International Tax Watch

Beware the Needle in the Haystack: The IRS Clarifies the Application of Notice 88-108 in CCA 201516064

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In April of this year, the IRS released Chief Counsel Advice 201516064 (the “CCA”), which clarifies that Notice 88-108 applies only to the extent that a CFC holds obligations of related U.S. persons for fewer than 60 calendar days during a tax year. While the CCA confirms what many practitioners and taxpayers already suspected the IRS’s position to be, for those taxpayers that rely on the Notice, the CCA highlights the importance of having in place internal accounting systems that can identify all potential obligations of a group’s U.S. affiliates that are held by CFCs. In this column, we discuss the CCA and its practical implications.

I. Code Sec. 956

Code Secs. 951(a)(1)(B) and 956 generally provide that a “U.S. Shareholder” of a CFC includes in income its pro rata share of the excess of the average of the amounts of “U.S. Property” that the CFC holds over the four quarters of a tax year—i.e., the CFC’s investment in U.S. Property for that year—over the CFC’s non-previously taxed earnings and profits. For this purpose, an investment in U.S. Property includes the acquisition of (1) an obligation of a U.S. person (“Obligation”); (2) tangible property located in the United States; (3) stock of a U.S. corporation; or (4) U.S. rights to intellectual property such as patents, copyrights and trade secrets. The term “Obligation” is broadly defined in the regulations to include “any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other indebtedness, whether or not issued at a discount and whether or not bearing interest.”

For CFC tax years beginning on or before September 30, 1993, the CFC’s holdings of Obligations at the close of the tax year, rather than the close of each quarter, were used in calculating the Code Sec. 956 investment in U.S. Property. Thus, prior to the 1993 Act, only one “snapshot” (at year-end) was taken of the CFC’s balance sheet. Currently, four “snapshots” (at quarter-ends) are taken and averaged.
Despite Code Sec. 956’s broad terms, there is an exception for obligations of unrelated persons. To qualify for this exception, the issuer cannot be a U.S. Shareholder in the CFC. The CFC’s U.S. Shareholders and their affiliates also must own, in the aggregate, less than 25 percent of the combined voting power in the issuer. In addition, for debt issued by a U.S. person that is not a corporation, the CFC (and its affiliates) cannot be a partner, beneficiary or trustee of the issuer.

II. Notice 88-108

Notice 88-108 provides that an Obligation that a CFC holds at year-end is not U.S. Property, provided that (1) the Obligation held at year-end is collected within 30 days of issuance; and (2) the CFC holds Obligations that, “without regard to the 30 day rule ..., would constitute an investment in U.S. property if held at the end of the CFC’s taxable year” on fewer than 60 days during the tax year. This narrow exception to Code Sec. 956 generally allows companies to replace third-party debt on quarterly financial reporting dates, and thereby present a more favorable financial picture to the markets. Notice 88-108 was issued prior to Code Sec. 956’s change from year-end to quarter-end measuring dates.

Notice 88-108 should continue to apply to CFC years beginning after September 30, 1993. The legislative history of the 1993 Act suggests that Congress intended Notice 88-108 to continue to apply after the change to quarter-end measuring dates. The House Report states that the 1993 Act “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 Notice 88-108 (1988-2 C.B. 445), interpreting present law.” In addition, both the year-end and quarter-end averaging methods use the “snapshot” approach to calculating a CFC’s investment in U.S. Property. The quarter-end method merely takes four “snapshots” and averages them, rather than taking one. Because Code Sec. 956’s underlying approach has not changed, and Notice 88-108 was specifically referred to in the legislative history, most practitioners believed that Notice 88-108 continued to apply, even after Congress amended Code Sec. 956 to require quarter-end testing, as opposed to year-end testing.

Nevertheless, prior to 2007, assuming Notice 88-108 had continued validity, there was some concern whether it could be applied on quarter-ends, rather than just on year-ends. The ambiguity was resolved in Generic Legal Advice Memorandum 2007-016, dated September 25, 2007. In this memorandum, the IRS concluded that Notice 88-108 continued to apply after the 1993 Act’s changes. More importantly, by using an example where the CFC loaned money to its U.S. parent across the CFC’s quarter end, the memorandum implicitly blessed the notion that Notice 88-108 applied to quarter-ends, just like it applied to year-ends. Importantly, the 30- and 60-day requirements set forth above still applied. Thus, each individual loan had to be repaid within 30 days and the CFC could not own Obligations for 60 or more days during the year, regardless of whether the Obligations crossed quarter-end or not.

III. The CCA

In the CCA, a U.S. parent corporation (“US Parent”) wholly owned a CFC (“CFC A”). During the course of a tax year, CFC A made several loans to US Parent pursuant to a line of credit between CFC A as lender and US Parent as borrower. On Date 1, CFC A loaned Amount 1 to US Parent. This loan was outstanding on the last day of CFC A’s quarter that included Date 1. On Date 2, fewer than 30 days after Date 1, US Parent repaid Amount 2 to CFC A. Amount 2 was less than Amount 1. The CCA designated the difference between the two amounts as Amount 3. Thus, Amount 3 remained outstanding after Date 2. On Date 3, CFC A loaned Amount 4 to US Parent. Amounts 3 and 4 were outstanding on the last day of CFC A’s quarter that included Date 3. On Date 4, fewer than 30 days after Date 3, US Parent repaid Amount 4 to CFC A.

Amounts 2 and 4 were each outstanding for fewer than 30 days during the tax year and were cumulatively outstanding for fewer than 60 days during the tax year. Amount 3 remained outstanding for more than 60 days during the tax year. As Amounts 2 and 4 otherwise qualified for the short-term Obligation exception in Notice 88-108, US Parent argued that only Amount 3 gave rise to a potential Code Sec. 956 inclusion.

IRS Chief Counsel disagreed. IRS Chief Counsel concluded that the exception for short-term Obligations in Notice 88-108 applies with respect to “obligations that meet the 30-day test if, and only if, all obligations held by a CFC meet the 60-day test.” As CFC A held the Obligation with respect to Amount 3 for 60 or more days during the taxable year, Notice 88-108 did not apply to exclude any of US Parent’s Obligations that CFC A held from the definition of U.S. Property for purposes of Code Sec. 956.
IRS Chief Counsel justified its conclusion by reference to the policy behind Notice 88-108. IRS Chief Counsel noted that Notice 88-108 “is intended to apply in fact patterns in which CFC earnings are available for use in the United States for a small portion of the year.” One example of such a fact pattern is where a CFC extends 10-day loans to its U.S. parent over quarter-ends but otherwise does not lend money to the parent. Notice 88-108 exempts such loans from the definition of U.S. Property because such loans “may not constitute a repatriation of the type that section 956 was intended to address”— *i.e.*, transactions that are “substantially the equivalent of a dividend,” in that they allow offshore earnings to remain in the United States indefinitely. In contrast, transactions that make CFC earnings “available for use by a related United States person for a significant portion of the year,” such as loans that extend over 60 or more days of a tax year, fall outside the scope of Notice 88-108, presumably because these loans are closer to dividends.

IRS Chief Counsel appears to have resorted to the policy rationale behind Notice 88-108 in responding to a request for advice because the taxpayer’s argument highlighted an ambiguity in Notice 88-108. Although the CCA does not provide any details on the taxpayer’s argument in favor of its position that only Amount 3 gave rise to a potential Code Sec. 956 inclusion, it is possible that the taxpayer read Notice 88-108 to exclude from its scope loans from a CFC that would otherwise qualify for the short-term Obligation exception only if the CFC holds such short-term Obligations for 60 days or more in a year. Specifically, it is possible that the taxpayer construed the reference in the last operative sentence of the Notice to “obligations which, without regard to the 30 day rule described in the preceding sentence, would constitute an investment in U.S. property if held at the end of the CFC’s taxable year” to limit the application of the 60-day rule to Obligations of the type that the 30-day rule otherwise exempted.

Under this argument, loans from a CFC that could not qualify for the short-term Obligation exception, such as loans that cross quarter-end and remain outstanding for more than 30 days, are not taken into account in determining whether a CFC exceeds the 60-day threshold. As Amount 3 remained outstanding for more than 30 days, Amount 3 did not qualify for the short-term Obligation exception. Thus, although the taxpayer had a potential Code Sec. 956 inclusion in an amount equal to Amount 3, the taxpayer’s short-term Obligations did not exceed the 60-day threshold, and, under the taxpayer’s argument, should have continued to enjoy the short-term Obligation exception in Notice 88-108.

If the taxpayer did indeed make the argument above, the policy rationale behind Notice 88-108 suggests that the taxpayer had a good argument. The earnings that CFC A loaned to and received back from US Parent in under 60 days arguably did not represent substantially the equivalent of dividends to US Parent because US Parent did not have access to the funds for a “significant” period of time. These loans did not lose their short-term character simply because US Parent had access to funds in an amount equal to Amount 3 for a longer period of time.

**Although the list of legislation appears long, the overall substance is a little weak.**

The CCA may not have reached the optimal conclusion with respect to the application of Notice 88-108 to the taxpayer’s facts, but it did confirm the continued vitality of Notice 88-108. Specifically, IRS Chief Counsel acknowledged that, although Treasury has yet to issue regulations under Notice 88-108, “Notice 88-108 continues to apply.” This point is important, as nearly three decades have passed since the IRS and Treasury notified taxpayers that Treasury would issue final regulations along the lines set forth in Notice 88-108.

**IV. Beware the Needle in the Haystack**

The CCA raises a number of practical considerations for U.S.-parented multinational groups. We discuss these considerations below.

**A. The Uninvoiced Sale or Service**

A typical multinational group engages in thousands of intercompany transactions over the course of a year. When a multinational group restructures, or transitions to a new accounting system, members of the group may neglect to issue invoices. As is relevant here, the U.S. parent of the group may buy goods from one of its CFCs pursuant to an intercompany supply agreement that provides that the CFC will invoice the U.S. parent within 60 days of shipping the goods. If the group’s systems are not yet fully on line when the transaction takes place, or if the CFC personnel are simply too busy with other matters, the CFC may simply fail to invoice the parent for the goods altogether.
In this case, as the CFC does not invoice the U.S. parent, a receivable from the U.S. parent arguably does not arise at the level of the CFC. Nevertheless, as the U.S. parent holds goods from the CFC pursuant to an agreement under which the U.S. parent promises to pay the CFC some consideration, and has yet to do so, the IRS could take the opposite view. If the CFC holds a receivable from the U.S. parent, the CFC holds an Obligation for purposes of Code Sec. 956. Assuming that the parties do not identify the issue promptly, this Obligation could easily be outstanding for 60 days or more. Under the CCA, the existence of this Obligation could cause the U.S. parent to recognize an income inclusion in the amount of all short-term Obligations that the CFC holds at quarter-end on the grounds that all of the Obligations to that CFC are not outstanding for fewer than 60 days in the aggregate, even if the offending Obligation the CFC failed to invoice was never outstanding over a quarter-end.\(^{14}\)

It is important to emphasize the binary nature of Notice 88-108 in this regard. Under the IRS's interpretation of the Notice, if a CFC holds Obligations for 60 days or more, the short-term Obligation exception does not apply. Thus, even an Obligation that is outstanding for one or two days, and does not cross quarter-end, can cause a taxpayer to fail to satisfy the requirements of the Notice if a CFC otherwise has short-term Obligations outstanding for 59 days.

A similar issue can arise if a group acquires a foreign target that becomes a CFC. If the CFC provides R&D services to the U.S. parent shortly after it is acquired, but the company has yet to integrate the CFC’s systems with the systems of the rest of the group, the CFC may not invoice the U.S. parent for the services. In this case as well, a receivable from the U.S. parent could arguably arise at the level of the CFC and could potentially trigger a Code Sec. 956 inclusion in the amount of any short-term Obligations that the CFC holds.

This result is not an appropriate consequence under Notice 88-108. Even under the IRS reading of the Notice, the 60-day rule is intended to prevent taxpayers from disguising long-term repatriations of offshore earnings as short-term loans, not to deny the benefit of the Notice to bona fide short-term loans due to inadvertent errors that cause the taxpayer to fall outside the technical rules of the Notice, as the IRS interprets it. Unfortunately, Treasury and the IRS have generally interpreted Code Sec. 956 very broadly and have not shown lenience.\(^{15}\)

**B. The De Minimis Receivable**

When multinational groups deal with intercompany transactions in the millions and billions of dollars, smaller transactions may receive less attention. For example, a U.S. parent could borrow $1 billion from its CFC five days before the CFC’s first quarter-end and pay the CFC back eight days later. The U.S. parent also could borrow $1 billion from the same CFC five days before the CFC’s second quarter-end and pay the CFC back eight days later. In addition, the U.S. parent could borrow $100,000,500 from the CFC five days before the CFC’s third quarter-end. The U.S. parent could intend to pay the CFC back eight days later, but, due to an administrative glitch, could only be able to pay the CFC in increments of $1 million. Thus, the U.S. parent could pay the CFC $100 million within the timeframe for the $100 million to qualify as a short-term Obligation for purposes of Notice 88-108, but could potentially fail to pay back $500. In this case, the U.S. parent could have a Code Sec. 956 inclusion of more than $2 billion simply because of the administrative challenges of returning $500 (or possibly an even smaller amount) to its CFC.

This result is not consistent with the intent and purpose of Notice 88-108. Viewed in light of receivables in excess of $2 billion, $500 is *de minimis*. A *de minimis* foot fault should not cause a U.S. parent to have a Code Sec. 956 inclusion in excess of $2 billion on the theory that the U.S. parent received substantially the equivalent of a dividend, as the U.S. parent has access to the vast majority of the funds it receives for less than 30 days of a tax year. Although there are authorities suggesting that one percent and even smaller amounts are not *de minimis*, when compared to $2 billion, $500 is a trivial rounding error.\(^{16}\) There are no authorities that we are aware of that suggest that such incredibly small amounts should be *de minimis*. In fact, common sense and practicality strongly suggest that such amounts should be *de minimis*. Given the way Treasury and the IRS have applied Code Sec. 956 and the Notice, we nevertheless would not expect them to be forgiving in this situation. Accordingly, as in the case of the un invoiced sale or service above, taxpayers that wish to have the benefit of Notice 88-108 are advised to closely monitor the period during which their intercompany loans to a U.S. parent remain outstanding and to close out all loans within the appropriate time limit, even though that may create a compliance burden and administrative headaches.

**C. The Post-Transaction Year Transfer Pricing Adjustment**

After the close of the tax year, a taxpayer may find that a CFC that holds IP undercharged its U.S. parent for royalties to use the IP. The taxpayer may adjust the U.S. parent’s payment obligation upward under Code Sec. 482 and pay the adjustment amount to the CFC at that time.\(^{17}\) The IRS
also may make a similar adjustment several years after the
close of the tax year, and the taxpayer may establish an ac-
count receivable from the U.S. parent in the amount of the
adjustment at the level of the CFC under Rev. Proc. 99-32. 18

If the account receivable were deemed to exist as of the
close of the year to which the adjustment relates, the CFC
could hold an Obligation that could potentially deny the
U.S. parent the benefit of Notice 88-108 for several years.
Under the Fifth Circuit’s recent decision in BMC Software, Inc., 19 however, this conclusion should not follow, as
“[t]he fact that the account receivable [is] backdated does
nothing to alter the reality that [it] did not exist during”
the tax year to which it relates. Accordingly, accounts rece-
ivable that relate to post-transaction year transfer pricing
adjustments should not be relevant to the availability of
the short-term Obligation exception in Notice 88-108,
provided, of course, that the U.S. parent pays off these
receivables shortly after they arise.

V. Conclusion

Although the CCA is a welcome development in that it
confirms the continued vitality of Notice 88-108, it is also
wise to remember that the Notice presents numerous traps
for unwary taxpayers. As illustrated above, there are numer-
ous little errors or foot faults that could possibly cause the
taxpayer to fall outside of the technical limits of Notice
88-108, at least as the IRS currently interprets the Notice.
For instance, no matter how small the de minimis amount
of related-party debt is, there is a risk that it could cause
the taxpayer to lose all potential benefits that the taxpayer
could otherwise reap under the Notice. Although guidance
providing some leniency would be welcome and consistent
with the purpose of the Notice, we would not expect it to be
forthcoming.

ENDNOTES

1 CCA 201516064 (Dec. 22, 2014).
3 A “U.S. Shareholder” of a foreign corporation is
a U.S. person who owns 10 percent or more of
the total combined voting power of all classes
of stock entitled to vote of such foreign corpora-
tion. Code Sec. 951(c).
4 A CFC is any foreign corporation in which U.S.
Shareholders own more than 50 percent of either
(1) the total combined voting power of all classes of stock of such corporation entitled
to vote, or (2) the total value of the stock of the
foreign corporation. Code Sec. 957(a).
5 Code Sec. 956(c)(1).
6 Temporary Reg. §1.956-2T(d)(2)(i).
7 The change from year-end to quarter-end mea-
suring dates was enacted in the Omnibus Budget
Reconciliation Act of 1993 (the “1993 Act”).
8 Code Sec. 956(c)(2)(F) and (c)(2)(L).
Ownership here includes constructive ownership
under Code Sec. 958(b).
9 Code Sec. 956(c)(2)(F).
10 Code Sec. 956(c)(2)(L).
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
interpreting present law. Obligations subject
to the special treatment of Notice 88-108 are those
that are collected within 30 days of their
issuance, but the exclusion of such short-term
Obligations does not apply if the controlled
foreign corporation holds obligations that would
constitute U.S. property if held by the controlled
foreign corporation on the date of measurement
(determined without regard to this 30-day rule)
for aggregate periods totaling at least 60 days
in the taxable year, without regard to whether
any such obligations are held on the date of
measurement.”). See also H.R. Conf. Rep. 103-
213 (containing almost identical language).
12 See S. Rep. No. 1881, 87th Cong., 2d Sess., at
87-88 (Apr. 2, 1962), Report of the Committee
on Ways and Means to Accompany H.R. 10650,
13 This conclusion assumes that the group does not
treat the receivable as an ordinary and necessary
Obligation under Reg. §1.956-2(b)(1)(v), on the
theory that unrelated parties also could neglect
to invoice for long periods of time following
systems transitions or corporate restrukturings.
14 See D.K. Ludwig, 68 TC 979, Dec. 34,672 (1977)
(rejecting the IRS’s argument that a pledge of CFC
stock as security for a loan made the CFC the guar-
antor of the loan for purposes of Code Sec. 956(d));
FSA 200216022 (Jan. 8, 2002) (concluding that the
amount of a U.S. parent’s Code Sec. 956 inclusion
may be multiplied times the amount of a loan where
multiple CFCs guarantee that loan).
15 See, e.g., Rev. Proc. 89-12, 1989-1 CB 798
(indicating that a partnership interest as
low as 0.2 percent should be respected as
non-de minimis); LTR 7952057 (Sept. 25, 1979)
(implicitly recognizing a 0.1-percent partnership
interest as non-de minimis); see also W.R.
Jordan, DC-NC, 94-2 ustc ¶50,501, 863 FSupp
270 (implying that a 0.1826-percent partnership
interest is non-de minimis); but see I.L. Block,
41 TCM 546, Dec. 37,459(M), TC Memo. 1980-554
(suggesting that a 0.001-percent partnership
interest may be de minimis).
16 This fact pattern assumes that the adjustment
does not decrease U.S. taxable income. See Reg.
§1.482-1(a)(3).
18 BMC Software, Inc., CA-5, 2015-1 ustc ¶50,236,
780 F3d 669, 675.

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