# REPATRIATION OF FOREIGN EARNINGS V. RELATED PARTY INDEBTEDNESS

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On March 13, 2015, the United States Court of Appeals for the Fifth Circuit (the "Appeals Court") reversed a decision of the United States Tax Court regarding the rules relating to the repatriation of earnings under Code §965.

Code §965 was a temporary statute permitting an 85% dividends received deduction in connection with the repatriation of earnings from a foreign subsidiary as long as the proper tests were satisfied. One test related to intercompany loans to foreign subsidiaries allowing them to pay the low-tax dividends. Even though the statute is not currently in effect, the reasoning of the Appeals Court suggests that substance will at times prevail, even if it works against the I.R.S.

BMC Software, Inc. ("BMC") was a software developer that generated income from licensing operations. It had in effect a qualified joint cost-sharing agreement with a subsidiary. In 2002, the agreement was terminated and BMC began to pay royalties to the subsidiary in return for the transfer of rights back to BMC. In an I.R.S. examination, the arm's length nature of the royalty amount was challenged and ultimately was resolved through two closing agreements entered into in 2007. The first determined that the amount of an arm's length royalty was less than the amount paid. The second permitted BMC to treat the excess payment as a loan to the foreign subsidiary. This treatment, which has a long history in practice, was permitted under Rev. Proc. 99-32. As a result, the cash flow between BMC and its subsidiary was not changed but made to conform to the agreed amount of an arm's length royalty, and the return of the cash would be tax-free but for some deemed interest.

Unrelated to the I.R.S. examination and closing agreements, BMC received a qualifying cash dividend from its subsidiary and, pursuant to Code §965 in effect at the time, BMC claimed an intercompany dividends received deduction of $603 million, reflecting 85% of the dividend received. Code §965 allowed a one-time deduction of 85% of a dividend repatriation from a foreign subsidiary during the period 2003 to 2006. This provision was designed to encourage U.S. companies to unblock foreign earnings so that they could be paid into the U.S. economy. To prevent paper earnings without accompanying cash from qualifying for the deduction, Code §965(b)(3) prevents U.S. companies from making loans to foreign subsidiaries to fund repatriated dividends under Code §965. The repatriated dividends must be reduced by the amount of any increase in related party indebtedness held by a U.S. affiliate during a testing period beginning October 3, 2004 and ending at the close of the taxable year in which the dividend was paid.

In the course of examining the BMC tax return for 2006, the I.R.S. asserted that the deemed receivable arising from the closing agreement with the I.R.S. was an intercompany loan that was in existence in 2006 and that the amount of the deduction under Code §965 should be decreased by that receivable. This action reflected Notice 2005-64, which stated that accounts payable established under Code §482 adjustments should be treated as an indebtedness for purposes of §965(b)(3). The I.R.S. issued a deficiency notice and a petition was filed in the Tax Court.

The Tax Court upheld the I.R.S. determination and BMC appealed. The Appeals Court reversed. According to the Appeals Court, Code §965 specifically requires that the final amount of indebtedness must be determined by the close of the taxable year for which the election is being made. Since the taxable year was 2006, the relevant testing period ended on March 31, 2006. By March 31, 2006, the indebtedness did not exist because the accounts receivable did not exist, as the accounts receivable were created by the second agreement, which was closed in 2007. Even though the second agreement backdated the accounts receivable, it did not exist during the required period. Moreover, no cash in the form of a loan was actually advanced to the subsidiary during that period of time.

Although, I.R.S. Notice 2005-64 states that accounts payable established under Code §482 adjustments are treated as indebtedness for purposes of Code §965(b)(3), the Appeals Court did not defer to the I.R.S. position.[1] In comparison to a regulation, courts are free to judge whether the rationale and conclusion of a notice or a revenue ruling is persuasive.[2] Here, there was very little explanation or reasoning provided. Consequently, the Appeals Court concluded that Code §965 should be interpreted in accordance with its plain meaning.

The Appeals Court looked at the intent of BMC and the I.R.S. when entering into the second agreement, in order to determine whether BMC consented to having the accounts receivable treated as related party indebtedness for purposes of Code §965. The closing agreement never mentioned Code §965, and the boilerplate provision stating that the determination of the agreement was "for federal income tax purposes" was not sufficient to indicate consent, as the agreement specifically listed those tax implications that would occur as a result of the adjustment to the transfer price. No mention was made of the effect the agreement would have on the dividends received deduction under Code §965.

Consequently, the Appeals Court reversed the Tax Court decision and held that the meaning of the statute was plain and the accounts receivable adjustment fell outside the testing period. In addition, the boilerplate language could not be expanded to cover unlisted tax consequences. To do so would render the contract impermissibly broad and vague. Finally, the Appeals Court was not required to defer to the 2005 Notice, as it contained no persuasive reasoning.

1 Chevron USA, Inc. v. Natural Res. Def. Council, Inc., 104 S.Ct. 2778 (1984).

2 Skidmore v. Swift & Co., 65 S.Ct. 161 (1944).