OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE
NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR JOHN SWEENEY
ATTORNEY CC:LM:FSH:MAN:1

FROM: Phyllis E. Marcus
Branch Chief, CC:INTL:BR2

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated December 14, 2000. In accordance with I.R.C. section 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND:

Corporation A =
DC1 =
DC2 =
FC1 =
FC2 =
Year 1 =
Year 2 =
Amount 1 =
Amount 2 =
Amount 3 =
Amount 4 =
X% =
Document =

ISSUE:

Whether back-to-back loan transactions involving intermediary controlled foreign corporations (CFCs) should be respected in determining the amount of earnings invested in United States property under section 956(a) of the Code?

CONCLUSION:

It appears that the back-to-back loan transactions involving intermediary CFCs should be disregarded, and therefore, the back-to-back loan transactions should be

treated as a loan from one domestic company to another domestic company, and not as an investment in United States property. However, more factual development is necessary.

FACTS:

Corporation A is a domestic corporation and it wholly-owns two domestic subsidiaries, DC1 and DC2. DC2 wholly-owns FC1, and FC1 in turn wholly-owns FC2. Both FC1 and FC2 are foreign corporations organized under the laws of United Kingdom and are controlled foreign corporations (CFCs) within the meaning of section 957(a).

A document between the parties dated December 22, Year 1, contemplated entering into a series of back-to-back intercompany loans for Amount 1 on December 29, Year 1. The parties to these transactions would be DC2, FC1, FC2 and DC1. These loans were expected to be in effect for approximately three months. The document did not indicate the interest rates (if any) applicable to these loans. A workpaper of FC2 indicated that the purpose of the FC2 loan to DC1 was to effectuate a section 956 dividend.

On December 29, Year 1, the parties entered into the back-to-back loan transactions, as previously planned. DC2 first loaned Amount 1 to FC1 (Transaction 1). FC1 in turn loaned that same amount to FC2 (Transaction 2). As a result, FC2 entered into a note agreement (the "Note") with DC1 for Amount 1 for a period of three months commencing on December 30, Year 1 (Transaction 3). The Note provided for a rate of interest at X% and matured on March 30, Year 2. On the maturity date, DC1 repaid the principal (i.e. Amount 1), plus interest, to FC2.

DC2 treated the loan transaction between FC2 and DC1 as FC2's investment of earnings in United States property under section 956(a). Since FC2 had no investments in United States property at the beginning of Year 1, the entire Amount 1 was treated as the increase of investment in United States property for the taxable year ended December 31, Year 1. Under section 956(a)(1), the amount of earnings invested in United States property for a taxable year is limited to the amount that would have constituted a dividend if it had been distributed. Therefore, the amount of earnings invested in United States property is limited to FC2's earnings and profits that had not been previously taxed, which totaled Amount 2.

Pursuant to section 951(a)(1)(B), DC2, the United States shareholder (as defined in section 951(b)) of FC2, included Amount 2 in gross income related to FC2's increase in earnings invested in United States property for its taxable year ended December 31, Year 1. As a result of this inclusion, DC2 claimed that under section 960(a), it was deemed to have paid a portion of FC2's foreign income taxes. Accordingly, DC2 claimed a foreign tax credit of Amount 3.

In Year 1, FC2 also distributed Amount 4 to FC1, who in turn distributed that same amount to DC2. DC2 did not report that distribution as a taxable dividend. Rather, the distribution was treated as previously taxed income under section 959(b)

because DC2 had included Amount 2 in gross income as a result of FC2's increase in earnings invested in United States property for the taxable year ended December 31, Year 1.

LAW AND ANALYSIS:

Section 951(a)(1)(B) requires the United States shareholder (as defined by section 951(b)) of a CFC who owns (within the meaning of section 958(a)) stock in such corporation on the last day of the taxable year in which such corporation is a CFC to include in gross income for the taxable year, its pro rata share of the CFC's increase in earnings invested in United States property as determined under section 956(a)(2). Under section 956(a)(1), 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 to the extent the amount would have constituted a dividend (i.e. earnings and profits) if it had been distributed. Sections 956(b)(1) and (b)(2)(F) define United States property to include, inter alia, an obligation of a related United States corporation. DC2 treated the loan of Amount 1 from FC2 to DC1 as an obligation of a related United States corporation and, accordingly included Amount 2 in gross income for Year 1 under section 951(a)(1)(B).

However, based on the facts presented, it appears that, in substance, the back-to-back loan transactions involve a loan between two domestic corporations (DC2 and DC1) and, the intermediary CFCs (FC1 and FC2) were interposed between the true parties to the transaction for purposes of claiming the deemed paid foreign tax credit under section 960(a). Under these circumstances, the transactions involving the intermediary entities should be collapsed so the incidents of taxation reflect the true economic substance of the transaction.

Under the doctrine of substance over form, the courts may look through the form of a transaction to determine its substance in light of economic realities. As explained by the Supreme Court in Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978) (citations omitted):

> In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. 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. In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding. Nor is the parties' desire to achieve a particular tax result necessarily relevant.

See also, e.g., Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945) ("to permit the true nature of a transaction to be disguised by mere formalisms, which exists solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress"); Gregory v. Helvering, 293 U.S. 465, 469 (1935)

(refusing to give effect to transactions that complied with formal requirements for nontaxable corporate reorganization; "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended").

In cases where a taxpayer creates a series of back-to-back loans involving domestic and related foreign corporations solely to achieve a particular tax consequence, the courts have applied the step transaction doctrine in determining the substance of the transaction. *See* Del Commercial Properties, Inc. v. Commissioner, T.C.M. 1999-411 at 1186 (1999), *citing* Aiken Industries, Inc. v. Commissioner, 56 T.C. 925, 934 (1971). Under the step transaction doctrine, "a series of transactions designed and executed as parts of a unitary plan to achieve an intended result ... will be viewed as a whole regardless of whether the effect of so doing is imposition of or relief from taxation." FNMA v. Commissioner, 896 F.2d 580, 586 (D.C. Cir. 1990), *cert. denied*, 499 U.S. 974 (1991) (citing Kanawha Gas & Utilities Co. v. Commissioner, 214 F.2d 685, 691 (5th Cir. 1954)); *see also* Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938) ("[a] given result at the end of a straight path is not made a different result because reached by following a devious path").

Courts have applied three alternative tests in deciding whether to invoke the step transaction doctrine: (1) the "end result" test, under which the transaction will be collapsed if it appears that a series of formally separate steps are really prearranged parts of a single transaction intended from the outset to reach the ultimate result, *see* King Enterprises, Inc. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969); (2) the "interdependence" test, which focuses on whether "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series," Redding v. Commissioner, 630 F.2d 1169, 1177 (7th Cir. 1980), *cert denied*, 450 U.S. 913 (1981); and (3) the "binding commitment" test, under which a series of transactions are collapsed if, at the time the first step is entered into, there was a binding commitment to under take the later step, *see* Commissioner v. Gordon, 391 U.S. 83, 96 (1968).

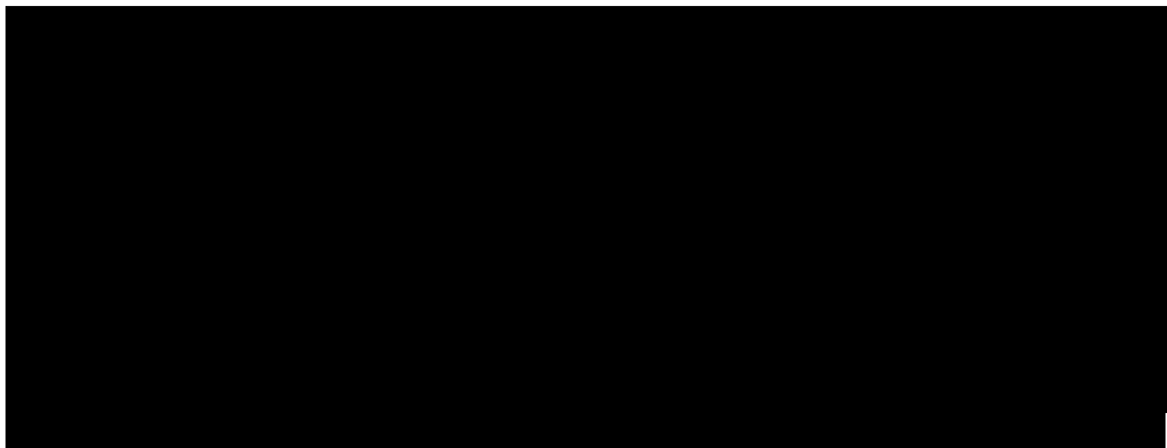
Based on the facts presented, it appears that the Service may argue that the step transaction doctrine applies to treat the back-to-back loans as a loan between DC2 and DC1. First, the Service could argue that the requirements of the end result test is satisfied because Transactions 1 and 2 were solely undertaken to create an investment in United States property by having FC2 make a loan to DC1 (i.e. Transaction 3). The purpose of Transaction 3 was to create an income inclusion for DC2 by virtue of section 956 so DC2 could claim the section 960(a) tax credit. However, Transaction 3 does not appear to be a bona fide section 956 investment in United States property because Amount 1 came from DC2 and was ultimately transferred to DC1 through FC1 and FC2, who were mere intermediaries that were used to facilitate the transfer of Amount 1.

Second, it appears that the Service may also argue that the requirements of the interdependent test is satisfied. The back-to-back loans related to Transactions 1

and 2 were executed so FC2 and DC1 could enter into Transaction 3. But for Transaction 3, Transactions 1 and 2 would have been fruitless because neither FC1 nor FC2 needed to borrow Amount 1. It appears that Transactions 1 and 2 occurred so FC2 would have Amount 1 to loan to DC1 and create an investment of earnings in United States property by FC2. Accordingly, the back-to-back loans are interdependent because the creation of Transactions 1 and 2 would have been fruitless without Transaction 3.

Lastly, the facts also appear to satisfy the requirements of the binding commitment test. The document dated December 22, Year 1, indicated that DC2, FC1, FC2 and DC1 planned to enter into a series of simultaneous back-to-back intercompany loans for Amount 1. At the time that DC2 entered into Transaction 1 with FC1 on December 29, Year 1, the parties had already committed to Transactions 2 and 3. In fact, those two transactions were carried out on or about the same day as Transaction 1. Therefore, there appears to be the existence of a binding commitment among the parties prior to the execution of the back-to-back loans.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:



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Please call if you have any further questions.

By: Phyllis E. Marcus
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