taxnotes federal

Volume 172, Number 6 ■ August 9, 2021

Foreign Investments in U.S. Renewables Through a Leveraged Blocker

by Anne S. Levin-Nussbaum

Reprinted from *Tax Notes Federal*, Aug. 9, 2021, p. 935

VIEWPOINT

tax notes federal

Foreign Investments in U.S. Renewables Through a Leveraged Blocker

by Anne S. Levin-Nussbaum

Anne S. Levin-Nussbaum

Anne S. Levin-Nussbaum is a member of Mintz, Levin, Cohn, Ferris, Glovsky & Popeo PC in New York.

In this article, Levin-Nussbaum explains how to determine how much debt to use when capitalizing a U.S. blocker corporation.

A question often asked by foreign investors in U.S. renewable energy projects is how much debt they can use to capitalize the U.S. blocker corporation they invest through. A blocker is a U.S. entity treated as a corporation for tax purposes and is needed to prevent the foreign investor's participation from (in some circumstances and to an extent) disqualifying the project for accelerated depreciation and possibly the investment tax credit. The investor must also be careful to ensure the blocker is not considered at least 50 percent owned by U.S. tax-exempt or government entities, or the blocker will be treated as a tax-exempt entity.

In an unleveraged blocker, the foreign investor contributes all the funds to the U.S. corporation as equity. In a leveraged blocker, the foreign investor would fund the blocker with a combination of debt and equity. The interest paid on the debt component is generally deductible and allows the blocker corporation to reduce its taxable income.[1] The caveat is that for the interest to be deductible, the debt must be respected by the IRS. That typically requires the loan's terms to be arm's length and the blocker corporation to be adequately capitalized.

Distinguishing debt from equity depends on determining the bona fides of the debt.[2] Courts have identified at least 11 relevant factors: (1) the names given to the instruments evidencing the indebtedness; (2) the presence or absence of a fixed maturity date; (3) the right to enforce payment of principal and interest; (4) the source of repayments; (5) participation in management; (6) payment of interest only out of dividend money; (7) the adequacy of capitalization; (8) the identity of interest between the creditor and the stockholder; (9) the corporation's ability to obtain financing from outside lending institutions; (10) the extent to which an advance is subordinated to the claims of outside creditors; and (11) the parties' intent.[3] No one factor controls, and a fact-specific inquiry must be conducted for each factor in each case.[4]

So what does it mean to be adequately capitalized? There is no bright-line test. However, in *John Kelley Co.*,[5] the U.S. Supreme Court appeared to set forth an informal safe harbor

[1] *See* discussion below regarding section 163(j), which imposes limitations on interest deductions. Further, the foreign investor should consider whether it will be subject to the 20 percent U.S. withholding tax on the interest payments, also discussed below.

[2] Under the authority of section 385, Treasury issued regulations to determine whether an interest in a corporation is treated as equity or debt (or as part equity and part debt) for federal income tax purposes. However, the section 385 regulations effectively implement the common law factors for evaluating debt characterization.

[3] *O.H. Kruse Grain & Milling Co. v. Commissioner*, 279 F.2d 123, 125 (9th Cir. 1960).

[4] *Tyler v. Tomlinson*, 414 F.2d 844, 848 (5th Cir. 1969).

[5] *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946).

deeming there is no thin capitalization if the debt-equity ratio is no more than 4 to 1.[6] However, the rule is not binding precedent because it is derived from dicta. It is also not a safe harbor for debt characterization, merely guidance on that one factor.[7]

The Tax Court has recharacterized debt as equity when there was a 1-1 debt-equity ratio because it determined there was never a real intent to repay the debt.[8] In that case, the noteholders were husband, wife, and infant daughter, and the husband held the majority stock in the corporation. The court concluded it was unreasonable to conclude the husband ever intended to enforce payment of the notes because doing so would impair the credit rating of the corporation, cause it to borrow from other sources, or bring about its dissolution. The court also concluded the wife and daughter never intended to act contrary to the husband's wishes.[9]

For the same reason, courts have viewed proportionality of interests — that is, when shareholder interests in the debt are proportional to equity interests — as a significant factor weighing against respecting purported debt.[10] Proportionality is viewed as bearing on the parties' intent to create a true debtor-creditor relationship because when the shareholders hold the purported debt proportionately with their equity interests, there is little incentive to enforce the claim as a creditor if doing so would harm the parties' equity interest.[11]

Different courts have taken different views about whether thin capitalization is an important factor. In a case involving shareholder debt, the Fifth Circuit declined to rule that a specific level of debt-equity ratio is needed, saying that is for Congress to establish.[12] However, while noting thin capitalization alone will not justify designating debt as equity, the Fifth Circuit said it is very strong evidence of such a finding when other factors also point in that direction.[13] The Tax Court appears to share the view that thin capitalization can be important.[14]

The Ninth Circuit said that looking at a corporation's debt-equity ratio is necessary to evaluate the risk that if the business were to suffer a loss the loan would not be repaid. Therefore, the relevant inquiry is not a court-imposed capitalization standard but rather the level of risk the capitalization structure presents and how the financial picture would be assessed by an independent lender. The court said it was concerned about:

> the degree of risk the loan presents to the lender and whether an independent lender, such as a bank, would be willing to make the loan. In addition to the numerical debt-to-equity ratio, other factors in the financial picture would also

---

[6] Cases have cited *John Kelley Co.* for the proposition that the thin capitalization factor need not be considered if the debt-equity ratio is no more than 4 to 1. *See, e.g., Ruspyn Corp. v. Commissioner,* 18 T.C. 769 (1952), *acq.*, 1952-2 C.B. 3 (ratio of 3.5 to 1).

[7] For example, in *Litton Business Systems Inc. v. Commissioner*, 61 T.C. 367, 379 (1973), *acq.*, 1974-2 C.B. 3, the Tax Court commented that the taxpayer's good debt-equity ratio is not a safe harbor. The court said, "This relatively low ratio [of 2 to 1] does counter any suggestion of thinness or patent inadequacy of a normal capitalization." *Cf. Brake & Electric Sales Corp. v. United States,* 185 F. Supp. 1 (D. Mass. 1960), *aff'd*, 287 F.2d 426 (1st Cir. 1961) (although the ratio of equity capital to the "loan" (1 to 4) did not by itself justify a finding of equity rather than debt, various other factors showed the notes involved represented an equity investment).

[8] *Gooding Amusement v. Commissioner,* 23 T.C. 408 (1954), *aff'd*, 236 F.2d 159 (6th Cir. 1956), *cert. denied*, 352 U.S. 1031 (1957).

[9] *Gooding Amusement*, 23 T.C. at 418-419. The court said the most important aspect of the case was "the complete identity of interest between and among the three noteholders, coupled with their control of the corporation."

[10] *See, e.g., Charter Wire Inc. v. United States,* 309 F.2d 878 (7th Cir. 1962) (despite a favorable debt-equity ratio, that stockholders held notes in direct proportion to their equity ownership raised a strong inference that the loans represented a capital investment); *P.M. Finance Corp. v. Commissioner*, 302 F.2d 789 (3d Cir. 1962) (that noteholders were the sole shareholder and his wife is persuasive evidence for not respecting debt; court found debt-equity ratio not to be significantly high for a finance business); *cf. Bauer v. Commissioner*, 748 F.2d 1365, 1369 (9th Cir. 1984) (Ninth Circuit agreed that when a stockholder "owns 'debt' in the same proportion to which he holds stock in a certain corporation, the characterization as 'debt' may be suspect"; however, the Tax Court miscalculated the amounts of the shareholder advances; circuit court respected purported debt).

[11] Moreover, advances made to a corporation proportionately by the shareholders resemble capital contributions. *Segel v. Commissioner*, 89 T.C. 816, 830 (1987) (payments made to a corporation by the shareholders in exact proportion to their interests was a factor in concluding advances were capital contributions rather than debt; the taxpayer argued for equity treatment).

[12] *Rowan v. United States*, 219 F.2d 51, 55 (5th Cir. 1955) (it would be an "unwarranted interference by the courts" to determine with hindsight what is the proper debt-equity ratio for the debtor corporation's business operations); *see also Gloucester Ice & Cold Storage Co. v. Commissioner*, 298 F.2d 183, 185 (1st Cir. 1962) (debt-equity ratio not considered; debt respected).

[13] *Curry v. United States*, 396 F.2d 630, 634 (5th Cir. 1968).

[14] *See, e.g., Bauer*, 748 F.2d 1365 (9th Cir. 1984) (the Tax Court concluded the shareholder debt was equity primarily because of thin capitalization — namely, debt-equity ratio of 92 to 1 — but the circuit court recalculated the debt-equity ratio as ranging from 1.5 to 1 to a maximum of 3.6 to 1 and reversed the Tax Court).

be important to an independent lender in analyzing the risk.[15]

To that end, in reversing the Tax Court and respecting the shareholder loans, the Ninth Circuit considered a letter from the vice president of Bank of America stating that the bank had dealt with the company, was familiar with its financing during the years in question, and would be willing to make loans equal to or greater than the amounts loaned by the shareholders.

Similarly, courts have said the acceptable level of debt to equity depends on the industry and the character of the business being conducted and have considered expert testimony to determine whether a given company was adequately capitalized by the standards of the industry.[16]

While courts have respected debt despite very thin capitalization — for example, a debt-equity ratio as high as 692 to 1[17] — a leveraged blocker is subject to greater scrutiny given that it is related-party debt,[18] the debt is held by the shareholders proportionally to their equity interests,[19] and there is no independent business purpose for the blocker corporation. Investors would be prudent to focus not only on trying to discern a bright-line standard but to also be able to show that an unrelated lender would be willing to make the loans taking into consideration the capital structure and industry.[20]

Before 2018, there was a bright-line capitalization standard that sometimes had to be met for interest to be deductible by the blocker, but that law no longer has any binding effect. Former section 163(j) contained the so-called earnings-stripping rules, which limited interest deductions for blockers using related-party debt if there was a debt-equity ratio over 1.5 to 1. That section was designed to prevent the earnings and profits of thinly capitalized corporations from being siphoned off in the form of interest by a foreign person or other person exempt from U.S. tax. Assuming a corporation's debt exceeded the 1.5-1 ratio test at the end of its tax year, the corporation was prohibited from deducting interest due to a related tax-exempt person during that year. That deduction disallowance applied if the total interest deduction (including interest due to unrelated persons) would otherwise exceed 50 percent of the corporation's adjusted taxable income (roughly speaking, its cash flow before deducting interest).[21] Interest in excess of that 50 percent limit was termed "excess interest expense,"[22] but despite its name, was deductible if due to an unrelated person.[23] While the rule limiting debt to less than 1.5 times equity no longer has any legal relevance, it could be viewed as guidance of what constitutes a safe ratio.

The Tax Cuts and Jobs Act replaced the earnings stripping rules in former section 163(j)

---

[15] *Bauer*, 748 F.2d at 1364.

[16] *See Scotland Mills Inc. v. Commissioner*, T.C. Memo. 1965-48 ("What amounts to adequate capitalization varies according to the industry and within the industry according to the type of operation planned"; expert testimony considered). Courts have found that a high debt-equity ratio is not unusual for financing companies. *See, e.g., P.M. Finance*, 302 F.2d at 786, 788 ("Where, as here, the taxpayer is a finance company, a business in which sizable amounts of borrowed capital are customary, the ratio of debt to capitalization would not appear to be significantly high."). Some courts even said that thin capitalization is not a relevant factor in cases involving finance businesses. *Security Finance & Loan Co. v. Koehler*, 210 F. Supp. 603 (D. Haw. 1962); and *Jaeger Auto Finance Co. v. Nelson*, 191 F. Supp. 693, 698 (E.D. Wis. 1961).

[17] *Baker Commodities v. Commissioner*, 48 T.C. 374 (1967) (692-1 ratio was not excessive for shareholder loans provided in connection with an acquisition of interest in a business that rendered animal meat byproducts into feeding fats and tallow because the business had a history of highly successful operations, and the principal and interest repayment schedule was based on well-supported business projections). *See also Murphy Logging Co. v. United States*, 378 F.2d 222 (9th Cir. 1967) (corporation with a 160-1 ratio was permitted interest deductions on loans when the shareholders contributed their substantial expertise and ability to negotiate and procure contracts); *cf. Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476 (1980), *acq.*, 1982-2 C.B. 1 (debt-equity ratio greater than 10 to 1 was too thin; debt not respected).

[18] *See, e.g., Matter of Uneco Inc. v. United States*, 532 F.2d 1204, 1207 (8th Cir. 1976) ("advances between a parent corporation and a subsidiary or other affiliate are subject to particular scrutiny 'because the control element suggests the opportunity to contrive a fictional debt'"; loans not respected based on numerous factors, including thin capitalization); *PepsiCo Puerto Rico Inc. v. Commissioner*, T.C. Memo. 2012-269 (related-party debt; 14-1 ratio supported equity characterization).

[19] *See Arlington Park Jockey Club v. Sauber*, 262 F.2d 902 (7th Cir. 1959) (advances made by each shareholder to the wholly owned subsidiary were in direct proportion to their shareholder ownership, which gave rise to a strong inference of additional capital investment).

[20] In *Gilbert v. Commissioner*, 248 F.2d 399, 406 (2d Cir. 1957), the circuit court said:

> In determining whether advances to closely held corporations may properly be treated as loans for tax purposes, the courts have stressed one or more of a number of factors, including the debt-equity ratio, the presence of an agreement to maintain proportionality between the advances in question and acknowledged risk capital, the presence of tax avoidance motives, the use to which the funds were put, whether outside investors would make such advances, and lack of reasonable expectation of repayment.

The case was remanded to the Tax Court for further findings based on the foregoing.

[21] Former section 163(j)(1)(A), (2)(B)(i).

[22] Former section 163(j)(2)(B)(i).

[23] Former section 163(j)(1)(A), (2)(A)(i).

with rules that apply to all taxpayers and generally limit interest deductions to the sum of business interest income and 30 percent of ATI,[24] with the ability to carry forward any disallowed expense deduction indefinitely. ATI is analogous to earnings before interest, taxes, depreciation, and amortization.[25] Starting in 2022, ATI is calculated without subtracting depreciation and amortization, resulting in a lower limit and lower interest deductions.[26]

Thus, the new version of section 163(j) creates a debt limitation that involves structuring considerations other than thin capitalization, but which still need to be planned for because there is no sense in having interest deductions in excess of permitted deductions. Accordingly, the owner of a blocker should first determine how much interest it expects to be able to deduct under section 163(j), then back into how much debt that means. Thin capitalization principles should be applied once the optimal level of debt is determined.

In making that determination, foreign investors should also consider how much interest can be deducted without potentially subjecting the blocker to the base erosion and antiabuse tax, which targets earnings-stripping transactions between some domestic corporations and related foreign persons. The BEAT functions as a minimum tax in that it applies only if a taxpayer's — that is, the blocker's — liability under the BEAT exceeds its regular tax liability.[27]

To be subject to the BEAT, businesses must have three-year average annual gross receipts of at least $500 million, as well as a so-called base erosion percentage above a specified threshold (3 percent for taxpayer groups without domestic banks and securities dealers and 2 percent for groups with domestic banks or securities dealers).[28] While the underlying deduction remains intact, when applicable, the BEAT is imposed as an additional tax — at 10 percent for 2019-2025, and increasing to a maximum rate of 12.5 percent thereafter. (The BEAT rate for banks and registered securities dealers is 1 percent higher every year.[29])

In applying the thin capitalization analysis, the question arises whether project-level debt should be included. As noted, the purpose of the thin capitalization factor is to determine if there is a likelihood of repayment and how the capital structure would influence an outside lender's risk assessment if it were not related-party debt.[30] Given that rationale, it makes sense to include the project-level debt because it directly affects the source of repayment for the blocker's debt (former section 163(j) had rules for including project-level debt). While the case law does not address that

[24] Section 163(j)(1). The Coronavirus Aid, Relief, and Economic Security Act increased the limitation to 50 percent of ATI retroactively for 2019 and 2020 for taxpayers other than partnerships (for which the increase to 50 percent applies only for 2020). Taxpayers have the option of electing out of that rule and using 30 percent instead of 50 percent.

[25] Section 163(j)(8)(A)(i)-(iv).

[26] Section 163(j)(8)(A)(v). *See also* David Burton and Anne Levin-Nussbaum, "The Impact of Tax Reform: What Equipment Leasing Companies Need to Know," Norton Rose Fulbright Project Finance (Jan. 19, 2018).

[27] Section 59A(b).

[28] Section 59A(e); and reg. section 1.59A-2(e). Taxpayers subject to the BEAT are applicable taxpayers. Once a taxpayer meets the definition of an applicable taxpayer, it must calculate its modified taxable income, which is taxable income determined without regard to any base erosion tax benefit for any base erosion payment. Section 59A(c). A base erosion payment includes any amount paid or accrued by the taxpayer to a related foreign person and for which a deduction is allowable. In general, a foreign person will be treated as a related party if there is at least a 25 percent ownership overlap with the taxpayer. A base erosion tax benefit includes a deduction that is allowed for a base erosion payment. Base erosion tax benefits generally include deductible payments for services, interest, rents, and royalties. Depreciation and amortization deductions for property acquired from related foreign persons may also be considered base erosion tax benefits and be disregarded in determining modified taxable income. No amount is generally added back in determining modified taxable income for payments to foreign related persons that are not deductible, but instead reduce gross income — for example, amounts included in cost of goods sold. Reg. section 1.59A-3(b)(2)(viii).

After an applicable taxpayer calculates modified taxable income, it applies the BEAT rate for the tax year to that income. If that amount exceeds the regular tax, the taxpayer must pay the excess amount (the base erosion minimum tax amount) as an additional tax. For that calculation, regular tax is adjusted to eliminate the benefit of all tax credits, other than some favored tax credits, through the end of 2025. Until then, regular tax is not reduced for 100 percent of research and experimentation credits and up to 80 percent of low-income housing credits and renewable energy credits. Reg. section 1.59A-5(b)(3)(i).

[29] Section 59A(b).

[30] *See, e.g.*, *PepsiCo*, T.C. Memo. 2012-269 (finding a 14-1 ratio to be a negative factor because it would be untenable for a commercial borrower in the taxpayer's industry; the purpose of the debt-equity ratio "is to determine whether a corporation is so thinly capitalized that repayment would be unlikely").

specific issue,[31] the prudent approach would be to include the project-level debt when calculating the debt-equity ratio.

Finally, foreign investors should consider the tax implications of receiving interest payments from the U.S. blocker. Interest payments from a U.S. corporation — that is, the blocker — to foreign persons are subject to a 30 percent withholding tax unless the portfolio interest exemption applies or the foreign lender is eligible for a reduced rate or complete exemption under an applicable treaty. For interest on the loan from the foreign investor to the blocker to qualify as portfolio interest: (1) the loan will need to be in registered form — that is, transferable by one holder to another only when the transferee is identified to the issuer; (2) the interest payments cannot be contingent; (3) the foreign investor cannot be a bank lending in the ordinary course of business; and (4) the foreign investor cannot directly or indirectly own 10 percent or more of the blocker's voting stock.[32] Most of the structuring to qualify for the portfolio interest exemption revolves around the last condition. The 10 percent test is done at the shareholder level of the foreign parent, and the shareholders are considered to proportionately own stock held by that corporation. In testing for ownership, attribution rules apply that can make the calculations quite complex.[33]

So what should a foreign investor in a renewable energy project take from this discussion? The first step is to determine the optimal level of debt taking into account section 163(j) and the BEAT, which is primarily a calculation exercise. The calculations involve applying complicated rules (a detailed discussion of which is beyond the scope of this article), and there may be areas of uncertainty, including regarding income projections. Thin capitalization principles should then be applied to determine if the optimal level of debt is likely to be respected as debt for tax. As outlined above, there is no clear standard for that. The United States no longer has earnings-stripping rules that impose a strict two-parts-equity-to-three-parts-debt standard; rather, common law principles control. While not legally relevant, one could use the 1.5-1 debt-equity ratio from the old earnings-stripping rules as a safe harbor because it seems unlikely that any court would view that ratio as thin capitalization (although it might not respect the debt for other reasons). However, based on *John Kelley Co.*, that is arguably too conservative: A debt-equity ratio of up to 4 to 1 seems a reasonable benchmark if one is looking for a bright-line test.

Based on the case law, it is also reasonable to conclude that there is no set debt-equity ratio required. Rather, the relevant inquiry is whether a third-party creditor would be confident lending with the given capitalization structure. Under that view, one should be confident in the optimal debt level if there is adequate support that an unrelated lender would provide similar financing, such as an evaluation from an independent rating agency or a letter from a bank. The most prudent approach would be to obtain that unrelated third-party support for whatever the optimal debt level is and consider the unofficial safe harbor standard from *John Kelley Co*.

The other takeaway is that thin capitalization is just one factor. It is crucial to follow all the formalities of a commercial debt instrument, including having a market interest rate. ■

[31] In one case, the Tax Court considered debt-equity ratios of related parties as a factor in its analysis, suggesting that a court could take a broad perspective. *See Sigmon v. Commissioner*, T.C. Memo. 1988-377 (although a company had substantial equity and a reasonable debt-equity ratio, it belonged to an integrated group of companies that in the aggregate was thinly capitalized, which supported the conclusion that the advance was a contribution to capital).

[32] Section 871(h).

[33] Section 871(h)(3)(C).