

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-115288-01/CC:INTL:B3

District Director: LMSB-Heavy Manufacturing Group 1736

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference:

LEGEND:

Taxpayer =

Product A =

Product B =

Business C =

ISSUE:

Whether non-interest bearing trade accounts receivable resulting from United States sales of goods and services are properly characterized as single category assets within Temp. Treas. Reg. §1.861-9T(g)(3)(i).

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CONCLUSION:

Non-interest bearing trade accounts receivable resulting from United States sales of goods and services are properly characterized as single category assets within Temp. Treas. Reg. §1.861-9T(g)(3)(i).

FACTS:

Taxpayer is a domestic corporation that conducts its foreign business operations through a number of foreign subsidiaries. Taxpayer is a leading supplier of Product A and a leading manufacturer of Product B. Taxpayer is also engaged in Business C. During the tax years in question, Taxpayer made sales of goods and services that generally gave rise to U.S. source income under section 861 of the Internal Revenue Code. Consistent with generally accepted business practice in the industry, Taxpayer permitted its customers to defer making cash payment for such purchases for 30 or 60 days following the sales date, at no additional charge. Although customers were sometimes delinquent in making full payment within the designated time period, Taxpayer has not identified any instance in which it charged a customer interest on any trade account receivable.

For the tax years in issue, Taxpayer claimed foreign tax credits under section 901. In computing its foreign source taxable income for purposes of determining its foreign tax credit limitation under section 904, Taxpayer allocated and apportioned its interest expense using the asset method as required by section 864(e)(2) of the Code. For purposes of applying this method, Taxpayer valued its assets using the tax book value method of asset valuation described in Temp. Treas. Reg. §1.861-9T(g). Taxpayer characterized its trade accounts receivable as single category assets under Temp. Treas. Reg. §1.861-9T(g)(3)(i), generating exclusively U.S. source income.

LAW AND ANALYSIS:

Section 901 of the Internal Revenue Code allows a credit against U.S. income tax liability for the amount of certain income taxes paid to a foreign country or possession of the United States.

Section 904 of the Code imposes a limit on the amount of foreign income taxes that may be credited under section 901. Section 904(a) limits the amount of foreign income taxes that may be credited in any one taxable year to the amount of a taxpayer's pre-credit U.S. income tax on its foreign source taxable income (the "section 904 limitation"). The section 904 limitation is calculated separately for different categories of foreign source taxable income. Section 904(d).

Sections 861(b), 862(b), and 863 of the Code provide that taxable income attributable to gross income from domestic or foreign sources shall be determined by deducting the

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expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, and other deductions that cannot definitely be allocated to some item or class of gross income. Treas. Reg. §§1.861-8 through 1.861-17 provide specific guidance regarding the allocation and apportionment of deductions. In general, deductions are allocated to classes of gross income and, as required by the operative sections of the Code, apportioned between statutory and residual groupings of gross income.

In the case of interest expense, section 864(e)(2) of the Code provides that all allocations and apportionments of such deductions shall be made on the basis of assets. Under the asset method, interest expense is apportioned between statutory and residual groupings of gross income (or among statutory groupings) in proportion to the average total values of the assets within each such grouping for the taxable year. Temp. Treas. Reg. §1.861-9T(g)(1)(i).

Temp. Treas. Reg. §1.861-9T(a) provides that the method of allocation and apportionment for interest expense is based on the approach that, in general, money is fungible. All of a taxpayer's activities and property require funds, and a business has a great deal of flexibility in determining the source and use of funds. Thus, interest deductions are considered related to all income-producing activities and assets of a taxpayer regardless of whether a particular interest-bearing obligation was entered into for a specific purpose.

Temp. Treas. Reg. §1.861-9T(g)(3) provides rules for characterizing assets for purposes of apportioning interest:

Assets are characterized for purposes of this section according to the source and type of the income they generate, have generated, or may reasonably be expected to generate. The physical location of the assets is not relevant to this determination. Subject to the special rules of paragraph (h) concerning the application of the fair market value method of apportionment, the value of assets within each statutory grouping and the residual grouping at the beginning and end of each year shall be determined by dividing the taxpayer's assets into three types—

(i) *Single category assets.* Assets that generate income that is exclusively within a single category grouping or the residual grouping;

(ii) *Multiple category assets.* Assets that generate income within more than one grouping of income (statutory or residual); and

(iii) *Assets without directly identifiable yield.* Assets that produce no directly identifiable yield or that contribute equally to the generation of all income of the taxpayer (such as assets used in general and administrative functions).

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Section 1.861-9T(g)(3) of the Temporary Treasury Regulations also provides that single category assets are directly attributable to the relevant statutory or residual grouping of income. In order to attribute multiple category assets to the relevant grouping of income, the income yield of each asset for the taxable year must be analyzed to determine the proportion of gross income generated by it within each relevant grouping. The value of each asset is then prorated among the relevant groupings of income according to their respective proportions of gross income. The value of each asset without directly identifiable income yield must be identified. However, because prorating the value of such assets cannot alter the ratio of assets within the various groupings of income, they are not taken into account in determining that ratio.

For purposes of determining its foreign tax credit limitation for the years in issue, Taxpayer characterized its non-interest bearing trade accounts receivable as single category assets that produce U.S. source income under §1.861-9T(g)(3)(i). The IRS examination team asserted that non-interest bearing trade accounts receivable are more properly characterized as assets without directly identifiable yield under §1.861-9T(g)(3)(iii).

We conclude that non-interest bearing trade accounts receivable are more appropriately characterized in a manner consistent with the characterization of the sales or services income that gave rise to them, in this case, single-category assets within the meaning of Temp. Treas. Reg. §1.861-9T(g)(3)(i). While non-interest bearing trade accounts receivable do not generate income directly, they are closely associated with the production of income created by the sale of goods and services, and so should be considered to generate such income within the meaning of Temp. Treas. Reg. §1.861-9T(g)(3)(i). Taxpayer's non-interest bearing trade accounts receivable generate income in the sense that they enable Taxpayer to sell goods and services consistent with the industry standard that does not require customers to pay cash at the time of the sale.

Put another way, Taxpayer's trade accounts receivable represent accrued income from sales of goods and services until a customer eliminates the account receivable with a cash payment. To the extent the non-interest bearing trade accounts receivable reflect sales of goods and services that generated U.S.-source income in this case, the accounts receivable should be characterized in the same manner. This analysis is consistent with the characterization of accounts receivable for other tax purposes, *e.g.*, in allocating a portion of the loss on the sale of certain accounts receivable "to the gross income generated by the receivable" (Temp. Treas. Reg. §1.861-9T(b)(3)(ii)); in calculating income effectively connected with the conduct of a U.S. trade or business (Treas. Reg. §§1.882-5(b)(1)(i) and 1.884-1(d)(2)(iv)); and in determining the percentage of assets that produce passive income for purposes of the passive foreign investment company (PFIC) rules (section 1297(a) and Notice 88-22, 1988-1 C.B. 489). In contrast, cash received in connection with income from sales of goods or services or the payment of a receivable is fungible in nature and therefore cannot be directly identified with income from the sales.

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Accordingly, Taxpayer's non-interest bearing accounts receivable are properly characterized within the first category of Temp. Treas. Reg. §1.861-9T(g)(3), that is, as single category assets.

CAVEAT

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.