

Example 2. The facts are the same as in example 1 except that, on rare occasions, an employee of P receives an order which he, after consultation with officials of S and because P cannot fill the order, accepts on behalf of S rather than on behalf of P. P does not hold itself out as a person which those wishing to do business with S should contact. Assuming that orders for S are seldom handled in this manner and that they do not constitute a significant part of that corporation's business, S shall not be considered to have an office or other fixed place of business in the United States because of these activities of an employee of P.

Example 3. The facts are the same as in example 1 except that all orders received by S are subject to review by an officer of P before acceptance. S has a business office in the United States.

Example 4. S, a foreign corporation organized under the laws of Puerto Rico, is engaged in the business of manufacturing dresses in Puerto Rico and is entitled to an income tax exemption under the Puerto Rico Industrial Incentive Act of 1963. S is a wholly owned subsidiary of P, a domestic corporation engaged in the business of buying and selling dresses to customers in the United States. S sells most of the dresses it produces to P, the assumption being made that the income from these sales is derived from sources without the United States. P in turn sells these dresses in the United States in its name and through the efforts of its own employees and of distributors appointed by it. S does not have a fixed facility in the United States, and none of its employees are stationed in the United States. On occasion, employees of S visit the office of P in the United States, and executives of P visit the office of S in Puerto Rico, to discuss with one another matters of mutual business interest involving both corporations, including the strategy for marketing the dresses produced by S. These matters are also regularly discussed by such persons by telephone calls between the United States and Puerto Rico. S's employees do not otherwise participate in P's marketing activities. Officers of P are generally responsible for the policies followed by S and are directors of S, but S has a chief executive officer in Puerto Rico who, from its office therein, handles the day-to-day conduct of S's business. Based upon the facts presented, and assuming there are no other facts which would lead to a different determination, S shall not be considered to have an office or other fixed place of business in the United States for purposes of this section.

Example 5. The facts are the same as in example 4 except that the dresses are manufactured by S in styles and designs furnished by P and out of goods and raw materials purchased by P and sold to S. Based upon the facts presented, and assuming there are no

other facts which would lead to a different determination, S shall not be considered to have an office or other fixed place of business in the United States for purposes of this section.

Example 6. The facts are the same as in example 5 except that, pursuant to the instructions of P, the dresses sold by P are shipped by S directly to P's customers in the United States. Based upon the facts presented, and assuming there are no other facts which would lead to a different determination, S shall not be considered to have an office or other fixed place of business in the United States for purposes of this section.

[T.D. 7216, 37 FR 23433, Nov. 3, 1972]

§ 1.864-8T Treatment of related person factoring income (temporary).

(a) *Applicability*—(1) *General rule.* This section applies for purposes of determining the treatment of income derived by a person from a trade or service receivable acquired from a related person. Except as provided in paragraph (d) of this section, if a person acquires (directly or indirectly) a trade or service receivable from a related person, any income (including any stated interest, discount or service fee) derived from the trade or service receivable shall be treated as if it were interest received on a loan to the obligor under the receivable. The characterization of income as interest pursuant to this section shall apply only for purposes of sections 551-558 (relating to foreign personal holding companies), sections 951-964 (relating to controlled foreign corporations), and section 904 (relating to the limitation on the foreign tax credit) of the Code and the regulations thereunder. The principles of sections 861 through 863 and the regulations thereunder shall be applied to determine the source of such interest income for purposes of section 904.

(2) *Override.* With respect to income characterized as interest under this section, the special rules of section 864(d) and this section override any conflicting provisions of the Code and regulations relating to foreign personal holding companies, controlled foreign corporations, and the foreign tax credit limitation. Thus, for example, pursuant to section 864(d)(5) and paragraph (e) of this section, stated interest derived from a factored trade or service receivable is not eligible for the subpart F de minimis rule of section

954(b)(3), the same country exception of section 954(c)(3)(A)(i), or the special rules for export financing interest of sections 904(d)(2) and 954(c)(2)(B), even if in the absence of this section the treatment of such stated interest would be governed by those sections.

(3) *Limitation.* Section 864(d) and this section apply only with respect to the tax treatment of income derived from a trade or service receivable acquired from a related person. Therefore, neither section 864(d) nor this section affects the characterization of an expense or loss of either the seller of a receivable or the obligor under a receivable. Accordingly, the obligor under a trade or service receivable shall not be allowed to treat any part of the purchase price of property or services as interest (other than amounts treated as interest under provisions other than section 864(d)).

(b) *Definitions.* The following definitions apply for purposes of this section and § 1.956-3T.

(1) *Trade or service receivable.* The term “trade or service receivable” means any account receivable or evidence of indebtedness, whether or not issued at a discount and whether or not bearing stated interest, arising out of the disposition by a related person of property described in section 1221(l) (hereinafter referred to as “inventory property”) or the performance of services by a related person.

(2) *Related person.* A “related person” is:

(i) A person who is a related person within the meaning of section 267(b) and the regulations thereunder;

(ii) A United States shareholder (as defined in section 951(b)); or

(iii) A person who is related (within the meaning of section 267(b) and the regulations thereunder) to a United States shareholder.

(c) *Acquisition of a trade or service receivable—(1) General rule.* A trade or service receivable is considered to be acquired by a person at the time when that person is entitled to receive all or a portion of the income from the trade or service receivable. A person who acquires a trade or service receivable (hereinafter referred to as the “factor”) is considered to have acquired a

trade or service receivable regardless of whether:

(i) The acquisition is characterized for federal income tax purposes as a sale, a pledge of collateral for a loan, an assignment, a capital contribution, or otherwise;

(ii) The factor takes title to or obtains physical possession of the trade or service receivable;

(iii) The related person assigns the trade or service receivable with or without recourse;

(iv) The factor or some other person is obligated to collect the payments due under the trade or service receivable;

(v) The factor is liable for all property, excise, sales, or similar taxes due upon collection of the receivable;

(vi) The factor advances the entire face amount of the trade or service receivable transferred;

(vii) All trade or service receivables assigned by the related person are assigned to one factor; and

(viii) The obligor under the trade or service receivable is notified of the assignment.

(2) *Example.* The following example illustrates the application of paragraphs (a), (b), and (c)(1) of this section.

Example. P, a domestic corporation, owns all of the outstanding stock of FS, a controlled foreign corporation. P manufactures and sells paper products to customers, including X, an unrelated domestic corporation. As part of a sales transaction, P takes back a trade receivable from X and sells the receivable to FS. Because FS has acquired a trade or service receivable from a related person, the income derived by FS from P’s receivable is interest income described in paragraph (a)(1) of this section.

(3) *Indirect acquisitions—(i) Acquisition through unrelated person.* A trade or service receivable will be considered to be acquired from a related person if it is acquired from an unrelated person who acquired (directly or indirectly) such receivable from a person who is a related person to the factor. The following example illustrates the application of this paragraph (c)(3)(i).

Example. A, a United States citizen, owns all of the outstanding stock of FPHC, a foreign personal holding company. A performs engineering services within and without the United States for customers, including X, an

unrelated corporation. A performs engineering services for X and takes back a service receivable. A sells the receivable to Y, an unrelated corporation engaged in the factoring business. Y resells the receivable to FPHC. Because FPHC has indirectly acquired a service receivable from a related person, the income derived by FPHC from A's receivable is interest income described in paragraph (a)(1) of this section.

(ii) *Acquisition by nominee or pass-through entity.* A factor will be considered to have acquired a trade or service receivable held on its behalf by a nominee or by a partnership, simple trust, S corporation or other pass-through entity to the extent the factor owns (directly or indirectly) a beneficial interest in such partnership or other pass-through entity. The rule of this paragraph (c)(3)(ii) does not limit the application of paragraph (c)(3)(iii) of this section regarding the characterization of trade or service receivables of unrelated persons acquired pursuant to certain swap or pooling arrangements. The following example illustrates the application of this paragraph (c)(3)(ii).

Example. FS1, a controlled foreign corporation, acquires a 20 percent limited partnership interest in PS, a partnership. PS purchases trade or service receivables resulting from the sale of inventory property by FS1's domestic parent, P. PS does not purchase receivables of any person who is related to any other partner in PS. FS1 is considered to have acquired a 20 percent interest in the receivables acquired by PS. Thus, FS1's distributive share of the income derived by PS from the receivables of P is considered to be interest income described in paragraph (a)(1) of this section.

(iii) *Swap or pooling arrangements.* A trade or service receivable of a person unrelated to the factor will be considered to be a trade or service receivable acquired from a related person and subject to the rules of this section if it is acquired in accordance with an arrangement that involves two or more groups of related persons that are unrelated to each other and the effect of the arrangement is that one or more related persons in each group acquire (directly or indirectly) trade or service receivables of one or more unrelated persons who are also parties to the arrangement, in exchange for reciprocal purchases of the first group's receivables. The following example illus-

trates the application of this paragraph (c)(3)(iii).

Example. Controlled foreign corporations A, B, C, and D are wholly-owned subsidiaries of domestic corporations M, N, O, and P, respectively. M, N, O, and P are not related persons. According to a prearranged plan, A, B, C, and D each acquire trade or service receivables of M, N, O, and/or P, except that neither A, B, C nor D acquires receivables of its own parent corporation. Because the effect of this arrangement is that the unrelated groups acquire each other's trade or service receivables pursuant to the arrangement, income derived by A, B, C, and D from the receivables acquired from M, N, O, and P is interest income described in paragraph (a)(1) of this section.

(iv) *Financing arrangements.* If a controlled foreign corporation (as defined in section 957(a)) participates (directly or indirectly) in a lending transaction that results in a loan to the purchaser of inventory property, services, or trade or service receivables of a related person (or a loan to a person who is related to the purchaser), and if the loan would not have been made or maintained on the same terms but for the corresponding purchase, then the controlled foreign corporation shall be considered to have indirectly acquired a trade or service receivable, and income derived by the controlled foreign corporation from such a loan shall be considered to be income described in paragraph (a)(1) of this section. For purposes of this paragraph (c)(3)(iv), it is immaterial that the sums lent are not, in fact, the sums used to finance the purchase of a related person's inventory property, services, or trade or service receivables. The amount of income derived by the controlled foreign corporation to be taken into account shall be the total amount of income derived from a lending transaction described in this paragraph (c)(3)(iv), if the amount lent is less than or equal to the purchase price of the inventory property, services, or trade or service receivables. If the amount lent is greater than the purchase price of the inventory property, services or receivables, the amount to be taken into account shall be the proportion of the interest charge (including original issue discount) that the purchase price bears to the total amount lent pursuant to the lending transaction. The following

examples illustrate the application of this paragraph (c)(3)(iv).

Example 1. P, a domestic corporation, owns all of the outstanding stock of FS1, a controlled foreign corporation engaged in the financing business in Country X. P manufactures and sells toys, including sales to C, an unrelated corporation. Prior to P's sale of toys to C for \$2,000, D, a wholly-owned Country X subsidiary of C, borrows \$3,000 from FS1. The loan from FS1 to D would not have been made or maintained on the same terms but for C's purchase of toys from P. Two-thirds of the income derived by FS1 from the loan to D is interest income described in paragraph (a)(1) of this section.

Example 2. P, a domestic corporation, owns all of the outstanding stock of FS1, a controlled foreign corporation organized under the laws of Country X. FS1 has accumulated cash reserves. P has uncollected trade and service receivables of foreign obligors. FS1 makes a \$1,000 loan to U, a foreign corporation that is unrelated to P or FS1. U purchases P's trade and service receivables for \$2,000. The loan would not have been made or maintained on the same terms but for U's purchase of P's receivables. The income derived by U from the receivables is not interest income within the meaning of paragraph (a) of this section. However, the interest paid by U to FS1 is interest income described in paragraph (a)(1) of this section.

Example 3. The facts are the same as in Example (2), except that U is a wholly-owned Country Y subsidiary of FS1. Because U is related to P within the meaning of paragraph (b)(2) of this section, under paragraph (c)(1) of this section, income derived by U from P's receivables is interest income described in paragraph (a)(1) of this section. In addition, the income derived by FS1 from the loan to U is interest income described in paragraph (a)(1) of this section.

(d) *Same country exception*—(1) *Income from trade or service receivables.* Income derived from a trade or service receivable acquired from a related person shall not be treated as interest income described in paragraph (a)(1) of this section if:

(i) The person acquiring the trade or service receivable and the related person are created or organized under the laws of the same foreign country;

(ii) The related person has a substantial part of its assets used in its trade or business located in such foreign country; and

(iii) The related person would not have derived foreign base company income, as defined in section 954(a) and the regulations thereunder, or income

effectively connected with a United States trade or business from such receivable if the related person had collected the receivable.

For purposes of paragraph (d)(1)(ii) of this section, the standards contained in §1.954-2(e) shall apply in determining the location of a substantial part of the assets of a related person. For purposes of paragraph (d)(1)(iii) of this section, a determination of whether the related person would have derived foreign base company income shall be made without regard to the de minimis test described in section 954(b)(3)(A). The following examples illustrate the application of this paragraph (d)(1).

Example 1. FS1, a controlled foreign corporation incorporated under the laws of Country X, owns all of the outstanding stock of FS2, which is also incorporated under the laws of Country X. FS1 has a substantial part of its assets used in its business in Country X. FS1 manufactures and sells toys for use in Country Y. The toys sold are considered to be manufactured in Country X under §1.954-3(a)(2). FS1 is not considered to have a branch or similar establishment in Country Y that is treated as a separate corporation under section 954(d)(2) and §1.954-3(b). Thus, gross income derived by FS1 from the toy sales is not foreign base company sales income. FS1 takes back receivables without stated interest from its customers. FS1 assigns those receivables to FS2. The income derived by FS2 from the receivables of FS1 is not interest income described in paragraph (a)(1) of this section, because it satisfies the same country exception under paragraph (d)(1) of this section.

Example 2. The facts are the same as in Example 1, except that the toys sold by FS1 are purchased from FS1's U.S. parent and are sold for use outside of Country X. Thus, any income derived by FS1 from the sale of the toys would be foreign base company sales income. Therefore, income derived by FS2 from the receivables of FS1 is interest income described in paragraph (a)(1) of this section. FS2 is considered to derive interest income from the receivable even if, solely by reason of the de minimis rule of section 954(b)(3)(A), FS1 would not have derived foreign base company income if FS1 had collected the receivable.

(2) *Income from financing arrangements.* Income derived by a controlled foreign corporation from a loan to a person that purchases inventory property or services of a person that is related to the controlled foreign corporation, or from other loans described in

paragraph (c)(3)(iv) of this section, shall not be treated as interest income described in paragraph (a)(1) of this section if:

(i) The person providing the financing and the related person are created or organized under the laws of the same foreign country;

(ii) The related person has a substantial part of its assets used in its trade or business located in such foreign country; and

(iii) The related person would not have derived foreign base company income or income effectively connected with a United States trade or business:

(A) From the sale of inventory property or services to the borrower or from financing the borrower's purchase of inventory property or services, in the case of a loan to the purchaser of inventory property or services of a related person; or

(B) From collecting amounts due under the receivable or from financing the purchase of the receivable, in the case of a loan to the purchaser of a trade or service receivable of a related person.

For purposes of paragraph (d)(2)(ii) of this section, the standards contained in § 1.954-2(e) shall apply in determining the location of a substantial part of the assets of a related person. For purposes of paragraph (d)(2)(iii) of this section, a determination of whether the related person would have derived foreign base company income shall be made without regard to the de minimis test described in section 954(b)(3)(A). The following examples illustrate the application of this paragraph (d)(2).

Example 1. FS1, a controlled foreign corporation incorporated under the laws of Country X, owns all of the outstanding stock of FS2, which is also incorporated under the laws of Country X. FS1, which has a substantial part of its assets used in its business located in Country X, manufactures and sells toys for use in Country Y. The toys sold are considered to be manufactured in Country X under § 1.954-3(a)(2). FS1 is not considered to have a branch or similar establishment in Country Y that is treated as a separate corporation under section 954(d)(2) and § 1.954-3(b). Thus, the gross income derived by FS1 from the toy sales is not foreign base company sales income. FS2 makes a loan to FS3, a wholly-owned subsidiary of FS1 which is also incorporated under the laws of Country X, in connection with FS3's purchase of toys

from FS1. FS3 does not earn any subpart F gross income. Thus, FS1 would not have derived foreign personal holding company interest income if FS1 had made the loan to FS3, because the interest would be covered by the same country exception of section 954(c)(3). Therefore, the income derived by FS2 from its loan to FS3 is not treated as interest income described in paragraph (a)(1) of this section, because it satisfies the same country exception under paragraph (d)(2) of this section. Such income is also not treated as foreign personal holding company income described in section 954(c)(1)(A) because the same country exception of section 954(c)(3) also applies to the interest actually derived by FS2 from its loan to FS3.

Example 2. FS1, a controlled foreign corporation incorporated under the laws of Country X, owns all of the outstanding stock of FS2, which is also incorporated under the laws of Country X. FS1 purchases toys from its U.S. parent and resells them for use outside of Country X. As part of a sales transaction, FS1 takes back trade receivables. FS2 makes a loan to U, an unrelated corporation, to finance U's purchase of FS1's trade receivables. Because FS1 would have derived foreign base company income if FS1 had collected the receivables or made the loan itself, the same country exception of paragraph (d)(2) of this section does not apply. Accordingly, under paragraph (c)(3)(iv) of this section, the income derived by FS2 from its loan to U is treated as interest income described in paragraph (a)(1) of this section.

(e) *Special rules*—(1) *Foreign personal holding companies and controlled foreign corporations.* For purposes of sections 551-558 (relating to foreign personal holding companies), the exclusion provided by section 552(c) for interest described in section 954(c)(3)(A) shall not apply to income described in paragraph (a)(1) of this section. For purposes of the sections 951-964 (relating to controlled foreign corporations), income described in paragraph (a)(1) of this section shall be included in a United States shareholder's pro rata share of a controlled foreign corporation's subpart F income without regard to the de minimis rule under section 954(b)(3)(A). However, income described in paragraph (a)(1) of this section shall be included in the computation of a controlled foreign corporation's foreign base company income for purposes of applying the de minimis rule under section 954(b)(3)(A) and the more than 70 percent of gross income test under section 954(b)(3)(B). In addition, income

described in paragraph (a)(1) of this section shall be considered to be subpart F income without regard to the exclusions from foreign base company income provided by section 954(c)(2)(B) (relating to export financing interest derived in the conduct of a banking business) and section 954(c)(3)(A)(i) (relating to certain interest income received from related persons).

(2) *Foreign tax credit.* Income described in paragraph (a)(1) of this section shall be considered to be interest income for purposes of the section 904 foreign tax credit limitation and is not eligible for the exceptions for export financing interest provided in section 904(d)(2) (A)(iii)(II), (B)(ii), and (C)(iii). In addition, such income will be subject to the look-through rule for subpart F income set forth in section 904(d)(3) without regard to the de minimis exception provided in section 904(d)(3)(E).

(3) *Possessions corporations*—(i) *Limitation on credit.* Income described in paragraph (a)(1) of this section shall not be treated as income described in section 936(a)(1) (A) or (B) unless the income is considered under the principles of § 1.863-6 to be derived from sources within the possessions. Thus, the credit provided by section 936 is not available for income described in paragraph (a)(1) of this section unless the obligor under the receivable is a resident of a possession. In the case of a loan described in section 864(d)(6), the credit provided by section 936 is not available for income described in paragraph (a)(1) of this section unless the purchaser of the inventory property or services is a resident of a possession.

(ii) *Eligibility determination.* Notwithstanding the limitation on the availability of the section 936 credit for income described in paragraph (a)(1) of this section, if income treated as interest income under paragraph (a)(1) of this section is derived from sources within a possession (determined without regard to this section), such income shall be eligible for inclusion in a corporation's gross income for purposes of section 936(a)(2)(A). If such income is derived from the active conduct of a trade or business within a possession (determined without regard to this section), such income shall be eligible for

inclusion in a corporation's gross income for purposes of section 936(a)(2)(B). (These rules apply for purposes of determining whether a corporation is eligible to elect the credit provided under section 936(a).)

(iii) *Example.* The following example illustrates the application of paragraph (e)(3) of this section.

Example. Corporation X is operating in a possession as a possessions corporation. In 1985, X earned \$50,000 from the active conduct of a business in the possession, including \$5,000 from trade or service receivables acquired from a related party. Obligors under the receivables acquired by X are not residents of the possession. Corporation X also earned \$20,000 from activities other than its active conduct of business in the possession. The \$5,000 derived by X from the receivables is not eligible for the section 936 credit. However, the \$5,000 may be used by X to meet the percentage tests under section 936(a)(2) to the extent that such income is considered to be derived from sources within the possession (for purposes of section 936(a)(2)(A)) or is considered to be derived from the active conduct of a trade or business in the possession (for purposes of section 936(a)(2)(B)), in either case determined without regard to the characterization of such income under this section.

(f) *Effective date.* The provisions of this section shall apply with respect to accounts receivable and evidences of indebtedness transferred after March 1, 1984 and are effective June 14, 1988.

[T.D. 8209, 53 FR 22166, June 14, 1988]

§ 1.865-1 Loss with respect to personal property other than stock.

(a) *General rules for allocation of loss*—(1) *Allocation against gain.* Except as otherwise provided in § 1.865-2 and paragraph (c) of this section, loss recognized with respect to personal property shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which gain from a sale of such property would give rise in the hands of the seller. For purposes of this section, loss includes bad debt deductions under section 166 and loss on property that is marked-to-market (such as under section 475) and subject to the rules of this section. Thus, for example, loss recognized by a