Tax Alert

New Chief Counsel Memorandum Revisits Definition of "Obligation" under IRC § 956

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ILM 201436047

In a recent memorandum, ILM 201436047 (Sept. 8, 2014), the IRS chief counsel seemingly exceeded the scope of its own regulations in advising that the amount of a CFC's section 956 investment included accrued but unpaid interest of its U.S. parent on debt guaranteed by the CFC. This ILM has important implications for the application of 956 since it demonstrates that the IRS will advocate an expansive definition of investments in U.S. property.

Background of ILM

In the ILM, the US Parent company was the borrower on a third party loan that required it to pay stated interest annually. The Parent's CFC provided a guarantee or other credit support to the lender, so that CFC, under § 956(d), was treated as having made an investment in U.S. property to the extent of the Parent's guaranteed indebtedness.

It is unclear from the ILM whether the CFC was deliberately or inadvertently included in the guarantee parties under the third-party loan agreement. Typically, CFCs are excluded from the parties who provide a guarantee to avoid Section 956 exposure. Section 956 can be a major pitfall for 1a U.S. borrower, as improperly structured credit support by its CFCs can easily lead to a full inclusion of the CFCs' earnings and a major tax liability to the United States parent corporation.

In the ILM, the Parent was required to make regular payments of stated interest on its third-party debt that was guaranteed by the CFC. Presumably due to the Parent's financial difficulties, the Parent had not made the payments of stated interest as required, so that there existed an unpaid interest balance on the indebtedness.

Analysis of the ILM

In the ILM, the specific issue addressed by the IRS was whether the guarantor CFC's amount of section 956 investment included not only principal on the guaranteed debt, but also accrued, but unpaid interest. In this situation, the regulations state that the amount of the section 956 investment "shall be the *unpaid principal amount* on the applicable determination date of the obligation with respect to which the controlled foreign corporation is a pledgor or guarantor."[1] (Emphasis provided). Thus, the taxpayer apparently argued that only principal, and not unpaid interest, was captured by § 956. The IRS, on the other hand, disagreed and advised that the full unpaid balance of the obligation should be included in CFC's § 956 investment.

In reaching this conclusion, the ILM sidestepped the regulations on guarantees and focused instead on the general definition of US property in the statute and regulations. The regulations, in relevant

1 Treas. Reg. § 1.956-1(e)(2).

part, define an "obligation" to "include[]any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other indebtedness…"[2] The amount of the CFC's section 956 investment in the case of a direct loan is the CFC's adjusted tax basis in the Parent's obligation.[3] Under that definition, the Parent's obligation to pay accrued interest would, in the IRS's view, constitute an "account receivable" or "other indebtedness" owing by the U.S. parent to the CFC. Further, as long as the CFC had sufficient prospects of recovery to be required to accrue the interest as income under the principles of the accrual method of accounting,[4] its adjusted tax basis in the Parent's debt obligation would include unpaid interest. The IRS then extrapolated this application of the direct investment rules to the guarantee case to hold that the CFC would have an investment in U.S. property indirectly through a guarantee to the extent that the accrued interest would have been included in the CFC's § 956 investment if made directly.

The IRS also put forth a policy rationale, stating that the purpose of section 956 is to tax earnings of a CFC that are available for use by a related United States person similarly to the way that earnings distributed to a United States shareholder of the CFC would be taxed. The ILM states that both principal and accrued interest fit within this category.

Commentary on the ILM and Implications for Other Areas

The ILM's reasoning, if correct, makes the guarantee rule (Treas. Reg. § 1.956-1(e)(2)) superfluous. There is simply no need for a rule stating that the principal amount of a U.S. parent's debt guaranteed by a CFC is section 956 property if regulations covering the definition of an obligation include guarantees of accrued interest. Since differences in regulatory language are presumed not to be superfluous, it would seem that the ILM can only mean one of two things: either Treasury erred by making the guarantee rule under-inclusive or, more likely, Treasury had a good reason for not including unpaid interest in the guarantee rule. Indeed, at the time a CFC guarantees its U.S parent's debt, its earnings are being used to induce a loan, and not to induce the nonpayment of interest. Further, if the U.S. parent is in such poor financial shape at the time the loan is made, then there are alternatives available to the IRS (see, e.g., *Plantation Patterns*) to characterize the obligation to pay both principal and unpaid interest as a direct indebtedness of the CFC.

The ILM does not attempt to square its interpretation of the guarantee rule with the plain language of the regulation's reference to "unpaid principal amount." The guarantee rule is written differently from the direct investment rule, and by treating interest as principal, the ILM ignores this difference in language. The principal balance of the third-party debt measures the amount of cash provided by the lender to the U.S. person benefitted by the guarantee that is treated as a § 956 investment. The ILM extends this analysis one step further to treat the unpaid interest on the third-party debt guaranteed by the CFC as constituting a direct benefit from the CFC to the Parent.

The ILM's analysis includes in the principal amount the stated interest that the unrelated party would be required to accrue in its income under the accrual method. If the Parent lacks liquidity or ability to pay interest, as seems likely on the facts of the ILM, one question is whether the lender would be entitled to apply the doubtful collectability exception[5] to stop the accrual of interest. The ILM's

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2 Temp. Treas. Reg. § 1.956-2T(d)(2)(i).

3 *See* Treas. Reg. § 1.956-1(e)(1).

4 In this regard, the ILM cites and applies Rev. Rul. 80-361 and Rev. Rul. 2007-32.

5 *See generally* Garlock, Federal Income Taxation of Debt Instruments, ¶1602.

analysis is premised on the conclusion that the interest did accrue for tax purposes to be added to the principal amount. The IRS appears to leave open the Parent to argue that the lender, in a doubtful collectability analysis, would not be required to accrue the interest on the debt.

The ILM's facts also are limited to the accrual of stated interest on the debt. It does not, by its terms, address original issue discount. For example, assume that, rather than borrowing $10 million at 5% interest, the Parent issued a $12 million zero coupon bond for a $10 million issue price. In this case, could the IRS assert that the "unpaid principal balance" in year 1 was $12 million face amount, or only the $10 million original issue price of the debt?

Conclusion

The ILM raises and resolves, in an anti-taxpayer manner, a difference between the rules for direct investments in U.S. property and indirect investments through a pledge or guarantee. It raises the prospects of the IRS broadly construing section 956 and the regulations thereunder in other instances where it believes a section 956 inclusion is warranted.

In the case of a third party loan to a U.S. parent, the borrowing company's best practice is to carefully analyze its credit agreements and push hard to avoid including CFCs within the net of guarantors of the agreement. Had the agreement been more carefully structured, or the taxpayer been more adamant to exclude the CFCs from the guarantee, the tax exposure addressed by the ILM would never have arisen.

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