BMC Software Inc. v. Commissioner, 141 T. C. No. 5 (2013)

In a landmark decision, the U. S. Tax Court ruled on the application of the one-time dividends received deduction under Section 965, clarifying the scope of the related party debt rule. The court determined that accounts receivable established under a closing agreement could be considered as increased related party indebtedness, impacting the eligibility of dividends for the deduction. This ruling significantly influences how multinational corporations manage repatriation of foreign earnings and navigate transfer pricing adjustments.

Parties

BMC Software Inc. (Petitioner) v. Commissioner of Internal Revenue (Respondent). BMC Software Inc. is a U. S. corporation that develops and licenses computer software. The Commissioner of Internal Revenue is the head of the Internal Revenue Service, responsible for enforcing the federal tax laws.

Facts

BMC Software Inc. (BMC) and its controlled foreign corporation, BMC Software European Holding (BSEH), collaboratively developed software under cost-sharing agreements (CSAs). After terminating the CSAs, BMC agreed to pay royalties to BSEH and licensed the software for distribution. The IRS determined that the royalty payments were not at arm's length under Section 482, leading to primary adjustments that increased BMC's income. BMC elected to establish accounts receivable under Rev. Proc. 99-32 instead of treating the adjustments as deemed capital contributions. BMC had previously repatriated funds from BSEH and claimed a one-time dividends received deduction under Section 965. The IRS disallowed a portion of the deduction, citing increased related party indebtedness due to the accounts receivable established during the testing period.

Procedural History

The IRS determined a deficiency in BMC's federal income tax due to its interpretation of Section 965. BMC filed a petition for redetermination with the U. S. Tax Court. The court had to decide whether accounts receivable established under Rev. Proc. 99-32 could constitute increased related party indebtedness under Section 965(b)(3). The standard of review was de novo, as the case involved questions of law and statutory interpretation.

Issue(s)

Whether accounts receivable established under Rev. Proc. 99-32 constitute increased related party indebtedness for purposes of the Section 965 dividends received deduction?

Rule(s) of Law

© 2025 SCOTUSreports.com. All rights reserved.

Section 965 allows a U. S. corporation to elect a one-time 85% deduction for certain cash dividends received from its CFC, subject to a reduction for increased related party indebtedness during the testing period. Section 965(b)(3) states that the amount of dividends eligible for the deduction is reduced by the excess of the CFC's indebtedness to any related person at the close of the taxable year over the indebtedness at the close of October 3, 2004. Rev. Proc. 99-32 allows a taxpayer to establish accounts receivable without the federal income tax consequences of secondary adjustments that would otherwise result from primary adjustments under Section 482.

Holding

The Tax Court held that accounts receivable established under Rev. Proc. 99-32 constitute increased related party indebtedness under Section 965(b)(3), reducing the amount of dividends eligible for the one-time deduction. The court further held that the accounts receivable closing agreement allowed BMC to avoid the federal income tax consequences of deemed capital contributions but did not preclude the application of the related party debt rule.

Reasoning

The court's reasoning focused on statutory interpretation, emphasizing that the plain language of Section 965(b)(3) did not include an intent requirement for increased related party indebtedness. The court rejected BMC's argument that the related party debt rule applied only to intentionally abusive transactions, noting that Congress did not amend the operative language when adding a grant of regulatory authority to address such transactions. The court also held that the term "indebtedness" in Section 965(b)(3) should be interpreted according to general federal income tax principles, encompassing accounts receivable established under Rev. Proc. 99-32. The court distinguished the trade payable exception, ruling that the accounts receivable did not qualify as they were not established in the ordinary course of business or paid within the required timeframe. Finally, the court interpreted the accounts receivable closing agreement as establishing the accounts for all federal tax purposes during the testing period, thus qualifying them as increased related party indebtedness.

Disposition

The Tax Court sustained the Commissioner's determination, reducing the amount of dividends eligible for the Section 965 deduction by the amount of increased related party indebtedness attributed to the accounts receivable established under the closing agreement.

Significance/Impact

This decision clarifies the scope of the related party debt rule under Section 965,

© 2025 SCOTUSreports.com. All rights reserved.

impacting how multinational corporations structure their repatriation strategies and manage transfer pricing adjustments. The ruling emphasizes that accounts receivable established under Rev. Proc. 99-32 can be considered as increased related party indebtedness, potentially limiting the benefits of the one-time dividends received deduction. The decision also highlights the importance of carefully drafting closing agreements to avoid unintended tax consequences. Subsequent courts have followed this precedent, and it has influenced IRS guidance on the application of Section 965 and related party indebtedness.

© 2025 SCOTUSreports.com. All rights reserved.