DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL
CC:LM:FS:HAR:B

FROM: Phyllis E. Marcus
Chief CC:INTL:BR2

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated October 9, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be used or cited as precedent.

LEGEND

USParent:
Number x:
Bank:
CFC1:
Foreign Country x:
Business a:

$a:
$b:
$c:
$d:
$e:
$g:
$n:
Year 1:
Year 2:
Date m:
x%:
amount a:
amount b:

amount c:
amount d:

ISSUES

1. Whether USParent's controlled foreign corporations ("CFCs") should be treated as indirectly guaranteeing their United States parent's debt for purposes of section 956(a) and (d) under the Year 1 financing arrangements described below.

2. Whether the proposed adjustment under section 956 may exceed the total amount of Bank's loans to USParent because of the contracts entered into by Bank with each of USParent's CFCs.

CONCLUSIONS

1. Under the facts described below, each of USParent's CFCs should be treated as indirectly guaranteeing its United States parent's debt for purposes of section 956(a) and (d).

2. Because each CFC has indirectly guaranteed USParent's debt, USParent may be required to include in its gross income under section 956(c) a multiple of its guarantied debt, depending on the extent of its CFCs' earnings.

FACTS

USParent, a United States corporation, is engaged in Business a. It owns approximately Number x CFCs which collectively, at the end of Year 1, held approximately $a in unrepatriated earnings and profits.

Since 1980, Bank has provided a line of credit and occasional term loans to USParent. In mid-1996, these included three term loans with initial principal balances aggregating $b; and a revolving line of credit dated Date m. In each case, Bank extended credit directly to USParent, but required that each of USParent's subsidiaries, including all of its CFCs, guarantee USParent's indebtedness to Bank.

During Year 2, USParent was contemplating restructuring its existing debt and possible business expansion. To that end, it entered into discussions with Bank that would culminate in its borrowing $c under a term loan and obtaining a new $d revolver.

Before it did so, USParent became aware that its CFCs' debt guarantees constituted investments in United States property under Treas. Reg. § 1.956-2(c)(1). Consequently, USParent asked Bank to refrain from requiring CFC guarantees of new USParent loans and credit lines. Bank rejected this request but proposed three alternatives to USParent. One proposal called for replacing the subsidiary guarantees with agreements between each of the CFCs and Bank.

After review, USParent chose to implement this option. Accordingly, Bank drafted, and USParent caused its CFCs to execute, agreements with Bank, which provide in part as follows.

Each CFC letter agreement acknowledges the making of the $c loan to USParent, and that benefits will accrue to the CFC from that loan. Each CFC represents that its covenants to Bank are in consideration of Bank granting the credit facility to USParent. Each CFC agrees to monitor, on an ongoing basis, USParent's ability to comply with the terms of the credit facility, and ensure that USParent will be able to meet its obligations thereunder. Each CFC agrees to provide USParent "with sufficient liquid assets via cash dividends to meet those obligations," and to take all necessary steps (to the extent of the greater of (i) x% of the CFC's net worth on the date of the letter, or (ii) x% of the CFC's net worth "on the date enforcement of [the agreement] is sought") to ensure that USParent's net worth is maintained at not less than $e at all times.

Each CFC agrees that as long as any direct or contingent USParent debt to Bank is outstanding, not to guarantee any debt of USParent or its subsidiaries without first guaranteeing USParent's debt to Bank on an equal basis. Each CFC also subordinates any debt of USParent to the CFC to any debt of USParent to Bank.

Each CFC agrees, with the exception of cash dividends paid directly or indirectly to USParent, not to pay any dividends or make any distributions of assets on account of any share of any class of its capital stock to anyone as long as any direct or contingent debt of USParent or any of its subsidiaries is outstanding or Bank has any commitment under the credit facility.

Each CFC represents and warrants to Bank that USParent directly or indirectly "owns 100% of [its] voting stock and has the authority on [the CFC's] behalf to declare and cause to be paid cash dividends."

Each CFC agrees to use its best efforts to comply with all covenants set forth in all agreements relating to the loan facility. The CFC assents, without notice, to all agreements USParent made or will make to Bank with respect to the loan facility.

The loan agreement between USParent and Bank warrants (affirmatively covenants) that none of the stock of any of USParent's subsidiaries is pledged or hypothecated. USParent warrants, in part, that it and its subsidiaries will maintain at all times on a consolidated basis: (i) a specified excess ($g) of consolidated current assets over consolidated current liabilities, to be determined in accordance with GAAP (also described as a "minimum working capital requirement"); (ii) a minimum debt service ratio of not less than amount a to 1.0 (taking into account, with respect to USParent's foreign subsidiaries, the maximum effective United States corporate tax rate); (iii) a total consolidated net worth of not less than $e; and (iv) a specified maximum debt ratio (of total consolidated liabilities to total consolidated tangible net worth, determined in accordance with GAAP) of not less than amount b to 1.0. USParent agrees that in the event of a default of any of its obligations to Bank, it would "use its best efforts and take whatever steps necessary to cause" one or more of the its Subsidiaries to declare dividends to it in an amount sufficient to repay all its Bank loans.

In addition, the loan agreement provides negative covenants restricting (except with Bank's consent) USParent and each of its subsidiaries from (i) incurring (except in connection with one specified settlement of intercompany debt) any liability for capital lease obligations or borrowed money; (ii) creating, incurring, or assuming most mortgages, pledges, or liens on its property, unless to Bank; (iii) entering into any significant corporate combinations or reorganizations; (iv) making loans, except in de minimis amounts, to subsidiaries, or extending trade credit to customers; (v) assuming, guaranteeing, or endorsing most liabilities incurred by any other person; (vi) limiting the ability to purchase stock or assets, or to make capital expenditures, within a fiscal year, in excess of specified amounts; (vii) in general, making any distributions to stockholders or repurchasing its shares, except (A) with respect to one subsidiary's preferred stock, subject to dollar-limited annual and aggregate amounts, and (B) certain purchases in connection with qualified retirement or stock bonus plans; (viii) selling any substantial part of its assets; (ix) leasing, for more than a specified aggregate dollar amount, real property, plant, or equipment; (x) granting guarantees, or incurring contingent liabilities (including "comfort letter" agreements), except in the ordinary course of business and with respect to its subsidiaries, and as provided in the loan agreement; and (xi) changing the nature of its business.

The loan agreement provides in part that all representations, warranties, agreements, covenants and obligations in it, or in any certificate or statement delivered by any party to the Bank, are all deemed material. The parties expressly acknowledge that the Bank has relied on, and will rely upon these representations, etc., which expressly survive the execution of the Loan Agreement and the closing of the loan transaction, and are not merged with the performance of any agreement by the Bank, USParent, or any CFC.

An “interim financial analysis report” and an “annual exposure review form” suggest that up to $n of earnings and profits were invested by CFC1 in Foreign Country x, which, during the taxable years in issue, may have imposed certain significant restrictions on the repatriation of those amounts. Those restrictions are not described in detail in the reports, but are reflected in USParent’s financial statements for at least part of the period in issue as “earnings that are not distributable under various regulations of foreign governments.” Based on the facts submitted, we cannot determine whether any of the blocked income provisions of subpart F (Treas. Reg. sec. 1.964-2) should apply to limit the application of section 956 [1] with respect to such amounts either for the years in issue or in subsequent years.

LAW AND ANALYSIS

Introduction

Every person who is a United States shareholder (as defined in section 951(b)) of a CFC and who owns, within the meaning of section 958(a), stock in such corporation on the last day in such year, on which such corporation is a CFC, is required to include in gross income for his taxable year in which or with which such taxable year of the corporation ends, the amount determined under section 956 with respect to such shareholder for such year (but only to the extent not excluded from income under section 959(a)(2) (i.e., previously taxed subpart F income). Section 956(a) defines that amount for any taxable year as the lesser of-

> (1) the excess (if any) of-
>
> > (A) such shareholder’s pro rata share of the average of the amounts of United States property held (directly or indirectly) by the CFC as of the close of each quarter of the taxable year, over

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[1] All section references are to the Internal Revenue Code in effect during the years at issue, unless otherwise noted.

(B) the amount of earnings and profits ("E&P") described in section 959(c)(1)(A) with respect to such shareholder, or

(2) such shareholder's pro rata share of the applicable earnings of such CFC.

For purposes of this section, the term "applicable earnings" of a CFC means the amount of current and accumulated E&P (but not taking into account any accumulated deficit in E&P), reduced by actual distributions made during the year, and by the amount of the CFC's retained earnings that are treated as previously included in its United States shareholders' income on account of investments in United States property or earnings invested in excess passive assets under section 959(c)(1)).[\2]

Sections 956(c)(1)(B) and 956(c)(2)(F) together provide that the term "United States property" includes the stock or obligations of a domestic corporation that is a United States shareholder (as defined in section 951(b)) of the CFC, or a domestic corporation 25 percent or more of the total combined voting power of which, immediately after the acquisition of any stock in such domestic corporation by the CFC, is owned, or considered as being owned, by such United States shareholders in the aggregate. If a CFC makes a loan that remains outstanding on the last day of any quarter of the taxable year to its sole shareholder, a United States person, the shareholder realizes income under Section 951, assuming sufficient unrepatriated CFC earnings and profits.

Section 956(d)[\3] provides that for purposes of section 956(a), a CFC shall, under regulations prescribed by the Secretary, be considered as holding an obligation of a United States person if such CFC is a pledgor or guarantor of such obligation.

For the reasons discussed below, we believe that the agreements between the USParent's CFCs and Bank to pay dividends to USParent, coupled with the covenants agreed to by USParent and the CFCs, are

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[\2] Pub. L. 10366 significantly modified sections 951(a)(1)(B) and 956 effective for taxable years beginning after September 30, 1993, and to tax years of United States shareholders within which or with which such tax years of foreign corporations end. The foregoing description reflects those changes.

[\3] Section 956(c) was redesignated as section 956(d) by Pub. L. 103-66, sec. 13232(a)(1)-(2), in 1993.

“indirect guarantees” of the USParent credit facility within the meaning of Treas. Reg. sec. 1.956-2(c)(2) (1980).

Rev. Rul. 76-125

Rev. Rul. 76-125 concluded that a United States shareholder’s pledge of the stock of a first-tier CFC holding company which owned a second-tier, operating CFC with unrepatriated earnings and profits should be treated as if the latter CFC indirectly guaranteed the controlling stockholder's obligation. A, a United States citizen, owned all of the outstanding stock of X, a CFC. X's sole asset was all of the stock of Y, a CFC engaged in the shipping business. A borrowed funds from a bank, pledging as collateral for the loan, and delivering custody to the bank, all of the stock of X. Y's stock was not delivered to the bank. In the loan agreement, which was signed by A for himself only, he represented that the X stock would be duly pledged as security for the loan subject to no prior liens, charges, encumbrances, or rights of others whatsoever and that X's assets were free and clear of any liens, charges, encumbrances, or rights of others whatsoever. Among the negative covenants contained in the loan agreement, A agreed not to cause or permit X to incur any new indebtedness or create any mortgage, pledge, lien, charge, or encumbrance upon or on any of its property. A retained the right to vote and exercise consensual powers pertaining to the X stock until a default occurred by A in which event the agent for the bank might cause any or all of the X stock to be transferred into its name and to exercise all pertinent voting and consensual powers including voting to distribute dividends from Y to X and A.

The ruling states:

> The purpose of section 956 of the Code is to terminate the tax deferment privilege with respect to the earnings of [CFCs] when such earnings are directly or indirectly repatriated. S. Rep. No. 1881, 87th Cong., 2d Sess. 80, 87-88 (1962), 1962-3 C.B. 707 at 794, states, in part, "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." Consistent with the intent of section 956, section 956(c) is interpreted to hold that use of the assets or credit of a [CFC] as collateral for an obligation of a United States person shall be considered a repatriation of earnings.
>
> The loan agreement in the instant case indicated it was the intention of the parties that if A defaulted on the loan, X's [the CFC’s] assets . . . would be available to answer for the debt of A. Thus, although the agreement was signed by A for himself only, the net effect of the

> agreement was the same as a guaranty by X of the loan to A. Under section 956(c) of the Code, X must therefore be considered as holding A's obligation, which is defined as United States property under section 956(b)(1)(C).

Prop. Reg. sec. 1.956-2(c)(2) ("indirect pledges and guarantees") and -(c)(3) ("facilitation") (1979)

Proposed regulations that expressly addressed indirect pledges and guarantees were issued under section 956(c) on April 23, 1979 (44 Fed. Reg. 23880). Prop. Reg. sec. 1.956-2(c)(2) (1979) provided as follows:

> Indirect pledge or guarantee. If the assets of a [CFC] serve, at any time, as security for the performance of an obligation of a United States person, then for purposes of [the general rule of paragraph (c)(1) pertaining to guarantees and pledges] the [CFC] will be considered to be a pledgor or guarantor of that obligation . . . .

The preamble to the 1979 proposed regulation described this provision as an amplification or clarification of the then-existing (1964) final section 956 regulations. The proposed regulation treated pledges of CFC stock merely as an example of one type of indirect pledge or guarantee. It did, however, also include an example (Prop. Reg. sec. 1.956-2(c)(5), Ex. (3)), which is substantially similar to Treas. Reg. sec. 1.956-2(c)(3), Ex. (3). That example recites negative covenants that "effectively restrict" the CFC's discretion with respect to the disposition of assets and incurring liabilities other than in the ordinary course of business. These were substantially the same covenants as those at issue in Rev. Rul. 76-125.

The 1979 proposed regulations also included another substantive rule, Prop. Reg. sec. 1.956-2(c)(3). This provision, had it been promulgated in final form as proposed, would have provided explicit regulatory authority under which the Service could treat as an investment in United States property, a transaction in which a CFC's assets "facilitated" the making of the loan to a related United States person but did not "secure" the loan. It read as follows:

> (3) Facilitation of borrowing. If the assets of a [CFC] do not serve as security for the performance of an obligation of a United States person under paragraph (c)(2) of this section, but the [CFC] otherwise facilitates a loan to, or borrowing by, that person, the corporation will be considered a pledgor or guarantor of the obligation of a United States person U.S. obligor [and thus considered to hold that person's obligation]. For example, where the assets of a [CFC] serve as an

> inducement, consideration, compensating balance, or other accommodation for the extension of a loan to, or the continuation of a pre-existing loan by, a United States person, the [CFC] will be considered to have facilitated a loan to, or borrowing by, that person.

A single example of "facilitation" was provided (in Prop. Reg. sec. 1.956-2(c)(5), Example (5)), as follows. A wholly-owned CFC made a deposit in an unrelated financial institution of $100,000. Shortly thereafter, the United States parent borrowed $100,000 from the same financial institution. The rate of interest earned by the CFC on its deposit and the rate of interest charged by the United States parent differed by a fraction of 1 percent. The deposit was designated a demand deposit, but the funds were not actually withdrawn by the CFC until its parent had repaid its loan. The example concluded that the CFC had "facilitated" the making of the loan. The facts of this example later appeared in Rev. Rul. 79-162, 1976-1 C.B. 205 (except that in the regulation's example, the foreign corporation first organized a foreign subsidiary to make the deposit in the bank). In that ruling, the Service analyzed the bank's role in the transaction as that of a conduit, and so held that the CFC in effect held the U.S. shareholder's obligation. The proposed regulations reached the same result without an explicit conduit analysis.

<u>The 1980 regulations (Treas. Reg. sec. 1.956-2(c)(2) and -2(c)(3) (1980))</u>

Treas. Reg. sec. 1.956-2(c)(2) (1980), which applies to the transactions here at issue, states as a general rule:

> 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, for purposes of [Treas. Reg. sec. 1.956-2(c)(1)], the [CFC] will be considered a pledgor or guarantor of that obligation.

Treas. Reg. sec. 1.956-2(c)(2) then provides a specific substantive rule applicable to pledges of stock of a CFC.

> Prop. Reg. sec. 1.956-2(c)(3) and the accompanying example were deleted entirely from the final regulation. The preamble to the 1980 final regulations state in part:

> Proposed section 1.956-2 (c)(3) dealing with the facilitation of loans to shareholders has been eliminated . . . . [A] number of comments were received that the proposed section was too vague and could be

> misconstrued to cover situations not prohibited by section 956. Any need for specificity will be covered in rulings on particular facts.

45 Fed. Reg. 52374.

The 1980 final regulations renumbered but retained substantially unchanged the example in the 1964 regulations illustrating that a “guarantee” includes an agreement by a CFC to buy its United States parent’s note at maturity if the parent does not repay the loan. See Treas. Reg. sec. 1.956-2(c)(3), Example (2) (1980).[4]

Discussion

The 1980 final regulations clearly are intended to address more than just pledges of CFC stock. Accordingly, we must determine whether, under the facts described here, the CFCs’ assets indirectly secure Bank’s loans to USParent and so should be treated as an “indirect guarantee” of that obligation under the 1980 regulations.

We believe that taking into account the statutory purpose of section 956(c), the contractual arrangements between USParent, its CFCs, and Bank are sufficiently like those described in Treas. Reg. sec. 1.956-2(c)(2), Example (3) (1980), to justify treating USParent’s CFCs as “indirectly guaranteeing” the Bank advances for purposes of applying Treas. Reg. sec. 1.956-2(c)(2) (1980). Like the arrangements in the example, USParent’s CFCs have not, in a technical sense, undertaken to “guarantee” USParent’s debt to Bank. Nevertheless -- and again like the arrangements in the example -- USParent’s CFCs have contractually bound themselves to make payments that inure to their United States parent’s benefit, and the covenants agreed to by the CFCs increase materially the likelihood that funds of the CFCs will be available to repay Bank if needed. Accordingly, these agreements have the same substantive consequences as the covenants described in Rev. Rul. 76-125 -- they effectively limit “the corporation’s discretion with respect to the disposition of assets and the incurrence of liabilities other than in the ordinary course of business” -- but are more like formal guarantees than those considered in the pledge ruling, in that they entail direct contractual undertakings by the CFCs as well as by their United States parent.

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[4] The only difference between the prior (1964) regulations example and the 1980 regulations example is that in the 1980 regulations the CFC’s purchase price is ten times that of the face amount of the parent’s note ($1,000,000 verses $100,000).

Considered together, the cumulative effects of USParent's and its CFCs' affirmative and negative covenants, and representations and warranties to Bank, gave Bank virtually de facto veto power over USParent's right to impair to any significant extent its and its CFCs' assets, including cash or cash equivalents held by the CFCs. We believe that the phrase "indirect guarantee" is reasonably construed to include the contractual relationships among Bank, USParent, and its CFCs.

We do not believe that the actions of the USParent CFCs merely "facilitated" the Bank loan to USParent, so that the arrangement would have been treated as giving rise to an investment in United States property only if Prop. Reg. sec. 1.956-2(c)(3) (1979) had been promulgated in final form as proposed. The language of the preamble to the 1980 regulations makes clear that the "facilitation" language was intended to describe arrangements that otherwise would have been subject to challenge under substance-over-form, step-transaction, and non-regulatory based conduit analyses (e.g., Aiken Industries, Inc. v. Commissioner, 56 T.C. 925 (1971), acq. 1972-2 C.B. 2; Rev. Ruls. 84-152, 1984-2 C.B. 381; and 84-153, 1984-2 C.B. 383). (If this were not true, then the preamble could not have described the arrangements targeted by Prop. Reg. sec. 1.956-2(c)(3) as appropriately addressed by future "rulings.")

Although the CFCs' agreements to pay dividends to USParent if USParent fails to comply with all of its pertinent contracts with the bank introduces an additional step or layer and was apparently intended to insulate the structure from the application of section 956(c), we do not believe that this additional, formalistic step should have this effect. The CFCs are required by contract with Bank to pay dividends to USParent; USParent in turn is required by its agreement with Bank to repay its loans; both are required to comply with a variety of restrictive covenants. Given the extent to which these covenants restrict USParent's and the CFCs' ability to incur liabilities that would materially and adversely affect USParent's ability to repay Bank with cash paid as dividends by the CFCs, we view as immaterial the possibility that USParent would, upon receiving dividends required to be paid by its subsidiaries, not pay Bank in violation of its loan agreement. We note that even if USParent did violate its loan agreement with Bank by doing so, its CFCs would then be required to continue to make dividend payments to USParent until USParent's liability to Bank was satisfied or applicable net worth limitations were triggered.

Amount of inclusion under section 956.

Section 1.956-1(e)(2) provides that for purposes of pledges and guarantees, the amount taken into account with respect to any pledge or guarantee shall be the unpaid principle amount on the applicable determination date of the obligation with respect to which the CFC is a pledgor or a guarantor. Nothing in section 956(c) or the regulations thereunder prohibits joint and several CFC guarantors of a United States parent's obligation from each being treated as repatriating its applicable earnings as the result of multiple guarantees of a single obligation of their United States parent. The same potential for multiple inclusions exists if an arrangement is treated as giving rise to indirect guarantees by multiple CFCs. Thus, in determining the appropriate ceiling on USParent's inclusion under section 956 for each taxable year in issue, it is necessary to determine the applicable earnings of each of CFC and the amount of earnings and profits ("E&P") described in section 959(c)(1)(A) with respect to that CFC. As noted above, the blocked earnings and profits rules of Treas. Reg. sec. 1.964-2 also may need to be considered.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

Neither the Code, nor regulations, under section 956 specifically deal with the treatment of multiple repatriations resulting from a single loan, such as in this case. However, section 1.956-1(e)(2) suggests that each guarantee or pledge with respect to a single loan is considered a separate investment in U. S. property. Computing the inclusion amount for purposes of section 951(a)(1)(B) under this rule could produce strange results. In fact, a 1989 field service advice provided that "[i]t is our position that a single investment in U.S. property can only serve as the base for one investment in U.S. property, and thus, one section 956 inclusion." In that case, the taxpayer was attempting to affirmatively use section 956 to bring up foreign tax credits by having one CFC make a loan to its U.S. parent and having another CFC guaranteeing the same loan. Although this is not an affirmative use case, we believe that the same principle should apply. Therefore, in the present case, we believe the best answer to compute the amount of investment in U.S. property is to prorate the amount of the loans indirectly guaranteed between the various CFCs involved.

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Please call if you have any further questions.

PHYLLIS E. MARCUS
Chief, Branch 2
Office of the Assoc. Chief
Counsel (INTL)