Reconciling U.S.-Foreign Intercompany Accounts to Avoid Taxable Deemed Dividends Under Section 956

WEDNESDAY, DECEMBER 9, 2015, 1:00-2:50 pm Eastern

IMPORTANT INFORMATION

This program is approved for 2 CPE credit hours. To earn credit you must:

• **Participate in the program on your own computer connection (no sharing).** If you need to register additional people, please call customer service at 1-800-926-7926 x10 (or 404-881-1141 x10). Strafford accepts American Express, Visa, MasterCard, Discover.

• **Listen on-line** via your computer speakers.

• **Respond to five prompts during the program plus a single verification code.** You will have to write down only the final verification code on the attestation form, which will be emailed to registered attendees.

• To earn full credit, you must remain connected for the entire program.

WHO TO CONTACT

For Additional Registrations:
- Call Strafford Customer Service 1-800-926-7926 x10 (or 404-881-1141 x10)

For Assistance During the Program:
- On the web, use the chat box at the bottom left of the screen

If you get disconnected during the program, you can simply log in using your original instructions and PIN.
Tips for Optimal Quality

Sound Quality
When listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, please e-mail sound@straffordpub.com immediately so we can address the problem.

Viewing Quality
To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.
Reconciling U.S.-Foreign Intercompany Accounts

Dec. 9, 2015

Lewis J. Greenwald
Mayer Brown
lgreenwald@mayerbrown.com

William R. Skinner
Fenwick & West
wrskinner@fenwick.com

Paul K. Marineau
Global Tax Consulting
marineap@cooley.edu

Lucas Giardelli
Mayer Brown
lgiardelli@mayerbrown.com
Notice

ANY TAX ADVICE IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN BY THE SPEAKERS’ FIRMS TO BE USED, AND CANNOT BE USED, BY A CLIENT OR ANY OTHER PERSON OR ENTITY FOR THE PURPOSE OF (i) AVOIDING PENALTIES THAT MAY BE IMPOSED ON ANY TAXPAYER OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY MATTERS ADDRESSED HEREIN.

You (and your employees, representatives, or agents) may disclose to any and all persons, without limitation, the tax treatment or tax structure, or both, of any transaction described in the associated materials we provide to you, including, but not limited to, any tax opinions, memoranda, or other tax analyses contained in those materials.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.
Section 956 — Investments in U.S. Property

Reconciling U.S.-Foreign Intercompany Accounts to Avoid Taxable Deemed Dividend Under Section 956

December 9, 2015
Strafford Webinar
William R. Skinner, Esq. is a tax partner with Fenwick & West LLP, in Mountain View, CA. He graduated from Stanford Law School and was recognized as a Rising Star in Tax by California Super Lawyers. He focuses his practice on U.S. international corporate tax, including the full range of international tax issues such as subpart F and deferral structures, foreign tax credit planning, transfer pricing, IP migration and structuring IP ownership within a corporate group, internal restructurings and cross-border M&A, and tax treaties and inbound tax planning. More information about his practice is available at www.fenwick.com.
Paradigm Example

- Intercompany Transactions
- Loans

USP

CFC Treasury Center

- CFC Operating Companies
- Loans

Cash Rich

CFC Operating Companies

Cash Poor
Section 956 Amount

- The amount determined under Section 956 is equal to the lesser of—

  1. The shareholder’s pro rata share of the quarterly average of the investments by the CFC in United States property, in excess of such shareholder’s amounts previously taxed under Section 956; and

  2. The shareholder’s pro rata share of the CFC’s “Applicable Earnings.”

The amount of investment in U.S. property is generally equal to the CFC’s adjusted tax basis in the property.

- The **applicable earnings of a CFC** means the sum of accumulated earnings (if positive) and current earnings, less any previously taxed income in Section 959(c)(1) and any distributions during the year. See § 956(b)(1).
Section 956 Amount - Example

CFC’s Investment | Quarter End
---|---
$0 | 1Q2015
$1,000 | 2Q2015
$1,000 | 3Q2015
$1,200 | 4Q2015

Quarterly Average = $800
Section 956 Amount – Example

- Amount determined under Section 956 equals the lesser of:
  1. The shareholder’s pro rata share of the quarterly average of the investments by the CFC in United States property ($800), in excess of such shareholder’s amounts previously taxed under Section 956 ($0) = $800; and
  2. The shareholder’s pro rata share of the CFC’s “Applicable Earnings” = $500.

- Here, the Section 956 amount is $500.

- What result would occur if the CFC distributed $500 in the year and then generated another $200 of earnings in the following year?
Section 956 – Overview

- Section 956 applies to four categories of U.S. property:
  - Obligations of U.S. persons
  - Stock in U.S. persons
  - Real or tangible property physically located in the U.S.
  - Certain intangible property acquired or developed for use in the U.S.

- The general intent of Section 956 was to deem a dividend to occur where earnings of a CFC are invested in US property of a lasting nature that would be expected to produce income over an indefinite period of time, and to exclude ordinary commercial transactions involving the CFC.

Our focus in this webinar
Section 956 – Investments *Other Than* Obligations of a U.S. Person

- Stock in a US person is included in a 956 investment if the CFC or other affiliates own 25% or more of the stock of the US corporation.
- Real or tangible property is generally included in the Section 956 amount, subject to an “export property exception” for inventory acquired for sale or use outside of the United States.
- The amount of the investment is generally measured based on adjusted tax basis of the CFC, so zero basis assets (e.g., self-created IP) do not result in a Section 956 investment.
Section 956 – Obligations of U.S. Persons

- Obligations of U.S. persons constitute a section 956 investment to the extent of the CFC’s adjusted basis in the obligation.

- “[T]he term ‘obligation’ includes any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other indebtedness....” Reg. 1.956-2T(d)(1).

- Exceptions to Section 956 treatment are provided for the following obligations:
  - Obligations issued by a person that is not a related person with respect to the CFC.
  - “Ordinary and necessary obligations” arising out of performance of services or the sale / processing of property.
  - Certain short-term obligations.
  - Deposits with certain federally regulated banking institutions.
  - Certain specialized exceptions for taxpayers in the financial services industry.
Obligations of Related U.S. Persons

- The loan to a related U.S. person is a § 956 investment of $200.
- If loan is outstanding for all 4 quarters, CFC will be deemed to make a dividend of $200, with $50 of foreign tax credits.
Obligations of U.S. Persons

“Ordinary and Necessary” Obligations

- Receivables arising from the sale or processing of property, or provision of services, in the ordinary course of business, may also be excluded from Section 956 if the loans, at no time during the year, exceed an amount that would be ordinary and necessary between unrelated persons.

- 60-day safe harbor for service receivables.

- In inventory cases, facts and circumstances test applies.
Loans to Related U.S. Persons—Ordinary and Necessary Exception

- An account receivable arising from purchase or manufacturing of property or provision of services is excluded from § 956, so long as the outstanding balance, at no time during the year, exceeds what is ordinary and necessary between unrelated parties.
“Ordinary and Necessary” Loans—LTR 200519005

Initial Manufacturing

Ships goods for further processing

“Complex and delicate” manufacturing process
“Long lead times”

Held to qualify for the ordinary and necessary exception.

Required to maintain M months of inventory to avoid supply disruptions.

Sale with payment due in M months

“Complex and delicate” manufacturing process
“Long lead times”
Other Authorities on “Ordinary and Necessary” Obligations

- TAM 8114032 – ordinary and necessary treatment upheld, where US Parent bought 3-4 year supply of ingredients from CFC and then paid off note as ingredients were incorporated into the final product.

- Greenfield v. Commissioner, 60 T.C. 425 (1973) – ordinary course exception denied where funds advanced on an open account reflected an unpaid balance that indefinite; subordination of intercompany debt to third party also precluded parent from making repayments to the CFC. Court also viewed open account as a single “obligation” for Section 956 purposes.

- Sherwood Properties, Inc. v. Commissioner, 89 T.C. 45 (1987) – ordinary treatment denied – Court found taxpayer’s arguments that CFC’s advances to parent were necessary to maintain its steel allocations in the United States were not supported by the facts.
Section 956(d) – Pledges & Guarantees

- A CFC is treated as holding an obligation of a US person as to which it serves as a pledgor or guarantor at any time during the year.

- CFC thus will trigger a deemed dividend on a direct provision of credit support to the US Parent’s lender through a guarantee or pledge of its assets.

- Reg. 1.956-2(c) treats a CFC as an indirect pledgor / guarantor of any debt where (1) 2/3 or more of the voting stock of the CFC is pledged to the lender to support the debt by the parent and (2) the parent gives the “negative covenants” as to CFC that are customary in lending transactions.
Section 956(d)—Pledges and Guarantees

- Pledges and guarantees by a CFC to secure a US shareholder’s loan will be treated as if the CFC acquired the US parent’s loan for Section 956 purposes.

- A US parent’s pledge of 65% of a CFC’s stock, coupled by ordinary “negative covenants,” generally is permitted.
Reconciling U.S.-Foreign Intercompany Accounts to Avoid Taxable Deemed Dividends Under Section 956

December 9, 2015

Lewis J. Greenwald
212.506.2437
lgreenwald@mayerbrown.com

Lucas Giardelli
212.506.2238
lgiardelli@mayerbrown.com
Topics

• The Short-Term Loan Exception

• The Section 956 Anti-Abuse Rule and Substance Over Form
The Short-Term Loan Exception
Introduction

• If a CFC has made a loan to a U.S. affiliate, there will not be a Section 956 inclusion if such loan is not outstanding at the end of a quarter of the CFC’s taxable year.

• However, certain exceptions allow taxpayers to avoid a Section 956 inclusion even with respect to loans outstanding as of the end of a CFC’s quarter:
  
  – “Ordinary and necessary” trade receivables from sale of property or performance of services; and
  
  – “Short-term loans” under Notice 88-108
Short-Term Loan Exception - History

• Prior to 1988, the regulations provided an exception for obligations collected within one year from the time incurred.

• The IRS eliminated this exception because CFCs were making successive loans (with maturities of less than one year) to avoid the application of Section 956.

• Although the exception was eliminated, the IRS issued Notice 88-108 to provide for a narrower short-term loan exception.

  – The short-term loan exception of Notice 88-108 was temporarily liberalized between 2008 and 2010 to facilitate short-term liquidity during the financial crisis (60/180 days tests instead of 30/60).

• No regulations have been issued so far to implement Notice 88-108.
Notice 88-108

• Under Notice 88-108, an obligation will not constitute an “obligation” for the purposes of Section 956 if:

  
  (1) The obligation is collected within 30 days from the time it is incurred, and

  (2) The CFC does not hold U.S. obligations for 60 or more calendar days during its taxable year.

• If a CFC fails condition (2), each of its U.S. obligations will be considered an “obligation” for Section 956 purposes as of the obligation’s origination date.

• A taxpayer may elect to apply or not apply Notice 88-108 for each of its CFCs for any particular year, and such election will not affect the choice to apply Notice 88-108 in a later year.

  – No formalities for the election.
The question arises as to whether the 60-day test is applied in the aggregate or on a CFC-by-CFC basis?

- GLAM 2009-13 confirmed that each CFC is evaluated *separately* under Notice 88-108:
  
  - Obligations of the *same U.S. person* may qualify for the exclusion pursuant to Notice 88-108 if they are held by *various CFCs* even when, in the aggregate, the obligations remain outstanding for more than 180 days during the tax year; and

  - If the obligations held by one CFC fail to qualify under Notice 88-108, it should not taint the obligations of other CFCs that qualify under Notice 88-108 on a separate basis
That said, GLAM 2009-13 provides three limitations on a U.S. taxpayer’s ability to receive loans from multiple CFCs:

- **The Treas. Reg. 1.956-1T(B)(4) anti-abuse rule**: If it is determined that CFC 1 transferred cash to CFC 2 so that CFC 2 could make a loan to U.S. parent with the principal purpose of preventing CFC 1 from failing the 60-day test.

- **The pledge/guarantee rule**: If CFC 1 holds an obligation of a U.S. affiliate that is financially impaired, and the repayment of such obligation is contingent on CFC 2 making a loan to the U.S. affiliate, CFC 2 will be considered a pledgor or guarantor of the obligation to CFC 1.

- **Step transaction/Jacobs Engineering**: If a series of loans from the same CFC are aggregated under a Jacobs Engineering theory, the periods of disinvestment will be ignored for purposes of the 30-day and 60-day tests.
CCA 201516064

• In CCA 201516064, CFC (calendar tax year) made several loans to its U.S. Parent (“USP”) pursuant to a line of credit:

  – On March 20, CFC loaned $100 to USP (“Loan 1”) (amount was outstanding as of March 31 quarter-end);

  – On April 5, USP repaid $70 of Loan 1 to CFC (i.e., $30 of Loan 1 remained outstanding);

  – On June 10, CFC loaned $80 to USP (“Loan 2”) ($30 of Loan 1, plus the $80 Loan 2 were outstanding as of the June 30 quarter-end); and

  – On July 3, USP repaid $80 to CFC.

• The taxpayer argued that $70 from Loan 1 and the $80 Loan 2 were each outstanding for less than 30 days during the tax year and were cumulatively outstanding for fewer than 60 days during the tax year. Thus, only the $30 of Loan 1 that remained outstanding should give rise to a Section 956 inclusion.
CCA 201516064 (cont’d)

• The IRS held that, because the $30 of Loan 1 were outstanding for more than 60 calendar days during the taxable year, Notice 88-108 would not exclude any of the CFC’s obligations from Section 956.

• Even a small obligation can result in the disqualification of all the CFC’s obligations under the short-term exception:
  
  – As such, taxpayers must carefully monitor intercompany accounts when relying on the short-term loan exception.

  – Also, obligations held by the same CFC from different U.S. affiliates are aggregated for purposes of the 60-day test.
Short-Term Loan Exception – Traps for the Unwary and Collateral Issues

• Do intercompany receivables resulting from secondary adjustments under Rev. Proc. 99-32 constitute an “obligation” for Section 956 purposes?

  – When does the account receivable created pursuant to Rev. Proc. 99-32 originate?

    • Rev. Proc. 99-32: As of the last day of the taxable year to which the adjustment relates. Risk of busting Notice 88-108 qualification for several years.

    • *BMC Software* (5th Cir. Mar. 2015): No retroactive receivable

• If a CFC inadvertently fails to timely invoice its U.S. parent or affiliate in accordance with their intercompany agreement, there is a risk of having an outstanding obligation.
Short-Term Loan Exception – Traps for the Unwary and Collateral Issues (cont’d)

• Netting and the short-term loan exception:

  – On March 5, CFC loans $50 to USP (“Loan 1”)

  – On March 20, CFC loans an additional $50 to USP (“Loan 2”)

  – On March 25, USP invoices $50 to CFC for certain intercompany services.

  – On March 31, pursuant to a netting agreement between CFC and USP, the obligations between the two parties are netted resulting in CFC holding a $50 receivable on USP.

  – On April 20, the outstanding receivable is repaid in full.

• No U.S. withholding should apply to interest payments under the short-term loans pursuant to Treas. Reg. § 1.1441-1(b)(4)(iv).
Short-Term Loan Exception – Traps for the Unwary and Collateral Issues (cont’d)

• The question arises as to whether the netting eliminated Loan 1 (on a FIFO basis) or Loan 2 (on a LIFO basis)?

  – FIFO basis:
    • Loan 1 was collected within 30 days (March 5-March 31)
    • Loan 2 was collected within 30 days (March 20-April 20)
    • Loans 1 and 2 were not, in the aggregate, outstanding for more than 60 days (March 5-April 20)

      – Both Loan 1 and Loan 2 benefit from Notice 88-108.

  – LIFO basis:
    • It took 46 days to repay Loan 1 (March 5-April 20)
    • Loan 2 was collected within 30 days (March 20-March 31)
    • Loans 1 and 2 were not, in the aggregate, outstanding for more than 60 days (March 5-April 20)

      – Although Loan 2 still benefits from Notice 88-108, Loan 1 does not benefit from Notice 88-108 and creates a Section 956 inclusion.
The Section 956 Anti-Abuse Rule and Substance Over Form
Section 956 Anti-Abuse Rule - Treas. Reg. 1.956-1T(b)(4)

- Treas. Reg. 1.956-1T(b)(4): A CFC will be deemed to hold an obligation of a U.S. person when:
  - the U.S. obligation is held on behalf of the CFC by a trustee or nominee; or
  - The U.S. obligation was acquired by any other foreign corporation or partnership that is related to the CFC and “a principal purpose of creating, organizing, or funding by any means (including through capital contributions or debt) the other foreign corporation or partnership is to avoid application of Section 956 with respect to the CFC.”

- The anti-abuse rule can apply even when Section 956 is not avoided entirely.
• Examples (CFC 1 has substantial E&P; CFC 2 has no E&P):

  – CFC 1 sells inventory to CFC 2 in exchange for a 60-day $50 trade receivable. CFC 2 loans $50 to USP.
    ▪ CFC 1 is not considered to hold the U.S. obligation because the establishment of the trade receivable did not have a principal purpose of avoiding Section 956.

  – Same facts, but CFC 1 and CFC 2 agree to defer CFC 2’s obligation under the trade receivable to allow CFC 2 to make the loan to USP with a principal purpose of avoiding Section 956.
    ▪ CFC 1 is considered to hold the U.S. obligation.
Section 956 Anti-Abuse Rule – CCAs 201420017 and 201420017

• “High-E&P CFCs” loaned significant amounts to “Low-E&P CFCs” and, on the same day, Low-E&P CFCs loaned substantially the same amounts to USP. USP limited its Section 956 inclusion by the E&P of the Low-E&P CFCs.

• The IRS held that the High-E&P CFCs should be deemed to hold the U.S. obligations because one of the principal purposes of why the High-E&P CFCs funded the Low-E&P CFCs through loans was to avoid the application of Section 956 with respect to the High-E&P CFCs. Several facts supported this conclusion:
  
  – The E&P disparity between the CFCs, which served to reduce the Section 956 inclusion.
  
  – By having the loans made by the Low-E&P CFCs, the taxpayer was able to claim a larger foreign tax credit than if the loans had been made by the High-E&P CFCs.
  
  – The fact that the loans from the High-E&P CFCs to the Low-E&P CFCs provided virtually all of the cash needed to fund the loans from the Low-E&P CFCs to USP.
  
  – The fact that both the loans to and from the Low-E&P CFCs were made on the same day.
Section 956 Anti-abuse Rule – Implications for Cash Management System

• If CFC 1 is in a net receivable position *vis-à-vis* a U.S. affiliate (or is guaranteeing a third-party loan to a U.S. affiliate), ensure that CFC 1 does not have payables to CFC 2 that are outside of the ordinary course of business or that have not been settled in accordance with agreed-upon terms.

• Otherwise, the IRS may argue that CFC 2 should be considered the holder of the U.S. obligation resulting in possible adverse consequences under Section 956:

  – CFC 2 may have greater E&P than CFC 1;

  – CFC 2 may have a smaller foreign tax credit pool than CFC 1; and

  – CFC 1 and CFC 2 may have different fiscal years and, thus, different quarter-end testing dates for Section 956 purposes.
Substance Over Form and Step Transaction Doctrine

- The IRS has repeatedly held that the application of Section 956 is concerned with the substance of a transaction rather than its form.

- The step transaction doctrine (which applies substance over form principles) treats a series of formally separate steps as a single transaction if the steps are in substance integrated, interdependent, and focused on a particular result.

- The IRS has used the step transaction doctrine in the Section 956 context to combine two distinct obligations and to treat them as a single obligation for Section 956 purposes.

  - The integration of different loans also presents issues with respect to the exemption from interest withholding to the extent the integrated obligation is deemed to have a term in excess of 183 days (see FSA 3824, May 17, 1996).
• **Example 1:**

  – On February 5, 1987, CFC purchased $200 of USP obligations that matured and were repaid on November 15, 1987.

  – On January 15, 1988 (60 days after repayment of Obligation 1), CFC purchased $225 of USP obligations, which it sold to a third person on November 10, 1988.

• **Example 2:**

  – On February 1, 1987, CFC purchased $200 of USP obligations that matured and were repaid on June 30, 1987.

  – On January 15, 1988, CFC purchased $225 of USP obligations, which it sold to a third person on November 15, 1988.
Rev. Rul. 89-73 (cont’d)

• The time period between the repayment of a loan from a CFC to its U.S. Parent and a subsequent loan (the “Disinvestment Period”) may be disregarded, resulting in the integration of the two loans for Section 956 purposes, i.e., there will be a Section 956 inclusion if there was a quarter-end during the Disinvestment Period.

• The inquiry focuses on Disinvestment Period as it compares to the period the debts are outstanding (the “Investment Period”).

• The ruling concluded that the loans should be integrated in Example 1, but not in Example 2.
  
  – The ruling clarifies that, in addition to the Disinvestment Period, other factors should be considered when determining whether two or more loans should be integrated
• Rev. Rul. 89-73 allowed loans to related U.S. persons for 150 days (roughly 40% of the testing period, which was one year at the time) followed by a Divestment Period of 199 days (roughly 54% of the testing period).

• Some practitioners view Example 2 of the ruling as a safe-harbor:
  – A reasonable interpretation of Rev. Rul. 89-73 would allow proportionally reduced periods of investment and divestment. As the testing period is now quarterly (approximately 90 days), this should allow Investment Periods of approximately 36 days (40% of 90 days) followed by Divestment Periods of approximately 49 days (54% of 90 days).
Like the loans in Rev. Rul. 89-73, each Investment Period is 40% of the testing period (40% of 90 days is 36 days), each Disinvestment Period is more than 54% of the testing period (54% of 90 days is about 48 days), and no loan is outstanding on a testing day.
Jacobs Engineering (C.D. Cal. 1997, aff’d 9th Cir. 1999)

• In order to avoid Section 956, the taxpayer in Jacobs Engineering structured a series of short-term loans (1-3 months) from Panamanian CFC to USP, separated by a few days.
  – Under applicable regulations at the time, any loan collected within one year was not considered an “obligation” for Section 956 purposes

• Applying substance over form, the court held that the short-term loans ought to be integrated and, thus, there was only one loan which was not collected within a year:
  – Effectively, USP was in possession of the funds for 93.5% of a testing period.
  – All loans related to the same working capital need of USP; they were interdependent and viewed as one unified transaction:
    • Nowhere it is suggested that plaintiff needed to raise capital twelve separate times for separate reasons; and
    • Individually, each loan would have been useless.
Recent IRS Guidance

• In August 2015, the IRS released a Practice Unit (training material for agents) addressing the application of the step transaction in the Section 956 context.

• According to the Practice Unit, the following factors should be considered in determining whether a series of loans should be respected in accordance to their form or if they should be integrated into one single obligation:
  – The related U.S. person’s access to commercial paper markets during the term of the loan;
  – The volatility of economic conditions (in general and in the taxpayer’s specific industry);
  – The availability and terms of alternative sources of outside financing to the related U.S. person;
  – The related U.S. person’s financial capacity to repay each obligation independently; and
  – The CFC’s Disinvestment Period.
Recent IRS Guidance (cont’d)

• The Practice Unit recommends that agents request the following information/documentation from the taxpayer:

  – Schedules reflecting receivable/payables terms, payment and balance history, including details of increases/decreases in the intercompany receivables;

  – Tax planning documents, including slide decks for multi-step transactions, internal correspondence regarding loan program, tax research, memos or opinions prepared by outside advisors;

  – Relevant intercompany agreements or manuals containing internal policies or procedures relating to the taxpayer’s treasury function;

  – Any materials (emails, documents, workpapers, etc.) that demonstrate that decisions with respect to the subject loans were driven by an intent to avoid IRC Section 956; and

  – Interviews with the tax department and treasury personnel.
The Hewlett-Packard Case

- In 2012, the U.S. Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations published a report addressing HP’s “alternating loan program.”

- HP US received loan funding from two offshore affiliates:
  - BCC (Belgium); and
  - CCHC (Cayman).

- BCC had an October 31st fiscal year end, and CCHC had a September 30th fiscal year end.
  - Section 898(C)(2) allows a CFC to have a taxable year beginning 1 month earlier than its U.S. shareholder.
The Hewlett-Packard Case (cont’d)

- HP alternated 45-day loans from each of BCC and CCHC to HP US so that:
  - neither CFC had a loan outstanding as of its respective quarter-end, and
  - each CFC had a 45-day Disinvestment Period with respect to each CFC.
- The Tax Department coordinated with Treasury for the making and repayment of the loans to ensure there was no Section 956 exposure.
- HP’s attest firm noted that Jacobs Engineering did not combine loans made by various CFCs.
The Hewlett-Packard Case (cont’d)
Netting of Accounts Receivable and Payable

December 9, 2015

Paul K. Marineau, CPA, JD
• Many companies maintain a centralized cash management system to record and offset intercompany payable and receivable balances, thereby minimizing cash transfers among related entities and maximizing the availability of cash for investment and working capital.

  – Thus, as part of this centralized cash management system, these companies disburse and receive cash on behalf of their CFCs, which create intercompany accounts receivable and payable positions with respect to these CFCs.

• Open intercompany payable position vis-à-vis a CFC constitutes an “obligation” within the meaning of Treas. Reg. §1.956-2T(d)(2)(i).
• Treas. Reg. §1.956-1(e)(1) – General Rule: The amount of a CFC’s investment in U.S. property shall be its adjusted basis reduced by any liability to which such property is subject.
  – A liability must constitute a specific charge against the property involved.
    • “Specific charges” do not include a liability evidenced by an open account or a liability secured only by the general credit of the CFC.
Netting of Accounts Receivable and Payable

• The Service will respect a netting of payables and receivables on the U.S. parent’s and CFC’s books as a means of payment so long as the offsetting accounts are extinguished and removed from the entities’ books.

  – Treas. Reg. §1.461-4(g)(1)(ii)(A): The term payment has the same meaning as is used when determining whether a taxpayer using the cash receipts and disbursements method of accounting has made a payment.

  • Thus, for example, payment includes the furnishing of cash or cash equivalents and the netting of offsetting accounts.

  – See FSA 003312.
FSA 003312: The Service’s position is that if the CFC, on its books, treats the netting of the accounts payable against accounts receivable as payment of the accounts receivable, this treatment will be followed for purposes of computing the section 956 amount so that the adjusted basis of the receivable, under Treas. Reg. §1.956-1(e), is the net balance of the receivable.

– Holding: The individual accounts receivable and payable were accounted for separately and were not netted on the CFC’s books, and there was no evidence of a cash management system under which payables and receivables between the CFC and U.S. affiliates were netted and reduced to a single payable or receivable balance; hence, the Service would not net the accounts receivable and payable even if the accounts receivable and payable involve the same U.S.
The Service has indicated that quarterly settlements on a first-in, first-out (FIFO) system of accounting would be acceptable in the context of payables and receivables arising from intercompany sales and services between a U.S. parent and its CFC, under which each new intercompany trade or services receivable would be offset against the oldest intercompany trade or services payable.

- See TAM 8332019.
- See FSA 200127005.
Netting of Accounts Receivable and Payable

- Treas. Reg. §1.482-2(a)(1)(iv)(A): In determining the period of time for which an amount owed by one member of the group to another member is outstanding, payments or other credits to an account are considered to be applied against the earliest amount outstanding, that is, *payments or credits are applied against amounts in a first-in, first-out (FIFO) order.*
  - Thus, tracing payments to individual intercompany trade receivables is generally not required in order to determine whether a particular intercompany trade receivable has been paid within the applicable interest-free period.
• **TAM 8332019:** Taxpayer argued in favor of applying a FIFO rule by analogy to the rule in a former Treas. Reg. §1.482-2(a)(3), which was subsequently replaced by the current FIFO rule in Treas. Reg. §1.482-2(a)(1)(iv)(A), so that all payments were viewed as extinguishing the earliest existing liability.
  
  – **Holding:** The Service rejected the section 482 analogy because the taxpayer functioned simply as a paying and collecting agent with respect to transactions between the CFC and third parties as opposed to related-party transactions between the U.S. parent and the CFC itself.

• The loans should be considered fungible and not related to any specific transaction involving the intercompany sale of goods or services.
  
  – Consequently, the transactions should be treated as one continuous loan and not numerous debts made throughout the year.
Need enterprise resource planning (ERP) software to separately track each invoice in a first-in, first-out (FIFO) system of accounting under which the oldest invoices are actually paid first.  
  – See *Gulf Oil Corporation v. Commissioner*.

Prior to the end of each quarter, U.S. parent company must identify and pay any remaining intercompany trade or services payable if outstanding for longer than the “ordinary and necessary” time period.
Netting of Accounts Receivable and Payable

• Gulf Oil Corporation v. Commissioner, 87 T.C. 548 (1986)
  – **Holding:** Under the taxpayer’s internal cash management system, the Service concluded that a valid netting of accounts payable and receivable had occurred. However, this netting process reduced the accounts payable and receivable to a single open accounts payable or receivable balance between the U.S. parent and the CFC; hence, it created a single obligation for IRC §956 purposes.
  
• **Excerpt:** “The fact that the individual transactions that give rise to the upward and downward movements in account 1950 [open intercompany account] lose their individual identity under the cash management system is shown by the petitioner’s inability to trace individual transactions through the cash management system. *The cash management account system was not designed to trace individual transactions on a FIFO basis or otherwise.*”

Netting of Accounts Receivable and Payable

- Failure to net intercompany trade or services payables and receivables on a quarterly basis in an IRS acceptable manner reduces these intercompany transactions to a single balance, thereby potentially tainting the entire intercompany trade or services payable.
  - **Cliff Effect:** If the amount outstanding at any time exceeds what would be “ordinary and necessary”, no part of the obligation may be excluded under IRC §956(b)(2)(C). [Clayton Greenfield v. Commissioner, 60 T.C. 425 (1973)]
Netting of Accounts Receivable and Payable

- If appropriately structured, a substitution of the U.S. parent’s obligation to a CFC with an obligation of another CFC with respect to which the U.S. parent held an intercompany receivable – i.e., a novation [See TAM 8122006], or an assignment by the U.S. parent of an intercompany receivable from another CFC to a CFC with respect to which the U.S. parent held an intercompany payable [See FSA 200127005], can constitute a collection or payment of the obligation.
Netting of Accounts Receivable and Payable

• **TAM 8332019**: Taxpayer argued that the effect of its end-year netting procedure is a substitution of the taxpayer’s obligations to the creditor CFCs with obligations of the debtor CFCs. The effect of the substitution of taxpayer’s obligations by debtor CFCs obligations was a “novation” in which the taxpayer’s obligations ceased to exist at year-end with the obligations of the debtor CFCs being substituted therefore.

  – **Holding**: The Service concluded that to the extent the obligations of the debtor CFCs to repay those amounts recorded as loans to the creditor CFCs had any fair market value on the date of their “year-end” recordation in the intercompany accounts then, to the extent of such value, the obligations of the taxpayer has been “collected”.
FSA 200127005: In accordance with industry practice, it was ordinary and necessary for the taxpayer’s intercompany trade accounts payable to a certain CFC to remain outstanding for a period of up to sixty days. Therefore, the taxpayer established the policy that all intercompany trade accounts payable incurred among related entities were to be paid within sixty days on a first-in, first-out (FIFO) basis. At the end of each fiscal quarter, the taxpayer reviewed its intercompany payables to a certain CFC to determine whether there were any balances outstanding beyond sixty days. To the extent that amounts were outstanding beyond sixty days, the taxpayer assigned certain receivable accounts from other CFCs and a domestic subsidiary to the CFC as payment against the overaged payable balances.

- **Holding:** If the form of the assignments were respected, the Service stated that they would be treated as valid payments by the taxpayer to the CFC that would have extinguished its obligation to the CFC. However, based on the facts, they concluded that the substance of the transaction was inconsistent with its form.
Today’s Presenter

Paul K. Marineau, CPA, JD
Chrysler House
719 Griswold Street, Suite 630
Detroit, MI 48226
Phone: 269-420-5417
Email: pmarineau@uhy-us.com
Website: www.uhy-us.com