

**Office of Chief Counsel
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Memorandum**

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to:

International Examiner
(Large Business & International)

from: Jeffery Mitchell
Chief, Branch 2
(International)

subject: Treatment of Accrued but Unpaid Interest as United States Property under Section 956

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Whether accrued but unpaid interest on obligations of United States persons that are treated as United States property under section 956(c) is United States property?

CONCLUSION

For purposes of section 956, the term "obligation" in Treas. Reg. §1.956-2T(d)(1)(i) includes accrued but unpaid interest on an obligation that is United States property within the meaning of section 956(c)(1)(C), and thus is United States property under section 956(c).

FACTS

The CFC _____ within the meaning of section 957(a) that _____ indirectly wholly owned by a domestic corporation ("Borrower"). _____ treated as holding under section 956(d) and Treas. Reg. §1.956-2(c), obligations of Borrower. Accordingly, obligations of Borrower held (or

treated as held) by _____ constitute United States property for purposes of section 956.¹

Stated interest on the obligations of Borrower is unconditionally payable by Borrower at least annually. Borrower and _____ use an accrual method of accounting for federal income tax purposes, and accordingly _____ include interest in income as it accrues, even if it is not paid.

LAW AND ANALYSIS

I. Section 956

A. General Rule: Section 956(a)(1)

Section 951(a)(1) provides that every person who is a United States shareholder (as defined in section 951(b)) of a CFC and who owns (within the meaning of section 958(a)) stock in such corporation on the last day in the CFC's taxable year, on which such corporation is a CFC, shall include in his gross income for his taxable year in which or with which such taxable year of the corporation ends, in addition to his pro rata share of subpart F income of the CFC, the amount determined under section 956 with respect to such shareholder for such year (but only to the extent not excluded from gross income under section 959(a)(2)).

Section 956(a) provides:

In the case of any controlled foreign corporation, the amount determined under this section with respect to any United States shareholder for any taxable year is the lesser of –

(1) the excess (if any) of—

- (A) such shareholder's pro rata share of the average of the amounts of United States property held (directly or indirectly) by the controlled foreign corporation as of the close of each quarter of such tax year, over
- (B) the amount of earnings and profits described in section 959(c)(1)(A) with respect to such shareholder, or

(2) such shareholder's pro rata share of the applicable earnings of such controlled foreign corporation.

¹ The exceptions to the definition of United States property and obligation contained in section 956(c)(2) and Notice 88-108 (1988-2 C.B. 446), Notice 2008-91 (2008-43 I.R.B. 1001), Notice 2009-10 (2009-5 I.R.B. 419), and Notice 2010-12 (2010-4 I.R.B. 326) do not apply to the obligations of Borrower held by

The amount taken into account under paragraph (1) with respect to any property shall be its adjusted basis as determined for purposes of computing earnings and profits, reduced by any liability to which the property is subject.

The regulations provide additional guidance on determining the amount taken into account with respect to United States property, which generally is the property's adjusted basis reduced by any liability to which the property is subject.²

B. Obligations of Related United States Persons

The term "United States property" generally includes an obligation of a domestic corporation that is a United States shareholder (as defined in section 951(b)) of the controlled foreign corporation.³ Treasury Reg. §1.956-2T(d)(2)(i) provides that the term "obligation" includes any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other indebtedness, whether or not issued at a discount and whether or not bearing interest.

C. Pledges and Guarantees

Section 956(d) provides that for purposes of section 956(a), a CFC shall, under regulations prescribed by the Secretary, be considered as holding an obligation of a United States person if the CFC is a pledgor or guarantor of the obligation. Treasury Reg. §1.956-2(c)(1) generally provides that any obligation of a United States person with respect to which a CFC is a pledgor or guarantor shall be considered for purposes of section 956(a) to be United States property held by such CFC. Treas. Reg. §1.956-2(c)(2) provides that if the assets of a CFC serve at any time, even though indirectly, as security for the performance of an obligation of a United States person, then, for purposes of Treas. Reg. §1.956-2(c)(1), the CFC will be considered a pledgor or guarantor of that obligation.

Pursuant to Treas. Reg. §1.956-1(e)(2), the amount taken into account with respect to a pledge or guarantee described in Treas. Reg. §1.956-2(c)(1) is the unpaid principal amount on the applicable determination date of the obligation with respect to which the CFC is a pledgor or guarantor.

II. **Amount of United States Property**

Accrued but unpaid interest on the obligations of Borrower held by _____ or treated as held by _____ under Treas. Reg. §1.956-2(c) constitutes United States property because it is an obligation within the meaning of Treas. Reg. §1.956-2T(d)(2)(i), and thus United States property within the meaning of section 956(c). The

² Treas. Reg. §1.956-1(e)(1). As discussed in section I.C. of the LAW AND ANALYSIS section, a special rule applies in the case of pledges and guarantees that are treated as United States property.

³ Section 956(c)(1)(C), 956(c)(2)(F), 956(c)(2)(L).

regulation indicates that the term “obligation” includes, in addition to an itemized list of types of indebtedness, “other indebtedness.” The term “other indebtedness” is not further defined in Treas. Reg. §1.956-2T(d)(2)(i) for purposes of applying section 956. However, the definition of indebtedness that is uniformly applied throughout the Code is, in general, a restatement of the common law definition applied to debts which arise from a debtor-creditor relationship based upon a valid obligation to pay a fixed or determinable sum of money.⁴ This definition of indebtedness encompasses accrued but unpaid interest, and thus accrued but unpaid interest is an obligation under section 956(c).

Treatment of accrued but unpaid interest as an obligation follows not only from the definition of an obligation in Treas. Reg. §1.956-2T(d)(2)(i) and the common understanding of the term, but also from the purpose of section 956 to tax earnings of a CFC that are available for use by a related United States person similarly to the way that earnings distributed to a United States shareholder of the CFC would be taxed.⁵ The continuing use by Borrower of amounts of money to which entitled, whether principal or accrued but unpaid interest, is subject to taxation under section 956 through the inclusion of all such amounts in United States property.

As discussed in section I.A. of the LAW AND ANALYSIS SECTION, the amount of United States property that is taken into account under section 956(a)(1) generally is the property’s adjusted basis as determined for purposes of computing earnings and profits, reduced by any liability to which the property is subject. As discussed in Section I.C. of the LAW AND ANALYSIS section of this advice, the amount taken into account under section 956 with respect to a pledge or guarantee is the unpaid principal amount of the obligation. Under an accrual method of accounting, accrued but unpaid interest gives rise to an obligation with an adjusted basis and an unpaid principal amount equal to the interest.⁶ Thus, the accrued but unpaid interest on the obligations of Borrower held by

⁴ See *Perrin v. United States*, 444 U.S. 37, 42 (1979) (noting that “words will be interpreted as taking their ordinary, contemporary, common meaning”); *Kavanaugh v. United States*, 575 F. Supp. 41, 42 (N.D.Ill. 1983) (“a bona fide debt ... can only arise from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable amount of money.”); *Cuyuna Realty Co. v. United States*, 382 F.2d 298, 300 (Cl. Ct., 1967) (“To constitute a valid debt, there must not only be a legal obligation to repay, but the money must have been advanced with reasonable belief at the time that it would be repaid.”). See also Treas. Reg. §1.166-1(c) (a receivable of an accrual method taxpayer is treated as debt for purposes of section 166 to the extent the income such debt represents has been included in income for the year for which the deduction as a bad debt is claimed or for a prior taxable year); Treas. Reg. §1.6050P-1(c) (defining indebtedness as including stated interest for purposes of information reporting for discharge of indebtedness); Rev. Rul. 80-361, 1980-2 C.B. 164 (1980) (treating accrued interest as debt for which a bad debt deduction could be taken); Rev. Rul. 2007-32, 2007-1 C.B. 1278 (treating the right to accrued but unpaid interest as a receivable).

⁵ See H.R. Rep. No. 94-658 at 216; S. Rep. No. 94-938 at 225 (“The reason why this provision was adopted was the belief that the use of untaxed earnings of a controlled foreign corporation to invest in U.S. property was ‘substantially the equivalent of a dividend’ being paid to U.S. shareholders.”).

⁶ See Rev. Rul. 80-361 (holding that a bad debt deduction could be taken for accrued interest but unpaid interest included in income that subsequently became uncollectible; given that section 166(b) defines the amount of a bad debt deduction as the adjusted basis of the debt, the adjusted basis of the debt

or treated as held by _____ under Treas. Reg. §1.956-2(c) is United States property with an adjusted basis and unpaid principal amount equal to the amount of the accrued but unpaid interest.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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represented by the amount of accrued but unpaid interest included in income is the amount of the accrued but unpaid interest included in income (see also Treas. Reg. § 1.166-1(e)); Treas. Reg. §1.595-1(d) (for purposes of former section 595, the adjusted basis of the indebtedness includes the amount of any unpaid interest with respect to such indebtedness, but only to the extent it has been included in gross income); cf. Treas. Reg. §1.6050P-1(c).