Appeals Court Reverses IRS-Favorable Tax Court Decision in BMC Software

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On March 13, 2015, the U.S. Court of Appeals for the Fifth Circuit unanimously reversed a U.S. Tax Court decision, finding that an account receivable created to implement a transfer pricing adjustment did not constitute related party debt and therefore should not have reduced the amount of the one-time dividends-received deduction permissible under Section 965 of the Internal Revenue Code. The opinion addressed an issue of first impression about the interaction of accounts receivable arising from Section 482 adjustments with Section 965 repatriations. The case offers valuable insights into judicial deference to notices and into interpretation of closing agreements with the IRS. The Fifth Circuit's opinion did not address other important questions about accounts receivable arising from Section 482 adjustments, such as when that indebtedness is deemed to arise for purposes of Section 956 or for valuation of the borrowing and lending entities, but there are some inferences that may be drawn from the opinion on those topics.

The case is *BMC Software, Inc. v. Commissioner*. The Fifth Circuit's opinion is available here and the Tax Court opinion here.

Tax Rate Reduction on Qualifying Dividends

The American Jobs Creation Act of 2004 (AJCA) added Section 965 to the Code to encourage controlled foreign corporations (CFCs) to pay cash dividends to their U.S. corporate shareholders by offering one-time tax relief on those transfers. Provided that dividends met certain requirements, a taxpayer was entitled to an 85 percent dividends-received deduction. The net effect of this provision was to reduce the effective tax rate on qualifying dividends from 35 percent to 5.25 percent.

To prevent the use of "round trip" or circular flows of cash to finance dividends that purportedly qualified for repatriation treatment, Section 965(b)(3) required taxpayers to show that their related party debt had not increased between October 2004 and the end of the year in which the dividend was paid. The disputed issue in BMC's case concerns intercompany debt that did not actually exist during that period but arose later, when, pursuant to Revenue Procedure 99-32 and the IRS's discretionary approval, the company retroactively created accounts receivable reflecting a Section 482 transfer pricing settlement.

BMC Software

BMC Software was a U.S. corporation that availed itself of the temporary dividends-received deduction under the AJCA. During 2006, it repatriated $725 million from its wholly owned CFC and claimed a dividends-received deduction for most of that amount. For multiple tax years that included 2006, the IRS made unrelated adjustments under Section 482, which increased BMC Software's taxable income by a total of approximately $102 million.

When the IRS makes an adjustment under Section 482, a correlative allocation must be performed to align the taxpayer's books of account to reflect the correct amount of income after that adjustment. If it qualifies under Rev. Proc. 99-32, a taxpayer is permitted to establish an account receivable corresponding to the required adjustments to its books of account. The objective of this procedure is to enable the taxpayer to avoid any secondary tax effects that might result from the correlative allocation. Under Rev. Proc. 99-32, the account receivable is deemed established on the last day of the year to which the Section 482 allocation relates. Because Section 482 disputes are rarely resolved during the tax year to which they

relate, implementing Rev. Proc. 99-32 will almost always result in the retroactive creation of accounts receivable.

In 2007, BMC Software entered into a closing agreement with the IRS concerning the Section 482 allocation of $102 million and the correlative allocation under Rev. Proc. 99-32. Two separate accounts receivable were deemed created in 2005 and 2006. BMC did not treat the creation of these accounts as reducing its ability to claim the Section 965 dividends-received deduction related to its CFC's 2006 dividend. The IRS disagreed: Some four years later, in 2011, the IRS issued a notice of deficiency for approximately $13 million with respect to 2006, reducing the deduction to reflect the existence of the Rev. Proc. 99-32 debt.

BMC filed a petition in U.S. Tax Court, which upheld the IRS adjustment, and the taxpayer appealed.

Court of Appeals Decision

The Court of Appeals for the Fifth Circuit conducted *de novo* review of the Tax Court decision. On brief, the commissioner of Internal Revenue (the Commissioner) conceded that the accounts receivable did not exist as of the close of 2006. Because Section 965(b)(3) requires that the related party debt be in existence as of the end of the taxable year, the Court of Appeals concluded that the plain language of the statute failed to support application of the related party indebtedness provision.

As part of this analysis, the court explained that "[t]he fact that the accounts receivable are backdated does nothing to alter the reality that they did not exist during the testing period." Although the case concerned only Section 965, it is possible that this rationale could be applied to conclude that Rev. Proc. 99-32 debt does not exist for purposes of valuations of the borrowing or lending entity during the relevant year, or for Section 956 analyses on whether an investment in United States property exists.

It is also noteworthy that the Court of Appeals, using strong language, declined to give any weight to a contemporaneous IRS notice (Notice 2005-64, Section 10.06) that had specifically classified accounts receivable created under Rev. Proc. 99-32 as related party debt for purposes of Section 965(b)(3). The court observed that the notice was "entirely conclusory," with "no analysis and explanation," and contained only a single sentence on the relevant point. The court found this lack of explanation particularly troubling where the notice squarely contradicted the plain language of Section 965. Finally, the court took heed that the IRS has recently changed its approach to closing agreements under Rev. Proc. 99-32 and now specifically outlines the Section 965(b)(3) consequences in those agreements. Taking all of those factors into account, the court found the notice "entirely unpersuasive and unworthy of deference." This analysis will be relevant to other situations where taxpayers face IRS arguments in litigation relying on similar IRS documents.

The Court of Appeals also rejected the Commissioner's alternative position in the nature of a contract argument, based on the closing agreement. The Commissioner argued that the closing agreement specified the results "for federal income tax purposes," and consequently the accounts receivable referenced in the closing agreement were correctly classified as debt for purposes of Section 965(b)(3). The court concluded that the cited language was boilerplate and that the closing agreement only addressed the specific items covered in the determination section of the agreement, which did not include Section 965(b)(3).

"The tax consequence-setting function of the Agreement," the Court concluded, "coupled with the specificity of its enumeration of tax consequences, strongly implies that the Agreement excludes those tax consequences which it failed to enumerate." This analysis is helpful to taxpayers when the IRS asserts that a closing agreement has some kind of collateral consequences for other facts or years.

Conclusion

U.S. corporate taxpayers that were subject to an IRS adjustment under Section 965(b)(3) as a result of a correlative allocation under Rev. Proc. 99-32 should consider the impact of the decision in *BMC Software*. Beginning in 2008, the IRS issued internal guidance, including an Industry Directive requiring closing agreements in transfer pricing cases to contain language regarding Section 965(b)(3). Consequently, later cases may present fact patterns distinct from the one presented in *BMC Software*. Moreover, because Rev. Proc. 99-32 provides for exceptions to the normal rules applicable to correlative allocations, the IRS could change those procedures and modify the classification of accounts receivable going forward.

Although the appellate decision is binding only in cases appealable to the Fifth Circuit, it calls into question whether the IRS will continue to defend adjustments with respect to similarly situated taxpayers in other circuits. And the Fifth Circuit's analysis that the debt did not exist during the relevant year may have valuation or Section 956 consequences. Finally, the court's comments on deference to the notice and the consequences of the closing agreement will be relevant in a wide variety of scenarios beyond the immediate scope of this case.