Recent Tax Court Memorandum Decision of Interest Re Cross-Border, Related-Party Debt Structures

Use of related-party Debt when a non-US corporation buys a US business is an important tool in international tax planning. The debt vs. equity issue is of importance both in respect of (i) the extent to which a non-US parent may be subject to US tax, and (ii) whether the US subsidiary may claim deductions for interest payments.

Last month, the Tax Court held that an advance made by Scottish Power plc, a Scottish power company (Scottish Power), to NA General Partnership & Subsidiaries, a Nevada partnership and indirect subsidiary of Scottish Power that elected to be treated as a corporation for US tax purposes (NAGP), in connection with the acquisition of PacifiCorp & Subsidiaries, an Oregon utility company (PacifiCorp), was properly characterized as a loan for US tax purposes, entitling NAGP to interest deductions.

This case is a memorandum decision, and therefore does not serve as binding precedent. It does, however, show the Tax Court's approach to determining whether an advance made by a parent corporation to its subsidiary is debt or equity for US tax purposes. The decision indicates that the Tax Court will continue to apply the traditional debt vs. equity factors established by case law to the taxpayer's particular facts and circumstances in making its determination in the related party context.

The Tax Court analyzed an 11-factor test for determining debt vs. equity that was set forth by the Ninth Circuit Court of Appeals in *Hardman v. United States*, 827 F.2d 1409 (9th Cir. 1987). These factors are as follows:

1. Document labels;
2. Fixed maturity date;
3. Source of repayment;
4. Right to enforce payment of principal and interest;
5. Participating in management;
6. Status equal to or inferior to regular corporate creditors;
7. Parties' intent;
8. Inadequate capitalization;
9. Identity of interest between creditor and sole shareholder;
10. Payment of interest; and
11. Ability to obtain loans from outside lending institutions.

Of particular significance in the Tax Court's analysis of these 11 factors is the Court's declaration that several of the debt vs. equity factors are not relevant in the related-party context.

- For example, the sixth factor deals with whether the instrument being analyzed is subordinated to creditors. The notes that were the subject of the Tax Court case were not initially subordinated, but NAGP was not restricted from taking on more senior debt, and did in fact later subordinate the notes to a credit facility. The Tax Court noted that, in the related-party context, certain creditor protections are not as important because Scottish Power's control of NAGP gave Scottish Power the ability to prevent NAGP from taking on any additional debt, including senior debt.

- In analyzing the seventh factor, the intent of the parties, the Tax Court concluded that while a failure to insist on interest payments may indicate an intent to create an equity relationship, strict insistence on payment when due is not expected and is not consistent with business realities in the related-party context. The fact that (i) NAGP had delayed the payment of interest due on the notes, (ii) Scottish Power made short-term loans to NAGP to fund the payment of interest, and (iii) Scottish Power subsequently capitalized a portion of the notes, did not prevent the Tax Court from finding an intent among the parties to form a debtor-creditor relationship.

- Finally, in analyzing the eleventh factor, which looks to whether the debtor could obtain loans from third-party sources on comparable terms, the Tax Court considered the IRS's claim that NAGP could not have obtained third-party financing on the same terms as under the loans from Scottish Power. The Tax Court held that the proper analysis of this factor does not require that the debtor be able to get financing on identical terms as in the underlying instrument, recognizing that a related-party lender may offer more flexible terms than could be obtained from an unrelated lender.

The Tax Court's decision is helpful to taxpayers, not only in affirming the debt vs. equity factor analysis that has been well established in prior case law, but in particular for the proposition that, in the related-party context, certain factors may be less relevant to the analysis. It remains clear, however, that a taxpayer relying on debt for tax treatment must be able to establish a sufficient factual basis for debt characterization by preparing contemporaneous documentation to establish the parties' intent, as well as the debtor's creditworthiness.

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