

A Note From the Editor-in-Chief

Short-Term CFC Loans May Avoid Code Sec. 956

Foreign subsidiaries of U.S. multinationals often have excess cash from their business operations. Under various circumstances it may be desirable for a U.S. parent to access offshore funds for short-term needs. Paying a dividend to the U.S. parent, however, can result in foreign and U.S. tax costs, such as withholding taxes and additional U.S. income taxes. Incurring taxes for short-term utilization of foreign cash in the United States generally is inefficient, particularly if the funds are expected to be needed by the foreign subsidiaries in the future.

A foreign subsidiary might loan excess funds to its U.S. parent. Such a loan, however, generally results in the same U.S. tax costs as a dividend. Under Code Sec. 956 of the subpart F rules, a loan made by a controlled foreign corporation (CFC) to a related U.S. person is an investment in U.S. property,¹ and the amount of the loan is included in the income of the U.S. shareholder as a deemed dividend.² Nevertheless, the subpart F rules may be navigated in a manner to avoid triggering a deemed dividend when a CFC loans its excess cash to its U.S. parent on a short-term basis.

The computational rules of Code Sec. 956 permit intra-quarter loans. The amount of a CFC's investment in U.S. property for the year is determined by taking the average of the amounts of U.S. property held by the CFC on the last day of each quarter of its tax year.³ Therefore, the application of Code Sec. 956 can be avoided if a loan is repaid before the close of any quarter of the CFC's tax year. For example, a CFC with a calendar year may make a loan to its U.S. parent from October 1 through December 30 without being subject to the deemed dividend rule of subpart F.⁴

The IRS also has provided an express exception for short-term loans that are outstanding over a quarter-end. An obligation of a related U.S. person held by a CFC at the end of the CFC's quarter will not be subject to Code Sec. 956 if the CFC collects the debt within 30 days from the time it is incurred. This exception will not apply, however, if the CFC holds for 60 or more days during its tax year any obligations which (without regard to the 30-day rule) would constitute an investment in U.S. property if held on the last day of the CFC's quarter.⁵

The 30-day exception can be helpful for financial reporting purposes. For example, a U.S. parent may have \$100



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million of third-party debt and \$30 million of excess cash offshore. For quarterly and annual financial reporting purposes, the \$100 million is reported as gross third-party debt, and the debt-to-equity ratio is calculated using that amount (*i.e.*, the \$30 million of excess foreign cash is not netted against the \$100 million of outside debt). Credit rating agencies also do not net the two amounts. Under the 30-day exception, the CFC may loan the \$30 million to the U.S. parent over each quarter-end and at the end of the year (subject to the 60-day limitation), which can then be used to reduce the \$100 million of U.S. debt to \$70 million. Therefore, \$70 million is the amount of outside debt for consolidated financial reporting purposes, and is the amount used to calculate the consolidated group's debt-to-equity ratio. This lower amount of outside debt reflected on the financial statements may result in a better credit rating and lower borrowing costs.

Taking advantage of the 30-day exception, however, limits the number of days loans from the CFC may be outstanding to the U.S. parent (or to any related U.S. person). For example, as discussed above, generally a CFC can have a loan outstanding for most of a quarter (*e.g.*, 80 days), and as long as the loan is paid off

before the end of the quarter, Code Sec. 956 should not apply. Nevertheless, since such loan would be outstanding for more than 60 days, the CFC would not be eligible for the 30-day exception.⁶

It should be noted that the 60-day requirement is stated with reference to the particular CFC that holds the obligation at the end of the quarter. Loans of related CFCs should not be taken into account for this purpose, which is consistent with the CFC-by-CFC approach of Code Sec. 956 and the regulations. Accordingly, a CFC not relying on the 30-day exception may have intra-quarter loans outstanding to its U.S. parent for more than 60 days without disqualifying a related CFC from meeting the 60-day requirement.⁷

Finally, it may be desirable to stagger the CFC's tax year. A CFC may elect to have a fiscal year that ends one month before the tax year of the U.S. parent. For example, a CFC may adopt a tax year ending on November 30 when its U.S. parent has a calendar tax year.⁸ Under these circumstances, a short-term loan by the CFC to the U.S. parent may be outstanding over the four quarter-ends of the U.S. parent without triggering Code Sec. 956 and should not be subject to the 30/60 requirements.⁹

ENDNOTES

¹ Code Sec. 956(c)(1)(C); Reg. §1.956-2(a)(1)(iii).

² Code Secs. 951(a)(1)(B), 956.

³ Code Sec. 956(a).

⁴ Under certain circumstances, the IRS might assert that successive loans outstanding in two consecutive quarters should be considered as a continuous loan outstanding at the end of a quarter. See Rev. Rul. 89-73, 1989-1 CB 258; *Jacobs Engineering Group Inc.*, DC-Calif., 97-1 USTC ¶50,340, *aff'd*, CA-9, 99-1 USTC ¶50,335. For a detailed analysis of this case, see Yoder and McGill, *Treatment of CFC Loans to U.S. Affiliates: The Sword and Sickle of Subpart F*, 26 TAX MGMT. INT'L J. 454 (Sept. 12, 1997).

⁵ Notice 88-108, 1988-2 CB 445. GLAM 2007-0016, *reprinted in* 2007 TNT 195-39, confirms that, although Notice 88-108 liter-

ally applies only to year-end obligations, the 30-day exception will be available for obligations outstanding at the end of each quarter. For a discussion of the GLAM, see Yoder, *IRS Applies Section 956 Thirty-Day Exception to Quarters*, 36 TAX MGMT. INT'L J. (Dec. 2007).

⁶ Exceptions are provided for obligations that arise when a CFC sells products or provides services to a U.S. related person. Code Sec. 956(c)(2)(C) & (F); Reg. §§1.956-2(b)(1)(v) & (viii), -2T(d)(2)(i)(B). Such obligations that qualify for the exception should not be taken into account for purposes of the 60-day rule, since they are not considered as U.S. property. Other business receivables, however, such as receivables for royalties, would be taken into account. In addition, a loan of previously taxed earnings, even

though it does not trigger a Code Sec. 956 inclusion, may be taken into account for purposes of applying the 30/60 exception (although there does not appear to be a policy basis supporting this result).

⁷ One must be aware, however, of the anti-abuse rule in the regulations which permits the IRS, under certain circumstances, to treat a CFC that funds another CFC as holding the investment made by the second CFC. Reg. §1.956-1T(b)(4)(i).

⁸ Code Sec. 898(c)(1)(B).

⁹ For additional planning ideas, see Yoder, 926 T.M., Subpart F—General, at 69-79; Yoder, *Subpart F Repatriation: Distribution Timing is Everything*, 32 TAX MGMT. INT'L J. 427 (Aug. 8, 2003); Yoder, *Subpart F Hopscotch Rule Permits Targeted Repatriation*, 32 TAX MGMT. INT'L J. 317 (June 13, 2003).

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