

## TAX REFORM ACT OF 1984 — INTERNATIONAL RELATED-PARTY FACTORING — A MAJOR TAX LOOPHOLE FOR MULTINATIONAL CORPORATIONS IS CLOSED

In recent years the use of tax shelters and tax loopholes has increased.<sup>1</sup> Similarly, the use of foreign tax havens by United States taxpayers has also risen sharply.<sup>2</sup> Reflective of these increases, international factoring<sup>3</sup> of accounts receivable has become a major technique multinational corporations use to reduce their payment of United States taxes.<sup>4</sup> The Tax Reform Act of 1984,<sup>5</sup> however, greatly reduced the tax advantages of international related-party factoring and thus has substantial financial implications for those corporations which have previously utilized such factoring.<sup>6</sup> This Recent Development discusses the changes in tax law brought about by the Tax Reform Act of 1984 which relate to international related-party factoring. *Tax Reform Act of 1984, contained in Deficit Reduction Act of 1984*, Pub. L. No. 98-369, 98 Stat. 494, reprinted in 1984 U.S. CODE CONG. & AD. NEWS.

The process of international related-party factoring begins when the United States parent of a multinational corporation sells goods

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<sup>1</sup> *Abusive Tax Shelters: Hearing Before the Subcomm. on Oversight of Internal Revenue Service of the Senate Comm. on Finance, 98th Cong., 1st Sess. 45 (1983)* (statement of Philip E. Coates, Acting Commissioner of Internal Revenue). The growth of the tax shelter industry intensified through the 1960's and into the early 1970's in response to tax legislation of the period and economic considerations such as inflation and stock market declines. *Id.*

<sup>2</sup> *Treasury Reports on Use of Caribbean Tax Havens*, 22 TAX NOTES 165, 166 (1984). "Direct investment by United States persons in Caribbean Basin tax havens other than the Netherlands Antilles increased from about \$14 billion in 1978 to \$20 billion in 1982." *Id.* at 165.

<sup>3</sup> Factoring is the sale of receivables at a discount to a purchaser (known as the factor) who earns income by collecting the face amount due on the receivables. Leak & Smith, *Factoring Receivables: Tax Considerations of Investing Accumulated Foreign Earnings*, 36 TAX EXECUTIVE 197, 198 (1978) [hereinafter cited as Leak & Smith].

<sup>4</sup> Sesit, *Major International Financing Gimmick of Tax-Haven Units is Curbed by New Law*, Wall St. J., July 26, 1984, at 10, col. 1. See also *An Analysis of the Tax Reform Act of 1984*, 24 TAX NOTES 67, 95 (1984) (stating that United States companies have increasingly made use of offshore receivable companies) [hereinafter cited as *Analysis*].

<sup>5</sup> Deficit Reduction Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 494 (Division A comprises the Tax Reform Act of 1984) [hereinafter cited as *Tax Reform Act of 1984*].

<sup>6</sup> Sesit, *supra* note 4.

or services on credit and establishes accounts receivable<sup>7</sup> with its customers.<sup>8</sup> The customers, who are either foreign or domestic, then become obligors on the receivables. The parent then sells the receivables at a discount to a foreign subsidiary which serves as the factor.<sup>9</sup> The factor is usually located in a tax haven country.<sup>10</sup> The obligor on the receivable is then notified to make payments on the receivables directly to the foreign factor,<sup>11</sup> which in turn earns a profit by collecting the face amount due on the receivables.<sup>12</sup> In addition, the factor assumes all credit risks relating to insolvency of the obligor,<sup>13</sup> and maintains ledgers on the accounts.<sup>14</sup> Once a corporation has established this factoring process, the factor uses its profits to purchase more receivables from the parent or from other foreign subsidiaries, thereby repeating the factoring cycle.<sup>15</sup>

Under the Internal Revenue Code prior to the Tax Reform Act of 1984, a number of tax and other financial advantages could be derived from international related-party factoring. The parent corporation selling the receivables could reduce its payment of United States tax by recognizing a loss on the discount sale of its receivables.<sup>16</sup> The parent corporation also could receive payment from the sale of goods and services more quickly by selling its receivables to a subsidiary for cash rather than waiting to be paid by the obligor.<sup>17</sup> At the same time, the sale of receivables allowed the parent to acquire cash from its subsidiary without generating additional tax liability.<sup>18</sup> Factoring further allowed a multinational cor-

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<sup>7</sup> Accounts receivable are claims against a debtor usually arising from sales or services rendered. BLACK'S LAW DICTIONARY 17 (5th ed. 1979).

<sup>8</sup> See Weil, *Commercial Finance, Factoring, and Other Asset-Based Lending*, 291 PRACTICING L. INST. 55 (1982).

<sup>9</sup> Leak & Smith, *supra* note 3, at 198. A factor is an entity which purchases a seller's accounts receivable for cash, collects the amounts due on the receivables, and assumes any losses which may arise from the obligor's inability to pay. Moore and Elkins, *International Factoring: The Practical Advantages*, 14 U.C.C. L.J. 115, 116 (1981).

<sup>10</sup> Sedit, *supra* note 4. The Netherlands Antilles and the Caymen Islands are tax havens which were frequently used for this purpose. *Id.* A tax haven involves the creation of a foreign corporation in a foreign country that has a low tax rate. 1 RHOADES & LANGER, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS § 3.03[3](c)(i) (1984).

<sup>11</sup> Weil, *supra* note 8, at 55-56.

<sup>12</sup> Leak & Smith, *supra* note 3, at 198.

<sup>13</sup> Weil, *supra* note 8, at 55.

<sup>14</sup> Moore and Elkins, *supra* note 9, at 116.

<sup>15</sup> Leak & Smith, *supra* note 3, at 198.

<sup>16</sup> *Id.*

<sup>17</sup> Sedit, *supra* note 4.

<sup>18</sup> Leak & Smith, *supra* note 3, at 198. Access to the subsidiary's cash by this method was especially advantageous when United States interest rates exceeded those available abroad.

poration to make more effective use of its international tax credits.<sup>19</sup> Finally, related-party factoring allowed a corporation to raise profits in a foreign subsidiary that was subject to little or no tax.<sup>20</sup> Federal taxes on the factored income was deferred until the corporation returned the earnings to the United States.<sup>21</sup>

The Tax Reform Act of 1984 seeks to prevent the use of multinational related-party factoring by treating the factored income as interest on a loan to the obligor under the receivable.<sup>22</sup> The United States shareholders of the factor are then immediately taxed on the income by the United States.<sup>23</sup> Further, the foreign subsidiary's purchase of receivables from a related party in the United States is treated as an investment in United States property.<sup>24</sup> To understand the mechanism by which the Tax Reform Act of 1984 accomplishes this objective, background knowledge of previously existing tax rules and their ineffectiveness in taxing internationally factored income is helpful.

Subpart F,<sup>25</sup> enacted in 1962,<sup>26</sup> is the portion of the Internal Revenue Code which primarily deals with income accumulated in tax havens.<sup>27</sup> Designed to deter United States taxpayers from shifting income to tax haven jurisdictions which have no natural business nexus with the earnings,<sup>28</sup> subpart F is concerned only with foreign corporations in which ten or fewer United States taxpayers

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*Id.*

<sup>19</sup> The Internal Revenue Service allows the taxes imposed by foreign countries to be credited against the United States taxes. I.R.C. § 33(a) (1982). The credit allowed, however, is limited by the following formula: the taxpayer's United States tax liability on total income multiplied by the ratio of foreign-source taxable income divided by the total taxable income of the taxpayer. I.R.C. § 904(a) (1982). Utilization of tax haven subsidiaries enables a multinational corporation to avoid the creation of unused foreign tax credits by providing untaxed or low-taxed foreign source income which serves to increase the limit imposed by the § 904(a) formula. See Sesit, *supra* note 4 (stating that tax haven subsidiaries provide untaxed or low-taxed income over which to spread taxes levied by foreign jurisdictions).

<sup>20</sup> Leak & Smith, *supra* note 3, at 198.

<sup>21</sup> Sesit, *supra* note 4. See also STAFF OF THE JOINT COMM. ON TAX'N, 98TH CONG., 2D SESS., PROPOSAL RELATING TO TAX SHELTERS AND OTHER TAX-MOTIVATED TRANSACTIONS 46 (Comm. Print 1984) (stating that United States taxpayers could defer earnings derived through a foreign corporation until the earnings were distributed as dividends or the taxpayers disposed of their shares in the foreign corporation) [hereinafter cited as PROPOSALS].

<sup>22</sup> *Analysis, supra* note 4, at 95.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> Subpart F includes I.R.C. §§ 951-64.

<sup>26</sup> Revenue Act of 1962, Pub. L. No. 87-834 § 12(a), 76 Stat. 960, 1006 (1962).

<sup>27</sup> 1 RHOADES & LANGER, *supra* note 10, § 3.01(2).

<sup>28</sup> 1 STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 2D SESS., DEFICIT REDUCTION ACT OF 1984, 348 (Comm. Print 1984) [hereinafter cited as SENATE COMM.].

own fifty percent or more of the voting power.<sup>29</sup> Such foreign entities are referred to as controlled foreign corporations (CFCs).<sup>30</sup>

Section 951 of subpart F states that the United States shareholders<sup>31</sup> of a CFC must include in gross income certain kinds of foreign corporation income as constructive dividends.<sup>32</sup> Subpart F, therefore, "does not purport to tax or directly affect the foreign corporations."<sup>33</sup> Instead, it attributes certain income of the CFC to its United States shareholders for purposes of assessing the requisite tax.<sup>34</sup>

The remaining sections of subpart F outline rules to determine which kinds of income invoke constructive dividend treatment.<sup>35</sup> Such income includes what is commonly referred to as "subpart F income,"<sup>36</sup> the shareholders' pro rata share of income from earnings of a CFC invested in United States property,<sup>37</sup> and any gain recognized on the sale of stock by a CFC.<sup>38</sup>

Prior to the Tax Reform Act of 1984, income derived from a carefully structured international factoring arrangement<sup>39</sup> could escape immediate federal taxation under subpart F.<sup>40</sup> Such income

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<sup>29</sup> 1 RHOADES & LANGER, *supra* note 10, § 3.01(3)(a).

<sup>30</sup> I.R.C. § 957(a) (1982).

<sup>31</sup> Shareholder in this context refers to United States persons or corporations who own 10% or more of the total combined voting power of the CFC. I.R.C. § 951(b) (1982).

<sup>32</sup> I.R.C. § 951(a)(1) (1982).

<sup>33</sup> 1 RHOADES & LANGER, *supra* note 10, § 3.01(3)(a).

<sup>34</sup> *Id.*

<sup>35</sup> *Id.* § 3.01(3)(b).

<sup>36</sup> Subpart F income includes income derived from the insuring of United States risks and foreign base company income. I.R.C. § 952(a) (1982). Foreign base company income consists of foreign personal holding company income (from interest, dividends, rents, royalties, and other passive income derived from United States sources), foreign base company sales income (from the purchase and resale of property from or to a related party by a CFC), foreign base company services income (from the purchase and resale of services from or to a related party by a CFC), and foreign base company shipping income (from the use of vessels or aircraft in foreign commerce). 1 RHOADES & LANGER, *supra* note 10, § 3.01(3)(d)(ii).

<sup>37</sup> I.R.C. § 956(a)(1) (1982). United States shareholders must consider as income their pro rata share of the investments in United States property whether or not subpart F income is generated. 1 RHOADES & LANGER, *supra* note 10, § 3.01(3)(e).

<sup>38</sup> I.R.C. § 958(a)(2) (1982).

<sup>39</sup> Under the tax laws prior to the Tax Reform Act of 1984, an international factoring arrangement would allow the multinational corporation certain tax advantages if the following conditions were met: (1) the receivables were sold to the CFC without recourse, (2) the CFC bore all the risk and expense of collection, (3) the purchase price of the receivables was set so as to compensate the CFC in accordance with the customary practice of factors operating at arms length, and (4) the receivables were clearly identified as property of the CFC. See *International Factoring May Not Generate Subpart F Income*, 60 J. TAX'N 190 (1984).

<sup>40</sup> Leak & Smith, *supra* note 3, at 198. See also H.R. REP. 861, 98th Cong., 1st Sess. 930 (1984) (stating that under the previous tax laws a foreign factoring subsidiary could transfer

was not considered by the courts as interest within the definition of personal holding company income.<sup>41</sup> Factored income, therefore, could not be taxed under the foreign personal holding company provisions of subpart F.<sup>42</sup> The Internal Revenue Service acquiesced to this view in a 1983 letter ruling<sup>43</sup> stating that the sale of receivables to a CFC constituted a bona fide sale, thereby excluding resulting income from foreign personal holding company provisions.<sup>44</sup>

Attempts to apply federal tax to internationally factored income under the principal purpose test contained in section 367<sup>45</sup> of the Internal Revenue Code often failed due to judicial interpretation.<sup>46</sup> Under this section, a foreign corporation cannot be considered a corporation for tax purposes if a transfer of property to the corporation has "as one of its principal purposes the avoidance of federal income taxes."<sup>47</sup> Determining whether a foreign corporation was established for legitimate business purposes, however, often has been difficult.<sup>48</sup> Narrow judicial interpretation of the principal purpose test has eroded the ability of the Internal Revenue Service to curtail international factoring by means of section 367.<sup>49</sup> Consequently, the Internal Revenue Code prior to the Tax Reform Act

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untaxed cash to its United States parent by buying the parent's receivables).

<sup>41</sup> *Elk Discount Corp. v. Commissioner*, 4 T.C. 196, 201 (1944) (involving the purchase by a factor of sales contracts and notes); *Thompson v. Commissioner*, 73 T.C. 878, 888 (1980) (involving the discount purchase of tax refund claims by a factor who attempted to classify its earnings as interest). Personal holding company income is passive income derived from interest, dividends, rents, and royalties. I.R.C. § 543 (1982).

<sup>42</sup> I.R.C. § 954(c) (1982).

<sup>43</sup> Letter Ruling No. 8338043 (June 17, 1983).

<sup>44</sup> *Id.* This letter ruling demonstrates the acceptance by the Internal Revenue Service of the existence of the factoring subsidiary. *Gattegno, Offshore Factoring*, 54 C.P.A. J. 52 (1984).

<sup>45</sup> I.R.C. § 367 (1982).

<sup>46</sup> PROPOSALS, *supra* note 21, at 46.

<sup>47</sup> I.R.C. § 367(a) (1982).

<sup>48</sup> See *LaBeau and Dostart, Offshore Tax Planning May Be Favorably Affected by Recent Hospital Corp. Decision*, 60 J. TAX'N 294 (1984) (discussing *Hospital Corporation of America v. Commissioner*, 81 T.C. 520 (1983), a tax court decision allowing a United States corporation to receive income through a wholly-owned subsidiary in the Cayman Islands even though no part of the subsidiary's income was shown to be attributable to its own activity).

<sup>49</sup> PROPOSALS, *supra* note 21, at 46. See also *Dittler Brothers, Inc. v. Commissioner*, 72 T.C. 896, 919 (1979) (holding that petitioner's transfer of cash and property to a foreign corporation in exchange for stock did not have as one of its principle purposes the avoidance of federal taxes); *Hershey Foods Corp. v. Commissioner*, 76 T.C. 312, 324 (1981) (holding that petitioner's transfer of its unprofitable Canadian branch to a wholly owned Canadian subsidiary did not violate the principle purpose provisions of § 367).

of 1984 permitted multinational corporations to engage in international factoring of receivables without generating immediate federal taxes either to the CFC or to its United States shareholders.<sup>50</sup>

The Tax Reform Act of 1984 contains important changes that largely eliminate the tax advantage of international related-party factoring.<sup>51</sup> Section 123 of the Tax Reform Act<sup>52</sup> seeks to accomplish this by adding sections 956(b)(3)<sup>53</sup> and 864(d)<sup>54</sup> to the Internal Revenue Code.<sup>55</sup>

Section 956(b)(3) provides that the term "United States property," as used in section 956, will now include "any trade or service receivable if (i) such trade or service receivable is acquired (directly or indirectly) from a related person who is a United States person, and (ii) the obligor under such receivable is a United States person."<sup>56</sup> As a result, the purchase of such receivables by a foreign corporation is now regarded as an investment in United States property with payments for the receivables taxable as dividends to the United States shareholders.<sup>57</sup>

Section 864(d) deals with the income resulting from the factored receivables. This section provides that when a person acquires a trade or service receivable from a related party, "any income of such person from the trade or service receivable so acquired shall be treated as if it were interest on a loan to the obligor under the receivable."<sup>58</sup> Section 864(d) further states that this section applies to the portions of subpart F relating to controlled foreign corporations.<sup>59</sup> Income derived from internationally factored receivables of a related party is treated, therefore, as foreign personal holding company income, and is taxed immediately to the United States shareholders under subpart F.<sup>60</sup>

Although the Tax Reform Act of 1984 treats income from international related-party factoring as interest income to the United

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<sup>50</sup> ERNST & WHINNEY, *THE TAX REFORM ACT OF 1984: AN ANALYSIS OF FOREIGN SALES CORPORATIONS AND OTHER INTERNATIONAL PROVISIONS* 25 (1984).

<sup>51</sup> See Gattegno, *supra* note 44, at 52.

<sup>52</sup> Tax Reform Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 494, § 123.

<sup>53</sup> *Id.* § 123(b).

<sup>54</sup> *Id.* § 123(a).

<sup>55</sup> *Id.* § 123.

<sup>56</sup> *Id.* § 123(b).

<sup>57</sup> ERNST & WHINNEY, *supra* note 50, at 26.

<sup>58</sup> Tax Reform Act of 1984, *supra* note 5, § 123(a).

<sup>59</sup> *Id.*

<sup>60</sup> ERNST & WHINNEY, *supra* note 50, at 26.

States shareholders,<sup>61</sup> the obligor under the receivables is not allowed to treat any part of the payments as deductible interest.<sup>62</sup>

In addition, any distribution from a foreign corporation which is attributable to international related-party factoring will be treated as investment in United States property, and therefore will be immediately taxable to the United States shareholders of the foreign corporation.<sup>63</sup> For example, when a foreign subsidiary lends money to another subsidiary of the same United States parent and the money is used to purchase receivables of the parent, the loan is treated as an investment in United States property by the lending foreign subsidiary for the purposes of section 956.<sup>64</sup> Such a transaction is an indirect acquisition under section 864(d),<sup>65</sup> thereby causing income earned by the lending subsidiary to be immediately taxable to its United States shareholders.<sup>66</sup>

The new rules regarding international related-party factoring also affect the ability of multinational corporations to gain foreign tax credit advantages that were previously available through this process.<sup>67</sup> Income from a factored receivable in which the obligor is a United States person is now considered United States source-income rather than foreign source-income.<sup>68</sup> Consequently, such income cannot be included in the pooling of foreign income and expenses in calculating allowable foreign tax credits to the corporation.<sup>69</sup> Further, interest is subject to a separate foreign tax credit

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<sup>61</sup> Tax Reform Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 494, § 123(a).

<sup>62</sup> H.R. REP. NO. 861, 98th Cong., 1st Sess. 930, 931-32 (1984).

<sup>63</sup> H.R. REP. NO. 432, pt. 2, 98th Cong., 2d Sess. 1306 (1984).

<sup>64</sup> *Id.*

<sup>65</sup> Tax Reform Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 494, § 123(a).

<sup>66</sup> Khokhar, *The Demise of Related Party International Factoring Operations?*, 13 TAX MGMT. INT'L J. 331, 336 (1984). "The interest income will be taxable to the United States shareholders of the CFC as subpart F foreign personal holding company income and it will be subject to separate I.R.C. § 904(d) limitation." *Id.*

<sup>67</sup> See Sedit, *supra* note 4 (stating that laws prior to the Tax Reform Act of 1984 permitted a multinational corporation to make better use of its foreign tax credits).

<sup>68</sup> Tax Reform Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 494, § 123(b).

<sup>69</sup> Sedit, *supra* note 4. Under the foreign tax credit rule, the amount of foreign taxable income acquired by a corporation in a taxable year is divided by the total taxable income of the corporation for that year. The amount of United States taxes which would normally be paid on the total income is then multiplied by this ratio to yield the allowable foreign tax credits. I.R.C. § 904(a) (1982). The effect of the new rule is to prevent factored income from being included in the pooling of foreign income, thus reducing the allowable foreign tax credits under § 904. See Sedit, *supra* note 4.

limitation under section 904<sup>70</sup> of the Internal Revenue Code. Because related-party factoring income is now classified as interest,<sup>71</sup> provisions for determining foreign tax credits will be applied separately and tax on such income will not be offset by foreign tax credits as non-interest non-factoring income.<sup>72</sup>

Though the new rules substantially restrict the tax benefits of international related-party factoring,<sup>73</sup> they do not prevent the United States parent from recognizing a tax loss on the discount sale of receivables.<sup>74</sup> In addition, the rules provide that United States property defined in section 956 does not include certain export receivables.<sup>75</sup> For purposes of this exception, export receivables refer to trade or service receivables arising from the sale, disposition, or lease of export property.<sup>76</sup> Apparently, then, the new rules do not apply when the obligor under the receivables is not a United States person.<sup>77</sup>

Certain multinational corporations criticize the factoring regulations contained in the Tax Reform Act of 1984, contending that the new rules penalize them for using a valuable means of managing liquidity and credit risks.<sup>78</sup> They further assert that these rules deprive multinational corporations of an important means of financing their foreign subsidiaries.<sup>79</sup> These criticisms of the new rules, however, were overridden by Congress' desire to eliminate artificial devices that shift income out of the United States and into tax havens.<sup>80</sup> In addition, Congress was concerned about the income in offshore factoring and the consequent tax free repatria-

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<sup>70</sup> I.R.C. § 904(d)(1)(A) (1982).

<sup>71</sup> Tax Reform Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 494, § 123(a).

<sup>72</sup> H.R. REP. No. 861, *supra* note 62, at 932.

<sup>73</sup> Khokhar, *supra* note 66, at 345. "Section 123 of the Tax Reform Act of 1984 may have dealt a death blow to related-party international factoring arrangements as they were known prior to the Act." *Id.*

<sup>74</sup> Sesit, *supra* note 4.

<sup>75</sup> SENATE COMM., *supra* note 28, at 350.

<sup>76</sup> *Id.*

<sup>77</sup> *Analysis*, *supra* note 4, at 95. Congress apparently created this exception to encourage the financing of exports. This exception provides exporters with a cash advantage to continue financing exports. Sesit, *supra* note 4.

<sup>78</sup> *Income From CFC Factoring of Foreign Receivables*, 21 TAX NOTES 503 (1984).

<sup>79</sup> *Id.* International factoring is a desirable means of financing foreign subsidiaries because inter-company lending is not always economically feasible due to foreign exchange control or withholding tax reasons. The alternative to factoring is for the subsidiaries to borrow from local banks on more costly terms. *Id.*

<sup>80</sup> H.R. REP. No. 432, *supra* note 63, at 1305.

tion<sup>81</sup> of foreign earnings.<sup>82</sup> Congress also wanted to avoid giving to foreign operations of a United States business an advantage over the domestic operations of the same business.<sup>83</sup> By enacting new factoring rules in the Tax Reform Act of 1984, Congress effectively achieved its goal of eliminating tax avoidance through international related-party factoring.

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<sup>81</sup> Repatriation is the return to one's own country of investments held by foreign parties. BLACK'S LAW DICTIONARY 1167 (5th ed. 1979). In this context, repatriation refers to the return of cash to the United States parent through the discount purchase of receivables by the foreign subsidiary.

<sup>82</sup> H.R. REP. NO. 432, *supra* note 63, at 1305.

<sup>83</sup> *Id.*

