon appeal, the Court of Claims that Bank of America's acceptance commissions, which were paid by foreign issuing banks, were for services rendered by Bank of America in the United States and, thus, taxable as U.S. source income. In contrast, Bank of America argued that the banker's acceptances had the effect of substituting Bank of America's credit for that of the foreign issuing bank—thereby making Bank of America primarily liable to the holder of the letter. Accordingly, the commissions should be sourced, like interest, to the country in which the foreign issuing bank resides. Both the trial judge and the appellate panel held for Bank of America.

In Bank of America, the appellate panel based its affirmance on the grounds that the acceptance commissions were most closely analogous to interest. In effect, a banker's acceptance was viewed as converting a purchase money loan by a U.S. seller to its foreign customer into back-to-back loans from the seller to the accepting bank and from the accepting bank to the foreign issuing bank, with the acceptance commissions being analogous to interest payable by the issuing bank on its loan from the accepting bank.

1. As Interest

Although clearly relevant to the issue, Bank of America does not require that an Affiliated Foreign Guarantor's guarantee fees be sourced in the same manner as interest. Guarantee fees are not like interest because a guarantor is not treated as having advanced any funds until required to do so by the creditor upon a default by the debtor. In general, interest is defined under U.S.
income tax law as "compensation for the use or forbearance of money."\textsuperscript{228}

Prior to the time that a guarantor becomes primarily liable for payments of
principal or interest to the creditor (e.g., upon the debtor's default or failure
to satisfy a judgment), the guarantor is not treated as having advanced any
funds to the debtor. Cases involving the deductibility of interest payments by
guarantors have held that until primary liability shifts to the guarantor,\textsuperscript{229}
the guarantor may not deduct such payments as interest because he has not
incurred any indebtedness.\textsuperscript{230} Consequently, guarantee fees, whether paid by
the debtor or otherwise, do not constitute interest income to the guarantor.

The holding in \textit{Bank of America} was based on a determination that a
banker's acceptance places a commercial bank in the same role of financial
intermediary as does an ordinary loan.\textsuperscript{231} A guarantee agreement serves a
different purpose: although a guarantor uses its credit to facilitate a loan, the
creditor primarily looks to the debtor, not the guarantor, for repayment of
the loan.

Despite this distinction, it could still be argued that the guarantee fees
should be sourced like interest because the guarantees are used to facilitate
loans of funds to a U.S. Issuer by the initial purchasers of Portfolio Debt
instruments.\textsuperscript{232} This analysis is particularly appropriate if the Foreign Hold-
ers are treated as conduits for the payment of the fees by the U.S. Issuer.
This view is also supported by the Tax Court's decision in \textit{Doyle, Dane, Bernbach, Inc. v. Commissioner},\textsuperscript{233} which concerned the source of a bad debt
deduction realized by a U.S. parent as a result of making payment upon its
guarantee of a defaulted loan to a foreign affiliate. The court held that the
deduction was allocable to the parent's foreign source income because the
guaranteed loan proceeds were used by the affiliate abroad. This case is nev-
nevertheless distinguishable on the grounds that, upon default by the debtor, the
 guarantor stepped into the debtor's shoes in becoming primarily liable on the
loan.\textsuperscript{234} Since a guarantee fee is paid prior to a default, it does not resemble

\begin{itemize}
\item \textsuperscript{228} Deputy v. DuPont, 308 U.S. 488, 498 (1940).
\item \textsuperscript{229} Even then, a guarantor is allowed a bad debt deduction upon his inability to collect
from the debtor only to the extent that he has actually advanced funds under the guarantee. \textit{See}
\item \textsuperscript{230} Nelson v. Commissioner, 281 F.2d 1 (5th Cir. 1960); Rushing v. Commissioner, 58
\item \textsuperscript{231} 680 F.2d at 148.
\item \textsuperscript{232} This argument can be blunted somewhat by making the guarantees optional. A holder
of guaranteed debt could be periodically given the choice whether to activate the guarantee by
paying guarantee fees for a future period. Although this feature enhances the likelihood that the
fees will be sourced outside the United States, a substantial risk remains that the IRS could
successfully apply the source rule for interest.
\item \textsuperscript{233} 79 T.C. 101 (1982).
\item \textsuperscript{234} \textit{See} Tonopah and Tidewater R.R. v. Commissioner, 39 B.T.A. 1043 (1939) (guarantor's
interest payments after borrower's default sourced to borrower's country of residence on theory
that guarantee was not a substitute for borrower's obligation), \textit{rev'd on other grounds}, 112 F.2d
970 (9th Cir. 1940).
\end{itemize}
interest and the guarantee may be viewed as a transaction which is separate
from the underlying debt.

2. As Service Income

The Court of Claims in *Bank of America* rejected the characterization of
banker's acceptance fees as service income because the dominant aspect of
Bank of America's involvement was that it incurred financial risk, rather than
provided services. Although a similar argument can be made with respect to
guarantee fees, *Bank of America* would not provide direct support for the
argument, because a guarantor only assumes secondary (rather than primary)
liability. Nonetheless, the tasks of an accepting bank are typically more ex-
tensive than those of a guarantor, because the accepting bank must validate
documents presented by the beneficiary of the letter of credit and collect
funds from the issuing bank to cover the amount of the letter upon its pay-
ment. In either case, the transaction involves credit administration and credit
risk.

In applying the sourcing rules in a Technical Advice Memorandum, the
IRS has characterized guarantee fees as compensation for services,\(^235\) and
there is no indication that its position has changed since the *Bank of America*
decision. Ironically, this characterization would not result in a U.S. sourcing
of an Affiliated Foreign Guarantor's guarantee fees as readily as would an
analogy of the guarantee fees to interest. The Affiliated Foreign Guarantor
could argue that its services are provided abroad (where its assets are lo-
cated), particularly if the Foreign Holders agree to waive enforceability of the
guarantee in U.S. courts.

(Sept. 19, 1980).

In Technical Advice Memorandum 77-12-289960A, a parent corporation guaranteed loans
to its foreign subsidiaries by foreign banks. The memorandum cited Howkins v. Commissioner,
49 T.C. 689 (1968), for the general rule that the source of an item of income is where the income
was produced, which it interpreted as the situs of the most incidents of the transaction. The
memorandum assumed without discussion that the proper characterization of the guarantee fee
was compensation for services. Since the risk undertaken by the parent as a result of the services
performed was that of a failure of a foreign subsidiary to meet obligations outside the United
States, the memorandum concluded that the guarantee fees were foreign source income.
Although the guarantee was executed at the parent’s headquarters in the United States, the ser-
vice performed by the parent was more closely linked to events outside the United States.

Technical Advice Memorandum 77-12-289960A conflicts with the reasoning and probably
also the result of Appeals and Review Recommendation 723, I-1 C.B. 113 (1922). In that ruling,
the foreign parent of a U.S. corporation guaranteed all notes and accounts payable of the U.S.
corporation in exchange for a premium calculated as a percent of the sales of the subsidiary's
manufactured products. The source of the premiums had to be determined under then-existing
regulations defining source as "the place of the origin of the income." The ruling held that the
premiums were foreign source income, on the grounds that "no incident of the transaction . . .
occurred in the United States." The foreign parent "had no domicile within the United States
and the business out of which the premiums arose was not situated in the United States." The
ruling evidently did not consider the foreign parent's risk of a failure of its U.S. subsidiary to
meet its guaranteed obligations to be an incident of the transaction.
A guarantor clearly does provide services to the guaranteed party, but those services are only incidental to the guarantor's assumption of risk. In cases involving lenders' fees, such fees generally will be recognized as interest if the amount of the fee bears a relationship to the principal amount and period of the loan.\textsuperscript{236} When the fee is for a service that is incidental to the making of the loan and that ordinarily is obtained from a lender, however, the fee is treated as interest without regard for how it is calculated.\textsuperscript{237} Although a guarantee is not a loan, these principles also should apply to guarantee fees. A guarantee fee should not be treated as compensation for services (e.g., loan brokerage services) if it is based solely on the period of the guarantee and the degree of financial risk assumed. A guarantor's assumption of financial risk typically is no more laden with services than either an ordinary bank loan or a bank's acceptance of a letter of credit.

3. \textit{As Gain from Sale of an Intangible Asset}

A guarantee creates a contractual right that could be viewed as an intangible asset separate from the Affiliated Foreign Guarantor's creditworthiness.\textsuperscript{238} The guarantee fees could thus be analogized to proceeds from the sale of an intangible asset and sourced to the Affiliated Foreign Guarantor's country of residence.\textsuperscript{239} This characterization could be improved if the guarantee were transferable with the Portfolio Debt instrument.

On balance, however, a characterization of the guarantee fees as proceeds from the sale of an intangible asset is not persuasive. The guarantee has value only to the extent that the Affiliated Foreign Guarantor has assets to support the guarantee, and, thus, logically does not exist as a separate asset.\textsuperscript{240} The IRS also has reached the conclusion that a guarantee is not an intangible asset, albeit on different grounds and only in a private ruling.\textsuperscript{241}

\textsuperscript{236} See Noteman v. Welch, 108 F.2d 206 (1st Cir. 1939); Rev. Rul. 72-315, 1972-1 C.B. 50.

\textsuperscript{237} Western Credit Co. v. Commissioner, 38 T.C. 979 (1962), \textit{aff'd per curiam}, 325 F.2d 1022 (9th Cir. 1963); Doehring v. Commissioner, 33 T.C.M. (CCH) 1035 (1974). \textit{Contra} Workersmen's Loan Ass'n v. Commissioner, 142 F.2d 359 (1st Cir. 1944); \textit{but cf.} Wilkerson v. Commissioner, 70 T.C. 240 (1978) and Lay v. Commissioner, 69 T.C. 421 (1977) (charges for specific services not commitment fees).

\textsuperscript{238} Compare Rev. Rul. 81-160, 1981-1 C.B. 312-13 (standby loan commitment fees treated as "similar to the cost of an option" for purposes of denying immediate deduction by payor).

\textsuperscript{239} I.R.C. § 865(a), (d)(3) (1986).

\textsuperscript{240} In cases that have distinguished between a license and a sale of an intangible asset for purpose of the source rules, sale treatment has been conditioned on a transfer of one's entire interest in the asset. See Misbourne Pictures, Ltd. v. Johnson, 189 F.2d 774, 776 (2d Cir. 1951) (movie distribution rights); Rohmer v. Commissioner, 153 F.2d 61, 63 (2d Cir. 1946), \textit{cert. denied}, 328 U.S. 862 (1946) (copyright); Sabatini v. Commissioner, 98 F.2d 753, 755 (2d Cir. 1938) (movie production rights); Rev. Rul. 71-564, 1971-2 C.B. 179 (trade secrets); Rev. Rul. 64-56, 1964-1 (Part 1) C.B. 133, 135 (know-how); Rev. Rul. 60-226, 1960-1 C.B. 26 (copyright).

4. As Royalties

The guarantees also may be viewed as licenses by the U.S. Issuer of the creditworthiness of its Affiliated Foreign Guarantor, which may be particularly appropriate in the case of a guarantee by a commercial bank, the creditworthiness of which is assured by governmental regulation. When an Affiliated Foreign Guarantor's creditworthiness is not governmentally regulated but the guarantee agreements contain financial covenants requiring the Affiliated Foreign Guarantor to maintain a specified net worth or credit rating, the analogy to royalties arguably continues to apply.

A characterization of the guarantee fees as royalties could support either U.S. or foreign sourcing, depending on where the licensed asset is used. Although an Affiliated Foreign Guarantor's assets are located abroad, its guarantee is used to ensure payment from a U.S. Issuer. Nonetheless, the likelihood of foreign sourcing may be improved by providing that the guarantee agreement is enforceable only in a foreign jurisdiction.

It is unclear whether the characterization of guarantee fees as royalties would be respected by the courts. The trial judge in Bank of America rejected the argument that banker's acceptance fees are royalties for the use of the accepting bank's creditworthiness. The judge stated:

"What is truly involved here is not the passive application of the bank's goodwill or creditworthiness to the business of another, but rather, its active participation as a primary obligor in the pursuit of its own business. There is no borrowed or rented use of goodwill here save as an incident to the bank's own independent profit-directed, risk assumption activity."

Whether a similar objection could be raised against characterizing the guarantee fees as royalties would depend in part on whether the Affiliated Foreign Guarantor is engaged in a business of providing guarantees, a possibility which is discussed in Part IV.A.2 above. If not, then the Affiliated Foreign Guarantor's involvement may be passive enough to warrant characterizing the fees as royalties.

Another more essential reason guarantee fees are unlike royalties is that the creditor does not in any ordinary sense use the guarantor's creditworthiness unless and until the debtor defaults. The creditor simply relies on the guarantor to be creditworthy should a default occur. Such reliance may occur whether or not the guarantor is in fact creditworthy; if not, then the guarantee is or has become worthless. Reliance is the only sense in which a

243. In its brief submitted to the trial judge in Bank of America, the government argued that banker's acceptance fees were not rentals or royalties for the privilege of using Bank of America's creditworthiness, because the "intangible resources [in question], rather than being licensed or conveyed to the foreign bank customer for its use, are instead used by plaintiff at the request and on behalf of that customer." Brief for the United States to the Trial Judge at 16, Bank of America v. United States, 47 A.F.T.R.2d (P-H) 81-652 (1981) (No. 402-71). This argument is based on a concept of who uses the intangible property, rather than of whether such use is active or passive. When the guarantor's use is passive, it is difficult to conclude that such use is primary to that of the guaranteed party.
creditor uses the guarantor's creditworthiness, and this sense entails no activity other than a shifting of financial risk. The transaction differs significantly from a license of know-how or managerial expertise because the guarantor retains the risk of loss with respect to the creditor's use of the "licensed" asset.

5. As Insurance Premiums

As applied by analogy to guarantee fees, the source rule for underwriting income provides a strong argument that the guarantee fees should be sourced abroad. Congress enacted this rule in 1976. Although the trial judge in Bank of America referred to this rule as providing additional support for characterizing the banker's acceptance fees in that case as foreign source income, the tax years at issue predated the enactment of the rule. Like banker's acceptances, guarantees are difficult to distinguish from insurance contracts, because their dominant aspect is the assumption of financial risk.

Section 861(a)(7) sources underwriting income to the United States if it is "derived from the insurance of U.S. risks (as defined in section 953(a))." The regulations under section 953(a) distinguish three types of U.S. risks, and it is relatively clear that only two of them—the risk of loss of property located in the United States and of liability arising out of an activity in the United States—are implicated here. Which of these two rules applies by analogy to the guarantee fees will determine whether the fees are U.S. or foreign source income.

In the case of a risk of property loss, the regulations define property as "any interest of an insured in tangible (including real and personal) or intangible property," and specifically include the interest of a mortgagor. Under the regulations, intangible assets held outside of the United States apparently are not located there, because they are not "exclusively" located in the United States.

In the case of a risk of liability arising out of an activity in the United States, the regulations generally treat an activity as carried on in the United

245. 47 A.F.T.R.2d (P-H) at 81-658 to 81-659.
246. Underwriting income is defined elsewhere in the I.R.C. to be "premiums earned on insurance contracts during the taxable year less losses and expenses incurred." I.R.C. § 832(b)(3) (1986).
247. Id. § 861(a)(7).
249. Id. § 1.953-2(b)(1).
250. Treasury Regulation section 1.953-2(b)(2)(i) states, in pertinent part: "Property will not be considered property in the United States if it is neither property which is exclusively located in the United States nor property which is ordinarily located in, but temporarily located outside, the United States." Id. § 1.953-2(b)(2)(i).

The legislative history of the sourcing rule for underwriting income favors foreign sourcing whenever such income cannot be sourced solely to U.S. risks. In its explanation of this rule, the Senate Finance Committee stated: "Underwriting income derived from the insurance of U.S. risks would be income from sources within the United States. All other underwriting income
States if a "substantial amount" of activity is carried on in the United States, based on the location of the insured's assets, the place where personal services are performed, and the place where sales occur. When the risk of loss from an activity carried on in the United States is separable from the risk of loss from an activity carried on outside the United States, an apportioning of the insurance premium with respect to such activities is required.

In order to determine which of these two sourcing rules applies by analogy in the case of guarantee fees, both the "insured" party and the "insured" risk must be identified. Under the interpretation that invokes the risk of loss of property rule, the insured would be a Foreign Holder and the insured risk would be the loss of its Portfolio Debt investment due to a default by the U.S. Issuer. Under the alternative interpretation that applies the risk of liability rule, the insured would be the U.S. Issuer and the insured-against "liability" would be the occurrence of a default by the U.S. Issuer.

Clearly, the Foreign Holder is the "insured" party, not the U.S. Issuer. In the insurance industry, the term "insured" ordinarily "refers to the owner of the property insured, to whom the policy is issued, and by whom the premium is paid, and does not include a person appointed a portion of the proceeds in case of loss." Although for U.S. federal income tax purposes, the U.S. Issuer may be treated as having paid for the guarantee, the guarantee will be issued to the Foreign Holders, and they presumably will have the sole right to vary the terms of the guarantee, as well as the sole entitlement to payments by the Affiliated Foreign Guarantor upon a default by the U.S. Issuer. Moreover, since upon a default by the U.S. Issuer, the Affiliated Foreign Guarantor would be subrogated to the rights of the Foreign Holders and, thus, could enforce payment of their instruments, the guarantee clearly does not protect the U.S. Issuer from the risks of its own default. This argument that the Foreign Holder is the insured party can be made even more

---


The regulations also favor foreign sourcing when the income is from underwriting the risks of an activity (rather than of ownership of property). Treasury Regulation section 1.953-2(c)(3)(i) provides, in pertinent part:

[A] loss or liability will not be considered a loss or liability which could arise from an activity performed in the United States if such loss or liability would result, if at all, from an activity which is neither exclusively carried on in the United States nor ordinarily carried on in, but partly carried on outside, the United States.


For purposes of these source rules, it generally will be easier to divide an activity between United States and foreign locations than to determine the location of passively-held intangible assets.

252. Id. § 1.953-2(c)(3)(i).
253. See id. § 1.953-2(c). Under this regulation, a "liability" arising out of an activity in the United States includes a "loss of an insured which could arise from the occurrence of the event insured against except that such term does not include any loss in connection with property . . . ." Id. § 1.953-2(c)(1).
GUARANTEED PORTFOLIO DEBT

persuasive by structuring the guarantee so that it is effective only upon the acceptance by the Foreign Holder of an irrevocable offer by the Affiliated Foreign Guarantor.

It is less clear what risks an Affiliated Foreign Guarantor's guarantee insures. The regulations imply that a risk of loss will be treated as a risk of property loss if the event of loss occurs "in connection with" property.255 A default by the U.S. Issuer necessarily would be a loss that occurs in connection with the intangible property of the Foreign Holders. In addition, if the guarantee is structured so that it may be enforced only after the Foreign Holder has obtained an unsatisfied judgment against the U.S. Issuer, the guarantee logically should not be treated as insurance against a loss of the U.S. Issuer. Such a guarantee would not protect the U.S. Issuer against a loss resulting to its credit rating or reputation.

On balance, as between these two rules for sourcing insurance risks, the rule pertaining to insurance against the risk of loss of intangible property is the more appropriate one to apply to the Affiliated Foreign Guarantor's fees, especially if the transaction is structured properly.

In many respects, an Affiliated Foreign guarantor's guarantees may closely resemble insurance. According to the IRS, in order to constitute insurance, a contractual arrangement must shift the risk of economic loss from the insured to the insurer. In addition, it must distribute the risk of loss among insureds so as to increase the likelihood that the unanticipated losses of any one insured will be recompensed.256 The guarantees serve to shift the risk of loss of each guaranteed Foreign Holder's investment from the Foreign Holder to the Affiliated Foreign Guarantor.257 The extent to which the risk


Based on these principles, courts have disallowed deductions for insurance premiums paid to affiliated (i.e., "captive") insurance companies that do not write significant amounts of insurance for unrelated parties. Mobil Oil Corp v. United States, 8 Cl. Ct. 555 (1983); Beech Aircraft v. United States, 84-2 U.S. Tax Cas. (CCH) ¶ 9803 (D. Kan. 1984), aff'd, 797 F.2d. 920 (10th Cir. 1986); Stearns-Roger Corp v. United States, 577 F. Supp. 833 (D. Colo. 1984), aff'd, 774 F.2d 414 (10th Cir. 1985); Gulf Oil Corp. v. Commissioner, 89 T.C. No. 70 (1987); Clougherty Packing Co. v. Commissioner, 84 T.C. 948 (1985); Carnation Co. v. Commissioner, 71 T.C. 400 (1978), aff'd, 640 F.2d 1010 (9th Cir. 1981), cert. denied, 454 U.S. 965 (1981); Humana, Inc. and Subsidiaries v. Commissioner, 50 T.C.M. (CCH) 784 (1985). But see Crawford Fitting Co. v. United States, 606 F. Supp. 136 (N.D. Ohio 1985).
257. In order for a Foreign Holder's investment to be treated as Portfolio Debt, the Holder cannot be related to the Affiliated Foreign Guarantor in a way that would cause the Holder to be treated as a ten percent shareholder of the U.S. Issuer. See supra notes 53-56 and accompanying text. Ordinarily, a Foreign Holder will be sufficiently unrelated to the Affiliated Foreign Guarantor so that the guarantee will shift the Foreign Holder's risk of loss to the Affiliated Foreign Guarantor. In a case where an insurance company was owned by thirty-one unrelated shareholders (and their affiliates) and was prohibited from insuring risks of loss of any one shareholder in excess of five percent of the company's total insured risks, the IRS ruled that the shareholders' insurance premiums were deductible. Rev. Rul. 78-338, 1978-2 C.B. 107.
is distributed by the Affiliated Foreign Guarantor among the insureds depends on the number and relative magnitude of the independent risks it assumes. It is irrelevant whether the Affiliated Foreign Guarantor writes guarantees for loans to related parties such as the U.S. Issuer so long as the pool of insured risks is sufficiently diverse. In applying the insurance analogy to guarantees, this comparison of relative risk distribution is a matter of degree and not of kind.

In addition, insurance companies typically are regulated by a governmental agency in a manner intended to insure that their assets (including investment income) will be sufficient to pay their actuarially estimated liabilities. If the Affiliated Foreign Guarantor is not subject to such regulation, provisions in each guarantee contract requiring that the Affiliated Foreign Guarantor maintain a specified net worth also should be sufficient to perfect this part of the insurance analogy.

The fact that the guarantees are used to facilitate loans to a U.S. person should not affect the application of the source rule for underwriting income. In cases where casualty insurance is used to facilitate investment by U.S. persons in property that will be used abroad, the premiums are required to be treated as foreign source income. In addition, assuming each Foreign Holder would be treated as a conduit for the payment of guarantee fees by the U.S. Issuer, there is no conceptual difficulty in the U.S. Issuer paying for the Foreign Holder's insurance even though it is not the owner of the guarantee.

In some instances the guarantees may be treated as insurance contracts for U.S. federal income tax purposes. If so, the fees would not be subject to the thirty percent withholding tax even if they were U.S. source income. This special treatment arises from a 1922 IRS ruling which reasoned that Congress intended the withholding tax to apply only to gross income items having a "high content" of net income, which insurance premiums do not have.\textsuperscript{258} The IRS recently reconfirmed this special exemption.\textsuperscript{259} Although insurance premiums are exempt from the thirty percent withholding tax, they may be subject to an excise tax of up to four percent of the premium amount under section 4371.\textsuperscript{260} In any event, the amount of that tax is substantially less

\textsuperscript{258} I.T. 1359, I-1 C.B. 292 (1922).
\textsuperscript{259} Rev. Rul. 80-222, 1980-2 C.B. 211.
\textsuperscript{260} I.R.C. section 4371 imposes an excise tax of four cents on each dollar (or fractional part thereof) of premium paid to a foreign insurer on a casualty insurance policy or indemnity bond issued "to or for, or in the name of," a defined insured. I.R.C. § 4371(a) (1986). An indemnity bond includes "any bond for the due execution or performance of any . . . obligation and to account for money received by virtue thereof. . . ." Id. § 4372(c). The tax is imposed if the insured is a U.S. corporation and the insured risk is wholly or partly within the United States, but not if the insured is a Foreign Person which is not engaged in a trade or business within the United States. Id. § 4372(d). The regulations provide that "the tax shall be remitted by the person who makes payment of the premium." Treas. Reg. § 46.4374-1(a) (1970).

In determining whether section 4371 imposes an excise tax on the guarantee fees, an important issue must be resolved. No excise tax is payable on the guarantee fees if the Foreign Holders, rather than the U.S. Issuer, are treated as the insureds. See Rev. Rul. 57-257, 1957-1 C.B. 417 (in the case of insurance covering shipments of goods to or from the United States, no excise
than the regular withholding tax. Consequently, the IRS is not likely to argue that the guarantee fees should be sourced like insurance premiums in cases where the guarantees are practically indistinguishable from insurance contracts.

In essence, the source of Affiliated Foreign Guarantor’s guarantee fees fundamentally depends on the resolution of a basic question: whether in this case a court should look to the situs of the economic activity facilitated by the guarantee or, instead, to the statutory sourcing rule that provides the best analogy. It is clear that the economic situs does not determine the source of income when such income falls within one of the categories defined in section 861(a), but the economic situs has played an important role in determinations of the source of income that does not fall within one of the statutory categories. Because the guarantees are provided in connection with the initial offering of Portfolio Debt, the situs of the economic activity facilitated by the guarantees may appear to be the United States, where the proceeds of the offering are placed at risk. On the other hand, if the Affiliated Foreign Guarantor is treated as engaged in the business of providing guarantees, the best analogy is to the sourcing rules for insurance premiums. While the Affiliated Foreign Guarantor’s guarantee provides a service to the U.S. Issuer, like the banker’s acceptances in Bank of America, that service is a transaction in which the dominant aspect is the assumption of financial risk. Bank of America and another case on which it relies,* Howkins v. Commissioner, have opted for the analogy test. Based on that analysis, the arguments for treating the guarantee fees as foreign source income may be persuasive.

CONCLUSION AND POLICY IMPLICATIONS

The use of Portfolio Debt to avoid U.S. federal income taxation of foreign investment in long-term U.S. debt securities is clearly preferable to other

---

263. 49 T.C. 689 (1968).
264. The analogy test is supported by the legislative history of the source rule for insurance underwriting income, I.R.C. section 861(a)(7), in which the IRS was criticized for sourcing insurance premiums to the situs where the "incidents" of the transaction that produced the income occurred, rather than to the situs of the risk insured. If the insurance contract was negotiated and executed in the United States, the IRS treated the premium as U.S. source income regardless of the location of the insured risks. The IRS's position was rejected because such a source rule would be "vulnerable to artificial manipulation by taxpayers." S. Rep. No. 938, 94th Cong., 2d Sess. 257 (1976). Generally, it is more difficult for taxpayers to manipulate the character of the income in question than its economic situs. Thus, the analogy test is more consistent with congressional concern with potential manipulation.
available means of obtaining an exemption, unless the instruments are sold to foreign banks.

The exception to the portfolio interest exemption for loans entered into in the ordinary course of a foreign bank's business has an uncertain scope under current law and must be examined carefully. The basis for the exception was a concern that the exemption should not encourage the diversion of ordinary bank loans from U.S. to foreign banks or bank offices. In this light, it can be seen that whether the exception applies to a particular debt instrument was intended to be determined upon its initial purchase and that subsequent resales of the instrument to Foreign Persons should have no effect on the initial determination. In addition, concern over the diversion abroad of ordinary bank loans must be viewed in the context of the congressional policy that a U.S. Issuer generally should have the benefit of the exemption in its effort to sell its debt securities on foreign markets. To carry out that policy in a workable manner, an instrument that is marketable on foreign securities markets but which closely resembles ordinary bank credit, should qualify for the exemption, notwithstanding a possible literal interpretation of the statute to the contrary.

Portfolio Debt that provides for the payment of contingent interest may be attractive both to foreign investors and to issuers (in the latter case, as a way of avoiding the need for investor indemnities). If the instrument is treated as debt for U.S. federal income tax purposes, interest paid thereon will be exempt from the thirty percent withholding tax. In addition the instrument can be used, in particular, to avoid taxes on real estate investments otherwise imposed under the Foreign Income and Real Property Tax Act of 1980. Although there is very little authoritative guidance concerning when a shared appreciation loan will be treated as debt, the courts can be expected to follow the lead of the few authorities that have recognized nonproportionately-held hybrid loans as debt, particularly when the amount of the contingent interest is sufficiently limited.

In considering whether Congress should curtail the beneficial treatment for contingent interest on Portfolio Debt several points are in order. First, from a policy standpoint, imposing the thirty percent withholding tax on such interest is preferable to denying the issuer an interest deduction. There is no principled way to justify prohibiting the issuer's deduction without treating contingent interest paid to domestic creditors similarly. Second, the fundamental objective of the portfolio interest exemption might be served better if the exemption were limited to fixed interest, because exempting contingent interest may not in fact improve the access of U.S. Issuers to efficient foreign financial markets. Investors would appear to have more difficulty evaluating the competitiveness of contingent interest rates than of fixed interest rates, particularly when contingent interest rates are calculated using differing formulae and are based on differing income streams or appreciation in different assets. The credit risks posed by contingent interest frequently will not be
reflected in commercial credit ratings. Markets for debt with contingent interest rates, therefore, may be less efficient than those for debt with fixed interest rates. Weighing on the other side of this policy issue is the difficulty of defining contingent interest for purposes of withholding a tax exemption. This problem might prove to be too acute to warrant a regulatory intrusion into the functioning of capital markets.

A U.S. Issuer often will need a guarantee from an affiliate in order to increase the marketability of its debt securities at a reasonable interest rate. When the guarantee is provided by an Affiliated Foreign Guarantor, the guarantee fees should not be treated as dividends if the Affiliated Foreign Guarantor is engaged in a business of providing such guarantees and the fees are the equivalent of arm's length amounts. In order to protect against dividend treatment, it is, therefore, desirable for the guarantor to enter into similar guarantees with unrelated parties. Even then, however, the IRS may successfully disallow the issuer's deductions for the guarantee fees unless the U.S. issuer can establish: (a) that the payment of guarantee fees to an affiliate is customary in the U.S. Issuer's industry; and (b) that the Affiliated Foreign Guarantor required compensation as a condition of providing the guarantees. Although these requirements do not have secure footing in background precedent, it is risky to expect that courts will refuse to recognize the authority of the cases that impose these requirements.

There are strong arguments that guarantee fees paid to the Affiliated Foreign Guarantor, either by the U.S. Issuer itself or the Foreign Holders acting as conduits, are exempt from the thirty percent withholding tax on the grounds that such fees are foreign source income. The resolution of the sourcing issue fundamentally depends upon whether the source of guarantee fees is determined by looking to the situs of the economic activity facilitated by the guarantee (presumably, the United States), or rather by applying the most closely analogous statutory source rule. The weight of recent authority supports the latter approach, under which the guarantee fees arguably have a foreign source if the Affiliated Foreign Guarantor is in the business of writing guarantees because the fees are analogous to income from the insurance of intangible property located abroad. Affiliated Foreign Guarantor's guarantees, therefore, may possibly be used as a way to avoid U.S. federal income taxation on payments from the U.S. Issuer to the Affiliated Foreign Guarantor for the use of its credit, even though interest on a loan from the Affiliated Foreign Guarantor to the U.S. Issuer would be subject to the thirty percent withholding tax.

Treating the Affiliated Foreign Guarantor's guarantee fees as foreign source income also is defensible from a policy standpoint. In determining whether the economic activity that generates such income is located in the United States or abroad, the relevant policy considerations are: for what is the fee paid; and where is that consideration transferred, performed, or otherwise effected? The fee is paid in exchange for an assumption of financial risk
that differs significantly from primary liability on a loan and that resembles insurance, particularly when the Foreign Affiliated Guarantor is in the business of providing guarantees. Whenever the comparison to insurance is appropriate, the sourcing rule for underwriting income provides a consistent rule for determining where the consideration for the guarantee fee is effected, i.e., the location of the guaranteed-against risk. In this case, the guaranteed-against risk logically must be the loss of the instrument's value upon a default by the U.S. Issuer. Since the Affiliated Foreign Guarantor would then be subrogated to the rights of the Foreign Holder, the guarantee certainly does not protect the U.S. Issuer from its own default.

If the guarantee were treated as insurance, as discussed above, the regulations would locate the instrument holder's risk of loss abroad. As a policy matter, however, the rationale for that result is somewhat unclear. When the instrument is not used in a U.S. trade or business of the Foreign Holder, the risk of its loss arguably should be located in the country of the Foreign Holder's residence because, as an intangible property right, the instrument has no physical location. Although the fee is paid by a U.S. person and the guarantee facilitates a loan to a U.S. business of that person, these facts do not appear to affect either the characterization or the location of the risk. In some instances the Foreign Holder may be required to enforce the instrument in the United States against the U.S. Issuer before presenting it for payment by the Affiliated Foreign Guarantor, but the guarantee can easily be structured without such a requirement.

Accordingly, if it is abusive to use affiliate guarantees to circumvent the prohibition on ownership of Portfolio Debt by a person related to the issuer, that abuse should not be remedied by an ad hoc sourcing rule. Instead, the real problem may be a failure to tax the Foreign Holder on the guarantee fee. The arguments for treating the guarantee fee as having a foreign source imply that the Foreign Holder is the primary beneficiary of the guarantee. As income with respect to the Foreign Holder's investment, however, the guarantee fees ordinarily would be treated as interest which is categorically eligible for the portfolio interest exemption. Thus, the appropriate legislative response would be to deny the exemption for interest paid to a Affiliated Foreign Guarantor, pursuant to a guarantee made in connection with the initial offering of the instrument. This approach would not, however, impose the full thirty percent withholding tax on the guarantee fees in cases where a bilateral tax treaty between the United States and the Foreign Holder's country of residence reduces the withholding rates on interest.

Whether the use of the guarantees to avoid the thirty percent withholding tax is abusive is another matter. To the extent that such guarantees facilitate an offering of a U.S. Issuer's debt, such guarantees help to effectuate the congressional policy of making foreign financial markets more accessible to U.S. borrowers. If the guarantee fees are arm's length in amount, they are in lieu of interest payments to the Foreign Holders to cover their credit risks,
which payments clearly would be exempt under the statutory scheme. In the face of the rather stringent requirements for deducting guarantee fees paid to affiliates, the fees are probably not an effective way for a foreign parent to withdraw earnings and profits from the U.S. Issuer free of U.S. income taxes.

Of course, it would be consistent with the ineligibility of ten percent shareholder loans for the portfolio interest exemption for Congress to apply the thirty percent withholding tax to an Affiliated Foreign Guarantor’s guarantee fees. In either case, an exemption creates possibilities for avoiding dividend taxation. However, the guarantee fees facilitate loans from unrelated investors that are respected as debt, whereas a ten percent shareholder may choose to make a loan rather than a capital contribution solely for tax reasons. Accordingly, exempting an Affiliated Foreign Guarantor’s guarantee fees from the thirty percent withholding tax is more defensible under the basic principle that tax consequences should turn on true economic differences. In conclusion, while guarantee fees may be a way to avoid the thirty percent withholding tax on payments by a U.S. Issuer to its foreign affiliates, in cases where the Affiliated Foreign Guarantor is in the business of providing financial guarantees, this kind of tax avoidance is not abusive.