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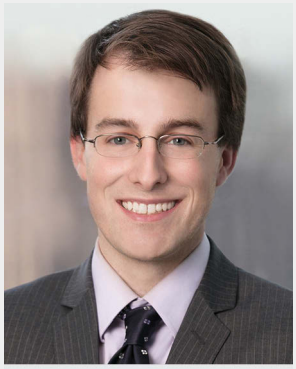

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In this article, the authors examine the mechanisms for and the tax consequences of secondary adjustments and analyze how taxpayers should conform their accounts following transfer pricing adjustments.

Taxpayers faced with transfer pricing adjustments have long relied on repatriation to shift funds in order to comply with regulatory requirements under section 482. However, the Tax Cuts and Jobs Act and other developments have brought about changes in this area that may make secondary adjustments involving deemed transactions — long considered to be fraught with adverse tax consequences — a more favorable alternative in some cases.

I. Effects of Primary Adjustments

Section 482 authorizes the Treasury secretary to "distribute, apportion, or allocate gross income, deductions, credits, or allowances" between related parties if necessary to clearly reflect income or prevent the evasion of taxes. Reg. section 1.482-1(a)(2) delegates this authority to make primary adjustments — referred to in the regulation as "allocations" — to the IRS district director. Of course, making a single adjustment to the income of one related party is not enough. As courts have recognized since the days of *Tennessee-Arkansas Gravel*[1] and *Smith-Bridgman*,[2] section 482 vests the secretary with the power to allocate income between related parties, not to create additional net income for a controlled group.

Accordingly, since the promulgation of the 1968 regulations, reg. section 1.482-1 has provided that the IRS district director will make appropriate correlative adjustments (also known as "correlative allocations") with respect to any primary adjustment that is made, to adjust the income of other affected related parties and effectively allocate income between the related

[1] *Tennessee-Arkansas Gravel Co. v. Commissioner*, 112 F.2d 508 (6th Cir. 1940).

[2] *Smith-Bridgman & Co. v. Commissioner*, 16 T.C. 287 (1951).

parties. These are designed to ensure that the imposition of a primary adjustment does not result in any net change to a group's overall income. Correlative adjustments are not restricted to recomputing the income and deductions of related counterparties; they may also be needed for other purposes, for example appropriately adjusting earnings and profits.

However, merely getting the income and deductions of all implicated taxpayers to balance out is not enough. Take the following example: A U.S. distributor (USC) buys widgets from a related foreign manufacturer (FC) for $50*x* and sells them to third parties for $55*x*, earning a profit of $5*x*. FC has costs of $40*x*, and so it earns a profit of $10*x*. If the IRS determines that the arm's-length price for this transaction is $45*x*, a primary adjustment will be made to USC, which must now recognize income of $10*x* rather than $5*x*. Then, too, a correlative adjustment will be made to FC, bringing its income from the transaction down to $5*x*; E&P will likewise be adjusted. But there is still a problem: USC actually paid FC $50*x*, and for nontax purposes, FC has $50*x*, rather than $45*x*, of revenue on its books.

In other words, the primary and correlative adjustments create a disparity between the taxpayer's tax position and its accounts, and the extra $5*x* that slips out of the United States needs to be accounted for from a tax perspective. Thus reg. section 1.482-1(g)(3)(i) provides for secondary adjustments (referred to as "conforming adjustments" in the regulation):

> Appropriate adjustments must be made to conform a taxpayer's accounts to reflect allocations made under section 482. Such adjustments may include the treatment of an allocated amount as a dividend or a capital contribution (as appropriate), or, in appropriate cases, pursuant to such applicable revenue procedures as may be provided by the Commissioner (see reg. section 601.601(d)(2) of this chapter), repayment of the allocated amount without further income tax consequences.

Thus there are two possible routes for secondary adjustments. They may be created either by comparing the tax situation to the taxpayer's accounts and inferring the existence of one or more transactions that would bring the former into conformity with the latter, or they may involve, to the extent permitted by the applicable revenue procedure(s), actually transferring the funds in question, thus bringing the taxpayer's accounts into conformity with the tax situation. Whichever route is chosen — and despite reg. section 1.482-1(g)(3)(i)'s suggestion that repayment may be made "without further income tax consequences" — additional tax consequences may arise as a result of the secondary adjustment.

While these principles are well established, the consequences of repatriation of funds and of the deemed transactions involved in secondary adjustments are complex, and they implicate several other provisions of the Internal Revenue Code. The TCJA and in particular the introduction of the participation exemption system with a 100 percent dividends received deduction (DRD) for dividends from foreign subsidiaries has directly affected these tax consequences. Moreover, changes in the IRS's and Treasury's positions on section 956 in recent years may also play a role in determining how to conform a taxpayer's accounts and its tax position. In light of these developments, the time is ripe to revisit secondary adjustments and their consequences.

A. Default Secondary Adjustments

Reg. section 1.482-1(g)(3)(i) identifies dividends and capital contributions as the mechanisms by which a taxpayer's accounts may be made to accord with its tax position following imposition of primary and correlative adjustments. To distinguish them from the repatriation transactions described later, which also fall under the umbrella of secondary adjustments, this article refers to these constructive transactions as "inferential secondary adjustments." The basic idea is that the party with the increase in income from the primary adjustment is deemed to have given the amount of the increase to the other party, thereby explaining how the latter has the funds themselves. However, the manner of effecting this depends on the relation between the parties.

If the primary adjustment allocates additional income to the parent company, it will be the

subsidiary that is left with cash that doesn't reflect its tax position, and so a contribution of capital will be inferred to eliminate the discrepancy. Conversely, if the primary adjustment results in additional income for the subsidiary and its parent is left with the cash, a distribution will be deemed to have occurred. If the section 482 adjustments are made between two subsidiaries, two transactions must be inferred: a deemed distribution by the subsidiary to which income was allocated up to the common parent, and a capital contribution from the parent to the subsidiary with the excess cash position.

The origin of the deemed distribution and deemed capital contribution concepts appears to be a line of cases beginning with *Columbian Rope*.[3] In that case, income in excess of an arm's-length amount was transferred from one of the U.S. taxpayer's foreign subsidiaries to another. While the IRS urged the Tax Court to attribute this excess to the common parent to the extent it remained undistributed by the subsidiary, it did not employ a section 482 theory, but rather rested its case on the notion that the second subsidiary was in effect a mere conduit for the earnings of the first subsidiary en route to the U.S. parent. Noting that the second subsidiary was properly incorporated and performed real business functions, the Tax Court declined to include the undistributed earnings of the second subsidiary in the parent's income.

While the IRS acquiesced in part to the Tax Court's decision, it refused to do so regarding the issue discussed here. Rev. Rul. 69-630, 1969-2 C.B. 112, provides that section 482 requires deemed distribution and deemed capital contribution treatment for a bargain sale between brother-sister corporations. This treatment was extended to cases in which services were provided between sibling corporations for less than arm's-length consideration in Rev. Rul. 78-83, 1978-1 C.B. 79, which looked at facts similar to those involved in *Columbian Rope*. There, the IRS refined its theory, abandoning the conduit notion and asserting that a section 482 adjustment should give rise to a constructive dividend:

> Section 482 of the Code applies to transactions between brother-sister corporations involving the performance of services by one for the benefit of the other that result in significant shifting of income.
>
> Where an allocation is made under section 482 as a result of an excessive charge for services rendered between brother-sister corporations, the amount of the allocation will be treated as a distribution to the controlling shareholder with respect to the stock of the entity whose income is increased and as a capital contribution by the controlling shareholder to the other entity involved in the transaction.

The IRS has been unsuccessful in convincing courts that combined deemed distribution and deemed capital contribution treatment is appropriate, and lost the issue in, for example, *White Tool*.[4] Nonetheless, the IRS apparently still adheres to the position that those adjustments should be made under section 482, and Rev. Proc. 99-32, 1999-2 C.B. 296, expressly provides repatriation as an alternative to this treatment in triangular cases. While taxpayers can take comfort in the authority of *White Tool* and similar cases, they should bear in mind that the IRS may continue to assert adjustments based on this triangular model. In Section II.B of this article, we explore in detail the income tax consequences associated with inferential secondary adjustments, including secondary adjustments in triangular cases.[5]

B. Repatriation of Funds

Inferring constructive transactions is not the only way to align a taxpayer's tax position with its accounts: Instead of adjusting its tax position, the taxpayer could, quite simply, move the cash to where — according to the primary adjustment — it should have been all along. Recognizing this, the IRS has long permitted taxpayers to move

[3] *Columbian Rope Co. v. Commissioner*, 42 T.C. 800 (1964).

[4] *White Tool and Machine Co. v. Commissioner*, T.C. Memo. 1980-443.

[5] It is important to note that various concepts under subchapter C of the code can result in similar constructive distribution treatment (*e.g.*, for bargain sales) without the need for a section 482 adjustment. *See, e.g.*, Jasper L. Cummings, Jr., "Constructive Distributions and Bargain Sales," *Tax Notes Federal*, June 15, 2020, p. 1889.

funds to reflect the consequences of section 482 adjustments, although the details of its approach have varied over time. As discussed later, repatriation, like the deemed transactions discussed earlier, may bring collateral tax consequences in its wake.

Rev. Proc. 65-17, 1965-1 C.B. 833, first permitted taxpayers to conform their accounts following primary and correlative adjustments without additional U.S. federal income tax consequences. The revenue procedure only applied to U.S. taxpayers whose taxable income was increased by a section 482 adjustment, and only if the transactions giving rise to the adjustment were not fraudulent and did not have as a principal purpose the avoidance of federal income tax. That is, it dealt with situations in which additional income was allocated to a U.S. taxpayer through a primary adjustment, and in which the U.S. taxpayer later received funds to conform its accounts to reflect that adjustment. For cases pending before the IRS, Rev. Proc. 65-17 treatment was available only if the taxpayer entered into a closing agreement.

Rev. Proc. 65-17 allowed a taxpayer to set up an interest-bearing account receivable from its counterparty in the transaction giving rise to the primary adjustment, in any amount not to exceed the amount of the increase to its taxable income resulting from the adjustment, minus any available setoff under section 482 and any dividend offset (discussed later). The account receivable could be satisfied by money, a setoff against an existing debt owed to the counterparty, or a written debt instrument with arm's-length interest payable at a fixed date. If it was paid within 90 days, it would be "established and paid without tax consequences," apart from interest, which would accrue at an arm's-length rate from the last day of the year for which the adjustment was made up until the date of payment.

Rev. Proc. 65-17 included a dividend offset mechanism, which applied to dividends that the U.S. taxpayer previously received from its related counterparty in the year for which the adjustment was made. The mechanism allowed those dividends to be offset against the amount of the primary adjustment, or any portion thereof. The payment, to the extent permitted as an offset, would not be treated as a dividend for any federal income tax purposes, which would require recalculation of the taxpayer's indirect foreign tax credits under the now defunct section 902. This allowed taxpayers to retroactively recharacterize dividends paid in the year for which the adjustment was made. Importantly, this revenue procedure, like its successors, was elective, and the dividend offset mechanism was likewise elective.

In Announcement 99-1, 1999-1 C.B. 302, the IRS declared its intention to replace Rev. Proc. 65-17 with a new revenue procedure that would, among other things, eliminate dividend offset treatment. The promised revenue procedure materialized in Rev. Proc. 99-32, which largely reiterated the principles of its predecessor while making some important modifications, as well as many minor alterations.

First, Rev. Proc. 99-32 extends repatriation treatment to U.S. taxpayers whose primary adjustments are taxpayer-initiated rather than IRS-initiated. Second, it permits taxpayers to qualify as long as an adjustment is made to their taxable income, and thus permits taxpayers to conform their accounts even if their U.S. taxable income is decreased. Third, it replaces the principal purpose test of the older revenue procedure with an objective inquiry: Taxpayers with IRS-initiated adjustments are eligible for revenue procedure treatment only if the taxpayer was not subject to a section 6662(e) penalty regarding the adjustment, while taxpayers who initiated their own adjustments are exempt from this rule.

Lastly, Rev. Proc. 99-32 vitiates the dividend offset option, allowing an offset only in limited circumstances. Generally, offsets may be claimed for bona fide debts, distributions, and capital contributions that are made in the year when a closing agreement is executed (for IRS-initiated adjustments) or when the taxpayer files a return reporting the adjustment (for taxpayer-initiated adjustments). While an offset may also be available for debts, contributions, and distributions occurring during the tax year for which a taxpayer-initiated adjustment was made, this is the case only when an original, timely return may still be filed for that year, as no untimely or amended return can be used to claim an offset. By contrast, Rev. Proc. 65-17 permitted

an offset for dividends paid in the year *for* which the IRS-initiated adjustment was made, which would often be several years before the year *in* which the IRS made the adjustment.

Because Rev. Proc. 99-32 applies to both increases and decreases in taxable income, it provides for the creation of either an account receivable (if the U.S. taxpayer's income increased) or an account payable (if it decreased). In either case, the account bears arm's-length interest, is deemed to have been created on the last day of the tax year for which the primary adjustment is made, and must be paid or satisfied by an offset within 90 days. While the account will lack the tax consequences associated with the inferential secondary adjustment that would otherwise result, it is not entirely free of U.S. federal income tax consequences. For instance, under Rev. Proc. 99-32, foreign tax credits are permitted for any withholding tax imposed on the repayment of principal and interest on an account payable.

Rev. Proc. 99-32 applies to exam cases for which a closing agreement is entered into, cases in litigation, and taxpayer-initiated adjustments. By its terms, it notably does not apply to adjustments made to competent authority proceedings or advance pricing agreements. However, the revenue procedures that govern competent authority cases and APAs extend the application and the principles of Rev. Proc. 99-32 to those areas, as set forth in more detail immediately below.

Regarding competent authority resolutions, Rev. Proc. 2015-40, 2015-35 IRB 236, provides that the competent authorities may address repatriation as an ancillary issue, but only if the taxpayer explicitly requests this in writing before a tentative resolution is reached. The terms of competent authority repatriation under Rev. Proc. 2015-40 are negotiated between the competent authorities for the case at hand, and "replace the treatment of the repatriation payments that otherwise would be available . . . under Rev. Proc. 99-32." Importantly, in both competent authority resolutions and bilateral APAs, interest on repatriation accounts is routinely waived.

However, if the competent authority resolution does not include repatriation, "the provisions of Rev. Proc. 99-32 or successor guidance . . . are not changed" by Rev. Proc. 2015-40, and remain available to the taxpayer under Rev. Proc. 2015-40. Accordingly, taxpayers who desire Rev. Proc. 99-32 treatment rather than a more customized solution — or who desire instead to simply proceed with inferential secondary adjustments in lieu of repatriation — need only omit a request for competent authority repatriation from their competent authority request, bearing in mind that this will only provide certainty as to the U.S. tax consequences of repatriating funds. Moreover, because Rev. Proc. 99-32 is elective, taxpayers who decline to seek (or are denied) competent authority repatriation may also forego repatriation altogether and fall back into the world of inferential secondary adjustments.

For APAs, Rev. Proc. 2015-41, 2015-35 IRB 263, provides that conforming adjustments are needed to conform a taxpayer's accounts following an APA primary adjustment, and that these adjustments can be accomplished by repatriation. Specifically, it states that "Rev. Proc. 99-32, or successor guidance, will govern the repatriation of funds to conform the accounts following an APA primary adjustment," unless (in the case of a bilateral or multilateral APA) competent authority repatriation under the principles of Rev. Proc. 2015-40 applies. Because an APA primary adjustment must ordinarily be reported on a timely filed U.S. return for the APA year, presumably the 90-day repayment window of Rev. Proc. 99-32 runs from the date the return is filed, as it does in the case of a taxpayer-initiated adjustment. Here too, the taxpayer retains the right to proceed with inferential secondary adjustments instead: While Rev. Proc. 2015-41 references Rev. Proc. 99-32, it does so only for repatriation of funds. Moreover, as remarked earlier, Rev. Proc. 99-32 itself supplies an elective mechanism that is an alternative to — rather than a replacement for — the deemed transaction analysis.

Competent authority repatriation applies only if agreed to in the competent authority resolution underlying the APA, and the advance pricing and mutual agreement program (APMA) will only agree to competent authority repatriation if the taxpayer expressly requests it before a tentative competent authority resolution. Thus, while the

taxpayer has the freedom to seek competent authority repatriation under a bilateral or multilateral APA, the choice must be made for the entire APA: The taxpayer cannot seek competent authority repatriation in one APA year and Rev. Proc. 99-32 treatment in another. Lastly, if a taxpayer does make conforming adjustments (including repatriation) for an APA primary adjustment, the manner, amount, and timing of the adjustments must be documented and disclosed in the APA annual report.

II. Tax Consequences

A. Repatriation and Section 956

1. Applicability of section 956 to intercompany payables.

While Rev. Proc. 65-17 provided that an interest-bearing intercompany payable established to repatriate funds could be "paid without tax consequences" within 90 days, Rev. Proc. 99-32 is more restrictive: Payables may be established and paid "without the Federal income tax consequences of the secondary adjustments that would otherwise result from the primary adjustment." Of course, this opens the door for collateral tax consequences other than those associated with inferential secondary adjustments.

Most notably, the IRS has asserted that intercompany payables are debt for purposes of section 956. Before 2019 regulations restricting its applicability (discussed later), section 956 operated alongside subpart F to cause U.S. shareholders of a controlled foreign corporation to recognize income based on their proportionate shares of the U.S. property — including obligations of U.S persons — owned by the CFC during the tax year.

On May 11, 2018, APMA released a new APA template, along with some supplemental materials: an announcement describing the changes, an annotated example of a filled-out template, and a redline comparison to a draft version of the template released in September 2017. On September 4, 2018, the IRS made minor technical edits to the template, which are not relevant here. Both the 2017 draft and the 2018 revised template take the position that intercompany payables established between related parties to account for primary adjustments made under an APA "will be treated as indebtedness for all U.S. federal tax purposes," including section 956, though the 2018 template attempts to mitigate the harshness of this position by supplying a safe harbor: Payables that are satisfied within 90 days of the end of the relevant APA tax year will not be treated as debt for section 956 purposes.

While the template is just a template and is not binding on taxpayers, except to the extent its form language is incorporated in a signed APA, the inclusion of this clause in the template suggests that it will be difficult for taxpayers to successfully negotiate APAs that don't provide for section 956 debt treatment. Moreover, it marks a shift in the IRS's treatment of intercompany payables created in response to transfer pricing adjustments, which historically were not considered to trigger income via section 956.

While the template applies to repatriation under an APA, the accompanying announcement clarifies that the IRS believes section 956 debt treatment applies to repatriation under Rev. Proc. 99-32 as well. This position, which drew criticism from taxpayers when the IRS issued the draft template in September 2017, means that section 956 income may be recognized when a primary adjustment increases the taxable income of a foreign taxpayer. In those cases, if the taxpayer elected to proceed under Rev. Proc. 99-32, an intercompany payable from the U.S. counterparty would be established, and this payable would be an obligation of a U.S. person that, under section 956, would create income for the U.S. shareholders of the foreign taxpayer whose income was originally adjusted. Conversely, when a primary adjustment increases the income of a U.S. taxpayer, the obligation of its foreign counterparty created under Rev. Proc. 99-32 would not create income under section 956.

While the section 956 issue has not been directly addressed by courts, the IRS has previously litigated, without success, the position that Rev. Proc. 99-32 payables constitute debt for other purposes. While the Tax Court in *BMC*[6] initially agreed with the IRS's contention that Rev.

[6] *BMC Software Inc. v. Commissioner*, 141 T.C. 224 (2013).

Proc. 99-32 payables constituted debt for purposes of a one-time dividend holiday under a prior incarnation of section 965, the Fifth Circuit reversed,[7] holding that neither the text of the provision nor the terms of the closing agreement between the IRS and the taxpayer permitted treating the payable as debt.

In *Analog Devices*,[8] the Tax Court took up the issue once more, again in the context of the dividend holiday. Notably, the Tax Court was not bound by the Fifth Circuit's decision in *BMC*, as *Analog Devices* on appeal would have gone to the First Circuit, which had not considered the issue. Nonetheless, the Tax Court agreed with the Fifth Circuit's reading of the plain language of the statute and reversed its prior holding. The Tax Court in *Analog Devices* displayed an awareness of the unusual step it was taking in reversing its precedent based on a single case: The opinion discusses at length the proper role of *stare decisis*, and it was reviewed by the entire court.

Because *BMC* and *Analog Devices* were decided on the basis of statutory language different from that of section 956, they do not control in this area, and thus did not preclude the IRS from asserting, in the announcement accompanying the new APA template, that it "continues to believe that its position is correct on legal and policy grounds." Whether courts would agree remains to be seen.

However, there is another, potentially more acute issue with the new APA template. Ordinarily, Rev. Proc. 2015-41 and Rev. Proc. 99-32 establish a 90-day safe harbor for repayment of an intercompany payable established to conform a taxpayer's accounts, during which time the payable can be satisfied without the federal income tax consequences associated with the inferential secondary adjustment that would otherwise occur. Confusingly, that 90-day safe harbor is not the same as the 90-day safe harbor established by the new APA template for repayment of the payable without triggering section 956. Although the rules coordinating Rev. Proc. 2015-41 and Rev. Proc. 99-32 are not explicit on this point, the first 90-day period appears to run from the filing date of a timely return that reports an APA primary adjustment. By contrast, under section 6(i) of the APA template, the 90-day period runs from the close of the APA tax year for which the payable is established.

Because taxpayers with APA years that align with their tax years ordinarily would not file their returns within 90 days of the close of the APA year, the safe harbor period established by the template language would generally already have expired before the APA primary adjustment could be known and reported. Thus, per the terms of the template, taxpayers may either undergo the gargantuan labor of filing an early tax return to fall within the safe harbor period — potentially creating other tax issues by doing so — or simply accept the treatment of the intercompany payable as debt for section 956 purposes.

Presumably, this incongruity is the result of a drafting error. Regardless, it poses real issues for taxpayers seeking to use repatriation to conform their accounts. Taxpayers could likely successfully negotiate an APA that corrects this probable error and aligns the 90-day safe harbor for avoiding section 956 treatment with the 90-day period for repayment of the intercompany payable. Taxpayers using the new template should beware of this issue, and should consult with APMA rather than submit an APA application including the problematic language.

2. Curtailing section 956: Regulatory developments.

On May 23, 2019, Treasury published final regulations under section 956 which render section 956 inapplicable in many cases. These regulations finalized proposed regulations published on November 5, 2018. The new regulations apply to tax years of a CFC beginning on or after May 23, 2019, and to tax years of U.S. shareholders in or with which those CFC tax years end. However, taxpayers may apply the final regulations to CFCs' tax years beginning after December 31, 2017, and U.S. shareholders' tax years in or with which those CFC tax years end, provided the taxpayer and its related parties do so consistently.

The impetus for the regulations was the TCJA's creation of a participation exemption system. Under sections 245 (for any U.S.-source portion of a dividend) and 245A (for any foreign-

[7] *BMC Software Inc. v. Commissioner*, 780 F.3d 669 (2015).

[8] *Analog Devices Inc. v. Commissioner*, 147 T.C. 429 (2016).

source portion), U.S. corporations may now deduct 100 percent of dividends received from 10 percent owned foreign corporations other than passive foreign investment companies. Because of the inherent unfairness in treating a deemed repatriation under section 956 as a taxable event while leaving an actual repatriation by means of a qualifying dividend tax free, Treasury has determined that continuing to apply section 956 as it did before the TCJA would be inconsistent with the purposes of the section. Therefore, new reg. section 1.956-1(a)(2) provides that the amount otherwise due under section 956 will be reduced "by the amount of the deduction under section 245A . . . that the shareholder would be allowed if the shareholder received as a distribution from the controlled foreign corporation" the same amount. Essentially, in most circumstances this makes section 956 inapplicable to corporate U.S. shareholders regarding payables that could have been paid as a dividend.

While it may at first glance seem that this should render the stance taken in the APA template irrelevant, this is not the case. First, while considerably curtailed in scope, section 956 continues to apply to noncorporate U.S. shareholders (subject to provisions in the new regulations on the treatment of partnerships). Moreover, section 956 remains a lurking issue even for domestic corporate shareholders, because section 245A only supplies a deduction for dividends, rather than distributions. To the extent a distribution does not qualify as a dividend, no deduction is available under section 245A. Thus, to the extent the amount of an intercompany payable exceeds the payer's E&P (and thus, if it had been a distribution, would not qualify as a dividend), reg. section 1.956-1 will not prevent an inclusion. In many cases this will not matter, as section 956 inclusions are limited to the CFC's "applicable earnings" in a given year under section 956(a)(2). However, the definition of applicable earnings in section 956(b) does not directly mirror E&P — importantly, deficits in accumulated E&P are not taken into account. Thus, there will be cases in which an amount would exceed E&P and fail to qualify as a dividend if paid as a distribution, and yet would result in a section 956 inclusion. Those cases may prove traps for the unwary and demonstrate that the language in the 2018 APA template still has teeth.

The applicability of section 956 thus remains a factor to consider in determining whether to use repatriation or inferential secondary adjustments to conform accounts, although it is a more prominent issue in the APA context, in which APMA may insist on section 956 treatment as a condition of an APA settlement. Outside the APA space, *BMC* and *Analog Devices* provide taxpayers a basis for arguing that the application of section 956 is inappropriate, and thus may make section 956 liability less of a concern. Taxpayers pursuing APAs that are concerned about section 956 should consider addressing these issues with APMA in a prefiling conference. Further, as noted earlier, taxpayers should consider seeking an APA settlement that aligns the section 956 safe harbor in the template with the Rev. Proc. 99-32 safe harbor.

B. Back to Basics

While repatriation has long been seen as a boon to taxpayers, allowing them to escape the adverse consequences associated with inferential secondary adjustments, this may no longer be the case following the passage of the TCJA and the developments concerning section 956. Today, the consequences of inferential secondary adjustments may in some circumstances be more favorable than those associated with repatriation, at least from a U.S. perspective.

The tax consequences of those adjustments are complex, and require consideration of an issue from several angles. Capital contributions, at least, are easy. Whether the deemed capital contribution is from a foreign parent to a U.S. subsidiary (in the case of an adjustment increasing the foreign parent's income) or from a U.S. parent to a foreign subsidiary (in the case of an adjustment increasing the U.S. parent's income), there should generally be no significant tax consequences associated with the deemed transaction apart from an increase in the parent's basis in the subsidiary's stock. Capital contributions are not deductible to the payer, nor are they income to the recipient corporation under section 118. However, capital contributions to a foreign subsidiary may trigger information reporting obligations under section 6038B, and

failure to report may be subject to a penalty of 10 percent of the amount of the capital contribution.

Deemed distributions are when things get trickier. Rev. Proc. 99-32 describes some of the tax consequences of a deemed distribution to a foreign parent:

> Absent a United States taxpayer's election of treatment under this revenue procedure, an adjustment under section 482 (the "primary adjustment") entails secondary adjustments to conform the taxpayer's accounts to reflect the primary adjustment. These secondary adjustments may result in adverse tax consequences to the taxpayer. For example, an allocation of income under section 482 from a foreign parent corporation to its domestic subsidiary corporation would entail a deemed distribution from the domestic subsidiary to its foreign parent in an amount equal to the primary adjustment in the year for which the allocation is made. The deemed distribution would be treated as distribution income to the foreign parent to the extent of the earnings and profits of the domestic subsidiary, as recomputed after taking into account the primary adjustment. Under section 881 of the Code, the foreign parent would be subject to a 30-percent tax liability (as reduced by any applicable income tax treaty), and under section 1442 of the Code, the domestic subsidiary would be a withholding agent required to withhold the tax. See Rev. Rul. 82-80, 1982-1 C.B. 89; reg. section 1.1441-2(e)(2).

A deemed distribution will be treated as a dividend to the extent of the subsidiary's E&P, and will reduce the subsidiary's E&P while increasing the E&P of its parent. Any portion of the distribution in excess of E&P goes to basis recovery. If this amount in turn exceeds the parent's basis in its subsidiary's stock, the amount of the excess will be treated as gain from the sale of property. A distribution is not deductible to the payer. Notably, only the portion of a distribution that qualifies as a dividend is subject to gross basis tax under section 881 and withholding under section 1442.

Reg. section 1.1441-2(e)(2) provides that "income arising as a result of a secondary adjustment made in conjunction with a reallocation of income under section 482 from a foreign person to a related U.S. person is considered paid to a foreign person" for withholding tax purposes, unless the taxpayer elects repatriation treatment. The regulation likewise provides that "for purposes of determining the liability for withholding, the payment of income is deemed to have occurred on the last day of the tax year in which the transactions that give rise to the allocation of income and the secondary adjustments, if any, took place."

While this regulation only addresses the withholding treatment, there is no reason to believe contrary treatment should apply for other purposes, and this timing rule is consistent with the rule formerly espoused by Rev. Proc. 65-31, 1965-2 C.B. 1024, which likewise considered inferential secondary adjustments to be made "as of the last day of the taxpayer's tax year for which the allocation [that is, the primary adjustment] is made." Although Rev. Proc. 65-31 has been superseded by Rev. Proc. 99-32, the latter is silent on this issue, and thus it appears that the former's rule, bolstered by reg. section 1.1441-2(e)(2), remains correct regarding the timing of inferential secondary adjustments.

When the recipient of the deemed distribution is the U.S. parent of the foreign payer, the U.S. federal income tax consequences are somewhat different than those described in Rev. Proc. 99-32. Again, the distribution will not be deductible, and it will have the same effect on E&P. However, no withholding tax will be imposed and, to the extent the distribution is treated as a dividend and the requirements of sections 245 and/or 245A are met, the resulting income to the U.S. parent will be offset by a 100 percent DRD, permitting receipt of the dividend free of tax.

To the extent the distribution exceeds the subsidiary's E&P, it will reduce the U.S. parent's basis in the subsidiary's stock, and to the extent it exceeds this basis as well, it will result in gain to the parent, which will be taxed at a maximum 21 percent rate. Thus, while a U.S. parent may ordinarily receive a deemed distribution arising from a secondary adjustment without recognizing

income, this is only true to the extent the distribution is less than the subsidiary's available E&P.

As remarked earlier, the IRS has historically not been successful in asserting similar consequences in triangular cases. Nonetheless, the IRS apparently continues to adhere to the position that they apply. Thus, at least in the IRS's view, when primary and correlative adjustments are made between sibling corporations, there will be a deemed distribution to their common parent, followed by a capital contribution, as discussed earlier. While the capital contribution prong should not have significant U.S. tax consequences except as regards basis, the consequences of the deemed distribution depend on whether the common parent is a U.S. or foreign entity.

A distribution from a foreign subsidiary to its foreign parent, followed by a capital contribution to a U.S. subsidiary, should ordinarily have no U.S. federal income tax consequences outside of basis and E&P computations. A distribution from a U.S. subsidiary to the foreign parent, followed by a capital contribution to a second subsidiary, would on the other hand trigger withholding tax, unless a tax treaty provides for different treatment. A distribution from a U.S. or foreign subsidiary to its U.S. parent, followed by a capital contribution to a second subsidiary, should lack significant U.S. tax consequences in many cases: The U.S. parent should be eligible for a 100 percent DRD under section 243 (for a domestic subsidiary) or sections 245 and/or 245A (for a foreign subsidiary), but only to the extent the distribution is treated as a dividend. Of course, when additional layers of entities are involved, the consequences may become more complex.

III. Secondary Adjustments Comparison

Inferential secondary adjustments that rely on deemed transactions have, in light of U.S. tax reform, in some cases become more attractive than they had been. Capital contributions ordinarily carry no significant tax consequences, and deemed distributions, too, can often be accomplished without material adverse tax effects — either because of the sections 245 and 245A DRDs, in the case of a deemed distribution to a U.S. parent, or because of tax treaties that eliminate or significantly reduce withholding tax, as in the case of deemed distributions to foreign parents in many developed countries. On the other hand, using repatriation to conform accounts has been complicated by the IRS's stance on section 956 treatment. Despite final regulations that scale back the applicability of section 956, there remain situations in which section 956 could result in the incidence of additional tax on top of the tax burden associated with the primary transfer pricing adjustments. As noted earlier, section 956 is less likely to be an issue outside of the APA context, as *BMC* and *Analog Devices* may be read to support a position that section 956 does not apply to repatriation accounts.

Of course, U.S. tax consequences are only one side of the coin in what is, at least theoretically, a bilateral quandary. Results in other countries regarding repatriation and secondary adjustments are mixed, and many do not have set procedures for addressing them, although competent authority proceedings, when available, should provide an avenue for mitigating double taxation arising from these issues. In some cases, there may be no foreign consequences at all: "If the foreign country does not 'see' secondary adjustments, there should be little risk of taxable dividend income or withholding tax abroad, though there may be a greater risk with actual movement of cash than with a deemed secondary adjustment dividend."[9]

With so many moving pieces, the ideal method of conforming accounts following a primary adjustment must depend on the taxpayer's own facts and circumstances. Still, it is possible to make some general comments. Importantly, the section 956 issue associated with repatriation only applies in cases when the primary adjustment increases the income of a foreign entity, creating an account payable from the U.S. counterparty, and only when the foreign entity is a CFC in which the U.S. counterparty — or another member of the controlled group — is a U.S. shareholder.

When the foreign entity is a subsidiary of its U.S. counterparty, a deemed dividend from the foreign subsidiary will not generate taxable

[9]Patricia Gimbel Lewis and John M. Breen, "Coming Full Circle? Secondary Adjustments and Repatriation in Transfer Pricing Cases," *Tax Management Transfer Pricing Report, Bloomberg BNA* (May 1, 2008).

income in the United States if the requirements of sections 245 and/or 245A are met (although if the amount of the distribution exceeds the sum of the subsidiary's E&P and the parent's stock basis, there would be taxable gain). When the parties are sister corporations, *White Tool* and other cases provide a basis for contending that no inferential secondary adjustments should apply. However, even if one accepts the IRS's position here, in many cases there should be no material tax issues. The triangular situation that implicates section 956 involves a transaction between a U.S. subsidiary and a foreign subsidiary of a U.S. parent, to which a primary adjustment is made to increase the foreign subsidiary's income. In that case, inferential secondary adjustments should not entail significant U.S. tax consequences as long as the entire deemed distribution from the foreign subsidiary qualifies as a dividend and thus is not taxed under sections 245 and/or 245A.

Interestingly, this creates a new parallelism between inferential secondary adjustments and repatriation: The non-incidence of tax in the secondary adjustment scenario hinges on the applicability of sections 245A and/or 245, and the section 956 regulations do not impose tax under section 956 to the extent the payable would have qualified under section 245A. However, this does not mean that both repatriation and inferential secondary adjustments always arrive at the same place in these scenarios. When repatriation is elected and the amount exceeds E&P and thus would not qualify for section 245A, sections 956 and 951(a)(1)(B) may result in an inclusion in taxable income, as discussed earlier.[10] Conversely, when inferential secondary adjustments are chosen, the amount by which the deemed distribution exceeds E&P will go first toward reducing the recipient's basis in the payer's stock. Only if the deemed distribution exceeds both the payer's E&P and its parent's stock basis will there be gain. Thus, in cases when section 956 would result in an inclusion in income, inferential secondary adjustments should generally be preferable to repatriation.

There is another important difference: Intercompany payables established under Rev. Proc. 99-32 bear interest from the last day of the tax year for which the primary adjustment is made, while inferential secondary adjustments do not involve an interest component. Whether an interest component is desired will, of course, depend on the direction of the adjustment and on the specific facts of the case. Of course, whether tax interest payable to the IRS or a foreign tax authority is due is a separate question from whether interest must be paid between the related parties. When repatriation treatment is chosen, a U.S. taxpayer should have additional taxable income on account of the interest received on an account receivable, and thus may owe both additional tax and interest payable to the IRS on that tax. Similarly, when an inferential secondary adjustment takes the form of a deemed dividend, interest may be due on any associated withholding tax liability.

IV. Conclusion

Inferential secondary adjustments — long a comparatively neglected feature of the reg. section 1.482-1(g) landscape, compared with the more popular repatriation regime — have in many cases become surprisingly favorable in light of tax reform. At the same time, developments have shown that repatriation may not be as free of tax consequences as was once thought, even though consequences such as section 956 liability may seldom materialize under the 2019 regulations. Determining which alternative is preferable requires careful consideration of a taxpayer's particular circumstances, but one thing is clear: Taxpayers that fail to consider inferential secondary adjustments going forward do so at their peril.[11] ■

[10]For instance, distributions during the year, E&P attributable to subpart F income, or a deficit in current E&P may prevent a section 956 inclusion.

[11]The preceding information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.