



PRACTICAL U.S./INTERNATIONAL TAX STRATEGIES

www.wtexec.com/tax.html
The International Business
Information Source™

A TWICE-MONTHLY REPORT ON US/INTERNATIONAL TAX PLANNING

October 15, 2008
Volume 12, Number 16

IRS Enhances Opportunity for U.S. Multinationals to Access Cash from Controlled Foreign Corporations

By Douglas S. Stransky, Lewis J. Greenwald, Ameek Ashok Ponda and Eric J. Fuselier
(Sullivan & Worcester LLP)

On October 3, 2008, the U.S. Internal Revenue Service (IRS) issued Notice 2008-91,¹ which expands the ability of a controlled foreign corporation (CFC) to make short-term loans to its U.S. parent to fund operations without creating an income inclusion for U.S. federal income tax purposes. This Notice applies for a CFC's first two taxable years ending after October 3, 2008. Thus, for a CFC with a calendar taxable year, the Notice applies for calendar years 2008 and 2009.² On October 16, 2008, the IRS issued a correction to provide that Notice 2008-91 will not apply to the taxable year of a CFC beginning after December 31, 2009.³

Current Law

Generally, under Internal Revenue Code (Code) section 956, a loan made from a CFC to its U.S. parent is considered to be an investment in U.S. property because the CFC holds an "obligation" of the U.S. parent.⁴ Under this Code section, the average amount of the CFC's investment in U.S. property held at the end of each quarter of the taxable year is potentially treated as a "deemed dividend" to the U.S. parent and, thus, taxable on the U.S. parent's federal income tax return.⁵

In some circumstances, however, the U.S. parent can have a loan outstanding from its CFC without triggering

any income inclusion. Under Notice 88-108,⁶ for example, even if a CFC makes a loan to its U.S. parent that extends over a quarter end, there should be no income inclusion provided that this loan is outstanding less than 30 days.⁷ But if the CFC were to hold any number of obligations that would (without regard to the 30-day exception) constitute U.S. property for aggregate periods totaling 60 or more days during a taxable year, this 30-day exception would not apply.

Notice 2008-91

In Notice 2008-91, the IRS has supplemented Notice 88-108 so that a loan from a CFC to its U.S. parent would only constitute an obligation that results in an income inclusion if the loan is held for more than 60 days from the

Notice 2008-91 presents a new and previously unavailable opportunity for a U.S. multinational that needs to finance its operations on a short-term basis.

Douglas S. Stransky (dstransky@sandw.com), Lewis J. Greenwald (lgreenwald@sandw.com), and Ameek Ashok Ponda (aponda@sandw.com) are Partners, and Eric J. Fuselier (efuselier@sandw.com) is an Associate, with the Tax Department in Sullivan & Worcester's Boston office. Mr. Stransky and Mr. Greenwald concentrate their practices on international tax planning for multinational companies. Mr. Ponda specializes in tax aspects of structuring corporate mergers and acquisitions, REIT transactions, and cross-border financings and acquisitions. Mr. Fuselier practices in international and corporate tax issues.

time it is incurred. Notice 2008-91 further provides that if a CFC holds obligations that would (without regard to the 60-day exception) constitute U.S. property for aggregate periods totaling 180 or more days during a taxable year, then this 60-day exception would not apply. Thus, Notice 2008-91 effectively extends the periods within which a taxpayer can hold an obligation without triggering the application of Code section 956. A CFC can apply Notice 2008-91 or Notice 88-108, but not both.⁸

Although Notice 2008-91 is more generous than Notice 88-108, there may be circumstances when a U.S. multinational would prefer to apply Notice 88-108. For example, a U.S. multinational may want to use Code section 956 affirmatively to include amounts in income in

order to access the earnings and available deemed foreign tax credits of a CFC with a high tax pool. In that case, the U.S. multinational would generally choose to have a loan from its CFC remain outstanding for the entire taxable year.

According to Notice 2008-91, the IRS issued the Notice "to facilitate liquidity in the near term" and to announce its intention to issue regulations under Code section 956(e). In issuing the Notice, the IRS recognizes that current market conditions have made funding operations more difficult for many U.S. multinationals. Notice 2008-91 provides a grace period whereby a CFC can loan funds to its U.S. parent (or related U.S. person) for no more than 60 days per loan and less than 180 days in total during a taxable year, but the Notice is silent on how long companies must wait between loans.⁹ In the context of Code section 956, the IRS and the courts have shown a willingness to collapse a series of transactions into one loan under the step transaction doctrine.¹⁰

For example, in *Jacobs Engineering Group Inc. v. United States*,¹¹ the court addressed the application of Code section 956 to successive loans. The U.S. parent had entered into a series of 12 short-term loan transactions with its CFCs. The parent repaid each loan within two months (with interest), but then took out another loan within a few days of repayment. The 12 loans spanned over two years and the borrowed funds remained within the U.S. parent's control 94 percent of the time. Using the principles of substance over form, the court concluded that the series of loans was, in reality, one continuous loan spanning 30 months and, thus, should be treated as a repatriation of cash from foreign sources for purposes of Code section 956.¹²

Designing the Loan (if Income Inclusion is Desirable)

For a loan by a CFC to its U.S. parent that is intended to result in a Code section 956 inclusion (pursuant to Code section 951(a)(1)(B)), careful planning may be required because of the interplay with the cross-border withholding rules of Code sections 881 and 1442.

Code sections 881 and 1442 generally provide for the imposition of a 30 percent federal tax on payments of interest (including original issue discount (OID), as defined under Code section 1273) made by the U.S. parent to its CFC.¹³ Under Code section 871(g)(1)(B), however, OID obligations do not include any obligation payable 183 days or less from the date of original issue; that is, OID on such short-term obligations is exempt from tax under Code sections 881 and 1442. As a result, provided that a CFC makes an OID loan to its U.S. parent that has a maturity of less than 183 days, there should be no U.S. federal tax imposed on that short-term obligation under Code sections 881 and 1442.¹⁴

Staying below the 183-day threshold for Code sections 881 and 1442 exemption purposes, while still qualifying for an affirmative Code section 956 inclusion,

can be accomplished by having the CFC make separate loans just before the beginning of each quarter in the CFC's taxable year and structuring the maturity date so that each loan remains outstanding over each respective quarter end of the CFC. Such loans would be issued at a discount using the applicable federal rate prescribed by Code section 1274(d) as the discount factor. Further, the maturity date of each loan would ideally be structured so that the combined period over which the four (or more) loans were outstanding in that taxable year is less than 183 days; in fact, over two taxable years, the combined outstanding period of the eight loans (or more) would ideally be less than 183 days. That way, even if the putatively separate loans were stepped together under a *Jacobs Engineering* analysis, the cumulative days outstanding of all the loans combined is, nevertheless, less than 183 days so that the short-term OID exception is secure.

Finally, the aggregate outstanding period for the series of loans in any taxable year should exceed 60 days to prevent the IRS from potentially arguing the application of Notice 88-108 and thereby denying the affirmative use of Code section 956. On the other hand, if the longer grace periods of Notice 2008-91 were to apply, then having a series of loans remain outstanding for less than 183 days to secure safely the short-term OID exception, while at the same time exceeding 180 days per taxable year to cause a Code section 956 income inclusion (because the loans are outside the grace period of Notice 2008-91), is a much trickier affair and one that may inevitably involve trading one tax risk for another.¹⁵ In such instances then, a taxpayer would very much prefer to be governed by Notice 88-108 rather than Notice 2008-91.

Conclusion

In sum, provided that the specified time limits are followed, Notice 2008-91 presents a new and previously unavailable opportunity for a U.S. multinational that needs to finance its operations on a short-term basis.

¹2008-43 I.R.B. 1.

²In the case of a CFC with a fiscal year, the Notice should apply into 2010. For example, if a CFC's current fiscal year began on July 1, 2008 and ends on June 30, 2009, then for the fiscal year beginning July 1, 2009, such CFC would be able to apply Notice 2008-91 through to June 30, 2010.

³The correction will appear in 2008-43 I.R.B., dated Oct. 27, 2008. Although the IRS did not specify a reason for the correction, it appears that the IRS intended to clarify that the Notice would not apply to a new CFC for a taxable year that begins after December 31, 2009. Prior to the correction, the Notice simply said that it would apply for the first two taxable years of a CFC ending after October 3, 2008. Therefore, if a CFC were to be formed four years from now, for example, Notice 2008-91 would apply but for the correction.

⁴IRC § 956(c)(1) defines United States property, *inter alia*, as an obligation of a U.S. person. Treas. Reg. § 1.956-2T(d)(2) defines the term "obligation" to include "any bond, note, debenture,

certificate, bill receivable, account receivable, note receivable, open account, or other indebtedness, whether or not issued at a discount and whether or not bearing interest.”

⁵Under IRC § 956(a), the amount taken into account with respect to any property is the adjusted basis of the property, as determined for purposes of computing earnings and profits, reduced by any liability to which the property is subject. More specifically, IRC §§ 951(a)(1)(B) and 956(a)(1) provide that a U.S. shareholder for any taxable year shall include in its gross income the lesser of two amounts: (1) the excess (if any) of (A) such shareholder's pro rata share of the average of the CFC's earnings invested in U.S. property at the close of each quarter of the taxable year, over (B) the amount of the CFC's earnings and profits that constituted previously taxed income (PTI) under IRC § 959(c)(1)(A); or (2) such U.S. shareholder's pro rata share of the "applicable earnings" of the CFC. IRC § 956(b)(1) defines "applicable earnings" as the sum of (1) the CFC's accumulated earnings and profits under IRC § 316(a)(1); plus (2) the CFC's current earnings and profits under IRC § 316(a)(2); less (3) distributions made during the taxable year; less (4) PTI under IRC § 959(c)(1).

⁶1988-2 C.B. 445.

⁷Specifically, Notice 88-108 provides that “final regulations issued under section 956 will exclude from the definition of the term ‘obligation’ an obligation that would constitute an investment in U.S. property if held at the end of the CFC's taxable year, so long as the obligation is collected within 30 days from the time it is incurred.” In AM 2007-016 (Oct. 5, 2007), the IRS concluded that the 30-day exception to the definition of “obligation” (for purposes of IRC § 956) that was provided by Notice 88-108 will continue to apply and exclude certain obligations, even though testing for IRC § 956 purposes was changed from yearly (i.e., end of the tax year) to quarterly (i.e., end of each quarter of the tax year).

⁸Although it is unclear whether an election to apply Notice 2008-91 must necessarily be made for both applicable tax years, our informal conversations with the IRS indicate that a taxpayer can elect Notice 2008-91 in one year and still apply Notice 88-108 in the other. Very strained and adverse readings of the “one but not both” limitation in Notice 2008-91 are also possible, e.g., a reading that applying Notice 2008-91 now will preclude the later re-application of Notice 88-108 once the effective period for Notice 2008-91 expires; our informal conversations with the IRS confirm that such strained and adverse readings are inconsistent with the liberalizing spirit of Notice 2008-91 and are not to be followed.

⁹See, e.g., Rev. Rul. 89-73, 1989-1 C.B. 258 (disregarding a two-month period of a CFC's non-investment in obligations of its U.S. parent for purposes of IRC § 956, but ruling that a six-month period of non-investment was sufficient enough to preclude the

separate obligations from being treated as one continuously outstanding obligation).

¹⁰In cases where a taxpayer creates a series of back-to-back loans involving domestic and related foreign entities solely to achieve a particular tax consequence, the courts have applied the step transaction doctrine in determining the substance of the transaction. See, e.g., *Aiken Industries, Inc. v. Commissioner*, 56 T.C. 925 (1971).

¹¹79 AFTR 2d 97-1673 (DC Cal. 1997), *aff'd without pub. opinion*, 168 F.3d 499 (9th Cir. 1999).

¹²Although *Jacobs Engineering* was decided under the pre-1993 measurement period (where testing was done at the end of the year rather than at the end of each quarter) and the pre-1988 testing period (where loans were not considered U.S. obligations if paid off within one year), the case still sets a precedent that the IRS may collapse a series of purportedly separate loans into one continuous loan for IRC § 956 purposes under the step transaction doctrine.

¹³No exemption is available under the “portfolio interest” rules. See IRC § 881(c)(3). The 30 percent gross withholding tax may be reduced (including to rates as low as 0 percent) by an applicable tax treaty, but not every CFC will be eligible for such tax treaty benefits. See, e.g., 2006 U.S. Model Income Tax Convention, Article 11 (Interest) and Article 22 (Limitation on Benefits).

¹⁴Based on the general Subpart F, sourcing, and characterization of income rules, the OID (treated as interest) income received by the CFC from the domestic U.S. company relating to a Code section 956 loan should be treated as Subpart F, foreign personal holding company, U.S. source, passive income. Therefore, if no exception or resourcing provisions apply, the U.S. shareholder of the CFC would recognize U.S. source, Subpart F income on the OID.

¹⁵Because the language in Notice 2008-91 states that a CFC “may choose to exclude from the definition of the term ‘obligation’” a loan to its U.S. parent that meets the requirements set forth in the Notice, it appears unlikely that the IRS would be able to successfully argue the application of Notice 2008-91 to deny the affirmative use of IRC § 956 if the CFC had not made an election to apply the Notice. □

Reprinted from the October 15, 2008 issue of *Practical U.S./International Tax Strategies*

©2008 WorldTrade Executive, Inc

www.wtexecutive.com