Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:CLE:PIT:TL-N-6074-00
MAYost

date:

to: John Niederst, Team Manager
[redacted] Audit

from: Associate Area Counsel, LM:MCT:CLE:PIT

---

subject: [redacted] - Dividend Received Deduction
[redacted] Audit
U.I.L. No. 246A.01-00

This is in response to your memorandum dated October 11, 2000, which forwarded a proposed adjustment on Form 886A involving the dividend received deduction claimed by [redacted] from [redacted]. This memorandum is subject to 10-day post review by our National Office and, therefore, is subject to modification.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE

Whether I.R.C. § 246A applies to reduce the dividend received deductions claimed by [redacted] with respect to dividends from [redacted] in the tax years [redacted] through [redacted].

CONCLUSION

I.R.C. § 246A does not apply to reduce the dividend received deductions claimed by [redacted] with respect to dividends from [redacted].

FACTS

On [redacted], [redacted] was formed as a holding company to acquire certain wholly-owned [redacted] subsidiaries of [redacted]. [redacted]'s shareholders were [redacted][1], which owned [redacted]% of the voting stock, [redacted], which owned [redacted]% of the voting stock, and [redacted]'s management, which owned a small amount of non-voting stock. The financial structure of [redacted] consisted of equity capital of $ [redacted] from [redacted] and $[redacted] from [redacted]. [redacted] also borrowed $[redacted] in the form of a senior bank term loan from a syndicate led by [redacted]. The loan proceeds were used by [redacted] to acquire [redacted]'s [redacted] subsidiaries. The banking syndicate also provided a $[redacted] revolving credit line for working capital.

After the leveraged buyout, [redacted] owned the [redacted] and [redacted] groups formerly part of [redacted]'s corporate family.[2] Throughout [redacted]'s existence, [redacted] was its [redacted] customer. [redacted]'s subsidiaries provided the [redacted] service and [redacted] to [redacted] of [redacted]'s [redacted] plants. At least one of the [redacted] agreements with [redacted] was a cost plus arrangement. In a Form 10K filing, [redacted] disclosed that it was a party to a [redacted] agreement with a subsidiary of [redacted] for [redacted] of raw materials. The agreement required [redacted] to pay, at a minimum, [redacted]'s annual fixed costs related to the agreement, including [redacted] costs, depreciation of owned [redacted], [redacted] fees and other administrative costs. The fixed costs amounted to about $[redacted] per year. In addition to [redacted], [redacted] also provided [redacted] services to other domestic [redacted] producers. It also [redacted] and other freight for numerous other customers.

Over the years, [redacted] was able to pay down its long-term

---

[1] [redacted] was a limited partnership set up by the [redacted], an unrelated investment banking firm. The [redacted] reportedly has participated in a number of leveraged buyouts.

[2] At the time of the sale of the subsidiaries, [redacted] was actively seeking cash to [redacted].

debt. In [redacted], [redacted] and [redacted], [redacted] also paid dividends to its shareholders.[3] The dividends were financed, in part, through additional corporate loans. [redacted] reported dividends from [redacted] of $[redacted] in [redacted], $[redacted] in [redacted] and $[redacted] in [redacted]. A [redacted]% dividend received deduction was claimed each year.

LAW AND ANALYSIS

In the Form 886A under review, Exam proposes to apply I.R.C. § 246A to limit the dividend received deduction claimed by [redacted] with respect to the dividends received from [redacted] during the years [redacted] through [redacted]. This section provides, in the case of any dividend on "debt-financed portfolio stock", that the dividend received deduction shall be reduced by a certain percentage related to the amount of debt incurred to purchase the stock.

Under I.R.C. § 246A(c)(1), the term "debt-financed portfolio stock" means any portfolio stock if at some time during a stated base period there was a portfolio indebtedness with respect to such stock. "Portfolio stock" includes any stock of a corporation unless the taxpayer owns at least 50% (20% if 50% is owned by 5 or fewer corporate shareholders[4]) of the total voting power and value of the stock. I.R.C. § 246A(c)(2). Finally, I.R.C. § 246A(d)(3)(A) provides that the term "portfolio indebtedness" means any indebtedness directly attributable to investment in the portfolio stock.

The legislative history of I.R.C. § 246A reflects that Congress was concerned that the conjunction of the dividends received deduction and the interest deduction could result in the avoidance of substantial corporate-level taxes on corporate earnings. Rev. Rul. 88-66, 1988-2 C.B. 34 (citing H.R. Rep. No. 432, 98th Cong., 2d Sess., pt. 2, 1180-81 (1984)). Therefore, I.R.C. § 246A was enacted to reduce the dividends received deduction where indebtedness is directly attributable to investment in portfolio stock. The legislative history further indicates that the "directly attributable" requirement is satisfied if there is a direct relationship between the debt and an investment in stock. Thus, where indebtedness is clearly

---

[3] Certain loan covenants in the original acquisition indebtedness were subsequently amended to permit the payment of dividends.

[4] Even though [redacted] has more than a 20% interest in [redacted], this exception does not apply, since [redacted] was a partnership and not a corporate shareholder.

incurred for the purpose of acquiring portfolio stock or otherwise is directly traceable to the acquisition, the indebtedness constitutes portfolio indebtedness. Id. Portfolio indebtedness can also arise where portfolio stock is acquired by a corporation using its equity capital, and later the corporation borrows money using the portfolio stock as collateral, if the corporation could reasonably have been expected to sell the portfolio stock rather than incur the indebtedness. Rev. Rul. 88-68 (citing H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 813 (1984), 1984-3 (Vol.2) C.B. 1, 67.)

In our case, [redacted] acquired its stock interest in [redacted] in exchange for a capital contribution of $[redacted]. The facts do not reflect, however, that [redacted] incurred any indebtedness to make this capital contribution. Further, there is no indication that any indebtedness directly attributable to [redacted]'s investment in [redacted]'s stock, either to acquire or carry such stock, was outstanding at any time during the requisite base period with respect to the [redacted] dividends for which the [redacted]% dividend received deductions at issue were claimed.[5] As a result, the [redacted] stock in the hands of [redacted] does not appear to be debt-financed portfolio stock. I.R.C. 246A(c)(1).

Exam contends that [redacted] was inadequately capitalized upon its formation. Based upon statistics gleaned from several employee buyout sites on the Internet, Exam points out that leverage buyouts normally entail a minimum 20.0% capital investment, whereas [redacted]'s equity capital represented only [redacted]% of the total financing involved in the leveraged buyout of [redacted]'s [redacted] subsidiaries. Exam also cites the fact that [redacted] and other forms of [redacted] transportation are capital intensive and are not the type of businesses which survive thin capitalization. Exam questions, therefore, whether part or even all of the initial acquisition indebtedness to the [redacted] syndicate should be recharacterized as debt incurred by [redacted] to secure its equity position in [redacted].

Regardless of whether [redacted] was thinly capitalized upon its formation, the initial acquisition indebtedness owed to the [redacted] syndicate was directly incurred by [redacted] itself to fund its purchase of [redacted]'s [redacted] subsidiaries. There is no evidence that [redacted] nor any other shareholder was liable,

---

[5] Pursuant to I.R.C. § 246A(d)(4), the base period is the shorter of the (1) the period beginning on the ex-dividend date for the most recent previous dividend on the stock and ending on the day before the ex-dividend date for the dividend involved, or (2) the one-year period ending on the day before the ex-dividend date for the dividend involved.

either primarily or secondarily, on the bank financing.[6] And, for this reason, it can not be reasonably argued that all or part of such debt should be allocable to [redacted] for purposes of I.R.C. § 246A.

Further, since the indebtedness at issue is a direct obligation of [redacted], a high debt-to-equity ratio stemming from the leveraged buyout is immaterial. Such a ratio is usually cited, along with a number of other factors, to recast as a contribution to capital what appears, in form, to be debt between related parties, such as a shareholder and its corporation. See e.g., Fin Hay Realty Co. v. United States, 398 F.2d 694 (3rd Cir. 1968); Dixie Dairies Corp. v. Commissioner, 74 T.C. 476 (1980). As noted, the debt at issue is not between [redacted] and [redacted], but rather between [redacted] and an unrelated banking syndicate. Moreover, even if part or all of the original acquisition indebtedness could be recharacterized as equity capital,[7] the indebtedness would lose its debt characteristics for tax purposes and, therefore, not represent portfolio indebtedness, and the deemed capital contribution to [redacted] would be attributed to the banking syndicate as the source of the capital, not [redacted].[8]

Finally, the form 886A at issue makes reference to the case of H. Enterprises International, Inc. v. Commissioner, 183 F.3d 907 (8th Cir. 1999), aff'g T.C. Memo 1998-97, as having a similar fact pattern to the [redacted] dividends, and I.R.C. § 246A was held to apply. In the case, a parent company (the taxpayer) purchased dividend-paying stock and tax-exempt securities with funds from dividends received from its subsidiary. The money to pay the dividends came from indebtedness incurred by the subsidiary. Such indebtedness was found to be directly attributable to the parent's stock investments on which dividends were paid. The fact that the indebtedness was incurred by a different entity was not significant, since the borrower was controlled by the taxpayer and the dividends used to make the

---

[6] It should be noted that we have not seen any of the debt instruments themselves and are relying solely upon the facts stated in the form 886A.

[7] We could not find any case law which recharacterizes straight debt, having no hybrid features such as convertibility to stock, that is owed to an independent creditor.

[8] Due to the high debt-to-equity ratio, Exam may want to consider whether [redacted] is paying [redacted] in excess of an arm's length amount under one or more of the [redacted] service agreements. Any excess payments may represent non-deductible capital infusions to [redacted].

stock investments were paid as part of a preplanned arrangement.

We believe, however, that the facts of H. Enterprises are clearly distinguishable from the instant case. Here, the [redacted] dividends, though financed at least in part through indebtedness, were not used by [redacted] to make investments in other dividend-paying stock. Further, as previously indicated, [redacted]'s original equity stake in [redacted] was not funded by any indebtedness incurred directly or indirectly through an affiliated entity.

If you have any questions, please feel free to call Michael A. Yost, Jr. at (412) 644-3441.

Richard S. Bloom
Associate Area Counsel (LMSB)

By: _____
MICHAEL A. YOST, JR.
Senior Attorney