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Intercompany Accounts Require Maintenance

Corporate groups almost universally designate one member as the "banker" and arrange for all of the group's cash to be swept into the banker's account, which is carefully managed by the group's treasury function. The principal, and often only, record of these transfers is electronic journal entries reflecting intercompany payables and receivables. Some companies even find it difficult to come up with a print-out of the journal entries and the account balances at various times. This is not necessarily a problem until something goes wrong and then, in hindsight, the flexible handling of intercompany accounts can look like a mistake.

The extreme example is *Higgins v. Smith*, 308 U.S. 473 (1940). Smith was general counsel of General Motors and had a "desk drawer" corporation to which he liked to sell stock at a loss (before §267). The Supreme Court did not allow the losses and upheld a fraud penalty, partly based on evidence that the corporation did not really have anything "of its own," but rather just existed in running accounts Smith maintained in the other desk drawer.

Mr. Smith's experience does not mean that book accounts between related parties will not be respected by the IRS, but it does mean that even accounting that satisfies GAAP and the company's accountants will not necessarily serve other functions. Therefore, corporate groups using a banker and other intercompany accounts should carefully document the intercompany transactions outside simple electronic accounting entries, should relate the entries to contracts, should service notes and otherwise should act as if the accounts were as "real" as those owed to third parties.

The following are some of the issues that can arise:

- **Why it matters?** BANKRUPTCY. The ultimate "enforcer" of intercompany agreements is bankruptcy of one or the other of the affiliated companies. The non-bankrupt affiliates will have the most to fear when the bankrupt affiliate is a creditor, because its trustee will try to collect its claims with relish. This occurred in *In re Nelco, LTD*, 264 BR 790 (Va. B. Ct. 1999), where the bankrupt was the "cash cow" that had advanced over six million dollars to its parent, which was not in bankruptcy.
- **Terms of "line of credit."** Many intercompany "line of credit" agreements do not exist on paper or, if they do, are comprised only of big number open-ended notes. While that might appear to leave maximum flexibility in all directions, you never know how that flexibility will cut. In the *Nelco* case, cited above, the parent claimed the trustee could not pursue its claim against the parent because the three-year statute of limitations had run and the five-year statute applicable to written agreements did not apply because there was no written line of credit agreement. The court found the notes and the accounting records to constitute sufficient "writing" to invoke the longer statute of limitations.
- **The "line of credit" agreement and the "tax sharing agreement" need to work together.** In the *Nelco* case, the parent received the bankrupt's share of estimated future tax liabilities and lent it back to the bankrupt, creating a payable from bankrupt to parent. Due to the economic reverses of the entities, however, the tax liability never came to pass. Therefore, the bankruptcy trustee refused to allow the parent to offset the payable to the parent against the receivable from the parent. The court agreed because the two agreements between the parties, sketchy as they were, did not require the bankrupt to pay a share of taxes that were not actually owed.
- **Vis-a-vis third parties, the ability to pay will be relevant.** Even though it ruled for the taxpayer and was reversed, the lower court in *Coltec*, 62 Fed. Cl. 716 (2004), reversed, 454 F3d 1340 (CA Fed Cir. 2006), was troubled by the intercompany accounts that were the lynchpin of the

Jack Cummings
Editor

The Atlantic Building
950 F Street, NW
Washington, DC 20004-1404
202.756.3300
Fax: 202.756.3333

www.alston.com

taxpayer's "tax shelter." One member issued a note to another member that supposedly replaced in large part an intercompany payable. The trouble was, though, that the taxpayer was not able to explain for what value the intercompany payable was recorded. Of course there does not need to be value received by a subsidiary, which can issue a note dividend to a parent. But it was important to the "tax shelter" that the note be good, so the parent gave its note to the sub to bolster the sub's ability to pay the note to the parent! That caused the court to wonder if the sub would ever enforce a note against its parent. Of course the court should not have wondered, because as *Nelco* showed, the sub's bankruptcy trustee could enforce it. Nevertheless, this case shows that you have to think about how unrelated parties will view the intercompany accounts.

- **What is it for?** Frequently an intercompany account will be established to move cash between affiliates first, and the reason for the account may be thought about later (or not at all). Even if the reason is thought of at the time, it may not be "documented," because companies are used to "documenting" cash transfers only in accounting entries and the scope of those entries may be dictated by a limited menu of possibilities (account receivable, inventory, payable). This occurred in *National Electrostatics Corp. v. U.S.,* 71 AFTR-2d 93-2003 (WD Wis), where the affiliate created the intercompany account and then later needed to claim that it was a prepayment for the purchase of export goods from the affiliate. The court was not persuaded.

- **Loans versus dividends.** Usually the cash cow is a subsidiary, when the parent is a holding company. This means that the cash will flow up and the payables will flow down. Although this may not matter a lot in a consolidated group, sometimes the cash cow is not affiliated or the group does not file consolidated, or the issue is one of state tax. Then the flow of cash up can be turned into a dividend, which may matter a lot. The classic case is *Alterman Food, Inc. v. U.S*., 611 F2d 866 (Ct. Cl. 1979). It pursued the classic pattern: parent serviced operating subs and they advanced all their cash to parent, which paid itself for its services from the account balances. Despite the fact that the subs actually paid dividends, the court found as a fact that the loans up were additional dividends. A key reason was that the loan balances built up year after year.

- **Don't leave the intercompany note "as idle as a painted ship upon a painted ocean."** Republic Steel Corp. found this out in 159 F. Supp. 366 (Ct. Cl. 1958), a case on which sat retired Supreme Court Justice Stanley Reed. The case is remarkably modern because it deals with the ability of the parent to claim a loss on the stock and debt of its liquidating sub. Republic held a $2.5 million note of its liquidating sub but, over the seven-year life of the note, payments by the sub had never been offset against the note balance on the books. For this and other reasons, the court found that note not to be bona fide and that the sub was solvent when it liquidated and Republic could not deduct losses.

- **Payments on accounts.** As the *Alterman* case showed, failure to even true up intercompany balances can be a negative fact. On the other hand, token payments may be held against the taxpayer, too. Hospital Corp. of America caused small payments to be made on accounts to "put some flesh on the bones" of the subsidiary, according to the IRS, but the IRS still lost for other reasons. 81 TC 520 (1983) non acq.

- **The price of flexibility.** Many groups view the use of intercompany accounts running in all directions as good, in large part due to the flexibility they provide. However, that very flexibility looks like uncertainty when it comes to writing off a receivable and claiming a deduction. The tax court found that open account balances were equity- and not debt-based on these factors: lack of fixed maturity date, lack of source of payment, lack of evidence of effort to enforce, subordination, no intent to pay, thin capitalization, sole shareholder was sole account creditor, never paid anything but interest, inability to borrow from unrelated lender and advances not used to acquire capital assets. *Flint Industries, Inc., TC Memo 2001-276.*

Conclusion

For state tax purposes, for bankruptcy purposes and even for liquidations within consolidation, properly documenting and servicing intercompany accounts is a real concern.

For additional information, call Jack Cummings at (919) 862-2302.

Federal Tax Group

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481

Edward Tanenbaum
Co-Chair
212.210.9425

John F. Baron
704.444.1434

Henry J. Birnkrant
202.756.3319

Robert T. Cole
202.756.3306

Philip C. Cook
404.881.7491

James E. Croker, Jr.
202.756.3309

Jasper L. Cummings, Jr.
919.862.2302

Tim L. Fallaw
404.881.7836

Terence J. Greene
404.881.7493

Brian D. Harvel
404.881.4491

Michelle M. Henkel
404.881.7633

L. Andrew Immerman
404.881.7532

Brian E. Lebowitz
202.756.3394

Clay A. Littlefield
704.444.1440

Vivek Patel
404.881.7686

Timothy J. Peaden
404.881.7475

Jennifer Siegel
202.756.3310

Matthew A. Stevens
202.756.3553

Gerald V. Thomas II
404.881.4716

Charles W. Wheeler
202.756.3308

ALSTON & BIRD LLP