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TAX TRANSACTIONS UPDATE

IRS Liberalizes the Rules for a Foreign Subsidiary to Make Short-Term Loans to its US Parent to Ease Liquidity

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The Internal Revenue Service (the "Service") recently issued guidance intended to address taxpayer difficulties in funding their operations as a consequence of current market developments. In particular, the Service issued Notice 2008-91 on Friday, October 3, 2008, "[t]o facilitate liquidity in the near term" by liberalizing certain guidance that would allow a foreign subsidiary to make a short-term loan to its US parent corporation without triggering immediate US taxation.

As is discussed in detail below, the Notice lengthens the permitted term of certain loans that a foreign subsidiary can make to a related US person, and the number of days over the taxable year a foreign subsidiary may make such loans, without triggering US tax. In particular, Notice 2008-91 extends a pre-existing safe harbor pursuant to which foreign companies can lend money back to related US persons for less than 60 days during a taxable year if each loan is outstanding for 30 days or less. Foreign companies can now lend money back to related US persons for less than 180 days during a taxable year if each loan is outstanding for 60 days or less. However, there are potential difficulties with relying on Notice 2008-91.

Generally, a United States shareholder[1] of a controlled foreign corporation (CFC)[2] is required to include in gross income the amount determined under section 956 with respect to such shareholder for such taxable year. The amount determined under section 956 generally relates to the United States shareholder's pro rata share of the average amount of United States property owned by the CFC on the closing date of each quarter of its taxable year.[3] Therefore, as a general matter, a shareholder will not have any section 956 inclusion to the extent that the CFC does not own any United States property on the closing date of each quarter of its taxable year. For purposes of section 956, United States property generally includes any obligation of a related US person (e.g., an indebtedness owed by a US person to the CFC).[4] There are a variety of exceptions to the definition of United States property, one of which relates to certain short term loans to a related US person.

In Notice 88-108, the Service provided for the so-called "30/60 day exception." Further, the Service stated that it would issue regulations that would exclude from the definition of the term "obligation" an obligation that would constitute an

investment in United States property under the then-applicable annual (as opposed to quarterly) testing regime, 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. This exclusion would not apply if the CFC held, for 60 or more calendar days during such taxable year, obligations which, without regard to the 30 day rule, would constitute an investment in United States property if held on the applicable testing date. The effect of this rule was that a CFC could have outstanding on the applicable section 956 testing date, an obligation that was collected within 30 days, provided it did not have 60 days or more of any obligations outstanding during the taxable year.

The legislative history relating to the amendment of section 956 from an annual to a quarterly testing period favorably cited to Notice 88-108 and suggested that this rule should continue to apply under a quarterly testing regime.[5] Last year, the Service issued a general advice memorandum that confirmed that Notice 88-108 continues to apply under the current quarterly testing regime.[6]

Notice 2008-91 effectively extends the 30-60 day periods provided in Notice 88-108. In Notice 2008-91, the Service has stated that due to the liquidity crisis, it would exercise its authority under section 956(e) to draft regulations to provide that a CFC may choose to exclude from the definition of the term "obligation," an obligation held by the CFC that would constitute an investment in United States property provided the obligation is collected within 60 days from the time it is incurred. This exclusion does not apply, however, if the CFC holds obligations for 180 or more calendar days during its taxable year that, without regard to the 60 day rule described in the preceding sentence, would constitute an investment in United States property. Therefore, in practice, a CFC would be limited to a total of 179 days of such loans, each of which must be collected within 60 days. Notice 2008-91 is effective for the first two taxable years of a CFC ending after October 3, 2008. In effect, the Service modified the 30-60 day rule, at least superficially, to a more taxpayer-favorable 60-180 day rule.

Notice 2008-91 does not, however, address the question of whether, or under what circumstances, a series of successive loans collected within 60 days may be treated as a single loan. The Service has been concerned that taxpayers would attempt to avoid the application of section 956 by repaying obligations immediately prior to a testing date and creating a new obligation after a brief period of disinvestment. Accordingly, to address this concern, the Service issued Rev. Rul. 89-73. The Service later litigated this issue successfully in *Jacobs Engineering Group, Inc. v. United States*.[7]

Rev. Rul. 89-73 relied on common law doctrines, such as substance over form, to treat a series of several loans as a single loan, which under the facts of the ruling was treated as outstanding on a section 956 testing date. In Rev. Rul. 89-73, the Service looked to the period of disinvestment between two loans to determine whether the period of disinvestment was "brief" when compared to the investment period in

order to treat the two separate loans as such or to step them together as one, single loan outstanding for all the intervening dates. Under the terms of that revenue ruling, which was issued when section 956 utilized an annual testing period, a 60 day disinvestment period was considered presumptively brief (i.e., too short) after a 284 day investment period, but a 150 day loan followed by a 198 day disinvestment period was respected as separate from the subsequent reinvested loan.

Accordingly, it is possible that the intended taxpayer-favorable terms of Notice 2008-91 could be undermined by Rev. Rul. 89-73 if the period of disinvestment between loans is considered too short under the current section 956 quarterly testing period. A taxpayer that seeks to obtain the full benefits of the Notice (i.e., total loans outstanding over the course of the taxable year that do not exceed 179 days) and uses shorter disinvestment periods between loans is more likely to increase the possible imposition of recharacterization by Rev. Rul. 89-73.

It is our understanding that Treasury and the Service do not read Notice 2008-91 as limiting, or providing a basis to ignore the implications of, Rev. Rul. 89-73. In other words, the Service could take the position that, under "appropriate circumstances," two successive loans that are repaid within 60 days may still be stepped together under the provisions of Rev. Rul. 89-73 such that the resulting loan may be treated as exceeding 60 days in length and no longer receive the benefits described in Notice 2008-91. It is not clear what might constitute the appropriate circumstances needed to step the loans together, but taxpayers may conclude that the shorter the period of disinvestment, the more likely the Service will attempt to step the loans together to be treated as a single loan.

This possible interpretation of this interaction of Notice 2008-91 and Rev. Rul. 89-73 could significantly undermine the purpose of the Notice: that is, to permit certain short-term borrowings from a CFC without implicating section 956 in light of the current credit crunch. The possibility of recharacterization under Rev. Rul. 89-73 does not serve the stated purpose of the Notice and creates a disincentive to undertake such borrowing when there is a risk of a taxable event due to a potential recharacterization.

On a procedural level, Notice 2008-91 fails to explain how taxpayers are to "choose" to exclude the obligations described in Notice 2008-91 from the definition of the term obligation. It would appear that reliance on this Notice is elective; however, there does not appear to be any stated means for a taxpayer to so elect to rely on the Notice. For example, it is unclear whether a taxpayer must attach a statement to its return indicating that it has chosen to rely on Notice 2008-91 to exclude certain obligations from the term obligations as used in section 956. The Service and Treasury should clarify this point.

Endnotes

1 The term United States shareholder means a US person that owns at least 10 percent of the voting stock of a controlled foreign corporation. Section 951(b). All section references are to the Internal Revenue Code of 1986, as amended or the regulations thereunder.

2 The term controlled foreign corporation means a foreign corporation that is more than 50 percent owned (by vote or value) by United States shareholders. Section 957(a).

3. Section 956(a)(1). Prior to 1993, section 956 utilized an annual testing period to determine the amount includable in a United States shareholder's income under section 951(a)(1)(B). The term "quarterly testing" will be used throughout this memorandum to refer to section 956, as currently in effect. The term "annual testing" will be used to refer to section 956 as was in effect prior to the 1993 amendment.
4. Section 956(c)(1)(C).
5. S. Rep. No. 36, 103d Cong., 1st Sess. (1993); H.R. Rep. No. 111, 103d Cong., 1st Sess. 700-01 (1993).
6. AM 2007-0016.
7. 1997-1 USTC 50,340 (CD Cal. 1997) *aff'd* 168 F.3d 499 (4th Cir. 1999).

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