

# ECI and Withholding Considerations in Cross-Border Receivables Factoring

By Steven D. Garden and Lucas Giardelli\*

## I. Introduction

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The global supply chain financing market has grown exponentially in the last decade. It is not only banks that provide this type of financing to companies of all sizes, but recent years have seen non-bank financial institutions, specialized funds, and fintech platforms all become important players in the market. Not surprisingly, a significant portion of supply chain financing is cross-border. The financing provider, the seller of the accounts receivable, and the obligors under the financed receivables may be located in two or more different jurisdictions.

While the industry continues to grow, tax practitioners face a dearth of guidance on several thorny tax issues, particularly when it comes to the purchase of U.S. accounts receivable by a non-U.S. buyer.<sup>1</sup> These issues have also not been a popular topic among tax commentators, with very few, if any, articles being written since Frederick R. Chilton, Jr.'s 1985 article appeared in this journal.<sup>2</sup> It has been almost 40 years since that article, so returning to the issues now does not feel too soon ...

Unless otherwise noted, the factoring transaction contemplated in the discussion ahead is (i) a "Seller" delivers goods or services to a U.S. taxpayer "Customer," (ii) Seller sells the account receivable on a nonrecourse basis to "Factor,"<sup>3</sup> a non-U.S. taxpayer, for an immediate payment of funds that is less than the amount owed by Customer under the account receivable, and (iii) Customer settles the account receivable with a payment that is received by Factor. This article will usually refer to the amount received by the Factor over the purchase price paid for the account receivable as factoring income or discount.

Actual facts of course vary and transactions observed in the market present an array of special features and nuances. For instance, sometimes there are other fees paid to the Factor, sometimes certain layers of recourse are accepted by the Seller, *etc.*<sup>4</sup> There are also other forms of supply chain financing including, importantly, so-called reverse factoring.<sup>5</sup> In addition, transactions



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**STEVEN D. GARDEN** is a Partner in the Chicago office of Mayer Brown. **LUCAS GIARDELLI** is a Partner in the New York office of Mayer Brown.

involving a Seller or Customer in a foreign jurisdiction may raise unique tax issues under applicable local law.<sup>6</sup> That said, this article will focus on certain U.S. tax issues involved in the plain vanilla accounts receivable purchase transaction outlined above, more specifically, the effectively connected income and withholding tax consequences.

Generally, a non-U.S. person is subject to (i) U.S. federal income tax on a net basis (with possible additional branch profits tax) for income that is effectively connected with a U.S. trade or business (“ECI”) and (ii) “chapter 3” withholding of tax under Code Secs. 1441 and 1442 at a 30% rate on U.S. source fixed, determinable, annual, or periodic income (“FDAPI”) that is not ECI (“NRA Withholding”). Both of these results can be altered (and alleviated in various degrees) by a relevant income tax treaty between the United States and the country of residence of the recipient of the income. As explained above, our focus here is generally limited to navigating the considerations of ECI and NRA Withholding in the contemplated factoring transaction and we do not intend to provide a comprehensive analysis of all relevant tax considerations. Specifically, this article will not discuss income tax treaties in great detail, chapter 4 Foreign Account Tax Compliance Act (“FATCA”) withholding, backup withholding, the treatment of factoring transactions under Code Sec. 163(j), or state and local tax considerations (which may include, among others, nexus for the Factor and bad debt deductions on factored accounts receivable for sales tax purposes).<sup>7</sup> This article will also not cover any of the topics unique to intercompany factoring arrangements, such as transfer pricing, applicability of the base erosion and anti-abuse tax, or issues specific to factoring by a controlled foreign corporation, including Subpart F and Code Sec. 956 considerations.

## II. Secured Debt *Versus* Purchase of Accounts Receivable

Both the ECI and NRA Withholding consequences of a factoring transaction could vary greatly depending on whether the arrangement is characterized, for U.S. federal income tax purposes, as a sale of the accounts receivable by the Seller to the Factor or, instead, as a loan from the Factor to the Seller secured by the accounts receivable. This determination ultimately depends on whether, considering all facts and circumstances, the benefits and burdens associated with the ownership of the accounts

receivable have been transferred to the Factor.<sup>8</sup> If the transfer of benefits and burdens is respected, the transaction will be treated as a sale of the accounts receivable and not as a loan. The courts and the Internal Revenue Service (“IRS”) have looked to different factors to make this determination.<sup>9</sup>

The primary factor considered by courts and the IRS in determining whether a transfer of accounts receivable should be treated as a sale for tax purposes is whether the risk of loss with respect to the accounts receivable has been shifted to the transferee, that is, whether the transferee has recourse to the transferor in case of default by the obligor on an account receivable. If there is full recourse against the transferor, the transaction will most likely be characterized as a secured financing, while if there is no (or very limited) recourse, the transaction would generally be treated as a sale of accounts receivable.<sup>10</sup> Beyond the recourse rights the transferee may have as a legal matter, courts have often considered as another indication of a sale that the transferee looks to the account debtors, and not to the transferor, for repayment of the advanced amounts.<sup>11</sup> Generally speaking, in most traditional factoring transactions observed in the market, accounts receivable are sold with no recourse to the Seller.<sup>12</sup> While other facts and circumstances still need to be considered, that is a first and important indication that the arrangements should be treated as a sale of accounts receivable for U.S. tax purposes.

The other main factors considered in case law and administrative guidance as an indication that the transaction ought to be respected as a sale of accounts receivable for tax purposes are (i) the transferee is entitled to retain amounts collected in excess of the amount advanced to the transferor,<sup>13</sup> (ii) there is a direct relationship between the terms of the advance made to the transferor of the accounts receivable and the terms of the underlying receivables,<sup>14</sup> (iii) the transferee has absolute power to dispose of the purchased accounts receivable,<sup>15</sup> (iv) the transferee is in charge of servicing the accounts receivable,<sup>16</sup> (v) the obligors on the accounts receivable are informed of the transfer,<sup>17</sup> (vi) the transferor is not made subject to covenants that are usually found in loan agreements,<sup>18</sup> (vii) the transferor does not pledge collateral in support of the obligation of the account debtors under the transferred accounts receivable,<sup>19</sup> (viii) the transferee does not have a right to inspect the books and records of the transferor as is common in lending transactions,<sup>20</sup> and (ix) the form of the transaction chosen by the parties is consistent with a sale of accounts receivable.<sup>21</sup> No

one factor is controlling and, certainly, a transaction may be characterized as a sale of accounts receivable for U.S. tax purposes, even if it does not meet every one of these characteristics.

While in some transactions the special features of a factoring contract may call into question its characterization for tax purposes, the rest of the article will focus on transactions that, after weighing the factors described above, are properly treated as a purchase and sale of accounts receivable and not as a loan.

### III. Effectively Connected Income

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A foreign corporation is subject to U.S. federal income tax on its net income only if the corporation is engaged in a trade or business in the United States and has income that is “effectively connected” with that trade or business.<sup>22</sup> Neither the Internal Revenue Code (the “Code”) nor the Treasury Regulations define what constitutes the conduct of a “trade or business within the United States.” Cases and rulings routinely state that this is a highly factual inquiry.<sup>23</sup> The determination is based both on the type and extent of the corporation’s activities within the United States.

As for the type of activity, the activities conducted by the foreign corporation in the United States in the first instance must be, for lack of a better term, “active.” The mere passive investment or ownership of property, and the collection of income therefrom, is insufficient to constitute the carrying on of a trade or business.<sup>24</sup> The activities of the foreign corporation must also be of a type that is closely related to the generation of profit, rather than being incidental, ministerial, clerical, or merely related to the collection of the income.<sup>25</sup> In addition to being “active” and not merely clerical, the economic activities conducted by the foreign corporation within the United States must be “considerable ... continuous, and regular.”<sup>26</sup> For purposes of determining whether a foreign corporation is engaged in a U.S. trade or business, the activities conducted by its agents within the United States are imputed to the foreign corporation.<sup>27</sup> In fact, even the activities of an independent agent that acts on behalf of the foreign corporation may generally be imputed to the foreign corporation in making this determination.<sup>28</sup>

In private guidance, the IRS twice addressed the question of whether the purchase of accounts receivable by a foreign Factor from a U.S. Seller results in the Factor being engaged in a U.S. trade or business. Both cases were related-party factoring.

In GCM 39220,<sup>29</sup> a foreign corporation purchased accounts receivable on a non-recourse basis from its U.S. affiliates. The receivables were generated from the sale of goods by the U.S. affiliates to foreign and domestic customers. The factoring transaction was directed by an executive officer of the foreign corporation located outside the United States. The U.S. affiliates acted as collection agents for the foreign Factor and were separately compensated for these collection services. The IRS concluded that the foreign corporation was engaged in the “business of factoring” and noted that the activities incident to such business were virtually all carried on in the United States. The IRS pointed to the fact that the books and records relating to the accounts receivable were maintained by the domestic affiliates in the United States and the collection activity was performed within the United States by the U.S. affiliates acting as agents of the foreign Factor. As explained below in Part IV.A, the IRS’ view in GCM 39220 was that the factoring income should be characterized as services income. Maybe this explains why, in making the determination of whether the Factor was engaged in a U.S. trade or business, the IRS turned its attention to, arguably, the more “tangible” activity involved in a factoring of accounts receivable, that is, the collection of proceeds from the Customers. In other words, the IRS’ U.S. trade or business determination in GCM 39220 may have been tainted by the characterization of the factoring income as services income.

Seventeen years later, the IRS addressed the same question on a very similar set of facts and reached an opposite conclusion. In FSA 200224003 (the “FSA”),<sup>30</sup> the IRS Office of Chief Counsel recommended that, due to hazards of litigation, the IRS Exam team not assert that a foreign corporation that factored U.S. accounts receivable from its U.S. affiliates was engaged in a U.S. trade or business. Under the factoring contracts, the foreign corporation was not obligated to purchase any of the accounts receivable offered by the U.S. affiliates. In practice, however, the foreign corporation had never rejected an offer to purchase an account receivable from the U.S. affiliates. According to the IRS, it appeared that the foreign corporation neither evaluated nor reviewed any of the offered accounts receivable before purchasing them. The factoring contract required the U.S. companies to staff a credit and collection department, and it was the U.S. companies who acted as the foreign corporation’s agent for the collection of the purchased accounts receivable in exchange for an administration fee. However, the U.S. company was not

authorized to forgive or settle any outstanding balance without the prior written advice and consent of the foreign corporation. The foreign corporation did not have any contact with individual account debtors nor did it have any involvement with the actual collection or management of the accounts receivable. The staff of the foreign corporation had little day-to-day dealings with the factored accounts receivable, mainly just summarizing and verifying data received from the operating companies. Except with respect to accounts receivable owed by certain debtors, the factoring contracts provided that the sales of the accounts receivable were made on a non-recourse basis.

First, the IRS Office of Chief Counsel was of the view that the acquisition (and servicing) of the accounts receivable was unlikely to constitute an activity that was covered by the “securities trading safe harbor” of Code Sec. 864(b)(2), because the taxpayer was passive and not a “trader.” The “securities trading safe harbor” generally precludes trading in securities from constituting a U.S. trade or business. The succinct rationale provided for this position in the FSA is somewhat questionable, but whether or not the “securities trading safe harbor” could apply to protect a Factor that is engaged in activities beyond that of a mere investor may well dovetail the recent focus on whether, and in what circumstances, a foreign person’s funding of loans in the United States is protected by the “securities trading safe harbor.”<sup>31</sup>

Notwithstanding the position that the “securities trading safe harbor” was inapplicable, the IRS Office of Chief Counsel concluded that the foreign corporation did not perform any substantial activities through the actions of its own employees and that all functions attendant to factoring the U.S. companies’ accounts receivable, other than the assumption of risk, were performed by the U.S. affiliates and remunerated with an administration fee. As such, citing *Higgins v. Comm’r*,<sup>32</sup> the IRS Office of Chief Counsel suggested that there was no U.S. trade or business because the foreign corporation’s involvement was more akin to a passive investment, which does not give rise to the conduct of a trade or business.

The question has been raised as to why the foreign corporation in the FSA was not imputed the activities conducted by its U.S. affiliates in determining whether the foreign corporation was engaged in a U.S. trade or business.<sup>33</sup> First, as for the collection activity performed by the U.S. affiliates, there is no discussion in the FSA of the extent of the servicing activities undertaken by

the U.S. affiliates. Courts have held that the mere collection of income within the United States does not give rise to a trade or business, so one may argue that, even if such activity had been imputed to the Foreign factor, it should not have altered the conclusion.<sup>34</sup> Additionally, the “origination” of the accounts receivable resulted from the U.S. affiliates extending credit to their customers in the ordinary course of their business of selling goods and services. It seems unreasonable to conclude that the U.S. affiliates acted as agents of the foreign Factor when they originated accounts receivable in the ordinary course of their sales or services business. On the above basis, the FSA’s reasoning is sound and a Factor’s employment of funds to earn a return by taking on credit risk of a Seller’s accounts receivable generated in the ordinary course of business is akin to a mere investment activity.<sup>35</sup>

While this Field Service Advice memorandum of course carries no precedential value and there is no guarantee that the IRS could not change course (again) on the issue, foreign Factors in the market are known to take comfort from this guidance. Yet, because the U.S. trade or business determination is such a highly factual inquiry, one must cautiously consider all relevant facts and circumstances of the transaction at hand before simply trying to extrapolate the IRS’ conclusion in the FSA.

An expansive reading of the FSA may suggest an IRS view that accounts receivable factoring can never give rise to a U.S. trade or business for a foreign Factor, regardless of where the relevant activities are conducted, because the purchase of accounts receivable at a discount should always be viewed as a passive investment. This interpretation appears questionable. Prior to reaching its conclusion in the FSA, the IRS noted that, under those specific facts, the foreign corporation was not conducting any activity beyond the assumption of passive risk. The implication is that the result could have been different had the foreign corporation performed other activities related to the purchase of accounts receivable and such activities were conducted within the United States. Moreover, various provisions in the Code and Treasury Regulations refer to the purchase of accounts receivable at a discount as a “trade or business” or as a “lending or finance business” for different purposes.<sup>36</sup> In fact, the legislative history to the Deficit Reduction Act of 1984, introducing changes to the Subpart F rules for related-party factoring, recognizes the possibility that a foreign corporation factoring U.S. accounts receivable could be engaged in a U.S. trade or business.<sup>37</sup> In addition, the IRS’ Audit Technique Guide for factoring

of receivables identifies as a “potential issue” for related-party factoring whether “the foreign factor’s factoring activities generate income from a trade or business within the United States.”<sup>38</sup> It seems unlikely that the IRS would view current law as providing a blanket exception under which factoring activity could never give rise to a U.S. trade or business.

A possibly important distinction between the facts in the FSA and other factoring transactions is the extent of activity necessary for a foreign Factor to source and arrange deals with unrelated Sellers. Because the foreign Factor in the FSA was purchasing accounts receivable from its affiliates, the Factor of course did not need to expend any real effort in advertising its financing services, finding potential counterparties, and negotiating the terms of the transactions. Moreover, as described above, the FSA also indicates that the foreign Factor did not conduct any independent credit risk analysis of the Customers and effectively did not reject any accounts receivable offered to it for purchase. In addition, the invoicing terms and systems and credit evaluations in the FSA were managed as part of the U.S. affiliates’ ordinary course business of selling its wares or services, presumably without significant input from any third-party service providers or market participants. Also, the FSA implied that the servicing activity involved the regular collection of accounts receivable in the ordinary course, as opposed to, perhaps, the Seller (or other U.S.-based servicer agent) negotiating discounts or settlements with delinquent debtors. Some or all of this may not be the case for Factors that purchase accounts receivable from unrelated Sellers.

Factors that purchase accounts receivable from unrelated Sellers may hold themselves out to the public as purchasers of accounts receivable and, through the activities of their employees or agents, conduct substantial activities to find potential Sellers and source deals. Once the Factor identifies a business opportunity, it needs to negotiate the receivables purchase contract with the Seller, including material terms such as the applicable discount, the eligible receivables, and the extent of any limited recourse to the Seller, among others. Finally, assuming the uncommitted nature of the arrangement, the Factor also needs to evaluate and decide whether it will purchase the different accounts receivable offered by the Seller, generally informed by its own independent credit analysis of the relevant Customers.<sup>39</sup> If one or more of these activities are conducted by the foreign Factor, or by an agent of the Factor, on a regular basis from within the United

States, this could materially increase the risk that the Factor be deemed engaged in a U.S. trade or business. Foreign Factors should seek to ensure that these activities are, to the greatest extent possible, conducted from outside the United States.

If the Factor were deemed engaged in a U.S. trade or business, the question then becomes whether the discount income should be considered effectively connected income under Code Sec. 864(c). The Factor would likely be deemed engaged in a “banking, financing or similar business” in the United States as defined in Reg. §1.864-4(c)(5).<sup>40</sup> The applicable rules to determine whether the factoring income is ECI will depend on the characterization and sourcing of such income.<sup>41</sup>

So long as the factoring income is treated as U.S. source income, there is considerable risk that the income would be treated as ECI under any alternative characterization. The applicable technical rules will depend on whether the factoring income is viewed as “interest” from a “security” or “gain” from the “sale” of a “security”<sup>42</sup> held by the Factor as a “capital asset” (“-4(c)(5) Income”) or, alternatively, as some other type of income. As discussed in more detail below in Part IV.A, it is unclear whether factoring income could be characterized as “interest” or “gain,” whether the collection on accounts receivable could be equated to a “sale” and whether the account receivable should be treated as a “security” for this purpose, so there is no certainty as to whether the factoring income would be treated as -4(c)(5) Income for these purposes. If the factoring income is viewed as -4(c)(5) Income,<sup>43</sup> the income will only be treated as ECI if the securities (*i.e.*, the accounts receivable) are “attributable to a U.S. office” which, according to the IRS’ interpretation, includes a U.S. office of an agent (including an independent agent) attributed to the Factor.<sup>44</sup> The regulations provide that the securities will be “attributable to a U.S. office” if the office “actively and materially participates in soliciting, negotiating, or performing activities required to arrange the acquisition of the stock or security.”<sup>45</sup> If the foreign Factor was deemed to be engaged in a U.S. trade or business in the first place (either because of the Factor’s own activities or the activities of an agent attributed to the Factor), it is likely that the Factor will also be found to have a U.S. office (either its own U.S. office or an agent’s U.S. office attributed to it) that actively and materially participated in soliciting or performing activities required to arrange the acquisition of the accounts receivable, which would result in the factoring income being treated as ECI. If, conversely, the factoring income is not viewed

as -4(c)(5) Income or the Factor's U.S. trade or business is not classified as a "banking, financing or similar business" for this purpose, the U.S. source factoring income would most likely be treated as ECI under one or both of the asset-use test or business activities test of Code Sec. 864(c)(2).<sup>46</sup>

If the factoring income is treated as foreign-source income, the outcome could be different. In that case, the factoring income recognized by the Factor should only constitute ECI if the Factor is classified as engaged in a "banking, financing or similar business" in the United States, the factoring income is classified as foreign-source "interest" or "gain from the sale of a security" and such income or gain is attributable to a U.S. office of the Factor.<sup>47</sup> For this purpose, however, the U.S. office of an agent will not be attributed to the Factor unless the agent is a dependent agent that has and regularly exercises the authority to negotiate and conclude contracts in the name of the Factor.<sup>48</sup> As such, even with respect to the factoring of accounts receivable from U.S. Customers, a Factor that is found to be engaged in a U.S. trade or business may still have a technical path to claim that the factoring income is foreign source not effectively connected income. For example, the position could be taken that the factoring income is characterized as, or at least sourced by analogy to, gain from the sale of personal property (and, thus, foreign-source income given the residence of the Factor), and that the account receivable is not a "security" (as defined in Reg. §1.864-4(c)(5)(v)), or that it is a security but the income is not attributable to a U.S. office because the agent conducting activities on behalf of the Factor qualifies as an independent agent.

We conclude the ECI analysis with two observations.

First, the foregoing discussion assumes that the foreign Factor is not entitled to the benefits of a U.S. tax treaty. When a foreign Factor is entitled to treaty benefits, it would still be protected from U.S. federal tax on its net income, even if it is engaged in a U.S. trade or business, so long as it does not have a "permanent establishment" in the United States (but *see* Part IV below in regard to withholding of U.S. federal income tax). The "permanent establishment" determination involves a higher threshold than the "U.S. trade or business" determination and, among other differences, the treaty-entitled foreign person is not imputed the U.S. activities of independent agents acting in their ordinary course of business.

Finally, it is worth noting that, if the factoring arrangement were characterized as a loan rather than a

sale/purchase of accounts receivable, the ECI risk may become an even more sensitive issue in the eyes of the IRS. Depending on where the different activities are performed, the situation may fall under the specter of the IRS audit campaign addressing whether foreign persons have ECI from inbound lending transactions.<sup>49</sup>

## IV. NRA Withholding Tax

Assuming the factoring income is not treated as ECI, the question then becomes whether the payments received by the Factor on the accounts receivable could become subject to NRA Withholding. We believe NRA Withholding should be addressed from three different perspectives.

First, one may consider whether the character of the underlying transaction between the Seller and the Customer may by itself result in the payment on the factored receivable, now to be received by a foreign person, to be characterized as FDAPI. For accounts receivable that arise from the sale of goods, it is clear that this is not the case because gains from the sale of property are excluded from FDAPI.<sup>50</sup> But what if the account receivable is for the provision of services, the rental of tangible property, or the license of intangible property? Payments for services, rents, and royalties are each items of FDAPI that are typically subject to NRA Withholding when payable to a foreign person. Yet, the case of the Factor should be distinguished. The Factor is not earning or recognizing services income, rental income, or royalty income when it purchases and collects an account receivable that relates to a service, lease, or license, respectively. By the time the Factor collects the account receivable, the service, rental, or royalty income should have already been recognized, with such character, by the Seller. If an accrual method Seller, the income would have been recognized by the Seller as dictated by the "all events test."<sup>51</sup> If a cash method Seller, the income should have been recognized by the Seller upon receipt of the purchase price from the Factor.<sup>52</sup> The services, rental, or royalty income need not, and should not, be recognized twice, once by the Seller and again by the Factor. The Factor has purchased an account receivable, which is generally a debt instrument. As such, upon collecting on such debt instrument, the Factor does not recognize income of the character generated by the underlying transaction that gave rise to the account receivable, but rather recovers its basis in the debt instrument and,

assuming the collections exceed the purchase price paid by the Factor, recognizes factoring income, the characterization of which is discussed below. The foregoing assumes, as is the case throughout this article, that the accounts receivable purchased by the Factor are for goods already delivered or services already provided and accepted by the Customer.<sup>53</sup>

Second, there is a question of whether the discount or factoring income recognized by the Factor is subject to NRA Withholding. This is addressed in Part IV.A below.

Third, separate from the above, one must consider whether, upon receiving payment on the account receivable, the Factor is receiving any explicit or imputed original issue discount (“OID”) or interest that could be subject to NRA Withholding. This issue is discussed in Part IV.B below.

If the factoring income or any explicit or imputed OID or interest are found to be subject to NRA Withholding, it may still be possible to avoid such withholding under exceptions set forth in the Code or tax treaties. Part IV.C briefly describes these possible exceptions.

It is worth noting that the Seller and Factor often agree in the receivables purchase agreement that the Seller is obligated to gross up and make whole the Factor for any withholding taxes (including, in principle, NRA Withholding) that are required to be deducted by applicable law from collections on the accounts receivable. The inclusion and exact scope of these gross-up and tax indemnity provisions are of course commercial issues subject to negotiation between the parties.

## A. NRA Withholding on Factoring Income

In determining whether a transaction will be subject to NRA Withholding, the first key question is to classify the characterization of the factoring income in order to determine its source, and if U.S. source, whether it is FDAPI that is subject to NRA Withholding.

In terms of determining the source of income, the Code sets forth whether certain categories of income are U.S. source, and for income that does not have a rule governing the source, courts and the IRS generally have allocated such items of income to either U.S. or foreign sources by analogizing to the source rules provided in the Code and regulations, or in certain circumstances, based on the business activities generating the income or to the place where the income was produced.<sup>54</sup>

In terms of determining if U.S. source income is FDAPI, for many years it has been observed that Treasury regulations are of little assistance in determining the

scope of FDAPI,<sup>55</sup> and since 2000, the Treasury regulations under Code Sec. 1441 generally provide that “all income included in gross income under Code Sec. 61 (including original issue discount)” is FDAPI with the only clear exclusion from FDAPI for “gains derived from the sale of property (including market discount and option premiums).”

Factoring income tends to be the discount spread between the price paid by the Factor to buy the receivable from Seller, and the amount received by the Factor from Customer. Unrelated party factoring income is not addressed in the Code and regulations for purposes of determining source under Code Sec. 861 or classification as FDAPI.<sup>56</sup>

Income characterization for one purpose is not necessarily indicative of its characterization for purposes of determining source under Code Secs. 861–863.<sup>57</sup> Therefore, it is possible to characterize factoring income in one of any category of income for various purposes and nevertheless conclude that the most appropriate sourcing analogy or production of income activity is based on a sale of personal property. Under this construct, the source would generally be based on the residence of the Factor, which would mean it is foreign source income, and thus not subject to NRA Withholding.<sup>58</sup> However, the conventional analysis is to determine the nature of factoring income in order to establish U.S. or foreign source income and if NRA Withholding applies.

Practitioners often seek to categorize an unknown or undifferentiated item under a class that is already addressed by tax law. This approach has support in the courts,<sup>59</sup> and without such an approach, the item’s tax treatment, in whatever context, would often be left without directive. However, given FDAPI’s broad construct, to the extent factoring income is sourced as U.S. source (*e.g.*, by analogy to interest), presumably even without precise identification of the nature of the income, the income is in fact FDAPI unless it is gains derived from the sale of property (including market discount and option premiums). That being said, there are a number of usual suspects that could potentially be a class of income to which factoring income should be associated.

### 1. Factoring Income as Service Income

In early guidance, discount income from factoring was considered to be income from the performance of services (*i.e.*, a service of factoring account receivable). In GCM 39220, discussed above, the IRS ruled that the discount earned by the factor was a commission for the

factoring activity (bearing risk and expense of collection), which corresponds to services income. Services income is sourced to where the services are performed, so income earned by a Factor providing factoring services in its home country should be foreign source, and not subject to NRA Withholding.<sup>60</sup> If, however, the Factor is relying solely on the activity of the Seller in respect to the factoring (e.g., collection activity) with the Factor making a one-time investment decision in its home country (or using a U.S. manager to make that decision in the United States), the foreign-source characterization of the performance of services is cloudier. Alternatively, the foreign service being provided in factoring may better be viewed as the foreign location of funds employed to implement the factoring. However, the IRS guidance in the above GCM was revoked by the IRS in a subsequent publication.<sup>61</sup> Virtually all financing transactions contain some elements of services, but that generally does not convert the overall characterization of the income into services income.<sup>62</sup> The question may be whether the Factor is predominately engaging in financing services as is the case for credit approvals and loan processing fees or is predominately earning income in consideration for the advance of funds that correlates to compensation for a combination of costs of capital and assumption of risk.

## 2. Factoring Income as Interest Income

The Tax Court, in *Elk Discount Corporation*,<sup>63</sup> held that the factoring income earned by an active U.S. factoring business was not interest for purposes of the definition of personal holding company income under prior law IRC §502. The court emphasized that the Factor is not a party to the receivable contract, does not enter the picture until after the contract is enforceable, is not advancing funds to the Customer, and that the Customer is not interested in borrowing money, but rather merely paying the purchase price for its goods over time on a deferred basis. It does not appear that any recent guidance has otherwise attempted to revive an interest characterization.<sup>64</sup> However, Congress observed in legislative history to rules for related-party factoring, “[i]n most respects, a factoring transaction is a financing transaction in which the factor has assumed a loan to the obligor on the account receivable and the discount earned by the factor is functionally the equivalent of interest.”<sup>65</sup> Similarly, Reg. §1.163(j)-1(b)(22)(iii)(E) treats factoring income as interest income for purposes of the Code Sec. 163(j) interest deduction limitation calculations.

If factoring income constitutes interest, the income from U.S. Customer receivables is U.S. source<sup>66</sup> and

FDAPI that is subject to NRA Withholding unless the portfolio interest exemption applies, the short-term obligation exception is present or an applicable income tax treaty reduces or eliminates the NRA Withholding, as explained in Part IV.C. below.

## 3. Factoring Income as OID

Another possibility is OID. This is a type of interest income that occurs when a debt instrument is issued for a price less than its stated redemption price at maturity. If the discount is treated as OID, then the discussion above regarding interest applies. The source is based on the residence of the obligor,<sup>67</sup> and for the U.S. Customer accounts receivable, the OID is U.S. source and OID is FDAPI.<sup>68</sup> As U.S. source FDAPI, OID is subject to NRA Withholding unless one of the exemptions discussed in Part IV.C applies.

Some guidance by the IRS suggests that factoring income could be characterized as OID.<sup>69</sup> However, it is difficult to reconcile OID characterization with the fundamental principle that OID is generated upon issuance of the instrument.<sup>70</sup> An obligation is generally deemed to have “OID” to the extent its stated redemption price at maturity exceeds its issue price, and the issue price is determined at issuance.<sup>71</sup> The discount generating the factoring income is generated by the secondary transaction of the Factor buying the account receivable from the Seller, and the parties generally do not associate any discount with the origination of the invoice upon the Seller providing value (i.e., goods or service) to the Customer whereby the Customer is paying the amount listed on the invoice in excess of such value received.<sup>72</sup> Indeed, Reg. §1.1441-2(b)(3) generally defines the OID subject to NRA Withholding based on Code Sec. 871(a)(1)(C), which considers OID as the discount on issuance described in Code Sec. 1273. There is no such OID on the accounts receivable here. Even under some theory of interpreting OID broader for purposes of Code Sec. 1441 or within the factoring context,<sup>73</sup> nevertheless, it is highly improbable that “original issue discount” could mean discount that is not part of the original issue of the instrument. Should this determination depend on whether the Factor buys the invoice immediately after issuance *versus* an hour or a day (or more) later, or whether the Factor is committed or uncommitted, or whether the Customer is aware of the sale (usually the Customer is not aware, but sometimes the Customer does know of the sale)? If the Factor is treated as lending funds to the Seller with payment by the Customer deemed to be the Seller’s repayment to

Factor, then such financing likely does give rise to OID; however, when the Factor is treated for tax purposes as purchasing the accounts receivable, this is difficult to contrive. Given that the instrument's economic issuance is based on the transaction between the Seller and the Customer, employing an approach that determines the presence of OID based on the Factor's relationship with the Seller seems theoretical and unsupported under current law.<sup>74</sup>

#### 4. Factoring Income as Discount or Gain

When viewing factoring in the context of an ongoing arrangement with Seller, there is perhaps some logic to characterizing the discount as service income or interest income, and query whether it should depend on if the Factor's factoring is on a committed or uncommitted basis with the Seller.<sup>75</sup> However, when viewing factoring in the context of each separate purchase by the Factor of the account receivable on a standalone basis, arguably, factoring income's economics are most akin to discount. In both scenarios, a future repayment obligation of borrowed value is purchased from the original lender at less than the repayment amount. In fact, in the preamble to the final regulations under Code Sec. 163(j), Treasury remarked that classifying factoring income as interest for purposes of Code Sec. 163(j) is "generally consistent with the rules in §1.954-2(h)(4), and is consistent with the treatment of other types of discount, such as acquisition discount and market discount".<sup>76</sup>

**a) Market discount.** The typical discount tax practitioners would think about in relation to the discount on accounts receivable, which arises from a secondary transaction, is market discount. Market discount is sourced like interest based on the obligor's residence, so under this construct, U.S. Customer receivables generate U.S. source market discount.<sup>77</sup> However, market discount is specifically excluded from FDAPI under Reg. §1.1441-2, and thus not subject to NRA Withholding.<sup>78</sup> It is clear that ordinary market discount described in Code Secs. 1276–1278 is part of the Reg. §1.1441-2 exclusion because Code Secs. 1276(a)(4) and 1278(b)(1) make clear that market discount is not treated as interest for purposes of Code Secs. 871(a) and 881, effectively exempting non-U.S. persons from tax on market discount (unless it is effectively connected with a U.S. trade or business), and therefore, the correlative exclusion from NRA Withholding is evident.

There is not a lot of gloss on the addition of market discount to this FDAPI exclusion, but the word

"including" signals the understanding that market discount is similar to gain from the sale of property because usually the income arises where a taxpayer purchases a debt instrument from an existing holder of the debt instrument after issuance, and through principal collection or subsequent disposition, the taxpayer recovers more than her purchase price for the debt instrument.<sup>79</sup> In addition, similar to a sale of property, the income event is largely seller-side because the seller's tax basis is the key driver of that determination.<sup>80</sup> To some extent, the specific reference to market discount may be viewed as a clarification that for purposes of Reg. §1.1441-2 the debt instrument generating market discount is "property" and the proceeds of market discount are treated as received from a "sale."<sup>81</sup>

That being said, this excluded-from-FDAPI "market discount" is not defined in Reg. §1.1441-2 or in the preamble to the promulgation of the regulations that included market discount as outside FDAPI in 1997. When these regulations were proposed in 1996, the proposed language of Reg. §1.1441-2(b)(2) excluding from FDAPI "Gains derived from the sale of property (including market discount and option premiums)" remained unchanged in the final regulations; however, Proposed Reg. §1.1441-2(b)(3) included in the OID provision a statement that "This paragraph (b)(3)(i) only applies to original issue discount as defined in Code Sec. 1273(a)(1). Therefore, it does not apply to *market discount as defined in Code Sec. 1278(a)(2)*" (emphasis added). These descriptive sentences were omitted from the final regulations. If the term "market discount" in Reg. §1.1441-2(b)(2) means market discount of Code Sec. 1278, then a few technical matters muddy the analysis.<sup>82</sup> It is rare for an account receivable to have a term of 364 days or more, and therefore, the *de minimis* rule of Code Sec. 1278(a)(2)(C) would eliminate the account receivable's market discount given the absence of any complete years to maturity, resulting in market discount of zero. Similarly, a Code Sec. 1278(a)(1) market discount bond does not include an obligation with a fixed maturity date of a year or less. Perhaps because Reg. §1.1441-2 only references "market discount," any limitations of Code Sec. 1278(a)(1) are irrelevant because that provision governs what is a "market discount bond." And furthermore, the elimination of "market discount" pursuant to Code Sec. 1278(a)(2)(C) can be defeated as a Code Sec. 1441 problem because, first, the general reference to Code Sec. 1278(a)(2) was scrapped from the final regulations, and moreover, Code Sec. 1278(a)(2)(C) does not provide that there is no market discount, but

rather that “the market discount shall be considered to be zero.” As such, the provision in fact stands for the proposition that this economic market discount is still market discount in the eyes of the Code; however, it is ignored for purposes of the special taxation rules of Code Secs. 1276–1278. Given the similarities between factoring income and market discount, the undefined use of market discount in the regulations, and the above analysis, even under the lens of the Code’s market discount framework, this approach is very persuasive in concluding that factoring income should be entitled to the market discount classification of Reg. §1.1441-2(b)(2) and therefore not FDAP (and thus not subject to NRA Withholding).

To the extent, contrary to the above, one concludes that factoring income constitutes economic market discount, but it is not the market discount listed in Reg. §1.1441-2(b)(2)(i) because it is not subject to Code Secs. 1276–1278, it appears that this approach means the 183 days or less short-term exception, which is discussed further in Part IV.C., is also not available to exempt the factoring income recognized by the Factor from U.S. taxation. The 183-day exception of Code Sec. 871(g) applies solely to OID under Code Sec. 1273, and this does not include market discount. That being said, there is another potential basis for not imposing NRA Withholding under this approach. Code Secs. 1276(a)(4) and 1278(b)(1) treat accrued market discount as interest for purposes of the sourcing rules, and so where Customer is a U.S. resident, accounts receivable generate U.S. source income. However, for factoring income that is market discount not addressed in Code Secs. 1276(a)(4) and 1278(b)(1), the source of income is not specifically governed by statute. If interest is the most appropriate analogy to market discount, then the source result will be the same. But if a more appropriate analogy is the sale of personal property, then the source is generally based on the residence of the Factor, which would result in the market discount being foreign-source income not subject to NRA Withholding.<sup>83</sup>

Finally, under this fairly strange approach of factoring income classified as market discount that is nevertheless FDAP, a Factor that is entitled to the benefits of a treaty may find the factoring income is still exempt from NRA Withholding under the “Business Profits” or “Other Income” article.

**b) Acquisition discount.** As mentioned, almost all accounts receivable in the type of factoring transactions discussed here have a term of 364 days or less. So, from

the perspective of Subchapter P Part V of the Code, the taxation of the accounts receivable falls out of Code Secs. 1276–1278 and instead is subject to Code Secs. 1281–1283. The above paragraphs proposed the conclusion that the term “market discount” in Reg. §1.1441-2(b)(2) can include market discount on a short-term instrument because it is economically market discount, as that term is typically used and can fit within the confines of Code Sec. 1278 as described above. But given that Subchapter P Part V of the Code probably categorizes the accounts receivable under Code Secs. 1281–1283 as opposed to Code Secs. 1276–1278, those provisions bear consideration.

Code Sec. 1281 provides a special set of rules for most nongovernmental short-term obligations,<sup>84</sup> and to the extent a nongovernmental short-term obligation is otherwise excluded from Code Sec. 1281, a taxpayer can elect into Code Sec. 1281.<sup>85</sup> The general rule of Code Secs. 1281–1283 for nongovernmental short-term obligations is that a holder of a short-term nongovernment obligation must currently take into account the “acquisition discount” inherent in the obligation as ordinary income through accruals. While acquisition discount starts out as being the excess of the obligation’s stated redemption price at maturity over the taxpayer’s basis (which would appear to include a Factor’s discount), the rules bottom out in a way that restates the applicable discount keying off of “issue price.”<sup>86</sup> This revision to the general rule means that taxpayers acquiring a short-term obligation after its original issue at a price less than the “issue price” do not have to currently accrue the acquisition discount that is in excess of any OID; however, they are permitted to elect to do so under Code Sec. 1283(c)(2).<sup>87</sup> If a short-term nongovernment obligation is not subject to Code Sec. 1281 (*e.g.*, the obligation is held by an individual who does not elect into Code Sec. 1281), Code Sec. 1271(a)(4) treats any acquisition discount on the short-term nongovernment obligation as ordinary income upon sale or retirement. However, if a short-term nongovernment obligation is subject to Code Sec. 1281, then any amount of discount not otherwise currently accrued into income is not subject to Code Sec. 1271(a)(4) and, thus, is treated as capital gain when received in sale or retirement. An example of this result where the short-term nongovernment obligation is retired would be if a short-term nongovernment obligation was issued at par of \$100 to A, thereafter B, an accrual-method taxpayer, acquired the obligation for \$98 and B does not have an election in place under Code Sec. 1283(c)(2). In that

case, when the borrower pays \$100 to B, B generally has a capital gain of \$2.

As noted above for market discount, Code Sec. 871(g)'s 183-day-or-less exemption appears inapposite under this characterization. Code Sec. 871(g) applies where the issue price is less than the stated redemption price at maturity; however, we assume for this purpose that in the factoring transaction, the only discount is the acquisition discount attributable to the Factor's purchase from the Seller.<sup>88</sup>

This produces the following question: Is a Factor's "acquisition discount" under Code Sec. 1281 included in "market discount" listed in Reg. §1.1441-2(b)(2)?

**c) Classification and sale or exchange of accounts receivable.** Before attempting to answer this query, it is appropriate for a sidebar that asks two additional questions that relate to each other.

First, should any of the rules above regarding OID, market discount, or acquisition discount actually be meaningful in analyzing accounts receivable? Code Secs. 1275(a)(1) (defining "debt instruments" for purposes of Code Secs. 1271–1275), 1278 (defining "bonds" for purposes of Code Secs. 1271–1288), and 1283 (defining "short-term obligations" for purposes of Code Secs. 1281–1283) all use the same descriptive formulation for the definition of the type of instrument subject to each category's regime: "bond, debenture, note, certificate, or other evidence of indebtedness."<sup>89</sup> Are accounts receivable included in these instruments?

Second, Reg. §1.1441-2(b)(2)'s exclusion from FDAPI, in substance, is "gain derived from the sale of property," with this category explicated as including market discount and option premiums. A Factor virtually always recognizes its factoring income from regular collection of payment by the Customer—is that a "sale"?

For the first question, the Bittker treatise asserts that debt not evidenced by any written instrument, such as an open-account debt, is not a debt instrument for purposes of Code Secs. 1271–1275.<sup>90</sup> This may be true, but arguably it doesn't answer the question for traditional accounts receivable in unrelated factoring transactions, which are virtually always governed by a written agreement. Nevertheless, one view is that under the doctrine of Code construction, *noscitur a sociis*, words in a list are to be constructed harmoniously, taking color from each other, and that should limit the scope of the term "evidence of indebtedness" to formal debt instruments, and accounts receivable are not formal debt instruments.<sup>91</sup> Moreover, there are some rules that enumerate separately

"evidence of indebtedness" or "notes" together with "accounts receivable," in particular, Code Sec. 864(d)(3), among others.<sup>92</sup> This implies that the Code and regulations know how to specifically add accounts receivable when they intend to do so, and it was not otherwise enumerated here.

According to this view, first, the 183-day-or-less exemption from NRA Withholding on OID and interest does not appear applicable because Code Sec. 871(g) only applies to bonds and evidence of indebtedness.<sup>93</sup> Similarly, the factoring income is not market discount or acquisition discount within the meaning of Subchapter P Part V of the Code. While it may be the case that factoring income in this view is simply neither interest nor OID under Code Sec. 871, and therefore not subject to tax liability in the hands of the Factor, this returns us to the start in that Code Sec. 871(a)(1)(A) also includes "other fixed or determinable annual or periodical gains, profits, and income," and Reg. §1.1441-2 similarly imposes NRA Withholding on the extraordinarily broad category FDAPI. So the absence of the income being specifically listed is cold comfort at best. As discussed above, given the generic nature of the income in this context, the next step is to ask whether the source of this FDAPI is United States or foreign. Again, maybe it is similar to interest and its ilk of financing income (including market discount) that is U.S. source based on Customer's residence, or maybe it is similar to sale of personal property that is foreign source based on Factor's residence. If the latter, there is no NRA Withholding. If the former, the only clear remaining exemption from NRA Withholding for any of Customer's accounts receivable is if it is nevertheless considered gain derived from the sale of property under Reg. §1.1441-2(b)(2)(i).<sup>94</sup>

The Supreme Court held "Payment and discharge of a bond is neither sale nor exchange within the commonly accepted meaning of the words."<sup>95</sup> The Code effectively changed this result for many purposes by providing that amounts received in retirement of debt constitutes an exchange for the debt. The Tax Court interpreted the developments of the law to mean that an obligor's payment on debt is not a sale or exchange unless the payment satisfies the special statutory rule that the payment is treated as an exchange.<sup>96</sup> The limits of this statutory result evolved over time. First, the Code limited this treatment to corporate and government debt with interest coupons or in registered form.<sup>97</sup> Next, the rule dropped the requirement for interest coupons or registered form.<sup>98</sup> Current law is enshrined in

Code Sec. 1271(a)(1) and provides “Amounts received by the holder on retirement of any debt instrument shall be considered as amounts received in exchange therefor.” This is a broad rule instructing exchange treatment to the retirement of a debt instrument, and an exchange is understood to also constitute a “sale.” Under the view that accounts receivable are not the type of formal instruments addressed by Code Sec. 1271, this case law points to a treatment of Customer’s payments as mere collection of income, and not gain from sale or exchange. On the one hand, this construct may make it difficult to conclude that Reg. §1.1441-2(b)(2)(i) treats the factoring income as gain from property sale. However, on the other hand, as discussed below, the inclusion of “market discount” as part of this exception from FDAPI argues for the conclusion that factoring income characterized as discount is within the confines of the intended FDAPI exception.

However, in any event, this view of “evidence of indebtedness” doesn’t seem in line with modern-day, third-party factoring. First, Code Sec. 864(d)(3) is explicitly defining “trade or service receivable” so it is sensible for the statute to clearly spell out an account receivable in addition to evidence of indebtedness in order to ensure inclusion of an open-account-type entry and to include, without further inquiry, other forms of trade payables. Also, looking to these other rules that separately list accounts receivable is not particularly persuasive in making this determination given the fairly different contexts of such rules.<sup>99</sup> More to the point, when Code Sec. 1275(a)(1) defines “debt instruments” for purposes of Code Secs. 1271–1275 as a “bond, debenture, note, certificate, or other evidence of indebtedness,” the pre-1994 regulations under Code Sec. 1275 included some expansion of the concepts by illustrating these terms as follows: “a bond, note, certificate, or other evidence of indebtedness, including all rights to deferred payments under a contract whether or not evidenced by a formal instrument.” In 1994, this regulation was revised in Reg. §1.1275-1(d), arguably to make it even broader, providing “debt instrument means any instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law (including, for example, a certificate of deposit or a loan). Nothing in the regulations under Code Secs. 163(e), 483, and 1271–1275, however, shall influence whether an instrument constitutes indebtedness for Federal income tax purposes.” On the one hand, there is an argument that the regulation, per its terms, is limited to Code Secs. 1271–1275, and on its face it

is only interpreting the single term “debt instrument” (as opposed to “bond” or “evidence of indebtedness”). As such, perhaps Reg. §1.1275-1(d) cannot be applied beyond its yard. That being said, this seems highly doubtful given the identical statutory formulation of the definition for each of the noted three regimes under Subchapter P Part V of the Code, and that there are no Treasury regulations for Code Secs. 1276–1283. Instead, it is likely that the Treasury regulations under Code Sec. 1275 describing the term “debt instrument,” for which the statute states means “bond, debenture, note, certificate, or other evidence of indebtedness,” should be viewed as applying for each of these other terms and Sections as well.<sup>100</sup> This means that all of these Sections apply to the same group of instruments, and Code Sec. 1271 tells us the relevant obligation subject to its rules is any instrument or contractual arrangement that constitutes indebtedness under tax law. Generally, accounts receivable sold in the traditional unrelated party factoring market have written terms intended to mandate payment at a fixed date certain, which is relied upon by the third-party purchaser.<sup>101</sup> As such, the accounts receivable or invoices almost certainly represent a contractual arrangement constituting indebtedness under general principles of federal income tax law, despite perhaps some informality or not explicitly checking every box of the case law’s multi-factor debt for tax test on account of its unique nature.<sup>102</sup>

This conclusion allows a different answer to the second question of whether a Factor’s collection of the Customer’s payment constitutes a “sale” of the accounts receivable. Because Code Sec. 1271(a)(1) applies to the accounts receivable, the Customer’s retirement of the accounts receivable is treated as a sale by the Factor for tax purposes. As such, as discussed further below, Reg. §1.1441-2(b)(2)(i)’s gains derived from the sale of property should exclude the factoring income from FDAPI.

**d) Sales gain and discount.** There is guidance by the IRS suggesting that factoring income could be characterized as gains derived from the sale of property, *i.e.*, the accounts receivable (or perhaps market discount).<sup>103</sup> “Property” is commonly defined very broadly in the Code and regulations, including debt instruments and receivables,<sup>104</sup> and so this characterization is sensible to the extent Code Sec. 1271(a)(1)’s exchange treatment applies to the Customer’s retirement of the account receivable.

As noted above, accounts receivable are short-term obligations, and Code Sec. 1271(a)(4) specifically includes short-term nongovernment obligations (in order

to require ordinary income characterization on sales or exchanges),<sup>105</sup> thereby implying that Code Sec. 1271(a)(1)'s proclamation of retirements constituting exchanges is equally applicable to this category of instruments.

That being said, Code Sec. 1283(d)(3) and Reg. §1.1271-1(b)(1) explicitly turn off Code Sec. 1271(a)(4) where Code Sec. 1281 applies, which means that an accrual-method taxpayer, for instance, is subject to the current inclusion of accruals of acquisition discount and not the special character inclusion rule of Code Sec. 1271(a)(4). However, this does not seem to otherwise disturb the principle of Code Sec. 1271(a)(1) as a general rule that nevertheless equates retirement of a Code Sec. 1281 short-term obligation with an exchange. This is the reason that any amount of Code Sec. 1283 short-term obligation acquisition discount not otherwise currently accrued into income that is collected in retirement is treated as capital gain. Therefore, a foreign Factor's collection of proceeds from the Customer on the accounts receivable constitutes a sale of property, which appears to be straight within the Reg. §1.1441-2(b)(2)(i) exception from FDAPI for gains derived from the sale of property.

Nevertheless, the labyrinth of these rules could continue to play tricks on the mind and risks bizarre conclusions. Should the foreign Factor be viewed as outside of Code Sec. 1281 because the accounts receivable are not described in Code Sec. 1281(b)(1) given that the foreign Factor does not accrue income for U.S. federal income tax purposes? In that case, Code Sec. 1271(a)(4) applies to recharacterize gain as ordinary income, but in any event not changing the conclusion above because the collection of proceeds is from an exchange under Code Sec. 1271(a)(1). Alternatively, a foreign Factor presumably uses the accrual method of accounting for its own foreign income tax purposes, and if accounts receivable are short-term nongovernment obligations in the hands of an accrual-method taxpayer, then the acquisition discount is generally subject to current income accrual under Code Sec. 1281; does that mean that the collection of payment does not constitute gain derived from a sale for the amounts previously "accrued" under the Code Sec. 1283(c) method? Perhaps the question itself is unnecessary because the Code Sec. 1283(c)(1) method of applying Code Secs. 1281 and 1282 by "taking into account OID in lieu of acquisition discount" generally means that the acquisition discount of accounts receivable will not in fact be subject to actual accrual without an affirmative election under Code Sec. 1283(c)(2),

which a foreign Factor would not file.<sup>106</sup> Moreover, the method of inclusion does not appear relevant, as Code Sec. 1278(b) allows an election for a current accrual of market discount into income, and yet market discount is included as a Reg. §1.1441-2(b)(2)(i) income that is not FDAPI without qualification for the type of income inclusion method.

At the end of the day, acquisition discount and market discount are defined the same in substance by the Code and are economically equivalent to each other, and both amounts are included in Code Sec. 1271(a)(1)'s sale or exchange treatment upon retirement (though each subject to separate special recharacterization rules).<sup>107</sup>

In sum, it would appear inappropriate to conclude that factoring income is unclassified, generic income that defaults to FDAPI. It seems possible in certain instances to conclude that factoring income is compensation for factoring services, but if not, factoring income likely is acquisition discount as described in Code Sec. 1283.<sup>108</sup> This very well could mean that the factoring income is also "market discount" under Reg. §1.1441-2(b)(2)(i) for the reasons stated above, *i.e.*, it is the same economic item and market discount in Reg. §1.1441-2(b)(2)(i) is not limited to the discount on a "market discount bond" described in Code Sec. 1278(a)(1). Finally, Reg. §1.1441-2(b)(2)(i)'s inclusion of market discount shines a light on the contours of the rule's general exception from FDAPI for "gains derived from the sale of property," and demonstrates that just like market discount is gain from the sale of property (even when collected from obligor's repayment) there is no rational distinction for not applying the same treatment to acquisition discount on an account receivable.<sup>109</sup>

## B. NRA Withholding on Explicit and Imputed Interest

Even if one concludes that the factoring income or discount earned by the Factor should not be subject to NRA Withholding for the reasons described in Part IV.A above, the accounts receivable may have an explicit or imputed interest or OID component that could be subject to NRA Withholding upon receipt by the Factor.

### 1. Explicit Interest

Accounts receivable do not generally accrue interest from the date of issuance of the invoice to the due date. Absent an "early payment discount" sometimes offered by the Seller, the Customer will owe the same amount

regardless of whether payment is made at any time prior to or on the due date. While, economically, the Seller may be taking into account the time value of money through the due date of the invoice when pricing the goods or services, there is typically no stated interest accrual on the accounts receivable from the date of issuance of the invoice (although, as discussed below, in some but not all cases, the tax law will impute the accrual of OID or interest from the date of issuance through the due date).

Some accounts receivable, or the contract under which these are generated, may not explicitly contemplate the accrual of interest or any finance charge after the due date. Often, however, the invoice itself or the master agreement between the Seller and Customer will explicitly provide for the accrual of interest or a “finance charge” upon late payments. Moreover, in lieu of, or in addition to, the explicit accrual of interest for an overdue payment, the Seller may charge a “late fee” expressed as a flat amount or a fixed percentage of the amount overdue. Unless there is evidence that this “late fee” compensates the Seller for a specific service performed in connection with the Customer’s account, this fee should also be treated as interest for federal income tax purposes.<sup>110</sup>

If, upon collection, the Factor receives an amount representing an agreed-upon interest, finance charge, or late fee on an overdue account receivable from the Customer, such amount should be subject to NRA Withholding unless an exemption is applicable,<sup>111</sup> and so long as the interest was accrued after the purchase of the account receivable by the Factor.<sup>112</sup>

## 2. Imputed OID or Interest

As noted above, accounts receivable do not generally provide explicitly for the accrual of interest between the date of issuance of the invoice and its due date. However, there are two provisions under the Code that, for certain accounts receivable, recharacterize as OID or interest a portion of the amount due: Code Secs. 1274 and 483.

It is worth noting that the scope of both Code Secs. 1274 and 483 is explicitly limited to debt instruments issued in sales of property. As such, interest will not be imputed under these rules to accounts receivable that arise, for example, from the provision of services, the rental of property, or the licensing of intangibles.<sup>113</sup> In fact, under Code Sec. 1273(b)(4), the issue price of a debt instrument issued for services or the right to use property shall be its stated redemption price, which should preclude the imputation of interest or OID to these types of accounts receivable.<sup>114</sup>

Code Sec. 1274 is the basic interest imputation rule and takes precedence over Code Sec. 483, which only applies to transactions excepted from Code Sec. 1274.<sup>115</sup>

Subject to the exceptions described below, Code Sec. 1274 applies to debt instruments issued in consideration for the sale of nonpublicly traded property that do not bear adequate stated interest if at least one payment is due more than six months after the sale. As discussed above, accounts receivable should be treated as “debt instruments” for these purposes (as defined in Reg. §1.1275-1(d)) and they do not typically bear stated interest. Thus, accounts receivable from the sale of property with a term of more than “six months” would generally be covered by the imputed interest rule in Code Sec. 1274.

The statute excepts several debt instruments from the scope of Code Sec. 1274. As it relates to accounts receivable, the more relevant exception is for debt instruments received in a sale of property if the total consideration received does not exceed \$250,000, subject to an aggregation rule discussed below.<sup>116</sup>

As noted above, Code Sec. 483 is also only potentially applicable to debt instruments with no adequate stated interest issued in consideration for the sale of nonpublicly traded property excepted from Code Sec. 1274. Code Sec. 483 only applies to payments that are due more than six months after the date of the sale, but unlike Code Sec. 1274, Code Sec. 483 also requires that the payments be made under a contract that has some or all of the payments due more than one year after the date of the sale.<sup>117</sup> As a matter of commercial practice, it is unlikely that accounts receivable purchased in a factoring transaction would have a term of more than one year. It is conceivable, however, that a sale with a term of more than six months could be viewed as being made under a contract that includes other payments that are due more than one year after the date of such sale, especially given the aggregation rule described below. Code Sec. 483 does not apply to any payment on account of a sale of property if the sales price does not exceed \$3,000.<sup>118</sup>

Recapping, (a) an account receivable from the sale of property may include imputed interest or OID, while an account receivable from the provision of services or the lease or license of property should not typically include imputed interest, (b) an account receivable from the sale of property with a term of more than six months for an amount of more than \$250,000 will include imputed OID, and (c) an account receivable from the sale of property for less than \$250,000, but more than \$3,000, will include imputed interest so long as the term is more than six months and the account receivable is viewed as

payable under the same contract that includes payments due more than one year after the date of the sale.

When determining the applicability of Code Sec. 1274 or 483, aggregation rules must be considered.<sup>119</sup> These rules provide that all sales that are part of the same transaction or series of related transactions between the same seller and buyer are aggregated into a single transaction and, for purposes of Code Sec. 483, all contracts calling for deferred payments arising from the same transaction or series of related transactions are treated as a single contract. If this rule applies to aggregate multiple sales of property that, together, exceed \$250,000, then Code Sec. 1274 would become applicable, so long as there is a payment under any of the sales that is due more than six months after the date of the first sale. Moreover, even if the aggregated sales do not exceed \$250,000, the aggregation rule may bring a sale under the purview of Code Sec. 483 if, looking at all aggregated sales, there is a payment due more than one year after the date of the first sale. The exact scope of these aggregation rules is unclear. For example, could Code Sec. 483 apply to an account receivable with a term between 184 and 365 days, solely because the sale is done under a multi-year supply contract between Seller and Customer? Could that mean that each invoice under that supply arrangement is potentially subject to Code Sec. 483 because there will likely be other sales made under the umbrella of the same master contract that will have payments due more than one year after the date of the tested sale? Should it make a difference if the Customer is committed to making future purchases under the same master contract?

In its limited private guidance, the IRS appears to have taken a fairly narrow view of these aggregation rules under Code Secs. 1274 and 483. In one case, the IRS ruled that neither aggregation rule applied when the existence of one transaction did not create an implicit or explicit obligation for the Customer to make additional purchases from that same Seller and each transaction was executed by means of a separate contract, often with differing terms.<sup>120</sup> In another case, the IRS did not aggregate monthly sales of timber for purposes of Code Sec. 483, even though all sales were contracted for in a single agreement and it appears the Customer had an obligation to make sequential purchases of timber over the term of the contract. In declining to apply the aggregation rule, the IRS simply noted that “each sale involves a transfer of ownership of a distinct quantity of timber and provides for payment for the timber transferred on an arm’s length basis.”<sup>121</sup>

If Code Sec. 1274 or 483 apply to a trade receivable, the face amount of the receivable must be discounted at the applicable federal rate to determine the imputed principal amount or issue price of the instrument.<sup>122</sup> The excess of the face amount (*i.e.*, the “stated redemption price at maturity”) over the issue price will be recharacterized as OID (under Code Sec. 1274) or “unstated interest” (under Code Sec. 483) and in both cases must be recognized by both parties as it accrues on a constant basis.<sup>123</sup>

When the Factor purchases an instrument that has OID under Code Sec. 1274, such OID should be subject to withholding upon collection (unless the Factor benefits from a treaty exemption or the portfolio interest exemption, discussed below).<sup>124</sup> In contrast, there are no specific rules on the treatment of “unstated interest” upon the purchase from the original holder of a debt instrument that is subject to Code Sec. 483 (*e.g.*, purchase by the Factor from the Seller). Garlock believes the issue is unclear and there are two possible reasonable approaches. Upon the purchase, the debt instrument would have market discount under Code Sec. 1278(a)(2) (or, we would add, acquisition discount in the factoring of typical accounts receivable) equal to the excess of its stated redemption price over the buyer’s basis. One possible solution, says Garlock, would be to reduce the amount of market (or acquisition) discount by the amount of unstated interest not yet accrued and have the buyer recognize the remainder of the unstated interest through maturity.<sup>125</sup> Alternatively, Code Sec. 483 may just not apply to the buyer, who would only recognize market (or acquisition) discount income. Interestingly, while the first approach would result in the possible imposition of NRA Withholding on the unstated interest amount, the former would result in the Factor escaping NRA Withholding given that, as explained above, market (and acquisition) discount is not FDAPI.

## C. Exception to NRA Withholding on Interest and OID

If the factoring income were characterized as interest or OID under the possible classifications described in Part IV.A, or if the account receivable has explicit or imputed interest or OID as discussed in Part IV.B, then NRA Withholding tax would in principle apply to any amount of interest or OID treated as received by the Factor. There are, however, some important exceptions that may be available to escape NRA Withholding in these circumstances.

## 1. Short-Term Debt Exception

First, no NRA Withholding should apply for any account receivable that has a term of 183 days or less from the date of original issuance.<sup>126</sup> This exception is set forth as an exemption for OID,<sup>127</sup> which receives separate treatment from interest under Code Sec. 871.<sup>128</sup> However, Code Sec. 871(g)(1)(B) extends to 183-day-or-less debt that contains (stated) interest because Reg. §1.1273-1(c)(5) treats the interest as non-qualified stated interest, which in turn converts this interest into OID under Code Sec. 1273, thus attracting Code Sec. 871(g)(1)'s short-term obligation exemption from tax liability. It should be noted that, as a technical matter, this exception has virtually no application to OID imputed under Code Sec. 1274 or unstated interest imputed under Code Sec. 483, precisely because OID or interest is only imputed under those provisions when payment is due more than six months after the sale.<sup>129</sup>

*Perhaps because factoring, historically, has typically been viewed as looking the same from deal to deal, and there are several technical paths to eliminate U.S. tax, there is a muted consensus that the transactions do not attract U.S. tax obstacles for foreign Factors.*

The substantial majority of factored accounts receivable in third-party arrangements have a term of 183 days or less from the invoice date, and thus, NRA Withholding tax would not apply on any interest or OID thereon. However, particularly with the recent increased appetite and market attention to factoring creating newer frameworks for arrangements, there is a significant minority of factored accounts receivable that have a term of more than 183 days, and thus are ineligible for this exception. If the factoring income on a 184-day-or-more account receivable is treated as interest or OID, or if such an account receivable is subject to Code Sec. 1274 or 483, the income is subject to NRA Withholding (subject to the portfolio interest exemption or application of an income

tax treaty, discussed below). In addition, there may be a question about the proper term of an account receivable. Imagine a Factor is buying six-month accounts receivable from a Seller, but all of the Customers routinely pay between five to 15 days late, and Seller never contacts a Customer or enforces any of its payment rights unless payment is delayed beyond 15 days. Should the accounts receivable be viewed as 180-day paper or over-183-day paper? There may be risk that the parties' practice with respect to their arrangement evidences a later legal due date than listed in the invoice or agreement, that is, that the parties' course of conduct could have modified the originally agreed payment terms. An analogy to this issue was specifically addressed under this Code Sec. 871(g) exemption in respect to reinvestment or roll-over arrangements,<sup>130</sup> and the contours of making this determination for the 183-day exemption in the above circumstances are not clear.

## 2. Portfolio Interest Exception

Code Secs. 871(h) and 881(c) provide interest and OID is portfolio interest and not subject to NRA Withholding if the underlying obligation is in "registered form," the payee is not a bank extending credit under a loan agreement entered into in the ordinary course of its trade or business, the payee is not 10% owner of the obligor, the payee is not a controlled foreign corporation related to the obligor, and the interest is not contingent interest. A couple of these elements warrant consideration here.

First, typically the registered form requirement is not clearly satisfied for accounts receivable. Registered form requires that an obligation is registered as to both principal and any stated interest with the issuer (or its agent) and transfer of the obligation may be effected only through a book entry system (maintained by the issuer (or its agent))<sup>131</sup> or the issuer's issuance of a new instrument.<sup>132</sup> Usually, the Seller and Customer have not created any system where the Customer or its agent maintains a record system of ownership of the accounts receivable. The Seller and/or the Factor may implement certain tracking in respect of accounts receivable, but because the rules require the register maintenance by the issuer or its agent, which is the Customer or a person appointed by the Customer, it is unclear to what extent after-the-fact self-help tracking measures will comply with the rule. Alternatively, the Seller can employ devices to pool the accounts receivable in certain vehicles where the interests in the pools are registered in order to meet the registered form requirement;<sup>133</sup> however, these strategies often raise practical and commercial obstacles.

Second, Code Sec. 881(c)(3)(A) provides that portfolio interest does not include interest “received by a bank on an extension of credit made pursuant to a loan agreement entered in the ordinary course of its trade or business,” which raises the issue of whether a Factor that is a foreign bank can treat factoring income as portfolio interest. There is little guidance on interpreting this exception from portfolio interest and commentators have elaborated on many of the uncertainties.<sup>134</sup> The legislative history generally describes the rule as applying to interest on an obligation that performs the function of a loan made in the ordinary banking business that therefore could be competitive to a U.S. bank, in contrast to an obligation purchased by a foreign bank as an investment asset.<sup>135</sup> Importantly, this exclusion only applies to a “bank.”<sup>136</sup> Assuming the Factor is a bank, the question becomes whether factoring fits within the description of this activity for which the interest thereon is not portfolio interest. On the one hand, the Factor is certainly not advancing funds “pursuant to a loan agreement” because the Factor and Seller enter into a receivables purchase agreement providing the parties, on a committed or uncommitted basis, depending on the terms, the right to offer and accept the purchase of Customer obligations, and further, the account receivable itself is not negotiated by the Factor with the Customer. Arguably, this bank loan exception should not apply given the absence of a loan agreement. On the other hand, the resemblance of the Factor’s activities to ordinary banking extensions of credit is concerning because the Factor typically negotiates extensively in an isolated transaction with Seller, and factors as part of its traditional banking function of providing financing solutions to its customers as opposed to purchasing the accounts receivable as part of its investment strategy. While the foregoing observation is commercial at best, and perhaps vulnerable to mercurial market conditions

and economic cycles, if “loan agreement” under this rule is interpreted broadly as any financing instrument of the type that is akin to bank loans when compared with marketed investment securities, this could result in a meaningful risk that this exception to portfolio interest applies to amounts characterized as interest or OID in a factoring transaction.

### 3. Treaty Exceptions

A major salve to the potential NRA Withholding described above is that the tax on interest and OID is reduced or eliminated under the “Interest” article of most income tax treaties. Therefore, as long as the Factor is eligible for treaty benefits under a treaty with the United States, any NRA Withholding otherwise potentially applicable to amounts received by the Factor that are treated as interest or OID will be reduced or eliminated in accordance with the applicable treaty.

## V. Conclusion

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Given that cross-border related-party factoring received great attention in 1984, and that the IRS has continued to address it in various circumstances, it is difficult to speculate on the reason, or any overt intent, over the paucity of guidance for third-party factoring, which leads to the several layers of uncertainty described above. Perhaps because factoring, historically, has typically been viewed as looking the same from deal to deal, and there are several technical paths to eliminate U.S. tax, there is a muted consensus that the transactions do not attract U.S. tax obstacles for foreign Factors. However, the relatively recent broadening and evolution of the factoring market and participants could challenge this ideal, and raise some of the undesired complexities and uncertainties discussed in this article.

## ENDNOTES

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\* The authors wish to thank their Mayer Brown colleagues Thomas Humphreys, Russell Nance, and Massimo Capretta for their helpful comments on this article. Errors and omissions are the sole responsibility of the authors.

<sup>1</sup> As explained below, the focus of this article is on commercial transactions between unrelated parties. The purchase of accounts receivable from a U.S. person by its related controlled foreign corporation has already drawn the attention of Congress. The Tax Reform Act of 1984 introduced Code Secs. 864(d) and 956(b)(3) addressing related-party

factoring, but we will not address these provisions here. See also Internal Revenue Service Factoring of Receivables Audit Techniques Guide, LMSB-04-0606-004 (Jun. 2006).

<sup>2</sup> Frederick R. Chilton, Jr., *International Factoring*, 11 INT’L TAX J. 139 (1985). See also Julie A. Roin and David Rosenbloom, *Bringing foreign profits to the U.S. by factoring: how to use this technique*, 58 J. TAX’N 164 (1983).

<sup>3</sup> The Seller will typically represent to the Factor that the receivables sold are for goods that have already been delivered or services that have already been provided to the Customer.

<sup>4</sup> See T.D. 9160, 2004-2 CB 785 (Oct. 22, 2004) (preamble to Treasury regulations under Code Sec. 6050P describing various unrelated-party factoring arrangements).

<sup>5</sup> Unlike traditional factoring, in reverse factoring the program is initiated by the customer in order to help its suppliers finance their accounts receivable against the customer through early payment by the factor.

<sup>6</sup> Merely as an illustration of non-U.S. tax issues that may arise in factoring transactions: (i) upon the purchase of accounts receivable from a Mexican Seller by a non-Mexican

Factor, the discount income is treated as interest for Mexican tax purposes and subject to withholding tax; (ii) payments made by a Canadian Customer to a non-Canadian Factor in respect of an account receivable arising from services performed within Canada may be subject to Canadian withholding tax. Also, for an overview of tax considerations in the United Kingdom, see Matthew Mortimer and Emma Noehrbass, *The Taxation of Receivables Finance Transactions*, Tax J., Apr. 23, 2021, p. 12.

<sup>7</sup> See Charles Kearn and Michael J. Kerman, *Sales Tax Considerations in Financing Transactions—Does Substance over Form Govern?*, 25 J. MULTISTATE TAX INCENTIVES 20 (2016).

<sup>8</sup> See Reg. §1.6050P-2(h) Ex. 5 (ownership of accounts receivable for federal income tax purposes based “on all facts and circumstances”).

<sup>9</sup> See LTR 8338043 (Jun. 17, 1983), revoked on other grounds in LTR 8748030 (Aug. 31, 1987), for a summary of factors considered by the IRS. However, as noted by commentators, the IRS has laid out factors “without identifying their relative importance, showing their interrelationship, or even explaining their relevance.” Walter C. Cliff, Philip J. Levine, *Reflections on Ownership – Sales and Pledges of Installment Obligations*, 39 Tax Law. 37 (1985).

<sup>10</sup> *United Surgical Steel Co. Inc.*, 54 TC 1215, 1228-29, Dec. 30,160 (1970), acq. 1971-2 CB 3. In exceptional circumstances, however, the discount could be sufficiently large to protect the transferee from economic loss based on the transferor’s collection experience, which would undermine the claim that a sale of the accounts receivable took place for tax purposes. See GCM 34602 (Sep. 9, 1971). Conversely, in certain cases the transaction may still be respected as a sale for tax purposes, even if the transferee has some degree of recourse to the transferor, when other relevant factors support sale treatment. See GCM 37848 (Feb. 5, 1979); *Packard Cleveland Motor Co.*, 14 BTA 118, Dec. 4577 (1928); *L.H. Elmer*, CA-2, 3 USTC ¶1114, 65 F2d 568 (1933); *East Coast Equipment Co.*, 21 TC 112, Dec. 19,943 (1953), *aff’d*, CA-3, 55-1 USTC ¶9463, 222 F2d 676 (1955); *J.R. Mathers*, 57 TC 666, Dec. 31,267 (1972), acq. 1973-1 CB 1.

<sup>11</sup> *L.H. Elmer*, CA-2, 3 USTC ¶1114, 65 F2d at 569; *Mapco Inc.*, CtClS, 77-2 USTC ¶9476, 556 F2d 1107 (1977); *Coulter Electronics, Inc.*, 59 TCM 350, Dec. 46,518(M), TC Memo. 1990-186 (1990), *aff’d*, CA-11, 943 F2d 1318 (1991); *Watts Copy Systems, Inc.*, 67 TCM 2480, Dec. 49,741(M), TC Memo. 1994-124 (1994).

<sup>12</sup> It is often the case that the Factor has recourse to the Seller in the case of dispute (Customer refuses to pay the account receivable by reason of a dispute relating to the goods or services provided by the Seller) or dilution (the amount of the account receivable is reduced as a result of returns, refunds, billing errors, etc.). These limited recourse rights are merely a guarantee of the integrity of the purchased accounts receivable and should not generally jeopardize the characterization as

a sale for U.S. tax purposes since they do not protect the Factor from the risk of loss based on the Customer’s insolvency or financial inability to pay.

<sup>13</sup> *J.A. Martin*, 56 TC 1255, 1259, Dec. 30,970 (1971), *aff’d per curiam*, CA-5, 72-2 USTC ¶9637, 469 F2d 1406 (1972); *Town & Country Food Co.*, 51 TC 1052, 1057, Dec. 29,512; *D. Nickoll*, 10 TCM 861, Dec. 18,535(M) (1951).

<sup>14</sup> *J.D. Branham*, 51 TC 175, 180, Dec. 29,206 (1968) (transaction held to be sale where there was a “coincidence of terms and amounts” owed to transferees and owed under transferred accounts receivable), *I. Bogatin*, DC-TN, 78-2 USTC ¶9733 (1978) (transaction held to be sale where transferor’s note to bank had terms very similar to installment obligation); *Town & Country Food Co. Inc.*, 51 TC 1049, 1057, Dec. 29,512 (1969), acq. 1969-2 CB xxv (loan found where amount of advance had no direct relationship to either single or aggregate installment note balances and repayment was not tied to collections on the underlying obligations).

<sup>15</sup> *East Coast Equipment Co.*, 21 TC 112, Dec. 19,943 (1953), *aff’d*, CA-3, 55-1 USTC ¶9463, 222 F2d 676 (1955); *Town & Country Food Co.*, 51 TC 1049, Dec. 29,512 (1969); GCM 37848 (Feb. 5, 1979); GCM 34602 (Sep. 9, 1971); LTR 9840001 (Apr. 10, 1998); LTR 8002124 (Oct. 17, 1979); LTR 7916081 (Jan. 19, 1979); GCM 39584 (Dec. 3, 1986); LTR 8136037 (Jun. 10, 1981).

<sup>16</sup> *United Surgical Steel Co. Inc.*, 54 TC 1215, 1228-29, Dec. 30,160 (1970), acq. 1971-2 CB 3; *Town & Country Food Co.*, 51 TC 1049, Dec. 29,512 (1969), acq. 1969-2 CB XXV, at 1052, 1057. However, this factor should be neutralized if the transferor is collecting on the accounts receivable as agent for the transferee, as is very often the case. See *J.R. Mathers*, 57 TC 666, Dec. 31,267 (1972); GCM 34602 (Sep. 9, 1971).

<sup>17</sup> *L.H. Elmer*, CA-2, 3 USTC ¶1114, 65 F2d 568, 569 (1933); *Mapco Inc.*, CtClS, 77-2 USTC ¶9476, 556 F2d 1107, 1110 (1977); *United Surgical Steel Co.*, 54 TC at 1229-31, Dec. 30,160; GCM 39584 (Dec. 3, 1986); GCM 34602 (Sep. 9, 1971).

<sup>18</sup> *United Surgical Steel Co. Inc.*, 54 TC 1215, 1228-29, Dec. 30,160 (1970), acq. 1971-2 CB 3; LTR 8338043 (Jun. 17, 1983).

<sup>19</sup> *Town & Country Food Co.*, 51 TC 1049, Dec. 29,512 (1969), acq. 1969-2 CB XXV. It is not uncommon for the Seller to pledge the collection accounts related to the accounts receivable. This fact should be viewed largely as neutral given that it is mostly a legal protection against other creditors of the Seller, as opposed to a term that informs the nature of the relationship between the Seller and the Factor. Moreover, this pledge is typically for assets or rights that are not materially in excess of what is intended to already belong to the Factor under the receivables purchase agreement.

<sup>20</sup> *Brierley v. Commercial Credit Co.*, D.C. Pa., 43 F2d 724 (1929), *aff’d*, CA-3, 43 F2d 730 (1930); *United Surgical Steel Co. Inc.*, 54 TC 1215, 1228-29, Dec. 30,160 (1970), acq. 1971-2 CB 3; GCM 39584 (Dec. 3, 1986); LTR 8803026 (Oct. 22,

1987); LTR 8643002 (Jun. 20, 1986); LTR 8136037 (Jun. 10, 1981).

<sup>21</sup> *United Surgical Steel Co. Inc.*, 54 TC 1215, Dec. 30,160 (1970); *J.R. Mathers*, 57 TC 666, Dec. 31,267 (1972). Although by no means dispositive, it has been noted that, “[n]ot surprisingly, in the vast majority of cases the form of the transaction (if unambiguous) has been followed, although the courts and the IRS are reluctant to identify the form as a factor in the analysis.” David Garlock, *Federal Income Taxation of Debt Instruments*, ¶104, 03[A].

<sup>22</sup> Code Sec. 882(a).

<sup>23</sup> Rev. Rul. 88-3, 1988-1 CB 268. See also *J.C. Lewenhaupt*, 20 TC 151, 162, Dec. 19,606 (1953), *aff’d*, CA-9, 55-1 USTC ¶9339, 221 F2d 227 (1955); GCM 18835 (1937) at 143.

<sup>24</sup> *Cont’l Trading, Inc.*, CA-9, 59-1 USTC ¶9316, 265 F2d 40, 43 (1959), *cert. denied*, 361 US 827 (1959); see also GCM 18835 (mere ownership of property is insufficient, but anything beyond mere receipt of income and the payment of expenses may constitute a trade or business); *E. Higgins*, Sct, 41-1 USTC ¶9233, 312 US 212, 61 Sct 475 (1941).

<sup>25</sup> *Investors’ Mortg. Sec. Co.*, 4 TCM 45, 47, Dec. 14,333(M) (1945); *Scottish Am. Inv. Co.*, 12 TC 49, Dec. 16,773 (1949); *Spermacet Whaling & Shipping Co.*, 30 TC 618, 633-34, Dec. 23,035 (1958), *aff’d*, CA-6, 60-2 USTC ¶9645, 281 F2d 646 (1960); *Linen Thread Co.*, 14 TC 725, Dec. 17,620 (1950).

<sup>26</sup> *Pinchot*, CA-2, 40-2 USTC ¶9592, 113 F2d 718, 719 (1940); *De Amodio*, 34 TC 894, 906, Dec. 24,315 (1960), *aff’d*, CA-3, 62-1 USTC ¶9283, 299 F2d 623 (1962); *Spermacet Whaling & Shipping Co.*, 30 TC 618, 634, Dec. 23,035 (1958), *aff’d*, CA-6, 60-2 USTC ¶9645, 281 F2d 646 (1960).

<sup>27</sup> *J.C. Lewenhaupt*, 20 TC 151, Dec. 19,606 (1953), *aff’d*, CA-9, 55-1 USTC ¶9339, 221 F2d 227 (1955); *Adda*, 10 TC 273, Dec. 16,244 (1948), *aff’d*, CA-4, 49-1 USTC ¶9109, 171 F2d 457 (1948); Rev. Rul. 70-424, 1970-2 CB 150.

<sup>28</sup> *De Amodio*, 34 TC 894, 906, 909, Dec. 24,315 (1960), *aff’d*, CA-3, 62-1 USTC ¶9283, 299 F2d 623 (1962); Rev. Rul. 55-617, 1955-2 CB 774.

<sup>29</sup> May 31, 1983.

<sup>30</sup> Mar. 19, 2001.

<sup>31</sup> The IRS appears to have considered in the FSA that holding the accounts receivable until collection could not be equated to “selling” the receivables. The veracity of such a view is suspect given the breadth of the definition of “effecting of transaction” in Reg. §1.864-2(c)(2). See references in note 49, and discussion in Part IV.A.4.iii. There is also a question as to whether the accounts receivable should be considered “securities” for purposes of Code Sec. 864(b)(2). However, that definition is also broad; see Reg. §1.864-2(c)(2) defining “securities” as “any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.” See, e.g., discussions in text at notes 42 and 98, *infra*. In any event, the scope of the “securities trading

safe harbor” is the subject of much commentary and discussion, and we do not address the issue further in this article.

<sup>32</sup> SCT, 41-1 USTC ¶9233, 312 US 212, 61 Sct 475 (1941).

<sup>33</sup> See David Garlock, *supra* note 21, ¶2005, 01; New York State Bar Association, Tax Section, *Report on Securitization Reform Measures*, 2003 TNT 11-11.

<sup>34</sup> *Scottish Am. Inv. Co.*, 12 TC 49, Dec. 16,773 (1949); *Linen Thread Co.*, 14 TC 725, Dec. 17,620 (1950).

<sup>35</sup> This is in contrast to the conclusion in GCM 39220 (Apr. 24, 1984) that appeared to view the expense and angst of bearing collection enforcement on the accounts receivable as constituting an activity that rises to the level of a trade or business.

<sup>36</sup> See Reg. §1.1362-2(c)(5)(iii)(B)(1)(iii); Reg. §1.6050P-2(h) Ex. 5; Code Secs. 279(c)(5); 542(d)(1)(A)(ii); 954(h)(4)(B).

<sup>37</sup> Legislative History of the Deficit Reduction Act of 1984, P.L. 98-369, 98 Stat. 494, July 18, 1984, p. 365 (“In some cases, it might be argued that a foreign corporation factoring U.S. receivables is engaged in business in the United States, and that its factoring income is, therefore, subject to U.S. tax.”)

<sup>38</sup> LMSB-04-0606-004 (Jun 2006).

<sup>39</sup> In a committed factoring arrangement, consideration should be given to the persons, places, and level of conduct relevant to the negotiation of the committed receivables purchase agreement.

<sup>40</sup> Under this regulation, a “banking, financing, or similar business” includes “purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness.”

<sup>41</sup> See Part IV.A. regarding the possible characterizations and sourcing of the factoring income.

<sup>42</sup> For this purpose, a “security” is defined as “any bill, note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to or purchase, any of the foregoing items.” Reg. §1.864-4(c)(5)(v).

<sup>43</sup> We assume the additional conditions in Reg. §1.864-4(c)(5)(ii) are present because the accounts receivable should have a term of less than one year from the date of purchase. Reg. §1.864-4(c)(5)(ii)(b)(1).

<sup>44</sup> Reg. §1.864-4(c)(5)(iii)(a). AM 2009-010 (Sep. 22, 2009). See also Moldenauer, *The Foreign Lender Memorandum and the Definition of a U.S. Office*, TAX NOTES (Dec. 14, 2009).

<sup>45</sup> Reg. §1.864-4(c)(5)(iii)(a).

<sup>46</sup> Reg. §1.864-4(c)(5)(vi)(b).

<sup>47</sup> Reg. §1.864-5(b)(2).

<sup>48</sup> Reg. §1.864-7(d)(1)(i).

<sup>49</sup> See at [www.irs.gov/businesses/corporations/lbi-active-campaigns#financial-service-entities-engaged](http://www.irs.gov/businesses/corporations/lbi-active-campaigns#financial-service-entities-engaged). See also AM 2009-010 (Sep. 22, 2009); CCA 201501013 (Jan. 2, 2015). For commentary on this issue, the reader may consult David S. Miller, *The Tax Guide to Offshore*

*Lending*, 74, 3, TAX LAW. (2020); Jason Schwartz and Alissa Kalinowski, *Rationalizing Lending Authorities*, TAX NOTES FEDERAL, July 5, 2021, p. 65. See also *YA Global Investments LP*, Nos. 14546-15 (151 TC No. 2, Dec. 61,237) and 28751-15. Reg. §1.1441-2(b)(2)(i).

<sup>50</sup> Reg. §1.451-1(a).

<sup>51</sup> LTR 201131023 (Aug. 5, 2011) (in making a Subpart F determination, the IRS held that any accelerated income received by a controlled foreign corporation upon the sale of receivables that it had generated from the sale of goods and services is a substitute for the income it would have collected under the relevant contracts, and should retain the same character).

<sup>52</sup> The sale of “future” receivables presents different issues that are not addressed in this article. See Matthew S. Blum, *The Purchased Right to Receive Payments*, BNA INT’L J., May 8, 2020; Matthew A. Stevens and Karla Johnsen, *Tax Treatment of Transactions Involving Royalty- and Revenue-based Income Streams, Taxation of Financial Products and Transactions*, 2015, Practising Law Institute, p. 41.

<sup>53</sup> See, e.g., *Helvering v. Stein*, CA-4, 40-2 USTC ¶9782, 115 F2d 468 (1940); *Bank of America*, CtCls, 82-1 USTC ¶9415, 680 F2d 142 (1982); *L. Hunt*, 90 TC 1289, 1301, Dec. 44,862 (1988); Rev. Rul. 70-304, 1970-1 CB 163.

<sup>54</sup> Regulations issued in 1956 adopting the holding of *P.G. Wodehouse*, SCT, 49-1 USTC ¶9310, 337 US 369, 69 Sct 1120 (1949), and language from it, stated that the term “fixed or determinable annual or periodical” income is “merely descriptive of the character of a class of income.” Former Treas. Reg. §1.1441-2(a)(1); T.D. 6187, 1956-2 CB 567. See also T.D. 6873, 1966-1 CB 101 and T.D. 6908, 1967-1 CB 222.

<sup>55</sup> Cf. Code Sec. 1221(a)(4); *Burbank Liquidating Corp.*, CA-9, 64-2 USTC ¶9676, 39 TC 999 (1963); REG-109367-06, 71 FR 44,600, 44,601 (Aug. 7, 2006); Proposed Reg. §1.1221-1(e)(1). Related party factoring income, on the other hand, is addressed in Code Sec. 864. See also related law in Code Secs. 904, 954, and 956. The legislative history remarked that factoring income is arguably foreign base company income when received by a controlled foreign corporation as interest or as income from the performance of services. Code Sec. 864(d) was enacted to provide special rules for cross-border related party factoring, and treats the income “as if it were interest on a loan to the obligor under the receivable.” These rules (and related rules) only apply for the limited purposes stated therein.

<sup>56</sup> See, e.g., *AMP, Inc.*, DC-PA, 79-2 USTC ¶9606, 492 FSupp 27 (1979) (patent payments treated as sales for capital gains purposes did not mean the payments were sales for purposes of determining the source of the income).

<sup>57</sup> Some support for this approach may be found in an old case *Hubert De Stuers*, 26 BTA 201, Dec. 7597 (1932) where the court determined

the sourcing under the predecessor statutes to Code Secs. 861-863 for the profit earned by a foreign individual on open market United States bonds acquired at a discount through the full repayment (redemption) of the obligor (the United States), based on the sourcing of income derived from the disposition of personal property. However, the vitality of that decision today is unclear in light of (i) the court employing this source rule to establish that the (discount) income was U.S. source under the law of the time, (ii) the enactment of Code Sec. 1276, and (iii) the intervening holding in *D. Fairbanks*, SCT, 39-1 USTC ¶9410, 306 US 436, 59 Sct 607 (1939) (regarding the treatment of redemptions of bonds as ordinary collections and not capital sales) and enactment of Code Sec. 1271 (though, again, character of income as capital versus ordinary is not necessarily evidence of whether the profit should nevertheless be viewed as a sale for sourcing purposes). Moreover, the Tax Court’s view may have been influenced by the fact that the profit was realized from the secondary market nature of the investment, which is similar to profit earned on a sale. On the other hand, a Factor’s direct relationship with the Seller may cut against this principle being applied too generously for factoring income, and further, to the extent Seller and Customer are both in the United States, that may further pressure the appropriateness of a conclusion solely based on the residence of Factor under Code Sec. 865 for a sale of personal property.

<sup>58</sup> *Bank of America*, CtCls, 82-1 USTC ¶9415, 680 F2d 142 (1982).

<sup>59</sup> See also S. Rep. No. 98-169, 98th Cong., 2nd Sess. (Senate Finance Committee Explanation of The Deficit Reduction Tax Act of 1984).

<sup>60</sup> LTR 8748030 (Aug. 31, 1987); IRS Memorandum NSAR 08101 (Nov. 21, 1991).

<sup>61</sup> *Bank of America*, CtCls, 82-1 USTC ¶9415, 680 F2d 142 (1982) (court concluded that although the confirming bank (in a letter of credit transaction) provided services in connection with the confirming activities, “the services performed were subsidiary” to the fact that the confirming bank assumed the risk of default of the opening bank and assured the beneficiary’s payment).

<sup>62</sup> 4 TC 196, Dec. 14,179 (1944).

<sup>63</sup> See also *J.D. Thompson*, 73 TC 878, Dec. 36,777 (1980). GCM 39220 (May 31, 1983) noted that while factoring income is largely services income, a portion of the discount may be an interest component to the extent Seller receives Factor’s funds before the account receivable due date, however, this memorandum was revoked, see LTR 8338043 (Jun. 17, 1983), revoked by LTR 8748030 (Aug. 31, 1987); IRS Memorandum NSAR 08101 (Nov. 21, 1991). Similarly, the IRS in internal audit guidelines contemplates that a Factor typically receives an interest payment as a component of its overall compensation for its activities

(separate from the discount income). Internal Revenue Service Factoring of Receivables Audit Techniques Guide, LMSB-04-0606-004 (Jun. 2006).

<sup>65</sup> Legislative History of The Deficit Reduction Tax Act of 1984, P.L. 98-369: 98 Stat. (Jul. 18, 1984).

<sup>66</sup> Code Sec. 861(a).

<sup>67</sup> Reg. §1.861-2(a)(4).

<sup>68</sup> Reg. §1.1441-2(b)(3) generally defines the original issue discount as FDAP subject to withholding based on Code Sec. 871(a)(1)(C) (though the withholding mechanics of Code Secs. 1441 and 1442 do not entirely mirror the imposition of tax under Code Secs. 871 and 881). Code Sec. 871 defines OID based on the OID rules of Code Secs. 1271-1275 but with some important modifications. Interestingly, Code Sec. 1272(a)(2)(C) provides that a holder does not currently accrue OID if the instrument has a fixed maturity date of one year or less from the date of issue, which is the case for substantially all typical accounts receivable. However, apparently that is not the touchstone for whether a foreign taxpayer is subject to Code Sec. 871 tax liability in respect to OID income. Code Sec. 1272 sets rules relating to the holder's inclusion of OID in income and excludes certain instruments from such inclusion, while Code Sec. 1273 sets rules for determining the existence of OID. Yet Code Sec. 871 defines an original issue discount obligation for which a foreign taxpayer is subject to taxation as "any bond or other evidence of indebtedness having original issue discount (within the meaning of Code Sec. 1273)," with the determination of the amount of OID (subject to taxation) as the amount determined under Code Sec. 1272 "without regard to any exception for short-term obligations." This framework means that instruments excluded from OID accrual under Code Sec. 1272 are still "original issue discount obligations" under Code Sec. 871 because they have OID under Code Sec. 1273, and those instruments would have accrual amounts subject to Code Sec. 871 to the extent so provided under the Code Sec. 1272 computations without regard to Code Sec. 1272(a)(2)(C).

<sup>69</sup> CCA 200849012 (Dec. 5, 2008) ("[t]he very nature of the purchase of trade receivables activity—the purchasing of the receivables at a discount and the anticipated payment of those receivables by unrelated third parties 30 days later—lends an inference that the interest payments (the discount is equivalent to original issue discount on a bond) ..."; see also reference to Code Sec. 871(g) in FSA 200224003 (Jun. 14, 2002).

<sup>70</sup> See GCM 39220 (May 31, 1983) ("... we believe that the holding of Rev. Rul. 75-430 on the issue of whether the discount income of S is interest income should be modified. GCM 36275 (May 16, 1975) erroneously concluded that the discount income was original issue discount, treated as interest. We believe that S's discount income arising from P's sale of

account receivable is not original issue discount income ...").

<sup>71</sup> See Code Sec. 1273(a)(1). See also Code Sec. 871(g)(1)(A); Reg. §1.1441-2(b)(3).

<sup>72</sup> We briefly explore the risk of imputed discount on this latter concept further below in Part IV.B.

<sup>73</sup> See LTR 8113118 (Jan. 5, 1981). cf. T.D. 8734, 62 FR 53387-53498 Preamble to 1997 final regulations: "In response to comments, the final regulations regarding withholding on original issue discount (OID) are simplified. As a general principle, withholding is required on a payment that is treated as taxable OID under Code Sec. 871(a)(1)(C) or 881(a)(3)(A) to the extent the withholding agent knows the amount that is OID."

<sup>74</sup> Though some analogies could exist, see, e.g., Reg. §1.1273-2(e) ("For purposes of determining the issue price and issue date of a debt instrument under this section, sales to bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters, placement agents, or wholesalers are ignored").

<sup>75</sup> Perhaps somewhat in this vein factoring pricing is often negotiated upfront with the discount based on a floating rate yield expressed as a spread over a benchmark, and may be further augmented with grids based on obligor (and perceived credit risk), duration, country, etc.

<sup>76</sup> T.D. 9905, 85 F.R. 56686 (Sep. 14, 2020).

<sup>77</sup> Code Secs. 1276(a)(4); 1278(b)(1); 861(a)(1).

<sup>78</sup> Reg. §1.1441-2(b)(2)(i).

<sup>79</sup> Although it is not strictly required under Code Sec. 1278 to purchase the debt in a secondary market transaction, market discount could arise in certain circumstances upon original issue of a bond. See, e.g., Code Sec. 1278(a)(1)(D)(ii).

<sup>80</sup> Indeed, remarks in the preamble to the 1996 regulations make abundantly clear that Treasury decided to include original issue discount only in circumscribed situations in order to account for the fact that this category of income possesses difficulties in determining the amount upon which to withhold. IL-62-90, 61 FR 17614-17667 (Apr. 22, 1996) ("... reflects the position adopted by the IRS in TIR-877 (Dec. 27, 1966) and in Rev. Rul. 68-333, 1968-1 CB 390 that FDAP includes original issue discount paid by an original issuer of bonds or other obligations with original issue discount. However, under the authority of Code Sec. 1441(c)(8), only certain items of original issue discount are currently subject to withholding of tax under Chapter 3. The lack of rules in this area in the past reflects the difficulties in determining the amount of OID upon which withholding should be applied. These proposed regulations, however, identify transactions in which information about the amount of original issue discount would generally be known or available to the withholding agent ..."). See also Roin and Rosenbloom, *supra* note 2, at 165 (1983) ("the amount of income

derived from a payment on a receivable is generally difficult for a withholding agent to determine with reasonable accuracy ... it is not surprising that on two occasions in which the Service passed upon a situation analogous to a factoring arrangement (the purchase at a discount and subsequent sale or collection of bankers acceptances), it ruled that the income generated thereby was neither interest nor otherwise fixed or determinable, annual or periodical. The first of these Rulings was declared obsolete in Rev. Rul. 68-575, 1968-2 CB 603, but no Ruling to the contrary has ever been published.") Very often, the Seller collects and remits the Customer's payment to the Factor; however, that alone does not convince a conclusion that Reg. §1.1441-2 somehow should mandate withholding on account of Seller having knowledge of the discount, because while this is a common feature, it is not at all integral or fundamental to a factoring transaction. Rather, the secondary nature of the Factor's transaction to the original transaction generating the account receivable is fundamental to a factoring transaction, and the payor to the Factor may not always know the Factor's discount amount.

<sup>81</sup> See Chilton, *supra* note 2, at 149-150 (1985). The preamble to the 1996 proposed regulations stated "Paragraph (b) simplifies Reg. §1.1441-2(a) of the existing regulations by providing that, for purposes of chapter 3 of the Code, fixed or determinable, annual or periodical (FDAP) income is any income includable in income under Code Sec. 61, subject to enumerated exceptions in paragraph (b)(2) (including certain exceptions for original issue discount and capital gains, including option premiums)" (emphasis added). The omission of market discount in this description is somewhat interesting because the only other omitted exceptions that appeared in that provision of the proposed regulations were insurance premiums and exclusions from gross income (e.g., tax-exempt interest). It may imply the notion that market discount is subsumed in capital gains and merely a clarification of that entry.

<sup>82</sup> Interpreting market discount in Reg. §1.1441-2(b)(2) consistent with Code Secs. 1276-1278 also means that market discount could arise in certain circumstances upon original issue of a bond, including where the taxpayer's basis is less than the issue price and determined under Code Sec. 1012 (e.g., where the price paid by the taxpayer was less than the first price at which a substantial amount of the debt instruments is sold for money). As an aside, this is not necessarily in conflict with a view that Code Sec. 1441 seeks to exclude amounts that are difficult for a withholding agent to determine, because often in cases where there is market discount on original issuance, there is also an increased risk of the obligor not having knowledge of the recipient's income amounts, e.g., in the case that

the relevant purchase price paid causing this result was from the minority of buyers.

<sup>83</sup> Code Sec. 865.

<sup>84</sup> As the rule applies to any accrual-method taxpayer.

<sup>85</sup> Code Sec. 1282(b)(2).

<sup>86</sup> Code Sec. 1283(c)(1). There are some modifications for determining this original issue discount for purposes of “acquisition discount” on a short-term nongovernmental obligation.

<sup>87</sup> An election is beneficial in the opposite scenario, *i.e.*, where a taxpayer acquired a short-term obligation after its original issue at a price that exceeded the obligation’s adjusted issue price at the time of acquisition.

<sup>88</sup> To the extent a short-term nongovernment obligation was purchased at an issue price that is less than the stated redemption price at maturity resulting in original issue discount, that obligation is treated as having OID subject to NRA Withholding, even though there is no OID for purposes of Code Secs. 1271–1275. Therefore, any such economic OID on an account receivable is generally subject to NRA Withholding (in accordance with those rules and subject to the 183-day-or-less exemption), irrespective of the Code Sec. 1283(c) method of computing the amounts subject to accrual (which is anyways generally irrelevant to a non-U.S. taxpayer).

<sup>89</sup> Note that Code Sec. 871(g) defines an original issue discount obligation as “any bond or other evidence of indebtedness.”

<sup>90</sup> Bittker and Eustice, *Federal Income Taxation of Corporations & Shareholders*, ¶ 4.03[2][c] (2022) (citing *D. Fairbanks*, SCT, 39-1 USTC ¶9410, 306 US 436, 59 Sct 607 (1939) and Reg. §1.1275-1(d)).

<sup>91</sup> Chilton, *supra* note 2, at 146 (1985); Roin and Rosenbloom, *supra* note 2, at 166 (1983).

<sup>92</sup> Code Sec. 279(c)(5) (“the term ‘lending or finance business’ means a business of making loans or purchasing or discounting accounts receivable, notes, or installment obligations”); Code Sec. 542(d)(1) (similar); Code Sec. 954(h)(4) (similar); Code Sec. 6166(b)(10)(B)(ii) (similar); Code Sec. 993(b)(3) (“the qualified export assets of a corporation are ... accounts receivable and evidences of indebtedness which arise by reason of transactions ...”). See also Reg. §1.956-2(d)(2) (“For purposes of section 956 and this section, the term ‘obligation’ includes any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other indebtedness, whether or not issued at a discount and whether or not bearing interest ...”).

<sup>93</sup> In addition, there is no OID within the meaning of Code Sec. 1273 because Code Sec. 1273 would not apply to accounts receivable under this characterization.

<sup>94</sup> As noted above, there is precedent for interpreting income in one fashion for character, and another fashion for determining source. See, *e.g.*, *AMP, Inc.*, DC-PA 79-2 USTC ¶9606, 492 FSupp 27 (1979).

<sup>95</sup> *D. Fairbanks*, SCT, 39-1 USTC ¶9410, 306 US 436, 59 Sct 607 (1939).

<sup>96</sup> See *Victor B. Gilbert*, 6 TC 10, Dec. 14,915 (1946); *A.B. Culbertson*, 14 TC 1421, Dec. 17,725 (1950); *Mace Osenbach*, 17 TC 797, Dec. 18,625 (1951), *aff’d*, CA-4, 52-2 USTC ¶9409, 198 F2d 235 (1952); *William A. Tombari*, 35 TC 250, Dec. 24,446 (1960); *Darby Investment Corporation*, 37 TC 839, Dec. 25,339 (1962), *aff’d*, CA-6, 63-1 USTC ¶9396, 315 F2d 551 (1963); *E.D. Rivers*, 49 TC 663, Dec. 28,884 (1968); *National-Standard Co.*, CA-6, 84-2 USTC ¶10,001, 749 F2d 369 (1984).

<sup>97</sup> Prior law IRC §117(f) of the 1939 Code provided “Retirement of Bonds, Etc.—For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.”

<sup>98</sup> Prior law IRC §1232(a) of the 1954 Code provided “For purposes of this subtitle, in the case of bonds, debentures, notes, or certificates or other evidences of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof ... Amounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954).”

<sup>99</sup> See *AMP, Inc.*, 79-2 USTC ¶9606, 492 FSupp 27 (1979) (“the same words may have different meanings, dependent on where they are found in the Code,” citing *Don E. Williams*, SCT, 77-1 USTC ¶9221, 429 US 569, 97 Sct 850 (1977)).

<sup>100</sup> The word “securities” is a separate term from “debt instrument” or “evidence of indebtedness,” and therefore, presumably there is no forced implication from Subchapter P Part V of the Code as to how “securities” should be defined for purposes of the Code, and *vice versa*. Indeed, “securities” is used in a variety of places in the Code, but not always consistently; and these inconsistencies have been explored by many commentators. See, *e.g.*, Chilton, *supra* note 2, at 145 (1985); Kevin M. Keyes and Jonathan R. Zelnik, *Federal Taxation of Financial Instruments & Transactions*, para. 16.02(2)(a) (1997 and Supp. 2020-1); Matthew Stevens, *Is Your Security on the Mark-to-Market Bus?*, 168 TAX NOTES FEDERAL 71 (Jul. 6, 2020); Monte Jackel, *Partnership Interest as a Security*, 168 TAX NOTES FEDERAL 669 (Jul. 27, 2020); Paul Carman, *A Systematic Approach to the Classification of Cryptocurrency*, 103 TAX NOTES INT’L 1701 (Sep. 27, 2021). However, perhaps it is worth noting one instance here. Code

Sec. 475 provides mark-to-market rules for dealers in “securities.” For this purpose, “security” under Code Sec. 475(c)(2)(C) is defined to include a “note, bond, debenture, or other evidence of indebtedness,” which is the same list of instruments for Subchapter P Part V of the Code other than the omission of certificate. Code Sec. 475(c)(4), then, specifically excludes any such instrument that is an account receivable (*i.e.*, a note, bond, debenture, or other evidence of indebtedness that arises out of the sale of nonfinancial goods or services by a person, the principal activity of which is the selling or providing of nonfinancial goods or services). Prior to the enactment of Code Sec. 475(c)(4), the regulations under Code Sec. 475 also excluded accounts receivable from mark-to-market, but allowed an election out of this exception to dealer status. In any event, Code Sec. 475 arguably implies that an account receivable, which is of the type that is like a debt instrument, is considered included under the term “evidence of indebtedness.” Although it is also possible that Code Sec. 475 and the regulations thereunder are not standing for any notion of whether an account receivable is typically considered evidence of indebtedness under the Code, but rather they simply sought to address accounts receivable solely to avoid any misconceptions regarding the treatment of accounts receivable under the mark-to-market rules. See Report of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1998 (JCS-6-98), Nov. 24, 1998; Proposed Reg. §1.475(c)-2; FSA 200012002 (Dec. 10, 1999).

<sup>101</sup> Commercial contracting is not monolithic and tends to vary by industry, and so there are no hard and fast rules. However, generally speaking, in non-recourse factoring where a sale should be respected (as opposed to loan treatment), the written terms are recorded in the invoice or, more often, in a master customer agreement governing the relationship between the Seller and Customer, and legally there are enforceability rights and financial penalties for late payment (although such rights and penalties are seldom imposed in practice, and thus parties will negotiate the terms of the factoring based on the real-life expectations).

<sup>102</sup> In certain uncommon circumstances, there may generally be a first principles type of question of when a delayed payment after delivery of value is simply an administrative grace or temporary deferment for settlement mechanic procedures that doesn’t constitute debt for tax purposes.

<sup>103</sup> See reference to Reg. §1.1441-2(b)(2)(i) in FSA 200224003 (Jun. 14, 2002).

<sup>104</sup> See, *e.g.*, Reg. §1.483-1(a); Reg. §1.704-3(a)(4); Rev. Rul. 54-43, 1954-1 CB 119 (account receivable constitute property); Rev. Rul. 80-198, 1980-2 CB 113; Rev. Rul. 84-115, 1984-2 CB 118.

<sup>105</sup> Reg. §1.1271-1(b)(1) states “Under Code Secs. 1271(a)(3) and (a)(4), all or a portion of the gain

realized on the sale or exchange of a short-term government or nongovernment obligation is treated as interest income.”

<sup>106</sup> Although for a non-tax-exempt short-term obligation of the United States or any of its possessions, or of a State or any political subdivision thereof or of the District of Columbia, the accrual is always based on acquisition discount. Sometimes Sellers do sell government-obligor accounts receivable to the Factor.

<sup>107</sup> Code Secs. 1271(a)(4); 1276(a); 1281(a)(1).

<sup>108</sup> Treasury intimated in the preamble to the final Code Sec. 163(j) regulations that factoring income is a discount of a type other than market discount or acquisition discount (“*The inclusion of factoring income in the definition of interest is generally supported by the commenters, is a taxpayer-favorable rule, is generally consistent with the rules in §1.954-2(h)(4), and is consistent with the treatment of other types of discount, such as acquisition discount and market discount.*” (emphasis added)). T.D. 9905, 85 F.R. 56686 (Sep. 14, 2020). This offhand remark in a preamble to regulations should likely not be viewed as a conclusive statement of Treasury’s position regarding the characterization of factoring income for all tax purposes and, in particular, for purposes of the sourcing and NRA Withholding. Moreover, in any event, as noted here, the Reg. §1.1441-2(b)(2)(i) reference to market discount should be read to expand “gains derived from the sale property” such that the exclusion from FDAPI includes all these equivalent types of discount.

<sup>109</sup> I.e., pursuant to Code Sec. 1271(a)(1) or based on withholding principles of what is a sale.

<sup>110</sup> See TAM 200533023 (late fees received by a bank are interest for federal income tax purposes, citing Rev. Rul. 77-417, 1977-2 CB 60; Rev. Rul. 74-187, 1974-1 CB 48; Rev. Rul. 72-315, 1972-1 CB 49).

<sup>111</sup> See Part IV.C.

<sup>112</sup> Receipt of interest that had been accrued prior to the purchase of the account receivable should be considered a return of capital to the Factor. Reg. §1.61-7(c); see also *First Kentucky Co. v. Gray*, CA-6, 62-2 USTC ¶9830, 309 F2d 845 (1962).

<sup>113</sup> See Reg. §§1.483-1(a)(1) and 1.1274-1(a) (providing that “property” does not include services or the right to use property for purposes of Code Secs. 483 and 1274, respectively).

<sup>114</sup> Referring to debt instruments issued for services, Garlock has described this as an “essentially unresolvable conflict.” He further explains: “If the fair market value of a note issued in exchange for services is less than its stated principal amount, the difference is economically a form of interest, but the

inapplicability of Code Sec. 1274 (including the potentially abusive situation rules) and Code Sec. 1273(b)(4) makes it difficult to treat the difference as interest. And no other treatment of the difference makes sense, either economically or legally ... In the authors’ view, the best way to resolve this conflict in most cases is to treat the amount received for the services as equal to the stated principal amount of the note, regardless of whether it has adequate stated interest and regardless of its actual fair market value. This is easily administrable and most likely what everyone does in practice. In tax avoidance cases, however, Code Sec. 7872 could be invoked to impute interest at the applicable Federal rate.” Garlock, *supra* note 21, ¶ 316. In the case of accounts receivable for the lease of tangible property, Code Sec. 467 may result in the imputation of interest, but the scope of this provision is limited to fairly specific circumstances; the rental agreement must have “increasing” or “decreasing” rents, or “deferred” or “prepaid” rents, as defined in the applicable regulations.

<sup>115</sup> Code Sec. 483(d)(1).

<sup>116</sup> The other exceptions in the statute are not particularly germane to traditional factoring transactions (e.g., exceptions for sales of farms, sales of principal residence and sales of patents). It should be noted that Code Sec. 1275(b)(1) turns off Code Secs. 1274 and 483 for the issuer of debt instruments given in exchange for “personal use property,” but not for the holder of the instrument.

<sup>117</sup> Code Sec. 483(c)(1)(A). The regulations clarify that Code Sec. 483 may apply to a contract whether the contract is express (written or oral) or implied. Reg. §1.483-1(a).

<sup>118</sup> Code Sec. 483(d)(2).

<sup>119</sup> Code Sec. 1274(c)(3)(C)(iii); Reg. §1.483-1(e).

<sup>120</sup> LTR 199901008 (Jan. 11, 1999).

<sup>121</sup> LTR 9639005 (Sep. 27, 1996).

<sup>122</sup> Code Secs. 1274(b); 483(b).

<sup>123</sup> Code Sec. 1272; Reg. §1.446-2(c)(1).

<sup>124</sup> Code Sec. 1272(a)(1); Reg. §1.1441-2(b)(3).

<sup>125</sup> Garlock, *supra* note 21, ¶ 302.03.

<sup>126</sup> Reg. §1.1441-2(a)(3). See also prior law Treas. Reg. §1.1232-3(b)(1)(iii)(e)(2); LTR 8739042 (Jun. 30, 1987); GCM 39301 (Nov. 2, 1984). See Rev. Proc. 2022-7, 2022-1 IRB 297, Reg. §3.01(3) (IRS will not rule on whether an instrument has OID if it is payable less than 184 days from the date of original issue).

<sup>127</sup> Code Sec. 871(g)(1)(B)(i); Reg. §1.1441-1(b)(4)(iv), 1.1441-2(a)(3). See also Michael Yaghmour, *OID and the Foreign Holder: Is It Really This Hard?*, TAX NOTES (Jul. 5, 2017).

<sup>128</sup> Code Sec. 871(a).

<sup>129</sup> The measurement of the relevant periods under Code Secs. 1274 and 483 in “months,” and not days, means that there could be a

theoretical scenario where this short-term debt exception could apply to OID or interest imputed under those provisions. For example, if a \$250,001 invoice is issued for the sale of property on January 1 with a due date of July 2 in a non-leap year, Code Sec. 1274 would impute interest since the payment would be due more than six months after the sale. However, the term of the account receivable would be 182 days, such that any OID imputed under Code Sec. 1274 would still be exempt from withholding for the Factor under Reg. §1.1441-1(b)(4)(iv).

<sup>130</sup> LTRs 8534070 (May 29, 1985); 8538034 (Jun. 21, 1985); 8504022 (Jul. 3, 1984) (series of rulings involving parent-subsidiary loans where the IRS analyzes five factors in determining that reinvestment would not taint the 183-day maturity period). However, these rulings were effectively revoked because the issues presented are too dependent on subsequent facts, see LTRs 8612018 (Dec. 18, 1985), 8612019 (Dec. 18, 1985), 8612023 (Dec. 18, 1985), and 8612024 (Dec. 18, 1985). See LTR 8739042 (Jun. 30, 1987) (IRS found less-than-183-day notes held by a bank under a facility agreement do not meet the 183-day maturity of Code Sec. 871(g) because of funding commitments; however, third-party-held notes do meet 183-day maturity of Code Sec. 871(g)); LTR 8647003 (Aug. 27, 1986) (same); FSA 199904014 (IRS advice to the field that there is no “intent” standard when determining whether debt has a maturity of one year or less under Code Sec. 163(f)). See also *Jacobs Engineering Group Inc.*, DC Calif., 97-1 USTC ¶150,340 (1997); AM 2009-013 (Oct. 19, 2009).

<sup>131</sup> Under proposed regulations, certain clearing systems also may perform this function. See Proposed Reg. §1.163-5(b)(1)(ii).

<sup>132</sup> Reg. §5.1103-1(c).

<sup>133</sup> See Reg. §1.163-5T(d)(1); Reg. §1.871-14(d); LTR 9613002 (Dec. 15, 1995); LTR 201504004 (Oct. 3, 2014); LTR 201610015 (Mar. 4, 2016); LTR 201504004 (Mar. 11, 2022); Proposed Reg. §1.163-5; Proposed Reg. §1.871-14(d).

<sup>134</sup> New York State Bar Ass’n, Tax Section, *Report on the “Bank Loan” Exception to the “Portfolio” Interest Rules* (Aug. 28, 1992); American Bar Association, Section of Taxation, *Comments Regarding Need for Guidance of Portfolio Interest Rules under 871(h) and 881(c) of the Internal Revenue Code* (Mar. 18, 2004).

<sup>135</sup> Staff of the Joint Comm. on Tax’n, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 395 (Joint Comm. Print 1984). See also LTR 9822007 (May 29, 1998).

<sup>136</sup> See references cited in note 134 for discussion of what institutions might be treated as a “bank” for this purpose.

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