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U.S. Tax Court Holds That Elective Rev. Proc. 99-32 Accounts Receivable Are for Certain Tax Purposes “Indebtedness” Existing at the End of the Year to Which the 482 Adjustment Relates

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On September 18, 2013 the Tax Court held that when controlled taxpayers elected the benefits of Rev. Proc. 99-32, and therefore established accounts receivable from a CFC by its U.S. shareholder in an attempt to minimize the fall-out from agreed section 482 adjustments, the accounts receivable constituted “indebtedness” of the CFC to a related person, and were deemed established as of the close of each year to which the section 482 adjustments related.¹

The narrow issue in the case was whether, for purposes of reducing the U.S. shareholder’s one-time section 965 dividends received deduction (DRD), a deduction not available after 2006, the IRS could treat such accounts as “indebtedness,” and if so, as of what date such debt should be treated as having been incurred. However, an important implication of Judge Kroupa’s BMC Software opinion seems to be that the Tax Court believes that the Rev. Proc. 99-32 accounts receivable “fiction” ought generally to be treated for tax purposes as “real.” Thus, taxpayers may want to consider whether the language used in the opinion will have broader implications (e.g., section 956 implications) when evaluating the effects of Rev. Proc. 99-32 elections on past, present, and future tax years.

Facts of the Case

Petitioner, which has a March 31 taxable year-end, elected to apply section 965 to its taxable year ending March 31, 2006, making it the Petitioner’s “election year.” On its election year tax return, Petitioner claimed \$709 million in “qualifying dividends” from BMC Software European Holding (“BSEH”) eligible for the 85% section 965 DRD.

Upon audit of Petitioner’s returns for the election year and the 4 prior years, the IRS determined that royalty payments from Petitioner to BSEH exceeded arm’s

¹ *BMC Software Inc. v. Commissioner*, 141 T.C. No. 5 (September 18, 2013).

length amounts. A closing agreement was reached making primary adjustments that increased Petitioner's income for each of those years. In order to allow BSEH to repay Petitioner the greater-than-arm's-length amounts without dividend characterization, a closing agreement establishing accounts receivable by Petitioner under Rev. Proc. 99-32 was also entered into, and the excess amounts, plus interest, were returned by BSEH to the Petitioner within 90 days of the effective date of this closing agreement.

The Section 965(b)(3) Issue

Section 965(b)(3) provides in effect that the amount of Petitioner's section 965 qualifying dividend income, as determined before applying section 965(b)(3), was reduced by the excess of (A) the amount as of the close of the election year of "indebtedness" of BSEH to certain related persons, including the Petitioner ("related person indebtedness," or "RPI"), over (B) BSEH's related party indebtedness as of October 3, 2004. The IRS argued that the Rev. Proc. 99-32 accounts receivable that were established by closing agreement after the election year, and that covered Petitioner's 2005 and 2006 section 482 adjustments, represented increases between October 3, 2004 and the close of the election year (March 31, 2006) in BSEH's related person indebtedness.

In opposition the taxpayer argued, among other things, that (1) the accounts receivable did not constitute "indebtedness" for this purpose; (2) the accounts receivable were established after the election year, and thus could not have increased RPI during the testing period that began October 4, 2004 and ended March 31, 2006; and (3) the closing agreement precluded any federal income tax consequences, including any section 965(b)(3) consequences, from the establishment of the accounts receivable.²

The Court's Decision

The Tax Court held for the Commissioner on each of taxpayer's arguments. Despite the fact that section 965 is no longer operative, the opinion retains relevance for the future, mainly because of the way in which the Tax Court rejected the taxpayer's arguments. There was arguably a narrow road available. For example, the court might have held the taxpayer to the rule announced in section 10.06 of Notice 2005-64, which provides: "Accounts payable established under Rev. Proc. 99-32 . . . are treated as indebtedness for purposes of section 965(b)(3)," and held that no inferences should be drawn about whether such accounts are treated as indebtedness for U.S. federal income tax purposes in general. If the Tax Court had taken this approach, the court might have confined the implications of its opinion to tax years from 2004 to 2006.

Alternatively, the court had the option to take a broader road, making the consequences of the opinion, at least in the Tax Court, such that they could potentially govern the interaction between Rev. Proc. 99-32 accounts and other Code sections, including section 956 ("Investment of Earnings in United States Property"). Section 956 can result in an income inclusion to a CFC's U.S. shareholder when the CFC holds "indebtedness" of a related U.S. person over a quarter-end.³

² The Petitioner also argued that section 965(b)(3) applies only to intentionally abusive transactions, and that the accounts receivable in this instance qualified for the "trade payables" exception under Notice 2005-38.

³ See Treas. Reg. § 1.956-2T(d)(2)(i).

The Tax Court chose the broader road. The court did not even discuss section 10.06 of Notice 2005-64.⁴ Citing the general rule announced in section 7.02(a) of Notice 2005-38,⁵ the court stated that in interpreting the word “indebtedness” in section 965(b)(3), “[t]he Commissioner applied the same meaning as that term has under general Federal income tax principles,” and “Respondent contends the term simply means debt. . . . [R]espondent’s definition is consistent with the term’s plain meaning. We hold that the term ‘indebtedness’ as it is used in section 965(b)(3) means the condition of owning money or being indebted.” Thus, the court’s decision about the status of Rev. Proc. 99-32 accounts for section 965(b)(3) purposes may have relied on a view that such accounts are indebtedness under the general federal tax law definition of that term.

Moreover, in answer to the third taxpayer argument listed above, the court stated that “[w]e disagree . . . that the [Rev. Proc. 99-32] election allows for inconsistent characterizations for Federal tax purposes,” and followed by saying “we hold that the accounts receivable are deemed established for all Federal tax purposes” (emphasis added). It was a short step from this for the court to state the following:

The accounts receivable closing agreement determined for all Federal income tax purposes that petitioner would establish interest-bearing accounts receivable from BSEH to petitioner. It further provided that two of the accounts receivable were deemed to have been established *during the testing period*. We therefore hold that the accounts receivable qualify as indebtedness during the testing period *because petitioner and respondent agreed that they were established then*.⁶

Conclusion

In light of the BMC Software decision, taxpayers need to consider, when choosing whether to make an election under Rev. Proc. 99-32, and in cases where the election has already been made, the consequences that would ensue if the elective account(s) receivable were treated as debt for all purposes of the Code. For those taxpayers facing adjustments to intercompany transactions between a U.S. resident and a resident of a country that has a tax treaty in force with the United States, and who intend to request competent authority assistance pursuant to the treaty’s mutual agreement procedure article,⁷ the potential broader ramifications of BMC Software may affect the nature of the relief to be requested through the competent authority process, as the IRS Advance Pricing and Mutual Agreement program has sometimes agreed to combine and implement transfer pricing adjustments for multiple tax years into a single tax year based on economic principles.

⁴ The court (or the IRS) may have wanted to avoid taking on the issue whether the IRS and Treasury have the power to bind a taxpayer by the terms a notice setting forth regulations to be issued in the future, when no such regulations are ever issued.

⁵ “Except as provided in this section, for purposes of section 965(b)(3), “indebtedness” is defined under general Federal income tax principles.”

⁶ Emphasis added.

⁷ Such a taxpayer, unlike BMC Software Inc. under the circumstances that led to the Tax Court decision, generally would not plan to execute a closing agreement with the IRS following the examination, as doing so could negatively impact the negotiations between the competent authorities of the two treaty partners. See Rev. Proc. 2006-54, §7.05.

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