TAX PROCEDURE: SOMETIMES SUBSTANCE OVER FORM MEANS EQUITY IS DEBT

Posted on **November 21, 2017** by **James R. Malone, Jr.**

The notion that substance controls over form does some heavy lifting in the tax world. Among other things, it separates real losses from fake ones; it tells us when debt is really equity; and, as the Ninth Circuit ruled earlier this month, sometimes it can tell us that equity is really debt. *Hewlett-Packard Co. v. Comm'r*, Nos. 14-73047 & 14-73048, 2017 U.S. App. LEXIS 22536 (9th Cir. Nov. 9, 2017).

In *Hewlett-Packard*, the taxpayer purchased preferred stock issued by a Dutch company that invested in notes which featured certain interest payments that were contingent upon future events. *Hewlett-Packard*, 2017 U.S. App. LEXIS 22536 at *4-*5. But this was no ordinary investment: It was "tax borscht. . . cooked up in the 1990s by AIG Financial Products." *Id.* at *4.

The primary ingredient was a quirk in Dutch tax law: Contingent interest payments that depended upon future events were immediately taxable in the Netherlands but were not immediately taxable in the United States. *Id.* This quirk meant HP would receive foreign tax credits based on the taxes associated with the contingent interest payments, which it could then deploy to offset taxes on other income. But there was a catch: Under section 902(a) of the Internal Revenue Code, HP was only entitled to credits if it owned ten percent or more of the voting stock of the Dutch company, known as Foppingadreef Investments or FOP. *See* I.R.C. § 902(a).

FOP's common stock was owned by ABN, a Dutch bank that would be selling it the contingent interest notes that would generate the credits. *Id.* at *5. Since FOP's sole function was to buy the notes, it would never have any creditors. *Id.* Thus, when HP acquired the preferred shares, it effectively acquired a fixed stream of payments and of tax credits. *Id.*

HP purchased FOP's preferred stock from AIG in 1996 for $200 million. At the same time, it acquired a put option from ABN, which allowed HP to sell ABN the preferred shares in either 2003 or 2007. FOP then served up foreign tax credits from 1997 through 2003, when HP exercised its put option and sold the preferred shares back to ABN at a loss. *Id.* at *5-*6.

The IRS did not swallow the borscht. Instead, it disallowed the credits associated with FOP, and it disallowed the loss that HP claimed on its disposition of the preferred shares. HP petitioned the Tax Court, where it lost.

The Court of Appeals commenced its analysis with a brief rumination on the standard of review. While Ninth Circuit precedent treated a debt v. equity determination as a fact issue subject to the clearly erroneous standard, the court acknowledged a split among the circuits on the issue. After noting the divided authority, the Ninth Circuit commented that the nature of the determination whether a particular financial instrument represented debt or equity warranted significant deference to the trier of fact because of the complexity of the issue and the multiple factors that are weighed in the determination. *Id.* at *7-*8.

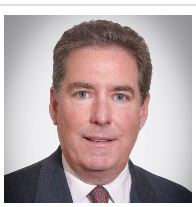
After briefly musing on the role intent played in determining whether an obligation was debt or equity, the Court of Appeals then turned to the serious business of affirming the Tax Court. Specifically, it noted that the Tax Court had properly determined that the arrangement had a fixed maturity date because FOP would stop producing foreign tax credits in 2003, a fact that HP knew from the outset. *Id.* at *11-*12. The Ninth Circuit also noted that the Tax Court finding that HP enjoyed a creditor's rights was supported by the record since the dividend stream was highly predictable. *Id.* at *12. The court cited three factors:

- HP was entitled to semiannual payments that equaled 97% of the after-tax base interest that FOP received on the notes;
- HP had contractual remedies against ABN if the interest was not paid on the notes; and
- The entire transaction "was arranged such that FOP's earnings were all but predetermined."

As a consequence, "HP's investment earned it a limited return for a fixed period, and the Tax Court made no error in concluding that the investment was debt." *Id.*

The Ninth Circuit then validated the Tax Court's decision to consider the put option that HP purchased from ABN as part of a single, integrated transaction, citing, among other things, the fact that FOP was obligated to take all necessary and appropriate actions to implement the put under the terms of a shareholder's agreement. *Id.*

The Ninth Circuit's opinion in *Hewlett-Packard* is a textbook application of a substance over form analysis in the context of determining whether a financial instrument is debt or equity, but with a twist: Usually, the taxpayer is trying to characterize an equity interest as debt so that interest can be deducted. Here, HP sought to characterize its investment as equity. In either case, the labels don't matter. No one buys a can of soup for the can.



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http://www.postschell.com/attorneys/james-r-malone

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