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.

APPEAL FROM THE UNITED STATES TAX COURT
HON. MARK V. HOLMES

BRIEF OF APPELLEE CONTAINER CORPORATION

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CERTIFICATE OF INTERESTED PERSONS

No. 10-60515

CONTAINER CORPORATION, Successor to Interest of
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Vitro International Corporation,

Petitioner - Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent - Appellant

The undersigned counsel of record certifies that the following listed persons and entities as described in the fourth sentence of Rule 28.2.1 have an interest in the outcome of this case. These representations are made in order that the Judges of this Court may evaluate possible disqualification or recusal.

A. Respondent - Appellant:

COMMISSIONER OF INTERNAL REVENUE

B. Counsel for Respondent - Appellant:

TAX DIVISION, DEPARTMENT OF JUSTICE, Washington, D.C.
John A. DiCicco
Richard Farber
Randolph L. Hutter

C. Petitioner - Appellee:

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

D. Affiliates of Petitioner - Appellee that May Be Financially Interested in the Outcome of the Litigation:

VITRO, SOCIEDAD ANONIMA DE CAPITAL VARIABLE, formerly Vitro, S.A. ("Vitro"), the prior owner of Container Corporation

Container Corporation is a privately held company. It was purchased from Vitro by Westgreen Holdings, which was primarily owned by Tom Mudd, Houston, Texas (or his affiliate).

E. Counsel for Petitioner – Appellee:

THOMPSON & KNIGHT LLP, Dallas, Texas
Emily A. Parker
Brian W. Stoltz

F. Tax Court Judge in Proceeding Below:

Hon. Mark V. Holmes

s/ *Emily A. Parker*
Attorney of Record for Appellee

STATEMENT REGARDING ORAL ARGUMENT

This appeal involves a straightforward application of income-sourcing rules under the Internal Revenue Code. The underlying decision was based on the parties' joint stipulation of facts and on the Tax Court's own well-supported factual findings regarding the income at issue, which are reviewed only for clear error. The parties' briefing fully addresses the evidence and applicable legal authorities, and there is no need for oral argument.

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STATEMENT OF THE ISSUE

The sole issue presented is whether the Tax Court correctly determined that the guarantee fee income of Vitro, S.A., ("Vitro") was earned by Vitro in Mexico. Vitro's U.S. subsidiary, Vitro International Corp. ("International"), and its successors, are parties to this case solely because International paid the guarantee fees to Vitro. International would be required to withhold tax on the guarantee fees paid to Vitro only if Vitro's guarantee fee income was from a U.S. source.[1] The source of payment of the fees and where benefits from the guarantee were received do not determine the source of the income from the fees. The Internal Revenue Code contains specific rules for sourcing stated categories of income, and "guarantee fees" are not one of these stated categories. Therefore, the Tax Court determined that the guarantee fees should be sourced to Mexico by analogy to fees for services, and that the assets, personnel and activities that produced the guarantee fee income to Vitro were located in Mexico. In so holding, the Tax Court rejected the IRS's arguments that the guarantee fees were analogous to interest and that the fees should be sourced to the United

[1] *See* Internal Revenue Code (I.R.C.) §§ 861(a), 862(a), 881(a) and 1442. Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, 26 U.S.C., in effect for the taxable years in issue.

States as the residence of the payor of the fees and of the lenders who received the benefit of Vitro's guarantee.

STATEMENT OF FACTS

Vitro, a successful glass manufacturing company, was established in Mexico in 1901. By the late 1980s, Vitro owned marketing and distribution subsidiaries incorporated and operating in the United States. In December of 1988, International became the U.S. holding company for these marketing and distribution subsidiaries.[2] About the same time, Vitro decided to acquire two well-established American glass container manufacturers: Anchor Glass Container Corp. ("Anchor") and Latchford Glass Co. ("Latchford"). Anchor was the second largest producer of glass containers in the United States, but Vitro's management believed it could expand Anchor's business and improve its profitability.[3]

To effect these acquisitions, Vitro organized Container Holdings Corp. ("Container"), as its direct U.S. subsidiary, and Container formed THR Corp. ("THR") to acquire Anchor's and Latchford's stock.[4] Vitro needed financing to purchase Anchor and Latchford. It was here Vitro ran

[2] Doc. 18 at 3. For consistency, Appellee will cite the Tax Court's opinion as the IRS did, by reference to the document number.

[3] *Id.* Tr. 22:9-15, 25:12-13, 34:17-25, 35:1 (Lopez); 119:1-3 (Thompson).

[4] *Id.*

into trouble. Although Vitro was a successful business, the devaluation of the peso in the 1980s had made the Mexican government unfinanceable. This made Vitro similarly unfinanceable, as Standard & Poor or Moody's will not give a borrower a higher credit rating than that of its sovereign.[5] Vitro hired Donaldson, Lufkin & Jenrette ("DLJ"), a U.S. investment bank, to help structure the financing of the purchase. DLJ believed in Vitro's vision for acquiring and operating Anchor and Latchford. It therefore agreed to provide $295 million in bridge financing to allow THR to acquire Anchor's and Latchford's stock.[6] DLJ, believing that THR would be a credit-worthy operating company once it merged into Anchor and Latchford, also intended to facilitate permanent financing after the acquisition was complete.[7]

At first, the plan was well on its way to success. In 1989, Container purchased all of Latchford's stock for approximately $41 million.[8] Vitro and Container also purchased just over 10% of Anchor's outstanding shares

[5] *Id.* at 4.

[6] Bridge financing is temporary financing provided to consummate a transaction with the intent and expectation that the temporary financing will be replaced with permanent financing. Tr. 30:6-12 (Lopez); 112:1-24 (Thompson).

[7] Doc. 18 at 4-5.

[8] Prior to the years in issue, Latchford merged into Anchor. *Id.* at 5, n.1.

on the market.[9] In August of 1989, Vitro made a tender offer for Anchor's remaining shares. Weeks before the sale was set to close, however, the high-yield bond market collapsed for reasons entirely unrelated to Vitro.[10] This unexpected turn of events meant trouble for Vitro, as Vitro and DLJ had intended to permanently finance the acquisition of Anchor and Latchford using high-yield bonds.[11] With the collapse of the high-yield bond market, Vitro could not obtain permanent financing in that market for its acquisition. DLJ, however, continued to believe that the Anchor acquisition was a credit-worthy transaction and that bridge financing could be used until permanent financing could be arranged when the high-yield bond market stabilized.

To finance the tender offer for Anchor's shares, Security Pacific National Bank ("SPNB"), a bank associated with DLJ, loaned THR $139 million (the "SPNB 1989 Tender Offer Loan") due on May 2, 1990.[12] Anchor Bridge Partnership ("Anchor Bridge"), an entity set up by DLJ, also loaned THR $155 million in exchange for senior subordinated floating rate

[9] *Id.* at 5.

[10] *Id.*

[11] *Id.*

[12] *Id.*

notes ("THR 1989 Bridge Note"), due on November 2, 1989.[13] The SPNB 1989 Tender Offer Loan was guaranteed by Container and Latchford and secured by pledges of the stock of THR, Anchor, and Latchford.[14] The THR 1989 Bridge Note was not guaranteed by any person or entity, other than THR.[15] Both Vitro and DLJ expected that the SPNB 1989 Tender Offer Loan and the THR 1989 Bridge Note would be refinanced as soon as the high-yield bond market stabilized.[16]

With the bridge financing in place, the acquisition proceeded as planned and THR eventually owned 100% of Anchor.[17]

Prior to the due date of the SPNB 1989 Tender Offer Loan, both Vitro and DLJ realized that the high-yield bond market was not improving as quickly as expected. Instead, the collapse of Drexel Burnham Lambert, which had created the high-yield bond market, made it even more difficult to refinance with high-yield bonds.[18] DLJ nonetheless continued to believe the financing market would improve. In May 1990, SPNB loaned Anchor

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[13] *Id.*

[14] Jt. Stip. ¶¶ 35-39.

[15] Jt. Stip. ¶ 41.

[16] *Id.* at 7.

[17] *Id.*

[18] *Id.* at 8.

$268.4 million to refinance the SPNB 1989 Tender Offer Loan and certain Anchor debts, as well as to provide working capital for Anchor ("SPNB 1990 Loans").[19] The terms of the SPNB 1990 Loans imposed several restrictions on Anchor, including the amount of other debt Anchor was allowed to take on, and the amount of money it could pay to THR. These restrictions meant that THR could not merge with Anchor, which, in turn, meant that THR could not refinance the THR 1989 Bridge Note using Anchor's assets and operating profits as collateral for the new loan, as it had expected to do.[20]

When it became apparent that THR could not immediately merge with Anchor, DLJ requested that the THR 1989 Bridge Note be restructured and guaranteed by Vitro.[21] The expected source for payment of the THR 1989 Bridge Note indebtedness was still Anchor's operating income, and THR planned to refinance that indebtedness when the financing market improved.[22] Nonetheless, to make the THR 1989 Bridge Note indebtedness more marketable in the meantime, DLJ and Vitro decided to refinance that

[19] *Id.*

[20] *Id.* at 8-9.

[21] *Id.* at 9.

[22] *Id.*

indebtedness through International. Vitro chose to refinance through International because International had U.S. assets and operations, and enough cashflow from operations to service at least part of the debt.[23] Further, potential institutional U.S. lenders preferred U.S. borrowers to Mexican borrowers.[24] Therefore, International issued $151 million of senior notes to Anchor Bridge ("International 1990 Bridge Note"), and used the proceeds to pay off the THR 1989 Bridge Note. In exchange for payment of the THR 1989 Bridge Note, THR issued to International a $151 million note ("THR 1990 Senior Note").[25] The THR 1990 Senior Note was a pay-in-kind note, which meant that THR was not required to make payments on the note until it matured on April 2, 1995.[26]

As the Tax Court held, at the time International refinanced the THR 1989 Bridge Note, Vitro expected that Anchor would soon be producing enough cashflow to allow THR to make payments on the $151 million THR 1990 Senior Note, which would then allow International to pay or refinance

[23] *Id.*

[24] Tr. 23:24-25, 24:1-25, 25:1-8, 36:12-25, 37:1-4 (Lopez); 115:18-25, 116:1-12, 124:25, 125:1-25, 130:1-5, 133:19-25, 134:1-3 (Thompson).

[25] Doc. 18 at 9-10.

[26] *Id.* at 9, n.5, 10.

the International 1990 Bridge Note.[27] In fact, Anchor was well on the way to achieving these goals. Between 1989 and 1991, Anchor substantially increased its annual cashflow from $100 million to $200 million.[28]

Although Anchor was succeeding, the financial markets remained depressed. Vitro and DLJ, however, agreed to refinance the $151 million International 1990 Bridge Note. Thus, International issued 21 senior notes (the "International 1991 Senior Notes") worth $155 million to a group of U.S. insurance companies (the "Note Purchasers").[29] To make payments of principal and interest on these notes, International would need THR to make payments on the THR 1990 Senior Note or THR and International would need to refinance their debt.[30] Since THR was not required to make payments on its 1990 Senior Note until its due date, DLJ advised International to obtain credit support to make its notes marketable.[31] That credit support came from Vitro's guarantee of the International 1991 Senior Notes ("the Guaranty Agreement").

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[27] *Id.*

[28] *Id.* at 10.

[29] *Id.* at 10-11.

[30] *Id.* at 11.

[31] *Id.* at 11-12.

For providing its guarantee, International paid Vitro 1.5% of the outstanding principal of the International 1990 Senior Notes. The Guaranty Agreement provided that if International defaulted, the Note Purchasers would be allowed to collect from Vitro, and Vitro would step into the shoes of the Note Purchasers with respect to such payments.[32] It was not expected, however, that International would default. Rather, Vitro, DLJ, the Note Purchasers, and International all expected that International would be able to repay the International 1991 Senior Notes through a combination of income from (1) Anchor operations that would allow THR to make payments on the THR 1990 Senior Notes, and (2) refinancing of the THR 1990 Senior Note and the International 1991 Senior Notes.[33]

International clearly had a short-term liquidity problem, however. For the period required to turn around Anchor's business and profitability and refinance its debts, International might not have the liquidity to make all of the interest and principal payments on its 1991 Senior Notes. This liquidity problem is described in Joint Stipulations Nos. 126 and 132, to which the IRS refers repeatedly.

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[32] Ex. 35-J (CH000155-180) (Guaranty Agreement).

[33] Tr. 32:11-22, 34:17-25, 35:1-11, 35:15-19, 37:5-17, 63:18-25, 64:1-19 (Lopez); 127:13-23, 128:25, 129:1-12, 130:6-14, 133: 8-25, 134:1-3; 136:11-14, 139:3-13 (Thompson).

Unfortunately, Anchor did not continue to perform as well as expected. In 1993, soft-drink producers switched to plastic containers, and in 18 months, the U.S. glass-container industry lost one-third of its demand.[34] Anchor's profits became losses. The collapse of Anchor's business meant that International's expected sources of income, along with the opportunity to refinance, never came to fruition. As the Tax Court specifically held, "Vitro expected that money from Anchor would eventually pay the [THR 1990 Senior Note]," which was the expected source of payment for the International 1991 Senior Notes.[35] Thus, Vitro and others involved were counting on Anchor's income to be the ultimate source of funds for International to pay off its 1991 Senior Notes. When that income unexpectedly fell through, Vitro and Container made capital contributions to International to pay the notes.[36] Using its own funds and capital contributions from Container and Vitro, International finally paid, in full, the balance of the principal and interest on the International 1991 Senior Notes in December 1994.[37] Due to continuing declines in demand for glass

[34] Doc. 18. at 13.

[35] *Id.* at 10.

[36] *Id.* at 13. Container made capital contributions after International became its wholly owned subsidiary effective September 1, 1993. Jt. Stip. ¶ 17.

[37] Jt. Stip. ¶ 135.

containers and increased competition in the U.S. market, Anchor ultimately filed for bankruptcy in 1997.[38]

SUMMARY OF ARGUMENT

The sole issue before the Court is the source of the guarantee fee income earned by Vitro, a Mexican corporation. International would be required to withhold the 30% tax pursuant to section 1442 only if Vitro's guarantee fee income was U.S. source income. Because the sourcing rules in sections 861 through 863 do not provide a rule specific to "guarantee fees," the source of this income is determined "by analogy" to one of the other specific rules contained in these sections. These rules source income from personal services to the location where the services were performed and source interest income to the residence of the debtor. These are the two potentially applicable sourcing rules in issue in this case.

The purpose behind the sourcing rules is to source income where it is earned, that is, where it was produced. As this Court expressly held in *Commissioner v. Piedras Negras Broadcasting Co.*,[39] who made the payment, where services are received, or where the benefits of services are received do not determine the source of income.

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[38] *Id.* at 14.

[39] 127 F.2d 260, 260-61 (5th Cir. 1942).

Vitro received the guarantee fees because of its agreement and financial ability to pay in the event that International defaulted on the International 1991 Senior Notes. Standing by to pay upon the occurrence of a future, contingent event is analogous to the performance of personal services. Guarantee fees for a standby guarantee are not analogous to interest on a loan because the guarantor does not advance funds while it stands by to pay. Thus, the Tax Court correctly applied the sourcing rule for services, and held that the guarantee fees are Mexican source income, since Vitro's assets, operations, and management, which gave it the ability to stand by, were all located in Mexico. That International paid the fees, that Vitro guaranteed International's debt, and that the guaranteed lenders were U.S. companies are all, individually and collectively, irrelevant. Vitro earned its guarantee fee income in Mexico and properly reported that income on its Mexican income tax returns.[40]

The guarantee fees are not analogous to interest because Vitro's guarantee is not analogous to a loan. International was primarily and unconditionally liable on, and expected to pay, the International 1991 Senior Notes. Vitro was liable to pay only if International defaulted. Vitro never loaned money to International, and Vitro never stepped into the Note

[40] Jt. Stip. ¶¶ 82-84.

Purchasers' shoes as the lender to International. The Tax Court found, as a matter of fact, that Vitro's liability under the guarantee was secondary to International's, and was contingent on International's default. The government's argument that International was expected to default, or that Vitro was in substance a lender to International is directly contrary to the Tax Court's findings. While the IRS does not expressly question the Tax Court's factual findings, its argument hinges on its showing that these findings are clearly erroneous. The IRS does not even attempt to show, and cannot show, that the Tax Court's findings are clearly erroneous.

Vitro did not receive payment from International for the use or forbearance of money, as there is no evidence that Vitro loaned International any money. Nonetheless, the IRS seeks to recharacterize Vitro's capital contributions to International, in effect, as a loan and the guarantee fees as compensation for that loan. This argument fails for several reasons.

First, this argument is premised on factual assertions that are contrary to the findings of fact made by the Tax Court. The Tax Court found that Vitro made the capital contributions in its capacity as a shareholder, and not in its capacity as a guarantor. The Tax Court's findings of fact are not clearly erroneous, so the IRS's argument fails for that reason alone.

Assuming, solely for the sake of argument, that Vitro made capital contributions because of the Guaranty Agreement, this fact shows only that sometimes guarantors must perform. That debtors sometimes default does not transform guarantees into loans. Guarantee fees do not become interest when a guarantor's contingent, secondary liability becomes an absolute primary liability. If a debtor defaults, under the doctrine of subrogation, the guarantor steps into the shoes of the lender when it pays the debt. The performing guarantor has all the rights of the lender, including the right to receive interest on the principal. Thus, upon a debtor's default, the guarantor is entitled – separate from any guarantee fees – to interest for the use or forbearance of its money. The nature and the source of guarantee fee income, however, was determined when the Guaranty Agreement was executed and cannot be retroactively re-determined based on events occurring after that date.

The IRS cites *Bank of America v. United States*[41] for the proposition that a fee paid for the use of another's credit closely resembles interest on a loan. The case does not so hold. *Bank of America* holds that commissions received for advancing money to one party with the expectation of repayment by a third party are analogous to interest. This holding is

[41] 680 F.2d 142 (Ct. Cl. 1982).

consistent with the accepted meaning of "interest" as compensation for the use or forbearance of money, because Bank of America actually advanced money and allowed another use of its money. Vitro, of course, did not advance any funds upon which interest could be calculated. This is the basis on which the Tax Court distinguished *Bank of America*. The Tax Court reached the obvious and reasonable conclusion that "a principal characteristic of a loan" is the extension of funds.[42]

Finally, even if the guarantee fee income is sourced by analogy to the sourcing rule for interest, it is still Mexican source income. Interest is sourced to the residence of the debtor, that is, to the residence of the person obligated on the debt. Vitro is the guarantor/obligor under the Guaranty Agreement. It follows that the guarantee fee should be sourced to the residence of Vitro, the guarantor. Vitro is a Mexican corporation so it is a resident of Mexico. Therefore, whether sourced by analogy to the sourcing rule for services or for interest, Vitro's guarantee fee income was not U.S. source income.

[42] Doc. 18 at 28.

ARGUMENT

The Tax Court correctly held that Vitro's guarantee fee income was Mexican source income and was not subject to tax under section 881(a).

I. Standard of Review

The Tax Court's ultimate decision that Vitro's guarantee fee income was not subject to tax under section 881(a) is a conclusion of law subject to *de novo* review. However, the Tax Court's decision rests, in part, on underlying findings of fact regarding the nature of Vitro's obligation under the Guaranty Agreement and the parties' expectations at the time (e.g., that the guarantee was a contingent, secondary obligation, not a primary obligation and that no default was expected). Those findings are reviewed only for clear error.[43] Factual findings may only be disturbed if the reviewing court is left with a "definite and firm conviction that a mistake has been committed."[44] This is a heavy burden for an appellant to satisfy. Factual findings must be affirmed so long as they are "plausible in light of the record viewed in its entirety."[45]

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[43] *See Af-Cap, Inc. v. Republic of Congo*, 383 F.3d 361, 368 (5th Cir. 2004) (findings underlying legal analysis are reviewed for clear error).

[44] *Hernandez v. New York*, 500 U.S. 352, 369 (1991).

[45] *Estate of Lisle v. Comm'r*, 541 F.3d 595, 601 (5th Cir. 2008).

II. The guarantee fees are not subject to U.S. withholding because they are not U.S. source income to Vitro.

A. Withholding – General Rules

As the Tax Court held, section 881(a) imposes a 30% tax on "fixed or determinable annual or periodical" ("FDAP") income of a foreign corporation 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."[46] The parties agree that the guarantee fees were FDAP income and were not income effectively connected with a U.S. trade or business. Thus, Vitro would be liable under section 881(a) only if the fees were income from a U.S. source. If Vitro is not liable under section 881(a), then the withholding requirement of section 1442 does not apply to International.[47]

Sections 861(a) and 862(a) specify that certain categories of income are gross income from sources within or without the United States. The source of "compensation for labor or personal services" is where the services are performed.[48] By contrast, sections 861(a)(1) and 862(a)(1) generally provide that the source of "interest on bonds, notes or other

[46] Doc. 18 at 14.

[47] *Id. citing* I.R.C. §§ 881(a), 1441(a)-(b), 1442(a).

[48] I.R.C. §§ 861(a)(3), 862(a)(3).

interest bearing obligations" is determined by the residence of the debtor. The residence of the debtor is used for sourcing interest because that is the situs of the obligation.[49] When, as here, the debtor is a corporation, its residence in the United States or a foreign country is determined by whether it is created or organized under the law of the United States, or under the law of a foreign country.[50]

A category of income not addressed in sections 861(a) and 862(a) may be sourced "by analogy" to the sourcing rules stated in those sections.[51] This process of sourcing by analogy is only necessary where there is no regulatory guidance as to the correct source. While section 863(a) authorizes the Treasury to issue regulations allocating and apportioning items other than those specified in sections 861(a) and 862(a) to sources within and without the United States, no regulations have been issued under section 863 that are relevant to the issues presented in this case. This lack of guidance is especially troublesome in the context of withholding because a

[49] *See Howkins v. Comm'r*, 49 T.C. 689, 694 (1968).

[50] I.R.C. § 7701(a)(4).

[51] *Howkins*, 49 T.C. at 693-95.

withholding taxpayer, such as International, is responsible for withholding the tax imposed by section 881(a) on a foreign recipient, such as Vitro.[52]

Effective September 27, 2010, Congress enacted sections 861(a)(9) and 862(a)(9) to provide that amounts paid by a U.S. corporation for the provision of a guarantee of such corporation's indebtedness is U.S. source income.[53] This new provision applies to guarantees issued after the date of enactment and no inference is intended with respect to the source of income received with respect to guarantees issued before the date of enactment.[54] As this Court held in *Petroleum Corporation of Texas, Inc. v. United States*,[55] had these new sections been "merely a codification of existing law, there would have been no reason for Congress to specify, as it did, that the new provision would only be applied prospectively."[56] Thus, if anything, the enactment of sections 861(a)(9) and 862(a)(9), with prospective

[52] *See Cent. Ill. Pub. Serv. Co. v. U.S.*, 435 U.S. 21, 31 (1978) (holding that withholding obligations should be "precise and not speculative").

[53] Small Business Jobs Act of 2010, Pub. L. No. 111-240 §2122 (Sept. 27, 2010) (adding I.R.C. §§ 861(a)(9), 862(a)(9)). `

[54] JOINT COMMITTEE ON TAXATION REPORT, Source rules for income on guarantees, H.R. No. 5297, 111th Cong., 2d Sess., 64 (2010).

[55] 939 F.2d 1165 (5th Cir. 1991).

[56] *Id.* at 1169.

application, confirms that before these amendments, the law was not as urged by the IRS in this case.

B. The Tax Court correctly held that the guarantee fees are analogous to income from services.

The Tax Court analyzed the purpose of the sourcing rules and the nature of the transaction to conclude that Vitro's income was more analogous to services income than to interest income. Before reaching this conclusion, however, the Tax Court discussed whether Vitro's guarantee fee income was literally either services income or interest income. The court easily concluded that the guarantee fee income could not be interest income because Vitro had not loaned International any money.[57] The court then struggled with whether the guarantee fee income was services income. After significant analysis, the Tax Court finally concluded that, although actual services are performed in the provision of a guarantee, the fee is not paid primarily for those services.[58] Thus, the Court moved on to consider which category of income provided the most apt analogy.

In deciding whether the guarantee fee income was most analogous to services income or interest income, the Tax Court kept the purpose of the

[57] Doc. 18 at 16.

[58] *Id.* at 23.

sourcing rules in mind.[59] In *Hunt v. Commissioner*, the Tax Court had previously held that Congress's intention in creating the sourcing rules was "to identify the source of income in terms of the business activities generating the income or to the place where the income was produced."[60] In other words, *Hunt* holds that "the sourcing concept is concerned with the earning point of income or, more specifically, identifying when and where profits are earned."[61] Thus, the goal is to source Vitro's guarantee fee income to either Mexico or the United States taking into account the purpose of the Code's income sourcing rules.

As the Tax Court found, Vitro was able to make the guarantee "because it had sufficient Mexican assets -- and its Mexican corporate management had a sufficient reputation for using those assets productively -- to augment International's credit."[62] When Vitro augmented International's credit, it did not loan money to International and it did not "substitute" its credit for International's credit, as the government contends. International paid Vitro for Vitro's agreement to stand by and to be prepared to pay

[59] *Id.* at 30-31.

[60] *Hunt v. Comm'r*, 90 T.C. 1289, 1301 (1988).

[61] *Id.*

[62] Doc. 18 at 30.

International's debt in the event of a default by International. Prior to International's default, Vitro was not liable on International's debt. Therefore, by standing by to pay, Vitro essentially provided an intangible benefit to International and that benefit was performed in Mexico, where Vitro's assets and management were located. That a U.S. company paid the fees; that the debt guaranteed was the debt of a U.S. company; and that the lenders were U.S. companies are all irrelevant.

This Court's holding in *Piedras Negras* shows that the source of the payment and where intangible benefits are received do not control the source of the income earned by providing those benefits.[63] It is the location at which an intangible benefit is produced that matters. In *Piedras Negras*, a radio station located in Mexico broadcast programs and advertising in English directed almost exclusively to U.S. listeners.[64] Advertisers located in the United States paid the Mexican radio station for advertising their products to U.S. listeners. This Court held that the Mexican radio station realized Mexican source advertising income because its radio station and personnel were located in, and broadcast from, Mexico. This shows that the

[63] 127 F.2d at 260-61.

[64] It is interesting to note that the radio station at issue in *Piedras Negras* was one of the famed "Border Blasters," whose most famous disc jockey was the howling Wolfman Jack.

location of the person making the payment and where intangible benefits are received do not determine the source of income received for providing those benefits. Similar to the advertising income of the radio station in *Piedras Negras*, Vitro earned the guarantee fees in issue because it provided an intangible benefit consisting of its guarantee. Vitro's assets and management located in Mexico allowed Vitro to provide this benefit. That a U.S. company (International) paid the guarantee fees; that U.S. lenders received the guarantee; and that International benefitted from Vitro's guarantee have no legal relevance to determining the source of Vitro's fee income.

While the Tax Court was the first court to hold that a guarantee is analogous to a service, the IRS has often taken the position that fees for similar financial commitments are not interest. For example, the IRS has repeatedly ruled that fees for financial services, such as commitment fees for agreeing to make a loan in the future, are not interest to the recipient.[65] Loan commitment fees are similar to guarantee fees in that the recipient is contingently obligated to make a loan in the future. Loan commitment fees are not interest either to the payor or to the payee.[66] Similarly, the IRS has

[65] Rev. Rul. 74-258, 1974-1 C.B. 168; Rev. Rul. 70-362, 1970-2 C.B. 147.

[66] *Id.*

held that credit card annual fees paid by a cardholder are not interest to the credit card issuer.[67] Implicitly, if commitment fees and annual credit card fees are not interest, then they are fees for services.[68] In 1922, in a scenario remarkably similar to this case, the IRS actually ruled that guarantee fees should be sourced to the country in which the guarantor resides.[69] Therefore, the Tax Court correctly held that the guarantee fees were Mexican source income in this case.

C. The Tax Court correctly held that the guarantee fees are not analogous to interest.

Guarantee fees are not only analogous to payments for services, they are also clearly distinguishable from interest. In holding that guarantee fees are not analogous to interest, the Tax Court reached the obvious and reasonable conclusion that the principal characteristic of a loan is the extension of funds.[70] The Tax Court thus reasoned that in a situation where

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[67] Rev. Rul. 2004-52, 2004-22 I.R.B. 973.

[68] *See* I.R.S. P.L.R. 7808038 (Nov. 25, 1977) (concluding that commitment fees were payments for the performance of services outside of the United States and, therefore, not interest under the section 862 sourcing rules). This ruling is not cited as legal authority or precedent, but is cited only to show that the IRS has determined that commitment fees were income from the performance of services under the sourcing rules.

[69] A.R.R. 723, I-1 C.B. 113 (1922). Although this ruling is obsolete under Revenue Ruling 78-345, 1978-2 C.B. 346, it nonetheless demonstrates that the Service at one point agreed with the taxpayer's position – that guarantee fees should be sourced to the country of the company making the guarantee.

[70] Doc. 18 at 28.

no funds are loaned, an analogy to interest is inapposite. This conclusion is amply supported by the case law defining interest as "compensation for the use or forbearance of money."[71]

The only case holding that income was analogous to interest where there was no extension of funds or forbearance of money is *Howkins*.[72] *Howkins* required the Tax Court to source alimony payments. The court noted that none of the specific sourcing rules applied, so alimony must be sourced by analogy to the specific sourcing rules. The Tax Court applied the sourcing rule for interest, stating that both alimony and interest involve "an obligation, usually to make periodic payments over a period of time, which is not incurred in exchange for property or services."[73] As the Tax Court commented, the court in *Howkins* adopted a "modern view of marriage" and thus did not view alimony as compensation for marital services, property, or any other tangible or intangible benefit.[74] Since it viewed alimony as merely a legal obligation to make periodic payments to the divorced spouse, it held

[71] *See, e.g.*, *Deputy v. du Pont*, 308 U.S. 488, 498 (1940); *Sharp v. Comm'r*, 75 T.C. 21, 24 (1980), *aff'd.* 689 F.2d 87 (6th Cir. 1982).

[72] 49 T.C. at 694.

[73] *Id.* The Tax Court noted, however, that the obligation to repay a loan is incurred in exchange for money.

[74] Doc. 18 at 24.

that alimony was analogous to interest and should be sourced to the residence of the obligor.

Interpreting its own decision, the Tax Court held that *Howkins* does not create a default rule in which any periodic payment not made for property or services is sourced like interest. Such a rule would take the analysis out of sourcing by analogy and, in effect, would treat all unlisted types of income as interest. Instead, the Tax Court read its decision in *Howkins* to hold that the alimony income was produced by the obligor, that is, the person making the alimony payments. Thus, applying the policy of the sourcing rules as stated in *Hunt*, the *Howkins* court sourced the alimony income to the location of the obligor, *i.e.*, where the income was earned by the payor.

By contrast to alimony, guarantee fees are more than just a legal obligation to make periodic payments. They are payments made in exchange for very real, albeit intangible, benefits to the debtor and its lenders. These benefits are the augmentation of the debtor's credit and the secondary and contingent liability of the guarantor. These benefits are, in effect, services provided by the guarantor for the benefit of the debtor and the lender. In order to provide these benefits, the guarantor must take actions to execute the guarantee, comply with its terms, and, most

importantly, have and maintain assets to allow it to perform under its guarantee, if necessary. Guarantee fees are payments for the guarantor taking these actions, which are necessary for it to stand by to pay upon the debtor's default. Therefore, guarantee fees are analogous to payments for services. If and only if the guarantor performs under its guarantee, then and only then would the guarantor be entitled to interest for the extension of its funds to the debtor.

The IRS briefly makes the argument that because the guarantee fees are calculated as a percentage of the outstanding principal, Vitro's guarantee fee income must be analogous to interest. In essence, the government argues that any payment tied to a fixed amount, such as principal, is analogous to interest and cannot be payment for services.[75] This argument has no factual or legal support. Examples abound of payments that are indisputably made for services but computed by reference to stated or fixed amounts.[76] In short, the method of calculating compensation has no bearing on what that compensation is for.

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[75] Appellant's Brief at 19.

[76] Real estate brokers normally are compensated based on a percentage of the sales price of property. Attorneys are frequently paid a contingency fee or success fee stated as a percentage of the final judgment awarded to, or the value of the transaction effected for, their clients. Investment bankers typically receive a small initial retainer and, if the financial transaction they facilitate is successful, a success fee is calculated as a percentage of the size of the transaction

D. The guarantee is more analogous to a service than to a loan.

As the Tax Court held, guarantees are contingent, secondary obligations that do not involve any forbearance of money.[77] This fact persuaded the court that a guarantee was not analogous to a loan, as "a principal characteristic of a loan" is the extension of funds.[78] The government never even attempts to refute this holding. Instead, it attempts to obscure the question, arguing that, "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."[79] This statement says nothing more profound than that both lenders and guarantors are paid for what they do. That both guarantors and lenders are paid for what they do has no bearing on whether what they do is analogous for purposes of applying the sourcing rules. What lenders and guarantors do is not analogous. Lenders lend money; guarantors do not. They stand by to pay under a contingent, secondary obligation.

[77] Doc. 18 at 30.

[78] *Id.* at 28.

[79] Appellant's Brief at 25.

E. Sourcing the guarantee fees to Mexico fits within the purpose of the sourcing rules because Vitro produced the guarantee fee income.

As *Hunt* makes clear, the purpose and policy of the sourcing rules is to source income to the location "of the business activities generating the income or to the place where the income was produced."[80] Here, the guarantee fees were produced by Vitro's guarantee. The Tax Court opinion thus concludes that "Guaranties, like services, are produced by the obligee and so, like services, should be sourced to the location of the obligee."[81]

The government criticizes this conclusion, stating "With all due respect to the Tax Court, its reasoning does not withstand analysis."[82] The government proceeds to argue that "guaranties are no more 'produced' by the obligee than loans are 'produced' by the lender."[83] The IRS obviously misunderstands the Tax Court's conclusion. The Tax Court's reference to "obligee" is clearly a reference to the person performing services and entitled to be paid for its services. In that context, both service providers and guarantors are "obligees" because they are entitled to fees for their services and guaranties. The authority the Tax Court cites makes this clear.

[80] *Hunt*, 90 T.C. at 1301.

[81] Doc. 18 at 31.

[82] Appellant's Brief at 25.

[83] Appellant's Brief at 25.

Section 861(a)(3) expressly provides that compensation for personal services is sourced by reference to the place the services are performed. *Hunt* provides that "the sourcing concept is concerned with the earning point of income."[84] Thus, when the Tax Court concludes that "Guaranties, like services, are produced by the obligee and so should be sourced to the location of the obligee," it means that income from guaranties, like income from services, is sourced to the location of the guarantor, since that is where a guarantor performs.

The government's statement that "guaranties are no more 'produced' by the obligee than loans are 'produced' by the lender"[85] is as confusing as it is inaccurate. To speak of loans as being "produced" within the context of the sourcing rules makes no sense. There is no sourcing rule for loans, nor would there ever need to be. Loan proceeds are not income.[86] Thus, where loans are "produced" is entirely irrelevant. Interest income must be sourced and, under section 861, it is sourced to the residence of the debtor, because the debtor's obligation produces the interest. By contrast, guarantee fees are produced by the guarantee and should be sourced to the location of the

[84] *Hunt*, 90 T.C. at 1301.

[85] Appellant's Brief at 25.

[86] *Comm'r v. Tufts*, 461 U.S. 300, 307 (1983) ("Because of [the repayment] obligation, the loan proceeds do not qualify as income to the taxpayer.").

guarantor. In arguing that guarantee fees are not "produced by" the guarantor, in effect, the government makes the illogical argument that such fees are instead produced by the persons benefitted by the guarantee, *i.e.*, the debtor and the debtor's creditors.

In order to support this argument, the IRS attempts to obfuscate the legal and economic differences between Vitro's obligation under its guarantee and International's obligation to the Note Purchasers. The Tax Court stated, however, that "Vitro's obligation was, in contrast [to International's], entirely secondary."[87] The Tax Court expressly found that "Vitro loses only if International defaults and Vitro repays the 1991 International senior notes (which transfers International's obligation from the Note Purchasers to Vitro) and then International defaults on the transferred debt."[88] The Tax Court emphasized that "Vitro's guaranty was not an obligation to pay immediately, but a promise to possibly perform a future act."[89] Thus, the Tax Court correctly found, as a matter of fact, that International was primarily liable on its notes and that Vitro's guarantee was a separate and secondary obligation.

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[87] Doc. 18 at 28.

[88] *Id.*

[89] *Id.* at 31.

The Tax Court's finding that Vitro's guarantee was entirely distinct from International's debt is not clearly erroneous. Vitro's guarantee acted only to "augment" International's credit. Vitro did not substitute its own money for International's and then ask International to pay it back.[90] The record supports this finding by demonstrating that International was not the insolvent shell that the government seems to suggest.[91] International had its own assets, operations and creditworthiness.[92] Moreover, Vitro reasonably expected that Anchor would continue to expand its business and profitability to allow refinancing of its debts and the THR 1990 Senior Notes. As a result, Vitro reasonably expected that International would not default on its notes. Vitro's guarantee was purely a backstop, in the nature of wearing both "a belt and suspenders."[93] Proof of International's creditworthiness comes, in part, from the fact that International refinanced the THR 1989

[90] Doc. 18 at 27.

[91] Tr. 32:11-22, 34:17-25, 35:1-11, 35:15-19, 37:5-17, 38:12-20, 63:18-25, 64:1-19 (Lopez); 126:11-16, 127:13-23, 128:25, 129:1-25, 130:1-14, 133: 8-18, 136:11-14, 139:3-13 (Thompson).

[92] International was first formed to put all Vitro's American marketing and distribution subsidiaries into one entity. Thus, International had income from these activities. Doc. 18 at 2.

[93] Tr. 126:11-16 (Thompson).

Bridge Note "because [it] had enough cashflow from its operations to service at least part of the Note."[94]

In short, the Tax Court held that Vitro did not make a primary promise to pay International's notes, either in form or in substance. International was primarily liable on its notes, both in form and in substance. Such findings of fact are supported by the record and are not clearly erroneous. The reason International required credit support was that it temporarily lacked liquidity to pay all of the interest and principal on the notes until Anchor's turnaround provided it with liquidity and the opportunity to refinance its and THR's debts. This short-term liquidity problem is what Joint Stipulations Nos. 126 and 132, which the Service quotes repeatedly, describe. This liquidity problem is also what the Tax Court referred to when it stated that "as expected, [International] did not have the cashflow to make the interest payments on the International 1991 senior notes."[95] International expected only that it would lack liquidity in the short period before THR could refinance. International's short term liquidity problem in no way justifies treating Vitro as, in effect, loaning funds to International or borrowing funds from International's Note Purchasers.

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[94] Doc. 18 at 9.

[95] *Id.* at 13.

In summary, the Tax Court found that, under the Guaranty Agreement, Vitro had a contingent, secondary obligation to pay the International 1990 Senior Notes and that this obligation was separate and distinct from International's obligation to the Note Purchasers. These findings are not clearly erroneous and the government's arguments that hinge on disregarding these findings should be rejected as contrary to the facts. Vitro's guarantee fee income was produced by Vitro's Guaranty Agreement using its assets, operations and management located in Mexico as found by the Tax Court. Thus, such guarantee fee income was Mexican source income to Vitro.

III. The government mischaracterizes the facts regarding Vitro's capital contributions.

The IRS attempts, as it did in the lower court, to treat Vitro's capital contributions to International as proof that the guarantee fees are analogous to interest. That is, the government argues that because Vitro, as a shareholder, made capital contributions to International, the guarantee fees paid to Vitro were "for the anticipated and expected use of Vitro's funds in meeting its debt obligations."[96] This argument regarding Vitro's capital contributions to International fails for four reasons.

[96] Appellant's Brief at 24.

A. The Tax Court found that Vitro did not expect International to default.

At the time Vitro executed the Guaranty Agreement, Vitro, DLJ, the Note Purchasers, and International all expected that International would be able to repay the 1991 Senior Notes through a combination of (i) its income and the income from Anchor's operations that would allow THR to make payments on its THR 1990 Senior Note, and (ii) refinancing of the THR 1990 Senior Note and the International 1991 Senior Notes.[97] The IRS ignores these facts and relies solely on Joint Stipulation No. 126. As previously discussed, this stipulation does not show that International was expected to fail. The stipulation provides, "[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*."[98]

[97] Tr. 32:11-22, 34:17-25, 35:1-11, 35:15-19, 37:5-17, 63:18-25, 64:1-19 (Lopez); 127:13-23, 128:25, 129:1-12, 130:6-14, 133: 8-18, 136:11-14, 139:3-13 (Thompson).

[98] Jt. Stip. ¶ 126 (emphasis added). Joint Stipulation No. 132 is nearly identical, except that it discusses principal payments rather than interest payments.

The IRS ignores the import of the italicized phrases. In particular, the last phrase is crucial, as it shows that the Stipulation merely provides that, for the short period of time before Anchor could refinance the debts, International expected to have a liquidity problem. As the record demonstrates, the expectation by all involved was that Anchor would be able to generate enough cashflow and assets to allow THR to refinance its pay-in-kind note and begin making payments on its debt to International, giving International the cashflow it needed to pay or refinance its 1991 Senior Notes.[99] Anchor could not refinance its debt because of the unexpected and severe decline in its business due to the sudden popularity of plastic soft drink bottles, which dramatically changed the U.S. glass industry.[100] This development was plainly not expected or anticipated by anyone and ultimately led to Anchor's bankruptcy in 1997.

Moreover, as discussed above, the Tax Court found that Vitro's guarantee was a standby guarantee and not a primary obligation to pay the 1991 Senior Notes. This finding is not clearly erroneous and is supported by the record. The government's argument that Vitro expected International to default on its notes is an argument that Vitro was agreeing to step into

[99] Tr. 32:11-22, 34:17-25, 35:1-11, 35:15-19, 37:5-17, 63:18-25, 64:1-19 (Lopez).

[100] Tr. 39:8-25, 40:1-25, 41:1-9 (Lopez); 134:4-25, 135:1-10 (Thompson).

International's shoes from the outset and take on the role of a primary debtor. The Tax Court found to the contrary. Therefore, Vitro never stepped into International's shoes and never assumed a primary obligation to the Note Purchasers.

B. The Tax Court found that Vitro's capital contributions to International were not made under the Guaranty Agreement.

The Tax Court found that Vitro's decision to "subsidize International through capital contributions" was a "later choice," made after its decision to take on the guarantee.[101] The Tax Court also found that Vitro's guarantee "lacks a principal characteristic of a loan because Vitro did not extend funds to International."[102] Thus, the Tax Court concluded that the capital contributions were made separately from the Guaranty Agreement.

The IRS does not even attempt to demonstrate that these findings are clearly erroneous, but nonetheless asserts that Vitro's capital contributions to International should be treated as made under the Guaranty Agreement. The only fact the government cites to support this assertion is that Vitro was making capital contributions to International in 1990 before the 1991 Senior

[101] Doc. 18 at 29.

[102] *Id.* at 28.

Notes were sold.[103] The IRS cites this fact as support for its assertion that Vitro's capital contributions were made under the Guaranty Agreement, even though Vitro also made contributions to International prior to entering into the Guaranty Agreement. The government's assertion that the capital contributions were made under the Guaranty Agreement is fatally flawed because it rests on the argument that Vitro expected International to default. As discussed above, the Tax Court found that that Vitro did not expect International to default. That finding is supported by the record and is not clearly erroneous.

C. The IRS inconsistently argues that Vitro made capital contributions as a shareholder, but should be taxed as a guarantor.

Ultimately, Vitro made capital contributions to International, which International used, along with funds from other sources, to repay the Note Purchasers. The government argues that because of these capital contributions, the guarantee fees were payment "for the anticipated and expected use of Vitro's funds in meeting its debt obligations."[104] As discussed above, if the government is arguing that the capital contributions were made by Vitro under the Guaranty Agreement, this argument is

[103] Appellant's Brief at 24.

[104] *Id.*

inconsistent with the Tax Court's findings. Given the Tax Court's findings that Vitro made the capital contributions as a shareholder, the IRS must be arguing that International paid the guarantee fees to Vitro for its capital contributions as a shareholder. If the guarantee fees were paid to Vitro for its capital contributions as a shareholder, then the IRS would have treated the guarantee fees as non-deductible distributions to Vitro as a shareholder, rather than as deductible ordinary and necessary expenses of International. Upon audit of International and at trial of this case, the IRS consistently treated the guarantee fees as deductible expenses of International and not as distributions to Vitro as a shareholder. Distributions by International to Vitro as a shareholder would have been subject to an entirely different scheme of taxation both to International and to Vitro.[105]

On this appeal, however, the government argues that, although Vitro made capital contributions to International as a shareholder, in effect, it received guarantee fees for making those contributions. This argument conflicts with the Tax Court's findings that the guarantee fees were paid to Vitro for its guarantee, and that Vitro's capital contributions were a "later choice."[106] This position is also at odds with the IRS's consistent treatment

[105] I.R.C. §§ 301, 316 (laying out the taxation scheme for distributions by a corporation to its shareholders).

[106] Doc. 18 at 29.

of the guarantee fees as deductible expenses of International and not as distributions to Vitro as a shareholder. Therefore, in determining whether the guarantee fees are U.S. source income to Vitro, such fees should be viewed as though paid to an unrelated party. That Vitro is also a shareholder in International and made separate capital contributions to International does not in any way affect the source of Vitro's guarantee fee income.

D. Even if Vitro's capital contributions were made because of the guarantee, a guarantee is not a loan, nor are guarantee fees like interest.

Accepting, solely for purposes of argument, that Vitro made the capital contributions because of the Guaranty Agreement, these facts would not justify treating the guarantee fee as compensation for the use of money. Performance under a guarantee does not transform the original guarantee agreement into a primary obligation. When debtors default and the guarantor pays the debt, only at that point will the guarantor become a lender.[107] If default occurs, the guarantor at that point becomes entitled to interest on the amounts paid by the guarantor to the debtor's creditors.

[107] *Benak v. Comm'r*, 77 T.C. 1213, 1218 (1981) ("As a guaranty is a secondary and not a primary obligation, no debt runs to the guarantor from the principal debtor until the guarantor makes payment on the guaranty.").

When a guarantor pays a guaranteed debt, the doctrine of subrogation allows the guarantor to step into the shoes of the lender.[108] This entitles the guarantor to "all the rights of the person he paid to enforce his right to be reimbursed."[109] If Vitro had been called upon to pay the guaranteed amounts, it would have become entitled to all the rights of the Note Purchasers – including the right to receive interest on the amount loaned. That interest would have compensated Vitro for the forbearance of its money. By contrast, Vitro received the guarantee fees in exchange for its willingness and financial ability to stand by to pay International's notes.

Even though a guarantor will become a lender if it pays the debt upon the debtor's default, that possibility is irrelevant to the nature of the guarantee. The tax effect of a guarantee or a standby letter of credit is determined when the obligation is incurred.[110] Likewise, the tax effect of

[108] *Putnam v. Comm'r*, 352 U.S. 82, 85 (1956).

[109] *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 136–37 (1962).

[110] Events subsequent to the year in issue are not taken into account because that would violate the basic income tax annual accounting and reporting principle. *See, e.g.*, *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 363 (1931); *Brent v. Comm'r*, 630 F.2d 356, 360 (5th Cir. 1980) (*citing Sec. Flour Mills Co. v. Comm'r*, 321 U.S. 281, 286 (1994)); *Noble v. Comm'r*, 368 F.2d 439, 444 (9th Cir. 1966).

Vitro's guarantee must be determined when incurred, and its treatment cannot be determined based on future events.[111]

IV. *Bank of America* does not support the IRS's position.

The government cites *Bank of America* for the proposition that payment for the use of another's credit is analogous to interest. *Bank of America* does not so hold. The facts of *Bank of America* are as follows: Bank of America earned commissions for confirming and accepting letters of credit. To "confirm" a letter of credit, Bank of America irrevocably committed itself to advance money to a seller. When the terms of the sale were fulfilled, Bank of America paid the seller, expecting to be reimbursed by the purchaser or the purchaser's bank.[112] To "accept" a letter of credit, Bank of America irrevocably obligated itself to pay the face amount of a draft on the day the draft became due. This required Bank of America to advance money, and wait to be repaid by the foreign bank.[113] Although the foreign banks customarily paid the face amount of the draft on the day

[111] *See, e.g.*, *Baldwin v. Comm'r*, 66 T.C.M. (CCH) 769 (1993) (whether a shareholder's advance was corporate debt or equity was determined at time of advance); *Frazee v. Comm'r*, 98 T.C. 554 (1992) (fair market value of property is based on events and expected events at the time of valuation); *Cherrydale Cement Block Co., Inc. v. Comm'r*, 21 T.C.M. (CCH) 1408 (1962) (whether debts were worthless was determined based on the facts at the end of the taxable year in which the bad debt deduction was claimed).

[112] 680 F.2d at 144.

[113] *Id.* at 145.

preceding maturity, Bank of America was obligated to pay the holder of an accepted letter of credit whether or not it had received payment from the foreign bank.[114] Thus, when confirming or accepting a letter of credit, Bank of America was required to advance money, and it had to look to the purchaser or foreign bank to be repaid.[115]

Based on these facts, the Claims Court held that the commissions received by Bank of America for accepting or confirming a letter of credit should be sourced by analogy to interest. The government repeatedly quotes the Claims Court's statement 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."[116] The facts clearly show that Bank of America was not being paid for substituting its credit for that of the foreign bank, but for substituting its money for that of the foreign bank. In fact, the opinion specifically states that Bank of America did not typically charge any commission for confirming a letter of credit when the seller prepaid.[117] This shows that when Bank of America charged fees for accepting or confirming

[114] *Id.* at 148.

[115] *Id.* at 148-49.

[116] *Id.* at 150.

[117] *Id.* at 144, 150.

a letter of credit, it was, in effect, charging for the use of its money. Thus, the analogy of the commissions to interest under the facts in *Bank of America* is clear.

The only similarity between Bank of America's situation and Vitro's is that both parties provided assurance. This assurance was provided in very different ways, however. Rather than using its creditworthiness to provide assurance, Bank of America used its money. Bank of America agreed to advance its money to the seller before the purchaser or foreign bank made an effort to pay. Vitro, on the other hand, provided assurance with its creditworthiness. Vitro agreed only to stand by; it was not obligated to step in and advance funds unless International defaulted. The difference is critical. Bank of America's obligation was absolute and primary the moment it accepted or confirmed a letter of credit. Vitro's obligation was contingent and secondary. Vitro was not obligated to pay anyone at the time it signed the Guaranty Agreement, only to stand by to pay.

The IRS argues that the Tax Court erred in distinguishing *Bank of America* on the basis that Vitro's promise to pay was purely contingent.[118] According to the IRS, the Tax Court's reasoning does not take into account

[118] Appellant's Brief at 31-32.

that Bank of America incurred less risk than Vitro.[119] The government contends that Bank of America incurred less risk than Vitro because (1) Vitro expected International to default, and (2) Bank of America frequently confirmed and accepted letters of credit for purchasers or foreign banks that kept accounts with Bank of America, meaning that Bank of America needed only to debit their bank accounts. There are two problems with this argument. First, it rests on the assertion that Vitro expected International to default, which is contrary to the Tax Court's findings and the record, as discussed above. Second, *Bank of America* barely mentions that foreign purchasers or foreign banks kept accounts with Bank of America. The case states only that in the context of accepting a letter of credit, the foreign bank would customarily pay Bank of America the face amount of the time draft on the day preceding the date of its maturity, normally by debiting the account of the foreign bank.[120] This is the only mention of whether foreign banks or purchasers kept accounts with Bank of America. Thus, there is no indication that Bank of America confirmed or accepted letters of credit only for foreign banks or purchasers that kept accounts with Bank of America.

[119] Appellant's Brief at 31.

[120] *Bank of America*, 680 F.2d at 145.

In any event, the fact that foreign banks or purchasers may have kept accounts with Bank of America did not influence the court's decision.

Further, the level of risk that Vitro or Bank of America incurred is irrelevant. The government is attempting to analogize guarantee fees to *interest*. Although the interest rate may take into account the risk of default by a debtor, interest is uniformly treated as compensation for the "use or forbearance of money."[121] Bank of America advanced money and, thus, forbore money. Vitro did not. Bank of America charged commissions when it forbore money; it typically did not charge commissions when no forbearance was involved.[122] Vitro charged a fee for standing by to pay International's debt. *Bank of America* does not hold or even suggest that guarantee fees are analogous to interest. Nor does it hold that payment for the "substitution of credit" is analogous to interest. As the Tax Court held, it holds only that where Bank of America "was, in effect, making a short-term loan, [that] the commissions approximated interest."[123]

[121] *du Pont*, 308 U.S. at 498.

[122] 680 F.2d at 144, 150.

[123] Doc. 18 at 27.

V. *Centel* does not support the IRS's position.

In *Centel Communications Co., Inc. v. Commissioner*,[124] the Tax Court considered whether stock warrants were issued "in connection with the performance of services" within the meaning of section 83. The taxpayer argued that the warrants were issued to compensate certain of its shareholders for personally guaranteeing the taxpayer's debts. The court in *Centel* emphasized that "whether property is transferred in connection with, or in recognition of, the performance of services [as provided by section 83] is essentially a question of fact."[125] The court found that (i) the warrants were not compensatory in nature; and (ii) were not transferred in connection with, or in recognition of, the performance of services. In so holding, the court stated (i) that the shareholders executed the personal guarantees "in their role as shareholders and investors," and (ii) that none of the shareholders "was engaged in a trade or business (or activity engaged in for profit) of guaranteeing loans, guaranteeing performance, or subordinating indebtedness for a fee."[126] Thus, the result in *Centel* was mandated by the court's factual finding that the warrants were issued to the shareholders in

[124] 92 T.C. 612 (1989).

[125] *Id.* at 629.

[126] *Id.* at 632.

their capacity as shareholders and investors. This finding substantially rested on the fact that none of the shareholders was engaged in the business of guaranteeing debts. By contrast, Vitro regularly guaranteed debts of its consolidated and unconsolidated subsidiaries in exchange for guarantee fees, as part of its longstanding business activities and purpose.[127] Vitro's estatutos or by-laws expressly state that providing guarantees for its subsidiaries was one of Vitro's business purposes.[128] Further, the IRS has consistently treated International as paying the guarantee fees to Vitro as a guarantor, rather than as a shareholder.

The opinion in *Centel* states that the decision in *Bank of America* "lends some support to the view that the guarantees . . . did not constitute the performance of services under section 83."[129] This statement is *dicta* because the court had already concluded that the warrants were not, in fact, issued in connection with the performance of services for purposes of section 83. Further, as discussed above, *Bank of America* provides no support for the proposition that guarantees are not services; it does not

[127] Doc. 18 at 13.

[128] *Id.*

[129] *Centel*, 92 T.C. at 634.

address guarantees at all. Therefore, the statements regarding *Bank of America* in *Centel* are both *dicta* and incorrect.

The *Centel* court also stated that it placed "little reliance" on the reasonable compensation cases, which expressly consider "guarantee services" as personal services actually rendered.[130] This demonstrates that the result in *Centel* rested on the court's factual finding that the warrants were issued to the shareholders in their capacity as shareholders, and not as guarantors. In so holding, the court emphasized that the shareholders in issue were not engaged in the trade or business of providing guarantees. Thus, *Centel* does not hold or support that guarantees are not "services."

VI. Even by analogy to the sourcing rule for interest, the guarantee fees are not U.S. source income.

As previously stated, if the source of a category of income is not prescribed by sections 861(a) and 862(a), the courts may determine the source "by analogy" to the rules stated in those sections. In *Howkins*, for example, the court held that the statutes and regulations did not prescribe a sourcing rule for alimony, so it could be sourced by analogy to the statutory rules.[131] The court explained that the intent of the sourcing rules is to

[130] *Id.* at 636.

[131] 49 T.C. at 693-94.

determine "where the recipient's income 'was produced,'" and that the "origin of the physical means of payment" does not establish the source of income.[132] As to interest, "Congress turned to the residence of the obligor -- the situs of the debt -- as the place where the [interest] income is produced, and thus the source of the income."[133] Thus, *Howkins* concludes that alimony is similar to interest because (like interest) it is a periodic payment not incurred in exchange for property or services, so it should be sourced to the residence of the person obligated to pay alimony.[134] This reasoning makes clear that interest is sourced to the location of the debt, and not by reference to the physical source of payment of the interest. This is also demonstrated by section 1.861-2(a)(5) of the Treasury Regulations, which provides that interest paid on an obligation of a U.S. resident by a nonresident acting as guarantor of the obligation is treated as income from sources within the United States.[135] That is, if Vitro had paid interest owed

[132] *Id.* at 693.

[133] *Id*. at 694.

[134] A debt obligation, however, is incurred in exchange for property (*i.e.*, loaned funds).

[135] 26 C.F.R. § 1.861-2(a)(5). This regulation apparently was issued to change the result reached in *Tonopah & T.R. Co. v. Comm'r*, 112 F.2d 970 (9th Cir. 1940), *rev'g* 39 B.T.A. 1043 (1939); *see also* Rev. Rul. 70-377, 1970-2 C.B. 175, which is consistent § 1.861-2(a)(5).

by International, that interest income would have been U.S. source income to the Note Purchasers.

This regulation properly focuses on the debt obligation to source the interest, rather than the identity of the person paying the interest. Therefore, this regulation recognizes two basic principles of law (i) sourcing of interest is determined based on the residence of the debtor, not the residence of the payor of interest; and (ii) a guarantor's guarantee obligation is a separate and distinct obligation from the debtor's debt obligation.[136] Both of these principles support the position that the guarantee fees are not U.S. source income to Vitro.

To the extent that the guarantee fees would be sourced by analogy to interest, therefore, the proper result would be to look to the residence of the "obligor" under the Guaranty Agreement. Vitro's obligation under the Guaranty Agreement is the source of the guarantee fee income to Vitro. Vitro is the obligor under the Guaranty Agreement and it is a resident of

[136] For federal income tax purposes, a guarantee and the guaranteed debt are consistently treated as separate obligations. *Benak*, 77 T.C. at 1218; *See also Abdalla v. Comm'r*, 647 F.2d 487, 503-04 (5th Cir. 1981) (holding that because interest is not deductible unless paid on the indebtedness of the taxpayer, guarantors may not deduct interest paid on the guaranteed debt); *Nelson v. Comm'r*, 281 F.2d 1, 5 (5th Cir. 1960) (same); *Rushing v. Comm'r*, 58 T.C. 996, 1000 (1972) (same).

Mexico.[137] Therefore, even if the interest sourcing rule were to apply by analogy, the guarantee fees would be Mexican source income to Vitro and would not be subject to U.S. withholding.

VIII. The IRS's alternative argument has no factual or legal support.

The IRS contends that to the extent the guarantee fees are sourced like services, such fees should still 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."[138] The government cites no authority for this proposition, since there is none. Section 861(a)(3) requires payments for services to be sourced to the location at which the services were performed. The section does not mention where the benefits of those services will be enjoyed or the location of the person receiving those benefits. It is only the location at which the services are performed that is legally relevant.

Piedras Negras makes this abundantly clear. There, this Court held that the source of income under section 861 or 862 is determined from the perspective of the person subject to tax. The source of income is not

[137] Doc. 18 at 1, 11. Vitro is the obligor under the Guaranty Agreement, but it is also the "obligee" in that it is entitled to payment of the guarantee fees, as the Tax Court stated. Doc. 18 at 31.

[138] Appellant's Brief at 26.

determined from the perspective of the person making the payments to the taxpayer or receiving the benefits of the taxpayer's services. In *Piedras Negras*, the benefit to the station's customers was advertising, which was primarily directed to listeners in the United States. Despite these benefits in the United States to U.S. persons, the court held that the source of the radio station's income was Mexico. Although the advertisers were obviously paying for advertising in the United States, the income was sourced to the location at which the broadcasts were produced, the place where the broadcasting facilities were located, and where the work was performed to attracted listeners.[139] Here, Vitro's standby guarantee was performed in Mexico where its assets, operations and management were located. The IRS asks the Court to ignore the facts, the terms and purpose of section 861, and the decision in *Piedras Negras*, and source Vitro's guarantee fee income to the United States.

[139] 127 F.2d 260 at 260-61.

CONCLUSION

For the foregoing reasons, the decision of the Tax Court should be affirmed.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on October 15, 2010, I electronically filed the foregoing brief with the Clerk of Court for the United States Court of Appeals for the Fifth Circuit. On this same day, service of this brief was made on counsel for the appellant by mailing two copies thereof by first class mail in an envelope properly addressed as follows:

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ECF CERTIFICATIONS

I hereby certify that (1) no privacy redactions were required under 5th Cir. R. 25.2.13; (2) the electronic submission is an exact copy of the paper document retained by the undersigned; and (3) this document has been scanned for viruses with the most recent version of a commercial virus scanning program and is free of viruses.

s/ Brian W. Stoltz
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CERTIFICATE OF COMPLIANCE

This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because this brief contains 11,211 words, excluding the parts of the brief exempted by Fed. R. App. P 32(a)(7)(B)(iii) and 5th CIR. R. 32.2. This brief complies with the typeface requirements of Fed. R. App. P 32(a)(5) and 5th CIR. R. 32.1 and the type-style requirements of Fed. R. App. P 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word 2002 in 14-point Times New Roman BT font size and type style, with 12-point footnotes.

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