

## Code Sec. 956: Developments Concerning the 30-Day Exception

A loan made by a subsidiary to its parent or to an affiliate generally is not a taxable event. Subpart F, however, provides a limited exception. When a controlled foreign corporation (CFC) makes a loan to a related U.S. person, the U.S. shareholders of the CFC must include in income the average of the amounts of such loans outstanding on the last day of each quarter.<sup>1</sup>

The IRS and Treasury issued a notice in 1988 providing an exception for short-term loans. Specifically, a loan to a related U.S. person held by a CFC that is outstanding over the end of the CFC's quarter will not result in an inclusion under Subpart F if the loan is repaid within 30 days from the time it is incurred (*i.e.*, the "30-day exception").<sup>2</sup> This exception applies only if the CFC does not hold for 60 or more days during its tax year any obligations of related U.S. persons which (without regard to the 30-day exception) would be subject to Code Sec. 956 ("the 60-day limitation").<sup>3</sup>

The 30-day exception can be used to reduce third-party debt outstanding at the end of a quarter. For example, a U.S. parent may have \$100 million of third-party debt and \$30 million of cash offshore. For quarterly and annual financial reporting purposes, the \$100 million is reported as gross third-party debt, and the company's debt-to-equity ratio is calculated using that amount (*i.e.*, the \$30 million of foreign cash is not netted against the \$100 million of outside debt). Under the 30-day exception, the CFC can loan the \$30 million to the U.S. parent over each of the CFC's quarter-end dates and at the end of the year (subject to the 60-day limitation), which can then be used to reduce the U.S. parent's \$100 million of third-party debt to \$70 million. The lower amount of outside debt reflected on the financial statements may result in a better credit rating and lower borrowing costs.<sup>4</sup>

The Treasury and the IRS recently issued temporary regulations that contain the 30-day exception and render Notice 88-108 obsolete.<sup>5</sup> This rule has an effective date with respect to obligations held on or after September 16, 1988. The 30-day exception will expire if not adopted in final regulations on or before April 4, 2019.<sup>6</sup>

The same temporary regulations contain a rule that defines U.S. property as including certain obligations of a foreign corporation held by a CFC that arise in a transaction related to an inversion transaction.<sup>7</sup> The preamble states that since the 30-day exception applies only to loans held by U.S. persons, it does not apply to an obligation of a non-CFC foreign related person that is treated as U.S. property pursuant to the temporary regulations. A comment requesting that the exception apply was rejected on the basis that: "The Treasury Department and the IRS are concerned that there is a heightened risk that taxpayers would take abusive positions in reliance on the short-term obligation exception announced in Notice 88-108 in post-inversion transaction structures, due to the fact that gaining access to the deferred foreign earnings of CFCs without paying U.S. federal income tax is often a stated goal of inversion transactions."<sup>8</sup>

Another recent development may be relevant in applying the 60-day limitation. The regulations provide that under certain circumstances a CFC that funds another CFC can be considered as holding U.S. property held by the other CFC. Recently



W  
CCH



**LOWELL D. YODER** is a Partner in the Chicago office of McDermott Will & Emery LLP, and Global Head of Tax.

finalized regulations expanded the circumstances when this indirect investment rule can apply to include any funding (not just by debt or capital), noncontemporaneous funding and funding a CFC which itself has sufficient earnings and profits to make the investment in U.S. property.<sup>9</sup> If the indirect investment rule is applied to a CFC relying on the 30-day exception, then that CFC may be required to take into account for purposes of the 60-day limitation any loan of the related funded CFC that is treated as U.S. property. Thus, this expanded indirect investment rule should be considered when relying on the 30-day exception.

Recently finalized Code Sec. 385 regulations can apply to reclassify as equity certain loans made by a CFC to a related domestic corporation.<sup>10</sup> For example, such loans will be treated as equity if not properly documented.<sup>11</sup> A loan reclassified as equity may not qualify for the 30-day exception, since the 30-day exception applies only to “obligations” which the regulations generally define as indebtedness.<sup>12</sup> On the other hand, the 60-day limitation may not take into account an obligation that is reclassified as equity.

The Code Sec. 956 rules for computing the amount invested in U.S. property provide another short-term loan exception. The amount of the U.S. property investment

is the average amounts of loans to related U.S. persons held by a CFC as of the end of each quarter of the CFC’s tax year. Loans outstanding during a quarter but not at the end of a quarter are not counted. Thus, a CFC can make intra-quartile loans to related U.S. persons without a deemed dividend under Code Sec. 956.

Relying on the intra-quartile loan exception permits loans to be outstanding more than 30 days, eliminates the 60-day limitation and Code Sec. 956 should not apply even if a loan is reclassified as equity.<sup>13</sup> It is recommended that a series of loans made by a CFC to a related U.S. person be off for approximately as many days as they are on to avoid the IRS asserting that the step transaction doctrine applies to treat the loans as one continuous loan.<sup>14</sup>

If a U.S. parent desires to obtain the financial reporting benefits of quarter-end loans, a CFC can adopt a fiscal year that closes one month earlier than the fiscal year of its U.S. parent.<sup>15</sup> This permits a CFC to loan funds over its U.S. parent’s quarter ends but not over the quarter ends of the CFC.

In sum, temporary regulations have been issued that formally adopt the 30-day exception, although other developments make it more difficult to qualify for this exception. A taxpayer may instead consider intra-quartile loans as an alternative for providing short-term funding to the U.S. parent.

## ENDNOTES

<sup>1</sup> Code Sec. 951(a)(1)(B), 956. The amount included in the income of the U.S. shareholder is limited to the earnings and profits of the CFC that have not been previously subject to U.S. taxation under Subpart F. See Lowell D. Yoder, *Subpart F Inclusions and Dividends: Key Ordering Rules*, 41 TAX MGMT. INT’L J. 570 (Oct. 12, 2012).

<sup>2</sup> Notice 88-108, 1988-2 CB 445. See GLAM 2007-0016 (Oct. 5, 2007) (stating that while Notice 88-108 literally applies to year-end obligations, the 30-day exception will be available for obligations outstanding at the end of each quarter); Yoder, *IRS Applies Section 956 Thirty-Day Exception to Quarters*, 36 TAX MGMT. INT’L J. (2007). Congress has expressly recognized the 30-day exception for loans as provided in Notice 88-108. H.R. Rep. No. 111, 103d Cong., 1st Sess. (1993), at 701 (May 23, 1993), 1993-3 CB 277.

<sup>3</sup> CCA 201516064 (Apr. 17, 2015) (all loans held by a CFC that are subject to Code Sec. 956 must be counted for purposes of determining whether the CFC held loans to related U.S. persons

outstanding for 60 or more days during the year, not just the loans qualifying for the 30-day exception). See Yoder, *Section 956: The 60-Day Limitation on the 30-Day Exception for Obligations of Related U.S. Persons*, 44 TAX MGMT. INT’L J. 644 (Oct. 9, 2015).

<sup>4</sup> See Yoder, *Short-term CFC Loans May Avoid Code Sec. 956*, 34 INT’L TAX J. 3 (Jan.–Feb. 2008).

<sup>5</sup> Reg. §1.956-2T(d)(2)(iv).

<sup>6</sup> Reg. §1.956-2T(i)(4), (j).

<sup>7</sup> Reg. §1.956-2T(a)(4). This rule was initially provided in Notice 2014-52, 2014-42 IRB 712. See Yoder, *Section 956: IRS Treats Foreign Property as U.S. Property*, 44 TAX MGMT. INT’L J. 157 (Mar. 13, 2015) (presents the case that there is no legislative basis for this rule because Code Sec. 956 applies only to investments in U.S. property which by definition does not include obligations of foreign persons).

<sup>8</sup> T.D. 9761, 81 FR 20,857 (Apr. 8, 2016), at 20,875.

<sup>9</sup> Reg. §1.956-1(b), T.D. 9792, 81 FR 76,497 (Nov. 3, 2016); see also T.D. 9733, 80 FR 52,976 (Sept.

2, 2015); Yoder, *Revised Reg. §1.956-1T(b)(4) Expands The Indirect Investment Rule*, 45 TAX MGMT. INT’L J. 98 (Feb. 12, 2016).

<sup>10</sup> T.D. 9790, 81 FR 72,858 (Oct. 21, 2016). See also REG-108060-15, 81 FR 20,912 (Apr. 8, 2016) (proposed regulations); Yoder, *Code Sec. 385: Proposed Debt vs. Equity Regs Would Limit Planning*, 42 INT’L TAX J. 3 (July–Aug. 2016).

<sup>11</sup> Reg. §1.385-2.

<sup>12</sup> Reg. §1.956-2T(d)(2).

<sup>13</sup> Other adverse U.S. tax consequences would result if the loan is reclassified as equity.

<sup>14</sup> See Rev. Rul. 89-73, 1989-1 CB 258; *Jacobs Engineering Group Inc.*, DC-CA, 79 AFTR 2d 97-1673 (1997), *aff’d*, CA-9, 168 F2d 499 (1999) (according to the court, *Jacobs Engineering* “is not appropriate for publication and may not be cited to or by the courts” of the 9th Circuit). See also Yoder, *Notice 2008-91 Exception to §956: Guidance on Particular Issues*, 39 TAX MGMT. INT’L J. 96 (Feb. 12, 2010).

<sup>15</sup> Code Sec. 898(c)(2).

This article is reprinted with the publisher’s permission from the INTERNATIONAL TAX JOURNAL, a bimonthly journal published by CCH, a part of Wolters Kluwer. Copying or distribution without the publisher’s permission is prohibited. To subscribe to the Journal of INTERNATIONAL TAX JOURNAL or other CCH Journals please call 800 449 8114 or visit CCHGroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of CCH, a part of Wolters Kluwer or any other person.