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US Inbound Corner

Factoring of receivables for US inbound companies

Factoring of accounts receivable involves an Operating Company selling its third-party accounts receivable to a financial intermediary (the "Factoring Company"). The price paid by the Factoring Company for the receivables is at a discount from the receivables' face value, after taking into account a number of factors (as described in the article herein).

While the cost-benefit of factoring receivables varies by company, in certain instances, an inbound US operating company may consider factoring its third-party receivables to a foreign affiliate, due to the potential operational, treasury, and other benefits of the arrangement. This article discusses some of the potential benefits, considerations, and analyses associated with implementing intercompany cross-border accounts receivable factoring arrangements.

In this edition

Factoring of receivables for US inbound companies

Tax News & Views podcasts

Calendars to watch

Potential benefits

Improved cash flow predictability, increased working capital, and mitigated credit risk
Since many businesses issue third-party invoices with payment terms of 30 days or longer, a common benefit of factoring involves quicker and more predictable cash flow. Selling the US third-party receivables to a Factoring Company can accelerate the cash flow, without the Operating Company needing to add debt to its balance sheet. The sale of accounts receivable typically occurs at a discount off face value, best approximated by annual net sales for many companies. The discount rate depends on the number of days such third-party

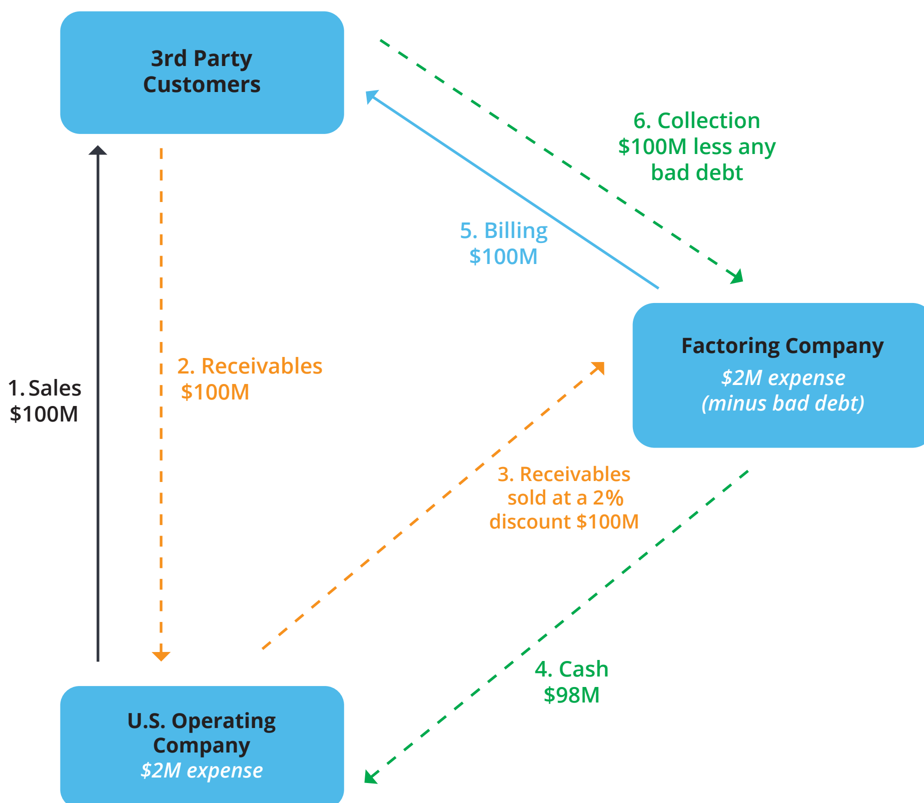
receivables tend to remain outstanding, the credit risk embedded in the receivables (i.e., the likelihood that customers may not pay), and the cost of undertaking the billing and collection function.

With improved cash flow, companies may also be better positioned to build up capital reserves for growth. Improved cash flow can help protect the business against the risk of running out of cash while waiting out the credit terms on their accounts receivable. With a non-recourse factoring structure, the Factoring Company assumes the risk of credit default, thus mitigating the Operating Company's credit exposure.

Customized arrangements offer flexibility
A factoring agreement allows the Operating and Factoring Companies to agree on which receivables should be factored, and which functions and risks are sold as part of the arrangement. Typically, all responsibilities for collections of receivables become those of the Factoring Company; however, alternative arrangements can also be considered, including third-party collections, or in certain instances, the Operating Company continuing collections. In terms of credit risk transfer, as previously mentioned, the Operating and Factoring Companies may agree on an arrangement under non-recourse (typical) or with recourse (not common and may have other implications). Furthermore, other risks, such as dilution risk (i.e., risk that an amount receivable is reduced through credits or rebates to the obligor), may or may not also be sold with the receivables as part of the factoring arrangement.

Application to US affiliates of foreign-based multinationals
Factoring arrangements may be particularly persuasive for non-US affiliates of foreign-based multinationals to consider, given they are not subject to income inclusions under the US anti-deferral regimes (i.e., Subpart F or Global Intangible Low-Taxed Income [GILTI]).

Below is an illustrative example of a factoring arrangement with a 2% discount rate:



Considerations and analysis

When looking at feasibility for a factoring arrangement, it is important to consider relevant US federal income tax technical issues, including the potential application of the base erosion and anti-abuse tax (BEAT); whether withholding tax may arise; whether the factoring arrangement is treated as a sale; whether the loss on the factoring arrangement is deductible; and US trade or business considerations for the non-US Factoring Company. Additionally, consideration should be given to whether the payment may be treated as interest under section 163(j). Finally, the losses from the sale of accounts receivable between two members of a controlled group could potentially be deferred under Section 267 and the regulations thereunder. Furthermore, if the loss on the factoring arrangement exceeds certain thresholds in any single taxable year or over five taxable years, taxpayers are required to disclose the arrangement under the reportable transaction rules.

A detailed planning analysis and, ultimately, a formal factoring agreement is essential for intercompany factoring structures. Setting up an intercompany factoring arrangement for an inbound US operating company also requires proper bank account setup; a deposit account control agreement evidences the Factoring Company's control over the deposit account used in the arrangement and details both parties' financial and legal roles and responsibilities. Furthermore, the non-US-related party buying US receivables (i.e., the Factoring Company), would need to have sufficient financing and appropriate substance to operate the arrangement.

Discount rate
Discount rates can vary depending on days sales outstanding (DSO), dilution risk, credit risk of the Operating Company's customers (assuming a non-recourse sale), and billing and collection efforts. The best method rule should be applied on a facts and circumstances basis in order to select the method that will provide the

most reliable measure of an arm's-length result. All of the above-mentioned factors need to be considered when selecting and applying the best method. The use of typical transactional or profit-based transfer pricing methods to benchmark the discount rate may be appropriate in certain circumstances, but particular attention should be given to ensuring proper comparability and accounting for how long receivables tend to be outstanding and the risk associated with such receivables, which are highly impactful on the discount rate. Furthermore, special consideration should be given to non-specified transfer pricing methods, such as those that are consistent with the Standard & Poor's "Trade Receivables Criteria" publication and the IRS's Audit Technique Guide (ATG). When analyzing the discount rate on factored receivables, the following factors should be considered:

1. *Carry factor* – This is the funding component of the factoring transaction, thus compensating for the time value of money. As the Operating Company is paid by the Factoring Company for the receivables at a discount, before customer payment is collected, the Carry Factor compensates the Factoring Company for advancing the funds to the Operating Company for a period of DSO days, plus a component to account for potential variability in DSO over time.

- Being in a high-interest-rate environment (such as the one we are experiencing now) may lead to higher overall discount rates through an increase to the Carry Factor.

2. *Loss factor* – Mostly relevant in a non-recourse arrangement, this is the risk-of-loss component of the factoring transaction, providing compensation for the risk of receivables non-payment by customers. It is a function of the potential expected and unexpected losses that the Factoring Company could reasonably expect, extent of risk reduction for the Operating Company in selling the receivables to the Factoring Company, and a profit element for the Factoring Company.

3. *Dilution factor (if relevant)* – This component compensates the Factoring Company for potential decreases in the value of receivables that are not due to default or write-offs; for example, merchandise returns, volume rebates or other discounts, and pricing disputes.

***4. Servicing factor* –** This compensates for the financial responsibility associated with billing and collection functions (which could be outsourced).

Documentation

Once a factoring arrangement is in place, having adequate transfer pricing documentation in place can help both the Operating and Factoring Companies to meet the documentation requirements and demonstrate compliance with the agreement. The company should also consider the requirements under US reportable transaction rules and file appropriate tax returns for the Factoring Company.

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Deloitte Tax Accounting Conference – Orlando, FL

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- Four distinct and insightful tax accounting courses spread over five days
- The opportunity to earn up to 36 hours of CPE credits
- Networking receptions to meet and learn from your tax, accounting, and finance peers

Registration: https://www.deloitteconference.com/profile/2279032

Upcoming Dbriefs:

March 9	**Dbriefs: Navigating the complex unclaimed property environment**
1:00 PM ET	Watch
March 23	**Dbriefs: FDII compliance, documentation, and Pillar Two considerations**
1:00 PM ET	Watch
March 31	**Financial accounting and reporting for income taxes: Important updates**
1:00 PM ET	Watch

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