New York State Department of Taxation and Finance
Taxpayer Services Division
Technical Services Bureau

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Corporation Tax
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STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C930519A

On May 19, 1993, a Petition for Advisory Opinion was received from Indopco, Inc., c/o Unilever United States, Inc. Tax Department, 800 Sylvan Ave., Englewood Cliffs, New Jersey 07632.

The issues raised by Petitioner, Indopco Inc., for purposes of Article 9-A of the Tax Law are (1) whether thin capitalization is tested on a book basis or a fair market value basis, and (2) assuming that thin capitalization is determined on a fair market value basis and that the taxpayer is not thinly capitalized, whether interest paid on a loan used to make a distribution to Petitioner's sole shareholder is deductible when computing entire net income under Article 9-A even though the distribution exceeded shareholder equity.

In 1990, Petitioner, a Delaware corporation, made two distributions to its parent, Indopco Holding, Inc., which is also a Delaware corporation. The first dividend of $400 million occurred in January, 1990. Although this dividend was made with borrowed funds, Petitioner had retained earnings in excess of $400 million recorded on its books at the time of the dividend. Nothing with regard to this first dividend is at issue.

The second dividend of $700 million was made in April, 1990. Immediately preceding the distribution, the balance of Petitioner's book capital account was less than $50 million, whereas the net fair market value of Petitioner's assets were independently appraised at approximately $1.6 billion. In order to make the distribution, Petitioner borrowed $700 million at an arm's length, variable market rate of interest from Unilever Capital Corporation, a brother/sister corporation of Petitioner. This second dividend was made in accordance with the laws of Delaware. Delaware's law permits the declaration of a dividend from a revaluation surplus(ie., the marking up of assets from their book values to their fair market values before declaring a dividend). In order to pay a dividend based on a revaluation surplus, a corporation may borrow against the fair market value of its assets. This borrowing did not impair Petitioner's solvency. Following the borrowing, Petitioner continued to meet its obligations to creditors on a timely basis.

Section 510 of the Business Corporation Law provides, in pertinent part:

> (a) A corporation may declare and pay dividends or make other distributions in cash or its bonds or its property, including the shares or bonds of other corporations, on its outstanding shares, except when currently the corporation is insolvent or would thereby be made insolvent, or when the declaration, payment or distribution would be contrary to any restrictions contained in the certificate of incorporation.

> (b) Dividends may be declared or paid and other distributions may be made out of surplus only, so that the net assets of the corporation remaining after such declaration, payment or distribution shall at least equal the amount of its stated capital ....
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> (c) When any dividend is paid or any other distribution is made, in whole or in part, from sources other than earned surplus, it shall be accompanied by a written notice (1) disclosing the amounts by which such dividend or distribution affects stated capital, capital surplus and earned surplus, or (2) if such amounts are not determinable at the time of such notice, disclosing the approximate effect of such dividend or distribution upon stated capital, capital surplus and earned surplus and stating that such amounts are not yet determinable.

For purposes of the Business Corporation Law, surplus is defined in section 102(a)(13) as the excess of net assets over stated capital. Surplus consists of earned surplus and capital surplus. Earned surplus is defined in section 102(a)(6) as that portion of the surplus that represents the net earnings, gains or profits, after deduction of all losses, that have not been distributed to the shareholders as dividends, or transferred to stated capital or capital surplus, or applied to other purposes permitted by law. Unrealized appreciation of assets is not included in earned surplus. Capital surplus is defined in section 102(a)(2) as the surplus other than earned surplus. Net assets is defined in section 102(a)(9) as the amount by which the total assets exceed the total liabilities. Stated capital and surplus are not liabilities. Stated capital is defined in section 102(a)(12) as the sum of (A) the par value of all shares with par value that have been issued, (B) the amount of the consideration received for all shares without par value that have been issued, except such part of the consideration therefor as may have been allocated to surplus in a manner permitted by law, and (C) such amounts not included in clauses (A) and (B) as have been transferred to stated capital, whether upon the distribution of shares or otherwise, minus all reductions from such sums as have been effected in a manner permitted by law.

Accordingly, under the Business Corporation Law Petitioner was not prohibited from making the $700 million distribution to its parent. However, it does not necessarily follow that such distribution will be treated as a dividend for franchise tax purposes under Article 9-A of the Tax Law.

Section 209.1 of the Tax Law provides that the franchise tax is imposed on a business corporation for the privilege of exercising its corporate franchise, or of doing business, or of employing capital, or of owning or leasing property in New York State in a corporate or organized capacity, or of maintaining an office in New York State, for all or any part of each of its fiscal or calendar years and such tax is measured by the corporations's entire net income base (or other applicable basis).

Section 208.9 of the Tax Law defines entire net income as total net income from all sources which shall be presumably the same as the entire taxable income which the taxpayer is required to report to the United States Treasury Department and is adjusted as required by sections 208.9 and 210.3 of the Tax Law. Section 3-2.2(c) of the Business Corporation Franchise Tax Regulations

provides that where a corporation participates in the filing of a consolidated return for Federal income tax purposes, but files a separate return for New York franchise tax purposes, Federal taxable income is computed as if the corporation had computed its Federal taxable income on a separate basis for Federal income tax purposes. (See also: Kenneth T. Zemsky, Adv Op Comm T&F, January 31, 1992, TSB-A-92(2)C and Leonard Koval, CPA, Adv Op St Tax Comm, March 16, 1984, TSB-A-84(2)C.)

Section 1-2.1 of the Business Corporation Franchise Tax Regulations provides that "Any term used in [Article 9-A] shall, unless a different meaning is clearly required, presumably have the same meaning as when used in a comparable context in ... the laws of the United States relating to Federal income taxes and the Federal tax regulations promulgated thereunder .... "

Accordingly, it must be determined how the issues raised herein would have been treated for Federal income tax purposes if Petitioner had filed a separate Federal income tax return for taxable year 1990.

With respect to Petitioner's first question, thin capitalization is an objective determination made upon the evaluation of a corporation's debt-to-equity ratio. An excessive ratio, one in which debt far exceeds equity, typically indicates thin capitalization. Because the nature and requirements of different businesses impose different standards of determining an acceptable debt-to-equity ratio, there are no "hard and fast rules" for what constitutes an excessive debt-to-equity ratio. However, "[i]n computing the ratio of debt to equity, the use of market values for the assets (including goodwill), rather than their cost or book value, is well established ..." (Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, 5th Ed.; Warren, Gorham &-Lamont (1987) at ¶4.04, p.4-24). See also, Liflins Corp. v U.S., 390 F.2d 965 (Ct. Cl., 1968) citing, with approval, Goldstein, "Corporate Indebtedness to Shareholders," 16 Tax L. Rev. 1, 19 (1960): "[t]he prevailing view seems to be that assets are to be taken at fair market value rather than at book value when valuing the equity interest in order to compute the [debt-to-equity] ratio."

The use of fair market asset values rather than book values to determine a permissible debt-to-equity ratio was embraced by the Second Circuit in Kraft Foods Company v Commissioner of Internal Revenue, 232 F.2d 118, 127 (2d Cir., 1956):

> The Commissioner argues that since the transaction in question produced a disproportionate ratio of debt to capital it would not constitute genuine indebtedness as against third party creditors, and therefore it should not be treated as indebtedness against the Government for purposes of determining taxpayer's income tax liability. ... However... it is apparent from the record that no disproportionate ratio of debt to capital resulted from the issuance of the debentures. **We think it obvious that in the determination of debt-to-equity ratios, real values rather than artificial par and book values should be applied.** See B.M.C. Mfg. Corp., 1952 [11 TCM 376], Cleveland Adolph Mayer Realty Corp., 1946, 6 TC 730, rev'd on other grounds 160 F2d 1012 (6th Cir., 1947). (emphasis added, footnote omitted).

Accordingly, the controlling law indicates that for Federal income tax purposes, a determination of thin capitalization is tested on the fair market value rather than the book value of a taxpayer's assets.

It appears that the thin capitalization issue is only one factor in determining whether a transaction is treated as debt or treated as equity. In John W. and Marie B. Dillin v United States, 433 F2d 1097, 1099 (1970), the Fifth Circuit stated:

> The problem of determining, in the context of the Internal Revenue Code and modern business relations, what constitutes an equity interest and what constitutes a debt interest has been a matter of continuing concern for the courts ....
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> In Montclair, Inc. v. Commissioner of Internal Revenue, 5 Cir. 1963, 318 F.2d 38, at page 40, we attempted to list some of the guiding considerations in deciding debt-equity cases:
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> "(1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a maturity date; (3) the source of the payments; (4) the right to enforce the payment of principal and interest; (5) participation in management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) 'thin' or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) payment of interest only out of 'dividend' money; (11) the ability of the corporation to obtain loans from outside lending institutions."
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> In applying these factors, each case must be decided on its own unique fact situation and no single test is controlling. Berkowitz v. United States, 5 Cir. 1969, 411 F.2d 818; Harlan, et al. v. United States, 5 Cir. 1969, 409 F.2d 904; Tomlinson v. 1661 Corporation, 5 Cir. 1967, 377 F.2d 291.

Accordingly, the determination of whether a transaction results in debt or equity, is a factual question. As shown in Dillin, supra, several factors must be considered, however "each case must be decided on its own unique fact situation and no single test is controlling".

With respect to Petitioner's second question, the determination of whether the interest Petitioner paid to Unilever Capital Corporation, a brother/sister corporation of Petitioner, on funds borrowed to pay a dividend to Petitioner's parent, Indopco Holding, Inc., is deductible under section 163 of the Internal Revenue Code is not easily assertained.

Section 163(a) of the Internal Revenue Code provides that there shall be allowed as a deduction interest paid or accrued within the taxable year on indebtedness. The United States Court of Appeals for the Eighth Circuit has stated:

> A debt is "that which is due from one person to another, whether money, goods or services; that which one person is bound to pay to another, or perform for his benefit." Webster's New International Dictionary .... The term "indebtedness" as used in the Revenue Act implies an unconditional obligation to pay. Any definition more flexible would only encourage subterfuge and deception. (Gilman v Commissioner 53 F 2d 47, 50 (8th Cir 1931)).

In Badi Zohoury and Wilma 3. Zohoury v Commissioner, 46 TCM 1521, Dec. 40,498(M), TC Memo 1983-597, the Tax Court provides that:

> [w]here ... the transaction giving rise to the claimed indebtedness is between family members, the evidence presented to establish such a debt must be closely scrutinized. See Woodward v United States 208 F2d 893 (8th Cir 1953); Wales v Commissioner [Dec 35,077(M)], TC Memo 1978-125, affd without published opinion (9th Cir 1980). The relevant Court decisions dealing with intra-family loans have identified several factors that have been given weight in determining whether a purported loan was in fact a bona fide debt. These factors include:
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> (1) Whether a specific rate of interest is charged to the taxpayer for the use of the money;
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> (2) whether there is a specific date for repayment;
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> (3) whether there is a written instrument evidencing the debt;
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> (4) whether there is a legitimate purpose for obtaining the loan;
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> (5) whether the taxpayer intended to repay the debt;
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> (6) whether the relative receiving the payments on the loan was impecunious; and
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> (7) whether the loan has economic substance.

In Georgia Cedar Corp., 55 TCM 853, Dec. 44,777(M), TC Memo 1988-213, a corporation was disallowed interest deductions taken for payments made on a promissory not because the transactions involving the note laced economic substance. The note was passed among two wholly owned subsidiaries, including the taxpayer, and their parent corporation. The corporate taxpayer failed to prove that its purchase of the note was not part of a preconceived plan to relieve cash flow problems. No genuine indebtedness existed, and negotiations for the note did not take place at arm's length.

In an Internal Revenue Service letter ruling, it was held that a transfer of funds between two commonly controlled foreign shipping subsidiaries, that was characterized as a loan, resulted in a constructive dividend from the transferor to the parent and in a contribution of capital by the parent to the transferee. Although the loan bore interest, was a bona fide debt in the opinion of the transferee's creditors, and was repaid, no debt was actually created for other than the purpose of

obtaining a tax benefit. Also, no purpose for the transfer other than a desire by the distributing corporation to invest surplus funds was demonstrated, and such investment rationale was deemed to be too generalized to be a recognizable business purpose. In addition, the enhanced investment in the transferee was a benefit to the common shareholder that could not be considered as merely incidental and effect the negation of the treatment of the transaction as a constructive dividend and simultaneous contribution of capital to the recipient subsidiary. (IRS Letter Ruling 8207010, November 10, 1981.)

Herein, the purpose of the loan to Petitioner was to enable Petitioner to pay a dividend to its parent. However, for purposes of section 316 of the Internal Revenue Code the distribution Petitioner made to its parent might not be treated as a dividend.

Section 1.316-1(a) of the Treasury Regulations states:

> (1) The term "dividend" for the purpose of subtitle A of the [Internal Revenue] Code ... comprises any distribution of property as defined in section 317 [of the Internal Revenue Code] in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of either--
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> > (i) Earnings and profits accumulated since February 28, 1913,
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> > or
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> > (ii) Earnings and profits of the taxable year computed without regard to the amount of the earnings and profits (whether of such year or accumulated since February 28, 1913) at the time the distribution was made.
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> The earning and profits of the taxable year shall be computed as of the close of such year, without diminution by reason of any distributions made during the taxable year. For the purpose of determining whether a distribution constitutes a dividend, it is unnecessary to ascertain the amount of the earnings and profits accumulated since February 28, 1913, if the earnings and profits of the taxable year are equal to or in excess of the total amount of the distributions made within such year.
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> (2) Where a corporation distributes property to its shareholders on or after June 22, 1954, the amount of the distribution which is a dividend to them may not exceed the earnings and profits of the distributing corporation.

Accordingly, pursuant to section 1.316-1(a) of the Treasury Regulations, the portion of the dividend that Petitioner paid to its parent that exceeded earnings and profits is not treated as a dividend but rather as a return of capital. Therefore, it must be determined whether the loan from Petitioner's brother/sister corporation to make such distribution is a bona fide debt having a legitimate purpose and economic substance. Such determination is a factual matter that must be decided before a determination can be made as to whether interest paid on loans used to make a distribution to Petitioner's sole shareholder where the distribution exceeded shareholder equity is deductible for Federal income tax purposes and, in turn, deductible for Article 9-A purposes.

A question of fact is not susceptible of determination in an Advisory Opinion. An Advisory Opinion merely sets forth the applicability of pertinent statutory and regulatory provisions to "a specified set of facts." Tax Law, §171.Twenty-fourth; 20 NYCRR 2376.1(a). Inasmuch as the question presented here arises within the context of an audit, the necessary factual determination will be made within such context, in accordance with the principles outlined above.

DATED: December 1, 1993

s/PAUL B. COBURN
Deputy Director
Taxpayer Services Division

NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.