2014—Issue 44—"I have been urging Congress to pass anti-inversion legislation, which is the only way to close the door on these transactions entirely," Treasury Secretary Jack Lew recently told reporters. "Now that it is clear that Congress won’t act before the lame-duck session, we are taking initial steps that we believe will make companies think twice before undertaking an inversion to try to avoid U.S. taxes."

Corporate inversions (and the potential erosion of the U.S. tax base) have been the hot topic in the news lately. Some U.S. companies are actively looking at foreign targets to achieve the inverted results, while others have openly said they would not invert. News anchors regularly discuss the strategy. Congressional members and the president have openly called for action to end the exodus from the U.S.

Only recently, September 22, 2014, has the U.S. Treasury stepped in to attempt to curb this abuse. But the Treasury’s approach is prospective in nature (applying to inversions completed after September 22, 2014) without any grandfathering for executed but not yet closed deals. So what about the past inversions? Never fear, the Internal Revenue Service has provided a stop-gap measure to help fill the hole in the U.S. tax base.

The IRS has focused its examinations teams to look for U.S. debt owed to foreign related parties and determine whether the underlying instrument is bona fide debt. While this structure (U.S. entities borrowing from a related foreign party) is common among companies that have technically inverted, it is also a common structure even without a technical inversion. The IRS is reviewing all U.S. debt from foreign related parties. Not surprisingly, the IRS will likely make a determination that the underlying instrument is not debt or that the intercompany loan transaction is a sham or lacks economic substance or business purpose. Get ready: this fight is coming to your doorstep.

**Debt Versus Equity**

The IRS has appeared to settle on a debt versus equity argument in attacking the deductibility of interest in certain intercompany financial transactions. As we all know, numerous facts must be considered when determining if internal transfers of cash are debt versus equity. Not only does the intent of the parties matter, but the objective facts must evidence true debt between the parties.

In assessing whether a given advance between parties is debt or equity, the often discussed IRC Section 385 and its regulatory history are brought into play. Under those rules (and recent case law discussed below), the important factors to be considered when characterizing intercompany financings as debt or equity are:

- The intent of the parties;
- Whether the intent to create a debtor–creditor relationship comports with economic reality;
- Existence of traditional documentation, approvals/authority, journal entries and cash transfers consistent with debt and the intent of the transaction;
- Commercial reasonableness of debt–to–equity ratios;
- The names given to the documents in the transaction and disclosures concerning the nature of the transaction;
- The presence or absence of a fixed maturity date on the security;
The source of the purported debt service payments and ability to make the debt service payments;  
the existence of traditional creditor rights;  
the extent of the purported lender’s participation in management of the purported borrower;  
commercially reasonable subordination to senior lenders;  
the purported borrower’s ability to obtain loans from outside lending institutions; and  
the interest rate charged on the intercompany debt compared to third party debt.

Two recent cases highlight the IRS’s approach (although, so far not so successfully) to attack these foreign intercompany lending transactions. In NA General Partnership & Subsidiaries v. Commissioner, T.C. Memo 2012–172, the Service attacked loans made to a U.S. entity from a foreign related entity (Scottish Power, via NA General Partnership & Subsidiaries). The IRS solely relied upon a debt versus equity attack to seek to have the U.S. interest expense deductions recharacterized as dividends and non-deductible in the U.S. The court applied traditional tests to determine if a given security is debt or equity and found for the taxpayer. The material terms of the security were more debt—like and the conduct of the parties (accounting entries, public and securities filings, etc., all treated the security as debt) was consistent with the intention to create debt between the parties.

In PepsiCo Puerto Rico, Inc. v. Commissioner T.C. Memo. 2012–269, the IRS was again arguing in court whether a given financial transaction created debt or equity in the U.S. The taxpayer intended to create a security that would be treated as equity in the U.S. and debt by the related holder in the Netherlands. The IRS sought to treat the U.S. equity side of the transaction as a loan. The court, recognizing the intent of the parties and the economic realities of the transaction as the primary factors in deciding whether a given transaction should be characterized as debt or equity, reviewed the traditional debt versus equity factors (those mentioned above). Again, the IRS lost the case, as the intent of the parties and economic realities suggested the U.S. side of the transaction was equity and not debt.

In addition to arguing traditional debt versus equity considerations, the IRS also asserted the general substance over form doctrine to attack the transaction. The court seemed to blend the substance over form argument with the general review of the traditional debt versus equity analysis to decide the case. Ultimately, the court held that the intent of the parties was to create a hybrid instrument that would be treated as equity in the U.S. and debt in the Netherlands. The conduct of the parties was consistent with the intended treatment, but perhaps the most significant piece of evidence was expert testimony that traditional lenders would not have made “loans” on the terms embedded in the U.S. side of the security. In addition, the company entered into the security to obtain financing to enter new markets, knowing that significant investment would be needed — capital in nature. The intent of the parties and economic realities helped the taxpayer prove that the U.S. security was equity.

What is clear from the cases is that the IRS is not afraid to attack a complicated financial transaction and assert that the parties’ intent or conduct is not consistent with economic reality. Even in light of two lost cases, the IRS is continuing its fight. It has made similar allegations against Tyco (see below), and we know that audits along these lines are continuing in the field with IRS exam teams. What is also clear is that a well—prepared case by the taxpayer is the path to victory. Assessing the above factors and documenting findings are imperial to the taxpayer’s case.

Proving Existence of Debt Is Step One — Cash Interest Payments Is Step Two
Congress also imposed limitations on deductions of interest on debt owed to related parties. Generally, IRC Section 267(a) requires a U.S. taxpayer to use the cash method of accounting for interest expense deductions on debt owed to a foreign related party. Accrual is not enough. There must be a “true” interest payment to secure the interest deduction. The IRS will look to see if any cash is actually leaving the U.S. company to service the interest on intercompany loans. Not only must the interest payments actually be made, but the borrowing entity must have the ability to make the interest (and principal) payments from its own sources. The IRS recently addressed the requirements that the debtor generate its own sources of income/cash to make debt service payments. In CCA 201334037 (August 23, 2013), the IRS Office of Chief Counsel essentially opined that round—trip payments of cash cannot be relied upon as interest payments and that additional borrowings from the lender to pay interest are not “interest payments” for U.S. tax purposes, but rather just more borrowing and deferred interest payments.

Payments of interest must be made by cash flows generated by the borrowing entity. Payments made from additional financing provided from the foreign lender will not be considered payments of interest, rather assumption of greater debt. The IRS will look to see if any additional funding is earmarked to pay interest, if additional funding is made in close proximity of interest payments, or if additional funding is made in the same amount of interest payments.
The IRS can also assert sham transaction, business purposes, substance over form, and economic substance for reasons of denying intercompany interest deductions. The existence of a strong business purpose for issuing intercompany debt will greatly help in defending intercompany interest deductions. Taxpayers can defend themselves from these doctrines by vigorous documentation of the factors mentioned above and completing an in-depth analysis of the economic realities surrounding the financial transaction in question.

**What Companies Are Being Targeted?**
Taxing authorities are increasingly scrutinizing intercompany financing arrangements between U.S. subsidiaries and foreign (or related) companies. According to a Form 8–K filed earlier this year, Tyco is currently challenging a $1–billion tax bill assessed by the IRS based on whether underlying financial transactions were loans or equity. Tyco has filed many responses in Tax Court, and according to public announcements and disclosures, it plans to vigorously defend its positions, stating that its intercompany loans all have debt characteristics, such as fixed maturities and regular interest payments. Ingersoll–Rand’s 8–K discloses that the IRS has challenged the company’s intercompany debt issued in connections with a 2001 headquarters move to Bermuda.

**What Can Your Company Do to Prepare?**
Before a company can defend a position, it must review its intercompany arrangements and documentation. The following should be reviewed in relation to intercompany instruments:

**Intent of the Parties and Economic Reality**: Understand the history around the intercompany financing arrangements. Document the business purpose for the intercompany transaction. The entity may have needed the advance to make an acquisition, or the entity may not have been able to secure a third–party loan. Analyze and understand the economic reality of the intercompany arrangement.

**Loan Documents**: Review and get copies of the loan documents for typical terms and covenants you would see in commercial debt. The interest rates, payment terms, maturity dates, covenants, etc., should be consistent with commercial debt terms and require that the debtors and creditors behave in an arm’s–length manner.

**Accounting**: Dig through the journal entries to find and document interest accruals and the corresponding reductions to cash interest expense payables to make sure the accrued interest is actually being paid. Also, find and document journal entries relating to the payment of principal. Once you have copied the relevant journal entries, verify that amounts and timing are in line with the terms of the loan documents.

**Cash Flows**: If you have determined that the interest accrued was actually paid to the related party, the next step is to determine the source of funding for the payments. Trace the movement of cash flows surrounding intercompany payments. Look to see if there were additional intercompany advances within the same time frame or in the same amount of “interest” payments. Was the interest paid with a PIK note? The historical overall cash flows of the company should also be reviewed as a “sanity check” of the reasonableness of the entity’s ability to service the debt.

**Alvarez & Marsal Taxand Says:**
The stakes are high for both the multinational corporations and the IRS with regards to potential adjustments to intercompany interest deductions. If your company has undergone an inversion or is just a multinational with intercompany financing arrangement in place, you need to make sure you can defend your positions upon audit. Companies need to understand their facts and make sure they tell a coherent story. The IRS has challenged interest deductions taken as far back as 1997, and the amount of data that will need to be reviewed can be overwhelming. Bringing in a forensic expert who is skilled in reviewing journal entries and cash movements can help your company marshal facts and present a detailed analysis when the IRS comes knocking on your door.

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Substance, Form and Ambiguity: Will the IRS Challenge Your Transaction by Asserting the Economic Substance Doctrine? [7]

It remains hard to say whether the IRS will challenge your transaction by asserting the economic substance doctrine, because the IRS said in December it won’t be issuing anticipated further guidance or an angel list. Therefore, make sure to structure your deals carefully, documenting their business purposes.

Dealing With the New IRS IDR Directive [8]

The Information Document Request (IDR) process that we have all followed in a typical IRS audit in the past has recently undergone some substantial changes that will require an evaluation of your current process for dealing with such requests and managing the overall audit process.