OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Paul S. Epstein
Senior Technical Reviewer CC:INTL:BR5

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated September 13, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

A Corp =
USCO =
Parent =
Parent Sub =
MergeCo =
MergeCo Sub=
Company =
Division =
Year 1 =
Year 2 =
Year 3 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Business A =
Business B =
Business C =
Business D =
Business E =
Business F =
Business G =
Business H =

Business J =
Article A =
Country A =
Country B =
Percent A =
Percent B =
Percent C =
Percent D =
Percent E =
Percent F =
Percent G =
Period 1 =
State A =
Tax Year 1 =
Tax Year 2 =
Tax Year 3 =
Tax Year 4 =
Amount 1 =

ISSUES

1. Whether A Corp's factoring activities constitute the conduct of a trade or business within the United States.

2. Whether A Corp's income may be taxed in the United States under the United States - Country A Income Tax Treaty.

CONCLUSIONS

1. Based on the facts presented, we recommend that the case not be pursued on a U.S. trade or business theory. A Corp did not perform any discernible functions incident to factoring U.S. companies' receivables. The facts were arguably consistent with A Corp being viewed merely as a passive investor with respect to an arguably small amount of credit risk, and only with respect to the Business A and Business B receivables. Further, no investment risk was demonstrably assumed on the Business C receivables.

2. Because we conclude that the Service should not pursue treating A Corp as engaged in a trade or business within the United States, we need not reach the issue under the United States-Country A Income Tax Treaty whether A Corp had income that may be taxed in a U.S. permanent establishment.

FACTS

Background

USCO was a Delaware corporation which filed consolidated returns for the years in issue as the parent corporation of a consolidated group (the “USCO Group”). Members of the USCO Group either owned or were U.S. distributors for a number of brands, such as, Business A, Business B, Business C, Business D, and Business E.

During the years under examination, USCO was a wholly-owned subsidiary of Parent, a Country B public corporation. On Date 4, in connection with the merger of Parent and MergeCo, USCO was merged with and into MergeCo Sub, with MergCo Sub being the surviving entity. On Date 5, MergeCo Sub changed its name to Company. Company is a State A corporation.

At all relevant times Parent had a Country A subsidiary, Parent Sub. Parent Sub had a division known as Division which was renamed A Corp following the Parent/MergeCo merger.

The Factoring Contracts

Beginning in Year 1, various members of the USCO Group (each of which was a U.S. corporation) began entering into contracts with A Corp which, in form, provided for the factoring of their accounts receivables to A Corp (the “factoring contracts”). The group members which entered into factoring contracts with A Corp were: Business A, Business B, Business C, Business D, Business E, Business F, Business G, Business H, and Business J (hereafter the “U.S. companies”). The earliest factoring contract was dated Date 1, with most of the contracts having been entered into during USCO's fiscal year ended Date 2. Except as noted below, the provisions of the factoring contracts do not materially differ.[1]

The typical factoring contract provides that at the end of each monthly accounting period, the U.S. company will offer to sell all accounts receivable which arose during the month to A Corp. A Corp is not obligated to purchase any of the accounts offered. Under the contract, however, full title to the accounts offered, along with a security interest in all related goods, contract rights, proceeds, etc., passes to A Corp unless A Corp rejects an account or accounts within 5 days of the offer.[2] The contract provides that the purchase price for the accounts sold to A

[1] The two contracts whose terms differ somewhat from the typical contract are the Business C and Business B contracts. They differ primarily in the amount of the commission charged and whether the accounts are sold on a recourse or nonrecourse basis.

[2] Clause 6 of the contract provides that title to the offered accounts will pass to A Corp “unless specifically rejected by A Corp within five days of receipt” of the letter of

Corp equals the gross amount charged the U.S. company's customer (minus discounts and credits) reduced by a present value discount based on the prime rate plus Percent A and computed from the "purchase date" (the date the account was billed to the U.S. company's customer) to the account's estimated maturity date (the Business B contract provides for a discount based on LIBOR plus Percent B). The contract also provides that the U.S. company will pay A Corp a commission of Percent C of the purchase price of each account purchased by A Corp (the Business C contract provides for a commission of Percent D and the Business B contract provides for a Percent E commission which was subsequently reduced to Percent F).[3]

The factoring contracts require the U.S. company to "staff a credit and collection department which will maintain all Customer accounts..." It also provides that the U.S. company's credit department will approve customer credit in accordance with its own established credit policies, but that changes to such policies must be approved by A Corp. It further provides that the U.S. company will act as A Corp's agent for the maintenance and collection of the purchased accounts and authorizes the U.S. company to take such actions as are necessary to collect the accounts. However, the contract states that the U.S. company is not authorized to forgive or settle any outstanding balance without the prior written advice and consent of A Corp. As compensation for the services rendered by the U.S. company in maintaining and collecting the accounts, the contract provides that A Corp will pay the U.S. company an annual administration fee. (The amount of the fee varies from contract to contract.)[4] The administrative fee is to be adjusted annually by an inflation factor, or, if the amount of the accounts offered by the U.S. Company increases or decreases by more than Percent G, the administrative fee will, prospectively, be determined based on actual expenses.

The factoring contract provides for settlement of the purchase price and the amounts collected by the U.S. company on a date approximately midway through the following month as determined by A Corp. Specifically, the contract provides that on the settlement date (1) A Corp will pay the U.S. company the purchase price

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offer. The form letter of offer attached to the contract, however, provides that title to the offered accounts will pass to A Corp except where A Corp determines not to purchase an account and notifies the U.S. company "of such determination within 14 days from the date hereof."

[3] Under Clause 8 of the contract, the commission is to be paid to A Corp on the date the account is billed to the U.S. company's customer (the "purchase date"), even though the accounts are offered to A Corp only at the end of the monthly accounting period in which they arise, and even though settlement for the purchased accounts is not made until the middle of the following month.

[4] The administration fees were apparently set based on the respective U.S. companies' direct costs for post-sale administration of the accounts.

for the purchased accounts, together with interest thereon at prime plus Percent A from the "purchase date" (the date the account was billed to the U.S. company's customer) to the settlement date, and (2) the U.S. company will pay over to A Corp all monies collected as A Corp's collection agent, together with interest thereon at prime plus Percent A from the date of receipt to the settlement date (the Business B contract provides for an interest rate of LIBOR plus Percent B).

Except for the Business C and Business B contracts, the factoring contracts provide that the sales of the accounts are nonrecourse. The Business C contract provides that A Corp may require the U.S. company to repurchase any account which remains outstanding for more than Period 1. It also provides that the U.S. company shall repurchase any account which is determined to be uncollectible. The Business B contract contains the standard nonrecourse provisions noted above. However, a letter agreement entered into on or about Date 3, provides that the accounts of specific customers, as agreed upon by the parties, will be factored on a recourse basis, and that the commission will be reduced from Percent E to Percent F.

Commissions, Net Present Value Discounts, Interest, and Administration Fees Paid

The factoring expenses deducted on the consolidated returns of the USCO Group consisted of the following items:

- The commission (computed at Percent D for Business C (recourse factoring), computed at Percent F or Percent E for Business B (recourse and non-recourse factoring, respectively), and computed at Percent C for the other U.S. companies (non-recourse factoring));
- The net present value discount component; and
- The interest component.

The administration fees due the U.S. companies are netted against the amounts due A Corp as part of the group-wide multilateral netting procedures.

The amounts deducted on the consolidated returns of the USCO Group for the years in issue were as follows:

	Tax Year 1	Tax Year 4
Net Present Value Discount		$
Commission		

Interest Expense

Administration
Fees

Net Deduction

A Corp did not file Forms 1120F for the years in issue.

Functions Performed by U.S. Companies and A Corp

At the time the U.S. companies entered into the factoring contracts with A Corp, they had their own credit departments, along with their own credit policy manuals and credit procedures. After entering into the factoring contracts, the U.S. companies continued to maintain and staff complete credit departments, and continued to follow their own credit policy manuals and credit procedures. The customers of the U.S. companies were not notified that their accounts had been factored to A Corp.

The U.S. companies provided A Corp with daily credit sales and receipts, advised on bad debts to be written-off and potential bad debt exposure, collected and deposited cash received, and implemented additional procedures for delinquent accounts. They also provided A Corp with forecasts of projected sales and projected cash receipts. The U.S. companies had relationships with external sources for maintaining customer data. They also processed new customer credit applications and determined the terms of sale, terms enforcement, proof of delivery, and bankruptcy/insolvency actions.

Various sections of the Business A Credit and Customer Financial Services Procedures Manual provide a helpful overview of the functions performed by the U.S. companies with respect to maintenance of the accounts receivable. The manual lists the numerous contacts the Credit and Financial Service Department makes inside and outside the company. It includes the Credit Department organizational chart and outlines the functions performed by the various department members and sets forth policies and procedures respecting bad debts. The manual highlights the extent of the functions performed within the U.S. with respect to the accounts. As noted, these functions did not materially change after the company entered into the factoring contract with A Corp.

Documentation of Intent that the functions performed by the U.S. companies would not materially change under the factoring arrangement is shown by the following statement from the Overview section of the A Corp Factoring Procedures Manual:

The most important points to remember at the outset are as follows:

- The Operating Company maintains complete control of the ledger. A Corp does not have any contact with individual debtor accounts nor does A Corp collect the cash directly from the debtors.

- The Operating Company continues to record sales, bad debts, cash receipts, etc., in the normal fashion (Ref. this section Appendix 1 - standard ledger entries) but additionally records a number of factoring entries to record the onward sale of the ledger.

. . .

(emphasis original).

In addition to managing the factoring arrangement, A Corp is responsible for multilateral netting, franchise funding, group foreign exchange risk management, intercompany lending, and transfer pricing review. A Corp does not perform services for any unrelated entities, but does factor the accounts of several related non-U.S. companies which are not part of the USCO Group. A Corp's staff has grown from 3 employees in Year 2 to 8 employees in Year 3. The submitted materials show that the A Corp staff has little day-to-day dealings with the factored accounts. The job description for the Treasury Administrator position reflects the greatest degree of day-to-day responsibility for factoring. A Corp's current Treasury Administrator stated that she devotes approximately 10 days per month to accounts receivable factoring functions. A majority of these functions, however relate to summarizing and verifying data received from the operating companies. A Corp has no involvement with the actual collection and management of the accounts. This is evidenced, for example, by the memorandums prepared by the Internal Audit Group with respect to the audit it conducted of Business D accounts receivable procedures shortly after Business D entered into its factoring contract with A Corp. Nowhere in the memos is A Corp mentioned or referred to.

The facts described to us state that A Corp finances the accounts receivables from the time of settlement with U.S. companies to the dates of maturity of the receivables. Settlement, however, occurs approximately midway through the month following the month in which the accounts arise. Therefore, the U.S. companies finance the accounts for approximately 30 days on average (assuming a 30-day month, with sales occurring ratably throughout the month, and settlement taking place on the 15th day of the following month). In some instances, accounts will have actually been collected prior to the settlement date. Further, amounts A Corp pays the U.S. companies for the accounts is netted against the amounts due A Corp as part of the group-wide multilateral netting procedures. Thus, in a given month, the U.S. companies may or may not actually receive any cash from the factoring arrangement.

Although the factoring contracts provide that A Corp can reject any account or accounts offered by the U.S. companies, A Corp has never rejected an account, and the accounts are in essence automatically transferred to A Corp by virtue of the pro forma "offers." It appears that A Corp neither evaluates nor reviews the offered accounts. An important fact concerns the manner in which title to the receivables is passed under the terms of the factoring agreements and the actual conduct of A Corp and U.S. companies with respect to this provision. Although the contract provides that title shall pass unless rejected within 5 days of the offer by U.S. companies, the conduct of the parties indicates that the "offer" to factor the receivables was never made until such time that a month-end reconciliation of receivable amounts is presented to A Corp. Exam has stated that factually, the receivables are not documented as having been offered until after the close of the month in which the receivables are acquired by U.S. companies.

The payment terms offered to customers of the U.S. companies vary, but 30 days from the date of delivery appears to be common. The average time accounts are outstanding ranges from about 25 to 30 days for some of the U.S. companies, to about 40 to 50 days for the remaining U.S. companies.

A Corp bears the risk of default on the accounts except in the case of the Business C accounts and some of the Business B accounts. The accounts with respect to which A Corp has assumed the risk of loss appear to be low risk accounts. The bad debt experience reflects a risk factor of approximately 0.01 percent of sales (computed as the average annual bad debt write-offs for the Tax Years 1-4, divided by average yearly sales for the Tax Years 1-4). The average amount written-off as uncollectible by A Corp for the Tax Years 1 through 4 with respect to the accounts factored by the U.S. companies was approximately Amount 1 per year. While any bad debts associated with the factored accounts are written-off by A Corp, the determination of whether an account is worthless has been delegated to the U.S. companies.[5]

LAW AND ANALYSIS

1. Determination of a Trade or Business Within the United States

[5] While the bad debts are reflected on A Corp's books and records, it appears that for purposes of management evaluation, the bad debts are charged to the U.S. companies. of the Factoring Manual provides that "As part of the factoring program the passes on all bad debts to A Corp. However, for tasked performance purposes the is still expected to retain responsibility for the monitoring and control of this expense. In order to maintain a focus on the bad debt expense at local level it was agreed that the would continue to show the bad debt expense as part of in the Management Accounts."

Taxpayer has argued to Exam that their factoring activities cannot constitute a trade or business within the United States because their activities are within the exemptions for trading in stocks and securities under section 864(b)(2)(A) and the receivables purchased incident to factoring constitute securities within the meaning of the statute. Section 1.864-2(c)(2)(i) defines securities as “any note, bond, denture, or other evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.”

For the tax years under Exam, Section 864(b) provided in relevant part that “the term ‘trade or business within the United States’ includes the performance of personal services within the United States at any time within the taxable year, but does not include-

(2) Trading in Securities or Commodities -
(A) Stocks and Securities -

(i) In General. - Trading in stocks or securities through a resident broker, commission agent, custodian, or other independent agent.

(ii) Trading for Taxpayer’s Own Account - Trading in stocks or securities for the taxpayer’s own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian, or other agent, and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions. This clause shall not apply in the case of a dealer in stocks or securities, or in the case of a corporation (other than a corporation which is, or gut for section 542(c)(7), 542(c)(10), or 543(b)(1)(C) would be, a personal holding company) the principal business of which is trading in stocks or securities for its own account, if its principal office is in the United States.

Section 864(b)(2)(A) only applies for certain foreign taxpayers that trade stocks and securities for their own account. It does not apply to taxpayers that are not engaged in trading activities. A Corp’s purported factoring activities do not constitute trading, because A Corp is not buying and selling securities on a regular basis. See Fuld v. Commissioner, 139 F.2d 465 (2d Cir. 1944), Adda v. Commissioner, 10 T.C. 273 (1948), acq., 1953-1 C.B. 3 and Nubar v. Commissioner, 13 T.C. 566 (1949), aff’d, 185 F.2d 584 (4^{th} Cir. 1951) (discretionary trading by an agent for a principal’s proprietary account constituted trade or business of the principal). However, the fact that A Corp’s activities do not fall within the safe harbor does not cause A Corp to be engaged in a trade or business within the United States under section 864(b). Section 1.864-2(e) provides in relevant part:

> The fact that a person is not determined by reason of this section to be not engaged in trade or business within the United States is not to be considered a determination that such person is engaged in trade or business within the United States. Whether or not such person is engaged in trade or business within the United States shall be determined on the basis of the facts and circumstances in each case.

If A Corp's activities constitute mere investing, then such activities will not cause A Corp to be engaged in a trade or business within the United States. See Higgins v. Commissioner, 312 U.S. 212 (1941) (the day-to-day management of an investment portfolio does not constitute a trade or business). The facts submitted demonstrate that A Corp did not perform any substantial activities through the actions of its own employees. The facts also show that A Corp assumed credit risk on only a portion of the contracts that purported to constitute a factoring arrangement. All functions attendant to factoring U.S. companies' receivables other than the assumption of credit risk, were performed by U.S. companies and remunerated under the contracts as an administration fee. In light of A Corp's functions being identified as limited to the passive assumption of credit risk and the potential consequences for characterizing these functions under the Higgins decision, we recommend that Exam not pursue trying to treat A Corp as being engaged in a trade or business. See also, Bank of America v. U.S., 680 F.2d 142 (1982); Centel Communication Company, Inc. v. Commissioner, 92 T.C. 612 (1989), aff'd 920 F.2d 1335 (7th Cir. 1990)(assumption of financial risks pursuant to a guarantee did not constitute the performance of services for purposes of section 83).

2. Treaty Issues

Because we recommend the Service not pursue treating A Corp as being engaged in a trade or business within the United States with respect to its factoring activities, we need not reach the treaty issue concerning whether A Corp had a U.S. permanent establishment through which such activities were conducted. Absent the finding of a U.S. trade or business, A Corp's income cannot be taxed in a U.S. permanent establishment under Article A of the United States-Country A Income Tax Treaty.

> Article A, of the United States-Country A Income Tax Treaty provides, in part, that:
>
> [a]n Irish enterprise shall not be subject to United States tax in respect of its industrial or commercial profits unless it is engaged in trade or business in the United States through a permanent establishment situated therein. If it is so engaged, United States tax may be imposed upon the entire income of such enterprise from all sources within the United States.

We have not determined whether the factoring income would constitute industrial and commercial profits under the United States-Country A Income Tax Treaty but do not foreclose the possibility of such characterization. See Rev. Rul. 86-156, 1986-2 C.B. 297. Further, potential alternative characterizations under the Code could also prohibit the imposition of withholding tax on the factoring income. For Tax Year 1 through Tax Year 4, see §1.1441-2(b)(2)(i), and sections 871(g) and 881(e). Similarly, under the facts of this case, we recommend that the Service not pursue the imposition of withholding taxes on the factored receivables between U.S. companies and A Corp. We recommend below, that further consultation be undertaken to determine the scope and manner for applying economic substance treatment and section 482 to various aspects of the factoring activities conducted by U.S. companies and A Corp.

3. Further consultation for Potential Application of Economic Substance and Section 482 to the Factoring Activities

Based on the facts provided, we recommend that the Service seek further development of economic substance principles and the potential application of section 482 to various components of U.S. companies' and A Corp's factoring activities. In this regard, the facts indicate that all of the material functions were performed and substantially all of the credit risk was assumed by U.S. companies. Our discussions so far have revealed that for a substantial number of the contracts and contractual amounts, A Corp did not assume any credit risk. Rather, in substance, it appears that A Corp's monthly function of accepting U.S. companies's offer to factor the receivables was nothing more than the act of reconciling its month end books and records, a function that A Corp must necessarily perform for itself and not for any other taxpayer. Accordingly, the amounts paid in settlement by U.S. companies to A Corp with respect to the purported factoring contracts, in substance, may not have constituted arm's length payments for factoring. Further, the commission portion of the contracts was paid for no demonstrable function over and above the discount already provided for. Based on discussions with Exam, the taxpayer has not contemporaneously documented or provided subsequent documentation to support the discount pricing for any of the contracts in question and they were nonresponsive to requests for such information. Accordingly, we believe that economic substance principles and application of section 482 to the activities and conduct of the parties may provide the most desirable solution for determining the total amount income from the transactions that should be subject to tax by the United States.

In particular we believe that further attention would be appropriate to determining:

1. The number and amount of contracts for which the parties conduct, in substance may not constitute the transfer of title on the receivables from U.S. companies to A Corp. In our discussions with Exam they indicated that perhaps one-half of all contractual amounts entered into

may in fact have been effected, in substance, as an offer and acceptance after the receivables were fully satisfied.

2. The extent to which section 482 may be applied to disregard the terms of the written contract and impute terms consistent with the economic substance of the transactions undertaken. See §§ 1.482-1(d)(3)(ii)(B)(i), 1.482-1T(d)(3)(ii) (1993), and 1.482-1A(d)(1) (1968). We recommend that the commissions and interest expense be further evaluated in this context. We further recommend that the amount of risk actually assumed by A Corp. be further evaluated to determine whether the discounted receivables were purchased at arm's length.

3. The extent to which §1.482-2(b)(7) may apply to functions performed by U.S. companies in accordance with the economic substance. In this regard, the potential application of §1.482-2(b)(7)(iii) should be further evaluated in the context of the administrative functions performed in the United States for which reimbursement was purportedly made only at cost.

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Please call if you have any further questions.

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