No. 10-60515

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

CONTAINER CORPORATION, Successor to Interest of Container Holdings Corporation, Successor to Interest of Vitro International Corporation,

Petitioner-Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLANT

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STATEMENT REGARDING ORAL ARGUMENT

Counsel for the Commissioner request oral argument because this is a case of first impression in this Court regarding a complex legal issue of substantial importance to the administration of the tax laws.

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JURISDICTIONAL STATEMENT

On November 30 and December 9, 2004, the Commissioner of Internal Revenue mailed timely notices of deficiency to Container Corporation determining income tax deficiencies for its tax years 1992, 1993, and 1994, as well as additions to tax under Section 6651(a)(1) of the Internal Revenue Code (26 U.S.C.) (I.R.C.).[1] (Exs. 1-J, 2-J; Doc. 8,

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[1] The notices of deficiency were identical. One was mailed to Container Corp. at an address in Plano, Texas (Ex. 1-J), and the other

(continued...)

¶2.)[2] On February 23, 2005, within 90 days after the mailing of the notices, Container Corp. timely filed a petition in the Tax Court challenging the Commissioner's determinations. (Doc. 1; Doc. 8, ¶3.) The Tax Court had jurisdiction under I.R.C. §§ 6213, 6214, and 7442.

On March 15, 2010, the Tax Court entered a final, appealable decision that disposed of all of the parties' claims. (Doc. 21.) On June 1, 2010, the Commissioner filed a timely notice of appeal. (Doc. 22.) This Court has jurisdiction under I.R.C. § 7482(a)(1).

STATEMENT OF THE ISSUE

Vitro International Corporation, formerly a United States subsidiary of Vitro, S.A., a Mexican corporation, paid $6.7 million in fees to its Mexican parent as consideration for the parent's guaranty of notes that Vitro International Corp. issued to third parties. The issue in this case is whether the Tax Court erred in holding that such fees were not United States source income and that, consequently, Container Corporation (successor to the interest of Vitro International

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[1](...continued)
at an address in Houston (Ex. 2-J).

[2] "Doc." references are to the docket control numbers assigned to the documents in the original record by the Clerk of the Tax Court. "Ex." references are to the exhibits admitted into evidence. "Tr." references are to pages of the trial transcript, Docs. 12 and 13.

Corp.) was not liable for the 30-percent withholding tax imposed on certain payments of United States source income to foreign corporations under I.R.C. § 881(a).

STATEMENT OF THE CASE

As part of the efforts by Vitro, S.A. ("Vitro"), a Mexican corporation, to acquire Anchor Glass Container Corp., a United States company, one of Vitro's American subsidiaries, Vitro International Corp. ("International"), sold $155 million in notes to a group of United States' insurance companies. Vitro guaranteed the notes and, in return, received guaranty fees from International totaling $2,309,758 in 1992, $1,912,867 in 1993, and $2,485,470 in 1994. The Commissioner issued a notice of deficiency to Container Corp., the successor to the interest of International, for International's failure to withhold taxes on its fee payments to Vitro. The Commissioner determined that, under I.R.C. § 881(a), the guaranty-fee payments were "fixed or determinable annual or periodical" income received by a foreign corporation from a source within the United States. As such, the fees were subject to a 30-percent tax, which must be withheld at the source.

Container Corp. filed a petition in the Tax Court challenging the Commissioner's determination and arguing that, under the applicable law, the guaranty-fee payments were not from a source within the United States, but were from a source within Mexico. Following a trial, the Tax Court agreed with Container Corp.'s position and, accordingly, held that Container Corp. had no tax deficiency. The Commissioner now appeals.

STATEMENT OF FACTS

The relevant facts may be summarized as follows.[3]

A. Factual background

In the late 1980's, Vitro, S.A. (Vitro), Mexico's largest manufacturer of glass containers, began attempts to expand its business into the United States. It chose to enter the market by acquisition, and one of its targets was Anchor Glass Container Corp. (Anchor), then the second-largest glass container producer in the United States and a publicly-traded company. (Doc. 18 at 2-3.) Vitro also sought to acquire Latchford Glass Co., a closely-held regional glass

[3] A more detailed narration of the financial aspects of Vitro's acquisition of Anchor may be found in the Tax Court's opinion. (Doc. 18 at 2-14.)

container producer headquartered in California. (*Id.* at 3.) The issue in this case concerns only Vitro's purchase of Anchor.

Vitro began by organizing marketing and distribution subsidiaries, and in December 1988, Vitro reorganized these subsidiaries by forming Vitro International Corp. (International) as their United States holding corporation. Vitro also organized a separate acquisition company, C Holdings Corp., which later merged into Container Holdings Corp. ("Container Holdings"). (Doc. 18 at 3.) Container Holdings formed a shell corporation, THR Corp., to acquire Anchor's and Latchford's stock. (*Ibid.*).[4] By the end of July 1989, Container Holdings (through THR) held 10.1 percent of Anchor's 14 million outstanding shares, and Vitro made a tender offer for the rest of Anchor's stock in August 1989. (Doc. 18 at 5.) Anchor eventually agreed to the purchase, and the sale closed on November 2, 1989. (*Id.*)

As part of an effort to refinance indebtedness used to finance the tender offer, International issued 21 senior notes (the "International

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[4] Effective December 31, 1994, International and THR were also merged into Container Holdings. (Doc. 8, ¶22) Container Corp., the petitioner-appellee in this case, is a successor to Container Holdings by means of a merger that took place on March 19, 1999. (*Id.*, ¶1). Container Corp. is a Delaware corporation with its principal place of business in Texas. (*Ibid.*; Doc. 18 at 14.)

1991 Senior Notes," or "the Notes") worth a total of $155 million. (Doc. 18 at 10; Doc. 8, ¶70.) As a condition of the Note Purchase Agreement executed by the purchasers of the Notes, Vitro was required to guarantee the Notes, and it executed a formal guaranty agreement for this purpose. (Doc. 18 at 11; Doc. 8, ¶74; Ex. 32-J at §3E; Ex. 35-J at 1; Tr. 52:6-25, 129:22-25, 136:2-4, 137:7-14.) The guaranty allowed the note purchasers to collect from Vitro if International defaulted. (Doc. 18 at 11; Ex. 35-J.) Pursuant to the guaranty agreement, International made monthly guaranty-fee payments to Vitro totaling $2,309,758 in 1992, $1,912,867 in 1993, and $2,485,470 in 1994. (Doc. 8, ¶79.) The guaranty-fee agreement set the fee at 1.5 percent of the outstanding principal balance of the Notes per year. (Doc. 18 at 13.) This was the standard fee Vitro charged all of its subsidiaries for loan guarantees, regardless of a subsidiary's capital structure or financial condition, and regardless of the amount of work done by Vitro in negotiating and monitoring the guarantee. (*Ibid.*) International did not withhold United States federal income tax from its guaranty-fee payments to Vitro and did not file annual withholding tax returns (Form 1042) with respect to the fee payments for the taxable years 1992 through 1994. (Doc. 8, ¶¶81, 116, 119, 122.)

International did not have, and was not expected to have, the cash flow needed to make the interest or principal payments on the Notes without additional borrowing or equity contributions. (Doc. 18 at 13; Doc. 8, ¶129, 133; Tr. 124:10-16, 129:22-25.) As the parties stipulated, the interest payments International made on the Notes during 1991 through 1994 were funded from International's operations and by capital contributions by Vitro and Container Holdings. (Doc. 8, ¶130.) International paid, in full, the balance of its principal and interest obligations under the Notes in December 1994. The source of funds used to redeem the Notes were funds from operations and from capital contributions from Container Holdings and from Vitro. (*Id.*, ¶135.) During the period 1990 through 1993, Vitro made cash contributions of capital to International in the total amount of $80,660,000. (Doc. 8, ¶131.)

B. The Commissioner's determination and Tax Court proceedings

Following International's merger with Container Corp. (*see* n.5, *supra*), the Commissioner issued a notice of deficiency to Container Corp. determining that the company was liable for withholding tax on the guaranty-fee payments made to Vitro. (Ex. 1-J.) I.R.C. § 881(a) imposes a 30-percent tax on "fixed or determinable annual or

periodical" (FDAP) income received by a foreign corporation from a source within the United States, to the extent that the amount so received is not effectively connected with the conduct of a trade or business within the United States. The tax is required to be withheld at its source. The Commissioner determined that the guaranty-fee payments were subject to the tax under § 881(a) and determined income tax liabilities against Container Corp. with respect to the years 1992, 1993, and 1994. The Commissioner also determined additions to tax for the same years under I.R.C. § 6651 for Container Corp.'s failure to file withholding tax returns. The Commissioner's determinations were as follows (Ex. 1-J):

Year	Tax	Penalty
1992	$692,927	$173,232
1993	$689,010	$172,253
1994	$630,491	$157,623

Prior to trial, the Commissioner conceded that Container Corp. was not liable for the withholding tax (or for the penalty) for 1994, and the Commissioner also conceded that Container Corp. was not liable for the penalty for 1993. Thus, only the tax liabilities for 1992 and 1993, and the penalty for 1992, remained for the Tax Court to decide. The

parties further agreed that the fees were FDAP income, and that the fees were not effectively connected with the conduct of a trade or business within the United States. (Doc. 18 at 14; Doc. 8, ¶115.) Accordingly, the resolution of the tax deficiencies determined by the Commissioner turned entirely on whether the guaranty fees paid to Vitro were deemed to have been received from a source within the United States. If the fees were such United States sourced income, they were subject to the withholding tax under § 881(a).

Following a trial, the Tax Court held that the fee payments were not subject to withholding, because they should be deemed to be Mexico sourced income. (Doc. 18.) The court noted (*id*. at 15) that the Code provides rules for sourcing certain types of FDAP income, but that the rules are not comprehensive, and the rules do not provide how guaranty fee payments must be sourced. *See* I.R.C. §§ 861-863. Accordingly, the court observed, "[i]f a category of FDAP is not listed [in the rules for sourcing income], caselaw tells us to proceed by analogy" to the closest item for which there is a specific sourcing rule. (*Ibid.* (citing, among other cases, *Howkins v. Commissioner*, 49 T.C. 689 (1968)).)

The court focused on two categories of income expressly covered by the sourcing rules in the Code -- interest and payment for services. Under applicable provisions of the Internal Revenue Code, interest is required to be sourced to the residence of the obligor, and payments for services are sourced to where the services are performed. I.R.C. §§861(a)(1), (a)(3); 862(a)(1), (a)(3); Treas. Reg. §§ 1.861-2, 1.861-4 (26 C.F.R.). The Commissioner argued, relying, *inter alia*, on *Bank of America v. United States*, 680 F.2d 142 (Ct. Cl. 1982), that the guaranty fees were most analogous to interest because Vitro had substituted its credit for International's in guaranteeing the Notes, and because Vitro furnished funds that allowed International to meet its obligations under the Notes. Accordingly, the Commissioner concluded that, because the fee payments were analogous to interest payments and were made by a U.S. company, they should be treated as income from a source within the United States. Container Corp. contended that the fees were for the provision of services rendered by Vitro in Mexico, or, alternatively, were analogous to payments for services performed in Mexico and, therefore, should be treated as income from a Mexican source.

The court found (as the Commissioner conceded) that the guaranty fee payments were not interest *per se* because "Vitro's guaranty was not a loan to International." (Doc. 18 at 16.) The court further found that the fees were not payments for services because "[t]he value of Vitro's guaranty stems 'from a promise made and not from an intellectual or manual skill applied" (*id.* at 23). The court, however, agreed with Container Corp. that the guaranty fee payments were most analogous to payments for services rendered in Mexico and thus were not U.S. source income. (*Id.* at 31.) Acknowledging that it was a "close question," the court rejected the Commissioner's position on the ground that Vitro had not actually lent money to International, and it reasoned that Vitro's contingent "promise to possibly perform a future act" was more akin to a service than to a loan. (*Ibid.*) It thus concluded that "[g]uaranties, like services, are produced by the obligee and so, like services, should be sourced to the location of the obligee." (*Ibid.*) Accordingly, the court concluded that "International was not required to withhold taxes on the guaranty fees that it paid Vitro because those fees are Mexican source income." (*Ibid.*)

SUMMARY OF ARGUMENT

Section 881(a) of the Internal Revenue Code imposes a 30-percent tax on "fixed or determinable annual or periodical" (FDAP) income received by foreign corporations "from sources within the United States." The sole issue in this case is whether guaranty fee payments made by International (now Container Corp.) to Vitro were from a source within the United States and thus subject to the 30-percent tax. The determination of the source of the payments is to be made by reference to the rules of I.R.C. §§ 861-863, but these rules are not exhaustive, and when the statutes do not specify the source of certain payments, such as the guaranty fee payments at issue, courts are required to determine the source of the income by analogy to a form of FDAP income for which an express sourcing rule is provided by statute.

International, a United States corporation, paid $6.7 million to Vitro, a Mexican corporation, in return for Vitro's guaranty of $155 million in notes International sold to help finance Vitro's purchase of Anchor Glass Container Corp. Guaranty fee payments are not expressly covered by the sourcing rules in the Code, and therefore the payments must be sourced by analogy to the closest item for which there is a statutory sourcing rule. As is relevant here, the source of

interest payments is considered to be the residence of the obligor, while the source of payments for services is considered to be the place where the services are performed. The Commissioner argued in the Tax Court that the fee payments were most analogous to interest paid by International (which was located in the United States) to Vitro and therefore subject to tax under I.R.C. §881(a). Taxpayer, on the other hand, argued that the fees were analogous to payments for personal services performed by Vitro in Mexico and thus not subject to the tax. The Tax Court pointed out there was no evidence that Vitro had performed any significant services in connection with the guaranty or that the amount of the fees was based on the services rendered by Vitro. On the contrary, the record shows that the fees were calculated on the basis of an annual charge of 1.5 percent of the outstanding principal balance of the Notes issued by International. Nevertheless, the Tax Court held that the guarantee fees were not analogous to interest, but, instead, were most analogous to compensation for the provision of services. The court then concluded that the fees were properly sourced to Vitro's location, *i.e.*, Mexico, and therefore not subject to the 30-percent tax.

The Tax Court's decision is erroneous and without factual or legal support. The court cited no evidentiary support for its conclusion, and indeed, the facts and circumstances support the Commissioner's position. The fees paid by International enabled International to borrow money, and they compensated Vitro for putting its assets at risk. Moreover, through its guaranty of the Notes, Vitro substituted its credit for that of International's. Indeed, the purchasers of the Notes were well aware from the outset that International did not have the income or capital to support the Notes, and they required Vitro's guaranty as part of the agreement to buy the Notes. As expected, International required cash payments from Vitro to pay the interest on the Notes and to pay the principal balance when the Notes matured. Accordingly, because the guaranty fee payments were made to Vitro for the use of its credit, to compensate it for putting its assets at risk, and for its assistance in enabling International to meet its obligations under the Notes, the guaranty fees resemble interest, not compensation for services, and should be considered United States source income.

The Tax Court did not rely on any legal precedent supporting its decision. Indeed, the court dismissed the reasoning of the two cases with facts most closely resembling those at issue. In *Bank of America*

v. United States, 680 F.2d 142 (Ct. Cl. 1982), the court held that, in transactions where Bank of America effectively substituted its credit for that of foreign banks, commissions paid in return by the foreign banks were analogous to interest. Similarly, in *Centel Communications Corp. v. United States*, 920 F.2d 1335 (7th Cir. 1990), the Court of Appeals relied on *Bank of America*, in a case where shareholders were issued stock warrants for guaranteeing their corporation's indebtedness, to reject the corporation's claim that the warrants represented compensation to the shareholders for services rendered by them. The court, after pointing out that guaranteeing a debt entails no provision of services, held that the payments for such guarantees were in the nature of interest. The decisions in *Bank of America* and *Centel* are the most apposite authorities and should have led the Tax Court to conclude that the guarantee fees in issue here were most analogous to interest, not the provision of services.

The decision of the Tax Court should be reversed.

ARGUMENT

The Tax Court erred in holding that the guaranty fee payments to Vitro were not United States source income and therefore not subject to the tax imposed by I.R.C. § 881(a)

Standard of Review

Whether the Tax Court correctly held that International's guaranty fee payments were not subject to tax under I.R.C. § 881(a) is a question of law subject to *de novo* review. *Cf. Compaq Computer Corp. v. Commissioner*, 277 F.3d 778, 780-81 (5th Cir. 2001) (characterization of a transaction for tax purposes is a question of law).

A. Introduction

I.R.C. Section 881(a) imposes a 30-percent tax on "fixed or determinable annual or periodical" (FDAP) income received by foreign corporations "from sources within the United States," "but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States." I.R.C. § 881(a).[5] Vitro is a foreign corporation not engaged in a trade or business in the United States (Doc. 8, ¶115), and the parties agreed that the guaranty fees at issue constitute FDAP income (Doc. 18 at 15).

[5] As the Tax Court observed (Doc. 18 at 15, n.8), FDAP income is further defined at Treas. Reg. § 1.1441-2(b) (26 C.F.R.).

Accordingly, the sole issue here is whether the fees were received "from sources within the United States." [6] If so, it is undisputed that they are subject to the 30-percent tax. Taxes owed under § 881(a) are required to be withheld at the source, *i.e.*, by the party paying the income (in this case International/Container Corp.). I.R.C. § 1442(a).

The determination of the source of FDAP income is made pursuant to the rules under I.R.C. §§861-863. Sections 861(a) and 862(a) expressly categorize certain income as gross income from sources within or without the United States. Under §§ 861(a)(1) and 862(a)(1), for example, the source of interest FDAP income is considered to be the residence of the obligor. *See also* Treas. Reg. § 1.861-2 (26 C.F.R.). The source of income paid for personal services is the location where the services are performed. I.R.C. §§ 861(a)(3), 862(a)(3); Treas. Reg. § 1.861-4 (26 C.F.R.).[7]

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[6] "Congress was not referring here to the origin of the physical means of payment, but rather to the place where the recipient's income was 'produced.'" *Howkins v. Commissioner*, 49 T.C. 689, 693 (1968).

[7] "The source of the income is determined by the situs of the services rendered, not by the location of the payor, the residence of the taxpayer, the place of contracting, or the place of payment." *Dillin v. Commissioner*, 56 T.C. 228, 244 (1971).

These sourcing rules are not comprehensive, and they do not specify the source of guaranty fee payments such as those at issue in this case. Under these circumstances, the determination of the source of the income in question is to be made by analogy to the closest form of FDAP income for which an express sourcing rule is provided by statute. *See Bank of America v. United States*, 680 F.2d 142, 147 (Ct. Cl. 1982); *Howkins v. Commissioner*, 49 T.C. 689, 693-95 (1968); *Hunt v. Commissioner*, 90 T.C. 1289, 1301 (1988). The Commissioner maintained in the Tax Court that the guaranty fee payments were most analogous to interest paid by International to Vitro and therefore should be deemed to be from a source within the United States and hence subject to tax under I.R.C. § 881(a). The Tax Court, however, held that the guaranty fees paid by International were most analogous to payments for services performed in Mexico, and thus held that they were "Mexican source income" not taxable under I.R.C. § 881(a). As we demonstrate below, this determination is erroneous and should be reversed.

B. The guaranty fees paid by International are more analogous to interest than to payments for services

1. The Tax Court's analogy to payment for services is unpersuasive

As an initial matter, the parties agreed that the fees paid by International were not interest *per se,* and the Court concurred. (Doc. 18 at 16.) On the other hand, the court correctly found that "International did not pay the guaranty fees to Vitro as compensation for services." (Doc. 18 at 23.) The court based its conclusion on the fact that Container Corp. presented "very little evidence about the specific acts [Vitro] performed and how much time it took to perform them" (*id.* at 22), and that the fees charged by Vitro were not based on any specific services that were performed or on the amount of work required to fulfill the guaranty, but rather solely on the "amount of the outstanding principal that Vitro was standing behind" (*id.* at 23). The court also found that "[t]he Guaranty agreement required only minimal accountings and reporting to the note purchasers." (*Ibid.*) Accordingly, the court correctly determined that the fees were not intended to compensate Vitro for services it performed, because the "services" it performed were minimal. Because guaranty fees were not expressly covered by the sourcing rules in the Code, the Tax Court was required

to determine the source of the guarantee fees by analogy to the closest item of income for which there are statutory sourcing rules. *See Howkins*, 49 T.C. at 693-95.

The court proceeded to conclude that the guaranty fees paid by International to Vitro most resembled a payment for services, as Container Corp. argued, rather than interest, as the Commissioner argued. In reaching that conclusion, the Tax Court ignored all the evidence that had led it to determine that the guaranty fees did not constitute payments for services provided to International by Vitro, *i.e.*, that Container Corp. had presented no evidence that Vitro had rendered any substantial services to International and that the amount of the fees was calculated exclusively on the basis of the amount of the outstanding principal of the Notes guaranteed by Vitro. Similarly, the Tax Court ignored the evidence that the guaranty fees Vitro charged to International (1.5% of the outstanding principal) was the standard fee that Vitro charged all of its subsidiaries for guaranteeing their indebtedness regardless of the extent of any services Vitro performed in connection with providing such guarantees. (Doc. 18 at 22-23.) The court nevertheless concluded that Vitro's guaranty itself was most analogous to the provision of services because it was a "promise to

possibly perform a future act" (Doc. 18 at 31), emphasizing that Vitro's obligation was "entirely secondary" (*id*. 28). The court, however, did not point to any actions Vitro took that resembled services, and it did not compare Vitro's guaranty to any other type of promise or service. It also did not cite any authority supporting its conclusion. Thus, there is neither legal nor factual support for the Tax Court's conclusion that the guaranty fees paid by International were most analogous to payments for services.

Similarly, as demonstrated below, the Tax Court misconstrued the undisputed facts in rejecting the Commissioner's position that the guarantee fees were most analogous to interest.

2. The undisputed facts show the fees to be most analogous to interest

As the parties stipulated (Doc. 8, ¶129), International lacked sufficient cash flow and assets to support the Notes. Accordingly, the note purchasers, as a condition of their purchase, required International to secure Vitro's guaranty. Vitro's guaranty did not merely assist International to sell the Notes; without its pledge of financial assistance, the transaction would not have occurred. (*See* Ex. 35-J at 1 (stating that the guaranty is a "condition precedent to the Purchasers purchasing the Notes that the Guarantor execute this

Guaranty"); Tr. 52.) Vitro's guaranty was an integral, essential part of the transaction, not simply a facilitating factor. International thus used Vitro's credit, and the assets backing it, to borrow money. A fee paid for the use of another's credit closely resembles interest paid for a loan. *See Bank of America v. United States*, 680 F.2d at 149 (finding commissions analogous to interest where "the predominant feature of these transactions is the substitution of plaintiff 's credit for that of the foreign banks").

Further, the parties stipulated that Vitro made capital contributions to International of more than $80 million before and during the years that International was paying interest on the Notes, and that International would have been unable to pay the interest on the Notes without financial assistance from Vitro. (Doc. 8, ¶¶129, 130.) Similarly, when the Notes matured, International required capital contributions from Vitro in order to satisfy the amounts due the note purchasers. (Doc. 8, ¶¶133, 135.) Accordingly, Vitro did more than simply "augment" International's credit, contrary to the Tax Court's statement. (Doc. 18 at 27.) Vitro pledged its credit to enable International to sell the Notes, and then, as expected, supplied funds to allow International to make the required interest payments, and finally

infused large amounts of capital into International so that International could pay the principal amount of the Notes at maturity. As the Tax Court itself stated: "Interest is the creditor's compensation for putting his own money at risk." (*Id*. at 28.) Because International paid fees to Vitro for its credit and for putting its assets at risk, the fees resemble interest. *See, e.g., Salley v. Commissioner*, 464 F.2d 479, 485 (5th Cir. 1972) (defining "interest" as "compensation for the use . . . of money" (quoting *Deputy v. DuPont*, 308 U.S. 488 (1939)); *accord* Black's Law Dictionary (5th ed. 1979) at 729 (defining "interest" (for use of money)).)

The Tax Court rejected the Commissioner's assertion that Vitro's infusion of capital to International following the sale of the Notes confirmed that the fees were analogous to interest on the ground that this infusion was a "later choice" made by Vitro, and because a capital contribution is different from a loan. (Doc. 18 at 29.) Vitro's financial assistance to International, however, was anticipated from the outset. The court itself found that the parties had "expected" that International would not have the cashflow to meet its interest

obligations under the Notes. (*Id*. at 13.)[8] Further, Vitro's contributions of capital were not a "later choice," but, instead began before the Notes were ever sold. International required capital contributions from Vitro totaling $12,300,000 in 1990, even before the Notes were sold, and its contributions continued and increased thereafter. (Doc. 8, ¶131.) Accordingly, International paid Vitro a fee not only for providing its credit, but for the anticipated and expected use of Vitro's funds in meeting its debt obligations. Vitro's undertaking accordingly was not, as the Tax Court characterized it, simply a contingent promise to pay International's debt if International defaulted.

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[8] The parties stipulated that, "[a]s of March 28, 1991, International was not expected to have, on a projected or forecasted basis, the cash flow needed to satisfy all of the interest payments under the International 1991 Senior Notes as they came due over the three year term of such notes, without additional borrowings or equity contributions, unless THR made interest payments to International in cash when due under the THR 1990 Senior Note." (Doc. 8, ¶ 126) The THR 1990 Senior Note, however, was a "pay-in-kind" note, which meant that THR was not required to pay interest, but instead was allowed to increase the amount of principal it owed. (Doc. 18 at 9-11 and n.5.) Between May 1990 and December 1994, annual interest payments were added to the principal of the THR 1990 Senior Note in the total amount of $133,253,543. (Doc. 8, ¶127.) The maturity date for the THR 1990 Senior Note was in 1995. (Doc. 8, ¶60.) Accordingly, cash interest payments from THR were not a realistic source of income for International. (*See also* Tr. 129:22-25.)

Ultimately, the Tax Court's decision, which is unsupported by any pertinent authority, rests on nothing but the following conclusory statements (Doc. 18 at 31 (emphasis added)):

> Guaranty fees . . . are payments for a possible future action.
>
> We think that makes guaranties more analogous to services. Guaranties, like services, *are produced by the obligee* and so, like services, should be sourced to the location of the obligee.

With all due respect to the Tax Court, its reasoning does not withstand analysis. First, guaranties are no more "produced" by the obligee than loans are "produced" by the lender. In a guaranty situation, the guarantor often, as here, receives a fee for providing the guaranty. In a loan situation, the lender normally receives a fee, in the form of interest, for advancing its funds. The fees paid to a guarantor are its compensation for giving the guaranty in the same manner that interest is the compensation to the lender for supplying its funds. In neither case can it be said that the "obligee" produced or rendered anything in the nature of services. *See Centel Communications Co. v. Commissioner*, 920 F.2d 1335, 1344 (7th Cir. 1990).

Further, contrary to the Tax Court's statement, income received from the provision of services is not sourced to the residence of the

service provider, but, rather, is sourced to where the services are performed. I.R.C. §§ 861(a)(3); 862(a)(3); Treas. Reg. § 1.861-4. Thus, even if the fees paid to Vitro by International were deemed most analogous to compensation for the provision of services, it does not follow, contrary to the Tax Court's conclusion, that such fees would be sourced to Mexico. In this regard, the Tax Court's opinion contains no explanation, and we perceive none, as to why a guaranty issued by a foreign corporation to its United States subsidiary to enable the subsidiary to issue and sell in the United States its debt obligations should be deemed to be the rendering of services by the foreign corporation in its resident country, as opposed to in the United States. We submit that, to the extent the fees paid to Vitro properly may be characterized as most analogous to compensation for Vitro's provision of services, such fees still should be sourced to the United States, because the guaranty was given to facilitate the sale by a United States corporation of its debt instruments in the United States.

3. *Bank of America* and *Centel* strongly support the Commissioner's position

The Tax Court erred in disregarding the legal precedents most closely on point. In *Bank of America*, *supra*, the Court of Claims held that commissions paid for a "substitution of credit" were best

analogized to interest for purposes of I.R.C. §§ 861 and 862. The opinion provides useful guidance for resolving the issue here.

At issue in *Bank of America* were transactions "involv[ing] commercial letters of credit issued by a foreign bank on behalf of a foreign purchaser for the benefit of an American exporter." *Bank of America*, 680 F.2d at 143-44. As the court explained (*id.* at 144):

> Such a transaction begins with an agreement by an American exporter to sell goods to a foreign purchaser. The foreign purchaser then requests a commercial letter of credit from a foreign bank. A commercial letter of credit is . . . a document issued by a bank on behalf of its customer . . . commit[ing] the bank to pay the beneficiary of the letter when certain terms have been met. By issuing a letter of credit, a bank has substituted its credit for that of its customer. The bank issuing the letter of credit is commonly referred to as the opening bank. An opening bank will only issue a letter of credit when it has evaluated its customer's credit and found it satisfactory. Thus, the foreign bank issues the letter of credit for the benefit of the American seller if it finds the foreign purchaser creditworthy.

As is relevant here, *Bank of America* concerned two types of commissions Bank of America earned in connection with letters of credit. One type, an acceptance commission, was paid by foreign banks to Bank of America "as a result of [Bank of America's] acceptance of time drafts drawn pursuant to usance letters of credit issued to those foreign banks or pursuant to lines of credit extended by [Bank of

America] to the foreign banks." 680 F.2d at 145. Bank of America ("BofA") received acceptance commissions in two situations: "if BofA determined that the conditions of a time [or "usance"] letter of credit had been met it would stamp the letter accepted, obligating itself to pay any holder in due course when the letter came due; or, if an opening bank with an established line of credit with BofA wanted to refinance a letter of credit, it would accept a time draft at a discount to the face amount of the letter of credit." (*See* Doc. 18 at 25.)

The Court of Claims held that the acceptance commissions paid to Bank of America by foreign banks were analogous to interest, rather than payment for services, and thus were to be sourced to the residence of the obligor, *i.e.*, the foreign banks.[9] The court noted that "[t]he essence of the transactions, like that of a direct loan, is the use of [Bank of America's] credit." 680 F.2d at 148. The court further observed that, although the foreign banks required an agent in the United States, such as Bank of America, to perform some services in connection with

[9] The issue in *Bank of America* was not whether the commissions at issue were subject to withholding under I.R.C. § 1442, as in the instant case, but rather whether the commissions were foreign source income for purposes of foreign tax credits claimed by Bank of America. The court, however, was required to analyze the income under I.R.C. §§ 861 and 862, and its analysis is thus applicable here.

the transactions, the court found that those "functions are not the predominant feature of the transactions." (*Id*. at 149.) "Instead," the court stated, "*the predominant feature of these transactions is the substitution of [Bank of America's] credit* for that of the foreign banks." (*Ibid*. (emphasis added).) The Court further noted that "[n]o one would question that lenders in making direct loans also perform personal services. Yet Congress in section 861(a)(1) and 862(a)(1) has determined that all interest will be sourced under those sections and not as personal services under sections 863(a)(3) and 862(a)(3). We find acceptance commissions to be similar." (*Ibid*.)

Also at issue were confirmation commissions, which were earned by Bank of America when it confirmed a "sight" letter of credit for a foreign bank. This involved advising the American party (the seller of goods) that a letter of credit had been issued in his favor, and also irrevocably committing itself to paying the face amount of the letter of credit to the American party. Once Bank of America advised the beneficiary of the letter of credit of its agreement to confirm the letter, it became obligated to pay the beneficiary "regardless of any changes that might take place affecting the ability of the opening bank to reimburse [Bank of America]." *Id*. at 144.

The Court of Claims held that the confirmation commissions earned by Bank of America also were analogous to interest and thus sourced to the residence of the obligors, the foreign banks. The court noted that in these "confirmation" transactions, Bank of America "has acted as an intermediate, has assumed the risk of default of the foreign bank, and has assured the draft's holder of payment." 680 F.2d at 149. Again, the court determined that what Bank of America "was really charging for was not the services performed but the substitution of its own credit for that of the foreign bank. . . . The services performed were subsidiary to this." *Id.* at 150.

As the Commissioner maintained in the Tax Court, the guaranty fees International paid Vitro are directly analogous to the acceptance and confirmation commissions at issue in *Bank of America*. On its own, International was unable to sell the Notes, because International lacked the income and assets to support them. It was required to bring Vitro's income and assets into the transaction by means of its guaranty of the Notes. This was a substitution of Vitro's credit for International's, similar to the acceptance and confirmation activities engaged in by Bank of America. And, as the court held in *Bank of America*, payments to a party for a substitution of its credit – *i.e.* using

a party's credit and assets in order to support a loan – are most analogous to interest, as opposed to the provision of services. Regardless of the fact that Vitro's guaranty might have entailed the rendering of some relatively minor services, as a loan does, the "essence" of its guaranty, and its "predominant feature," was the use of Vitro's credit. *See* 680 F.2d at 148.

The Tax Court's attempt (Doc. 18 at 27-29) to distinguish the acceptance commissions and confirmation commissions analyzed in *Bank of America* from the guaranty fees here is unpersuasive. The court stated that the guaranty fees did not resemble interest because Vitro did not lend money to International for the fees, but instead provided only a contingent promise to pay its Notes. (Doc. 18 at 28.) Thus, the Tax Court stated in this regard that Bank of America "put its money directly at risk when it paid the seller." (*Ibid.*) Bank of America, however, appears to have incurred less risk than Vitro. The foreign banks had accounts with Bank of America, and, with respect to confirmations, Bank of America debited the foreign banks' accounts shortly after it paid the beneficiaries. 680 F.2d at 144. With regard to acceptances, the foreign banks would pay Bank of America the face amount of the particular time draft (also by having its account debited)

on the day before it matured. *Id*. at 145. Bank of America thus ran little risk of not being paid, whereas International's need for assistance in paying its debt was "expected" from the outset. (Doc. 18 at 13.)

Moreover, prior to Bank of America agreeing to undertake any of the activities regarding the issuance of letters of credit, it would perform an "evaluation and credit analysis of the opening bank." *Id*. at 144, 145. Vitro, on the other hand, guaranteed International's Notes, not because it found International creditworthy, but rather *because* International's credit was so poor that it would have been unable to sell its Notes without Vitro's guaranty. Accordingly, Bank of America's risk in earning the acceptance and confirmation commissions was hardly a basis for distinguishing the Court of Claims' decision, when the bank's risk was actually far less than Vitro's in the transaction at issue here. As the Tax Court itself found (Doc. 18 at 13), International was "expected" to require assistance in meeting its obligations under the Notes, and Vitro, in fact, provided that assistance. The Tax Court therefore erred in distinguishing *Bank of America* rather than applying the reasoning of *Bank of America* to analogize the guaranty fees to the commissions sourced as interest in that case.

Also relevant is *Centel Communications Co. v. Commissioner*, *supra*, 920 F.2d 1335, a case that applied the reasoning of *Bank of America*. In *Centel*, three shareholders guaranteed, for no consideration, a series of bank loans made to Fisk Telephone Systems, the predecessor of Centel Communications Co. 920 F.2d at 1336. Five years later, when the company was more profitable, Fisk granted the shareholders warrants authorizing them to purchase shares of stock at $1 per share. In its 1980 tax return Centel claimed a deduction in the amount of approximately $1,860,000 under I.R.C. § 83(h), claiming that the warrants were transfers to the shareholders "in connection with the performance of services." *Id*. at 1337. The Tax Court, agreeing with the Commissioner, rejected the taxpayer's position, concluding from the legislative history and other sources that "services" were generally performed by employees and independent contractors, and further that the shareholders were not employees or independent contractors and had performed no services through their guarantees. *Centel Communications v. Commissioner*, 92 T.C. 612, 626-33 (1989). The Seventh Circuit agreed with the Tax Court's reasoning in affirming its decision. 920 F.2d at 1342-43.

The Tax Court here dismissed the Commissioner's reliance on *Centel* on the ground that this case does not involve I.R.C. § 83 and does not depend on whether any party was an employee or independent contractor. (Doc. 18 at 21.) The Tax Court, however, ignored the critical fact that in *Centel* both the Tax Court and the Seventh Circuit had relied on the reasoning in *Bank of America* in reaching their respective decisions. *See* 920 F.2d at 1343-44; 92 T.C. at 633-36. In this regard, the Seventh Circuit expressly applied the reasoning in *Bank of America* (920 F.2d at 1344 (emphasis added)):

> Applying the reasoning of *Bank of America*, it is apparent that [the shareholders] did not perform any "service" to Fisk solely by guaranteeing Fisk's loans. They *substituted their credit for that of Fisk*, and Fisk granted them warrants in recognition of the increased risk they assumed as stockholders. They did not receive warrants in return for any "service" they supplied to Fisk.

Thus, that the shareholders were not employees or independent contractors was not the sole basis for the decision in *Centel*, as the Tax Court here implied. Rather, the Seventh Circuit agreed with the reasoning of the Court of Claims and further recognized that the guaranteeing of a debt does not entail the provision of any significant services. On that basis, it concluded that the stockholders in *Centel* did not receive their warrants in return for any services rendered by them.

The Tax Court in the instant case not only erred in failing to recognize that the decision in *Bank of America* strongly supported the Commissioner's position here, but compounded that error by failing to appreciate that the Seventh Circuit in *Centel* heavily relied on the reasoning in *Bank of America* in reaching its conclusion that the warrants issued to the shareholders there as consideration for guaranteeing certain debts could not be deemed to be compensation for services rendered because the act of guaranteeing a debt does not involve the provision of services.

In short, the guaranty fees paid by International to Vitro, like the commissions paid in the *Bank of America* case, were compensation for the substitution of the payee's credit for that of the payor, and, as such, were analogous to interest, not compensation for services. The Tax Court therefore committed reversible error in holding that the guaranty fees should be sourced to Mexico and not the United States.

CONCLUSION

For the foregoing reasons, the decision of the Tax Court is erroneous and should be reversed.

Respectfully submitted,

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SEPTEMBER 2010

CERTIFICATE OF SERVICE

It is hereby certified that on this 15th day of September, 2010, the foregoing opening brief for the appellant was filed with the Court using the Court's CM/ECF system. On the same date, an original and six copies of this brief were mailed to the Clerk by first-class mail, and service of this brief was made on counsel for the appellee by mailing two copies thereof by first-class mail in an envelope properly addressed as follows:

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ECF CERTIFICATIONS

Pursuant to Fifth Circuit Rule 25.2, I hereby certify on this 15th day of September, 2010, that (i) any required privacy redactions have been made, and (ii) the electronic submission is an exact copy of the paper document, and (iii) the document has been scanned for viruses with a commercial virus scanning program and is free of viruses.

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Dated: September 15, 2010