Office of Chief Counsel
Internal Revenue Service
memorandum

Number: **201910021**
Release Date: 3/8/2019

CC:INTL:B2
PRESP-149185-12

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 956.00-00, 956.05-00, 951.00-00

date: December 27, 2013

to:

(Large Business & International)

from: Jeffery Mitchell
Chief, Branch 2
(International)

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subject: Application of Section 956 to the

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

US Parent =

R =

S =

T =

U =

V =

Products and Services =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =

Year 1 =
Year 2 =
Year 3 =
Year 6 =

Month 1 =
Month 2 =
Month 3 =
Month 4 =
Month 5 =
Month 6 =
Month 7 =
Month 8 =
Month 9 =
Month 10 =
Month 11 =
Month 12 =

X day =
Y day =

State =

Country 1 =
Country 2 =
Country 3 =
Country 4 =

Accounting Firm =

Issue =

Title 1 =

Title 2 =

Title 3 =

Quote 1 =

Quote 2 =

Quote 3 =

Quote 4 =

Quote 5 =

Quote 6 =

Quote 7 =

Quote 8 =

Quote 9 =

Amount W =

Amount X =

Amount Y =

Amount Z =

ISSUE

Whether US Parent must include amounts in income under sections 951(a)(1)(B) and 956 as a result of the , for Tax Year 3.

CONCLUSION

Under the substance over form and step transaction doctrines, US Parent must include amounts in income under sections 951(a)(1)(B) and 956 as a result of the , for Tax Year 3. Under Treas. Reg. § 1.956- , US Parent also must include amounts in income under sections 951(a)(1)(B) and 956 because the of directly or indirectly of the US Parent during the .

FACTS

I. Ownership Structure and Business Operations

US Parent is a State corporation and the common parent of an affiliated group of corporations that file a consolidated U.S. federal income tax return (the US Group or Taxpayer). The US Group provides Products and Services. The US Group's taxable year ends on the last day of Month 12.

Throughout Tax Year 3,[1] the year currently under audit, US Parent indirectly wholly owned controlled foreign corporations within the meaning of section 957 (CFCs).

.[2] Like the taxable year for the US Group, the taxable year for ends on the last day of Month 12.

, a business entity organized under the laws of Country 2, which is for U.S. federal income tax purposes.

, an eligible entity organized under the laws of Country 3, for U.S. federal income tax purposes. , a business entity organized under the laws of Country 3, which is

for U.S. federal income tax purposes. During Year 3,

.

II. Purpose of the

US Parent on nearly from (the). US Parent asserts that the business purpose of the was to meet U.S. needs.

.[3]

[1] For purposes of this advice, "Tax Year 3" refers to the taxable year ending in Year 3. Tax Year 2 refers to the taxable year ending in Year 2, and so on.

[2]

[3]

.[4]

.[5] In addition, a Date 1 US Parent presentation titled Title 1, that described the , stated Quote 2.

The presentation further states that Amount W before the end of Tax Year 2. It also states that Quote 3.

A Date 2 email between partners in Accounting Firm discusses Issue and reads, in part, Quote 4.

III. Establishing the

The was designed to provide a means for US Parent's to ,[6] to US Parent without resulting in an income inclusion to US Parent under section 956.

[7]

[4]

[5] Quote 1.

[6] An internal memo prepared by a team of employees in US Parent's tax and treasury departments discussed the potential adoption of the and noted that . Quote 6.

[7] As explained below, section 956 applies, in part, based on the amounts of U.S. property held by a CFC as of the close of each quarter of its taxable year.

.[8]

In an email, Accounting Firm stated that, for tax purposes,

In addition, during a summons interview, an employee of US Parent indicated that .[9]

[8]

[9] Quote 7.

In response to an IDR,

.[10]

IV. Operation of the

US Parent's Tax Year 3 monthly , prepared by US Parent's treasury department, demonstrate that US Parent consistently anticipated

.

US Parent's bank allowed US Parent to have a

In response to an IDR, US Parent indicated, in part,

.[11] US Parent also identified potential sources for repayment, including cash received from operations, issuance of commercial paper and bonds, distributions of previously taxed earnings excluded from gross income under section 959, and other distributions from .

[10] Quote 8.
[11] Quote 9.

.[12]

The were not formally . Nor were any formally . There were no formal commitments to .

US Parent had the ability to from third parties to in Tax Year 3 but did not .

V. US Parent's Treatment of the

under sections 951(a)(1)(B) and 956 related to the because , in form, held US Parent as of quarterly measuring dates.

LAW AND ANALYSIS

I. Overview

The policy and intent of section 956 is to treat a CFC that invests its earnings in U.S. property as effectively repatriating those earnings to its U.S. shareholder.[13] Authorities such as Jacobs Engineering,[14] discussed elsewhere in this advice, reflect that policy by denying recognition of the form (so as technically to avoid holding U.S. property on the relevant measuring date), in circumvention of the purpose of section 956.

This advice concludes that these authorities, such as Jacobs Engineering,[15]

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[12]

[13] S. Rep. No. 1,881 at 88 (1962), *reprinted in* 1962-3 C.B. at 794. S. Rep. No. 94-938, at 226 (1976), *reprinted in* 1976-3 C.B. 3.

[14] Jacobs Engineering Group v. United States, 79 A.F.T.R. 2d 97-1673 (C.D. Cal. 1997), aff'd by unpublished decision, 168 F.3d 499 (9th Cir. 1999).

[15] Id.; Greenfield v. Comm'r, 60 T.C. 425 (1975) (

apply

.

Sections III and IV of the LAW AND ANALYSIS section conclude that the substance over form and step transaction doctrines, as interpreted in the section 956 context by the existing precedents, apply to treat the as a repatriation of earnings that requires US Parent to include income under sections 951(a)(1)(B) and 956.

Section V of the LAW AND ANALYSIS section of this advice discusses how is treated as a of the , pursuant to Treas. Reg. § 1.956- .

II. Section 956

A. Statute

Section 951(a)(1) provides that every person who is a U.S. 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, shall include in his 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 gross income under section 959(a)(2)).

Section 956(a) provides:

> In the case of any controlled foreign corporation, the amount determined under this section with respect to any United States shareholder for any taxable year is the lesser of –
>
> (1) The excess (if any) of—

); Schering-Plough Corp. v. United States, 651 F.Supp.2d 219, at 244 (D.N.J. 2009), *aff'd*, Merck & Co., Inc. v. United States, 652 F.3d 475 (3d Cir. 2011) ( ).

See also Rev. Rul. 87-89, 1987-2 C.B. 195 ( ); Rev. Rul. 89-73, 1989-1 C.B. 258 ( ).

(A) Such shareholder's pro rata share of the average of the amounts of United States property held (directly or indirectly) by the controlled foreign corporation as of the close of each quarter of such tax year, over
(B) The amount of earnings and profits 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 controlled foreign corporation.

The amount taken into account under paragraph (1) with respect to any property shall be its adjusted basis as determined for purposes of computing earnings and profits, reduced by any liability to which the property is subject.

B. Legislative History

Before 1962, U.S. shareholders of controlled foreign corporations were not subject to U.S. tax on earnings of the foreign corporations unless and until earnings of the foreign corporations were distributed to the shareholders as a dividend. In 1962, Congress added the subpart F provisions (which include section 956) to the Code. Section 956 was intended "to prevent the repatriation of income to the United States in a manner which does not subject it to U.S. taxation." H.R. Rep. No. 1447, at 58. The investment by a CFC of its earnings in U.S. property, including obligations of a U.S. person, "is substantially the equivalent of a dividend." S. Rep. No. 1,881 at 88 (1962), *reprinted in* 1962-3 C.B. at 794. As noted in the legislative history, "[t]his objective also accounts for some of the features of this provision, which deny tax deferral where funds are brought back and invested in the United States in a manner which does not otherwise subject them to U.S. taxation." H.R. Rep. No. 87-1447, at 58 (1962), *reprinted in* 1962-3 C.B. 405, 462. "[S]ince the investment . . . in the stock or debt obligations of a related U.S. person or its domestic affiliates makes funds available for use by the U.S. shareholders, it constitutes an effective repatriation of earnings which should be taxed." S. Rep. No. 94-938, at 226 (1976), *reprinted in* 1976-3 C.B. 3.

C. Obligations of Related U.S. Persons

The term "United States property" generally includes an obligation of a domestic corporation that is a United States shareholder (as defined in section 951(b)) of the CFC.[16] Before their amendment in 1988, the regulations under section 956 provided an exception for indebtedness collected or maturing within one year from the time it is

[16] Section 956(c)(1)(C), 956(c)(2)(F), 956(c)(2)(L). As discussed in section II.E. of the LAW AND ANALYSIS section of this advice,

. See Notice 2008-91, 2008-43 I.R.B. 1001; Notice 88-108, 1988-2 C.B. 446.

incurred.[17] This exception was eliminated in 1988.[18] The preamble to the regulation explained that the exception was removed because "CFC's may make successive loans with a maturity of less than one year as a means of loaning their earnings to related U.S. corporations on a long term basis in avoidance of section 956."[19]

US Parent is a domestic corporation that is a U.S. shareholder of . Accordingly, of US Parent held by constitute U.S. property.

D. Quarterly Measuring Dates

Before its amendment in 1993, section 956 measured the amount of U.S. property held by a CFC on an annual, rather than a quarterly, basis.[20] The Senate Report to the 1993 amendment, providing for measurement on a quarterly basis, explained that

> [the] measurement of assets as of the close of each quarter of the taxable year shall disregard short-term loans or other temporary arrangements with regard to the corporation's assets, where one of the principal purposes of such an arrangement was to avoid taking assets into account for purposes of this provision. Examples of what the IRS views as such arrangements are discussed in Rev. Rul. 89-73 (1989-1 C.B. 258), interpreting present law.[21]

E. Short-Term Loan Exception under Notices 88-108 and 2008-91

Shortly after the repeal of the exception for loans outstanding less than one year, discussed above in section II.C. of the LAW AND ANALYSIS section of this advice, the IRS and Treasury Department issued Notice 88-108, 1988-2 C.B. 446. Notice 88-108

[17] Treas. Reg. § 1.956-2(d)(2)(ii) (1987).

[18] T.D. 8209, 1988-2 C.B. 174 (June 14, 1988).

[19] Id.

[20] The former version of section 956 provided that "the amount of earnings of a [CFC] invested in United States property at the close of any taxable year is the aggregate amount of such property held, directly or indirectly, by the [CFC] at the close of the taxable year."

[21] S. Rep. No. 103-37, at 178 (1993). Revenue Rul. 89-73 is discussed in section III.C.2. of the LAW AND ANALYSIS section of this advice.

provides that the final section 956 regulations 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 when it is incurred. The notice further provides that this exclusion shall not apply, however, if the CFC holds for 60 or more calendar days during the taxable year (or 120 days or more during the CFC's taxable year that includes June 14, 1988) obligations that would otherwise qualify as an investment in U.S. property.[22]

Notice 2008-91, 2008-43 I.R.B. 1001, was issued in response to the 2008 liquidity crisis during which U.S. corporations had difficulty funding their operations. Notice 2008-91 effectively expanded the scope of the short-term loan exception provided in Notice 88-108 to provide that a CFC may exclude from the definition of the term "obligation" an obligation that was collected within 60 days from when it was incurred. This exclusion does not apply if the CFC holds obligations that would otherwise qualify as an investment in U.S. property for 180 or more calendar days during the taxable year. Notice 2008-91 applies to the first two taxable years of a foreign corporation ending after October 3, 2008.[23]

Thus, Notices 88-108 and 2008-91 provide that, under certain circumstances, obligations held as of the end of a quarter of a CFC's taxable year are not treated as U.S. property.

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As discussed in sections III and IV of the LAW AND ANALYSIS section of this advice, , in substance, held US Parent over quarterly measuring dates. US Parent is not eligible to apply to exclude the held by from the definition of U.S. property because set forth in the .

F. U.S. Property

[22] The 1993 amendment to section 956 to change the measuring date from the end of the taxable year to the end of each quarter "is not intended to change the measurement of U.S. property that may apply, for example, in the case of certain short-term obligations, as provided in IRS Notice 88-108 (1982-2 C.B. 445), interpreting present law." S. Rep. No. 36, 103rd Cong., 1st Sess. (1993).

[23] The duration of Notice 2008-91 was later extended by Notice 2009-10, 2009-5 I.R.B. 419, and Notice 2010-12, 2010-4 I.R.B. 326. The extension ends for tax years beginning on or after January 1, 2011.

.[24]

.[25]

G.

H. Section 1.956-1T(b)(4) Anti-Abuse Rule

The section 956 regulations contain an anti-abuse rule designed to prevent the repatriation of a CFC's earnings through the use of related corporations. The rule provides that, at the discretion of the District Director, a CFC will be considered to hold indirectly U.S. property acquired by any foreign corporation that is controlled by the CFC if one of the principal purposes for creating, organizing, or funding (through capital contributions or debt) that foreign corporation is to avoid the application of section 956 with respect to the CFC. Treas. Reg. § 1.956-1T(b)(4). For purposes of this rule, a foreign corporation is considered to be controlled by a CFC if a common parent owns at least 50 percent of the vote or value of both corporations. Treas. Reg. § 1.956-1T(b)(4).

[24] Treas. Reg. §1.956-2(a)(3). See also Rev. Rul. 90-112, 1990-2 C.B. 186.

[25]

This Chief Counsel Advice does not address the potential application of Treas. Reg. § 1.956-1T(b)(4). As noted in part III.B.1 of the LAW AND ANALYSIS section of this advice, the was designed to avoid the application of this anti-abuse rule. Whether this rule applies to the would depend on, among other things, further factual development and on whether, for example, the

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III. Substance Over Form Doctrine

A. In General

The substance of a transaction, and not its form, governs its treatment for tax purposes. See Comm'r v. Court Holding, 324 U.S. 331, 334 (1945). Courts recast transactions where the taxpayer's form does not comport with the reality of the transaction. Id. "The court has never regarded the simple expedient of drawing up papers as controlling for tax purposes when the objective economic realities are to the contrary." Merck & Co., Inc. v. United States, 652 F.3d 475, 481 (3d Cir. 2011) (quoting Frank Lyon v. United States, 435 U.S. 561 (1978)). The substance over form doctrine is used to effect the underlying purpose of a statute. Consolidated Edison Co. of N.Y. v. United States, 703 F.3d 1367, 1374 (Fed. Cir. 2013). The purpose of the substance over form doctrine is to deny legal effect to transactions that comply with the literal terms of a statute but contravene the purpose of the statute. See Stewart v. Comm'r, 714 F.2d 977, 988 (9th Cir. 1983).

The substance of a transaction is assessed in light of all the facts and circumstances. Grodt & McKay Realty, Inc. v. Comm'r, 77 T.C. 1221 (1981). The substance over form doctrine requires viewing the transaction as a whole. John Hancock Life Ins. V. Comm'r, 141 T.C. 1 (2013). When applying the substance over form doctrine, "transactions between related parties merit extra scrutiny." Merck & Co., Inc. v. United States, 652 F.3d 475, 481 (3d Cir. 2011).

Courts have applied the substance over form doctrine to various transactions that have been structured with the intent to avoid the application of section 956. See Greenfield v. Comm'r, 60 T.C. 425 (1975) (

); Jacobs Engineering Group v. United States, 79 A.F.T.R. 2d 97-1673 (C.D. Cal. 1997), aff'd by unpublished decision, 168 F.3d 499 (9th Cir. 1999) (

); Schering-Plough Corp. v. United States, 651 F.Supp.2d 219, at 244 (D.N.J. 2009), aff'd, Merck & Co., Inc. v. United States, 652 F.3d 475 (3d Cir. 2011) (

).

Courts have applied the substance over form doctrine to re-characterize various transactions involving indebtedness, especially cases involving related parties. See Merck & Co., Inc. v. United States, 652 F.3d 475 (3d Cir. 2011) ( ); Rogers v. United States, 281 F.3d 1108, 1127 (10th Cir. 2002) (re-characterizing loan as a sale in substance); BB&T Corp. v. U.S., 523 F.3d 461 (4th Cir. 2008) (disregarding nonrecourse indebtedness incurred to finance a "head" lease when indebtedness was not genuine in substance); Fin Hay Realty Co. v. Comm'r, 398 F.2d 694 (3d Cir. 1968) (holding purported debt to be equity in substance); ; Plantation Patterns, Inc. v. Comm'r, 462 F.2d 712 (5th Cir. 1972) (treating purported guarantor as obligor in substance); In re G-I Holdings Inc, No. 02-3082, 2009 WL 4911953 (D. N.J. 2009) (determining whether a party is liable on debt); Maher v. United States, No. 16253-1 (W.D. Mo. 1969) (holding that property was not in substance subject to a liability where the lender was not actually relying on the property as collateral); Lang v. Comm'r, 32 B.T.A. 522 (1935) (determining whether a taxpayer has primary or secondary liability under an obligation).

It is also the long-standing ruling position of the IRS to apply the substance over form doctrine to transactions that in form attempt to avoid the application of section 956. See Rev. Rul. 87-89 ( ); Rev. Rul. 89-73 ( ). Congress endorsed the analysis of these revenue rulings. See H. Rep. 2264, Omnibus Budget Reconciliation Act of 1993 ( ); S. Rep. 103-37, at 178 (1993) ( ).

B. Application to

The issue is whether, under the substance over form doctrine, the should be respected , or whether the should be viewed as . To answer this question, the "economic reality" of the must be carefully analyzed to determine whether it corresponds to its formal and technical characterization. Merck & Co., 652 F.3d at 481. Towards this end, it must be determined whether the , while structured to technically avoid the application of section 956, produces results that are contrary to the purpose of the

provision at issue. Stewart v. Comm'r, 714 F.2d 977, 988 (9th Cir. 1983) (finding that taxpayer's contribution of property to transferee, followed by transferee's sale of the contributed property, conflicted with the purpose of section 351; upholding the application of the substance over form doctrine to disregard the sale by the transferee).

Several characteristics distinguish the

. First, the

.[26]

, through the meticulous orchestration of Taxpayer's tax and treasury departments,

US Parent's treasury department prepared annual and monthly

and monitored to be sure that the could meet those .

In form,

. In substance, however,

. In substance,

[26]

. In substance,

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1. Purpose of

It is undisputed that the was designed to repatriate earnings from

to US Parent , while avoiding the application of section 956. Between Date 5 and Date 6, the duration of

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During this period, US Parent had a

.

Before the restructurings undertaken had a sufficient amount of cash that could have been used to fund US Parent's

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Accordingly, but for tax considerations, could have simply distributed cash to US Parent or, alternatively, US Parent could have simply borrowed funds, on a long-term basis, from . But these alternatives would have resulted in income to US Parent -- either dividend income or, if US Parent borrowed the funds, an inclusion under sections 951(a)(1)(B) and 956.

The attempts to avoid section 956 by exploiting

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,[27]

.[28]

2. Congressional Intent

Interpreting section 956 to permit the is contrary to explicit Congressional intent. Congress enacted section 956 "to prevent the repatriation of income to the United States in a manner which does not subject it to U.S. taxation." H.R. Rep. No. 1447, at 58. The was designed for this very purpose – to repatriate earnings to US Parent from without running afoul of section 956 by exploiting . In addition, when changing the year-end measuring date to quarter-end measuring dates in 1993, Congress specifically stated such short-term loans should be disregarded where one of the principal purposes of the arrangement is to avoid taking assets into account for purposes of section 956.[29]

Thus, Congress acknowledged that even with quarterly measuring dates, taxpayers could attempt to avoid the application of section 956 through and did not intend those arrangements to be respected. Accordingly, the not only undermines the purpose of section 956, but is contrary to explicit legislative history .

Generally, obligations held by a CFC that are, in both form and substance, short-term in nature and that are not outstanding on a quarterly measurement date are not taken into account under section 956. Such short-term obligations do not constitute a repatriation of funds under section 956 because the obligations are not held for a significant period of time.[30]

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3. Case Law

The is not only contrary to the purpose of section 956 as set out in the legislative history but is also inconsistent with case law. The Ninth Circuit rejected a where the taxpayer's form satisfied the

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[27] This advice does not consider the proper treatment of the various transactions , or whether the transactions should be respected for U.S. tax purposes.

[28] These transactions, and the in general, were also carefully structured in an effort to avoid the anti-abuse rule in Treas. Reg. § 1.956-1T(b)(4).

[29] S. Rep. No. 103-37, at 178 (1993).

[30] Id. ( ).

literal requirements of a then-existing regulatory exception. In Jacobs Engineering, the court considered the proper treatment of a series of short-term loans that were structured to avoid the application of section 956.[31] In Jacobs Engineering, the domestic parent corporation was in need of capital and therefore sought to borrow funds from its wholly owned CFC. To avoid an income inclusion under section 956, however, the parent corporation structured this borrowing through a series of twelve short-term loans from the CFC, none of which had a term in excess of a few months. These loans spanned the taxable years 1982 through 1984. For the years at issue, regulations under section 956 provided that the term "obligation" did not include indebtedness collected within one year from the time in which it was incurred.[32] The district court noted that nothing in the exception limited the number of loans that could be made in a given period, or required a period of delay between loans. Accordingly, the taxpayer took the position that section 956 did not apply because each loan, in form, qualified under this exception.

The government conceded that the taxpayer technically avoided the literal application of section 956, but argued that the tax consequences of the loans should be analyzed based on the substance of the loans, not their form. Accordingly, the government asserted that the substance of the loans resulted in a repatriation of funds to the domestic parent corporation beyond the one-year maximum allowable under the exception and therefore resulted in an income inclusion under section 956.

The district court agreed with the government that the domestic parent corporation was in possession of the funds in question for almost all of the two and a half year period, and that this reflected the economic reality that the capital was repatriated for more than a year. The court noted that the parent corporation was not in need of working capital on 12 different occasions for unrelated reasons, but instead needed working capital over the entire two and a half year period. The court concluded that "for 93.5% of that time, Jacobs obtained that capital from its foreign subsidiary in violation of the spirit of 26 U.S.C. section 956."

The Ninth Circuit Court of Appeals affirmed, holding that the district court correctly applied the substance over form doctrine. The court found that the transaction "violated the purpose and spirit of that regulation, which was to except true, short term obligations from the imposition of tax under IRC sections 951 and 956."

The facts of Jacobs Engineering

Jacobs Engineering

, the domestic parent corporation needed capital over

[31] This issue also arose in McCulloch Corporation v. Comm'r, T.C. Memo 1984-422, but the court resolved the case on other grounds.

[32] Jacobs Engineering involved section 956 before its amendment in 1993, which used an annual, rather than quarterly, testing period.

(in Jacobs Engineering,) and sought to borrow it from Jacobs Engineering, for unrelated reasons, but rather needed over a period.

Both the taxpayer in aware of section 956, considered its application, and implemented with the intent to avoid its application. Like the in , the structure of the had no business purpose apart from avoiding the application of section 956. Despite having a , both the taxpayer in attempted to avoid section 956 by using that, in form, would avoid the application of section 956.

The only potentially meaningful factual difference between and the instant matter is that the taxpayer in

. provides that designed primarily to avoid the literal terms of section 956 are ignored under the substance over form doctrine. The substance over form doctrine is not so inflexible that it can be side-stepped by the artifice of structuring what in substance . Indeed, the substance of this situation is no different from the substance in . The court in found it key that the taxpayer had possession of the . The in . The

. And like the , the was devised the in the U.S.

Given the long-term nature of US Parent's needs and the , the substance of the arrangement does not comport with its form. The statutory quarterly measuring dates are intended to ensure that there are no long-term reinvestments of CFC earnings with a related U.S. person. The conflicts with this purpose because US Parent did in fact receive from , although it was structured such that, in form, . In substance,

must be treated as what it was in substance: a over the entire taxable year of .

4. Summary

For section 956 to apply, a CFC must hold U.S. property at the end of a quarter of its taxable year. In the did not, in form, hold US Parent at the end of quarterly measuring dates.

The substance over form doctrine recharacterizes a transaction's form in accordance with its substance. For example, although in Jacobs Engineering and

(discussed below), the CFC did not actually hold U.S. property on the measuring date, the substance over form doctrine (and step transaction doctrine) recharacterized the separate loans' form as a continuous loan, consistent with the CFC's continuing commitment to the U.S. shareholder that in substance bridged the measuring date. In the instant case, although the did not, in form, hold the on quarterly measuring dates, the substance over form doctrine (and step transaction doctrine) recharacterizes the

C.

that the substance over form doctrine does not apply to the to result in a section 956 inclusion.

1. Case Law

.[33] In Moline Properties, the Supreme Court held that a sole shareholder of a corporation holding real estate was unable to treat gain realized by the corporation as gain taxable to him as an individual.[34] Although Moline Properties generally stands for the principle that courts

[33] Moline Properties, Inc. v. Comm'r, 319 U.S. 436 (1943).

[34] Id. at 440.

recognize corporations as distinct legal entities, this principle is subject to other doctrines, such as the substance over form doctrine.[35] The fact that a corporation is regarded as separate under Moline Properties does not prevent courts from recharacterizing transactions that, in form, involve that corporation.[36] For example, courts will apply a version of the substance over form doctrine to disregard intermediary "conduits" used to avoid U.S. withholding tax, while stopping short of finding that the intermediary's corporate existence should be disregarded as a factual matter or that the intermediary is the agent of a principal.[37]

Similarly, Moline Properties does not bar a court from finding a section 1031 exchange, in substance, where one corporation sells property to a third party for cash while a related corporation buys new property from the third party for cash in a purportedly separate transaction.[38] The decision reached in Redwing Carriers demonstrates that courts will collapse transactions involving separate, related corporations when doing so better reflects the substance of the transaction.

. Humana Inc. v. Comm'r, 881 F.2d 247 (6th Cir. 1989). Humana involved a domestic parent company and its subsidiaries, all of which operated hospitals. The parent corporation formed a domestic captive insurance company, which provided insurance for the parent corporation and the operating

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[35] It is also subject to authorities such as section 482. See, e.g., National Securities Corp. v. Comm'r, 137 F.2d 600 (3rd Cir. 1943) (upholding the application of the predecessor to section 482 to disallow a loss claimed by a subsidiary that sold shares it received, with a built-in loss, from its parent corporation; the court otherwise respected the separate existence of the subsidiary that purportedly sold the built-in loss shares).

[36] See, e.g,. Wolf v. Comm'r, 357 F.2d 483 (9th Cir. 1966) (deeming target corporation to have assumed shareholder's liability in substance, when in form shares of the target were contributed to a newly formed corporation, which assumed transferor's liability, in a purported section 351 transaction, after which target corporation merged into newly formed corporation; court reached its conclusion despite acknowledging that newly formed corporation was a valid corporation that technically had survived the merger).

See also Long Term Capital Holdings, et. al. v. United States, 330 F.Supp.2d 122, 193 (D. Conn. 2004), aff'd 150 Fed.Appx. 40 (2d Cir. 2005) (rejecting taxpayer's argument that the step transaction doctrine could not apply to a transaction involving a partnership that was an ongoing business entity engaged in independent profit making activities).

[37] See, e.g., Del Commercial Properties, Inc. v. Comm'r, T.C. Memo 1999-411 (disregarding role of Dutch affiliate lender to U.S. borrower to find that the borrower in substance paid interest to a Canadian affiliate that indirectly funded the Dutch affiliate; although the court noted the Dutch affiliate had minimal assets and business activity, it did not disregard that affiliate's existence as a factual matter or find that it was an agent of the Canadian affiliate).

[38] See Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652 (5th Cir. 1968).

subsidiaries. The IRS disallowed premiums paid to the captive insurance company on the grounds that the contracts at issue did not qualify as insurance contracts.

At issue in Humana was whether contracts constituted insurance, which requires an analysis of whether there was appropriate "risk shifting" (shifting of risk of loss between the insured and the insurer) and "risk distribution" (distributing the risk insured against over a group). The Sixth Circuit disagreed with the IRS and found that there was risk shifting and risk distribution between the operating subsidiaries and the captive insurance company. As a threshold matter, the court noted that the parent, the captive insurance company and the operating subsidiaries must each be treated as separate corporate entities under Moline Properties. The Sixth Circuit determined that the Tax Court misapplied the substance over form doctrine to the transaction to find that there was no risk shifting. The Sixth Circuit stated that the substance over form doctrine is not a broad doctrine that can be applied "at the discretion of the tax court whenever it feels that a taxpayer is taking advantage of the tax laws to produce a favorable result for the taxpayer."[39] Rather, the doctrine should apply to disregard a corporate entity only "where Congress has evinced an intent" to disregard the separate entity, and noted that "a particular legislative purpose . . . may call for the disregarding of the separate entity", as may "the necessity of striking down frauds on the tax statute."[40] The court further noted that the doctrine can apply when there is specific congressional intent to disregard the form of a transaction. The Sixth Circuit noted that Congress had manifested no intent to disregard the separate corporate entity of captive insurers and that the taxpayer had a valid business purpose for incorporating its captive insurer.

The is distinguishable from Humana. As discussed earlier, Congress has expressed a specific concern about the creation of temporary arrangements that result in CFCs, in form, not holding U.S. property on quarterly measuring dates, and thus, avoiding section 956.[41] The was carefully planned to avoid section 956. There is no non-tax business purpose for the . Accordingly, the substance over form doctrine is not applied to the simply because the taxpayer's related party transaction produced a favorable tax result; rather, it applies because the substance of the is a repatriation of earnings subject to section 956, and Congress specifically provided that taxpayers should not be able to avoid section 956

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[39] 881 F.2d at 254.

[40] 881 F.2d at 254-255.

[41] S. Rep. No. 103-37, at 178 (1993).

.[42] That case involved a dispute over the tax basis that a bank had in certain rights acquired when it took over failed savings and loans institutions. The taxpayer argued that it had a cost basis in the rights at issue because it acquired them (along with other consideration) in exchange for acquiring the liabilities of three failing thrift institutions. Whether taxpayer's position was correct turned on the characterization of the transaction negotiated between the acquirer and the Federal Savings and Loan Insurance Corporation. The Ninth Circuit held that the taxpayer did have a cost basis in the rights, equal to some portion of the thrifts' excess liabilities.

Neither Washington Mutual nor the briefs filed in that case discuss the substance over form doctrine. Washington Mutual because of language that the court quotes from Lewis and Taylor, Inc. v. Comm'r, 447 F.2d 1074 (9th Cir. 1971): "the fact that a transaction is so arranged that the tax consequences are highly favorable to one of the parties affords the commissioner no license to recast it into one of less advantage."[43]

Lewis and Taylor involved a dispute over an amount that a corporation paid to a shareholder's estate for deferred compensation that it owed the decedent.[44] Although the corporation initially offered the estate an amount solely to redeem shares owned by the shareholder, it later revised the offer to attribute a portion of that amount to deferred compensation, deductible by the corporation.[45] The corporation offered evidence that it properly valued the shares, while the IRS offered no evidence.[46] In light of the uncontroverted evidence offered by the corporation, the Ninth Circuit held that the form of the transaction was consistent with the substance of the transaction.[47]

The unobjectionable quote from Lewis and Taylor , and the opinion more generally, merely stand for the proposition that the form of a transaction will be respected when it is in accordance with its substance. In contrast, the form of the is not consistent with its substance , and, thus, must be recharacterized in accordance with its substance.

2.

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[42] Washington Mutual, 636 F.3d 1207 (9th Cir. 2011).

[43] Lewis and Taylor, 447 F.2d at 1077.

[44] Id. at 1076.

[45] Id.

[46] Id. at 1077.

[47] Id. at 1078.

that the complied with

applies the substance over form doctrine to involving the

[48]

The first states that the facts and circumstances of each case must be reviewed to determine if, in substance, there has been a repatriation of the earnings of the CFC. The further provides that if a CFC

The concludes in

The further concludes in

. Finally, the notes that other factors, in addition to , may indicate a repatriation of earnings of the CFC that should be taken into account for section 956 purposes.

because the

will not be recharacterized under the .

on is misplaced. to the argument the taxpayer asserted in the taxpayer entered into a complex transaction ("reinvestment plan") in an attempt to repatriate funds from a CFC to its domestic parent corporation without incurring any tax. The taxpayer attempted to rely on a to support its technical position that it did not have an income inclusion under section 956. In evaluating the taxpayer's ability to rely on the the court in

[48] During the years at issue , section 956 measured U.S. property only as of the close of the taxable year.

The court then explained that the taxpayer in order to show that it reasonably relied on the conclusions in the to preclude the Commissioner from challenging the reinvestment plan: (1) that the form of the reinvestment plan is respected; and (2) that the facts of the reinvestment plan are substantially the same as those considered in the . The court held that the taxpayer failed to . The taxpayer failed to because the reinvestment plan, in substance, constituted a dividend. The court found that the taxpayer also failed in part because it found substantial differences between the reinvestment plan and the . The court explained that

Accordingly, under , US Parent must demonstrate that both the form of the is respected, and the facts of the are substantially the same as those considered in . As was the case in , the fails to .

First, as discussed above, the form of the is not respected under the substance over form doctrine or, alternatively, as described below under the step-transaction doctrine. Instead,

. Thus, in substance, and , by its terms, does not apply.

Second, the facts of the are not substantially the same as those considered in that the should be

applied
. Taxpayers cannot apply a to only certain aspects of a single plan or transaction. In , the taxpayer similarly attempted to rely on a for purposes of one aspect of an overall transaction. The tax court rejected this argument and stated:

Because the part of a pre-arranged plan, the facts of the entire must be compared to the facts considered in
.
This comparison highlights substantial factual differences. The pivotal facts of the involve a acquiring, from unrelated parties, publicly-held debt of its U.S. shareholder that matures and is repaid shortly before the CFC's year end. As was the case in , the pivotal facts of the differ substantially from those of the . Those differences include: (1)
; (2)
;

(4) the involved, directly or indirectly, ; (5)

and
(6) most significantly,

.

Indeed, the in an attempt to distinguish its facts from the facts of and , discussed above.
that should be applied
. fails because the must be considered together (as required under), and when so considered, the facts differ substantially from those in .

In summary, on because the form of the is not respected, and the facts of the are substantially different from the facts considered in .

3.

that not meet technical requirements . that

. that because the

“substantially complies” with , it does not have a section 956 inclusion. that is evidence of a general policy of

.

substantial compliance with is misplaced. The provides a limited exception to the general application of section 956 that applies only if specific requirements are satisfied, which was not the case with the . The limitations in the are intended to prevent the results sought under the

. The is intended to apply to that, unlike under the , . Finally, nothing in the , or in any other authorities, suggests that “substantial compliance” with the has any relevance for purposes of interpreting section 956. Indeed, the fact that the provides limitations based on confirms that are not in compliance.

4.

on for its position that the form of the should be respected for purposes of section 956. that, under , should be applied

.

reviews the application of of a related U.S. person held by in light of certain judicial doctrines and regulations under section 956. Specifically, the provides that each

must not in a unified transaction, citing and . The advice then explains that if, under these authorities, constitutes

. To determine whether , the explains that all relevant facts and circumstances at the time of the must be taken into account. It notes that such factors may include

and the related U.S. person's financial capacity to independently. Finally, the notes that the must be taken into account.

on is misplaced for several reasons.

.[49] Moreover, the does not support and, in fact, supports the conclusion that the , in substance, results in an inclusion under section 956.

The US Parent held by fail to satisfy any of these three requirements. First, as noted above, the by its terms does not apply to the . on an interpretation of a when the does not apply to its facts. Second, the US Parent are not by . To the contrary, US Parent is funded pursuant to the pre-arranged

Indeed, the second and third requirements of the are intended to

[49] Moreover, the sentence of provides,

prevent the application of the to arrangements like the . Accordingly, the , even if it were precedential, does not support Taxpayer's position that the form of the should be respected.

IV. Step Transaction Doctrine

A. In General

Under the step transaction doctrine, individual steps in a transaction are consolidated into a single integrated transaction in order to ensure that a transaction is taxed in accordance with its substance rather than its form. Greene v. United States, 13 F.3d 577, 583 (2d Cir. 1994). The step transaction doctrine can be viewed as a subset of the substance over form doctrine. Penrod v. Comm'r, 88 T.C. 1415, 1428 (1987).

The courts have developed three tests to determine whether to apply the step transaction doctrine in a particular transaction: (i) the "end result" test, under which a transaction is collapsed if a series of formally separate steps are prearranged parts of a single transaction intended from the outset to reach an ultimate result; (ii) the "interdependence" test, which focuses on the relationship between the steps and analyzes whether the "steps were so interdependent that the legal relations created by one of the transactions seem fruitless without completion of the series;" True v. United States, 190 F.3d 1165, 1175 (10th Cir. 1999) and (iii) the "binding commitment" test, under which a series of transactions are collapsed if, when the first step is entered into, there was a binding commitment to undertake the later steps. Penrod, 88 T.C. at 1428. A transaction needs to satisfy only one of the three tests in order for the step transaction doctrine to apply to the transaction. True, 190 F.3d at 1175.

B. Application of the Step Transaction Doctrine to the

The relied on a coordinated to US Parent, and

.

Under the step transaction doctrine, the deserves particular scrutiny because the parties to the transaction are related. Schering-Plough Corp. v. United States, 651 F.Supp.2d 219, 246 (D.N.J. 2009) (

).

Under either the end result test, the interdependence test, or the binding commitment test,[50] the step transaction doctrine applies to

[50] This section of the advice focuses on the end result and interdependence tests, as the tests a court is most likely to apply. See, e.g., Barnes Group at 48-49 (describing the binding commitment test as seldom applied and the appropriate test only where a substantial period of time has passed between the steps that are under scrutiny).

.

1. End Result Test

The end result test analyzes whether a series of steps are prearranged parts of a single transaction that, from the outset, is designed to achieve a specific end-result. True, 190 F.3d at 1175. The test focuses on the parties' subjective intent when they structure the transaction. Superior Trading, LLC v. Comm'r, 137 T.C. 70, 89 (2011).

The application of the end result test to the facts at hand to that in Jacobs Engineering, in which the court applied both the end result and interdependence tests to collapse . In Jacobs Engineering, the U.S. parent needed working capital for a two and a half year period, but wanted to avoid the application of section 956. Thus, the U.S. parent entered into a series of loans that repatriated the CFC's earnings for 93.5% of the two and half year period, but did not, in form, result in a section 956 inclusion to the U.S. parent. The series of loans were designed to fulfill the U.S. parent's long-term need for working capital, and there was no evidence that the U.S. parent had a separate business purpose for each of the short term loans.

, in this case, US Parent needed over the duration . There is no evidence of a business purpose for making . While it is true that the taxpayer in Jacobs Engineering secured its long-term funding

of US Parent, does not prevent the application of the step transaction doctrine to the . The inquiry under the end result test is focused on the intent of the parties in structuring a transaction, and determines whether various steps were undertaken in order to achieve an ultimate result. The analysis is not limited to transactions between ; transactions that are collapsed under the end result test often involve . See Long Term Capital Holdings, 330 F. Supp. 2d 122 (

).

We also note that even where courts have chosen to apply the binding commitment test, a contract that compels the steps to occur is not a prerequisite. See McDonald's Restaurants of Illinois v. Comm'r, 688 F.2d 520, 525 (7th Cir. 1982) (applying the binding commitment test to find that historic shareholders of target were extremely likely, although not contractually bound, to dispose of acquiring corporation's stock because of the likelihood that the acquiring corporation's stock would be registered).

thereby literally complying with the specific technical requirements of section 956 to avoid an income inclusion. The step transaction doctrine prevents US Parent from being able to avoid the application of section 956 to this repatriation

. Under the end result test,

, which results in section 956 inclusions to US Parent.

2. Interdependence Test

The interdependence test analyzes the relationship between the intermediate steps in a complex transaction, rather than the "end result." Assoc. Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1523 (10th Cir. 1991). This test focuses on whether the intervening steps in a series of steps would have been fruitless or meaningless if the other steps in the series had not taken place. Penrod, 88 T.C. at 1430.

to be interdependent, and thus recharacterized the under the interdependence test, . In reaching its conclusion that were interdependent, the Jacobs Engineering court emphasized the contrast between the taxpayer's long-term borrowing needs and the short term of . In the case of US Parent, in , and US Parent has not provided a non-tax business reason as to why . Jacobs Engineering, US Parent needed

for all of Tax Year 3, and would not have satisfied this long term need. Likewise, in isolation would not have provided US Parent with that it needed for Tax Year 3 because . US Parent's needs are satisfied only if

which occurred pursuant to the . Accordingly, the interdependence test applies to . As a result, – throughout Tax Year 3.

The presence of does not preclude applying the step transaction doctrine. The Fifth Circuit's holding in Redwing Carriers illustrates that transactions are collapsed and treated in accordance with their substance when they are interrelated, even when enter into one side of a transaction (such as a section 1031 exchange of like-kind property) normally entered into by a .[51] In Redwing Carriers, a corporation sold used property to a third party for cash, and at or about the same time, that corporation's subsidiary bought new like-kind property from the third party for cash.[52] The fact that the selling corporation and its subsidiary were separate entities did not prevent the court from finding an integrated section 1031 exchange and stating that "[t]he buying and selling were synchronous parts meshed into the same transaction and not independent transactions."[53]

Similarly, in the , the fact that does not preclude application of the step transaction doctrine

[54]

In its application of the interdependence test, the Tax Court in Barnes Group focused its inquiry on whether there was a non-tax business purpose for each of the separate steps in the transaction. As discussed, US Parent has not provided business purpose for . Rather, Taxpayer needed over the entire term of the . As in Barnes Group, the lack of a non-tax business purpose

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3. Summary

, the effectively a long-term repatriation of foreign earnings that was subject to section 956. The steps in the were designed to achieve the end result of providing US Parent with access to cash while improperly avoiding the application of section 956, and, thus, should be collapsed under the end result test. Accordingly, the under the interdependence test, should be . As a

[51] 399 F.2d 652.

[52] The taxpayer chose the form of separate purchase and sale transactions because (under the law in effect at the time) it would have allowed the taxpayer to (i) increase the basis of the newly acquired trucks, which would allow for greater depreciation with respect to the trucks that would be used to reduce ordinary income; and (ii) treat the gain on the sale of the old trucks as capital gain.

[53] Id. at 656.

[54] Id.

result, held an obligation of US Parent – – throughout Tax Year 3.

Schering Plough and Long Term Capital, the application of the step transaction doctrine to the case at hand does not invent new steps; rather it reorders and eliminates the steps that were taken by US Parent and .

Thus, the recast from is consistent with the parties' underlying intent, and recognizes the reality of the transaction.

V. Indirect

A. Overview

If would be considered to hold U.S. property if are directly or indirectly for US Parent's under the . As described above in section II.G. of the LAW AND ANALYSIS section of this advice, section 956( ) and Treas. Reg. § 1.956- provide rules addressing . It must be determined whether those rules apply to the , such that of US Parent held by on quarterly measuring dates.

B. Assets of

The general rule of Treas. Reg. § 1.956- provides that if the of a CFC at any time, , as for the of of a U.S. person, the CFC will be considered a . The application of this general rule does not depend on a formal, executed between the CFC and the . Although the regulations contain an example involving ,[55] nothing in the general rule requires a . When the are all related, the parties can easily dispense with a formal . Recognizing the flexibility that is peculiar to related parties, courts subject related party transactions to a higher level of scrutiny than a transaction involving unrelated parties. See, e.g., Merck & Co., 652 F.3d, at 481.

entered into formal with respect to the .[56] The facts and circumstances surrounding the

[55] Treas. Reg. § 1.956- .

[56] Because US Parent wholly owns , no such were necessary.

planning and operation of the support the conclusion that the of indirectly for US Parent's throughout the duration of the . The was conceived and designed as a way to repatriate on a long-term basis cash held by US Parent's in a way that avoided section 956. The required constant and meticulous coordination between US Parent, . This high degree of coordination meant that of indirectly for the US Parent based on conduct of the parties, rather than directly by formal .

The actions of US Parent, both through the team that devised the and the treasury department that implemented, monitored, and oversaw the , leave no doubt that the of would be available that US Parent had the necessary in whole or in part any .

An agreement by to sufficient to satisfy US Parent's to can be inferred from the conduct of the parties.[57] did not to US Parent on an ad hoc basis .

US Parent prepared monthly , showing . Consistent with the monthly , to satisfy US Parent's needs.

[57] The conduct of the parties is a commonly used tool of jurisprudence for determining the existence as well as the terms and substance of an agreement. For example, in Lincoln Electric Co. v. Comm'r, 444 F.2d 491 (6th Cir. 1971), the court held that a long-standing, consistent practice of paying bonuses to manufacturing employees constituted a liability for such bonuses that was required to be included as part of the direct labor cost of the taxpayer's inventory cost at year end. In contract law, courts have long looked to the conduct of the parties to determine both the existence of an agreement and the terms of an agreement. Simon v. Riblet Tramway Co., 505 P.2d 1291 (Wash. App. 1973); J.C. Schaefer Electric, Inc. v. O. Frank Heinz Construction Co., Inc., 300 F.Supp. 396 (1969); see also, 1 Corbin on Contracts § 1.19 (Rev. Ed. 1993), and cases cited therein; 17 C.J.S. *Contracts* § 6 (2011), and cases cited therein. Similarly, in tax law substance over form cases, the courts often compare the conduct of the parties to the formal terms of the transactional agreement to determine the weight to be given the form of the transaction. See, e.g., Barnes Group v. Comm'r, T.C. Memo. 2013-109 (No. 27211-09). Simply put, the consistent conduct of the parties is often the best evidence of what the parties, themselves, believe to be their own obligations and the obligations of other parties to the transaction.

Although US Parent could have the

nonetheless
indirectly as for US Parent's . A CFC is treated as a for purposes of Treas. Reg. § 1.956 if its , as of a U.S. person. This general rule applies regardless of whether that U.S. person has sources other than those owned by the CFC that is an indirect .

Instead of agreeing to on behalf of US Parent . In this way, the of , indirectly, as to the . Accordingly, the of indirectly for the US Parent under the , and, thus, is treated as a of held by .

C. Application to

As discussed, section 956( ) and Treas. Reg. § 1.956 apply when a CFC directly or indirectly is a of a related U.S. person. Neither the Code nor the regulations specifically address the application of section 956 to such as the indirect by discussed above in section V.B. of the LAW AND ANALYSIS section of this advice.

.[58]

If
those for the performance of US Parent's to

[58]

would be treated as holding those under section 956( ) and Treas. Reg. § 1.956 .[59] The section 956 regulations specifically provide that section 956( ) applies to situations in which the of a CFC indirectly for a a related U.S. person.[60]

of Treas. Reg. § 1.956 illustrates that the of a CFC for an of a related person where the stock of the CFC is

Thus, is considered a of US Parent's to under the , and treated as holding the on quarterly measuring dates, because significant of directly or indirectly for the .

VI. Results of Applying Section 956 to the

A. Substance Over Form and Step Transaction Doctrines

The substance over form and step-transaction doctrines, described above in sections III and IV of the LAW AND ANALYSIS section of this advice, treat the , held by as , outstanding over the course of the entire taxable year of . The authorities discussed above, such as Jacobs Engineering, support looking beyond to conclude that the is in substance a

59

60 Treas. Reg. § 1.956

.

The amount of , in substance, may be approximated by the of that outstanding, in form, over the course of the taxable year of the . Section 956 would then apply to by treating it as holding an interest in the amount of

, calculated under the preceding sentence, held as of the close of each quarter of taxable year.

B. Indirect

The indirect rule, described above in section V of the LAW AND ANALYSIS section of this advice, treats as a of US Parent held by . Under Treas. Reg. § 1.956-

each US Parent held by for which is considered a is treated as held by . Thus,

is treated as holding U.S. property as of the close of each quarter of taxable year equal to the amount of the US Parent determined to be held by on that date.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call (202) 317-6934 if you have any further questions.