

Financing International Operations

Recent IRS Interpretation of the Code Sec. 267(a)(3)(B) Payment Standard Could Disrupt Taxation of International Treasury Operations

By L.G. "Chip" Harter, David H. Shapiro and Elizabeth Bouzis



L.G. "CHIP" HARTER is a Principal in the Washington National Tax Service of PricewaterhouseCoopers LLP.



DAVID H. SHAPIRO is a Principal in the Washington National Tax Service of PricewaterhouseCoopers LLP.



ELIZABETH BOUZIS is a Manager in the Washington National Tax Service of PricewaterhouseCoopers LLP.

Code Sec. 267(a)(3)(B) generally provides that a taxpayer accruing a deductible amount owed to a related foreign person is not entitled to a deduction in a year before the amount is paid. In 2013, the IRS released Chief Counsel Advice 201334037¹ (the "CCA"), which analyzes when an amount should be considered paid for these purposes. The CCA asserts a very high standard for establishing that payment is made, in that it disregards, under a circular cash-flow analysis, actual payments if the payments are directly or indirectly funded by the related payee.

If the payment standard set forth in the CCA were a correct interpretation of the statute, the effect on modern international treasury cash management practices would be dramatic.² As discussed below, the goal of cash management practices—such as international cash pooling and international payment netting systems—is to minimize the need for actual cash transfers between members of an affiliated group. Applying the CCA's payment standard to such treasury structures could result in the current accrual of income by payees, while the corresponding deductions of the related payors would be deferred for U.S. tax purposes, thus creating an artificial doubling up of earnings and profits within the affiliated group. Such an artificial inflation of the earnings and profits of group members could, in turn, have significant consequences in terms of foreign tax credit and repatriation planning and interest expense allocation.

The authors of this article believe that the payment standard set out in the CCA is not the correct standard for purposes of Code Sec. 267(a)(3)(B). As discussed below, the CCA applies the standard for payment that governs when a cash-basis payor is entitled to deduct an expense. Code Sec. 267(a)(3)(B), however, is a matching provision, which allows a deduction to the payor of a deductible amount in the tax year when the payee is taxable on the corresponding income amount. The regulations under Code Sec. 267(a)(3)(B) therefore specifically provide that payment is considered made for purposes of that section when a

cash basis *payee* would be taxable on the corresponding income. The standard for a “payment” triggering income to a cash-basis payee is a much lower standard than the one that applies to a cash-basis payor, in that a cash-basis payee can be taxed on deemed payments under the constructive receipt doctrine.

This article first traces the history and evolution of section 267(a) as applied in the international context, then reviews existing authorities governing what constitutes payment for purposes of Code Sec. 267(a)(3)(B). It next summarizes the CCA and discusses how, in the authors’ view, the CCA applies the wrong standard in testing whether payments had been made. We then discuss the potential impact of the CCA’s analysis on two important international treasury practices—international cash pooling and international payment netting—and explore how taxpayers might wish to modify their practices in response to the uncertainty created by the CCA.

I. Evolution of Code Sec. 267(a) in the Cross-Border Context

A. Code Sec. 267(a)(2): 1937–1984

In 1937, Congress enacted a provision (which, in 1954, would become Code Sec. 267(a)(2)) to permanently disallow deductions for interest and other expenses accrued in a related party transaction between taxpayers with different accounting methods, unless the accrued expense was actually paid within 2.5 months after the close of the tax year.³ Thus, to be allowed a deduction for an expense payable to a related party on the cash method, a taxpayer had to pay the expense in the year accrued, or very shortly thereafter. If the accrued expense was not paid within the specified window, the deduction was permanently denied—a particularly harsh result.⁴

In 1984, Congress mitigated this harsh result by amending Code Sec. 267(a)(2) to provide for a “matching rule” rather than a permanent disallowance rule. As amended, Code Sec. 267(a)(2) provides that a payor is not allowed to deduct its accrued expense owed to a related taxpayer *until* the corresponding amount is “includible in the gross income” of the payee.⁵ Notwithstanding this more lenient treatment, the rule was still designed as an anti-abuse rule, forcing related taxpayers “to use the same accounting method with respect to transactions between themselves in order to prevent the allowance of a deduction without the corresponding inclusion in income.”⁶ Congress explained that “the deduction by the payor will be allowed no earlier than when the corresponding income is recognized by the payee.”⁷

It is worth pausing here to focus on the specific statutory mechanic of Code Sec. 267(a)(2): For a taxpayer to deduct an expense that has accrued to a related person, the corresponding amount must be “*includible in the gross income*” of the recipient. When the related recipient is a U.S. person, this concept is clear—Code Sec. 61 (defining “gross income”) is purposefully broad, and Code Sec. 451 (describing the cash method of accounting) is not difficult to apply. However, when the related recipient is a foreign corporation, Code Sec. 882(b) provides that “gross income includes *only* (1) gross income which is derived from U.S. sources and is not effectively connected with the conduct of a trade or business in the United States, and (2) gross income that is effectively connected with the conduct of a trade or business within the United States.”⁸

In other words, foreign corporations only have “gross income” for U.S. tax purposes when that income is subject to U.S. tax, either as U.S.-source fixed or determinable, annual or periodic income (“FDAPI”) or effectively connected income (“ECI”). In respect of amounts constituting U.S.-source FDAPI or ECI payable to foreign corporations, Code Sec. 267(a)(2), as enacted in 1984, was clearly designed to limit a U.S. payor from taking a deduction for such amounts against its taxable income until such time as the foreign corporate recipient was subject to U.S. tax on the corresponding amount.

The law was less clear where a U.S. taxpayer owed an amount to a related foreign corporation, but the amount was *not* subject to U.S. tax in the hands of the foreign corporate recipient as either ECI or U.S.-source FDAPI. Such an amount would never be “includible in the gross income” of the related foreign corporation under Code Sec. 882(b). It was not clear that the U.S. taxpayer could ever accrue an expense deduction in respect of such an amount. An example was a foreign corporation that performs services outside the United States for its related U.S. subsidiary. Could the U.S. subsidiary accrue a deduction for these service fees, which would constitute foreign source non-ECI in the hands of the foreign corporation? The 1984 Bluebook noted:

The application of this provision [(i.e., Code Sec. 267(a)(2))] is not entirely clear in all situations involving amounts owed to related foreign corporations which are not included in gross income under section 882(b).⁹

B. 1986 Enactment of Code Sec. 267(a)(3)(A)

To address this uncertainty, Congress enacted in 1986 Code Sec. 267(a)(3)(A)¹⁰ as a technical correction to Code Sec.

267(a)(2).¹¹ It provides that “[t]he Secretary shall by regulations apply the matching principle of section 267(a)(2) in cases in which the person to whom the payment is to be made is not a United States person.”

In the legislative history, Congress again acknowledged that the application of the matching provision of Code Sec. 267(a)(2) was “unclear when the related payee was a foreign person that does not, for many Code purposes, include in gross income foreign source income that is not effectively connected with a U.S. trade or business.”¹² Congress posed the following example to illustrate the point and to explain the regulations that might be forthcoming:

[A]ssume that a foreign corporation, not engaged in a U.S. trade or business, performs services outside the United States for use by its wholly owned U.S. subsidiary in the United States. That income is foreign source income that is not effectively connected with a U.S. trade or business. It is not subject to U.S. tax (or, generally, includible in the foreign parent’s gross income). Under the bill, regulations could require the U.S. subsidiary to use the cash method of accounting with respect to the deduction of amounts owed to its foreign parent for these services.¹³

Notwithstanding the fact that Code Sec. 267(a)(3)(A) was designed to address a specific ambiguity in the application of Code Sec. 267(a)(2), the actual text of the statutory provision grants the Treasury broad regulatory authority. The regulations can apply the matching principle to any case in which the recipient of a payment is foreign. For example, Congress noted:

In the case of amounts accrued to a controlled foreign corporation by a related person, regulations might appropriately require the payor’s accounting method to conform to the method that the controlled foreign corporation uses for U.S. tax purposes.¹⁴

C. 1992 Regulations under Code Sec. 267(a)(3)(A) (issued prior to the enactment of Code Sec. 267(a)(3)(B))

1. The General (a)(3) Matching Rule

In accordance with the statutory direction of Code Sec. 267(a)(3)(A), regulations were issued under Code Sec. 267(a)(3) in 1992. As a general rule, Reg. §1.267(a)-3(b)(1) provides:

An amount that is owed to a related foreign person and that is otherwise deductible under Chapter 1 ... may

not be deducted by the taxpayer until such amount is paid to the related foreign person An amount is treated as paid for purposes of this section if the amount is considered paid for purposes of section 1441

Treas. Reg. §1.1441-2(e)(1) in turn provides:

A payment is considered made to a person if that person realizes income whether or not such income results from an actual transfer of cash or other property. ... A payment is considered made when the amount would be includible in the income of the beneficial owner under the U.S. tax principles governing the cash basis method of accounting

This article collectively refers to these two provisions—Reg. §1.267(a)-3(b)(1) and Reg. §1.1441-2(e)(1)—as the “General (a)(3) Matching Rule.” Note that defining payment by reference to when a cash-basis payee would take an amount into income is consistent with the matching architecture of Code Sec. 267(a). This definition of payment creates timing symmetry between when a payor gets to deduct an amount and when the payee would take the amount into income for U.S. tax purposes if it were subject to U.S. income tax.

The regulations draw a clear distinction between the basic rule of Code Sec. 267(a)(2) and the General (a)(3) Matching Rule. Thus, if an amount is otherwise “includible in gross income” of a related foreign recipient under Code Sec. 882(b), then the statutory matching rule of Code Sec. 267(a)(2) already applies, and there is no need for a clarifying regulation under Code Sec. 267(a)(3). The payor’s deduction is unlocked on the day the amount is actually “includible in the gross income” of the recipient.¹⁵ However, if the recipient/payee has no gross income from a U.S. perspective, it also has no U.S. accounting method with respect to such income. The General (a)(3) Matching Rule then steps in and provides one. It assigns a hypothetical accounting method to foreign persons lacking one¹⁶—and it does so by reference to the time at which the income would have been subject to U.S. withholding tax if the income had been taxable by the United States. Thus, when it applies, the General (a)(3) Matching Rule looks to when the payee would otherwise have been taxed by the United States and matches the payor’s deduction to this time.

2. Scope of the General (a)(3) Matching Rule

When regulations were issued under Code Sec. 267(a)(3)(A), the drafters exercised their discretion to exclude important categories of income other than interest from the scope of the provision. For example, the General

(a)(3) Matching Rule was not applied to amounts other than interest that are (1) from foreign sources and not ECI¹⁷ or (2) from U.S. sources but exempt by virtue of treaty.¹⁸ For example, fees paid to a foreign related party for services performed by the related party outside of the United States are not subjected to the General (a)(3) Matching Rule.

The regulations, however, applied the General (a)(3) Matching Rule much more broadly to related-party interest accruals. The rule is applied to amounts of both U.S. and foreign-source interest to be received by a related foreign person who is not engaged in a U.S. trade or business, whether or not the interest is exempt from tax under a tax treaty. The rule is also applied to interest payable to a foreign person who is engaged in a U.S. trade or business, but only if the amount is exempt from tax under a tax treaty.¹⁹

A cautious taxpayer therefore might wish to avoid having a Netting Center effectively finance its participants by requiring that such negative balances be paid to the Netting Center before year-end.

The drafters of the regulations presumably chose to exclude from the operation of Code Sec. 267(a)(3)(A) amounts of foreign-source non-ECI other than interest, such as foreign-source related-party service fees, because such amounts typically arise in the ordinary course of business and are unlikely to involve inappropriate tax planning. As discussed below, an open issue exists as to whether these regulatory exceptions survived the enactment of Code Sec. 267(a)(3)(B) as part of the American Jobs Creation Act of 2004 (“AJCA”), described below.

3. The Pre-AJCA CFC Exception

Notwithstanding the regulation’s broad approach to interest, it did provide an important exception for payments owed to controlled foreign corporations (“CFCs”). Notably, Reg. §1.267(a)-3(c)(4)(ii) (hereinafter, the “Pre-AJCA CFC Exception”) provides:

If [U.S. or foreign source interest] is owed to a related foreign person that is a controlled foreign corporation . . . , then the amount is allowable as a deduction as of the day on which the amount is includible in the

income of the controlled foreign corporation. The day on which the amount is includible in income is determined with reference to the method of accounting under which the controlled foreign corporation computes its taxable income and earnings and profits for purposes of sections 951 through 964.

This rule meant that a deduction could be claimed with respect to interest owed to a related, accrual-basis CFC, *even if that interest was not subpart F income to the CFC.*²⁰ Thus, the fact that the amount was “includible” in the income of the CFC for E&P purposes—albeit not subject to current U.S. tax as U.S. source FDAPI, ECI or subpart F income—was seen as sufficient to satisfy the matching principle of Code Sec. 267(a)(2). The preamble to the regulations noted that:

This [exception for amounts owed to related CFCs] is a substantial exception to the otherwise applicable general rule of these regulations. Relief is deemed appropriate in such cases because there is little material distortion in the matching of income and deductions with respect to amounts owed to a related foreign corporation that is required to determine its taxable income and earnings and profits for United States tax purposes pursuant to the foreign personal holding company, subpart F, or passive foreign investment company provisions.²¹

Nothing in the preamble language implies that the IRS and the Treasury were focused solely on circumstances in which a CFC payee would treat the accrued payment as subpart F income, and an example in the regulations clearly demonstrates that the IRS and the Treasury understood the implication for payments that were excludible from the payee’s subpart F income.²²

4. The Tate & Lyle / Square D Litigation

The validity of the 1992 regulations described above was the subject of considerable litigation. Two companies—Tate & Lyle and Square D—challenged the validity of the regulations in separate cases, arguing that it was improper to apply the “matching principle” to interest income that is exempt from tax under a U.S. tax treaty.

These taxpayers acknowledged that Code Sec. 267(a)(3)(A) requires that the “matching principle” of Code Sec. 267(a)(2) be applied by regulations to amounts owed to foreign persons. However they articulated the “matching principle” in the following manner: the deduction of an accrued expense must be deferred when (1) a taxpayer accrues an expense that is otherwise deductible, (2) the

taxpayer and the payee are related, and (3) the item is not included in the payee's gross income during the year *by reason of the payee's method of accounting*.²³

These taxpayers argued that when a related payee did not include an item in its gross income by reason of an income tax treaty, which effectively exempts the item from gross income, the third prong of this principle was not met because the exclusion from gross income is unrelated to the foreign recipient's method of accounting. Thus, these taxpayers argued that the regulations were invalid to the extent that they applied the General (a)(3) Matching Rule to situations in which interest was payable to a related foreign person who was exempt from tax by virtue of tax treaty. This argument initially met with success in the Tax Court.²⁴ However, the IRS prevailed in the Third Circuit,²⁵ and subsequently in the Tax Court²⁶ and the Seventh Circuit.²⁷ These courts held that the regulation was a valid exercise of regulatory authority, even though it applied the General (a)(3) Matching Rule to taxpayers paying interest to exempt treaty recipients. These decisions indicated that the intent of Code Sec. 267(a)(3)(A) was not clear, but noted that the legislative history had anticipated that the matching principle would apply to situations where payments were made to foreign persons who did not owe U.S. tax with respect to those amounts. Therefore, the courts held that the regulations were entitled to deference and valid.

D. 2004 Enactment of Code Sec. 267(a)(3)(B)

As implemented by regulations, Code Sec. 267(a)(3)(A) applied predominantly to deductible amounts owed by U.S. taxpayers to related foreign persons that were not CFCs. The Pre-AJCA CFC Exception exempted amounts owed by U.S. taxpayers to related CFCs, provided that the CFCs were on the accrual method of accounting, which most were. Payments owed by one CFC to a related CFC were similarly exempted, provided that the payee CFC was on an accrual method of accounting.²⁸ Therefore, prior to 2004, Code Sec. 267(a)(3) applied mainly in the inbound context, where U.S. subsidiaries of foreign multinationals owed deductible amounts to foreign affiliates that were not CFCs. In the outbound context, involving U.S.-owned multinational groups, most deductible amounts owed to foreign related parties were owed to accrual-method CFCs and therefore exempt. Code Sec. 267(a)(3) therefore received relatively little attention in the outbound context.

This paradigm shifted dramatically in 2004, when Congress added Code Sec. 267(a)(3)(B) as part of the American Jobs Creation Act specifically to override the Pre-AJCA CFC Exception. Code Sec. 267(a)(3)(B) provides:

- (i) In general. Notwithstanding subparagraph (A), in the case of any item payable to a [CFC] . . . , a deduction shall be allowable to the payor with respect to such amount for any taxable year before the taxable year in which paid only to the extent that an amount attributable to such item is includible (determined without regard to properly allocable deductions and qualified deficits under section 952(c)(1)(B)) during such prior taxable year in the gross income of a United States person who owns (within the meaning of section 958(a)) stock in such corporation.
- (ii) Secretarial authority. The Secretary may by regulation exempt transactions from the application of clause (i), including any transaction which is entered into by a payor in the ordinary course of a trade or business in which the payor is predominantly engaged and in which the payment of the accrued amounts occurs within 8-1/2 months after accrual or within such other period as the Secretary may prescribe.

Whereas under the prior regulations, Code Sec. 267(a)(3)(A) did not apply so long as the deductible amount was owed to an accrual-basis CFC, Congress in 2004 provided that the deduction of any amount owed to a related CFC must be deferred until payment, unless the corresponding income amount is subpart F income taxable to the U.S. shareholder.

The relevant portions of the AJCA legislative history focused primarily on situations in which the payor of the interest (or other deductible amount) was a U.S. net-basis taxpayer obtaining a current U.S. tax benefit from the deduction, but the income of the related CFC was subject to U.S. tax only on a repatriation of its earnings to its U.S. shareholders.²⁹ Referring to the Pre-AJCA CFC Exception of the regulations, the House Report notes “[t]he Committee believes that this premise [that the subpart F regime would prevent material distortions] fails to take into account the situation where amounts owed to the related foreign corporation are included in the income of the related foreign corporation but are not currently included in the income of the related foreign corporation's U.S. shareholder.”³⁰

Although the focus of Code Sec. 267(a)(3)(B) was with respect to accruals of amounts owed by U.S. taxpayers to related CFCs, it also appears that the provision applies to payments made *between* CFCs. Thus, where a CFC is the party owing a deductible amount to another CFC, Code Sec. 267(a)(3)(B) provides, in effect, that the timing of the deduction to the CFC payor must be matched to the income recognition by the *U.S. shareholder* of the CFC payee, *not* to the timing of recognition by the CFC payee. Code Sec. 267(a)(3)(B) thus overrides the Pre-AJCA CFC Exception in the regulations, and thus expands the

application of Code Sec. 267 to many kinds of foreign-source items paid between CFCs.

Code Sec. 267(a)(3)(B) can also apply to defer the deduction with respect to a payment owed between related CFCs, even though the payee CFC must, itself, accrue income currently for all U.S. federal income tax purposes. Whereas prior to 2004, Code Sec. 267(a)(3) was a topic of interest primarily in the inbound context, after the addition of Code Sec. 267(a)(3)(B) by the AJCA, the section potentially applies to all deductible amounts payable between all foreign subsidiaries of U.S.-owned multinational groups.

Little thought appears to have been given by Congress to these payments made *between* CFCs,³¹ and virtually no consideration was given to the interaction between Code Sec. 267(a)(3)(B) and the CFC look-thru rules that were enacted at the same time. Notwithstanding this lack of congressional consideration, when Code Sec. 267(a)(3)(B) applies, a payee CFC on the accrual method must recognize and characterize its income in a year before the payor CFC has a deduction to allocate.

This timing mismatch raises issues, such as to how to apply “look-thru” rules under the foreign tax credit basketing regime and the subpart F regime to such payments, because these “look-thru” rules base the characterization of the income accruing to the CFC payee on how the corresponding deduction to the CFC payor is allocated. These issues can be quite complex and have been addressed elsewhere.³² But, importantly, taxpayers hoping to avoid these complex issues (rather than take advantage of them) can do so by making sure the payments are actually made between related CFCs in the years they accrue. In other words, as with all issues under Code Sec. 267(a)(2) & (3), satisfying the requirement that “payment” be made ensures that no expense will be deferred. Therefore, a key question in complying with Code Sec. 267(a)(3) is what constitutes “payment” for purposes of that section.

II. Definition of “Payment” for Purposes of Code Sec. 267(a)(3)

Although the AJCA expanded the types of transactions to which the Code Sec. 267(a)(3) payment requirement applies, there is no indication that Congress intended to change what constitutes a payment for purposes of Code Sec. 267(a), which had long been established by regulation.

As discussed above, Reg. §1.267(a)-3(b)(1) starts with the language:

Except as otherwise provided ... section 267(a)(3)(B) requires a taxpayer to use the cash method of accounting with respect to the deduction of amounts owed to a related person. An amount that is owed to a related person and that is otherwise deductible ... thus may not be deducted by the taxpayer until such amount is paid to the related foreign person.

If the regulation ended there, the relevant authorities would be those interpreting Reg. §1.451-1(a), which governs when a cash-basis taxpayer is entitled to a deduction. Extensive case law exists interpreting what constitutes payment for this purpose.

It is crucial to note, however, that the regulation does not end there. Instead it further provides that “An amount is *treated as paid for purposes of this section* if the amount is considered paid for purposes of section 1441 or 1442”³³ This specific rule providing that an amount “is treated as paid for purposes of this section,” and therefore deductible, when it is considered paid for purposes of the withholding tax provisions thus shifts the frame of reference of the test in a subtle but important way: The withholding tax provisions define payment by reference to when a *payee* must take an amount *into income* rather than when a *payor* obtains the *deduction*. Reg. §1.1441-2(e)(1) provides:

A payment is considered made to a person if that person realizes income whether or not such income results from an actual transfer of cash or other property. For example, realization of income from the cancellation of indebtedness results in a deemed payment. A payment is considered made when the amount would *be includible in the income of the beneficial owner* under U.S. tax principles governing the cash method of accounting.³⁴

This definition of payment by reference to the treatment of the beneficial owner, or payee, is entirely consistent with the matching principle underlying Code Sec. 267(a)(3)—the timing of the deduction to the payor is intended to match the timing of the income inclusion to the payee. Therefore, defining payment by reference to what results in an income inclusion to the payee achieves that matching.

At this point, it should be noted that there is a very important difference between the standards governing when a cash-basis borrower deducts interest expense and when a cash-basis lender includes interest income. Simply put, the concept of “constructive receipt” applies to a cash-basis lender earning interest income, but it has no application to a cash-basis borrower and the timing of its deduction. This is evidenced most clearly in Reg. §1.446-2(c)(1)(i),

which describes the cash method of accounting and provides that income is “to be included for the taxable year in which *actually or constructively* received ... [whereas] [e]xpenditures are to be deducted for the taxable year in which *actually* made.”³⁵

Thus, regulations under Reg. §1.451-2, relating to the constructive receipt of income, apply to cash-basis lenders, but not to cash-basis borrowers. Under those regulations, a cash-basis lender accounts for interest income when the interest is “credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time” without substantial restrictions.³⁶ As an example, the constructive receipt regulations note that “interest credited on savings bank deposits ... is income to the depositors ... for the taxable year when credited.”³⁷ Furthermore, “[a]mounts payable with respect to interest coupons which have matured and are payable but which have not been cashed are constructively received in the taxable year during which the coupons mature, unless it can be shown that there are no funds available for payment of the interest during such year.”³⁸

From the beginning, Code Sec. 267(a) has specified that the authorities regarding cash method accounting *for income recognition* are dispositive of the question of when the payor gets a deduction and that the doctrine of constructive receipt applies when determining income recognition. Indeed, the regulations that implement the pre-1984 version of Code Sec. 267(a)(2) are explicit on these points.

Recall that prior to 1984, an accrual-method taxpayer was permanently denied a deduction for interest expense owed to a related party on the cash method unless the accrued expense was “paid” within 2.5 months after the close of the tax year.³⁹ The pre-1984 regulations provide an example that allows a deduction to an accrual-method taxpayer “if the interest [accruing in 1956] had actually been paid to [the related person on the cash method] on or before March 15, 1957, *or* if it had been made available to [him] before that time (and thus had been constructively received by him).”⁴⁰ Thus, the regulations expressly allowed a deduction if the creditor *constructively received* the interest, regardless of whether the payor *actually paid* the interest. In cases applying the matching principle of Code Sec. 267(a)(2), courts accordingly have looked to the constructive receipt doctrine of Code Sec. 451 to determine whether payees have constructively received income such that a deduction can be taken by the related payors.⁴¹

It should also be observed that when the current regulations specifically provide that “an amount is treated as paid for purposes of this section if the amount is considered paid for purposes of section 1441 or section 1442 ... ,”

the regulations are cross-referencing the extremely broad definition of payment used in the withholding tax context. A broad definition of payment maximizes withholding tax revenues, and a fairly mechanical definition of payment allows the withholding agents to withhold appropriately even when they need to operate based on limited facts. By deeming constructive receipts to be payments subject to withholding, the broad withholding tax definition of payment thus maximizes revenues.⁴² By making all “actual” cash payments subject to withholding, the regime simultaneously institutes a mechanical rule that withholding agents can apply.

It would be inconsistent with the architecture of the withholding tax rules to conclude that an actual payment of cash was not a payment subject to withholding tax under some circular cash-flow or substance-over-form doctrine, given that such an application would reduce withholding tax revenues and require a factual inquiry that withholding agents are not capable of discharging. The authors are aware of no authority that has disregarded an actual cash payment for withholding tax purposes.

III. CCA 201334037

In CCA 201334037, however, the IRS disregarded actual payments for purposes of Code Sec. 267(a)(3)(B), notwithstanding that the definition of payment under that section is the withholding tax definition.

The CCA involved a U.S. corporate taxpayer that had borrowed from its foreign parent. When the taxpayer owed an interest payment to its foreign parent, the IRS states that “funds sufficient to cover these ‘payments’ ... were obtained shortly before or shortly after a claimed payment of interest, either through additional loans from the foreign parent or pursuant to draw-downs on one or more lines of credit with the foreign parent.” Sometimes, interest due to the foreign parent “was ‘paid’ to the foreign parent by directly netting a required interest ‘payment’ against a foreign parent new advance.” All interest amounts were actually paid by wire transfer from a general bank account of the U.S. subsidiary, in which it commingled its funds from operations, from third-party borrowings and from related-party borrowings.

Although the interest amounts were actually paid by wire transfer, the IRS focused on the fact that the funds used to pay the interest were directly or indirectly advanced by the lender or an affiliate of the lender. Among the permutations discussed in the CCA were cases where: (i) the parent advanced funds to the subsidiary shortly before the payment of the interest; (ii) the parent advanced funds shortly after the payment of the interest; (iii) a foreign

affiliate advanced funds to the U.S. borrower; and (iv) a foreign affiliate advanced funds to a consolidated group member of the U.S. borrower, which in turn advanced funds to the borrower. The analysis of the CCA focused heavily on the fact that the outstanding balance of the amount owed by the U.S. borrower to the foreign parent increased in the aggregate over the years in question.

The CCA held that, by reason of Code Sec. 267(a)(3), the taxpayer was not entitled to an interest deduction in respect of interest due to its foreign parent. Effectively, the CCA held that the interest due to the foreign parent was not “paid” for purposes of Code Sec. 267(a)(3) because the payment was directly or indirectly funded by the foreign parent. In the IRS’s view, the U.S. borrower had not “paid” the interest because it had, instead, borrowed the amount from the foreign parent and transferred it back (but not “paid” it) in a circular transaction.

The CCA based its conclusions on *Battelstein, Davison* and other cases⁴³ “dealing with the taxation of lender-borrower circular cash flows.” Factually, each of the cited cases is unique, but they all involve a similar paradigm: (1) A cash-method borrower owes interest to a lender, and (2) the lender advances cash to the borrower of an equal amount, which is then paid back by the borrower to the lender in satisfaction of the interest due. The cases address the borrower’s ability to deduct this payment under the cash method of accounting.

Not surprisingly, the cases focus on the “circle” of cash, observing that the funds go from the lender to the borrower and back again. Essentially, the cases probe whether the borrower: (i) has “unrestricted control” over the new funds advanced by the lender (a helpful fact in establishing that the “circle” of cash is not inevitable, and therefore, helpful to the cash method borrower sustaining its deduction); or (ii) has “specifically earmarked” the funds advanced by the lender to pay the interest due (a fact that shows that the circular flow of cash was preordained and should be disregarded as a “payment” made by a cash method borrower).

The cases cited by the CCA relate to the *deduction* of interest under the cash method of accounting—*i.e.*, they address whether the borrower has made a “payment” of interest, for which it is entitled to take a deduction, as a cash-method taxpayer. They do not address whether a cash-method lender has received a “payment” that must be included in income. As noted above, a cash-method lender must consider the doctrine of constructive receipt when determining whether it has income.

As discussed above, when Code Sec. 267(a)(3) applies, it assigns a cash method of accounting to the *recipient* of the income and matches the payor’s deduction to the

timing of this income inclusion. In other words, Code Sec. 267(a)(3) does not put the payor on the cash method of accounting; rather, it puts the payee on the cash method of accounting and matches the payor’s deduction to the payee’s inclusion.

The CCA does not reflect that Reg. §1.267(a)-3(b)(1), by providing in its last sentence that “[a]n amount is *treated as paid for purposes of this section* if the amount is considered paid for purposes of sections 1441 or 1442 ...”⁴⁴ shifts the test from that of a cash-basis payor to a cash-basis payee. The CCA similarly does not reflect that the withholding tax definition of payment incorporated into the Code Sec. 267 regulations is a broad definition that incorporates all actual payments as well as deemed payments under the constructive receipt doctrine. The CCA thus applied the wrong legal standard in analyzing the transactions before it, and the cases it relies upon dealing with cash-basis payors are not relevant. If the interest payments discussed in the CCA had been subject to withholding and the issue was whether payment had been made for purposes of Code Secs. 1441 and 1442, it is difficult to imagine that the IRS would have determined that no withholding tax was due.

IV. Application of Code Sec. 267(a)(3)(B) to International Treasury Operations

The potential application of Code Sec. 267(a)(3)(B) to international treasury operations is extremely broad, given that the section can apply to payments made by both domestic corporations and CFCs to foreign related persons. With respect to U.S.-based multinational groups, both outbound and foreign-to-foreign deductible payments are potentially covered. With respect to foreign-based multinational groups, payments from U.S. group members to foreign affiliates are the main concern, unless the U.S. group members themselves own CFCs. Rather than attempt to catalogue all potential applications of Code Sec. 267(a)(3)(B) to international treasury operations, the analysis that follows will focus on two types of international treasury structures frequently used by multinational corporations: international cash pools and international netting centers.

A. International Cash Pools and International Netting Centers

To better manage their liquidity and to fund operations internally, most large multinational groups have established

international cash pooling structures. The group typically designates an entity (a “Treasury Center”) that effectively acts as an internal bank to the group, taking deposits from affiliates with excess cash and extending loans to affiliates that require funding. The Treasury Center will typically earn a modest spread between what it earns on the loans and what it pays on the deposits.

Such a cash pooling arrangement has several operational advantages. If each member of the group simply deposited with or borrowed from an external bank, that practice would tend to “balloon” the group’s balance sheet and cost the group the difference between the rate charged on loans and the rate earned on deposits. Cash pooling allows free cash to be efficiently employed within the group. It also can simplify banking relationships by avoiding the need for each group member to have external banking transactions. Another important benefit of cash pooling is that it helps centralize the management of foreign currency risk because each depositor can place deposits with the Treasury Center in the depositor’s functional currency, while each borrower can borrow in its functional currency. The Treasury Center then can hedge its net foreign currency position with respect to its portfolio of deposits and loans.

International Netting Centers are structured to simplify the settlement of amounts owed by different affiliates of a multinational group to each other. The members of the group frequently do business with each other, resulting in payment obligations for the sale of goods, provision of services, payment of royalties and the like. In a group with dozens of affiliates doing business with each other, each affiliate can have numerous obligations to dozens of other affiliates, resulting in a complex matrix of intercompany payment obligations. If each affiliate were itself to make payment on all of its related-party obligations, it would need to make numerous payments in multiple currencies.

Netting Centers simplify this process through a broad multilateral netting process. One group entity, the Netting Center, effectively acquires from each affiliate all of the affiliates’ intercompany receivables and assumes the obligations under all of the affiliates’ intercompany payables. To the extent the amount of receivables acquired by the Netting Center from a given affiliate in a netting cycle exceeds the amount of the affiliate’s payables that it assumes, the Netting Center credits the affiliate for the difference in an intercompany account between the Netting Center and the affiliate. To the extent that the Netting Center assumes more payables than the receivables it acquires, that excess is charged against the affiliate in its account with the Netting Center.

Once the Netting Center has acquired all of the intercompany receivables and payables from each affiliate in

the group, the affiliates no longer have amounts payable to and receivable from multiple affiliates; instead, all of the obligations run to and from the Netting Center. The Netting Center then has a single net balance with each affiliate in that affiliate’s functional currency, which then can be settled or carried forward. Through this mechanism, multinational groups can avoid the need to make thousands of intercompany payments and mitigate the foreign currency exposures of affiliates as they deal with each other in multiple currencies.

International Cash Pools and International Netting Centers are both structures used to minimize the need for cash payments among global affiliates and the need for external bank accounts and banking activity. Given that these structures are used to make payments of deductible expenses among related parties, a question arises as to whether such payments satisfy the requirements of Code Sec. 267(a)(3)(B) and what the consequences might be if those requirements are not met. This article next separately considers International Cash Pools and International Netting Centers and discusses how the payment requirement of Code Sec. 267(a)(3)(B) could be satisfied in each case.

B. Application of Code Sec. 267(a)(3)(B) to International Cash Pools

1. What is at stake if the payment requirement is not satisfied?

If the payment requirement is not satisfied with respect to a deductible amount accrued by a U.S. person with respect to a related foreign payee, Code Sec. 267(a)(3)(B) simply defers the deduction for the accrued amount until the payment requirement is satisfied. Where the related foreign person is a CFC, however, payment is not required if the corresponding income accrual to the CFC is currently taxable to its U.S. shareholder under subpart F. Where the related foreign person is not a CFC, the payment requirement must always be satisfied for the payor to obtain a deduction. To the extent that the IRS seeks to apply a standard of “payment” that is inappropriately narrow, it therefore will be deferring deductions for U.S. payors where such amounts are properly deducted currently.

If the payment requirement is not satisfied with respect to a deductible amount accrued by a CFC in favor of a related CFC, the effects can be more complex. Because a deduction is allowed to an accrual basis payor regardless of whether payment is made if the corresponding income item is currently taxed to a U.S. shareholder under subpart F, these issues arise only if the income accrued by the related CFC payee is not currently taxed to the U.S.

shareholder. Given the broad availability of subpart F exceptions for related-party interest, rents and royalties under Code Sec. 954(c)(6), and the same-country exceptions under Code Sec. 954(c)(3), however, the income of the CFC payee often will not be subject to current subpart F taxation. In those cases, if the payment requirement is not satisfied, the net effect of Code Sec. 267(a)(3)(B) is a doubling-up of offshore earnings and profits until payment is made. The CFC payee, as an accrual-basis taxpayer, will accrue the unpaid amount into income currently, while the related CFC payor will not have a deduction for purposes of computing either income or earnings and profits⁴⁵ until the year payment is made.

To illustrate the effects in the context of an international cash pooling structure, assume that a Treasury Center takes a deposit from CFC1 and lends a corresponding amount to CFC2. For the sake of simplicity, assume that the Treasury Center earns no spread on the transactions and earns \$100 of interest on the loan to CFC2 and pays \$100 of interest on the deposit from CFC1. Further assume that no actual payments of interest are made during the tax year. If the Treasury Center and CFC1 are not considered in constructive receipt of the accrued interest and the payment requirement is not otherwise satisfied, the results would be as follow.

CFC2's \$100 interest deduction with respect to its borrowing from the Treasury Center would be deferred for U.S. tax purposes until the year the interest is paid. The interest expense likely would be currently deductible for foreign tax purposes, with the result that CFC2 would be reporting more current net income for U.S. tax purposes than for foreign tax purposes. This mismatch would lower the foreign effective tax rate on CFC2's earnings pool during years before the interest is paid. Therefore, distributions made out of CFC2's earnings pools during this period would carry fewer foreign taxes to credit against the U.S. tax liability on the distributions.

The Treasury Center would currently accrue into income the \$100 of interest on the loan to CFC2, notwithstanding that no payment had been made and that CFC2 is not able to deduct a corresponding amount currently. Code Sec. 267(a)(3)(B) would simultaneously defer the Treasury Center's deduction for its \$100 of interest expense accrued with respect to its deposit from CFC1. Therefore, the Treasury Center would currently report \$100 of net income for U.S. tax purposes, notwithstanding the fact that it has no economic income. The Treasury Center would likely accrue currently both its \$100 of interest income and its \$100 of interest expense for foreign tax purposes and have no net income for foreign tax purposes. Therefore, the \$100 of earnings and profits that the Treasury Center

would have until it pays its interest expense would have zero foreign tax credits associated with it.

CFC1, meanwhile, would currently accrue into income its \$100 of interest on its deposit with the Treasury Center and would likely do so for foreign tax purposes as well, creating a \$100 earnings pool taxed at the foreign statutory rate. The combined effect on the three group members involved in the deposit and the loan is that they experience an increase in their combined earnings and profits of \$200 from intercompany transactions that produce no net income to the group. The foreign effective tax rate on the earnings of CFC2, the borrower, is reduced by the fact that it is likely entitled to a current deduction for foreign tax purposes, despite the deduction being deferred for U.S. tax purposes. The \$100 earnings pool created in the Treasury Center likely has a zero-percent foreign effective tax rate, and the \$100 earnings pool created at CFC1, the depositor, likely has a rate equal to the foreign effective tax rate. The mismatched effects to CFC 2 and the Treasury Center can reverse out if interest payments are made in a subsequent year before either CFC2 or the Treasury Center makes a dividend distribution and before their earnings and profits are otherwise taken into account, for example, under Code Sec. 1248 or Code Sec. 956. Even if interest payments are made in a subsequent year prior to any distributions or deemed distributions, however, the temporary doubling up of earnings and profits within the CFC group would have adverse interest expense allocation effects under Reg. §1.861-12(c)(2).

The example discussed above is the simplest possible illustration of Code Sec. 267(a)(3)(B) applying to an international cash pool among CFCs. As a practical matter, because dozens of CFCs can participate in a cash pool, the complexity soon becomes overwhelming if the payment requirement is not satisfied prior to every year-end with respect to all interest accruals.

If the payment requirement has not been satisfied, but the group has not taken into account the application of Code Sec. 267(a)(3)(B), the earnings and profits pools of the group members will be incorrectly calculated, as will the effective foreign tax rates on those pools. Such errors would likely lead to errors in repatriation planning and in analyzing the impact of corporate restructurings, both of which are heavily dependent on the correct calculation of such tax attributes. In addition, more of the taxpayer's consolidated interest expense would be allocated against foreign-source income, thereby eroding the group's foreign tax credit limitation because the inflated earnings and profits of the CFCs would increase the group's foreign asset basis for interest expense allocation purposes.

2. Observations on satisfying the payment requirement

It should be possible for taxpayers to draft the legal agreements implementing a cash pooling agreement in such a way to provide a strong basis for concluding that each creditor is in constructive receipt of its accrued interest income immediately prior to the end of each tax year. The deposit agreements can provide that accrued interest income must be paid periodically to the depositors unless the depositors affirmatively notify the Treasury Center to roll the principal and accrued interest into a new deposit shortly before the maturity date of the existing deposit.

Provided that the decision to re-invest the accrued interest is the exercise of a unilateral right of the depositor, the depositor should be considered in constructive receipt of the accrued interest income, and the payment requirement of Code Sec. 267(a)(3)(B) should be satisfied under the authorities discussed above. Having such deposits mature on a 30-day cycle, for example, with a maturity date falling very shortly before year-end, should provide that essentially all of the interest accrued on the deposits over the year would be treated as paid during the year for purposes of Code Sec. 267(a)(3)(B); that result would entitle the Treasury Center to deduct its accrued interest expense.

The documentation of the loans made by the Treasury Center can similarly be drafted to support a conclusion that the Treasury Center is in constructive receipt of the interest accruing on the loans. The loan or overdraft agreements, like the deposit agreements, can be structured as a series of short-term (*e.g.* 30-day) advances, with the Treasury Center entitled to receive a full repayment of principal and interest at the maturity of each advance. Provided that any relending of the principal and accrued interest at the maturity of a loan is based on a new mutual agreement of the parties, the Treasury Center should be viewed as in constructive receipt of the interest income accrued on the first loan even if it is refinanced in the second loan rather than paid. It is important to note, however, that if the borrower has the unilateral right to roll its accrued interest expense into a new borrowing, the constructive receipt doctrine might not be available. It therefore can be problematic to combine committed credit facility terms with an international cash pooling structure.

As discussed above, the IRS's analysis in the CCA appears to be inconsistent with a reliance on the constructive receipt doctrine to satisfy the payment requirement of Code Sec. 267(a)(3)(B). Although the authors of this article believe that the IRS's analysis in the CCA is incorrect and that constructive receipt should constitute payment for purposes

of Code Sec. 267(a)(3)(B), taxpayers may wish to consider what additional steps they could implement with respect to their cash pooling structures to avoid potential conflicts with the IRS. Unfortunately, implementing payment procedures that would clearly satisfy the IRS's analysis in the CCA would often end up undermining the commercial utility of cash pooling structures.

To clearly satisfy the CCA's payment standard, each debtor in a cash pooling structure would need to make a cash transfer in payment of its accrued interest expense for the year and show that the creditor has not directly or indirectly financed the payment of the accrued interest. Seeking to satisfy this standard would present a number of commercial difficulties.

With respect to the interest owed by the Treasury Center to the depositing affiliates, the commercial reality is that the depositing affiliates typically do not want to receive a current payment of their accrued interest income. The depositors are depositing cash that they hold in excess of the needs of their businesses. The interest earned on the deposits represents additional excess cash that must be invested somewhere. The central purpose of the cash pooling structure is to give such affiliates an efficient place to invest such excess cash within the group so that they are not required to maintain deposit balances with external banks. In theory it would be possible to satisfy the CCA's payment standard by requiring each depositor to take cash payment from the Treasury Center of its accrued interest income and to deposit that amount with an unrelated party for a considerable period of time before lending it back to the Treasury Center. Requiring such operational protocols, however, would considerably undermine the commercial utility of a cash pooling structure.

Similar commercial inefficiencies would arise if one were to satisfy the CCA's definition of payment with respect to the accrued interest on the loans from the Treasury Center to the borrowing affiliates. Some borrowing affiliates may need increasing levels of funding over time. If the Treasury Center (or other affiliates) provides increasing levels of funding to an affiliate, the analysis in the CCA would conclude that the Treasury Center has directly or indirectly financed interest paid or accrued by the borrower. The only lending by a Treasury Center that would satisfy the CCA's standard would be a loan in respect of which all of the interest is currently paid in full and the balance of which never increases.

In light of the uncertainty created by the CCA and the commercial inefficiencies that arise if one were to attempt to implement payment protocols that fully satisfy the analysis of the CCA, taxpayers might consider taking an intermediate position. At least with respect to participants

in the cash pool that have external bank accounts, it could be worthwhile to make actual wire transfer payments prior to year-end of interest accrued during the year. Even if this interest amount is then immediately re-lent to the Treasury Center or to the borrowing affiliate, producing a circular cash flow, the authors of this article believe that it is unlikely that the IRS could successfully disregard a demonstrable payment through the external banking system for purposes of Code Sec. 267(a)(3)(B). Although the IRS disregarded circular cash flows in the CCA, we believe that its analysis is incorrect because the definition of payment for purposes of Code Sec. 267(a)(3)(B) is the definition of payment provided under the authorities interpreting the withholding tax provisions of Code Sec. 1441. We are not aware that a circular cash flow analysis has ever been applied to disregard an actual payment for purposes of Code Sec. 1441.

If a group drafts the agreements implementing a cash pooling structure to place the creditors in constructive receipt of their accrued interest income and actually makes annual payments of such income by wire transfers, we believe it is highly unlikely that the IRS could successfully assert the circular cash flow analysis of the CCA to defer the deduction of interest under Code Sec. 267(a)(3)(B).

C. Application of Code Sec. 267(a)(3)(B) to International Netting Centers

1. What is at stake if the payment requirement is not satisfied?

Netting Centers present many of the same issues as International Cash Pools, but with at least two additional sources of complexity.

First, Netting Centers typically net payment obligations arising from a wide range of transactions in addition to interest accruals, including, for example, payment obligations arising with respect to fees for services, the purchase price of goods and the accrual of royalties. The statutory language of Code Sec. 267(a)(3)(B), as enacted in 2004, literally appears to apply to any payments made to related foreign persons that could give rise to a deduction. It is not clear whether Congress intended to override the existing regulatory exceptions for accruals of amounts representing foreign-source income to the payee that are neither interest nor treaty-benefitted ECI. For example, a

CFC's obligation to pay a service fee to a related CFC for performance of services outside of the United States might literally be pulled within Code Sec. 267(a)(3)(B). Given that a wide variety of potentially deductible payment obligations typically are netted within a Netting Center, additional issues as to the scope of Code Sec. 267(a)(3)(B) are raised if the payment requirement is not satisfied.

Second, the operational complexity of Netting Centers is also often much greater than for Cash Pools. Dozens of separate CFC's may be settling thousands of obligations with each other each *via* a single net credit or debit through its account with the Netting Center. The purpose of the system is to minimize or eliminate the need for cash payments. The Netting Center therefore must rely for purposes of the payment requirement under Code Sec. 267(a)(3)(B) entirely on the principle that offset of obligations by netting constitutes payment. If, however, a given CFC's growing negative balance over year-end in its account with the Netting Center were viewed as evidence that the CFC has not made full payment to the other participants in the system, it would be difficult to unscramble the egg and determine how Code Sec. 267(a)(3)(B) would apply.

2. Observations on Satisfying the Payment Requirement

The principle that netting offsetting obligations constitutes payment of those obligations for purposes of the Code Sec. 1441 definition of payment is well established.⁴⁶ The IRS's analysis in the CCA does not appear to be inconsistent with this principle. The scenario in which the IRS might seek to apply the analysis in the CCA might be where the Netting Center effectively finances a participant's shortfall by allowing the participant to maintain a negative balance in its account with the Netting Center over year-end. A cautious taxpayer therefore might wish to avoid having a Netting Center effectively finance its participants by requiring that such negative balances be paid to the Netting Center before year-end. This can be accomplished where a cash pooling system is maintained separately from the netting system so that a participant with a negative balance with the Netting Center can draw from the cash pool to pay the netting system. This technique obviously shifts the Code Sec. 267(a)(3)(B) analysis back to the cash pool, but those issues typically can be better limited and managed in the cash pool context, as discussed above.

ENDNOTES

¹ CCA 201334037, Dated April 3, 2013, publicly released August 23, 2013.

² A number of articles have catalogued a variety of complex subpart F issues facing international

treasury operations and the transactions that they execute to manage foreign currency and interest rate exposures. This article does not address these issues, but focusses solely on

interest deductions under Code Sec. 267(a)(3). For a discussion of these other issues, see, e.g., L.G. "Chip" Harter, *The Subpart F Treatment of Financial Transactions and Hedges Entered*

into by Controlled Foreign Corporations, 38 TAX MANAGEMENT MEMORANDUM CORPORATE TAX AND BUSINESS PLANNING REVIEW No. 6, S-70 (1997); Michael J. Feder, *Making CFC Hedging Work—Avoiding Whipsaws in an Ambiguous Environment*, J. TAXATION OF FINANCIAL PRODUCTS, Winter 2003; L.G. “Chip” Harter, Rebecca E. Lee and David H. Shapiro, *Inherently Hedgeable: Hedging Foreign Currency Exposure Arising from the Branch Operations of a CFC*, INTERNATIONAL TAX J., Sept.–Oct. 2011, at 11; John D. McDonald, Ira G. Kawaller, L.G. “Chip” Harter and Jeffrey P. Maydew, *The Devil is in the Details: Problems, Solutions and Policy Recommendations with Respect to Currency Translation, Transactions and Hedging*, TAXES, March 2011, at 199; New York State Bar Association Tax Section, *Report on Subpart F Issues Involving Currency Gain and Loss*, June 3, 2013 Tax Analysts Doc. # 2013-13534.

³ See Act Sec. 301(c) of the Revenue Act of 1937 (P.L. No. 75-377).

⁴ This rule is still reflected in the regulations applicable to years prior to 1984—see, Reg. §1.267(a)-1(b). The 1937 legislative history indicates that Congress was particularly concerned with abusive transactions in which taxpayers accrued expense deductions for payments that were never subsequently made. See, H.R. Rep. No. 75-1546 (1937), *reprinted in* 1939-1 CB (Pt. 2) 704, 724-25.

⁵ See 1984 Bluebook, p. 541.

⁶ H. Rep. No. 98-432, 98th Cong., 2nd Sess., *reprinted in* 1984 U.S.C.C.A.N. 697, 1206. Like the 1937 legislative history, the 1984 legislative history also expresses a view that the provision is an “anti-abuse rule.” The Ways and Means Committee stated that “[t]he failure to use the same accounting method with respect to one transaction involves unwarranted tax benefits, especially where payments are delayed for a long period of time, and in fact may never be paid.”

⁷ *Id.*

⁸ Emphasis added.

⁹ 1984 Bluebook, p. 542, footnote 18.

¹⁰ As enacted in 1986, the provision was enumerated simply as Code Sec. 267(a)(3). However, in 2004, the provision (otherwise unchanged) was re-numbered to be Code Sec. 267(a)(3)(A). For ease of reference, we simply refer to it as Code Sec. 267(a)(3)(A) (its current number).

¹¹ Because the provision was enacted to clarify the application of the matching principle of Code Sec. 267(a)(2), it was included in the Tax Reform Act of 1986 as a technical correction of Code Sec. 267(a)(2). Because it was added as a technical correction, Code Sec. 267(a)(3)(A) carries the same effective date as Code Sec. 267(a)(2). See Act Sec. 1881 of the Tax Reform Act of 1986, P.L. No. 99-514, 100 Stat. 2085, 2914.

¹² S. Rep. No. 99-313, 99th Cong., 2d Sess., at 959 (1986), *reprinted in* 1986-3 CB (Vol.3) 1, 959. See also H.R. Rep. No. 426, 99th Cong., 2d Sess. 939 (1986).

¹³ *Id.*

¹⁴ *Id.*

¹⁵ Thus, if the foreign recipient/payee receives an amount that constitutes ECI, the regulations explicitly provide that the provisions of Code Sec. 267(a)(2) apply, and not the General (a)(3) Matching Rule. See Reg. §1.267(a)-3(c)(1). The regulation further states, however, that if the income is exempt under a treaty (e.g., because the foreign recipient has no PE), the General (a)(3) Matching Rule does apply—i.e., the rule is needed to “step in” and provide a cash method of accounting for a recipient/payee for whom such concept would otherwise be irrelevant. The Tax Court noted this dynamic in *Square D*: “The authority granted by section 267(a)(3) does not apply in the case of effectively connected income because ... the foreign recipient in this instance would have a U.S. method of accounting for such income, triggering a straightforward application of section 267(a)(2) (i.e., “present law already imposes matching”). Regulations under section 267(a)(3) would be necessary, however, where treaty benefits are available.”

¹⁶ As the Tax Court noted in *Square D*: “[T]he fundamental principle underlying the intended regulatory authority, in our view [is] namely, the scope of the regulations under section 267(a)(3) is generally determined by the presence or absence of a U.S. method of accounting for the income item in the hands of the foreign recipient, where the U.S. payor seeks to accrue a deduction with respect to that item. ... [T]he regulations ... reflect this principle. The provisions in general impose the cash method on the U.S. payor under section 267(a)(3) only where the related foreign payee lacks a U.S. method of accounting for the item otherwise accruable by the payor and apply section 267(a)(2) where such payee has a U.S. method of accounting for the item.”

¹⁷ See Reg. §1.267(a)-3(b)(2) (third sentence). Thus, the example described in the 1986 legislative history (relating to foreign services provided by a foreign corporation to its domestic subsidiary) is not covered by the General (a)(3) Matching Rule, and the payor gets to take a deduction as it accrues.

¹⁸ See Reg. §1.267(a)-3(c)(2).

¹⁹ If a foreign person is engaged in a U.S. trade or business and is not exempt from tax under a treaty, the General (a)(3) Matching Rule does not apply; instead Code Sec. 267(a)(2) applies. See note 15, *supra*.

²⁰ See Reg. §1.267(a)-3(c)(iv), Example 2 (deduction permitted where corresponding income is excludable from subpart F income under the *de minimis* rule of Code Sec. 954(b)(3)(A)).

²¹ 56 FR 11531-01, 1991-1 CB 944.

²² See, Reg. § 1.267(a)-3(c)(4)(iv) Example 2 (U.S. affiliate owes interest to a CFC where the subpart F *de minimis* exception applies).

²³ Among other things, these taxpayers pointed to the following passage of Notice 89-84 to support their position:

“Section 267(a)(2) ... provides generally that a taxpayer may not deduct any amount owed to a related party ...

until it is includible in the payee’s gross income *if the mismatching arises because the parties use different methods of accounting*. Section 267(a)(3) authorizes the Secretary to issue regulations *applying this principle*” (emphasis added).

²⁴ See *Tate & Lyle, Inc.*, 103 TC 656, Dec. 50,241 (1994).

²⁵ See *Tate & Lyle, Inc.*, CA-3, 96-2 USTC ¶150,340, 87 F3d 99, reversing Tax Court.

²⁶ See *Square D*, 118 TC 299, Dec. 54,687 (2002) (essentially reversing the Tax Court’s prior position in *Tate & Lyle*, and agreeing with the Third Circuit’s opinion in that case—“To the extent our opinion in *Tate & Lyle* is inconsistent, we will no longer follow it.”).

²⁷ See *Square D*, CA-7, 2006-1 USTC ¶150,162, 438 F3d 739, affirming Tax Court.

²⁸ See, Reg. §1-267(a)-3(c)(4)(iv), Example 3 (CFC owes accrued interest to a related cash method CFC).

²⁹ These circumstances are similar to those involved in Enron’s Project Apache, where the interest deductible to the U.S. affiliate was income to a related CFC, but the interest accrual did not result in a subpart F inclusion. (Following Enron’s failure, the Joint Committee on Taxation reviewed the company’s old tax returns and tax opinion letters, and published a comprehensive report describing the company’s tax planning. Several legislative changes were made in response to this report.) See, Joint Committee on Taxation, 108th Cong., Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations, Vol. 1-3 (the “JCT Enron Report”). Project Apache is described in Volume 1, p. 242. In the words of the JCT Enron Report:

Project Apache was a financing arrangement in which the Enron group borrowed funds from third-party foreign lenders. By channeling this third party borrowing through an Enron controlled foreign corporation and blending this borrowing with debt that the Enron group owed itself, the Enron group sought to claim U.S. tax deductions not only for interest paid on the third party debt, but also for the interest paid to itself, without triggering any offsetting income inclusion on the Enron controlled foreign corporation’s receipt of such interest.

The JCT Enron Report primarily focused on the impact of specific subpart F provisions on the Project Apache structure (including the allocation of subpart F income under Code Sec. 951, which the IRS and the Treasury have since addressed by regulation—See Reg. §1.951-1(e)). While the current accrual of a deduction for interest by a U.S. taxpayer with no current subpart F inclusion to the U.S. shareholder of the CFC payee created some of the U.S. tax benefits from the Project Apache structure, the predominant benefits of the structure related to the allocation of earnings and profits of the

CFC under Code Sec. 951. This conclusion is further supported by the fact that, while the JCT Enron Report mentions the Code Sec. 267(a)(3) issue, the legislative history to the AJCA amendments to section 267(a)(3) does not specifically mention Project Apache (while other AJCA amendments do).

³⁰ H.R. Rep. No. 108-393, 108th Cong., 1st Sess., at 267 (2003).

³¹ There is one reference in the legislative history to a mismatch that could arise where a CFC accrues a deduction with respect to an amount owed to a related CFC, and the deduction offsets subpart F income earned by the payor CFC but does not result in a subpart F inclusion to the U.S. shareholder of the payee CFC. See, H.R. Rep. No. 108-548(I), 108th Cong., 2d Sess., at 291 (2004) (repeal of the FASIT rules specifically addresses the use of a FASIT in Project Apache). However, this statement in the legislative history ignores the fact that a payment or accrual by a CFC that reduces the payor CFC's subpart F income would not qualify for a subpart F exemption in the hands of the payee CFC under either the same country exception of Code Sec. 954(c)(3) or the new CFC look-thru rule of Code Sec. 954(c)(6). (The potential mismatch which concerned Congress would appear to arise only in very limited circumstances—where the corresponding income

to the payee CFC qualified under either the *de minimis* exception of section 954(b)(3) or the high-tax exception of Code Sec. 954(b)(4).)

³² See L.G. "Chip" Harter and Rebecca E. Lee, *The Application of Code Section 267(a)(3)(B) to Expenses Accrued by Controlled Foreign Corporations*, INTERNATIONAL TAX J., May–June 2008, at 15.

³³ Emphasis added.

³⁴ Emphasis added.

³⁵ Emphasis added.

³⁶ Reg. §1.451-2(a).

³⁷ Reg. §1.451-2(b).

³⁸ *Id.*

³⁹ See Part 1, A, *supra*.

⁴⁰ Reg. §1.267(a)-1(b)(4) Example (emphasis added).

⁴¹ See e.g., *Kaw Dehydrating Co.*, 74 TC 370, Dec. 36,963 (1980); *Young Door Co., Eastern Division*, 40 TC 890, Dec. 26,283 (1963).

⁴² *Casa de la Jolla Park, Inc.*, 94 TC 384, Dec. 46,450 (1990). In FSA 200006003, FSA 199922034, FSA 199926018, for example, the IRS argued that a capitalization of accrued interest owed to a shareholder resulted in a deemed payment to the shareholder subject to withholding tax, whether or not shares were issued in the capitalization.

⁴³ *B.L. Battlestein*, CA-5, 80-2 ustr ¶19840, 631 F2d 1182 (*en banc*), *cert denied*, Sct, 451 US

938; *C.H. Davison*, 107 TC 35, Dec. 51,524 (1996), *aff'd*, CA-2, 98-1 ustr ¶150,296, 141 F3d 403; *D.L. Wilkerson*, CA-9, 81-2 ustr ¶19657, 655 F2d 980, *rev'g and rem'g*, 70 TC 240, Dec. 35,156 (1978); *N.W. Menz*, 80 TC 1174, Dec. 40,248 (1983); *N.A. Burgess*, 8 TC 47, Dec. 15,550 (1947).

⁴⁴ Emphasis added.

⁴⁵ Given that Code Sec. 267(a)(3)(B) merely defers a deduction, rather than denying it permanently, it is generally believed that a corporation's earnings and profits under Code Sec. 312 are reduced by the deferred amount only when it is recognized for purposes of calculating income. There is some confusion on this point, given that Reg. §1.312-7(b)(1) states that losses disallowed under Code Sec. 267 reduce earnings and profits currently. Given that the regulation was last amended in 1972, it appears to be referring to cases where section 267 permanently denies a deduction. Since the regulation was issued, Code Sec. 267(a)(2), Code Sec. 267(a)(3) and Code Sec. 267(f) have been amended or added to provide for temporary deferral, rather than permanent denial of deductions.

⁴⁶ See, e.g., Reg. § 1.1441-2(e)(1) ("A payment is considered made to a beneficial owner if it is paid in partial or complete satisfaction of the beneficial owner's debt to a creditor").

This article is reprinted with the publisher's permission from the INTERNATIONAL TAX JOURNAL, a bimonthly journal published by CCH, a part of Wolters Kluwer. Copying or distribution without the publisher's permission is prohibited. To subscribe to the Journal of INTERNATIONAL TAX JOURNAL or other CCH Journals please call 800 449 8114 or visit CCHGroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of CCH, a part of Wolters Kluwer or any other person.

CCH