DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE
NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
ATTORNEY

FROM: Valerie A. Mark
Assistant to the Branch Chief, CC:INTL:BR2

SUBJECT:

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<u>LEGEND</u>:

Corporation A =
FC1 =
DC1 =
FC2 =
FC3 =

Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Amount 1	=
Amount 2	=
Amount 3	=
Amount 4	=
Amount 5	=
Amount 6	=
Amount 7	=
Amount 8	=
Amount 9	=
Amount 10	=
Amount 11	=
Amount 12	=
Amount 13	=
Amount 14	=
Amount 15	=
Amount 16	=
Amount 17	=
Amount 18	=
Amount 19	=
Amount 20	=
Amount 21	=
Amount 22	=
Amount 23	=
Amount 24	=
X%	=
Y%	=

ISSUE:

Whether Corporation A's purported assignments of intercompany receivables of FC3 to FC2, to offset its overaged intercompany payable owed to FC2, must be respected for purposes of determining whether FC2 holds United States property under section 956?

CONCLUSION:

Although the form of Corporation A's transaction, if respected, would not support an adjustment under section 956, the substance of the transaction would warrant such an adjustment, under either of two theories. First, one could disregard Corporation

A’s assignments of intercompany receivables of FC3, to offset its overaged intercompany payable owed to FC2, because they had no substance and no economic effect upon Corporation A’s or FC2's financial condition since Corporation A continued to possess, control and use the cash related to the total assigned receivables. Therefore, FC2 continued to hold the obligation of a U.S. person for purposes of determining the amount of earnings of FC2 invested in United States property under section 956. Alternatively, the substance of the purported loan between FC1 and FC3 could be challenged, and the loan recharacterized as a loan to Corporation A, which would be taxable to the extent that there were earnings and profits in FC1. Assuming that the assignment of receivables is disregarded or shown to be a sham, the amounts distributed from FC2 to FC1 are disguised dividends, creating earnings and profits in FC1 to support a section 956 adjustment in the amount of the Master Loan.

FACTS:

Corporation A is a domestic corporation engaged in the manufacture, development and worldwide distribution of goods through a network of wholly owned domestic and foreign subsidiaries. For the taxable years at issue (Years 4 through 6), Corporation A directly owned FC1, a foreign corporation organized in Singapore, and DC1, a domestic corporation. FC1 in turn wholly owned two foreign subsidiaries, FC2 (incorporated in Singapore) and FC3 (incorporated in Netherlands). FC1 formed FC3 in Year 1 to engage in buy-sell activities with related parties for the goods manufactured by FC2. In addition to Corporation A’s ownership of FC1 and DC1, it also directly owned numerous European marketing subsidiaries (EMS) and non-European marketing subsidiaries (NEMS), during Years 4 through 6.

Purchase of Goods from FC2:

Corporation A organized FC2 to manufacture the goods that are sold to its world-wide customers. All goods manufactured by FC2 are first sold to Corporation A, who in turn sell these products to its customers through an intercompany chain of distribution between Corporation A and its numerous subsidiaries as described below. In general, the transfer price charged by FC2 to Corporation A is higher than the transfer price charged by Corporation A to its subsidiaries as the goods are sold from one entity to another within the chain of distribution.

For accounting purposes, Corporation A recorded the amount owed to FC2 for the purchase of goods in an intercompany payable account titled CA-A/P-FC2. FC2 in turn recorded on its books a corresponding amount due from Corporation A in its intercompany receivable account FC2-A/R-CA. As a result of these intercompany sales transactions, FC2 derived and accumulated significant earnings and profits.

Corporation A’s Policy Regarding Intercompany Transactions:

Corporation A's policy on intercompany purchases of goods is to buy the product on account by creating an intercompany accounts payable. This policy is applicable to both Corporation A and its domestic and foreign subsidiaries. The intercompany payables represent unsecured informal obligations related to open account trade debt which is extended by a related entity without any formal or written obligation to pay.

In accordance with industry practice, Corporation A established the policy that all intercompany trade accounts payable incurred among related entities are to be paid within sixty days on a first-in-first-out (FIFO) basis. Thus, pursuant to this policy, Corporation A has sixty days, from the date of purchase, to pay for the goods it acquired from FC2. Similarly, all subsidiaries that acquire goods from related entities, within the chain of distribution, also have sixty days to pay off their intercompany account payables.

<u>European Intercompany Distribution System</u>:

For accounting purposes, Corporation A established two intercompany distribution systems in connection with the sale of products to its world-wide customers. The first relates to the sale of products within Europe, and the second relates to sale of products outside of Europe. For the European sales, the intercompany chain of distribution originated with Corporation A, who then sold the products to DC1. DC1 in turn sold the goods to FC3, who then sold the products to EMS. EMS ultimately sold the goods to unrelated customers.

With respect to the sales transaction between Corporation A and DC1, the parties entered into a Distribution Agreement dated February 1, Year 2. Pursuant to that agreement, Corporation A appointed DC1 as the master distributor for goods destined for sale in Europe, Middle East and Africa. Corporation A retained title to the goods, and assumed the related risk of loss until delivery of such products to DC1's warehouse located in the Netherlands. Although DC1 assumed all costs of shipment to the authorized ports upon resale of the goods to the marketing subsidiaries, DC1 ultimately recovered those costs from such entities. Corporation A used the standard manufacturing cost as the transfer price for the goods sold to DC1 that were manufactured by FC2.

For accounting purposes, as the goods were sold from one related entity to another within the chain of distribution, each respective party recorded the sale/purchase transaction in its respective intercompany receivable and/or payable accounts. For example, when Corporation A sold the goods to DC1, Corporation A recorded an amount due from DC1 in its intercompany receivable account CA-A/R-DC1, and DC1 recorded the corresponding amount due to Corporation A in its intercompany payable account DC1-A/P-CA. When DC1 sold the products to FC3, DC1 recorded an amount due from FC3 in its intercompany receivable account DC1-A/R-FC3, and FC3 recorded the corresponding amount due to DC1 in its intercompany payable account FC3-A/P-DC1. As FC3 sold the products to EMS, FC3 recorded an amount due from EMS in its intercompany receivable account FC3-A/R-EMS, and EMS recorded the corresponding amount due to FC3 in its intercompany payable account EMS-A/P-FC3. As EMS sold the goods, it recorded the sale as a trade receivable from the customers.

Non-European Distribution System:

With respect to Non-European sales, the intercompany chain of distribution for accounting purposes also originated with Corporation A who then sold the products to FC3. FC3 in turn sold the goods to NEMS who then sold the products to unrelated customers.

Corporation A and FC3 also entered into a Distribution Agreement dated January 1, Year 3. Pursuant to that agreement, FC3 was appointed as the master distributor for goods destined for sale in Europe, Asia, the Middle East and Africa. With respect to the goods that were physically shipped from the United States, Corporation A retained title to the goods, and assumed the related risk of loss or damage,until the products reached the ports of entry generally used by its customers. However, if the products were shipped from outside the United States, FC3 took title and assumed the risk of loss within the country of origin in connection with the products. Corporation A used the standard manufacturing cost as the transfer price for the intercompany sale of goods to FC3 that were manufactured by FC2.

For accounting purposes, each respective party within the chain of distribution recorded the sale/purchase transaction using the same intercompany accounts receivable and payable mechanism as that of the European sales. That is, when Corporation A sold the goods to FC3, Corporation A recorded an amount due from FC3 in its intercompany receivable account CA-A/R-FC3, and FC3 recorded the corresponding amount due to Corporation A in its intercompany payable account FC3-A/P-CA. As FC3 sold the products to NEMS, FC3 recorded an amount due from NEMS in its intercompany receivable account FC3-A/R-NEMS, and NEMS recorded the corresponding amount due to FC3 in its intercompany payable account NEMS-A/P-FC3. As NEMS sold the goods, it recorded the sale as a trade receivable from the customers.

Customer Collections and Application of Cash:

Corporation A maintained a centralized cash management system for purposes of minimizing cash transfers among related entities, and maximizing the availability of cash for investment and working capital. Thus, as part of this centralized cash management system, Corporation A disbursed and received cash on behalf of a subsidiary in transactions involving unrelated parties and the respective subsidiary.

All customer payments were collected by either EMS or NEMS since these were the entities that ultimately sold the goods to Corporation A’s world-wide customers.

While the goods were considered sold through each entity within the chain of distribution for accounting purposes, the actual cash payments from the customers did not flow back, or get credited to the bank accounts of each of these entities. That is, the cash that was collected by EMS and NEMS were transferred directly to Corporation A.

However, for accounting purposes, the books and records of each entity reflected the cash collected by EMS and NEMS as payments against the intercompany payables that were generated in connection with the purchase of goods within either the European or Non-European chain of distribution. Therefore, as EMS and NEMS collected the cash from customer payments, they applied such funds for book purposes as payments against their respective intercompany payables owed to FC3, on a FIFO basis. As such, EMS and NEMS were considered to have applied their cash to pay the oldest outstanding intercompany payable balances owed to FC3.

In turn, FC3 reflected the cash collected on its books and reduced its respective intercompany receivables from EMS and NEMS on a FIFO basis. FC3 then applied that cash as payment against its intercompany payables owed to either Corporation A (Non-European transactions) or DC1 (European transactions) on a FIFO basis. Thus, FC3 applied that cash against the oldest outstanding payable balances owed to the respective entity, Corporation A or DC1.

Consequently, Corporation A and DC1 also had to reflect the foregoing cash transactions on their books. With respect to the Non-European chain of distribution, Corporation A accordingly decreased its receivable from FC3, and increased the balance in its cash account. That increase to its cash account actually represented the cash that was directly transferred by NEMS to Corporation A.

As for the European chain of distribution, DC1 recorded the application of cash by first reducing its receivable from FC3, and then reducing the intercompany payable owed to Corporation A on a FIFO basis. That is, DC1 applied the cash as payment against the oldest outstanding payable balances owed to Corporation A. Thereafter, Corporation A reflected the application of cash by decreasing the intercompany receivable from DC1 and increasing its cash account. That increase to its cash account reflected the cash that was directly transferred by EMS to Corporation A.

Activities of FC3:

For Netherlands tax reporting purposes, FC3 characterized its back-to-back buy-sell transactions as financing activities, whereas for U.S. tax purposes, it characterized those same activities as a sale of goods. For both European and Non-European sales, FC3 used the same transfer price for both purchase and resale of the goods, and thus, its back-to-back intercompany purchases/sales transactions produced no profit.

In November Year 2, FC1 provided additional capital contributions to FC3 so the latter could acquire the warehouse distribution center (WDC) from DC1 located in the Netherlands. The acquisition of the WDC was subject to a lease-back by DC1, and pursuant to the net lease agreement executed between the parties, FC3 would receive rental income totaling the aggregate of the ascertainable depreciation costs, plus the net expenses of the lessor and the interest payable on the mortgage loan related to the WDC. FC3 would also receive reimbursement from DC1 for all costs associated with the ownership of the WDC, plus a profit on the lease-back transaction of X% on the unpaid mortgage loan balance. In addition, FC3 would be compensated at cost plus Y% for logistical services performed in connection with WDC. These services were performed by FC3's employees which consisted of less than ten individuals.

Corporation A's Intercompany Payable to FC2:

The balance in Corporation A's intercompany payable to FC2 (CA-A/P-FC2) increased each time Corporation A purchased goods from FC2. To reduce the balance in CA-A/P-FC2, Corporation A either: (1) made a lump sum cash payment to FC2, (2) made payments to third-party vendors on behalf of FC2, or (3) netted the balance from an intercompany accounts payable owed by FC2 to Corporation A.

To determine the amount that was outstanding for more than sixty days at the end of each fiscal quarter in Corporation A's payable account CA-A/P-FC2, it calculated the opening balance in the account CA-A/P-FC2 at sixty days preceding the end of the current quarter, less all payments made to that date, or to be made during the succeeding sixty-day period within the end of the current quarter, applied on a FIFO basis. The resulting balance represented the portion of Corporation A's payable account held by FC2 that had been outstanding for more than sixty days (overaged amount). During Years 4 through 6, Corporation A determined that the following amounts in payable account CA-A/P-FC2 were overaged:

Date	Overaged Amount in Account CA-A/P-FC2
2/28, Year 4	Amount 1
8/31, Year 4	Amount 3
11/30, Year 4	Amount 5
2/28, Year 5	Amount 6
5/31, Year 5	Amount 8
5/31, Year 6	Amount 10

Assignment of Receivables by Corporation A:

In order to avoid current income inclusion pursuant to section 956, Corporation A sought to reduce the overaged amounts (i.e. Amounts 1, 3, 5, 6, 8, and 10) in its payable account CA-A/P-FC2 by assigning to FC2 Corporation A's intercompany receivables due from FC3 that were originally derived by Corporation A in connection with the sale of goods to FC3. For each assignment within Year 4, Corporation A took certain balances in its receivable account CA-A/R-FC3 and transferred those balances to FC2 as payment against the overaged portion in the payable account CA-A/P-FC2. Corporation A applied the FIFO method in selecting the assigned receivables in account CA-A/R-FC3. Under the FIFO method, Corporation A was deemed to have assigned the oldest balance outstanding in receivable account CA-A/R-FC3 to FC2. During Year 4, Corporation A assigned the following amounts to FC2 from receivable account CA-A/R-FC3:

Date	Overaged Amount in Account CA-A/P-FC2	Amount Assigned from Account CA-A/R-FC3
2/28, Year 4	Amount 1	Amount 2
8/31, Year 4	Amount 3	Amount 4
11/30, Year 4	Amount 5	Amount 5

As of the first fiscal quarter in Year 5, Corporation A began assigning receivables held by DC1 that were due from FC3 to satisfy its overaged payable to FC2. Specifically, Corporation A assigned account DC1-A/R-FC3 as payment against the overaged payable balance owed to FC2. Hence, the receivables that were assigned as of Year 5 were not the assets of Corporation A, but rather the assets of DC1 that were derived from the sale of goods between DC1 and FC3 as part of the European chain of distribution. It is assumed that for purposes of the assignment related to account DC1-A/R-FC3, Corporation A also applied the FIFO method and transferred the oldest receivable balances in that account to FC2. During Years 5 and 6, Corporation A assigned the following amounts to FC2 from receivable account DC1-A/R-FC3:

Date	Overaged Amount in Account CA-A/P-FC2	Amount Assigned from Account DC1-A/R-FC3
2/28, Year 5	Amount 6	Amount 7
5/31, Year 5	Amount 8	Amount 9
5/31, Year 6	Amount 10	Amount 11

Transfer of Corporation A's FC3 Receivables by FC2 to FC1 and Master Loan.

After FC2 received the assigned receivable CA-A/R-FC3 for Amount 2 on February 28, Year 4, FC2 distributed that entire receivable as a non-cash dividend to FC1 in April Year 4. Accordingly, as of April Year 4, FC1 was the new holder of the receivable CA-A/R-FC3.

FC1 converted this receivable to a long-term note receivable that would be owed by FC3 under a pre-existing master loan agreement. This master loan agreement was entered into between FC1 and FC3 in November Year 2. Under this agreement, FC1 granted FC3 a line of credit to borrow a maximum of Amount 12 (Master Loan). That line of credit has been subsequently increased to Amount 13. The principal amount was due in thirty years, on October 31, Year 7, and the interest was payable on a quarterly basis at LIBOR. While FC3 remained the ultimate obligor regardless of whether the debt was an open account trade payable or a long-term thirty-year note, the effect of this conversion was to replace an open account trade debt that was subject to payment within sixty days, with a long-term note whose principal was due in thirty years.

As previously noted, FC3 received minimal income from its activities. It received a small mark-up for performance of logistical services relating to the Netherlands''s warehouse distribution center and a small profit from the lease-back of that center to DC1, but it earned no income from its back-to-back buy-sell transactions because it used the same transfer price for both purchase and resale of the goods within the chain of distribution. To comply with the Netherlands's tax characterization of the buy-sell transactions as financing activities, FC3 was required to show a certain net income for each taxable year. Once FC3 began to accrue the interest expense in Year 4 under the Master Loan, it no longer had any net income. To create net income, both Corporation A and FC3 made year-end adjustment that effectively reduced the transfer price on the goods sold from Corporation A to FC3. The amount of the year-end adjustment was equal to the interest expense accrued by FC3 under the Master Loan.

With respect to the remainder of the assignments that occurred in August Year 4 through May Year 6, Corporation A and its related entities continued to engage in the above described transfers with certain modifications. Specifically, after Corporation A assigned the receivable account CA-A/R-FC3 to FC2 in August Year 4, FC2 transferred that receivable to FC1 as a non-interest bearing loan instead of a dividend distribution. Corporation A represents that the transfers between FC2 and FC1 were structured as non-interest bearing loans because of the restrictions under Singapore law regarding the payment of dividend, and that FC1 had no intent to repay those loans. Rather, they would be forgiven once the Singaporean authority granted approval to FC2 to distribute a dividend. Therefore, the non-interest bearing loans from FC2 to FC1 represent disguised dividends.

During Years 4 though 6, FC2 transferred the following receivable amounts to FC1 as non-interest bearing loans:

Date Receivable Assigned to FC2	Account Assigned to FC2	Amount Assigned to FC2 and Transferred to FC1	Date Transferred to FC1 as Non-Interest Loan

8/31, Year 4	CA-A/R-FC3	Amount 4	6/28, Year 5
11/30, Year 4	CA-A/R-FC3	Amount 5	6/28, Year 5
2/28, Year 5	DC1-A/R-FC3	Amount 7	November, Year 5
5/31, Year 5	DC1-A/R-FC3	Amount 9	November, Year 5
5/31, Year 6	DC1-A/R-FC3	Amount 11	August, Year 6

Application of Cash Collections Related to the Assigned Receivables:

Since FC3 was the obligor on the receivable accounts CA-A/R-FC3 and DC1-A/R-FC3, FC3 maintained separate intercompany payables to reflect the amounts owed to Corporation A and DC1 in payable accounts FC3-A/P-CA and FC3-A/P-DC1 respectively. As a result of Corporation A's assignment of receivable accounts CA-A/R-FC3 and DC1-A/R-FC3, FC3 was required to pay the holder of such receivables (either FC2 or FC1) in accordance with the assignment transactions. To comply with Corporation A's FIFO policy of paying intercompany payables within sixty days, FC3 would have been required to apply the customer cash collections received by EMS or NEMS against the oldest balances in FC3's payable accounts (FC3-A/P-CA and FC3-A/P-DC1) to Corporation A and DC1 on a FIFO basis. However, the cash was never applied to the benefit of either FC2 or FC1 pursuant to the assignment. As cash (i.e., Amounts 15 through 23) was received after each assignment transaction, the cash was credited to Corporation A with respect to the unassigned balances, thus leaving no cash to be applied to the benefit of FC2 or FC1.

FC3's Payment on the Master Loan:

On or about February, Year 6, Corporation A transferred Amount 24 to FC1 as payment against the principal owed by FC3 to FC1 under the Master Loan. As a result of this transfer, FC3 decreased the amount of debt owed to FC1 under the Master Loan and, in lieu thereof, increased its intercompany payable owed to Corporation A by Amount 24.

LAW AND ANALYSIS:

FC1, FC2 and FC3 are controlled foreign corporations (CFCs) within the meaning of section 957(a). Corporation A is the U.S. shareholder of these CFCs pursuant to section 951(b), and is therefore required, under section 951(a)(1)(B), to include in gross income for the current taxable year, its pro rata share of the amount of earnings of the CFCs invested in United States property, as determined under section 956.

Section 956(c)(1) defines United States property to include, inter alia, an obligation of a United States person. Section 956(c)(2) however, excepts certain transactions from the definition of United States property, one of which is described under subparagraph (C):

> [A]ny obligation of a United States person arising in connection with the sale or processing of property if the amount of such obligation outstanding at no time during the taxable year exceeds the amount which would be ordinary and necessary to carry on the trade or business of both the other party to the sale or processing transaction and the United States person had the sale or processing transaction been made between unrelated persons ....

Treas. Reg. § 1.956-2(b)(1)(v) states that whether the amount of an obligation is ordinary and necessary is to be determined from all the facts and circumstances under each case.

In this case, Corporation A argues that, in accordance with industry practice, it is ordinary and necessary for its intercompany payables to FC2 to remain outstanding for a period of up to sixty days. Therefore, at the end of each fiscal quarter, Corporation A reviewed its intercompany payables to FC2 to determine whether there were any balances outstanding beyond sixty days. To the extent that amounts were outstanding beyond sixty days, Corporation A assigned receivable accounts, CA-A/R-FC3 and DC1-A/R-FC3, to FC2 as payment against the overaged payable balances.

Corporation A claims that by virtue of the assignment of the receivables to FC2, Corporation A satisfied its obligation to pay FC2 with respect to the overaged payables, and therefore, Corporation A had no payable amounts outstanding to FC2 for a period beyond what is considered ordinary and necessary under Treas. Reg. § 1.956-2(b)(1)(v). Therefore, Corporation A takes the position that it is not subject to current income inclusion under section 951(a)(1)(B) because its intercompany payables to FC2 were excluded from the definition of United States property under section 956(c)(2)C).

If the Service respects the form of the assignments by treating them as valid payments by Corporation A to FC2 that extinguished its obligation to FC2, Corporation A would not be subject to current income inclusion under section 951(a)(1)(B). In that case, FC2 would not hold any United States property for purposes of section 956. However, the facts suggest that the Service should disregard the form.

In general, a taxpayer is entitled to have a transaction taxed in accordance with its form provided that the substance of the transaction is consistent with the form. However, the Service has been allowed to discount the form of a transaction and determine the tax consequences based on its substance if the form does not comport with the substance. *See* Gregory v. Helvering, 293 U.S. 465.

Numerous factors indicate that there is an inconsistency between the form and substance of Corporation A’s transactions. These include: (1) FC2's willingness to accept the assignment of Corporation A’s overaged receivables due from FC3 in satisfaction of the overaged intercompany payables owed by Corporation A to FC2, notwithstanding the fact that FC3 was applying all of its incoming cash to first pay Corporation A on the underaged payables owed to Corporation A by FC3; (2) FC1's willingness both to accept an overaged assigned receivable as a dividend, or disguised dividend, from FC2 and, subsequently, to convert the overaged assigned receivables into a long-term note under the Master Loan; (3) FC1's willingness to allow FC3 to use all of FC3's incoming cash to prepay underaged payables due to Corporation A, leaving FC3 with no ability to accumulate funds to repay the Master Loan; and (4) the fact that Corporation A was the party that economically bore the interest expense under the Master Loan and provided Amount 24 to repay the principal under the loan. In light of these questionable facts, the Service has a reasonable basis to challenge Corporation A's argument that it is not subject to current income inclusion by reason of section 956 under the doctrine of substance over form.

The substance over form doctrine provides that while taxpayers are free to structure their transaction in any form they choose, the substance of the transaction governs for federal income tax purposes. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935). The doctrine of substance over form focuses on the "objective economic realities of a transaction rather than the particular form the parties employed." Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978).

> [The Supreme 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.

Id. (citations omitted). In applying the doctrine of substance over form, the courts look to the transaction "as a whole, and each step, from the commencement ... to the consummation ... is relevant. ACM Partnership v. Commissioner, 157 F3d. 231, (3rd Cir. 1998) (*citing* Weller v. Commissioner, 270 F.2d 294, 297 (3rd Cir. 1959)).

In Gregory v. Helvering, the taxpayer attempted to avoid dividend income by structuring a series of steps to disguise the form of the transaction as a corporate reorganization. However, the court did not respect the form of the transaction even though the taxpayer satisfied each element of the reorganization provision because "the whole undertaking, though conducted according to the statutory terms ... was in fact an elaborate and devious form of conveyance masquerading as a corporation reorganization.". Gregory v. Helvering, 293 U.S. at 469.

There are two possible theories that would support an adjustment by reason of section 956 under the doctrine of substance over form. The first theory is that even though an assignment of a receivable can constitute payment if there is an absolute and unqualified assignment of an interest in judgment in return for the cancellation of the assignor's liability on a note, such assignment would not be respected for tax purposes if it lacks economic substance. *See e.g.,* Marteney v. United States, 245 F.2d 135, 138 (10th Cir. 1957). In this case, the assignment lacks economic substance because as the parent company of its wholly-owned subsidiaries, Corporation A controlled such entities and designed a series of individual accounting journal entries that had to be recorded by each subsidiary to give the appearance that Corporation A paid its overaged payables to FC2. In structuring these series of transactions, it is evident that Corporation A sought to reduce its overaged payables to FC2 to avoid section 956, but did not intend to give any cash, or other property, to the benefit of FC2 at the time the assignments were made. For this reason, Corporation A created an illusory payment by assigning the oldest receivable balances in accounts CA-A/R-FC3 and DC1-A/R-FC3 to FC2 without fully relinquishing possession and control over the underlying cash related to such assigned receivables. In fact, after each assignment, Corporation A retained the cash related to the assigned receivables.

During Years 4 through 6, Corporation A assigned receivables totaling Amount 14 to FC2. As FC3 was credited with the cash from customer collections from EMS and NEMS, FC3 was required, under industry practice and Corporation A's internal accounting policy, to credit those funds to first pay off receivables that were held by FC2 since such receivables represented the oldest balances that were assigned by Corporation A in accounts CA-A/R-FC3 and DC1-A/R-FC3 (i.e. FIFO application). Instead, after each assignment, Corporation A directed FC3 to apply the cash collected (i.e. Amounts 15, 16, 17, 18, 19, 20, 21, 22, and 23), to the unassigned receivable balances held by Corporation A and DC1. Consequently, none of the cash was credited to FC2 with respect to the assigned receivables. In substance, Corporation A does not appear to have divested itself of its interest in, or control over, the property assigned to FC2. In an arms length transaction, it is unlikely that an unrelated creditor would accept an assigned receivable as payment on a debt when the assignor did not relinquish control over the underlying cash related to the assigned receivables.

Even after FC2 received the assigned receivables and distributed them to FC1 as a dividend, or disguised dividend in the form of a non-interest bearing loan, Corporation A continued to retain the cash related to those assigned receivables. Since FC1 was the new holder of the assigned receivables, any cash collected by FC3 should have enured to the benefit of FC1. However, such cash collections again were credited to Corporation A. Because FC1 converted the amounts due under the assigned receivables to a long-term thirty-year note receivable, FC3 was under no obligation to pay such amounts until Year 7 in accordance with the Master Loan. By converting the sixty-day trade receivable to a thirty-year note receivable, Corporation A relieved FC3 from having to apply any cash collections to FC1 on behalf of the assigned receivables, thereby permitting FC3 to redirect the cash collection to the benefit of Corporation A.

FC3 did not make any payments under the Master Loan. The interest expense arising from the Master Loan was borne by Corporation A through the year-end adjustments that effectively reduced the transfer price on the goods sold from Corporation A to FC3. The amount of year-end adjustments equaled the interest expense accrued by FC3 under the Master Loan.

Moreover, all of the funds used to pay the principal amount under the Master Loan were also provided by Corporation A. In February, Year 6, Corporation A transferred Amount 24 to FC1, on behalf of FC3, as principal payment under the Master Loan. Moreover, FC3 would not have had any funds to pay the principal amount since all of its cash received from EMS and NEMS were directed to pay Corporation A on FC3's intercompany payable owed to Corporation A.

Based on these facts, it appears that the assignments had no economic substance upon Corporation A's or FC2's financial condition because Corporation A continued to possess, control and use the cash related to the total assigned receivables of Amount 14. The form of the transactions at issue (i.e. assignment of receivables to FC2, followed by a disguised dividend to FC1 with a subsequent conversion into the master loan between FC1 and FC3) was undertaken so Corporation A could qualify for the section 956(c)(2)(C) exception without actually making any payments for the goods it purchased from FC2. Accordingly, FC2 continued to hold United States property for a period of time beyond that which would be considered ordinary and necessary to carry on the trade or business of both Corporation A and FC2.

The second theory that the Service may argue is that the amounts that were distributed from FC2 to FC1 as dividends, or disguised dividends, in substance, were not the assigned receivables from Corporation A that were owed by FC3, but instead were FC2's own overaged receivables due from Corporation A. This theory is premised on the Service's ability to recharacterize Corporation A's transactions to comport with their substance, including the events related to the assignments of receivables, distribution of assigned receivables as dividends or disguised dividends, and the conversion of the assigned receivables into a long-term note under the Master Loan. Since the transactions herein involve related parties, it would be appropriate for the Service to recharacterize the transactions so the incidents of taxation reflect the true economic substance of the transaction. *Cf.* Treas. Reg. § 1.482-1(d)(3)((ii)(B).

These transactions would be recharacterized as follows. To the extent that FC2 is treated as having distributed its own overaged receivables due from Corporation A as a dividend, or disguised dividend, to FC1, then such distribution would increase the amount of earnings and profits of FC1, even if the dividends do not result in subpart F income for FC1 by reason of the exception under section 954(c)(3)(A). Upon receiving FC2's overaged receivables due from Corporation A, FC1 converted those receivables into a thirty-year note receivable under the Master Loan. Although the Master Loan was structured between two foreign corporations (FC1 and FC3), in substance, that transaction was a loan between FC1 and Corporation

A. As previously noted, Corporation A was the party that ultimately assumed the interest expense on the Master Loan via a year-end adjustment to the transfer price for the goods sold to FC3, and Corporation A was the party that provided Amount 24 to FC3 to repay the principal under the Master Loan. Consequently, it could be argued that the debtor under the Master Loan is Corporation A rather than FC3. Therefore, when FC1 converted the receivables into the Master Loan, that loan should be treated as an obligation of a United States person under section 956 to which the section 956(c)(2)(C) exception would not apply. Accordingly, Corporation A would be subject to a current income inclusion under section 951(a)(1)(B) by reason of the Master Loan.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

Please call if you have any further questions.

By: VALERIE A. MARK
Assistant to the Branch Chief
CC:INTL:Br2