TRANSFER PRICING ADJUSTMENT DOES NOT REDUCE DIVIDENDS RECEIVED DEDUCTION FROM C.F.C.

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Under a largely expired provision, a U.S. corporate shareholder of a controlled foreign corporation ("C.F.C.") could receive a one-time 85% dividends received deduction ("D.R.D.") for eligible cash dividends received from the C.F.C. However, the D.R.D. was reduced by any C.F.C. debt to any related party during the testing period. In a recent Tax Court case, the court held that there is only an increase in related-party indebtedness – and, thus, a reduction in the D.R.D. – if the indebtedness "existed" as of the close of the taxable year.

BACKGROUND

A U.S. corporation is allowed a D.R.D. for distributions received from a domestic subsidiary. The amount of the deduction varies. If a corporation owns less than 20% of the corporation paying the dividend, the D.R.D. is 70% of the dividend received. If the corporation's interest in the subsidiary ranges between 20% and 80%, the D.R.D. is 80% of the dividend received. For stakes exceeding 80%, the D.R.D. is 100% of the dividend received.[1] These deductions, complemented by the consolidated return rules, function somewhat imperfectly to tax corporate income only once until it is finally distributed to noncorporate shareholders. In general, no D.R.D. is available to U.S. corporate shareholders for dividends received from a C.F.C.

An exception previously existed under Code §965, by which a U.S. corporate shareholder could elect a one-time 85% D.R.D. for eligible cash dividends received from the C.F.C. Under this provision, the amount of the dividend was reduced by any C.F.C. indebtedness to a related party. However, indebtedness incurred in the ordinary course of business with a related party and paid within 183 days would not be subject to the reduction.[2] A taxpayer could make the election to either the taxpayer's last taxable year beginning on October 22, 2004, or the taxpayer's first taxable year starting during the one year period beginning on October 22, 2004.[3] Accordingly, although this provision has largely expired, its ramifications still transpire in the context of transfer pricing.

If an adjustment is made by the I.R.S. under transfer pricing principles, a taxpayer may need to make internal adjustments to its own accounts to reflect the original I.R.S. adjustment. Under I.R.S. procedures, internal adjustments required as a result of an I.R.S. adjustment, such as the creation of an "accounts receivable" between the related parties, does not result in income tax consequences.[4] In 2015,

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1 Code §243.

2 Code §965(b)(3); Notice 2005-64. Activities include sales, leases, licenses, or the rendition of services that a related person provides to or for a C.F.C.

3 Code §965(f).

4 Rev. Prov. 99-32, 1999-2 CB 296.

the Fifth Circuit, reversing a Tax Court holding, held that such an internal adjustment did not increase related-party indebtedness and, consequently, did not reduce the D.R.D.[5]

THE ANALOG DEVICES CASE

In *Analog*,[6] a U.S. corporation was the parent of a Dutch B.V., which was a C.F.C. The U.S. parent claimed the 85% D.R.D. on a distribution made from the subsidiary, and the U.S. parent did not report any related-party indebtedness that would reduce the amount of the D.R.D. The U.S. parent also received a 2% royalty payment from the C.F.C.

In a transfer pricing audit, the I.R.S. adjusted the 2% royalty payment and increased it to 6%. The U.S. parent and the C.F.C. established accounts receivable and deemed the accounts receivable created as of the last day of the tax year to which they related. However, the I.R.S. then held that the creation of the accounts receivable amounted to "related-party indebtedness" and thus reduced the D.R.D. for the C.F.C. dividend.

"A C.F.C. is only subject to an increase in related-party indebtedness if the debt existed as of the close of the election year."

The Tax Court rejected with the I.R.S. position, holding that the accounts receivable were not related-party indebtedness. The court further held that a C.F.C. is only subject to an increase in related-party indebtedness if the debt existed as of the close of the election year. Since the U.S. parent's testing period closed before the accounts receivable was created, the debt could not have existed as of the close of the year, and therefore, the full D.R.D. could be taken.

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5 *BMC Software, Inc. v. Commr.*, (CA 5 3/13/2015) 115 AFTR 2d 2015-1092.

6 *Analog Devices Inc. & Subsidiaries*, (2016), 147 TC No. 15.

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