A Note From the Editor-in-Chief

Code Sec. 956: Developments Concerning the Definition of U.S. Property

There is much talk in Washington concerning international tax reform. Unfortunately, the Administration’s current international tax reform proposal does not meaningfully address the disincentive, which is built into our worldwide tax system, to distribute foreign earnings to the United States. Dividends received from foreign subsidiaries are subject to full U.S. taxation, and because most countries have lower tax rates than the United States, incremental U.S. tax generally is due after reduction for foreign tax credits. This repatriation cost is in contrast to most other countries that do not tax dividends from foreign subsidiaries under their territorial tax systems.

In addition, unlike other countries, a loan made by a foreign subsidiary to a U.S. affiliate or an investment in assets located in the U.S. (“U.S. property”) is treated as a deemed dividend under Code Sec. 956. Not all transfers of funds to the United States are within the scope of Code Sec. 956, but taxpayers must carefully navigate those rules in managing their worldwide cash needs. This column discusses two recent developments concerning transfers of funds to the United States and the application of Code Sec. 956.

In CCA 2009-13, the IRS provided guidance concerning the application of Notice 2008-91, particularly with respect to multiple obligations of one or more CFCs. This Notice is one of two Notices that provide exceptions permitting U.S. companies to access offshore funds on a short term basis without triggering a deemed dividend. Notice 88-108 excepts obligations that are collected within 30 days, as long as the CFC does not have loans to related U.S. persons outstanding during the year for 60 or more days (“30/60 day exception”). In light of liquidity needs in the United States, Notice 2008-91 expanded this exception, allowing taxpayers to choose (for three years) to exclude from the definition of U.S. property obligations that are collected within 60 days, as long as the CFC does not have loans outstanding to related U.S. persons during the year for 180 or more days (“60/180 day exception”).

The CCA makes clear that choosing the application of Notice 2008-91 is made on a CFC-by-CFC basis, and can be applied to one or more available years. When counting the number of days an obligation is outstanding, the date of issuance is excluded and the date of repayment is included. If a loan...
originating in 2008 carries over into 2009, the 60-day test is determined for 2008 by counting the days the loan is outstanding during both 2008 and 2009.

The CCA warns taxpayers concerning the possible application of the anti-conduit rule of Reg. §1.954-1T(b)(4). For example, if CFC1 funds CFC2 (through capital contributions or debt) and CFC2 makes a loan to a U.S. affiliate, CFC1 may be considered as holding the obligation, which would be taken into account in applying the 60/180 day tests to CFC1.

Where multiple CFCs make sequential loans to a U.S. borrower, under certain circumstances the IRS may view a CFC as effectively guaranteeing a U.S. obligation. A CFC that guarantees an obligation of a U.S. related person is treated as holding such obligation when applying the 60/180 day tests. The CCA indicates that this might occur where a U.S. borrower is financially impaired and repayment of an obligation of one CFC is contingent on a subsequent obligation to another CFC. The mere fact the CFCs are related, however, does not create a presumption of a guarantee.

Finally, the CCA warns that a series of loans from one CFC must be executed and repaid independently or else the periods of disinvestment will be ignored for purposes of applying the 60/180 day tests. It lists a number of factors to take into account, including the volatility of economic conditions and access to commercial paper markets, as well as the period of disinvestment. This seems to suggest that a short disinvestment period is acceptable if the facts support that the loans are independent. At a minimum, a 60-day disinvestment period should avoid two loans being considered as continuously outstanding.4

In the second development, Schering-Plough Corp.,5 the court addressed whether advance payments made by two CFCs to their U.S. parent should be subject to Code Sec. 956. Schering-Plough had entered into two 20-year interest rate swap transactions with an unrelated foreign bank. Under the swaps, the two counterparties agreed to exchange periodic payments based on a hypothetical amount (the “notional principal”) and two different interest rate indices. Schering-Plough assigned the rights to receive interest payments from the foreign bank to two of its Swiss subsidiaries for lump sum payments totaling approximately $690 million.

Pursuant to Notice 89-21, Schering-Plough reported the transactions as a purchase by the CFCs of the future rights to the interest payments and accordingly not subject to Code Sec. 956. The court, however, after a lengthy factual and legal analysis, determined that the advance payments at issue were in substance loans to the U.S. parent and therefore subject to Code Sec. 956.

A disconcerting theme running through the opinion is the court’s unsupported conclusion that Congress intended for Code Sec. 956 to apply because the advance payments were a repatriation of the cash of foreign subsidiaries to the United States. Code Sec. 956, however, does not apply to an arrangement unless a CFC holds property that falls within the limited definition of “U.S. property” and none of the numerous exceptions apply. In addition, the courts have consistently rejected the government’s arguments to expansively apply Code Sec. 956 in order to carry out asserted Congressional intent, even where the CFC’s cash is brought back to the United States pursuant to an arrangement that might be considered as abusive.7 Unfortunately, the court does not indicate that it is aware of the limited scope of Code Sec. 956, and fails to discuss, or even cite to, the series of cases that refused to rely on Congressional intent in deciding subpart F issues.

The court’s superficial and uninformed discussion of Code Sec. 956 is unfortunate, but should not cast a pall over proper planning in navigating the provisions of Code Sec. 956. Contrary to the court’s suggestion, taxpayers can rely on the proposition that the rules of subpart F should not apply to arrangements outside the language of the Code, regulations and other authorities, even where the policies underlying subpart F arguably could be furthered by an expansionary interpretation.8

ENDNOTES


6 1989-1 CB 651; see 1997 FSA LEXIS 206 (Aug. 29, 1997). The Notice was subsequently replaced with regulations that permit the Commissioner to treat any nonperiodic swap payment as a loan for purposes of Code Sec. 956. Reg. §1.446-3(g)(4).

7 For a discussion of these authorities, see Yoder, Schering-Plough Corp. v. United States: Subpart F Analysis Gone Awry, 38 Tax Mgmt., Int’l J. 705 (Dec. 11, 2009).