BMC Software Inc. v. Commissioner, 141 T. C. 224 (2013) (United States Tax Court, 2013)

In BMC Software Inc. v. Commissioner, the U. S. Tax Court ruled that accounts receivable established under a closing agreement to adjust transfer pricing could be considered related party indebtedness under I. R. C. § 965. This decision impacted the eligibility of dividends for a one-time deduction, affirming that such accounts receivable did not need to be part of an intentionally abusive transaction to reduce the deduction amount. The ruling clarified the scope of related party indebtedness, affecting how multinational corporations handle repatriated dividends and transfer pricing adjustments.

Parties

BMC Software Inc. (Petitioner) and Commissioner of Internal Revenue (Respondent) were the parties involved in this case. BMC Software Inc. was the plaintiff at the trial level, and the Commissioner of Internal Revenue was the defendant. On appeal, BMC Software Inc. remained the petitioner, and the Commissioner of Internal Revenue remained the respondent.

Facts

BMC Software Inc. , a U. S. corporation, developed and licensed computer software and was the parent of a group of subsidiaries, including BMC Software European Holding (BSEH), a controlled foreign corporation (CFC). BMC Software Inc. and BSEH had cost-sharing agreements (CSAs) for software development, which were terminated in 2002, resulting in BMC Software Inc. paying royalties to BSEH for distribution rights. The IRS audited BMC Software Inc. 's royalty payments for the years 2002 through 2006 and determined they were not at arm's length under I. R. C. § 482. Consequently, BMC Software Inc. and the IRS entered into a closing agreement in 2007, adjusting BMC Software Inc. 's income for those years and requiring secondary adjustments. BMC Software Inc. elected to establish accounts receivable from BSEH under Rev. Proc. 99-32 to avoid the tax consequences of deemed capital contributions. Separately, BMC Software Inc. repatriated $721 million from BSEH and claimed a one-time dividends received deduction under I. R. C. § 965. The IRS determined that the accounts receivable established during the testing period constituted increased related party indebtedness, reducing the eligible deduction amount by $43 million.

Procedural History

The IRS issued a deficiency notice to BMC Software Inc. for the tax year ending March 31, 2006, disallowing $43 million of the claimed dividends received deduction due to increased related party indebtedness. BMC Software Inc. filed a petition for redetermination with the United States Tax Court. The Tax Court reviewed the case de novo, examining the legal issues and the facts as presented.

Issue(s)

Whether accounts receivable established under a closing agreement pursuant to Rev. Proc. 99-32 constitute increased related party indebtedness for the purpose of reducing the dividends received deduction under I. R. C. § 965(b)(3)?

Whether the related party debt rule under I. R. C. § 965(b)(3) applies only to increased indebtedness resulting from intentionally abusive transactions?

Rule(s) of Law

I. R. C. § 965 provides a one-time dividends received deduction for U. S. corporations repatriating dividends from controlled foreign corporations, subject to certain limitations, including a reduction for increased related party indebtedness under I. R. C. § 965(b)(3). The statute does not specify an intent requirement for the related party debt rule. Rev. Proc. 99-32 allows taxpayers to establish accounts receivable in lieu of deemed capital contributions following a primary adjustment under I. R. C. § 482, avoiding certain tax consequences.

Holding

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

Reasoning

The court's reasoning focused on the statutory interpretation of I. R. C. § 965(b)(3). The court applied general principles of statutory construction, emphasizing the plain language of the statute, which defines increased related party indebtedness as the difference in indebtedness between the end of the testing period and October 3, 2004. The court found no intent requirement in the statutory text. The court also considered the legislative history and regulatory authority granted under the statute, concluding that the related party debt rule's scope was not limited to abusive transactions. The court rejected BMC Software Inc. 's argument that the accounts receivable should be exempt as trade payables, as they were established post-audit and not in the ordinary course of business. The court's analysis of the closing agreement under Rev. Proc. 99-32 determined that the accounts receivable were established for all federal income tax purposes during the testing period, thus qualifying as related party indebtedness. The court referenced prior case law, such as Schering Corp. v. Commissioner, to support its conclusion that the closing agreement did not preclude all federal income tax consequences but allowed BMC Software Inc. to avoid the consequences of a deemed capital contribution.

Disposition

The Tax Court sustained the IRS's determination, ruling in favor of the Commissioner of Internal Revenue. The court's decision affirmed the deficiency notice, reducing the dividends received deduction by $43 million due to increased related party indebtedness.

Significance/Impact

This case significantly clarifies the application of the related party debt rule under I. R. C. § 965, establishing that accounts receivable established pursuant to Rev. Proc. 99-32 can be considered related party indebtedness, even if not part of an intentionally abusive transaction. The ruling impacts multinational corporations' strategies for repatriating dividends and managing transfer pricing adjustments, as it affects the eligibility for the one-time dividends received deduction. Subsequent courts have followed this interpretation, and the decision has influenced IRS guidance on the application of I. R. C. § 965. The case underscores the importance of understanding the full scope of federal income tax consequences when entering into closing agreements with the IRS.

