WHEN DOES AN AGED ACCOUNT RECEIVABLE GIVE RISE TO A DEEMED REPATRIATION?

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Ownership of a "controlled foreign corporation" ("C.F.C.") by a "U.S. shareholder" presents the potential for imputed income, that is, income treated as received from the C.F.C. and recognized as income to the U.S. shareholder in a current tax year. Under certain circumstances, aged accounts receivable may be seen as an investment in U.S. property and treated as a deemed repatriation, therefore constituting imputed income of the U.S. shareholder.

BACKGROUND

A C.F.C. is a foreign corporation in which U.S. shareholders (defined below) directly, indirectly, or constructively own more than 50% of either: (i) the total combined voting power of all classes of stock entitled to vote or (ii) the total value of the stock, on any day during the foreign corporation's tax year.[1]

A U.S. shareholder is a U.S. person,[2] such as a U.S. citizen or U.S. corporation, that owns (or is considered as owning) 10% or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation. Voting power generally means the votes inherent in the shares held to elect members of the board of directors or its equivalent under the laws of the jurisdiction where the entity is formed. That is, if the voting shares grant the power to elect, appoint, or replace the body of persons exercising the powers ordinarily exercised by the board of directors of a domestic corporation.[3]

Arrangements to shift formal voting power away from U.S. shareholders are not given effect if voting power is retained in reality.[4] Consequently, the mere ownership of stock entitled to vote does not by itself mean that the shareholder owning the stock has the voting power inherent in the stock for purposes of determining whether a foreign corporation is a C.F.C. This rule covers agreements by non-U.S. shareholders to refrain from voting with respect to shares actually owned and corporate structures in which two or more classes of shares exist and the class or classes with voting power are separated from the class that is entitled to substantially all of the earnings.

One type of imputed income is Subpart F income, which includes the C.F.C.'s

- investment income (*e.g.*, dividends, interest, rents, royalties),
- income (*e.g.*, profits, commissions, fees) from certain sales or purchases of

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1. Code §957(a).
2. As generally defined under Code §7701(a)(30).
3. Treas. Reg. §1.957-1(b)(1)(i).
4. Treas. Reg. §1.957-1(b)(2).

personal property in transactions involving a related party as a supplier or purchaser in which the personal property is manufactured or produced in a jurisdiction outside the C.F.C.'s country of incorporation and the property is sold or purchased for use outside that country of incorporation,

- income (*e.g.*, compensation, fees) from rendering services for or on behalf of a related person outside the C.F.C.'s country of incorporation.[5]

Another situation in which a U.S. shareholder will have imputed income with respect to a C.F.C. arises when the C.F.C. makes an investment in "U.S. property," as discussed in detail below. Under certain circumstances, an investment in U.S. property may include accounts receivable in favor of the C.F.C. for which the obligor is a U.S. person.

"A U.S. shareholder generally must increase its gross income by its pro rata share of the increase in the earnings invested by the C.F.C. in U.S. property for the tax year. Thus, the C.F.C.'s investment in U.S. property is treated as a deemed repatriation."

INVESTMENT IN U.S. PROPERTY

Code §956 provides the rules that govern the taxation of U.S. shareholders in the case of an investment in U.S. property by the C.F.C. Code §956(c)(1) defines U.S. property as

- tangible property located in the U.S.,
- stock of a domestic corporation,
- obligations of U.S. persons, or
- any right to use certain items in the U.S. (*e.g.*, patents and copyrights, acquired or developed by the C.F.C. for use in the U.S.).

Code §951(a)(1)(B) states that a U.S. shareholder generally must increase its gross income by its *pro rata* share of the increase in the earnings invested by the C.F.C. in U.S. property for the tax year. Thus, the C.F.C.'s investment in U.S. property is treated as a deemed repatriation.

The original rationale for this provision is that the earnings of the C.F.C. are effectively repatriated to the U.S. in a transaction that is not otherwise taxable.[6] This may be accompanied by a deductible expense, for example, if the investment is in the form of an interest-bearing loan to a U.S. parent company. The loan is not taxable and the interest may be deductible.

EXCEPTION AND SAFE HARBOR

Code §956(c)(2) provides exceptions to the definition of U.S. property for certain accounts receivable of a U.S. person. Under the exception, the account receivable is not an item of U.S. property if, *inter alia*, it reflects:

> any obligation of a U.S. person[7] arising in connection with the sale or processing of property, if the amount of such obligation outstanding

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[5] Code §954(a).

[6] H.R. Rep. No. 1447, 87th Cong., 2d Sess. 58, 1962-3 C.B. 405, 462 (1962).

[7] As defined in Code §957(c), which refers to the definition in Code §7701(a)(30), which includes a U.S. corporation.

> at no time during the tax year exceeds the amount which would be ordinary and necessary to carry on the trade or business of both the other party to the sale or processing transaction and the U.S. person had the sale or processing transaction been made between unrelated persons.[8] (emphasis added)

Under the Treasury Regulations, the term "obligation" specifically includes an account receivable in which the obligor is a U.S. person.[9] In accordance with the exception under Code §956(c)(2), the regulations provide an exclusion from the definition of an obligation for any obligation of a U.S. person that arises in connection with the provision of services by a C.F.C. to that U.S. person if the amount of the obligation outstanding at any time during the tax year of the C.F.C. does not exceed an amount that would be ordinary and necessary to carry on the trade or business of the C.F.C. and the U.S. person if they were unrelated.[10]

The regulations add a safe harbor, which states that the amount of the obligation is considered to be "ordinary and necessary" to the extent of such receivables that are paid within 60 days.[11] Whether the amount of an obligation is ordinary and necessary to carry on a trade or business is to be determined from all the facts and circumstances in each case.[12]

At least two Tax Court cases and two I.R.S. private letter rulings ("P.L.R.'s") apply the ordinary and necessary standard to the length of time an account receivable remains unpaid. The Tax Court cases each involve a C.F.C.'s prepayment for goods or services provided by the U.S. parent corporation. They indicate that the analysis is not limited to a factual inquiry into the duration of the obligation. The private letter rulings involve sales of goods by the C.F.C. to its U.S. parent corporation, with the obligation arising as a result of delayed payment. Though they also indicate that the analysis is not limited to a factual inquiry into the duration of the obligation, they provide some guidance on how the I.R.S. might analyze the length of time of an obligation.

Amount Ordinary and Necessary to Carry on a Trade or Business

In *Sherwood Props., Inc. v. Commr.*,[13] the U.S. parent corporation was a supplier of steel to the C.F.C. The taxpayers argued that advances, in the amount of $500,000, made by the C.F.C. to the U.S. parent corporation were to be used by the U.S. parent corporation to purchase steel allocations in the U.S. on behalf of the C.F.C. The allocations guaranteed that if steel were ever in short supply, the steel mill would sell to the U.S. parent corporation a certain amount of steel, which it could then resell to the C.F.C. The taxpayers argued that the advances arose in connection with the sale or processing of property and were in an amount that was ordinary and necessary to carry on the trades or businesses of both the U.S. parent corporation and the C.F.C. The Tax Court stated that although there may have been a business reason for the C.F.C. to advance funds to the U.S. parent corporation, the record did not

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[8] Code §956(c)(2)(C).

[9] Treas. Reg. §1.956-2T(d)(2).

[10] Treas. Reg. §1.956-2T(d)(2)(i)(B).

[11] *Id.*

[12] Treas. Reg. §1.956-2(b)(1)(v).

[13] 89 T.C. 651 (1978).

show specific factors considered in calculating the amount necessary to maintain the steel allocations. Further, the court found that there was no objective evidence to establish that the advances were actually used for the purpose of maintaining the steel allocations. In essence, the funds advanced were not encumbered at the level of the parent and served the same purpose as a loan.

In *Greenfield v. Commr.*,[14] two sister corporations, one domestic and the other a C.F.C., had an agreement under which the domestic corporation would supply materials needed for the C.F.C.'s operations on a cost-plus basis. The C.F.C. typically advanced funds to the domestic corporation so that the domestic corporation could take advantage of discounts for cash purchases, prepay freight charges, and pay customs duties in order to receive materials from the docks. The Tax Court acknowledged that there were business reasons for the C.F.C. to advance funds to the domestic corporation. However, it could not conclude that those business reasons made it ordinary and necessary to the C.F.C.'s business to provide funds in such amounts that there was always a substantial balance in favor of the C.F.C. at the end of each tax year. Again, the advances made to the domestic corporation served the same purpose as a loan.

Time During Which Aged Accounts Receivable May Be Outstanding

In P.L.R. 8114032,[15] the I.R.S. determined that extended payment terms as long as four years were ordinary and necessary. Under the facts of the ruling, N was a domestic corporation in the business of aging and distilling alcohol. R was its Canadian subsidiary, which supplied N with aged alcohol known as "base." At one point, continued inflation made the last in, first out ("L.I.F.O.") accounting method the only practical way to value R's inventory, but Canadian law prohibited the use of L.I.F.O. as long as the inventory was owned by R. As a result, it was decided that N would own the inventory of base at the time that it was first placed by R in the aging barrel, so that L.I.F.O. could be used by N in computing income for U.S. tax purposes without causing N to have a permanent establishment in Canada. N bought R's existing inventory for a note, which was to be paid down as base was blended with other alcohols and shipped to N. Pursuant to this payment method, it was expected that 85% of the note would be paid within three years and that 100% would be repaid within four years. The I.R.S. determined that the entire amount of the note at any time during the tax years in question was ordinary and necessary to effectuate the purchase by N and the sale by R of base because the amount of the outstanding note was reduced on a monthly basis as base was shipped to N.

A similar result arose in P.L.R. 200519005,[16] in which the taxpayer represented that, due to long manufacturing lead times and the delicate and unique nature of the product manufactured, it was necessary to store "M" months of inventory supply with the U.S. distributor. M was not identified by a number in the private letter ruling. The taxpayer represented that due to the low margins typical of a distributor, it was both ordinary and necessary to provide M-month payment terms to correspond with the actual sale of the product. The I.R.S. determined that, based on the taxpayer's representations, the M-month obligations obtained by the C.F.C. supplier in exchange for the sale of its products to the U.S. distributor did not constitute an investment in U.S. property to the extent that (i) the amount of such obligations did not exceed the

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[14] 60 T.C. 425 (1973).

[15] P.L.R. 8114032, Dec. 30, 1980.

[16] P.L.R. 200519005, May 13, 2005.

amount of inventory held in the U.S. at the end of each month when the U.S. distributor closed its books and (ii) such obligations were not outstanding for a period exceeding M months.

WHEN DO AGED ACCOUNTS RECEIVABLE BECOME INVESTMENTS IN U.S. PROPERTY?

If an account receivable is older than the 60-day safe harbor, the U.S. shareholder must determine whether the length of time during which the account receivable is outstanding is ordinary and necessary the business of the C.F.C. and its U.S. shareholder.

Since the ordinary and necessary test involves a facts and circumstances analysis, the case law and private letter rulings discussed above may be instructive as to how the courts and the I.R.S. may view the standard in certain circumstances, even if they are not determinative.

The private letter rulings are instructive in evaluating the business needs of the purchaser and seller in a case in which the C.F.C. is a supplier and the U.S. shareholder is a distributor. In P.L.R. 8114032, the entire amount of the note at any time during the tax years in question was ordinary and necessary to effectuate the purchase by N and the sale by R of base because the amount of the outstanding note was reduced on a monthly basis as the product was shipped from the supplier to the distributor. In P.L.R. 200519005, the ordinary and necessary standard was met, in part, because the amount of the obligations did not exceed the amount of inventory held in the U.S. at the end of each month when the U.S. distributor closed its books. In both private letter rulings, there was a correlation between the amount of the obligation and the inventory held in the U.S. Thus, based on these private letter rulings, in order to meet the ordinary and necessary standard, it may be important that an aged account receivable is in an amount that correlates with the inventory that has not yet been sold to, or paid for by, the third-party customers.

The Tax Court cases are less instructive because they do not involve accounts receivable but rather C.F.C.'s that advanced money to U.S. corporations. In each case, there was evidence that the U.S. corporation needed the advance to finance its operations. Therefore, the cases illustrate that an advance needed to finance the operations of the U.S. shareholder generally will not be considered an amount ordinary and necessary to carry on the trades or businesses of the C.F.C. and the U.S. corporation.

CONCLUSION

In sum, the cases are both set in fact patterns where the C.F.C. advanced excess cash to the related U.S. company without any objective trigger as to the time of payment. The absence of any indication that the funds advanced were "impressed" at the level of the U.S. shareholder suggests that the "prepayment" or "deposit" was a disguised loan. In comparison, the facts in the private letter rulings suggest that the time of the settlement of the account receivable was triggered by the U.S. shareholder's receipt of payments from third-party customers. Consequently, it was clear that the accounts receivable remained open until the inventory was sold, generating cashflow with which to the U.S. shareholder could make payment.

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