Coldwater Seafood Corp. v. Commissioner, 69 T. C. 966 (1978); 1978 U. S. Tax Ct. LEXIS 152

Quarterly payments made by a subsidiary to its foreign parent for the use or forbearance of money are considered interest subject to withholding tax under IRC sections 1441 and 1442.

Summary

In Coldwater Seafood Corp. v. Commissioner, the Tax Court held that quarterly payments from Coldwater, a U. S. subsidiary, to its Icelandic parent were interest under IRC sections 1441 and 1442, thus subject to a 30% withholding tax. The payments were calculated at a 6% rate on the outstanding balance of an open account for seafood purchases. Despite Coldwater's argument that these payments were reimbursements for financing costs, the court found they constituted interest due to their calculation based on the account balance. However, the court also ruled that Coldwater's failure to withhold and file returns was due to reasonable cause, not willful neglect, due to reliance on professional advice, thus exempting it from additional penalties under IRC section 6651(a).

Facts

Coldwater Seafood Corp. , a wholly owned U. S. subsidiary of the Icelandic cooperative Association of Icelandic Freezing Plants (Icelandic), purchased seafood from Icelandic and resold it in the U. S. Prior to 1963, Coldwater acted as a commission agent, but due to delayed payments, Icelandic required Coldwater to pay promptly like other importers. To facilitate this, Icelandic established a financing arrangement with the National Bank of Iceland (NBI) and Citibank, where NBI drew drafts on Citibank based on shipping documents, covering up to 85% of the invoice price. Coldwater orally agreed to pay Icelandic 6% annually on the outstanding balance of its open account, which it did quarterly from 1963 to 1969. These payments were recorded as interest and later transferred to a cost of goods sold account.

Procedural History

The Commissioner determined deficiencies in Coldwater's withholding tax and added penalties under IRC section 6651(a) for the years 1963 through 1969. Coldwater filed a petition with the U. S. Tax Court, challenging the determination that the quarterly payments were interest subject to withholding tax and arguing that its failure to file returns was due to reasonable cause, not willful neglect.

Issue(s)

1. Whether the quarterly payments made by Coldwater to Icelandic from 1963 through 1969 constituted interest under IRC sections 1441 and 1442, thus subject to a 30% withholding tax.

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2. Whether Coldwater's failure to file the required withholding tax returns and withhold the tax was due to willful neglect or reasonable cause under IRC section 6651(a).

Holding

1. Yes, because the quarterly payments were compensation for the use or forbearance of money on an open account, meeting the definition of interest under the IRC.
2. No, because Coldwater's reliance on the advice of a certified public accountant, who concluded the payments were not interest, constituted reasonable cause and not willful neglect.

Court's Reasoning

The court applied the IRC definition of interest as compensation for the use or forbearance of money, requiring an existing, valid, and enforceable obligation to pay a principal sum. The quarterly payments were calculated at a fixed rate on the outstanding balance of Coldwater's open account, which was an enforceable obligation for purchased seafood. The court rejected Coldwater's argument that the payments were reimbursements for Icelandic's financing costs, emphasizing that the payments were tied to the account balance, not Icelandic's expenses. The court also noted that both parties treated the payments as interest. For the second issue, the court found that Coldwater's reliance on professional advice, although erroneous, did not constitute willful neglect or negligence, thus satisfying the reasonable cause standard under IRC section 6651(a).

Practical Implications

This decision clarifies that payments calculated as a percentage of an outstanding account balance are likely to be considered interest for withholding tax purposes, regardless of whether they are intended to reimburse financing costs. It emphasizes the importance of the method of calculation over the underlying purpose of the payments. For legal practitioners, this case underscores the need to carefully analyze the nature of intercompany payments and to ensure compliance with withholding tax requirements. Businesses should be aware that similar financing arrangements with foreign parents may trigger withholding obligations. Subsequent cases have cited Coldwater for its definition of interest and its application of the reasonable cause standard in penalty assessments.

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