Part III - Administrative, Procedural, and Miscellaneous

Intercompany Financing Using Guaranteed Payments

Notice 2004-31

The Internal Revenue Service and Treasury Department are aware of a type of transaction, described below, in which a corporation claims inappropriate deductions for payments made through a partnership. This notice alerts taxpayers and their representatives that these transactions are tax avoidance transactions and identifies these transactions, and substantially similar transactions, as listed transactions for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and §§ 301.6111-2(b)(2) and 301.6112-1(b)(2) of the Procedure and Administration Regulations. This notice also alerts parties involved with these transactions of certain responsibilities that may arise from their involvement with these transactions.

FACTS

The transactions described in this notice use a partnership in an attempt to convert interest payments that would not be currently deductible under § 163(j) into deductible payments. One such transaction involves the formation of a partnership (PRS) by a domestic corporation (DC2) and a foreign person (FP). FP is the common foreign parent, or an affiliate of the common foreign parent, of the affiliated group (within the meaning of § 1504(a), but without regard to § 1504(b)(3)) to which DC2 and a second domestic corporation (DC1) belong. In the transaction, FP and DC2 contribute property to PRS. PRS contributes a substantial portion of the contributed assets to DC1 in exchange for preferred stock. Under the partnership agreement, FP is entitled to (1) a substantial guaranteed payment for the use of capital, and (2) a disproportionately small share (relative to FP's capital contribution) of both the gross dividend income from DC1 and PRS's deductions for guaranteed payments. Under the partnership agreement, DC2 is entitled to a disproportionately large share (relative to DC2's capital contribution) of both the gross dividend income from DC1 and PRS's deductions for guaranteed payments.

Each year, DC1 pays substantial dividend income to PRS on the preferred stock. PRS allocates to DC2 the dividend income as well as PRS's deductions for guaranteed payments. If the guaranteed payment right to FP were instead debt of DC1 to FP, then interest on such indebtedness would be subject to the limitations imposed by § 163(j).

DC2 claims, based on its affiliation with DC1 (the corporation paying the dividend), a 100 percent dividends received deduction under § 243(a)(3) for its distributive share of dividend income. In addition, DC2 deducts its distributive share of the guaranteed payment. Consequently, DC2 claims a substantial net deduction.

In one variation of this transaction, PRS has an obligation to make guaranteed payments to a partner (X) unrelated to FP and its affiliates and PRS's obligation to make guaranteed payments to X is assured by a related party, such as FP, in a manner similar to a disqualified guarantee as defined in § 163(j)(6)(D), so as to avoid treatment as disqualified interest under § 163(j)(3)(B).

DISCUSSION

The Service intends to challenge the purported tax benefits of these transactions on various grounds. The Service may treat FP as directly acquiring an equity investment in DC1, because FP and DC2 lack the requisite non-tax business purpose to form a valid partnership. See ASA Investerings Partnership. v. Commissioner, T.C. Memo 1998-305, aff'd, 201 F.3d 505 (D.C. Cir. 2000), cert. denied, 531 U.S. 871 (2000); Andantech, L.L.C. v. Commissioner, T.C. Memo 2002-97, aff'd, 331 F.3d 972 (D.C. Cir. 2003). The Service also may challenge the transaction under the partnership anti-abuse rule contained in § 1.701-2. In addition, the Service may challenge the purported tax results on the grounds that the allocations under the partnership agreement lack substantial economic effect (as discussed below) and are not in accordance with the partners' interests in the partnership as required by § 704(b).

In particular cases, the Service may argue that the allocations lack economic effect. Alternatively, where the allocations have economic effect, or are deemed to have economic effect, the Service may assert that such economic effect is not substantial. The economic effect of allocations is not substantial if, at the time the allocations became part of the partnership agreement, (i) the after-tax economic consequences to one partner might, in present value terms, have been enhanced compared to such consequences if the allocations had not been contained in the partnership agreement, and (ii) there was a strong likelihood that the after-tax economic consequences of no partner would, in present value terms, have been substantially diminished compared to such consequences if the allocations were not contained in the partnership agreement.

In the example described above, under the partnership agreement, DC2 is entitled to a disproportionately large share of both the gross dividend income from DC1 and PRS's deductions for guaranteed payments. To the extent the dividend income and guaranteed payment deduction offset, this allocation will not alter the economic returns of DC2 and FP compared to their returns if such items were allocated to FP. Neither DC2 nor FP suffers a detriment to its after-tax economic consequences as a result of the special allocations. However, the allocations in the agreement will improve the after-tax consequences to DC2 because a larger share of partnership items will allow DC2 to claim a larger net deduction attributable to the dividends received deduction. The Service may argue, based on this analysis or on other relevant analyses, that the economic effect of the allocations in the agreement is not substantial and that the allocations are not in accordance with the partners' interests in the partnership.

Transactions that are the same as, or substantially similar to, the transactions described in this notice are identified as "listed transactions" for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2) and 301.6112-1(b)(2) effective April 1, 2004, the date this notice was released to the public.

Independent of their classification as “listed transactions,” transactions that are the same as, or substantially similar to, the transactions described in this notice may already be subject to the disclosure requirements of § 6011 (§ 1.6011-4), the tax shelter registration requirements of § 6111 (§§ 301.6111-1T, 301.6111-2), or the list maintenance requirements of § 6112 (§ 301.6112-1). Persons who are required to register these tax shelters under § 6111 but have failed to do so may be subject to the penalty under § 6707(a). Persons who are required to maintain lists of investors under § 6112 but have failed to do so (or who fail to provide those lists when requested by the Service) may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on parties involved in these transactions or substantially similar transactions, including the accuracy-related penalty under § 6662.

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