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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Chief, Branch 4
Office of Associate Chief Counsel (International) CC:INTL

SUBJECT:

This Field Service Advice responds to your memorandum dated July 21, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

US1 =

US2 =

Country A =

Date B =

Corp C =

Country C =
Corp D =

Date E =

Year F =

ISSUES:

1. Whether the prepayment made to US2, under the terms of the sale contract, constitutes an advance payment for the purchase of deliveries or constitutes nontaxable loan proceeds; and, if the payment constitutes an advance payment, in what taxable year is the payment includable in income?

2. Does section 367(a) apply to the outbound transfer of the contract pursuant to a reincorporation of US2 from a domestic corporation to a Country C corporation in a reorganization described in I.R.C. §368(a)(1)(F)?

CONCLUSION:

1. The prepayment to US2 under the contract constitutes an advance payment and is includable in income in Year F, after the year of the section 368(a)(1)(F) reorganization, if the requirements of Treas. Reg. §1.451-5(c) are satisfied.

2. Section 367(a) applies to the outbound transfer of the contract in the section 368(a)(1)(F) reorganization.

FACTS:

US1 was a publicly traded domestic corporation. US2 was a second-tier domestic subsidiary of US1. US2's primary asset was a in Country A. US2's Country A operations were conducted through a Country A branch.

On Date B, US2 entered into a sale agreement involving the sale of from the Country A with an unrelated third-party, Corp C, incorporated in a tax haven jurisdiction. On Date B, Corp C also entered into a sale agreement with another third-party, Corp D, a domestic banking corporation. The sold between US2 and Corp C was resold by Corp C to Corp D. The terms and conditions were similar (except for the prepayment paid

US2) in both agreements. Corp C apparently functioned strictly as a conduit between US2 and Corp D and borrowed money for the prepayment.

The agreement between US2 and Corp C provided a purchase price amount of consisting of a prepaid amount of and a balance of The balance was placed in interest-bearing reserve accounts. The taxpayer, US2, treated the prepaid amount as deferred income and the balance as an account receivable. US2 was entitled to receive the balance, constituting the account receivable and interest, when and when certain other conditions were met. The prepaid amount of was used immediately by US2 to pay-off an inter-company loan used by US2 to fund its activities with respect to its in Country A.

Under the agreement, Corp C receives The total "payment" (the barrels at the fixed price) is greater than the purchase price, although the difference represents an approximate discounted present value.

The agreement contained provisions in case In such an event, the agreement permitted US2 Also, the agreement permitted the purchaser (Corp C) to purchase with US2 having the obligation to reimburse Corp C for the cost of the

On Date E, US2 was reincorporated in Country C, which taxpayer treated as a section 368(a)(1)(F) reorganization. At the time of the reincorporation, US2 reported, on its financial statements, deferred income of from the agreement and listed as accounts receivable. US2 did not report the advanced payment as income on its U.S. tax return when it was received. Instead, US2 reported the deferred income on its U.S. tax return over the term of the agreement while it was a domestic corporation.

<u>LAW AND ANALYSIS</u>

1. <u>The treatment of amounts prepaid under the contract.</u>

The first issue is whether the prepayment is an advanced payment taxable as income or is a loan which is not taxable. In determining whether there is an advanced payment or a deposit, the Supreme Court has stated that "[t]he key is whether the taxpayer has some guarantee that he will be allowed to keep the money." Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203, 210., 107 L.Ed. 2d 591, 110 S.Ct. 589 (1990). This goes to whether the taxpayer acquires unfettered dominion over the money at the time of receipt.

Whether these payments constitute income when received, depends upon the parties' rights and obligations at the time the payments are made. Id. at 211. The facts indicate that US2 entered into an agreement for the sale of goods that will be fulfilled or from other sources within the reach of US2. At the time the agreement was entered into, US2 had unfettered control over the advanced funds. US2 had the right to keep the income and controlled the conditions under which the payment would be satisfied, either through Thus, the advanced funds do not qualify as loans under Indianapolis Power, but instead are treated as advanced payments.

Under section 636 and the regulations thereunder, a production payment (a payment for a right to a specified share of the production from mineral in place) shall be treated as a mortgage loan on the property. However, a production payment shall not be treated as a mortgage loan under section 636 if, in part, the payment is not pledged for use in the future exploration or development of the mineral property which is burdened by the production payment. Treas. Reg. §1.636-1(b)(1).

In other words, advance funds will be treated as production payments under section 636 if the funds are used for the exploration or development of mineral property and the repayment of the funds (in cash or kind) comes exclusively from the mineral property. However, if the repayment of the advanced funds can be from sources other than a specified mineral source, then the payment does not qualify under section 636. Treas. Reg. §1.451-5(g) implies that the advanced funds would then be treated as an advanced payment under the section 451 regulations.

The next issue is in what taxable year the prepayment is includable in gross income. Under section 451(a), the amount of any item of gross income will be included in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for in a different period. Treas. Reg. §1.451-1(a) provides that, under an accrual method of accounting, income is includable in gross income when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. The right to receive income becomes fixed at the earliest of (1) required performance, (2) the date payment becomes due, or (3) the date payment is made. Rev. Rul. 84-31, 1984-1 C.B. 127.

Treas. Reg. §1.451-5 provides rules for the inclusion of income in a taxable year for a taxpayer using the accrual method of accounting and receiving an advance payment with respect to the sale in a future taxable year of goods held by the taxpayer primarily for sale to a customer in the ordinary course of his trade or business (§1.451-5(a)(1)). In general, advance payments for the sale of goods must be reported in (1) the year of receipt or (2) the earlier of (a) the year when the amounts would otherwise be reported for tax purposes or (b) the year when the amounts would be reported for financial accounting purposes (§1.451-5(b)(1)). Thus, the taxpayer can report an advance payment otherwise than upon receipt if it is consistent with its financial reporting of the amount. In this case, US2 reported the advance payment for both financial and tax accounting purposes

Under this method, therefore, it is possible for US2 to obtain a deferral of several years.

Under Treas. Reg. §1.451-5(c), this deferral period is limited where (1) the advance payment is substantial and (2) the taxpayer has on hand in the year of payment (or has available to it in such year though its normal source of supply) goods of a kind and quantity sufficient to satisfy the agreement. In these circumstances, all advance payments received with respect to the agreement by the last day of the second taxable year following the year of receipt, and not previously included in income in accordance with the taxpayer's normal accrual method of tax accounting, must be included in income in that second taxable year. A taxpayer is considered to have received substantial advance payments if all advance payments received through the end of the current taxable year (including advance payments received in prior taxable years) equal or exceed the total cost of expenditures reasonably estimated as includable in inventory with respect to the agreement (§1.451-5(c)(3)). Where the two-year limitation rule applies, the taxpayer must take into account in the taxable year the costs and expenditures (or reasonably estimated costs or expenditures) included in inventory at the end of that year with respect to those goods.

If the advance payment received by US2 on Date B is a substantial advance payment, as defined in §1.451-5(c)(3) (being those that are equal to or exceed the total costs and expenditures reasonably estimated as includable in inventory), then US2 must have included the payment in income by the end of the second taxable year following the year the payments were received. In this case, that would have been Year F, after the section 368(a)(1)(F) reincorporation and therefore not likely reportable on US2's U.S. income tax return. The portion of the prepayment received before the reincorporation would have been reportable on US2's U.S. tax return. This is the same result under US2's normal tax and accounting methodology, Treas. Reg. §1.451-5(f) provides that if a taxpayer adopts a method of deferral and then ceases to exist in a transaction other than one to which section 381 applies, or if its liability under the agreement otherwise ends, then the amount of the advance payment (which was not includable in gross income in preceding taxable years) must be included in income in that year. Because a section 368(a)(1)(F) reorganization involves the carryover of certain tax attributes under section 381, this provision does not apply.

Section 453(b) defines the term “installment sale” as a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. Section 453(b)(2) provides the term installment sale does not include a dealer disposition. Section 453(l) provides that the term dealer disposition means any disposition of personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan. We do not believe that the forward oil agreement qualifies for installment sale treatment because (1) no disposition of property had taken place at the time of entry into the agreement and (2) even if it had, the taxpayer likely would be treated as a dealer and thus not be entitled to use the installment method pursuant to section 453(l).

With respect to amounts placed in interest-bearing accounts, which were treated as accounts receivable by US2, we believe that US2 properly excluded them from income in the year the parties entered into the agreement. When and when certain other conditions are met, US2 will receive the balance in the interest-bearing accounts. Such conditions were projected to be met in Year F. As those conditions were to occur in Year F at the earliest, that is the year that the balance due under the agreement would be includable in income.

2. <u>Treatment of the contract under section 367(a).</u>

Under section 367(a), if a U.S. person transfers property to a foreign corporation in an exchange described in section 332, 351, 354, 356, or 361, the foreign corporation is not considered to be a corporation for purposes of the nonrecognition provision and gain is recognized on the exchange. In the section 368(a)(1)(F) reorganization, US2 transferred the contract on which a prepayment had been received (along with the accounts receivable) to US2-foreign in a section 361 exchange. The issue is to what extent the contract and the accounts receivable are taxable on the outbound transfer under section 367(a).

An exception to gain recognition under section 367(a) is provided for the transfer of any property used by the foreign corporation in the active conduct of a trade or business (see section 367(a)(3)(A)). The trade or business exception does not apply, however, to the transfer of certain property, which includes installment obligations, accounts receivable, and similar property (section 367(a)(3)(B)(ii)). The legislative history indicates that these assets were made taxable under section 367(a) because (even if the assets are trade or business assets) their nature allows a U.S. taxpayer to avoid U.S. tax by transferring the assets to a foreign corporation which can receive the income and avoid U.S. income tax (see H.R. Rep. No. 4170, 98th Cong., 2d Sess., 1316-17 (1984)).

Because the taxpayer treats the portion of the contract as an accounts receivable, its outbound transfer in the section 368(a)(1)(F) reincorporation is taxable under section 367(a) (section 367(a)(3)(B)(ii)). The remaining issue is whether the balance of the contract (representing the prepayment) constitutes "similar property" to installment obligations and accounts receivable under section 367(a)(3)(B)(ii). In this case, the prepayment on the contract is a liquid and passive asset representing income whose transfer to a foreign corporation resulted in income associated with the contract avoiding U.S. income taxation. Congress intended such types of trade or business assets to be taxable under section 367(a) when their outbound transfer readily results in the avoidance of U.S. tax. We believe this transfer falls within the "similar property" category of section 367(a)(3)(B)(ii).

The above analysis does not necessarily preclude the Service from considering other arguments under section 367 or other sections of the Code in regard to the transfer.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

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If you have any further questions, please call Robert Lorence at 202-622-3860.

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