

# Factoring of Receivables Audit Techniques Guide

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**NOTE:** This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date.

### Overview

Companies generate accounts receivable by selling goods or services to their customers on credit. Many companies who extend credit to their customers sell their accounts receivable to a factor. A factor is a specialized financial intermediary who purchases accounts receivable at a discount. Under a factoring agreement a company sells or assigns its accounts receivable to a factor in exchange for a cash advance. The factor typically charges interest on the advance plus a commission. The price paid for the receivables is discounted from their face amount to take into account the likelihood of uncollectibility of some of the receivables.

Factoring is a technique used by companies to manage their accounts receivable and provide financing. Typically companies that have access to sources of financing that is less expensive than factoring would not use factoring as source of credit.

A factor may provide any of the following services:

1. Investigation of the credit risk of customers of the client;
2. Assumption of the credit risk of customers;
3. Collection of the client's accounts receivable from customers;
4. Bookkeeping and reporting services related to accounts receivable;
5. Provision of expertise related to disputes, returns and adjustments;
6. Advancing or financing.

There are numerous types of factoring arrangements. Some of the basic types vary the treatment of credit risk assumption and customer or debtor notification. When the factoring agreement involves the purchase of accounts receivable where the factor bears the risk of a customer or debtor failing to pay the client for reason of financial inability it is a non-recourse or without-recourse agreement. In the situation where the client must bear the risk of nonpayment due to financial inability, the agreement is a recourse agreement. In many instances, factoring agreements provide for accounts to be purchased on both a recourse and non-recourse basis depending on the credit worthiness of the customers or the debtors.

## Compliance Focus

A strategy has been identified in which multinational corporations use the factoring of accounts receivable among related parties. The goal of this strategy is to avoid U.S. taxation by shifting income offshore and to significantly reduce remaining U.S. income by deducting expenses related to the same income.

### Typical Fact Pattern:

A U.S. subsidiary (“Taxpayer”) of a foreign parent earns sales income and books accounts receivable. The Taxpayer then factors (sells at a discount) the accounts receivable to a brother-sister foreign affiliate. The Taxpayer pays the foreign factor the following fees: a discount; administration fees; commissions; and interest.

The Taxpayer deducts these fees or may net them against gross receipts. However, the foreign factor does not perform any of the typical services of a factor, including collection of the Taxpayer’s accounts receivable. Instead, the Taxpayer agrees to continue doing all or most of its own collection work on its accounts receivable. In some cases, factoring arrangements involve the use of a domestic (U.S. based) factor instead of a factor located offshore. In cases involving a domestic factor, some audit steps and issues discussed below may not apply. If the transaction is between two domestic entities it may be structured for state tax purposes and has no federal tax effect. In addition, in some cases, the Taxpayer and factor may be engaged in a financing arrangement involving securitizing the accounts receivable.

### General Audit Steps

Although U.S. taxpayers are taxed on their worldwide income, the income of foreign subsidiaries of U.S. taxpayers is generally deferred from taxation in the U.S. Consequently, the existence of a factoring arrangement may not be readily identified on the face of a return. Therefore, at a minimum the following audit steps should be utilized:

1. Submit a specific IDR to determine if any accounts receivable were sold. If yes, were they sold to:
  - a related entity; and/or
  - any entity located offshore.
2. Review the tax return balance sheet to determine if the accounts receivable reflected thereon are reasonable for the size and type of business.
3. Perform a comparative analysis of the balance sheets for the current **and at least 5 prior tax years**, noting any significant reduction in accounts receivable.
4. Review the tax preparation workpapers for large debits to income.
5. Review **and analyze Form 5472 and** the audited financial statements of both the domestic entity and the related foreign entity for any footnotes reflecting the sales and/or securitization of the accounts receivable. **Request that the foreign entity provide this information in English.** Note whether this analysis demonstrates income shifting from the domestic entity to the foreign entity. Also note whether there is evidence that the foreign entity was conducting a trade or business within the United States.

**The following facts should be determined during the audit through IDRs or functional analysis and by requesting documentary substantiation where appropriate.**

### **The Factor**

1. Name and location of the factor;
2. Relationship of the factor to the taxpayer;
3. The name and location of a common parent of the factor and the taxpayer;
4. Whether the taxpayer and the factor are part of a consolidated group;
5. Whether the factor is a Controlled Foreign Corporation (CFC);
6. The name of any promoter/advisor or accounting firm involved in structuring the taxpayer's factoring arrangement.

### **The Factoring Arrangement**

The factoring arrangement is usually set forth in a Factoring Agreement between the factor and the taxpayer. Obtain a description of the terms of the factoring arrangement including if applicable the following:

1. The names of the parties that entered into the Factoring Agreement;
2. The date the Factoring Agreement was signed;
3. The services the factor agreed to provide;
4. The services the factor contracted back to the taxpayer;
5. The fees the taxpayer charged the factor for performing the services contracted back to the taxpayer;
6. The discount and fees charged by the factor for:
  - o discount on accounts receivable;
  - o administrative fees;
  - o commission fees;
  - o interest charges.
7. The date the taxpayer was required to transfer accounts receivable to the factor;
8. The date the factor had until to accept or deny the factored accounts receivable;
9. Whether the sale of the receivables to the factor was recourse or non-recourse;
10. The reasons the taxpayer provided for entering into the factoring arrangement;
11. Whether the taxpayer ever entered a factoring arrangement before;
12. Whether it is a common practice in the taxpayer's industry to factor receivables;
13. If a related entity is utilized to perform factoring, explain the source of the funding used by this entity to acquire the accounts receivable.

### **Securitization**

If the factoring arrangement involves the securitization of factored accounts receivable then obtain a description of the securitization process including:

1. The purpose for securitizing the accounts receivable;
2. The names and location of all entities involved in the securitization process;
3. The relationship between the parties involved in the securitization arrangement;

4. Whether any of the entities involved in securitizing the accounts receivable were a Special Purpose Vehicle (SPV);
5. The fees charged by the parties involved in securitizing the accounts receivable;
6. A description of how the accounts receivable were securitized, including the flow of funds;
7. Whether the sale of the receivables to the factor was recourse or non-recourse;
8. Whether the taxpayer ever securitized its accounts receivable before;
9. Whether it is a common practice in the taxpayer's industry to securitize accounts receivable;
10. If a related entity is utilized to perform securitization, explain the source of the funding used by this entity to acquire the accounts receivable.

### **Tax Return**

1. Indicate where on the tax return the expenses from the factoring arrangements are deducted. Identify if the factoring fees are netted against other items such as sales. Also, indicate if the factoring deductions are reflected as book/tax difference on Schedule M.
2. Provide all tax preparation workpapers related to the factoring/securitization arrangement.

### **Financial Statements**

Indicate if and how the factoring arrangements are presented on the taxpayer's financial statements. Compare the treatment of how the factoring arrangements are presented on the financial statements with the presentation on the tax returns.

### **Transfer Pricing Studies**

Taxpayers engaged in transactions with related parties are required to establish an appropriate transfer price in accordance with prescribed methodologies. Analysis and evaluation of the appropriate price is what is known as a Transfer Pricing Study.

To obtain a copy of any and all Transfer Pricing Studies, prepare a separate IDR consisting of the following two paragraphs:

Please provide **within 30 days** of this request any principal documentation outlined in Treas. Reg. Section 1.6662-6(d) (2) (iii) (B) that has been prepared to support your transfer pricing methodologies for all years under examination. This information would generally be provided in the form of a study; however all principal documentation outlined under the Code and associated Treasury Regulation which was prepared for the years under examination, regardless of form, is requested. This documentation should include all internal and/or external studies.

It should be so noted that any documentation prepared by the taxpayer pursuant to Section 6662(e) must be in existence when the return was filed in order to meet the documentation requirement. In addition, if this documentation is not provided **within 30 days** of this request, and if there are significant adjustments to your transfer price as

determined under IRC Section 482, a penalty may be applicable under IRC Section 6662(e) or (h).

### **Functional Analysis**

When determining the appropriate amount of factoring fee charged between related parties, it may be necessary to perform a functional analysis to determine the actual services performed; the entity which performed the services; and, any compensation charged for these services.

A functional analysis prepared with respect to factoring arrangements should include, but not be limited to, the following:

1. Identity of the factor and its geographic location.
2. Identity of the legal form (partnership, corporation, LLC, etc) of the factor
3. Identity of the tax form (partnership, corporation, disregarded entity) of the factor.
4. Identity of the functions performed by the factor; and, if appropriate, the functions which the factor contracts to be performed on its behalf.
5. Identity of the number, names and location of any employees of the factor.
6. Identity of duties specifically performed by each employee.
7. Identity of who performs the factoring functions.
8. Explanation, in detail, of any transfer pricing methodology used in determining how a related entity reimbursed the taxpayer for services provided (i.e. servicing rights).
9. Explanation, in detail, of any risks assumed with regard to the factored receivables and the entity assuming such risks.
10. Analysis, in detail, of the amounts attributable to these risks, to be supported by appropriate workpapers.

### **Bad Debt History**

Determine the bad debt history of the taxpayer's accounts receivable for the years under exam and if possible the past 3 to 5 years. Calculate the percentage of receivables written off as bad debts for each of the years. Identify the first time that the taxpayer entered into a factoring arrangement and indicate the reasons the taxpayer provided for entering into such an arrangement.

### **Dates the Receivables Were Collected and Transferred**

The legal analysis of factoring arrangements may require identifying the dates and amounts of receivables transferred to the factor. Accordingly, for all the factored receivables determine:

1. The dates and the amounts of the accounts receivable the taxpayer transferred to the factor.
2. The dates the taxpayer received collection on the accounts receivable; and
3. The dates the factor had until to accept or deny the transferred accounts receivable.

### **Prior History on Sale of Accounts Receivable/Repeal of Mark-To-Market Treatment under Section 475/Tax Avoidance**

Obtain answers to the following questions:

1. Prior to July 1998, did the taxpayer utilize Section 475 to mark-to-market its accounts receivable?
2. Did the taxpayer start or complete setting up transactions involving the "sale" of its accounts receivable to related corporations after July, 1998?
3. Were any of these corporations created or acquired around or after July, 1998 to carry out this sale of accounts receivable?
4. Were any of these types of transactions set up and promoted/marketed by any of the accounting firms or other promoters/advisors?
5. Were any of the valuation services (for the accounts receivable) provided by the same accounting firm which marketed the transaction? Who provided the valuation services?

### **Other**

1. Obtain a copy of the Accounting Manual; Standard Operating Procedures and/or Flow Charts which describe the corporate factoring/securitization policies and/or procedures.
2. Obtain all legal, accounting, financial, and economic opinions and memoranda secured by or on behalf of the taxpayer in connection with this transaction.
3. Determine whether a Tax Contingency reserve was established for any transactions.
4. Obtain copies of any communications, brochures, memoranda or other materials received from or sent to the Taxpayer or its representatives describing the factoring arrangement.

### **Treas. Reg. section 6050P**

Treas. Reg. section 6050P contains final regulations to the information reporting requirement under section 6050P of the Internal Revenue Code for discharges of indebtedness. The preamble of the Treas. Reg. section 6050P regulations, describe typical unrelated party pricing of factoring transactions and provide an example demonstrating how a bona fide unrelated party factoring transaction is often priced. The preamble states that factoring between unrelated parties ordinarily involves a factor who performs the following functions:

1. Initial credit investigation;
2. Selective assumption of the risk of loss (sometimes referred to as guaranteeing credit);
3. On-going credit monitoring of the client's customers, collection and bookkeeping.

The preamble states that for typical transactions with **unrelated** parties factoring fees range between 0.35 percent of the face value of the accounts receivable (if the client retains the collection function) and 0.70 percent of the face value (if the factor undertakes the collection function).

Accordingly, it may be indicative that a factoring arrangement between related parties is abusive if the factoring fees are much higher than the typical factoring fees charged for unrelated parties. This type of analysis should be made in determining whether a section 482 adjustment is warranted.

## **Typical Issues:**

Potential issues include, but are not limited to:

1. Were there deemed dividends from the U.S. taxpayer to its foreign parent in the amount of collected accounts receivable transferred to the foreign factor; and, were withholding taxes due on the dividends paid to a foreign recipient?
2. Have the arm's-length principles under section 482 been applied with respect to the sale of accounts receivable to a related party?
3. Did the foreign factor's factoring activities generate income from a trade or business within the United States?
4. Should losses between the related parties in the factoring transaction be adjusted under Section 267?
5. Was the factor a controlled foreign corporation ("CFC") conducting intercompany transactions with the Taxpayer pursuant to Treas. Reg. 1502?
6. Should losses from the factoring transaction be disallowed under Section 269 because the factor was acquired or created to evade or avoid income tax?