

**Office of Chief Counsel  
Internal Revenue Service  
Memorandum**

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from: Jeffery G. Mitchell  
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subject: Application of Treas. Reg. § 1.956-1T(b)(4) to Back-to-Back Loans

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

LEGEND

Taxpayer =

CFC1 =

CFC2 =

CFC3 =

CFC4 =

CFC5 =

CFC6 =

CFC7 =

CFC8 =

Country 1 =

Country 2 =

Continent =

Activity A =

Activity B =

Activity C =

Activity D =

Activity E =

Activity F =

Year 1 =

Year 2 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

E&P1 = \$

1

E&P2 = \$

E&P3 = \$

E&P4 = \$

E&P5 = \$

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<sup>1</sup> For purposes of this Memorandum, figures are provided in U.S. dollar equivalent amounts.

E&P6 = \$

E&P7 = \$

CFC5PTI = \$

InitialLoan1Amt = \$

InitialLoan2Amt = \$

InitialLoan3Amt = \$

InitialLoan4Amt = \$

InitialLoan5Amt = \$

FinalLoan1Amt = \$

FinalLoan2Amt = \$

FinalLoan3Amt = \$

FinalLoan4Amt = \$

Loan5AmtA = \$

Loan5AmtB = \$

FinalLoan5Amt = \$

CFC7AvgQtr = \$

FTC1 = \$

FTC2 = \$

### ISSUE

Whether certain loans to Taxpayer held by CFC3, CFC4, CFC5, CFC6, and CFC7 (collectively, "Lower-Tier CFCs") are considered held indirectly by CFC1 and CFC2 pursuant to Treas. Reg. § 1.956-1T(b)(4).

### CONCLUSION

Yes. Under the facts and circumstances described below, Lower-Tier CFCs were funded with a principal purpose of avoiding the application of section 956 to CFC1 and

CFC2, and the Taxpayer loans held by Lower-Tier CFCs will be considered held indirectly by CFC1 and CFC2.

## FACTS

Taxpayer is a United States shareholder within the meaning of section 951(b) of CFC1, CFC2, Lower-Tier CFCs, and CFC8. CFC1 is a controlled foreign corporation within the meaning of section 957 ("CFC"), wholly owned by Taxpayer and organized under the laws of Country 1. CFC1 is a holding company that owns other CFCs and foreign disregarded entities. CFC1 wholly owns CFC2, a CFC organized under the laws of Country 2, where it conducts Activity A, its principal business activity. CFC2 wholly owns CFC3 and CFC7. In addition to indirectly owning 100% of the stock of CFC3 and CFC7 through CFC2, CFC1 indirectly owns 100% of the stock of CFC4, CFC5, and CFC6.

As explained in further detail below, on the same day: (i) CFC1 and CFC2 loaned significant amounts to Lower-Tier CFCs; and (ii) Lower-Tier CFCs loaned substantially the same amounts to Taxpayer. CFC1 and CFC2 have substantial earnings and profits ("E&P"), while Lower-Tier CFCs have limited E&P. CFC1's E&P is greater than the aggregate E&P of Lower-Tier CFCs, as well as greater than the sum of the loans to Taxpayer discussed herein. Taxpayer treated the Taxpayer loans held by Lower Tier CFCs as United States property under section 956, and included an amount in gross income under sections 951(a)(1)(B) and 956. However, the amount determined under section 956(a) ("section 956 amount") was limited due to the E&P of Lower-Tier CFCs.

Below is a description of each transaction.

### Loan 1 (CFC3)

CFC3's principal business activity is Activity B.

On Date 1, CFC1 loaned CFC3 InitialLoan1Amt. The loan from CFC1 appears on CFC3's Year 1 end of year balance sheet. As of Date 3, Taxpayer has not provided loan documents for the loan between CFC1 and CFC3. However, Taxpayer has provided a shared service agreement between CFC1 and CFC3. The shared service agreement relates to CFC1 performing duties such as: collection of receivables, paying bills and other payables, and acting as a credit facility.

On Date 1, CFC3 made three loans to Taxpayer, totaling FinalLoan1Amt, which is less than 1% more than the amount CFC loaned to CFC3 on Date 1 (InitialLoan1Amt). The loans made to Taxpayer appear on CFC3's Year 1 end of year balance sheet. Taxpayer provided loan documents between CFC3 and Taxpayer.

Taxpayer has provided CFC3's bank account statements showing the transfer of funds

from CFC3 to Taxpayer. Additionally, the bank account statements show a receipt of funds from CFC1 occurring on Date 1.

CFC1 has applicable earnings as determined under section 956(b)(1) (“applicable earnings”) in the amount of E&P1. CFC3 has applicable earnings in the amount of E&P3, which is significantly less than E&P1. The section 956 amount determined by Taxpayer was limited by CFC3’s applicable earnings of E&P3. By structuring the loans through CFC3 instead of directly from CFC1 to Taxpayer, Taxpayer excluded a portion of the loan to Taxpayer from the section 956 amount in Year 1.

### **Loan 2 (CFC4)**

CFC4’s principal business activity is Activity C.

On Date 1, CFC1 made three loans to CFC4 in amounts totaling InitialLoan2Amt. The loans from CFC1 appear on CFC4’s Year 1 end of year balance sheet. As of Date 3, Taxpayer has not provided loan documents for the loan between CFC1 and CFC4. However, Taxpayer has provided a shared service agreement between CFC1 and CFC4. The shared service agreement relates to CFC1 performing duties such as: subrogation of rights to accounts receivable, serving as paying agent for accounts payable, joint forecasting, hedging, currency exchange, use of credit facilities, and deposit of funds, and use of overdraft facilities.

On Date 1, CFC4 made three loans to Taxpayer, totaling FinalLoan2Amt, which is equal to the aggregate amount CFC1 loaned to CFC4 on Date 1. The loans made to Taxpayer appear on CFC4’s Year 1 end of year balance sheet. Taxpayer provided loan documents between CFC4 and Taxpayer.

Taxpayer has provided CFC4’s bank account statements showing the transfer of funds from CFC4 to Taxpayer. Additionally, the bank account statements show a receipt of funds from CFC1 occurring on Date 1.

CFC1 has applicable earnings in the amount of E&P1. CFC4 has applicable earnings in the amount of E&P4, which is significantly less than E&P1. The section 956 amount determined by Taxpayer was limited by CFC4’s applicable earnings of E&P4. By structuring the loans through CFC4 instead of directly from CFC1 to Taxpayer, Taxpayer excluded a portion of the loan to Taxpayer from the section 956 amount in Year 1.

### **Loan 3 (CFC5)**

CFC5’s principal business activity is Activity D. CFC5’s balance sheet assets consist of investments in other foreign subsidiaries of Taxpayer.

On Date 1, CFC1 loaned CFC5 InitialLoan3Amt. The loan from CFC1 appears on

CFC5's Year 1 end of year balance sheet. As of Date 3, Taxpayer has not provided loan documents for the loan between CFC1 and CFC5. However, Taxpayer has provided a shared service agreement between CFC1 and CFC5. The shared service agreement relates to CFC1 performing duties such as: subrogated rights to account receivables, paying agent for account payables, joint forecasting, hedging, currency exchange, use of credit facilities, and deposit of funds and use of overdraft facilities.

On Date 1, CFC5 made two loans to Taxpayer, totaling FinalLoan3Amt, which is equal to the amount CFC1 loaned CFC5 on Date1 (InitialLoan3Amt). The loans made to Taxpayer appear on CFC5's Year 1 end of year balance sheet. Taxpayer provided loan documents between CFC5 and Taxpayer.

Taxpayer has provided CFC5's bank account statements showing the transfer of funds from CFC5 to Taxpayer. Additionally, the bank account statements show a receipt of funds from CFC1 occurring on Date 1.

CFC5's balance sheet did not show any funds available to loan to Taxpayer prior to the loan from CFC1. CFC1 has applicable earnings in the amount of E&P1. CFC5 has applicable earnings in the amount of E&P5, which is significantly less than E&P1. Additionally, CFC5 has E&P attributable to amounts previously included in gross income under section 951(a)(1) described in section 959(c)(1) or (c)(2) ("PTI") in the amount of CFC5PTI. After taking into account the PTI of CFC5, Taxpayer's section 956 amount for Year 1 did not include any amount of the loan from CFC5. By structuring the loans through CFC5 instead of directly from CFC1 to Taxpayer, Taxpayer excluded a portion of the loan to Taxpayer from the section 956 amount in Year 1.

#### **Loan 4 (CFC6)**

CFC6's principal business activity is Activity E. CFC6's balance sheet assets consist of investments in Taxpayer's foreign subsidiaries. CFC6's income consists solely of dividends and interest.

On Date 1, CFC1 loaned CFC6 InitialLoan4Amt. The loan from CFC1 appears on CFC6's Year 1 end of year balance sheet. As of Date 3, Taxpayer has not provided loan documents for the loan between CFC1 and CFC6. However, Taxpayer stated that the business purpose for this loan "stems from the fact that [CFC1] acts and has acted for many years as the shared service center for among other things cash management across most of [Continent] for the [Taxpayer's] Group." Furthermore, Taxpayer has provided a shared service agreement between CFC1 and CFC6. The shared service agreement relates to CFC1 performing duties such as: subrogated rights to account receivables, paying agent for account payables, joint forecasting, hedging, currency exchange, use of credit facilities, and deposit of funds and use of overdraft facilities.

On Date 1, CFC6 made four loans to Taxpayer, totaling FinalLoan4Amt, which is equal to the amount CFC1 loaned CFC6 on Date 1. The loans made to Taxpayer appear on

CFC6's Year 1 end of year balance sheet. Taxpayer provided loan documents between CFC6 and Taxpayer.

Taxpayer has provided CFC6's bank account statements showing the transfer of funds from CFC6 to Taxpayer. Additionally, the bank statements show a receipt of funds from CFC1 occurring on Date 1.

CFC1 has applicable earnings in the amount of E&P1. CFC6 has applicable earnings in the amount of E&P6. The section 956 amount determined by Taxpayer was limited by CFC6's applicable earnings of E&P6, which is significantly less than E&P1. By structuring the loans through CFC6 instead of directly from CFC1 to Taxpayer, Taxpayer excluded a portion of the loan to Taxpayer from the section 956 amount in Year 1.

### **Loan 5 (CFC7)**

CFC7's principal business activity is Activity F.

On Date 1, CFC2 loaned CFC7 InitialLoan5Amt. The loan from CFC2 appears on CFC7's Year 1 end of year balance sheet. As of Date 3, Taxpayer has not provided loan documents for the loan between CFC2 and CFC7.

On Date 1, CFC7 made three loans to Taxpayer, totaling Loan5AmtA. On Date 2, less than three months after Date 1 and still within Year 1, CFC7 made two loans to Taxpayer, totaling Loan5AmtB. The five loans made from CFC7 to Taxpayer in Year 1 total FinalLoan5Amt, which is less than the amount of the loan from CFC2 to CFC7 on Date 1 (InitialLoan5Amt). The loans made to Taxpayer appear on CFC7's Year 1 end of year balance sheet. Taxpayer provided loan documents between CFC7 and Taxpayer.

Taxpayer has provided CFC7's bank account statements showing the transfer of funds from CFC7 to Taxpayer. Additionally, the bank statements show a receipt of funds from CFC2 occurring on Date 1.

CFC2 has applicable earnings in the amount of E&P2. CFC7 has applicable earnings in the amount of E&P7, which is significantly less than E&P2. The amount of the loans to Taxpayer from CFC7 exceeds E&P7. Here, the section 956 amount determined by Taxpayer for Year 1 was limited by Taxpayer's pro rata share of the average of the amounts of U.S. property held (directly or indirectly) by CFC7 as of the close of each quarter of such taxable year rather than being limited by CFC7's applicable earnings because the quarterly average amount, CFC7AvgQtr, is less than E&P7. Provided the loans remain outstanding in Year 2, the amount of the loans to be included as a section 956 amount for Year 2 would be limited by the E&P of CFC7 in Year 2 reduced by PTI. If CFC7's E&P does not increase substantially in Year 2, a portion of the loans to Taxpayer would remain excluded from the section 956 amount. Thus, by structuring the

loans through CFC7 instead of directly from CFC2 to Taxpayer, Taxpayer would exclude a portion of the loans to Taxpayer from the section 956 amount in Year 2.

In addition to the reduced section 956 amounts, by funding Lower-Tier CFCs and avoiding the application of section 956 with respect to CFC1 and CFC2, Taxpayer claimed foreign tax credits in the amount of FTC1. In contrast, if CFC1 and CFC2 directly made the loans to Taxpayer, Taxpayer could claim foreign tax credits in the amount of only FTC2 (which is less than 20% of FTC1).<sup>2</sup>

## LAW AND ANALYSIS

Section 951(a) requires that a “United States shareholder,” as defined in section 951(b), of a CFC who owns stock in the corporation on the last day of the corporation's taxable year include in its gross income various items, including “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 951(a)(1)(B). A CFC is a foreign corporation in which more than 50% of the total combined voting power of all classes of stock of the corporation entitled to vote or more than 50% of the total value of the stock of the corporation is owned, directly, indirectly or constructively, by United States shareholders on any day during the taxable year of the foreign corporation. Section 957(a). A United States shareholder is a “United States person” who owns, directly, indirectly or constructively, 10% or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation. Section 951(b). For this purpose, a “United States person” includes a domestic corporation. Sections 957(c) and 7701(a)(30).

The amount determined under section 956 with respect to a United States shareholder for any taxable year is generally the lesser of (i) the excess of the shareholder's pro rata share of the average of the amounts of United States property held (directly or indirectly) by the CFC as of the close of each quarter of the taxable year over the amount of PTI described in section 959(c)(1)(A) with respect to the shareholder, or (ii) the shareholder's pro rata share of the applicable earnings of the CFC. Section 956(a).

Subject to certain exceptions not applicable to the facts of this memorandum, United States property includes “an obligation of a United States person.” Section 956(c). For purposes of determining a section 956 amount, the amount taken into account with respect to an obligation of a U.S. person is determined by reference to the CFC's adjusted basis in the obligation. Section 956(a) and Treas. Reg. § 1.951-1(e)(1). Section 956(c)(1)(C), when read together with sections 956(a) and 951(a)(1)(B), generally requires a United States shareholder of a CFC to include in income any E&P of the CFC that are loaned to the shareholder (provided the E&P is not PTI).

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<sup>2</sup> Taxpayer and Exam agree that Taxpayer's CFCs acquired the loans described herein before the effective date of section 960(c).



Under Treas. Reg. § 1.956-1T(b)(4), a CFC will be considered to hold indirectly

at the discretion of the District Director, investments in U.S. property acquired by any other foreign corporation that is controlled by the controlled foreign corporation, if one of the principal purposes for creating, organizing, or funding (through capital contributions or debt) such other foreign corporation is to avoid the application of section 956 with respect to the controlled foreign corporation. For purposes of [Treas. Reg. § 1.956-1T(b)(4)], a foreign corporation will be controlled by the controlled foreign corporation if the foreign corporation and the controlled foreign corporation are related parties under section 267(b). In determining for purposes of this paragraph (b) whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c). (Emphasis added.)

Lower-Tier CFCs are controlled by CFC1 and CFC2 within the meaning of Treas. Reg. § 1.956-1T(b)(4), and the loans from Lower-Tier CFCs to Taxpayer are U.S. property for purposes of section 956. Thus, Treas. Reg. § 1.956-1T(b)(4) will apply to treat CFC1 and CFC2 as holding the Taxpayer loans if one of the principal purposes for CFC1 and CFC2 funding Lower-Tier CFCs (through loans) was to avoid the application of section 956 with respect to CFC1 and CFC2. As discussed, Taxpayer included section 956 amounts in income with respect to the Taxpayer loans held by Lower-Tier CFCs. However, the focus of the “principal purpose” requirement in Treas. Reg. § 1.956-1T(b)(4) is on the avoidance of section 956 with respect to the funding CFCs: CFC1 and CFC2.

Several facts indicate that a principal purpose for the loans from CFC1 and CFC2 to Lower-Tier CFCs (*i.e.*, the funding) was to avoid the application of section 956 with respect to CFC1 and CFC2. First, the section 956 amounts that Taxpayer included in income with respect to Lower-Tier CFCs were limited by Lower-Tier CFCs applicable earnings. However, CFC1 and CFC2 had applicable earnings in excess of the amounts loaned to Taxpayer (and limited PTI), and, thus, the section 956 amounts derived from the Taxpayer loans would not have been limited if the loans had been made directly by CFC1 and CFC2. Consequently, funding Lower-Tier CFCs as a first step in on-lending to Taxpayer reduced Taxpayer’s income inclusion under section 951(a)(1)(B) by applying section 956 with respect to Lower-Tier CFCs rather than applying section 956 with respect to CFC1 and CFC2. Additionally, if Taxpayer’s section 956 inclusions were treated as out of applicable earnings of Lower-Tier CFCs rather than out of the applicable earnings of CFC1 and CFC2, Taxpayer would potentially be entitled to a much larger deemed paid foreign tax credit. CFC1 and CFC2 funded Lower-Tier CFCs so that section 956 would apply to Lower-Tier CFCs and not CFC1 and CFC2 in order to reduce the section 956 amounts derived from the Taxpayer loans, and to increase the amount of foreign tax credits it could claim with respect to the loans.

Moreover, the fact that the loans from CFC1 and CFC2 to Lower-Tier CFCs supplied most or all of the cash needed to fund the loans from Lower-Tier CFCs to Taxpayer indicates that the initial loans to Lower-Tier CFCs were made in order to provide Lower-Tier CFCs with cash to on-lend to Taxpayer, rather than for a legitimate business purpose. Taxpayer stated that the business purpose for the loans from CFC1 to Lower-Tier CFCs “stems from the fact that [CFC1] acts and has acted for many years as the shared service center for among other things cash management across most of [Continent] for the [Taxpayer’s] Group.”<sup>3</sup> This does not explain why Lower-Tier CFCs needed to borrow from CFC1 or CFC2 apart from the need to fund their loans to Taxpayer. The proximity in time of the loans to and from Lower-Tier CFCs also indicates that a principal purpose of the loans to Lower-Tier CFCs was to fund their loans to Taxpayer, and thus avoid section 956 with respect to CFC1 and CFC2. Lower-Tier CFCs that were funded by CFC1 did not even have possession of the funds for a whole day. This fact further illustrates that the loans to Lower-Tier CFCs did not have a valid business purpose other than to fund the loans to Taxpayer; the funds simply were not available for use by Lower-Tier CFCs for any significant length of time.

Under Treas. Reg. § 1.956-1T(b)(4), CFC1 and CFC2 are considered to hold indirectly the loans from Lower-Tier CFCs to Taxpayer (*i.e.*, United States property) for purposes of section 956 because one of the principal purposes for the loans from CFC1 and CFC2 to Lower-Tier CFCs was to avoid the application of section 956 with respect to CFC1 and CFC2. Accordingly, pursuant to sections 951(a)(1)(B) and 956, Taxpayer must include in income the section 956 amounts derived from CFC1 and CFC2 indirectly holding the Taxpayer loans rather than including in income the section 956 amounts which would be derived if Lower-Tier CFCs were considered to hold the Taxpayer loans.

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 317-6934 if you have any further questions.

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<sup>3</sup> An Information Document Request asking for the business purpose of the loan was not issued with respect to the loan between CFC2 and CFC7. However, for purposes of this memo, it is assumed that the business purpose for the loan between CFC2 and CFC7 would have been the same as the stated business purpose for the loans between CFC1 and Lower-Tier CFCs.