THE OPAQUE MEANINGS OF U.S. PROPERTY UNDER SECTION 956

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Outline

• Introduction
• Broadly: what is US property?
• Modern interpretive issues:
  – Lending transactions
  – Intellectual Property
  – Intercompany transactions: Related Party Cash Management
• Traps for the Unwary
• Views contained herein are those of the speakers—
not their firms, partners or clients!
Background
**Subpart F Background**

- Kennedy (1961) – wanted to eliminate tax deferral completely
- Congress – concerned with impacting US competitiveness in foreign markets – wanted a more targeted approach to limiting deferral
- Subpart F, including section 956, enacted in 1962
  - Where are we 51 years later?
  - Even more material foreign cash pools as businesses globalize; greater international tax competition
Section 956

- Goal of Section 956 is to impose U.S. tax on investments that are “substantially the equivalent of a dividend”
  - House proposed a broader rule applying to earnings attributable to investments in any property, regardless of jurisdiction, other than those necessary for active conduct of trade or business
  - Treasury thought would be unworkable; narrowed scope to investments in certain US property
**US Property**

- Section 956 taxes a shareholder of a CFC on such shareholder’s share of the CFC’s earnings invested in certain “United States property,” including:
  - Tangible property located in the United States
  - Stock of a domestic corporation
  - Obligations of related United States persons (including as a result of application of the pledge/guaranty rules)
  - Certain intangible property rights
  - Trade/service receivable acquired from a related US person and obligor is a US person (regardless of whether related)
Section 956:
Issues in Lending Transactions
Obligation

- Obligation “includes 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”; Treas. Reg. § 1.956-2T(d)(2)(i)
  - Transfer pricing adjustments? i.e., US person owes amounts to CFC
  - Prepayments? Sale/processing of property/services exception – does not apply to royalties. What if not refundable? (Then a dividend?)
  - A US person’s obligation as a guarantor?
USP’s Guaranty: is it an Obligation?

- TAM 8042001 – USP’s mere secured guarantee of CFC2’s debt did not rise to level of an “obligation” for purposes of 956 – so USP’s pledge of CFC1 equity to secure USP’s guarantee of CFC2’s debt not an investment in US property. No evidence of CFC’s earnings being directly or indirectly repatriated to the US because obligation not US.

- See also TAM 8101012 – USP guaranteed loan made to CFC1, CFC2 made subordinated loan to CFC1 (likely to make sure CFC1 had enough cash). CFC2’s subordination of the debt owed to it by CFC1 did not cause an investment in US property of USP, because USP’s guarantee not an “obligation.”
**Ludwig, 68 TC 979 (1977)**

- In 1963, TP borrowed 100M, backed by a pledge of 100% of the equity of his wholly owned CFC, Oceanic – to buy 15% interest in Philips Petrol
- Pledge accompanied by typical negative covenants with respect to CFC
- IRS argued CFC was guarantor
- Tax Court concluded no guarantee because
  1. No undertaking/promise on part of CFC and
  2. CFC had no liability to pay if taxpayer defaulted
Ludwig (cont’d)

• On default, banks would have sold stock, couldn’t have liquidated – testimony that it would have been “impracticable” – in fact “outrageous” to liquidate the CFC

• Court frowned upon IRS bootstrap Revenue Ruling on same facts and ruled 100% pledge coupled with negative covenants not equivalent to a “guaranty” and only Congress could extend the rule
Legacy of Ludwig: Administrative Fiat

• Indirect pledgor/guarantor – IRS overruled Ludwig court by publishing regs
  – Are the regulations valid?

• Legacy of Ludwig:
  – IRS enacted a rule that ignores the practical reality of being an equity holder (and of being behind trade creditors) and ignores the intent to prevent indirect repatriation
  – Over-breath has potential chilling effect on lending transactions
  – Creates uncertainty and makes a coherent framework for analysis impossible
Legacy of Ludwig (cont’d)

• Lack of guidance and enforcement leaves enforcement to auditors and private parties (e.g., diligence in M&A transaction)

• The problem: increasingly global economy, stockpiles of foreign cash (PSI reports that MNCs hold more than $1.7 trillion in cash offshore and keep 60% of cash overseas), cheap US debt, lenders who demand all possible collateral
Treas. Reg. § 1.956-2(c)(2)

• “If the assets of a [CFC] serve at any time, even though indirectly, as security for the performance of an obligation of a United States person, then . . . the [CFC] will be considered a pledgor or guarantor of that obligation.”

• Pledge of stock of a CFC equivalent to indirect pledge of the assets of the corporation if
  – (1) at least 66 2/3% of the total combined voting power of all classes of stock entitled to vote is pledged and
  – (2) if the pledge of stock is accompanied by one or more negative covenants limiting the corporation's discretion with respect to the disposition of assets and the incurrence of liabilities.

• Regulations do not state the rule as a safe harbor – but everyone treats it as such
Example 1: Base Case

- In Opco default, Bank can take:
  - 100% of Opco and obtain indirect ownership of 100% of CFC.
  - 65% of voting stock of CFC and get in line with Opco’s unsecured creditors for the remainder of CFC’s stock.
  - What if remaining 35% of CFC’s stock is subject to a drag along covenant? So if Bank sold 65% of CFC’s stock to a third party, Bank could force Opco to sell the remaining 35%? Possible that 100% of cash would go to bank, depending on how security agreement works.
Example 2: CFC Holdco

- In Opco default, Bank can take:
  - 100% of Opco and obtain indirect ownership of 100% of CFC.
  - If Opco pledges 100% of CFC Holdco (which is a domestic corporation), concern is if Bank acquires CFC Holdco, Bank has a virtual 100% stock pledge of CFC if CFC Holdco has no creditors, even if in form direct pledge limited to 65% of voting equity
    - Is there a covenant preventing CFC Holdco from having creditors?
  - Limit pledge of CFC Holdco and CFC to 65% of voting equity. Limit any guaranty by CFC Holdco to value of 65% of CFC’s voting equity.
Example 3: US Holdco

- Same as previous. Market definition of CFC Holdco is entity substantially all of the assets of which are stock. Definition moving toward stock and debt instruments of CFCs.

- Is Holdco here a CFC Holdco if US sub has any material value?

- If 100% pledge of Holdco, and Holdco has no creditors, Bank can obtain virtual 100% pledge of CFC.

- Shouldn’t definition be by reference to whether Holdco has liabilities? Is it enough if Holdco does not currently have liabilities, but is not prohibited from incurring them? Idea behind current definition may be that if all assets are stock, unlikely to have creditors.
**Example 4: Multi-Tier CFCs, 100% Pledge 1st Tier CFC**

- Indirect pledge rule causes CFC1 to have an investment in US property. Negative covenants + > 66 2/3rds % of voting stock

- What about CFC2? In 1994 CCA 03673, IRS concluded CFC2 would not have investment in US property provided the value of the stock of CFC2 was not a “significant amount “of the total assets of CFC1.

- IRS seems to ignore the broad reach of the regs. Why? Is it recognition that ownership of CFC1 doesn’t give lender priority to CFC1’s assets (stock of CFC2) over CFC1’s creditors? Would it be different if CFC1 had guaranteed the debt and directly pledged its assets? Why is stock of CFC2 any different than the remainder of CFC1’s assets? If it’s not effectively pledged, why are CFC1’s other assets treated as such?
Example 5: Non-US Sandwich

- Same as Example 1, except for US Opco Sub guaranty

- Legislative history explains Congressional concern that CFCs would avoid repatriation costs by running US branches

- CFC’s investment in US Opco Sub is a clear investment in US property

- What about US Opco Sub’s guaranty of US Opco Parent’s debt?
  - For US Opco Sub to provide cash to US Opco Parent, would require a dividend up the chain through CFC, at which time would be taxable
  - But US Opco Sub is not a CFC – although its assets are indirectly wholly owned by CFC
  - If investment in US property, how measured? Guaranty permits access to full value of US Opco Sub, not just CFC’s tax basis in equity of US Opco Sub.
Example 6: Pledge of Disregarded Entity

• Many commentators express concern that pledge of a flow through interest is a pledge of the underlying assets of the flow through.

• Legitimate concern that the pledge/guaranty rule might be applied without regard to intent, but is this the “right” answer?

• If Bank takes 100% of Opco here, Bank is in no different position from a credit support position than when Opco is a C corp for tax purposes. Bank still only gets 65% of CFC stock and gets in line to fight for the remaining value.

• Any difference if Opco is partnership and not DRE? So respected as an entity for tax purposes?

• You’ve probably had this fact pattern!
Example 7: Pledge of Intercompany Note

- Same as Example 1, except for pledge of CFC’s obligation to Opco.

- Note could be repaid without a dividend – provided respected as debt/not treated as equity.

- Principal amount of CFC’s obligation never changes, even if pledged to secure a much greater Opco obligation.

- If note old/cold, w/out Opco borrowing, CFC still owes same amount to Opco. If note new, tax law permits shareholders to choose whether to structure an investment as debt or equity. Bank could loan directly to CFC w/out causing 956 issue.

- Other considerations: cross defaults, maturity date similarity, security on CFC note
Example 8:
Collateral Allocation Mechanism (CAM)

• Lenders enter into a CAM. Agree to swap interests in their lender positions in the event either borrower defaults.

• If Opco defaults, Bank 2 gives Bank 1 some of its loan issued by CFC. Amount of loan to CFC does not change, but Bank 2 holds less of that loan.

• How is this any different than Example 7? Lender to US is receiving, as an asset, the pledge of a receivable of CFC, which receivable could be repaid without a dividend to Opco.

• Other considerations: Cross defaults? Security? Borrower not a party? Borrower doesn’t know about the agreement?
Amount of Inclusion

• Lesser of outstanding principal amount of underlying US obligation and CFC’s E&P.
  – Treas. Reg. § 1.956-2(c)(2) Ex. 3.
  – No correlation to value of CFC’s assets pledged. Pledge asset with a value of $1, could be required to include $1B.

• What about pledge of interco note? Limited to face amount of note if triggers an inclusion at all?

• Duplication: Multiple CFC guarantees of an obligation – Inclusion not capped by the amount of the obligation. Inclusion up to amount of obligation times number of CFCs that made an investment in US property.
  • FSA 200216022 – 2 CFCs entered into separate agreements with bank to remit dividends to US parent to enable parent to meet loan and maintain net worth + negative covenants.
Traps

- 956 inclusion not limited to value of assets pledged
- Can be required to include full amount of debt w/r/t to each CFC (if it has sufficient E&P)
- Do these rules make sense in a repatriation model? Overinclusive.
- Pledges/guarantees of Holdcos that own equity of CFCs
**Other Issues: Credit Agreement Covenants**

- Repatriation covenants, cash flow sweeps, limits on excess foreign cash
  - FSA 200216002 -- agreement to pay dividends = investment in US property
  - What does no requirement to repatriate if it has an adverse tax effect mean?
  - Prepay “an amount” of US debt, but no requirement to bring actual foreign cash back.
  - Do projections show ability to service US debt with just US cash flow?
- Leverage ratios, EBITDA hurdles tested on a world-wide basis, including CFCs
  - Do the assets serve, even indirectly, as credit support for the US debt?
• Judge Learned Hand commenting on the income tax act:
  – “In my own case the words of such an act . . . Merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception – couched in abstract terms that offer no handle to seize hold of – [leaving] in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract.”
Summary of Guaranty and Pledge Rules

• Applied without regard to timing, without regard to amount and (potentially) without regard to whether or not there is a disguised repatriation.

• Puts companies with US owners at a competitive disadvantage (contrary to goals, to not put US people at a disadvantage). No other country has a 956 rule (although several have subpart F analogs).

• Other options:
  – Repeal 956, go to territorial system – no (or limited) tax on dividends from subs
  – Just wait for repatriation/obligation assumption to occur
  – *Plantations Patterns* (treat the debt as non-US, deny U.S. deductions - but limitation would apply currently if US couldn’t borrow without foreign guarantees/security); Obama budget proposals re: limiting interest deductions in US if support foreign subsidiaries
Suggestions for Guidance

• Focus the pledge/guaranty regulations. Read literally, nothing escapes the current regulations.

• What is the right trigger for indirect repatriation?
  – Does the transaction present an actual opportunity for avoiding repatriation?
  – Or is it maximizing USP’s value of the CFC stock as an equity position? In some cases, foreign sub would never be liquidated, e.g., b/c foreign creditors, not permitted under foreign law, business more valuable as a whole. But this thinking would eliminate the rule as to all pledges/guarantees except those engaged in by the CFC itself

• Guidance re: pledge of loan, CAMs, holdco implications, pledge of flow-through equity
Section 956: 
Intangible Property Related Issues
Section 956(c)(1)(D)

- Section 956(c)(1)(D) defines United States property or "U.S. Property" to include:
  
  "(D) any right to the use in the United States of—
  
  (i) a patent or copyright,
  
  (ii) an invention, model, or design (whether or not patented),
  
  (iii) a secret formula or process, or
  
  (iv) any other similar property right,

  which is acquired or developed by the controlled foreign corporation for use in the United States.” (emphasis added).

The amount of the investment subject to income inclusion under section 956(a)(1) is the U.S. property's adjusted basis as determined for purposes of computing earnings and profits, reduced by any liability to which the property is subject.
Proposal to Tax Income From Section 956-Type Intangible Property

• “The second component of the subpart F income which will be taxed to the U.S. shareholders in the case of controlled foreign corporations is income from U.S. patents, copyrights, and exclusive formulas and processes. For the income from these patents, copyrights, etc., to be included they must have been substantially developed, created, or produced in the United States, or, alternatively, acquired directly or indirectly from related U.S. persons. Your committee concluded that it was desirable to tax this income to the U.S. shareholders on the grounds that where a patent, copyright, etc., was developed or created in the United States, it is likely that, if it were not for lower taxes abroad, the rights to it would still be held by the domestic company with this company merely licensing its use by the foreign corporation. This, of course, would result in rental or royalty income taxable to the U.S. company.

The income to be taxed here is that derived from the license, sublicense, sale, exchange, use, or other means of exploitation of the patent, copyright, exclusive formula, or process.”
Legislative History – Senate Finance Committee Report

S. Rep. No. 87-1881, at 3391 (1962)

• “Generally, earnings brought back to the United States are taxed to the shareholders on the grounds that this is substantially the equivalent of a dividend being paid to them.”
Treas. Reg. § 1.956-2(a)(1)(iv)

• Treas. Reg. § 1.956-2(a)(1)(iv) defines "U.S. Property" to include:
  "(iv) Any **right to the use** in the United States of--
   (a) A patent or copyright,
   (b) An invention, model, or design (whether or not patented),
   (c) A secret formula or process, or
   (d) Any other similar property right,
   which is acquired or developed by the foreign corporation for use in the United States **by any person**.

   Whether a right described in this subdivision has been acquired or developed for use in the United States by any person is to be determined from all the facts and circumstances of each case.” (Emphasis added)

• The regulations also create a rebuttal presumption that if a right is **actually used principally in the United States**, it will be considered to have been acquired or developed for use in the United States.
The scope of section 956(c)(1)(D)

- Statute and regulations provide 7 enumerated items, plus “any other similar property right”
  - Are “marketing intangibles” covered – e.g., goodwill, trade name, and trade mark?
  - What other types of intellectual property might be covered by the residual category of section 956(c)(1)(D)?
  - Analogy to section 1249 regulations which were adopted contemporaneously

- The rule applies to the “right to the use” of certain intellectual property rights “in the United States”
  - What is the relative importance of “actual use” versus the mere “right to use” (compare the “principally used” language in the regulations with CCA 201106007, next page)
  - How is the place of use determined?
CCA 201106007

Acquisition or development of IP for use in the U.S. is an investment in U.S. property

Facts

• CFC and USP enter into a cost sharing agreement (CSA).

• USP develops software products. CFC acquires rights to exploit copyrights in U.S. market pursuant to the CSA. It is inferred that CFC reproduces the software outside of the United States.

• CFC sells software products into the U.S. market pursuant to the CSA.

Issue

• Whether the sale of software products by the CFC into the U.S. market give rise to an investment in U.S. property.

CCA’s interpretation of section 956(c)(1)(D)

• The CCA states that “U.S. property” is defined in relation to whether a CFC develops or acquires U.S. intangible property rights that are intended for use in the United States and not in relation to whether such right is actually exercised.

• Accordingly, an investment in U.S. property arises upon the acquisition and development of the rights to use the IP in the United States, not upon the actual use of the IP in the United States.
Section 956(c)(1)(D)
Definition of use in the United States

• No clear guidance for determining the place of use for purposes of section 956

• Analogies exist in the sourcing area (e.g., sections 861(a)(4) and 862(a)(4)), but the guidance is not consistent (place of use issue has been on IRS/Treasury priority guidance plan) –
  • Place of commercial exploitation (where the intellectual property is legally protected). See Rev. Rul. 72-232 (copyrights) and Rev. Rul. 84-78 (copyrights)
  • Place where the activities related to the intangible property (patents) are performed. See, Sanchez v. Comr., 6 T.C. 1141 (1946), aff'd, 162 F.2d 58 (2d Cir. 1947) and FSA 200222011
  • Place of legal protection (IP law approach, See Rev. Rul. 68-443) (trademarks).
Rev. Rul. 72-232 – Source of Royalty Income
Use determined by place of commercial exploitation

Facts
• A, a nonresident alien prepares manuscript as an independent contractor for textbooks for use in Country X public schools.
• A owns both the U.S. and Country X copyrights and licenses the U.S. copyright to M, a U.S. corporation.
• The books were printed in the United States by M.
• The books were not designed for use in the United States, and were sold exclusively in Country X.
• A received royalties from M for the books sold in Country X.

Conclusion
• Royalties received by A are not U.S. source income and are not subject to U.S. withholding tax.
• IRS stated that “[i]n the instant case there is no commercial publication of the textbooks within the United States in that the textbooks are not sold within the United States. Without such commercial publication M is engaged solely in printing or manufacturing books within the United States, which books are later sold in the foreign country. In the vending of such books in the foreign country, the foreign country copyrights are used and not the United States copyright.”
Sanchez v. Commissioner, 6 T.C. 1141 (1946), aff'd, 162 F.2d 58 (2d Cir. 1947)  
Use determined by location of business activities

Facts

- Under an agreement S, a nonresident alien individual, granted to Sucro-Blanc a U.S. corporation, full and exclusive worldwide rights and license to his invention and patent (a chemical agent and process for refining sugar), including rights to make, use and sell products.
- Patents were held in the U.S. and foreign countries.
- S did not charge Sucro-Blanc for use of the patented process, and Sucro-Blanc did not charge its licensees for the use of the patented process. Practically all of Sucro-Blanc’s income was derived from the sale of the chemical.

Conclusion

- Source of the royalty income was determined by reference to the location where Sucro-Blanc conducted its business activities in connection with the exploitation of its right to sublicense the patented process and sell the patented product rather than the locations of Sucro-Blanc’s customers and sublicensees.
- The court noted the fact that the contract between S and Sucro-Blanc, a U.S. corporation, was executed in the United States, the product was manufactured in the United States, and by reason of this contract, S was entitled to and received payments which were made to him in the United States from funds held in the United States by a U.S. company. The fact that Sucro-Blanc received part of the funds from sales made to customers doing business in foreign countries or from sublicensees granted to persons who used the process licensed in foreign countries, does not affect the characterization of the income derived by S.
Example: Section 338 Acquisition

Facts

- USP acquires FT and makes a section 338 election.
- FT owns U.S. and foreign patents, copyrights, trademarks and trade names.
- FT manufactures products outside the United States and sells to both U.S. and foreign customers.
- Title passes outside the United States for sales of products to U.S. customers.

Issue

- Where is the IP used?
  - Trademarks and trade names
  - Patents and copyrights
- How is basis allocated?
Recommendations

1. Clarify the scope of section 956(c)(1)(D)
   a. Marketing intangibles
   b. Actual use v. Right to use

2. Clarify the “place of use” determination. Alternatives might include:
   a. Separate valuation of each U.S. v. non-U.S. copyrights, patents, trade secrets, etc. versus a “top-down” approach
   b. A mechanical rule to determine U.S. v. non-U.S. use
   c. Place of business activity by user of IP
   d. Location of consumer market
   e. Facts-and-circumstances approach
Section 956:
Intercompany Transactions -- Related Party
Cash Management Issues
Related Party Cash Management

- Exceptions from US property definition for obligations of USP that are ordinary and necessary to carry on a trade or business of both parties to the transaction
  - Sale or processing of property.
    - § 956(c)(2)(C); Treas. Reg. § 1.956-2(b)(1)(v)
  - Provision of services by a CFC to a related USP;
    - Treas. Reg. §1.956-2T(d)(2)(i)(B), add 60 day safe harbor
  - No exception for other trade receivables – e.g., lease or license of tangible or intangible property
Related Party Transactions

• Typically arise when US company is buying goods or services from CFC, can also arise from a prepayment for US company’s obligation to deliver goods/services

• *Greenfield*, 60 TC 425 (1973) – ordinary / necessary test not satisfied by CFC/US sister for sale/processing exception
  – But facts reasonably inconsistent with such treatment

• TAM 8114032 – 4 year maturity satisfied sale/processing exception based on assumption that unrelated persons might agree to same terms.
  – Underlying contract for alcohol that required at least 3 years to mature.

• Traps: receivables aren’t timely paid
Example

• USP buys goods from CFC, always results in an account payable. USP typically pays off in 6 months.
• CFC also sells goods to unrelated parties. Those receivables typically paid off in 90 days.
• In this particular industry, most sellers have at least 6 month tails on their receivables.
• Facts and circumstance in market or in particular CFC’s business?
• Treas. Reg. § 1.482-2—rules regarding amount and timing of interco trade receivables before interest must be charged
**Related Party Cash Management**

- (More) legislation by administrative fiat
- Both more and less restrictive
- Churning of loans results in US property investment even when no loan outstanding on test date
  - *Rev. Rul. 89-73*: 60 day disinvestment around testing date disregarded, but 185 days would be respected. 1993 legislative history cited this R.R. with approval.
  - *Jacobs Engineering (9th Cir 1999)* – 12 back to back loans treated as one borrowing despite compliance with technical requirement of payment by year end
**Relief: Notice 88-108**

- Notice 88-108 provided some relief to measuring US property investment at year end. If obligation held at year end, **not** US property if collected w/in 30 days, and CFC doesn’t hold U.S. obligations for 60 or more days.
  - In other words, CFC can own US property in the form of an obligation of a related person at any time during the year provided doesn’t own such loans for more than 59 days
  - Credit crisis extension of rule to 60/180 days (Notice 2008-91; 2009-10; 2010-12)
  - 1993 – amendments to 956, legislative history states “not intended to change” measurement of US property as provided for in Notice 88-108
  - Potential trap: if relying on 30/60 day rule, have to be careful as an inadvertent small *obligation* could push the CFC over the cliff
Relief: GLAM 20070016 (Oct 8, 2007)

- USP wholly owns CFC, both calendar year end for tax/financial accounting purposes.
- USP has revolving line of credit with 3P lender. Approx 5 days before each quarter end, USP borrows the outstanding balance from CFC. And five days after, reborrows from 3P lender and pays off CFC.
- Extends Notice 88-108 to quarter-end testing. Since USP always paid off obligations to CFC within 30 days and did not have a balance outstanding for more than 59, no investment in US property.

• Apply Notice 88-108 to each CFC separately

• Treas. Reg. § 1.956-1T(b)(4) (anti-conduit rule) must be taken into account
  – CFC will be considered to own obligation of a related USP acquired by another CFC that is controlled by the first CFC if one of principal purposes of creating, organizing or funding the other CFC is to avoid the application of § 956

• Pledges/guarantees must be taken into account – e.g., requirement for another CFC to loan to USP to trigger repayment

• USP must execute and repay each obligation owed to its CFC as a separate, independent transaction (cf Jacobs Engineering) / CFC must make independent
2012 PSI Hearings: HP

• Discussion of HP’s “structured loan program to obtain billions of dollars in continual, alternating loans each year from two offshore entities” – used funds to run US operations, take position no repatriation

• Two entities – internal bank and a “stagnant pool of cash” – provide constant loans over course of year to fund HP US, including payroll, working capital, share repurchases, and possibly acquisitions
HP (cont’d)

• None of the loans are ever outstanding over the quarter end (not relying on Notice 88-108); two CFCs never co-mingle funds and had different year ends

• Billions of dollars provided since 2008; in 2010 – between 6-9B provided without interruption throughout first 3qs of year

• EY at a “should” assuming HP avoided behavior that could be interpreted as abusive – e.g., documents, workpapers indicating an intent to avoid section 956; loans between the CFCs; should not be a loan schedule contemplating a series of loans to be made and retired at specific times
HP Offshore Alternating Loan Program

Loan dates:
Loan 1: Jan 2 – Feb 17
Loan 2: Apr 2 – May 17
Loan 3: July 2 – August 17
Loan 4: Oct 2 – Nov 17

Loan dates:
Loan 1: Feb 17 – Apr 2
Loan 2: May 17 – July 2
Loan 3: August 17 – Oct 2
Loan 4: Nov 17 – Jan 2
Summary: Traps for the Unwary
Traps for the Unwary

- Impact of formed or funded rule. Treas. Reg. § 1.956-1T(b)(4).
- A section 338 election is made on the acquisition of a foreign target that was not a CFC; the target owns stock in a U.S. subsidiary, has U.S. IP, or has loans to a U.S. affiliate.
- Traps in relying on section 956(b)(2) - property acquired prior to CFC status.
  - The benefit is contingent on existence of pre-acquisition E&P amount, which may be variable based on subsequent events (i.e., distributions, deficits), and the pre-acquisition E&P amount remains part of “applicable earnings.”
- Traps involving foreign cash pools when a CTB election is made by a participating CFC.
  - If the CFC has a payable to the pool, and an election is made to disregard the CFC, the loan constitutes U.S. property for 956 purposes.
Traps for the Unwary

Formed or funded example

Facts
- USP owns CFC1 which owns CFC2.
- CFC2 purchases inventory from CFC1.
- CFC2 pays a dividend to CFC1.
- CFC2 repays a loan from CFC1.

Consideration
- Does formed or funded rule under Treas. Reg. § 1.956-1T(b)(4) apply?
**Traps for the Unwary**

*Acquisition of a foreign target not a CFC*

**Facts**

- USP acquires a foreign target FT which was not a CFC.
- FT owns stock of U.S. subsidiary US1 and has loans to other U.S. affiliates.
- Consider whether to make a section 338 election.

**Consideration**

- Upon acquisition, FT becomes a CFC.
- Section 956 implications?
Traps for the Unwary

- Corporate treasury department may not be educated concerning section 956; may allow a U.S. affiliate to borrow from CFC affiliate; or just forget to timely repay a loan.
- CFC and U.S. parent have offsetting loans to one another, but loans are not netted on their respective books before quarter end.
- Obligation of a U.S. affiliate guaranteed by multiple CFCs.
  - Is the inclusion amount capped by the amount of the obligation if the CFC guarantors have E&P in excess of the loan amount? (FSA 200216022)
- Impact of GLAM 2009-013 on the use of alternating CFC loans?
- 30/60 cliff effect ($1 loan outstanding 61 days taints whole loan). See Notice 88-108.
- U.S. affiliate does not timely pay trade or services payables to CFCs (or accounting group does not keep up with payments).
- No grace period for royalty payables.
- Inventory and royalty prepayments.
Traps for the Unwary

Multiple CFC guarantees of an obligation

Facts

• USP borrows $100 from a 3rd party bank in exchange for a note.
• CFC1 and CFC2 each guarantee the USP’s loan.
• CFC1 and CFC2 each have E&P of $100.

Considerations

• What is the inclusion amount under section 956?
• See FSA 200216022
  • Each guarantee counted up to full amount of the obligation or the CFC’s E&P.
  • Amount determined for each CFC that guarantees USP’s debt.
  • Potentially results in multiple inclusions.