

## LB&I Concept Unit

<b>Unit Name</b>	Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)	
<b>Primary UIL Code</b>	9423.05-02	Application of section 267(a)(3) to related party debt interest – post Tax Cut Jobs Act (TCJA)

Library Level	Title
<b>Knowledge Base</b>	International
<b>Shelf</b>	Business Inbound
<b>Book</b>	Inbound Financing
<b>Chapter</b>	Matching Principle 267(a)(3)

<b>Document Control Number (DCN)</b>	INT-C-262
<b>Date of Last Update</b>	05/03/23

*Note: This document is not an official pronouncement of law, and cannot be used, cited or relied upon as such. Further, this document may not contain a comprehensive discussion of all pertinent issues or law or the IRS's interpretation of current law.*

# Table of Contents

*(View this PowerPoint in “Presentation View” to click on the links below)*

[General Overview](#)

[Facts of Concept](#)

[Detailed Explanation of the Concept](#)

[Examples of the Concept](#)

[Index of Referenced Resources](#)

[Training and Additional Resources](#)

[Glossary of Terms and Acronyms](#)

[Index of Related Practice Units](#)

# General Overview

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

Foreign businesses often capitalize their U.S. subsidiaries (USS) with both equity and intercompany debt. The use of intercompany debt may allow for deductible interest expense which reduces U.S. taxable income. Such related party debt may be from a foreign parent company or one of its offshore affiliates, often in a low tax jurisdiction. The related party debt may be provided as part of the initial formation of the USS, to finance an acquisition, and/or for a major capital expansion. U.S. tax law has several restrictions and limitations on the deductibility of USS's interest expense on such debt with foreign related parties. IRC 267 addresses losses, expenses, and interest with respect to transactions between related taxpayers. The purpose underlying IRC 267(a) is to prevent related persons from using different methods of accounting for federal tax purposes in order to mismatch the timing of deductions/losses and inclusions inappropriately.

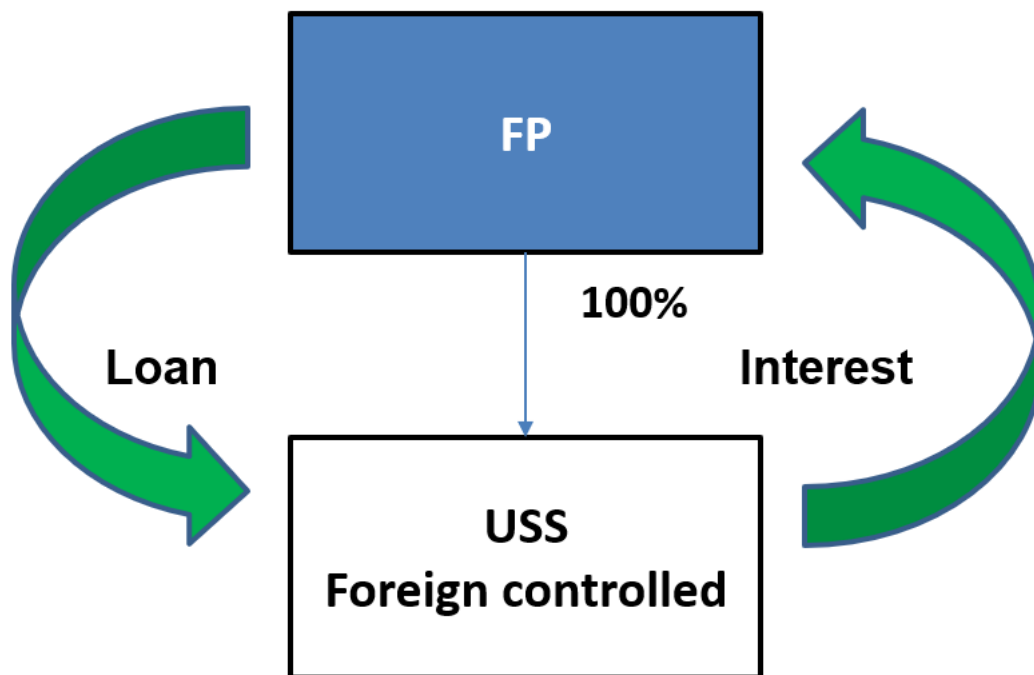
Interest expense attributable to bona fide debt between a USS (borrower) and its foreign parent (FP) or foreign affiliate (lender) is limited to interest considered paid under the cash method of accounting regardless of the taxpayer's overall method of accounting. Essentially, USS is required to use the cash method of accounting with respect to this deduction. An amount owed to a related foreign person may not be deducted by USS until the amount is paid to the related foreign person. If an amount is not paid within the cash method of accounting, the deduction will be deferred until paid. This is often referred to as the matching principle. The matching principle matches the recognition of deductions with the related income in the same taxable year. Without the matching principle, a deduction could be taken while the corresponding income is deferred indefinitely.

This Practice Unit examines the deductibility of interest expense under the provisions of IRC 267(a)(3). This unit does not examine other interest limitations that may apply such as IRCs 267A, 163(j), 482, etc. The focus of this unit is purely on IRC 267(a)(3). This unit assumes that the debt is bona fide debt under IRC 385.

# Facts of Concept

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

Diagram of Concept



- USS is wholly owned by FP and both corporations use the accrual method of accounting.
- USS borrows funds denominated in U.S. dollars from its FP to reduce its U.S. tax liability while funding major capital acquisitions. The loan requires monthly interest payments to FP.
- The loan is bona fide debt under IRC 385 (see Practice Unit: Bona Fide Debt Determination as the debt v. equity considerations are important to the capital structure of any business as it affects the cost of capital and borrowing).
- Assume the debt is priced at an arm's length result under IRC 482 (see Practice Unit: IRC 482 Arm's Length Interest Rate for Intercompany Debt for how to make this determination).
- There is no effectively connected income (ECI).

# Detailed Explanation of the Concept

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

Many foreign owned USSs enter intercompany debt financing arrangements to reduce their U.S. tax liability while funding major acquisitions or capital spending. Interest expense attributable to bona fide debt between a USS (borrower) and its FP or affiliate (lender) is limited to interest considered paid under the cash method of accounting regardless of USS's overall method of accounting.

Analysis	Resources
<p>IRC 267(a)(1) discusses when deductions for losses are disallowed. It states no deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between certain related parties. An exception is any loss of the distributing corporation (or the distributee) in the case of a distribution in complete liquidation of the corporation.</p> <p>The related parties are those depicted in IRC 267(b). Related parties relevant to typical LB&amp;I examinations include, but are not limited to (See IRC 267(b) for full list):</p> <ul style="list-style-type: none"> <li>▪ An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual.</li> <li>▪ Two corporations which are members of the same controlled group (defined as more than 50% of the total combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock).</li> <li>▪ A corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock of the corporation, and more than 50 percent of the capital interest, or the profits interest, in the partnership.</li> <li>▪ An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation.</li> <li>▪ An S corporation and a C corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation.</li> <li>▪ See IRC 267(b) for other possible relevant related parties subject to IRC 267.</li> </ul>	<ul style="list-style-type: none"> <li>▪ <i>IRC 267(a)(1) - Losses, Expense, And Interest With Respect to Transactions Between Related Taxpayer, In General</i></li> <li>▪ <i>IRC 267(b) - Relationships</i></li> </ul>

# Detailed Explanation of the Concept (cont'd-1)

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

### Analysis

Taxpayers subject to IRC 267(a)(2) must apply the matching principle. The matching principle matches the payor's deduction and the payee's income to the same period. Without the application of this code section, the timing of the deduction and income could be mismatched due to differences in accounting methods of the payor and payee. IRC 267(a)(2) states that if, by reason of its accounting method, the payee does not include the payment received in gross income (and it is not treated as paid for purposes of IRCs 1441 or 1442) and at the close of the taxable year of the payor the amount would be deductible, then any deduction allowable is allowed as of the last day of which the amount is includible in the gross income of the person to whom the payment is made (or if later, as of the day on which it would be so allowable but for IRC 267(a)(2)).

A special rule applies to payments to foreign persons under IRC 267(a)(3). In general, the matching principle stated above applies in cases in which the person to whom the payment is to be made is not a U.S. person. In the case of any item payable to a controlled foreign corporation (CFC) or a passive foreign investment company (PFIC), a deduction is allowable to the payor for any amount for any taxable year before the taxable year in which paid only to the extent that an amount attributable to the item is includible (determined without regard to properly allocable deductions and qualified deficits under IRC 952(c)(1)(B) dealing with insurance income) during the prior taxable year in the gross income of a U.S. person who owns the corporation directly or indirectly within the meaning of IRC 958(a). Therefore, this rule does not apply if no U.S. person owns stock of the recipient CFC or PFIC within the meaning of IRC 958(a).

### Resources

- IRC 267(a)(2) – *Matching of Deduction and Payee Income Item In The Case Of Expenses And Interest*
- IRC 267(a)(3) – *Payments to Foreign Persons*
- IRC 1297(a) – *Passive Foreign Investment Company*
- IRC 957(a) – *Controlled Foreign Corporations; United States Persons*
- IRC 952(c)(1)(B) – *Insurance Income*
- IRC 958(a)(1) – *Rules For Determining Stock Ownership*
- Treas. Reg. 1.267(a)-3(b) – *Deduction of amount owed to related foreign person*

# Detailed Explanation of the Concept (cont'd-2)

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

### Analysis

A CFC is a foreign corporation if more than 50% of the total combined voting power of all classes of stock entitled to vote or the total value of the stock is owned (within the meaning of IRC 958(a)) or considered owned by U.S. shareholders by applying the ownership rules of IRC 958(b) on any day during the taxable year of the foreign corporation.

A PFIC is defined as any foreign corporation if 75% or more of the gross income for the taxable year is passive or the average percentage of assets held during the taxable year which produce passive income or which are held for the production of passive income is at least 50%.

What all this sums up to is that IRC 267(a)(3) generally requires the taxpayer to use the cash method of accounting with respect to the deduction of amounts owed to foreign related parties. That means an amount that is owed to a related foreign person and that is otherwise deductible under Chapter 1 generally may not be deducted by the taxpayer until such amount is paid to the related foreign person. An amount is treated as paid if the amount is considered paid for purposes of IRCs 1441 or 1442.

### Resources

- IRC 951(b) – *United States Shareholder Defined*
- IRC 1297(a) – *Passive Foreign Investment Company*
- Treas. Reg. 1.267(a)-3(b) – *Deduction of amount owed to related foreign person*

# Detailed Explanation of the Concept (cont'd-3)

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

### Analysis

### Resources

#### What is Considered a Payment?

The netting of foreign related party payables and receivables between a U.S. subsidiary and its foreign related party is allowable. However, circular cash payments are not considered cash payments for purposes of IRC 267(a)(3).

In *Battelstein v. IRS*, 611 F.2d 1033 (5th Cir. 1980), U.S. individual taxpayers borrowed money from a domestic person, Gibraltar Saving Association (Gibraltar). Gibraltar agreed to loan the Battelsteins more than three million dollars to cover the purchase of a piece of property. Gibraltar also agreed to make the Battelsteins future advances of the interest costs on this loan as they became due (i.e., the individuals borrowed more money from Gibraltar and used it to pay the interest on the original loan from Gibraltar). The Battelsteins never paid interest except by way of these advances. The Battelsteins claimed they had made payment of the interest despite the circular nature of the cash flows. The Fifth Circuit agreed with the IRS holding that the taxpayers did not “pay” any interest and were not entitled to an interest deduction. The Fifth Circuit stated, “What happened at the time of each of the exchanges, as the Battelsteins now concede, is that the Battelsteins gave Gibraltar their note promising to pay the amount of interest then due, plus interest, in the future . . . Payment for tax purposes must be made in cash or its equivalent, and a note promising payment of cash in the future is not cash or its equivalent.” See also *Davison v. Commissioner*, 107 T.C. 35 (T.C. 1996), aff’d, 141 F.3d 403 (2d Cir. 1998).

- *Battelstein v. IRS*, 611 F.2d 1033 (5th Cir. 1980)
- *Davison v. Commissioner*, 107 T.C. 35 (T.C. 1996), aff’d, 141 F.3d 403 (2d Cir. 1998)



# Detailed Explanation of the Concept (cont'd-4)

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

### Analysis

### Resources

#### What is Considered a Payment? (cont'd)

- In Chief Counsel Advice (CCA) 201334037, the IRS concluded that wire transfers of funds to related foreign persons that the taxpayer treated as payments of interest are not deductible under IRC 267(a)(3) (whether considered made by wire transfer or notes). The facts in this CCA were that USS recorded what it deemed to be payments of interest to FP financings advanced to USS. In each instance, funds sufficient to cover these payments were obtained shortly before or after a claimed payment of interest, either through additional loans from the FP or through draw-downs on one or more lines of credit with the FP that were credited to the taxpayer's general account. The IRS relied on case law disallowing deduction of interest in cases of circular cash flow, citing *Battelstein* and *Davison*. The IRS argued that "when funds are (in form) loaned by the FP to the taxpayer and "paid" back via return wire transfers, the resulting "U-turn" transaction is one that changes neither the economic position of the lender nor the borrower. The IRS further argued that in form, the FP received wire transfers in payment of claimed interest expense, but in substance, the wire transfers achieved no economic change in position. The IRS further noted that because the FP has a relationship with the debtor via an equity interest, it is willing to indefinitely defer realization and recognition of the fruits of its investment in the taxpayer. The IRS concluded that under these circumstances and applying the Tax Court's analysis in *Davison*, the borrowed funds were, in substance, the same funds used to satisfy the interest obligation and that the real and underlying purpose of the loans here at issue was to substantiate (albeit superficially and in form only) a deduction for an amount claimed to be a "payment" within the meaning of the cash method of accounting. Thus, under these facts, the taxpayer may not claim a deduction for interest so paid.

- CCA 201334037 – *Application of section 267(a)(3) to certain claimed payments of interest made to related foreign persons and associated with related foreign person borrowings*

# Detailed Explanation of the Concept (cont'd-5)

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

Analysis	Resources
<p><u>Tax Cut Jobs Act (TCJA) Impact</u></p> <p>IRC 318 governs the constructive ownership of stock. IRC 318(a)(3) attribution (“downward attribution”) rules state:</p> <ul style="list-style-type: none"> <li>▪ If 50% or more in value of the stock of a corporation is owned, directly or indirectly, by or for any person, the corporation is considered as owning the stock owned, directly or indirectly, by or for such person.</li> <li>▪ Stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate is considered as owned by the partnership or estate.</li> <li>▪ In general, stock owned, directly or indirectly, by or for a beneficiary of a trust is considered as owned by the trust, unless the interest is contingent.</li> </ul> <p>The IRC 318 attribution rules generally apply in determining ownership of foreign corporations for purposes of subpart F under IRC 958. Pre-TCJA, IRC 958(b)(4) stated that the downward attribution rules did not apply to consider a U.S. person as owning stock which is owned by a person who is not a U.S. person. Meaning, there was no downward attribution causing a foreign person’s ownership to be attributed down to a U.S. person. However, the TCJA repealed IRC 958(b)(4).</p>	<ul style="list-style-type: none"> <li>▪ IRC 318 – <i>Constructive Ownership of Stock</i></li> <li>▪ Pre TCJA IRC 958(b)(4) – <i>Constructive Ownership</i></li> </ul>

# Detailed Explanation of the Concept (cont'd-6)

Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)	
Analysis	Resources
<p><u>Tax Cut Jobs Act (TCJA) Impact (cont'd)</u></p> <p>As a result of this repeal, certain foreign companies that previously were not considered CFCs became CFCs.</p> <p>Treasury Reg. 1.267(a)-3(c)(4) addressed the issue caused by the repeal of IRC 958(b)(4) and the creation of new CFCs which may not have any U.S. shareholders that own stock within the meaning of IRC 958(a). It provides that an amount that is income of a related foreign person is exempt from the application of IRC 267(a)(3)(B)(i) if the related foreign person is a CFC that does not have any IRC 958(a) U.S. shareholders.</p>	<ul style="list-style-type: none"> <li>▪ <i>Treas. Reg. 1.267(a)-3(c)(4) – Amounts owed to a foreign personal holding company, controlled foreign corporation, or passive foreign investment company</i></li> </ul>

# Detailed Explanation of the Concept (cont'd-7)

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

### Analysis

### Resources

#### Exceptions and Special Rules

- Another exception to the general cash method of accounting rule applies for ECI of a related foreign person (see the Jurisdiction to Tax Practice Units explaining what income equates to ECI). ECI interest is generally subject to the matching rule under IRC 267(a)(2) but is generally NOT subject to the cash method rule of Treas. Reg. 1.267(a)-3(b). (Note: IRC 267(a)(2) is not covered by the Inbound Financing Practice Network. Please consult the Jurisdiction to Tax Practice Network for questions regarding its application to ECI.)
- Interest that is not ECI is subject to Treas. Reg. 1.267(a)-3(b) regardless of whether the related foreign person is exempt or subject to a reduced rate of tax under a treaty. In *Tate & Lyle v. Commissioner*, 87 F.3d 99 (3rd Cir. 1996), the taxpayer challenged the IRS' disallowance of its interest deduction for interest expense accrued to its FP. The taxpayer argued that because the FP was exempt from U.S. tax on its non-ECI interest income via treaty, Treas. Reg. 1.267(a)-3(b) could not properly construe the "matching principle" to prevent the current deduction for interest owed to the FP. The Third Circuit court ruled that the interest could not be deducted until a cash payment was made to the FP upholding IRC 267(a)(3) even though the taxpayer was an accrual method taxpayer. A similar holding was found in *Square D v. Commissioner*, 118 T.C. 299 (T.C. 2002).

- IRC 267(a)(2) – *Matching of Deduction and Payee Income Item In The Case of Expenses And Interest*
- Treas. Reg. 1.267(a)-3(b) – *Deduction of amount owed to related foreign person*
- Treas. Reg. 1.267(a)-3(c)(1) – *Effectively connected income subject to United States tax*
- *Tate & Lyle v. Commissioner*, 87 F.3d 99 (3rd Cir. 1996)
- *Square D v. Commissioner*, 118 T.C. 299 (T.C. 2002).

# Detailed Explanation of the Concept (cont'd-8)

Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)	
Analysis	Resources
<p><u>Exceptions and Special Rules (cont'd)</u></p> <ul style="list-style-type: none"><li>▪ Amounts accrued but unpaid (whether by U.S. or foreign persons) to related CFCs or PFICs are deductible in a particular year only to the extent that such amount is includible in the income of the direct or indirect U.S. owners of the related foreign corporation under the inclusion rules.</li></ul> <p><u>Special Issues Regarding Cash Pooling Arrangements</u></p> <p>IRC 267(a)(3) may apply to a cash pooling scenario with certain facts and circumstances. Cash pooling may look like a circular cash flow scheme, but it is very important to understand how cash pooling works and how it impacts your circular cash flow analysis. In general, the cash pool arrangement serves as a group sweep account, netting the short-term borrowings and lending of the participants. Related entities will be grouped into the cash pool and participants will share short falls or excess cash by borrowing or lending amongst each other for short-term needs. The goals of cash pooling are to achieve capital mobility, manage short term cash requirements, treasury efficiency and to minimize interest expense (or maximize interest income). Cash pool arrangements can either be “physical” or “notional.”</p> <p>Notional cash pooling allows a multinational group to net balances of different accounts across different countries without physically moving cash. Notional cash pools are not respected in all countries.</p>	

# Detailed Explanation of the Concept (cont'd-9)

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

### Analysis

### Resources

#### Special Issues Regarding Cash Pooling Arrangements (cont'd)

Physical cash pooling (also known as zero balancing) sweeps excess cash out of individual entity's bank accounts into a central bank account (the cash pool account) on a daily basis. At the end of each day, each participant would figure out whether they are short in cash (liability to cash pool) or have excess cash (deposit to cash pool). Each participant either 1) borrows from the cash pool account to cover the shortage or 2) deposits excess cash into the cash pool account for others to borrow from. Multinational groups may have separate cash pools for each functional currency or may have regional operating units and multiple currencies. They often structure U.S. cash pools for U.S. subs and foreign cash pools for foreign subs in order to avoid application of certain U.S. tax rules, for example IRC 956 (when a U.S. shareholder borrows from a CFC it can give rise to an income inclusion by a U.S. shareholder of the CFC under IRC 956).

When there is a deficit in the cash pooling account, the pool manager borrows funds from a third-party bank (bank). When excess funds are available, they are invested with the bank at an advantageous rate. A bank will likely offer better terms and lower fees for loans and deposits made through a cash pool than if made to individual corporations. The cash pool arrangement will centralize the lending function for the multinational group. Cash pool participants will get a daily report of its respective net cash balances. Payment of third party and intercompany loan principal and interest may be made through cash pooling arrangements and they may resemble a circular cash flow transaction.

- IRC 956 – *Investments Of Earnings in United States Property*

# Detailed Explanation of the Concept (cont'd-10)

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

### Analysis

To determine whether IRC 267(a)(3) applied will require tracing of the transactions. Many times, the cash pool will essentially result in payments that are netted at the cash pool level, whereby economic payment has been made for purposes of IRC 267(a)(3) and an interest deduction is allowed. This should be able to be traced through the loan documents, recorded transactions on the participants books and daily cash pooling reports. However, if economic payment has not been made, then a deduction is not allowed under IRC 267(a)(3) until payment is made. Economic ownership changes when the balance in the U.S. group member's account decreases by the amount of the interest payment during the taxable year in which the interest is credited. This doesn't have to happen as soon as the interest payment is credited and it can happen later in the same taxable year. It can be difficult to determine if this happens at some point during the year if the balance in the U.S. group member's account then increases before the end of the taxable year (the year will likely have multiple increases and decreases to the cash pool making tracing difficult).

If the U.S. corporation alleges that it made a payment on the loan payable to a foreign corporation, for purposes of IRC 956 that payment must be reflected as journal entries in the accounting books of both parties. See *Gulf Oil*.

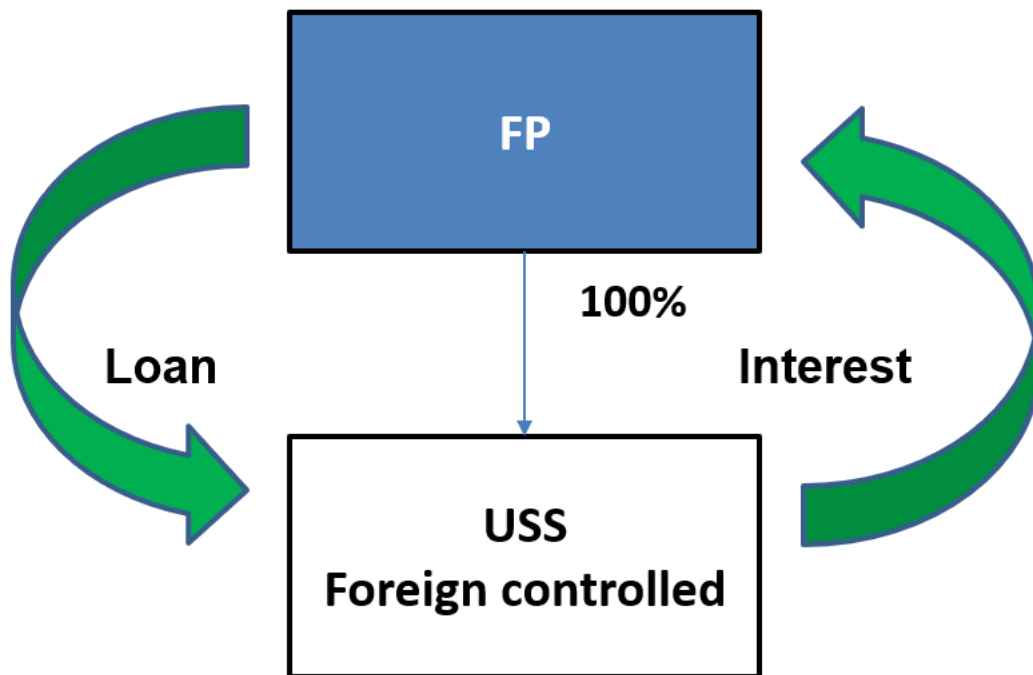
### Resources

- *Gulf Oil Corp v. Commissioner*, 87 T.C. 548 (1986)

# Examples of the Concept

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

### Examples



### Example

- Continuing the example from Slide 4.
- Year 1: USS accrues, but does not pay, interest owed to FP for the related party loan.
- The amount will not be deductible due to the application of IRC 267(a)(3).
- Year 2: USS pays the interest owed to FP for the related party loan. USS may deduct the interest paid; however, the interest would be subject to other potential limitations such as IRCs 163(j) and 482.

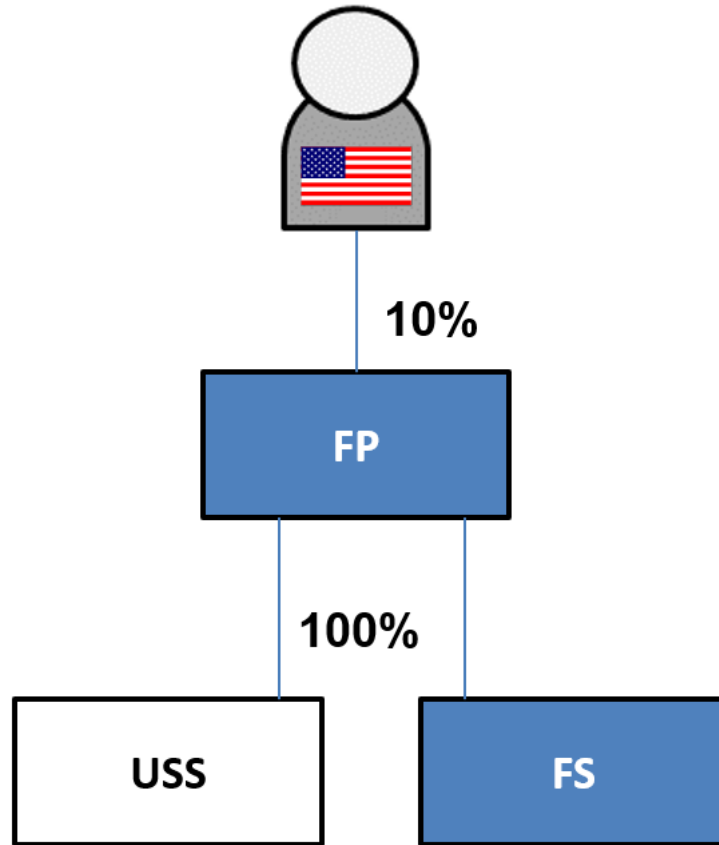
Note: The same result would occur if the loan and interest were owed to a foreign related subsidiary of FP, if it is an IRC 267(b) related party.



# Examples of the Concept (cont'd-1)

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

### Examples

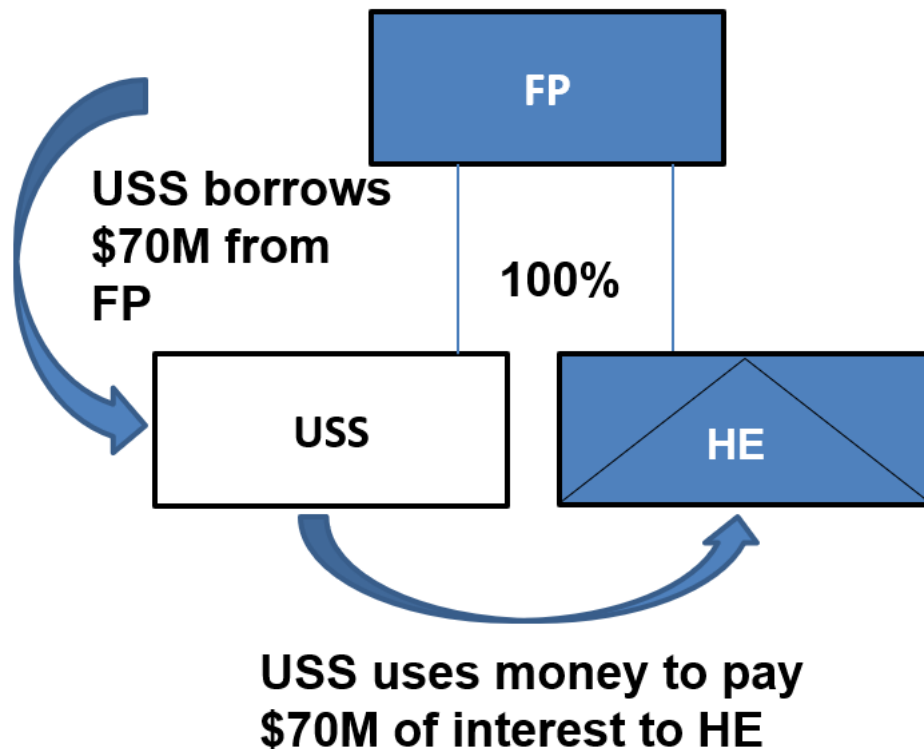


- Pre TCJA, Foreign Sub (FS) was not a CFC.
  - Prior to its repeal, IRC 958(b)(4) prevented “downward attribution” of Foreign Parent’s ownership of the Foreign Sub’s stock to US Sub.
- Post TCJA, Foreign Sub became a CFC.
  - After the repeal of IRC 958(b)(4), through the application of “downward attribution” rules of IRC 318(a)(3), US Sub constructively owns 100% of the stock of Foreign Sub, thus making Foreign Sub a CFC.

# Examples of the Concept (cont'd-2)

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

### Examples



- FP wholly owns USS.
- FP owns a hybrid entity (HE) treated as a disregarded entity for U.S. purposes and a corporation for foreign purposes; thus, the interest paid by USS is viewed as being paid to FP rather than FS.
- USS has an outstanding loan with HE. Interest of \$70 million is due yearly.
- On April 17, 2020, USS borrows \$70 million dollars from FP evidenced by a wire transfer.
- On April 17, 2020, USS pays \$70 million of interest owed to HE evidenced by a wire transfer.
- *Battelstein* is applied to this transaction to deny the USS interest deduction under IRC 267(a)(3). The circular cash flow payment is not a payment within the meaning of the cash method of accounting.
- See also CCA 201334037.

# Examples of the Concept (cont'd-3)

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

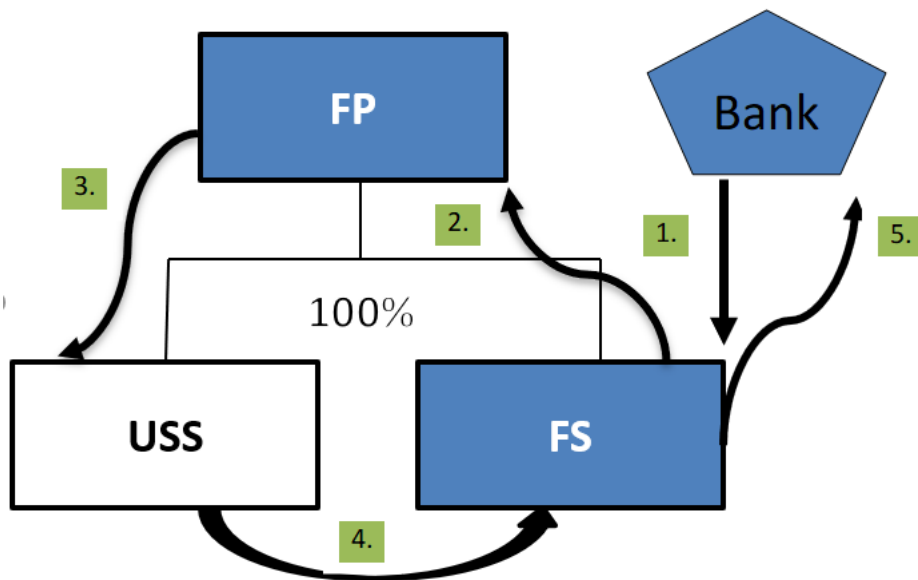
### Examples

#### Circular Cash Flow Example

FP wholly owns USS and FS, both corporations. In a prior year tax year, USS borrowed funds from FS and owes interest yearly. In the current year:

1. FS borrows \$70 million from Bank.
2. FS loans \$70 million to FP.
3. FP loans \$ 70 million to USS.
4. USS pays \$70 million to FS on prior year loan.
5. FS repays \$70 million to Bank.

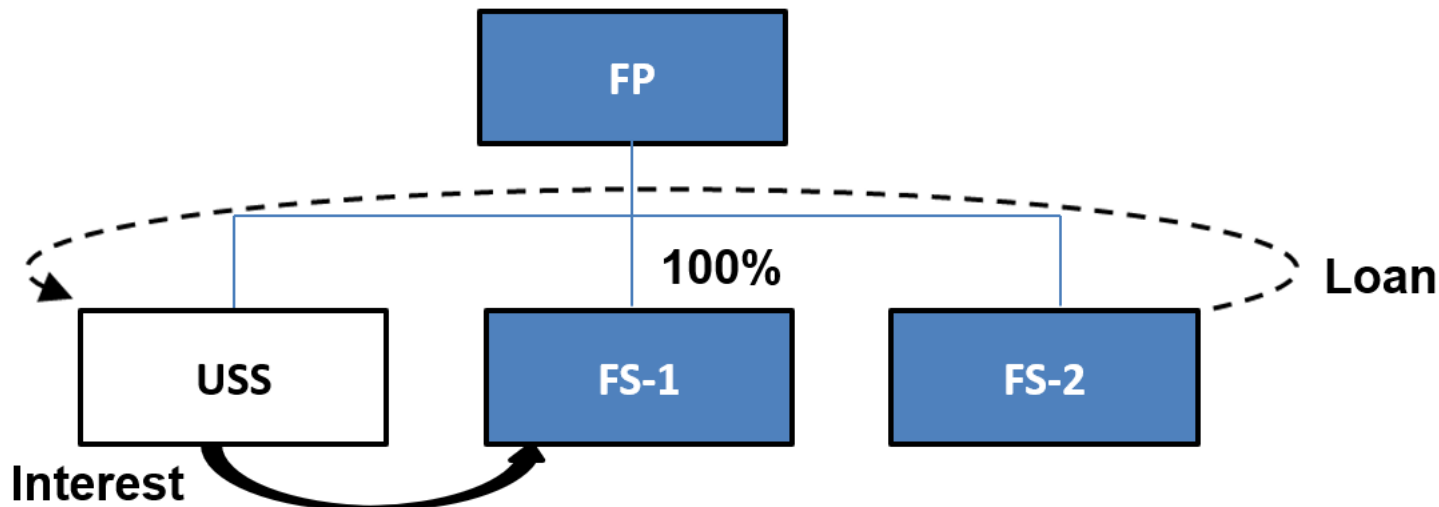
*Battelstein* is applied to this transaction to deny the USS interest deduction under IRC 267(a)(3). The circular cash flow payment is not a payment within the meaning of the cash method of accounting. See also CCA 201334037.



# Examples of the Concept (cont'd-4)

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

### Examples



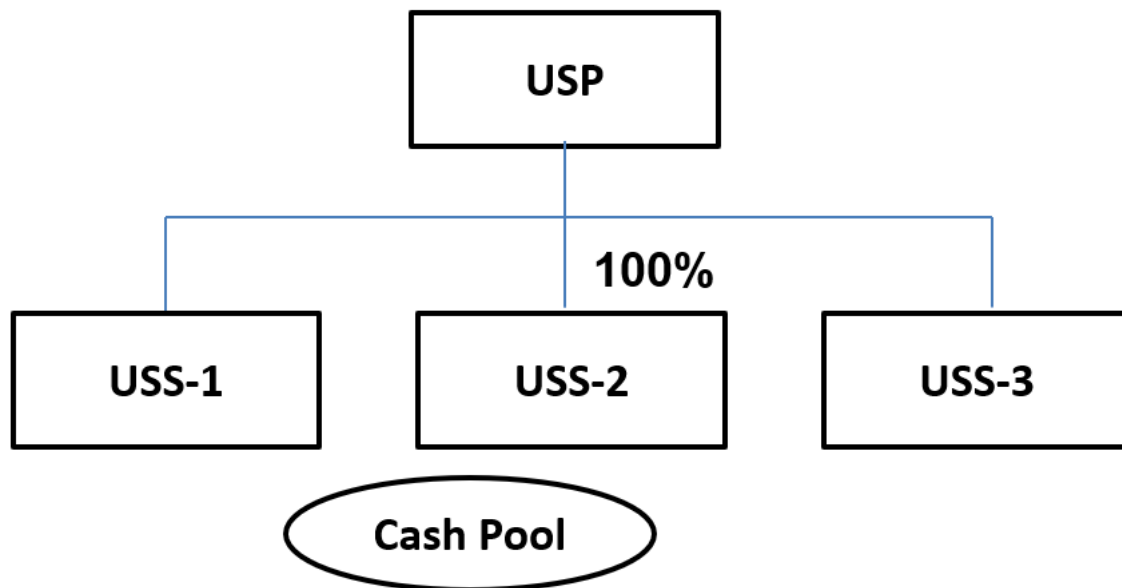
### Circular Cash Flow Example – IRC 1.267(a)-(3), Example 5

- USS obtains loans from FS-1 and owes \$70 million of interest due April 17th.
- On April 17th, USS borrows \$70M from FS-2 evidenced by a wire transfer.
- On April 17th, USS pays interest of \$70M to FS-1 evidenced by a wire transfer.
- *Battelstein* may apply to this transaction to deny the USS interest deduction under IRC 267(a)(3). In this example, the loop is not fully closed and it may not be considered a circular cash flow, but, if based on the facts and circumstances, this is determined to be a circular cash flow, the payment is not a payment within the meaning of the cash method of accounting. See also CCA 201334037.

# Examples of the Concept (cont'd-5)

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

### Examples



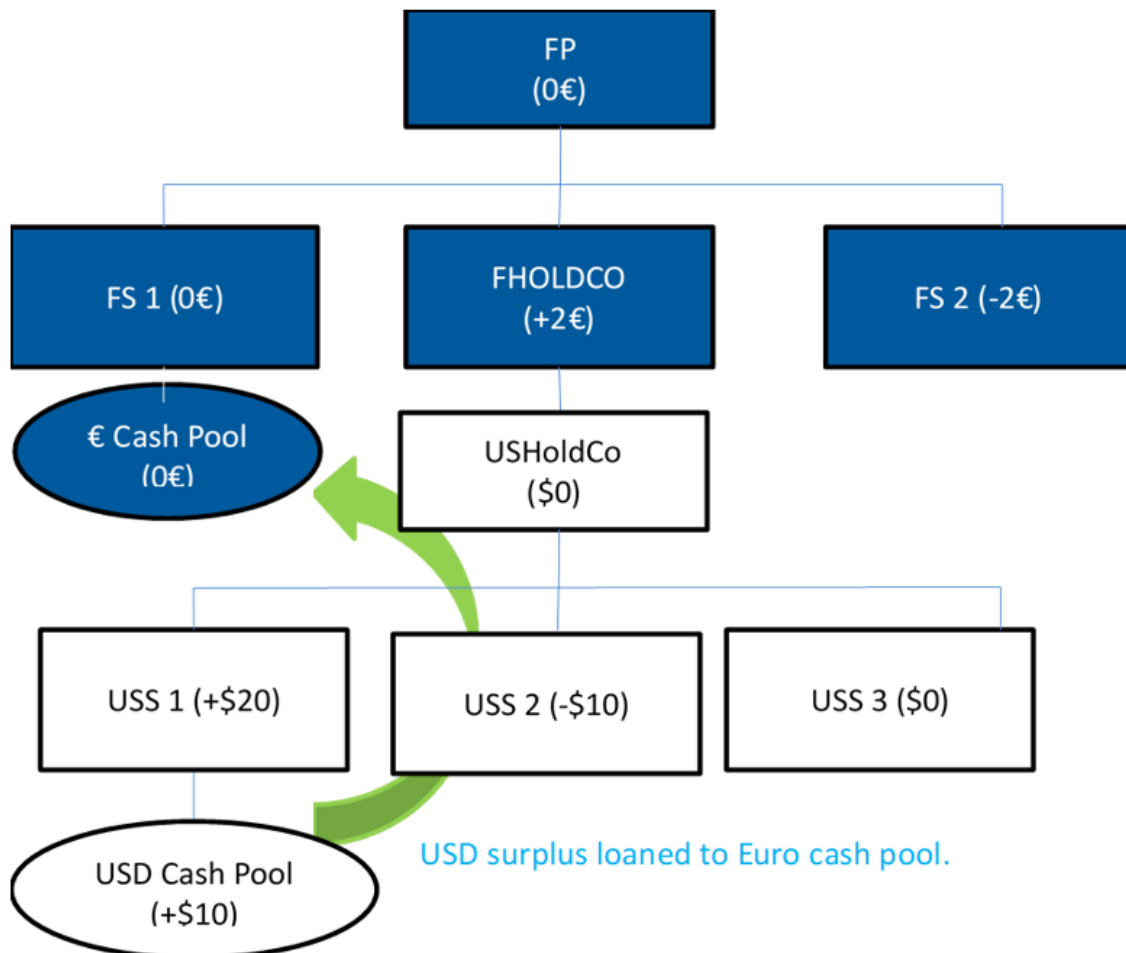
- USS 1, USS 2, and USS 3 enter into Cash Pooling Agreement.
- The Cash Pool can be managed by a third-party bank or “in-house” (an “internal bank”).
- Separate cash balances and deficits are netted.
- At the end of each day, all account balances are “zeroed out” and transfer to a “Header Account” or Cash Pool Leader Account.

Cash	10,000	(5,000)	(8,000)	
Sweep to pool account	(10,000)	5,000	8,000	(3,000)
Subtotal	0	0	0	5% interest rate
Income (cost)				(150)

# Examples of the Concept (cont'd-6)

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

### Examples

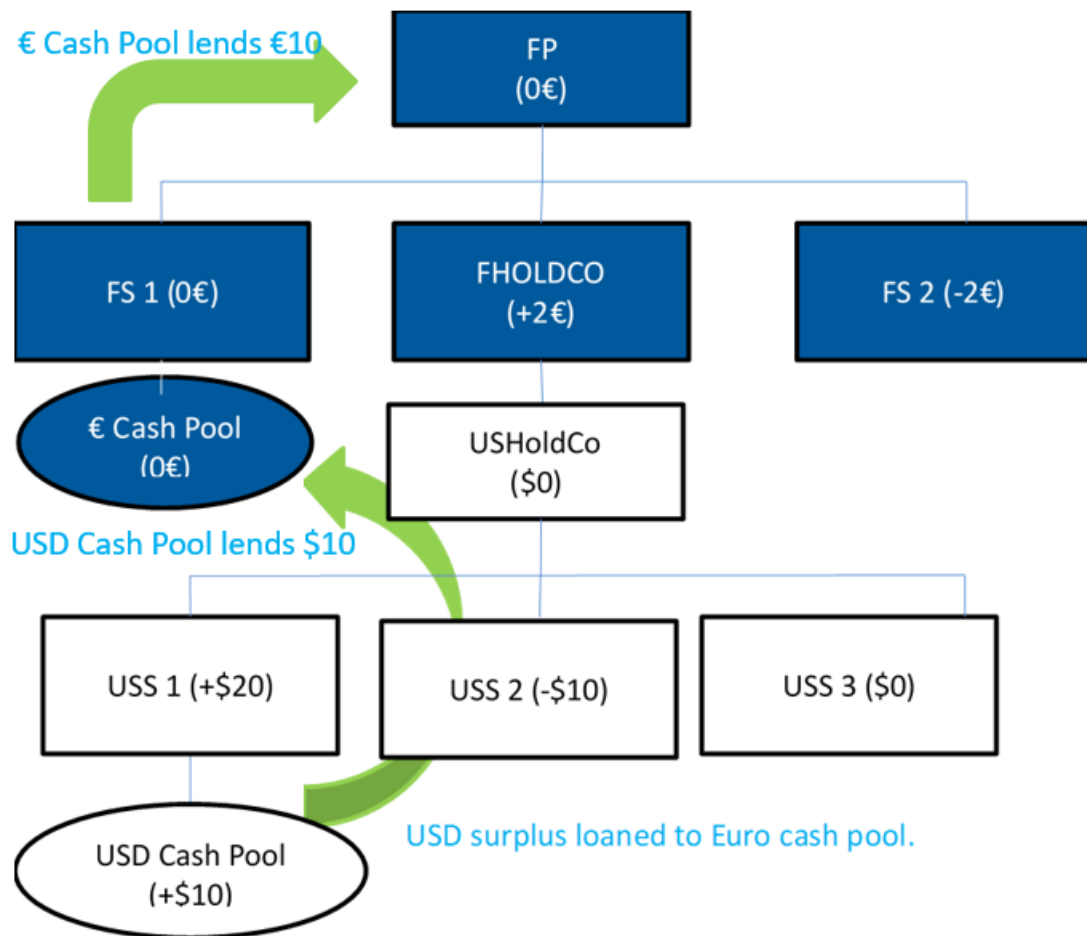


- Typical flow of funds.
- USS 3 has \$0, USS 2 has negative \$10 and USS 1 has positive \$20 to total a net USD cash pool balance of \$10.
- FS 1 and FP have €0, FS 2 has negative €2, FHOLDCO has positive €2, to total a net Euro cash pool balance of €0.
- The USD cash pool may lend its \$10 surplus to the Euro cash pool.
- Arm's length interest would be charged on the loan.

# Examples of the Concept (cont'd-7)

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

### Examples

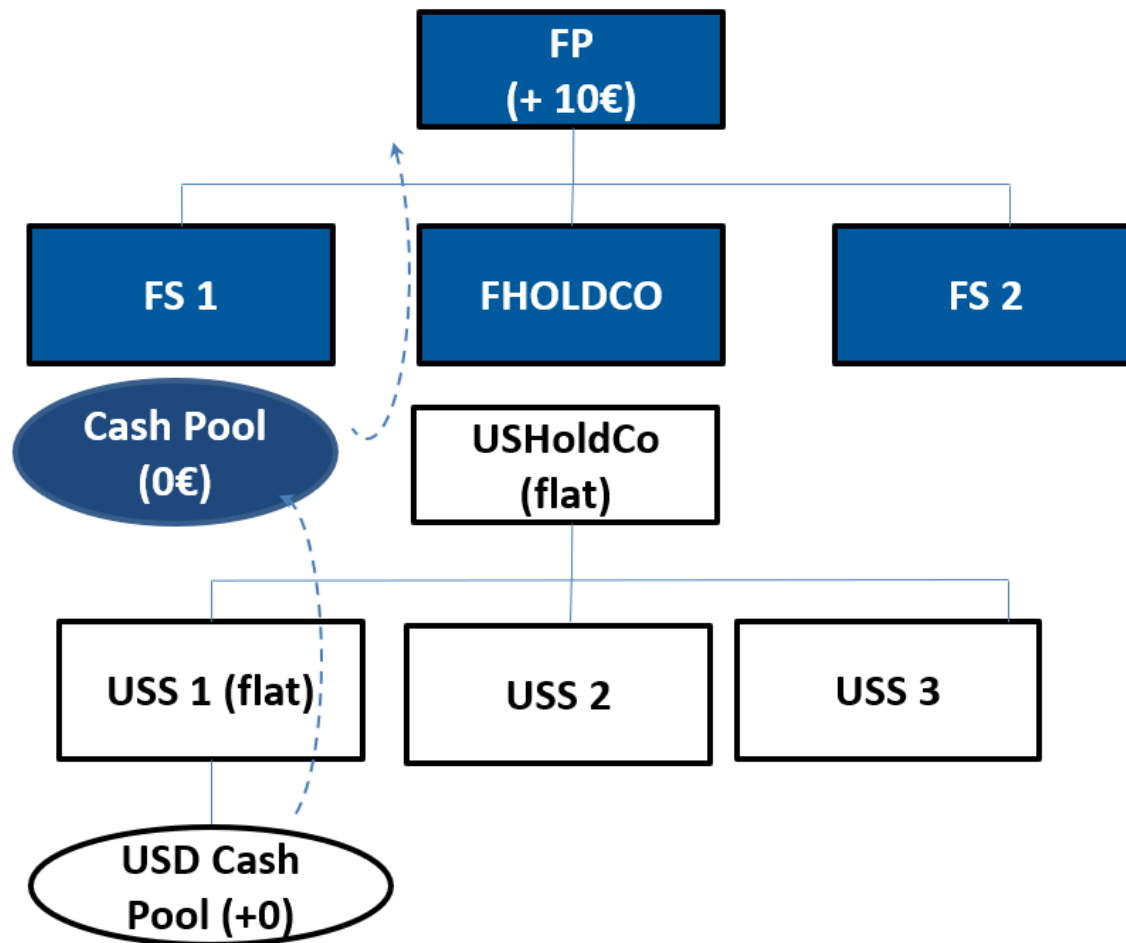


- Assume same facts as previous slide.
- Assume that FP has an outstanding €100 long-term loan to USS 1, and that an interest payment of €10 is due.
- Cash pool participants execute revolving loan agreements, record intercompany receivables and payables on participants books for cash pool activity, and earnings and interest are properly recorded to participant's books.
- The USD cash pool loans \$10 to the Euro cash pool. USD cash pool now has \$0 balance.
- The Euro cash pool exchanges the \$ for € and loans €10 to FP for business needs.
- USS1 loses economic ownership of the \$10 for tax purposes upon transfer to the € pool.
- There should not be a circular cash flow if the debits and credits made through the cash pools reflect the U.S. taxpayer has relinquished economic ownership of those funds. The \$10 loan payment would be deductible under IRC 267(a)(3).
- USD cash pool would have \$0 after the loan. Euro cash pool would have \$10/€10 until the loan is made to FP, then it would be €0 .

# Examples of the Concept (cont'd-8)

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

### Examples



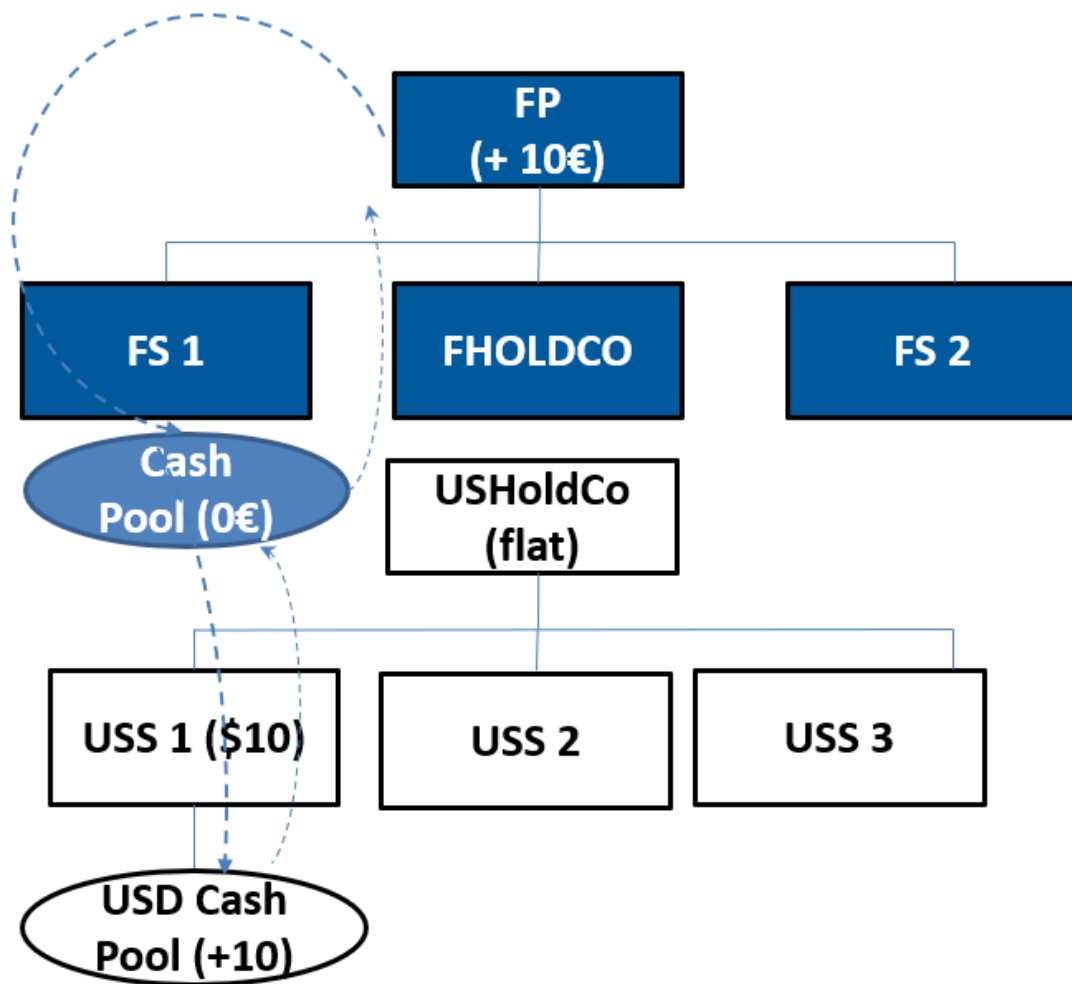
- This diagram here shows the results after USS group loses economic ownership of the excess \$10 balance and the foreign cash pool borrowing the \$10 to meet its cash needs.
- The euro cash pool with excess cash makes a loan to FP.



# Examples of the Concept (cont'd-9)

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

### Examples

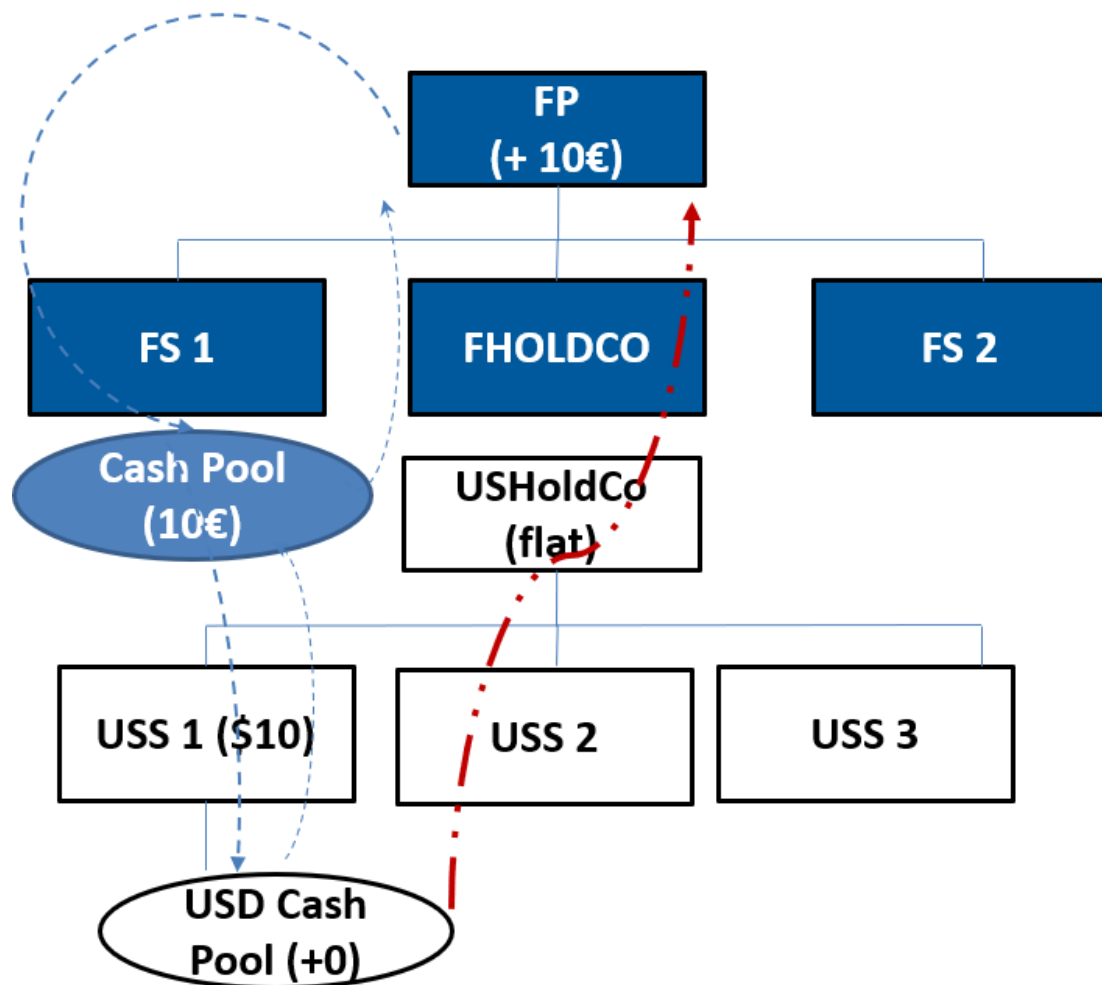


- One year later, there is a zero balance in the USD cash pool and a \$10/€10 balance in the Euro cash pool. All \$10/€10 are attributable to FP's cash pool account.
- USS 1 must make a \$10/€10 interest payment on FP's loan tomorrow.
- To cover the obligation today, USS 1 borrows \$10/€10 through the USD and Euro cash pools to make its interest payment to FP. The balance in the Euro cash pool drops to zero.

# Examples of the Concept (cont'd-10)

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

### Examples



- The next day, USS 1 “pays” \$10 to FP with funds it has indirectly borrowed from FP.
- The balance in the USD pool decreased by the amount USS 1 has borrowed.
- The funds circle back to the Euro cash pool and will be redeployed elsewhere in the Euro zone.
- This is not a payment within the meaning of the cash method of accounting. Remember the *Battlestein* case.
- Economic ownership did not change.
- Both before and after the transactions, FP earned interest on the same amounts in the Euro cash pool.
- Further, USS 1 still owes \$10 to FP (through the cash pools).

# Index of Referenced Resources

## Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)

IRC 267 – *Losses, Expenses, and Interest With Respect To Transactions Between Related Taxpayers*

IRC 318 – *Constructive Ownership of Stock*

IRC 952(c)(1)(B) – *Insurance Income*

IRC 956 – *Investment Of Earnings In United States Property*

IRC 957(a) – *Controlled Foreign Corporations; United States Persons*

IRC 958(a)(1) – *Rules For Determining Stock Ownership*

IRC 1297(a) – *Passive Foreign Investment Company*

Treas. Reg. 1.267(a)-3(b) – *Deduction of amount owed to related foreign person*

*Battelstein v. IRS*, 611 F.2d 1033 (5th Cir. 1980)

*Davison v. Commissioner*, 107 T.C. 35 (T.C. 1996), aff'd, 141 F.3d 403 (2d Cir. 1998)

*Square D v. Commissioner*, 118 T.C. 299 (T.C. 2002).

*Tate & Lyle v. Commissioner*, 87 F.3d 99 (3rd Cir. 1996)

CCA 201334037 – *Application of section 267(a)(3) to certain claimed payments of interest made to related foreign persons and associated with related foreign person borrowings*

# Training and Additional Resources

Interest Expense Limitation on Related Foreign Party Loans Under IRC 267(a)(3)	
Type of Resource	Description(s)
Saba Meeting Sessions	<ul style="list-style-type: none"> <li>▪ CBA Introduction to Financing – Transactions 482 and 267 Part 2</li> </ul>
Issue Toolkits	<ul style="list-style-type: none"> <li>▪ Audit Toolkit – IRC 267(a)(3) Flowchart</li> </ul>
White Papers / Guidance	<ul style="list-style-type: none"> <li>▪ CCA 201334037 – <i>Application of section 267(a)(3) to certain claimed payments of interest made to related foreign persons and associated with related foreign person borrowings</i></li> </ul>
Reference Materials – Treaties	<ul style="list-style-type: none"> <li>▪ BNA Tax Management Int'l Portfolios (click on the Inbound Financing Tab)</li> </ul>
Other Training Materials	<ul style="list-style-type: none"> <li>▪ (CBA) IRC 267(a)(3) Primer – April 2021</li> <li>▪ (CBA) Inbound Financing – Expanding on Basic IRC 267(a)(3) Concepts PPT – May 2021</li> <li>▪ Introduction to Financing Transactions 482 and 267 - 2021</li> <li>▪ (CBA) Inbound Financing – Applicable Tax Doctrines PPT – April 2021</li> <li>▪ Financial Products and Transactions Phase III – CPE 2019</li> <li>▪ NOPA Best Practices</li> </ul>

# Glossary of Terms and Acronyms

Term/Acronym	Definition
CCA	Chief Counsel Advice
CFC	Controlled Foreign Corporation
ECI	Effectively Connected Income
FP	Foreign Parent
FS	Foreign Subsidiary
HE	Hybrid Entity
PFIC	Passive Foreign Investment Corporation
TCJA	Tax Cut Jobs Act
USS	United States Subsidiary

# Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
446	<i>General Rule for Methods of Accounting (Permissible v Not Permissible)</i>
9423	<i>Arm's Length Interest Rate for Intercompany Debt</i>
9423	<i>Bona Fide Debt Determination</i>
9423	<i>Deductibility of Foreign Related Party Financial Guarantee Fees</i>
9423	<i>Hybrid Inbound Financing Transaction Under Section 267A</i>
9423	<i>Hybrid Instrument with a Repurchase Agreement</i>
9423	<i>Interest Expense Limitation Computation under IRC Section 163j – Pre-TCJA</i>
9423	<i>The General and Funding Rules of Treasury Regulations 1.385-3</i>
9423	<i>Interest Expense Limitation Computation under Treas. Reg. 1.163j-7</i>
9423	<i>Guarantee Fee Pricing Methods</i>
9423	<i>IRC 245A(e) – Anti-Hybrid Rules</i>
9421	<i>Hedge Fund Basics</i>
9422	<i>Interest Expense of a Foreign Corporation Engaged in a USTB Non Bank Non Treaty</i>
9422	<i>Interest Expense of a US Branch of a Foreign Bank Non Treaty</i>
9424	<i>Branch Level Interest Tax Concepts</i>
9424	<i>FDAP Withholding under Chapter 3</i>