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United States - Accounts receivable may be related-party indebtedness

September 18: The U.S. Tax Court today in a case of first impression held that an accounts receivable established under Rev. Proc. 99-32 may constitute increased related-party indebtedness for purposes of the related-party debt rule under section 965(b)(3). *BMC Software Inc. v. Commissioner*, 141 T.C. No. 5 (September 18, 2013)

The Tax Court held that the related-party debt rule under section 965(b)(3) does not apply only to increased indebtedness resulting from intentionally abusive transactions, but that an accounts receivable established under Rev. Proc. 99-32 may constitute increased related-party indebtedness for the purposes of the related-party debt rule.

Accordingly, the Tax Court upheld a \$13 million deficiency determination, that was based on the IRS interpretation that the amount qualifying for the dividends received deduction is reduced by the amount of increased related-party indebtedness under section 965(b)(3).

Read the [Tax Court opinion](#) [PDF 99 KB]

Background

The taxpayer (a U.S. corporation that develops and licenses computer software) and its wholly owned, controlled foreign corporation (CFC) collaborated to develop software. Cost sharing agreements governed that relationship. Subsequently, the taxpayer terminated the cost sharing agreements and took sole ownership of the software. It agreed to pay future royalties to the CFC.

The IRS determined that royalty payments from the taxpayer to the CFC were not at arm's length under section 482. The taxpayer and the IRS then entered into a closing agreement, under which they agreed to primary adjustments regarding the royalty payments.

The primary adjustments increased the taxpayer's income and required it to conform its accounts with secondary adjustments. These secondary adjustments would have been treated as deemed capital contributions, except that the taxpayer elected to establish accounts receivable pursuant to Rev. Proc. 99-32.

The taxpayer and the IRS then entered into another closing agreement (the accounts receivable closing agreement) that established interest-bearing accounts receivable from the CFC to the taxpayer.

The taxpayer had previously repatriated funds from its CFC in transactions unrelated to the royalty payments or adjustments. The taxpayer claimed a corresponding one-time dividends received deduction under section 965. The deduction was subject to certain limitations, including a reduction for an increased related-party indebtedness between the taxpayer and the CFC. The taxpayer had claimed this deduction before agreeing to the primary adjustments or establishing the accounts receivable.

The IRS determined that the accounts receivable, deemed established during the “testing period,” constituted an increase in related-party indebtedness and disallowed a corresponding amount of the deduction. The IRS issued a deficiency notice, and the taxpayer filed a petition with the Tax Court.

The taxpayer contended that:

- The reduction for related-party indebtedness applies only to transactions intended to finance dividends.
- The parties had agreed in a closing agreement that the taxpayer would avoid any federal income tax consequences from establishing the accounts receivable.
- The accounts receivable do not constitute related-party indebtedness.

Tax Court’s opinion

The Tax Court held that the related-party debt rule under section 965(b)(3) does not apply only to increased indebtedness resulting from intentionally abusive transactions, but that an accounts receivable established under Rev. Proc. 99-32 may constitute increased related-party indebtedness for the purposes of the related-party debt rule. The court found that the accounts receivable were deemed established during the testing period and qualify as increased related-party indebtedness.

The Tax Court further found that the election under Rev. Proc. 99-32 may allow the taxpayer to avoid the federal income tax consequences of a deemed capital contribution, but that the repayment is treated as a return of principal and interest for all federal income tax purposes.

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