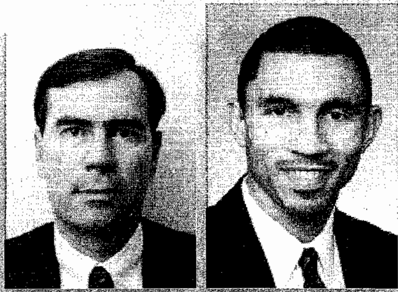
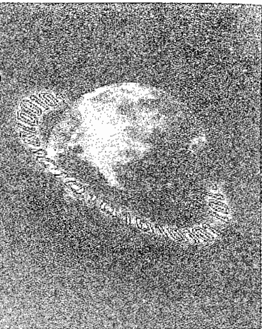


Financing International Operations



By L.G. Chip Harter and L. Richard Winchester

Interest Prepayments on Cross-Border Financings

Taxpayers might consider making unscheduled payments of interest or original issue discount (OID) on cross-border financings for a variety of reasons. For example, a U.S. borrower might wish to prepay interest to a foreign lender in anticipation of an impending increase in the withholding tax rate under an amendment to a tax treaty or an adverse change in withholding tax regulations. Alternatively, a U.S. subsidiary might wish to make an unscheduled payment of accrued OID under a zero coupon term borrowing from a foreign affiliate to enable it to deduct the OID under Code Sec. 163(e)(3). In either case, it is possible that the payment of what the taxpayer thinks is interest or OID would be characterized as a payment of principal under Treasury regulations providing ordering rules for payments under debt instruments. Some or all of a purported prepayment of interest could be characterized as a reduction of the outstanding principal balance, with the result that interest would thereafter continue to accrue currently on the reduced principal balance. The taxpayer's goal of moving interest payments into the current tax period could thereby be frustrated. A purported payment of OID accrued on a zero coupon borrowing could be treated as a partial redemption of the debt instrument under the *pro rata* prepayment regulations of Reg. §1.1275-2(f). This treatment could result in much of the payment being characterized as a return of principal. If the borrowing is from a related foreign person, the U.S. borrower might therefore be able to deduct only a portion of the payment under Code Sec. 163(e)(3). Whether these results will apply in a given case will depend on the terms of the debt instrument and how the unscheduled payments are structured.

In a cross-border financing, the characterization of a payment as principal or interest has consequences beyond those that apply in the purely domestic context. Interest payments to foreign persons can be subject to U.S. withholding tax under Code Sec. 871 or 881, whereas principal payments are not. In addition, when a U.S. taxpayer borrows from a related foreign person, Code Secs. 267(f) and 163(e)(3) put the borrower on a cash basis method of accounting for deducting interest and OID. The taxpayer is not entitled to a deduction for such interest or OID until the interest or OID is considered paid under the ordering rules characterizing payments under debt instruments.

This column will illustrate the operation of these payment ordering rules by considering three examples of unscheduled payments: (1) interest prepayments under an open account advance; (2) prepayments of qualified stated interest under a term loan; and (3) an unscheduled payment of accrued OID under a zero coupon debt instrument. These examples illustrate that surprising differences in the treatment of prepayments can result from differences in the terms of the debt.

Prepayments of Interest on an Open Account Advance

Assume that a U.S. corporation has borrowed $1,000,000 from a foreign affiliate in the form of an open account advance. Interest accrues annually on the unpaid balance at eight percent, but there is no specified payment schedule for interest or principal. Anticipating an increase in the rate of withholding tax on future payments of interest because of an impending change in treaty or regulation, the U.S. taxpayer would like to pay not only all interest that has accrued through December 31, 2001, on that date, but also to pay an additional $160,000 and treat that additional pay-

L.G. Chip Harter is a principal at PricewaterhouseCoopers, Washington, D.C.

L. Richard Winchester is a manager at PricewaterhouseCoopers, Washington, D.C.

Table 1

Year	Beginning Principal Balance	Interest Accrued	Ending Principal Balance
2002	$840,000	$67,200	$907,200
2003	$907,200	$72,576	$979,776

ment as a prepayment of interest accruing over the next two years on a continuing principal balance of $1,000,000. As an accrual basis taxpayer, the corporation could not accelerate its income tax deduction by prepaying the interest, but it hopes to shift $160,000 in payments of interest from future years to the current year to benefit from the current low withholding tax rate. Assume further that the taxpayer then makes no payments of interest at the end of years 2002 and 2003 and pays $1,000,000 at the end of 2003 to retire the borrowing. The taxpayer would like to treat the entire $1,000,000 payment in 2003 as a payment of principal not subject to withholding tax.

Taxpayers might consider making unscheduled payments of interest or original issue discount (OID) on cross-border financings for a variety of reasons.

The payment ordering rules for debt instruments would instead treat the entire $160,000 payment at the end of 2001 as a reduction of the principal balance of the loan, and treat a portion of the $1,000,000 paid at the end of 2003 as a payment of accrued interest subject to withholding tax. Reg. §1.446-2(c) provides that interest other than qualified stated interest accrues under rules "similar to those in regulations under sections 1272 and 1275 for the accrual of original issue discount." Reg. §1.446-2(e) provides that "each payment under a loan ... is treated as a payment of interest *to the extent of the accrued and unpaid interest* determined under paragraphs (b) and (c) of this section as of the date the payment becomes due." Reg. §1.1275-2(a)(1) further provides the general rule that "each payment under a debt instrument is treated first as a payment of OID to the extent of the OID that has accrued as of the date the payment is due and has not been allocated to prior payments, and second as a payment of principal. Thus, no portion of any payment is treated as prepaid interest."

In our example, none of the interest is qualified stated interest (QSI), because the interest is not unconditionally payable on fixed, periodic dates over the term of the debt.[1] Although the cross-references between the Reg. §1.446-2 rules for interest and the Reg. §1.1275-2 rules for OID do not mesh as smoothly as one might hope, it is nonetheless reasonably clear that the entire $160,000 prepayment would not be treated as interest because it has not yet accrued. The payment would instead be treated as a reduction of the outstanding principal balance, and new interest would continue to accrue at the eight-percent rate on the reduced principal balance over the next two years as illustrated in Table 1.

Under this accounting, $840,000 of the $1,000,000 payment at the end of 2003 would be treated as a return of principal and $139,776 (*i.e.,* $67,200 + $72,576) would be treated as a payment of accrued interest. The $20,224 difference between the $1,000,000 paid and the ending balance would, at best, be treated as a deductible redemption premium under Reg. §1.163-7(c), or, perhaps more likely, as a payment not due under the debt and therefore as a dividend. The payment treated as interest in 2003 would be subject to withholding tax at the then current rate, and the borrower's deduction for interest for 2002 would be deferred into 2003 under Reg. §1.267(a)-3(b), because the interest accruing in 2002 would be paid only in 2003.

Prepayments of Scheduled, Qualified Stated Interest

Would the answer be different if the loan had been structured as a term loan with periodic stated interest payments? Curiously enough, it might. If the open account advance instead had been documented as a term loan of $1,000,000 due December 31, 2003, and requiring payments of $80,000 of interest on December 31 of each year, the $80,000 annual interest payments would qualify as QSI.[2] The payment ordering rule of Reg. §1.1275-2(a) that prevents any portion of a payment from being treated as prepaid interest specifically states that it does not apply to payments of QSI. There is not a corresponding exception in the payment ordering rules of Reg. §1.446-2(e), but at least one prominent treatise states that such an exception "can be inferred."[3] Assuming that is the case, there would appear to be nothing to characterize the prepayment of the last two qualified stated interest payments in our example as anything other than prepayments of interest. As an accrual basis

©2001 CCH INCORPORATED

taxpayer, the borrower would not be able to accelerate its income tax deduction for the interest by prepayment, but the prepayments would be effective for withholding tax purposes. The prepayments would qualify for the favorable withholding tax rate in effect on the date of the prepayments, and none of the $1,000,000 paid at the end of 2003 would be characterized as a payment of interest subject to withholding tax at the new rates. Although the appropriateness of inferring an exception to the Reg. §1.446-2(e) ordering rule for QSI is well beyond the scope of this column, if such an exception does exist, a minor difference in the form of the related-party debt could produce a major difference in withholding tax treatment of interest prepayments.[4]

Table 2

Year	Adj. Issue Price (Start of Year)	Adj. Issue Price OID	Accrued OID Payment	Adj. Issue Price (Year End)	Accrued OID (Year end)
1	$508,349.29	$35,584.45	$0.00	$543,933.74	$35,584.45
2	$543,933.74	$38,075.36	$0.00	$582,009.10	$73,659.81
3	$582,009.10	$40,740.64	$0.00	$622,749.74	$114,400.45
4	$622,749.74	$43,592.48	$0.00	$666,342.22	$157,992.93
5	$666,342.22	$46,643.96	$0.00	$712,986.18	$204,636.89
6	$712,986.18	$49,909.03	$0.00	$762,895.21	$254,545.92
7	$762,895.21	$53,402.66	$0.00	$816,297.88	$307,948.58
8	$816,297.88	$57,140.85	$0.00	$873,438.73	$365,089.44
9	$873,438.73	$61,140.71	$0.00	$934,579.44	$426,230.15
10	$934,579.44	$65,420.56	$0.00	$1,000,000.00	$491,650.71

Unscheduled Payment of Accrued OID on a Zero Coupon Borrowing

A different, and somewhat surprising, result can arise in the case of an unscheduled payment of accrued OID on a zero coupon borrowing. Suppose, for example, that a U.S. subsidiary borrows $508,349.29 from its foreign parent, repayable in a lump sum of $1,000,000 at the end of 10 years. The borrowing would be treated as a zero coupon, OID obligation with a yield to maturity of seven percent, compounded annually. OID would accrue as shown in Table 2.

Under Code Sec. 163(e)(3), the U.S. subsidiary would not be entitled to any deduction for the accrued OID until the year the OID is paid. Suppose further that the U.S. subsidiary made an unscheduled payment of $300,000 at the end of year seven, hoping to have the payment treated as a payment of accrued OID and to obtain an income tax deduction for that amount. The amount of the payment is less than the $307,948.59 balance of OID accrued as of that date. What would be the result?

As discussed above, the general rule of Reg. §1.1275-2(a)(1) is that "each payment under a debt instrument is treated first as a payment of OID to the extent of the OID that has accrued as of the date the payment is due ... " If this general rule were applicable, the entire amount of the U.S. subsidiary's payment would be treated as a payment of accrued OID, allowing the subsidiary to deduct the entire amount under Code Sec. 163(e)(3). An important exception to the general rule of Reg. §1.1275-2(a)(1) applies, however, in the case of a *pro rata* prepayment described in Reg. §1.1275-2(f)(2). A partial prepayment will fall within this exception if it satisfies three conditions. First, the payment must be made prior to the time the debt instrument matures.[5] Second, the payment must not be pursuant to the payment schedule of the debt instrument, including a payment schedule determined on the basis of contingencies that are significantly more likely than not to occur.[6] Third, the payment must result in a substantially *pro rata* reduction of each payment remaining to be paid on the debt instrument.[7] Whenever an OID debt instrument provides for no payment other than the payment due at maturity, any unscheduled partial prepayment will produce a *pro rata* reduction in the single payment due at maturity, causing the partial prepayment to fall within the *pro rata* prepayment exception.

When an issuer makes such an unscheduled *pro rata* prepayment, the original debt instrument is treated as two separate instruments: one that is being retired, and one that will remain outstanding. Furthermore, the adjusted issue price, the holder's basis and the accrued but unpaid OID on the original debt instru-

continued on page 60

Anti-Deferral

continued from page 10

ENDNOTES

corpus in himself (or certain other powers), such person will be treated as the owner of the trust.

[24] *Id.* at 176, n.17.

[25] *B. Madorin*, 84 TC 667, Dec. 42,023 (1985).

[26] *Id.* at 671; *Cf. also American Nurseryman Publishing Co.*, 75 TC 271, Dec. 37,398 (1980); *H.A. Gregg Est.*, 69 TC 468, Dec. 34,784 (1977).

[27] *E.g., W.C. Swanson, Jr.*, CA-8, 75-2 USTC ¶9528, 518 F2d 59; *J.D. Ringwalt*, CA-8, 77-1 USTC ¶9218, 549 F2d 89; *Sun First National Bank of Orlando*, CtCls, 79-2 USTC ¶9634, 607 F2d 1347; *Terriberry*, MD Fla., 74-2 USTC ¶13,002, rev'd, CA-8, 75-2 USTC ¶13,088, 517 F2d 286. *Contra H. Rothstein*, CA-2, 84-1 USTC ¶9505, 735 F2d 704; *Cf. also W&W Fertilizer*, CtCls, 76-1 USTC ¶9130, 527 F2d 621.

[28] Pursuant to Code Sec. 7701(a)(31), a foreign trust need not be formed under the laws of another jurisdiction. Rather, a trust will be foreign if U.S. persons do not have the authority to control all substantial decisions of the trust.

[29] Code Sec. 552(a).

[30] Code Sec. 554(a)(1).

[31] Code Sec. 267(a) would disallow any loss realized from a sale between an individual and a corporation more than 50 percent of the value of which is owned, directly or indirectly, by or for such individual. Code Sec. 267(b)(2) provides that if the grantor is not related to the beneficiary, however, he would not be considered to own any shares owned by the trust.

International Operations

continued from page 13

ment are allocated between the two fictional instruments. The allocation is based on the portion of the original instrument that is treated as retired by the prepayment.[8] This allocation will depend in part on the terms of the debt. If, under the terms of the borrowing in our example, the prepayment of $300,000 at the end of year seven reduced the borrower's obligation at the end of year 10 by only $300,000, the prepayment would be treated as the retirement of three-tenths of the outstanding debt, rather than simply as a prepayment of $300,000 of accrued OID. The adjusted issue price of the separate redeemed debt instrument would be three-tenths of the adjusted issue price of the original debt as of the end of year seven or $244,889.36. The price paid to redeem the separate debt instrument would be the $300,000 amount of the unscheduled prepayment, of which $92,384.57 would represent accrued OID (*i.e.*, three-tenths of the $307,948.58 accrued OID on the original instrument). The resulting redemption premium of $55,110.64 (*i.e.*, $300,000—$244,889.36) would be deductible by the borrower under Reg. §1.163-7(c), but generally should not be interest subject to withholding tax to the foreign parent.[9]

What is interesting to note is that in the absence of the *pro rata* prepayment exception, the entire $300,000 payment would be treated as a payment of accrued OID under Reg. §1.1275-2(a)(1), enabling the U.S. subsidiary to deduct the full amount of the $300,000 payment under Code Sec, 163(e)(3). As a result of the adoption of the *pro rata* prepayment rule, $152,507.79 of the $300,000 payment is treated as a payment of principal, leaving only $147,495.21 deductible by the U.S. subsidiary. The form in which the related party financing is cast has again had a material impact on the tax treatment.

ENDNOTES

[1] Reg. §1.1273-1(c).

[2] *Id.*

[3] DAVID C. GARLOCK, FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS (2000), §6.04[A], n. 59.

[4] It should be noted that any attempt to take advantage of the potentially more favorable regime for debt with QSI by re-documenting the debt to provide for QSI then prepaying the QSI could be subject to challenge. Such a re-documentation of existing debt might be characterized as a reissuance of the debt at a discount. In this case, the attempted prepayment of QSI would be treated instead as a reduction of the amount borrowed, resulting in OID.

[5] Reg. §1.1275-2(f)(2).

[6] Reg. §1.1275-2(f)(2)(i).

[7] Reg. §1.1275-2(f)(2)(ii).

[8] Reg. §1.1275-2(f)(1).

[9] If, under the terms of the note, the $300,000 prepayment at the end of year seven reduced the borrower's payment obligation at the end of year 10 by $367,512.90 (the future value at seven percent of the $300,000 at the end of year 10), a correspondingly larger portion of the total debt would be treated as redeemed and no redemption premium would result.

Foreign Investment

continued from page 20

ENDNOTES

[22] 66 Fed. Reg. 12445 (Feb. 27, 2001).

[23] *Id.*

[24] Reg. § 1.894-1(d)(1).

[25] Proposed Reg. §1.894-1(d)(2)(ii)(A).

[26] *Id.*

[27] *Supra* note 22.

[28] Proposed Reg. §1.894-1(d)(2)(ii)(B)(1)(iii).

[29] *Id.*

[30] Proposed Reg. §1.894-1(d)(2)(ii)(B)(1)(i).

[31] Proposed Reg. §1.894-1(d)(2)(ii)(B)(1)(ii).

[32] *Supra* note 28.

[33] Proposed Reg. §1.894-1(d)(2)(ii)(B)(1)(iv).

[34] *Id.*

[35] Proposed Reg. §1.894-1(d)(2)(ii)(C).

[36] Proposed Reg. §1.894-1(d)(2)(ii)(B)(3).

[37] *Id.; see also* Example 2 at Proposed Reg. §1.894-1(d)(2)(iii).

[38] *Id.* This rule is referred to herein as "the related person anti-abuse rule."

[39] 66 Fed. Reg. 14352 (Mar. 12, 2000).

[40] Revenue Reconciliation Act of 1993 (P.L. 103-66), §13238, 107 Stat. 312, 508-509 (1993).

[41] H.R. REP. NO. 103-111 (1993), reprinted in 1993 U.S.C.C.A.N. 378, 960.

[42] Reg. §1.881-3 and Reg. §1.1441-3(g).

[43] Reg. §1.7701(l)-3.

[44] Proposed Reg. §1.7701(l)-2, 61 Fed. Reg. 68175 (Dec. 27, 1996).

[45] *See, e.g.,* Thomas R. May, *U.S. Treasury Attacks Domestic Reverse Hybrid Planning*, 22 TAX NOTES INTL. 1945 (2001) (referred to herein as "Treasury Attacks"); Anthony C. Infanti, *The Proposed Domestic Reverse Hybrid Entity Regulations: Can The Treasury Department Override Treaties?* 30 TAX MGMT. INTL. J. 307 (2001) (referred to herein as "Treaty Overrides").

[46] *Id.* May.

[47] Code Sec. 7701(l) explicitly grants authority to the IRS to collapse a multiple-party financing transaction where such recharacterization is appropriate "to prevent the avoidance of any tax imposed by this subtitle." *See* May, *supra* note 45.

[48] May, *supra* note 45. *See, e.g.,* Article 24(3)