

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

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Refer Reply To:

CC:ITA:1 – PLR-120044-01

Date: September 17, 2001

In Re:

LEGEND:

X =

Y =

Z =

Group =

Dear _____ :

This letter responds to your request for a letter ruling concerning the application of section 265(a)(2) of the Internal Revenue Code to interest payments made by members of an affiliated group.

FACTS:

The facts are represented to be as follows. X is the common parent of an affiliated group of corporations that files a consolidated return. Y, a subsidiary of X, acts as a financing subsidiary for X and the other members of Group. Y provides financial services to all members of Group and its customers to facilitate the sale of Group products and services.

Group's customer's include

_____ described in § 501(c)(3), and commercial for-profit entities. Group provides products and services to _____ customers in exchange for obligations, including financing leases and conditional sale agreements, the interest on which is not included in gross income under § 103 ("Obligations"). To the extent the Obligations do not originate with Y, the Obligations are transferred by other members of Group to Y or a Y subsidiary.

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Transfer of the Obligations is restricted. The Obligations may not be assigned, transferred or sold, except to another member of Group. Transfers of the Obligations outside Group are permitted, however, in the event of the customer's or issuer's insolvency or bankruptcy, or in the event of extended default (*i.e.*, 90 days).

An important consideration for many of Group's customers when making a purchase decision is Group's ability to provide the financing related to the purchase of products and services. Y or another member of Group can provide greater flexibility by

Members of Group, including Y, obtain capital from third-party lenders. Y and Y subsidiaries also obtain funds by borrowing money from other members of Group. No member of Group, other than Z, is a . You represent that Z will not hold any of the Obligations described in this request.

RULINGS REQUESTED:

You have requested that we rule as follows:

- (1) Rev. Proc. 72-18, 1972-1 C.B. 740, applies to determine whether loans made by third-party lenders to members of Group are directly or indirectly incurred to provide funds for such members of Group to purchase or carry tax-exempt obligations;
- (2) Rev. Proc. 72-18 applies to determine whether loans made by a member of Group to Y or a Y subsidiary are directly or indirectly incurred to provide funds for Y or that Y subsidiary to purchase or carry tax-exempt obligations; and,
- (3) In applying § 3.05 of Rev. Proc. 72-18 with respect to loans made to a member of Group, tax-exempt obligations acquired by a member of Group in the ordinary course of business in payment for services performed for, or goods supplied to, state or local governments, which cannot by their terms be resold will not be included in the amount of tax-exempt obligations considered to be held by such member of Group.

LAW AND ANALYSIS:

Section 265(a)(2) provides that interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations is not deductible.

Rev. Proc. 72-18 provides guidelines for the application of § 265(a)(2). Section 3.01 of the revenue procedure provides that the application of § 265(a)(2) requires a determination, based on all the facts and circumstances, as to the taxpayer's purpose

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in incurring or continuing each item of indebtedness. Such purpose may be established either by direct or indirect evidence.

Section 3.02 of Rev. Proc. 72-18 provides that direct evidence of a purpose to purchase tax-exempt obligations exists when the proceeds of indebtedness are used for, and are directly traceable to, the purchase of tax-exempt obligations.

Section 3.04 of Rev. Proc. 72-18 provides that in the absence of direct evidence linking indebtedness with the purchase or carrying of tax-exempt obligations, § 265(a)(2) will apply only if the totality of the facts and circumstances supports a reasonable inference that the purpose to purchase or carry tax-exempt obligations exists.

Section 3.05 of Rev. Proc. 72-18 provides that generally, when a taxpayer's investment in tax-exempt obligations is insubstantial, the purpose to purchase or carry tax-exempt obligations will not ordinarily be inferred in the absence of direct evidence. In the case of a corporation that is not a dealer in tax-exempt obligations, an investment in tax-exempt obligations shall be presumed insubstantial only if during the taxable year the average amount of the tax-exempt obligations (valued at their adjusted basis) does not exceed two percent of the average assets (valued at their adjusted basis) held in the active conduct of the trade or business.

Section 6.03 of Rev. Proc. 72-18, as modified by Rev. Proc. 87-53, 1987-2 C.B. 669, provides that the required relationship (*i.e.*, the purpose to use borrowed funds to purchase or carry tax-exempt obligations) will generally not be present when the taxpayer is unable to sell holdings of tax-exempt obligations acquired in the ordinary course of business in payment for services performed for, or goods supplied to, state or local governments.

CONCLUSIONS:

- (1) The rules of Rev. Proc. 72-18 apply in determining whether loans made by third-party lenders to members of Group are directly or indirectly incurred to provide funds for such members of Group to purchase or carry tax-exempt obligations.
- (2) The rules of Rev. Proc. 72-18 apply in determining whether loans made by a member of Group to (i) Y are directly or indirectly incurred to provide funds for Y to purchase or carry tax-exempt obligations or (ii) a Y subsidiary are directly or indirectly incurred to provide funds for that Y subsidiary to purchase or carry tax-exempt obligations.
- (3) With respect to loans made to a member of Group, tax-exempt obligations acquired by a member of Group in the ordinary course of business in payment for services performed for, or goods supplied to, state or local governments, § 501(c)(3) organizations, or other entities qualifying as recipients as tax-exempt financing under § 103, which cannot by their terms be resold, will not be included in the

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amount of tax-exempt obligations considered to be held by that member to determine whether such member's holdings of tax-exempt obligations are insubstantial under § 3.05 of Rev. Proc. 72-18.

CAVEATS:

Except as expressly provided above under CONCLUSIONS, no opinion is expressed or implied concerning the tax consequences of any aspect of any item discussed or referenced in this letter. Pursuant §§ 4.01(21) and 4.02(1) of Rev. Proc. 2001-3, 2001-1 I.R.B. 111, we express no opinion whether, for purposes of Rev. Proc. 72-18 as modified by Rev. Proc. 87-53, any Obligations held by Y or a Y subsidiary are obligations that Y or a Y subsidiary is unable to sell, or whether any such Obligations are acquired in the ordinary course of business in payment for services performed, or goods supplied to, state or local governments, § 501(c)(3) organizations, or other entities qualifying as recipients as tax-exempt financing under § 103. Except as provided in CONCLUSION (3) above, we express no opinion as to whether borrowing from third-party lenders by Y or other Group members may be for the purpose of purchasing or carrying tax-exempt obligations. See H Enterprises Int'l v. Commissioner, 105 T.C. 71 (1995), and H Enterprises Int'l v. Commissioner, T.C.M. 1998-97. In addition, notwithstanding anything set forth under CONCLUSIONS, above, no opinions are expressed regarding the tax consequences of any transactions with respect to Z. A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,
Michael J. Montemurro
Senior Technician Reviewer, Branch 4
Office of Associate Chief Counsel
(Income Tax & Accounting)

cc: