

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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CC:INTL:6--PLR-119164-98

Date:

September 14, 1999

DO: TY:

LEGEND:

Country A	=
Parent	=
Product A	=
Taxpayer	=

Dear Taxpayer:

This responds to your request dated October 7, 1998, and supplemented by letter dated May 21, 1999, for a private letter ruling concerning whether interest income may be allocated to Taxpayer under section 482 or section 7872 of the Internal Revenue Code with respect to certain advance payments made by Taxpayer for intercompany purchases under the circumstances described below.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by statement executed by an appropriate party under penalty of perjury. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

FACTS:

Taxpayer represents the following facts:

Taxpayer is the principal United States operating subsidiary of Parent, a Country A corporation engaged in research, design, manufacturing, marketing and servicing of Product worldwide. Taxpayer files a consolidated Federal income tax return, and references to Taxpayer herein include any of Taxpayer's subsidiaries joining in such consolidated return. Taxpayer uses an accrual method of accounting.

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As part of their ordinary business operations, Parent, certain of Parent's foreign subsidiaries, and Taxpayer purchase and sell to each other tangible inventory property used by the purchasing party in the manufacture of products. Parent and such foreign subsidiaries are collectively referred to as "Affiliates." The Affiliates actively conduct their business operations outside the United States. Under current procedures established by Parent, the selling party in such an intercompany transaction expresses the price charged to the purchasing party in terms of the purchaser's functional currency. For example, if a Country A Affiliate sells goods to Taxpayer, the invoice submitted to Taxpayer by the selling Affiliate is denominated in United States dollars, the functional currency of Taxpayer as purchaser. Under this practice, once the seller has submitted an invoice for an order of goods, the currency exchange risk is placed on the seller because the seller receives payments based on the value of a currency other than its functional currency.

For various business reasons, Parent plans to change its intercompany invoicing policy to denominate purchase prices in the functional currency of the seller. The new policy will have the consequence of shifting the currency exchange risk to Taxpayer with respect to its purchases of goods from Affiliates. For example, under the new policy, the price payable by Taxpayer for its purchase of goods from a Country A Affiliate would be expressed in the currency of Country A. If that currency rises in value relative to the United States dollar between the time of shipment of the goods and the time of Taxpayer's payment of the purchase price in the Country A currency, Taxpayer will have borne a loss attributable to the change in the currency exchange rate. Conversely, if the Country A currency declines in value relative to the United States dollar between the times of shipment and payment, Taxpayer will have enjoyed a currency gain.

To mitigate the impact of the shift of currency exchange risk, and in lieu of maintaining a currency hedging program, Taxpayer has proposed to enter into an advance payment agreement with Parent on behalf of each Affiliate. This agreement generally provides that the purchasing party in an intercompany sale of goods may, at its option, make an advance payment of the purchase price at any time after all of the following events have occurred: (1) the order has been placed; (2) assembly, production or manufacturing of the goods on order has begun; (3) the seller has issued an invoice to the purchaser; and (4) the seller has provided the purchaser a current shipping schedule indicating that the goods are expected to be provided to the purchaser by a date that is within three and one-half (3½) months after the date the advance payment is to be made. The advance payment option is intended to allow the purchaser to evaluate the most appropriate time to make payments for purchases based on factors such as anticipated changes in currency exchange rates, prevailing interest rates and available cash balances.

Advance payments under the proposed agreement are non-refundable. In the event that the purchaser seeks to cancel an order for which an advance payment has

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been made, the advance payment shall be applied first to any negotiated costs of cancellation, with any remaining portion of the advance payment to be applied to outstanding orders of goods reasonably expected to be provided within 3½ months of the date of cancellation. The proposed agreement contains no provision for payment of interest on advance payments.

Additional representations by Taxpayer are indicated where appropriate in the analysis that follows.

LAW AND ANALYSIS:

Section 482

Section 482 of the Code provides, in pertinent part:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Section 1.482-2(a)(1)(i) of the Income Tax Regulations provides that, where a member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group and either charges no interest, or charges interest at a rate which is not equal to an arm's length rate of interest, the district director may make appropriate allocations to reflect an arm's length rate of interest for the use of such loan or advance.

Section 1.482-2(a)(1)(ii)(A)(2) specifies that among the kinds of indebtedness to which section 1.482-2(a) applies is bona fide indebtedness arising in the ordinary course of business from sales, leases, or the rendition of services by or between members of the group of controlled entities, or any other similar extensions of credit.

Section 1.482-2(a)(1)(iii)(A) provides that the period for which interest shall be charged with respect to bona fide indebtedness between controlled entities begins on the day after the day the indebtedness arises and ends on the day the indebtedness is satisfied (whether by payment, offset, cancellation, or otherwise).

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Section 1.482-2(a)(1)(iii)(A) also recognizes certain alternative periods, referred to as interest-free periods, during which interest is not required to be charged on indebtedness described in section 1.482-2(a)(1)(ii)(A)(2) (relating to bona fide indebtedness incurred in the ordinary course of business from sales, services, etc., between members of the group) and not evidenced by a written instrument requiring the payment of interest. These amounts of indebtedness subject to interest-free periods are referred to as intercompany trade receivables.

Section 1.482-2(a)(1)(iii)(A) further provides that, in general, an intercompany trade receivable arises at the time economic performance occurs, within the meaning of section 461(h) of the Code and the regulations thereunder, with respect to the underlying transaction between controlled entities.

Section 1.482-2(a)(1)(iii)(B) provides generally that interest is not required to be charged on an intercompany trade receivable until the first day of the third calendar month following the month in which the intercompany trade receivable arises.

Section 1.482-2(a)(1)(iii)(C) provides that in the case of an intercompany trade receivable arising from a transaction in the ordinary course of a trade or business which is actively conducted outside the United States by the debtor member, interest is not required to be charged until the first day of the fourth calendar month following the month in which such intercompany trade receivable arises.

Section 1.482-2(a)(3) provides generally that, if an interest income adjustment may be made under both section 482 and any other Code section, section 482 applies after application of the other Code section.

Sections 461(h)(2)(A)(ii) and 1.461-4(d)(2)(i) provide that if the liability of the taxpayer arises out of the providing of services or property to the taxpayer by another person, economic performance occurs as the services or property is provided.

Section 1.461-4(d)(6)(ii) provides that a taxpayer is permitted to treat services or property as provided to the taxpayer as the taxpayer makes payment to the person providing the services or property, if the taxpayer can reasonably expect the person to provide the services or property within 3½ months after the date of payment.

Section 1.461-4(d)(6)(iii) provides that a taxpayer is permitted to treat property as provided to the taxpayer when the property is delivered or accepted, or when title passes.

In Rev. Rul. 82-135, 1982-2 C.B. 104, the Service held that no interest allocation under section 482 should be made to a domestic corporation that chose to protect itself from currency exchange risk by making advance payments for merchandise purchased from a related foreign corporation. Under a former version of section 1.482-2, the Service found that the indebtedness represented by the advance payments arose in the

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ordinary course of business and resulted in no interest allocation because the advance payment was offset by orders of merchandise shipped to the domestic corporation within the then-applicable period (6 months) that the Treasury Regulations provided as free of interest.

Taxpayer has represented that indebtedness arising from advance payments made by Taxpayer or an Affiliate pursuant to the proposed agreement will constitute indebtedness arising in the ordinary course of business from sales of goods by or between members of the group of controlled entities comprising Taxpayer and the Affiliates, within the meaning of section 1.482-2(a)(1)(ii)(A)(2). Based on Taxpayer's representation, intercompany trade receivables subject to an interest-free period will arise under section 1.482-2(a)(1)(iii)(A) at the time economic performance occurs with respect to the purchaser's underlying obligation to pay for the goods ordered.

The purchaser's payment obligation arises out of the providing of property to the purchaser by the seller. Accordingly, under sections 461(h)(2)(A)(ii), 1.461-4(d)(2)(i) and 1.461-4(d)(6)(iii), economic performance would ordinarily occur at the time that the selling party provides the ordered goods to the purchasing party by delivery or title passage. However, under the special rule of section 1.461-4(d)(6)(ii), property may be treated as provided to the purchaser as payment is made to the seller if there is a reasonable expectation that the goods will be provided within 3½ months after the date of payment. Taxpayer has represented that it is reasonably expected that goods will be provided within the meaning of section 1.461-4(d)(6)(iii) to the purchasing party within 3½ months after any advance payment is made for such goods. Additionally, the terms of the proposed agreement generally would not contemplate an advance payment to be made unless the parties reasonably expect such goods to be provided within such 3½-month period. Therefore, economic performance will occur at the time of the advance payment. Accordingly, based on Taxpayer's representations, intercompany trade receivables will arise at the time of advance payments by the purchaser.

Provided that the Affiliates' sales of goods to Taxpayer pursuant to the proposed agreement are transactions in the ordinary course of the Affiliates' trade or business actively conducted outside the United States, the interest-free period of an intercompany trade receivable arising upon an advance payment by Taxpayer for such a purchase will be determined under section 1.482-2(a)(1)(iii)(C). Such interest-free period will end on the last day of the third calendar month following the month of the advance payment. If the Affiliate has not provided the goods to Taxpayer by that date, interest income may be allocated to Taxpayer as of the first day of the fourth month following the month of the advance payment.¹

¹ In the event an order subject to an advance payment is canceled, and assuming the advance payment was reasonably expected to be satisfied by provision of the goods within 3½ months, the intercompany trade receivable and interest-free period

Section 7872

Section 7872 of the Code recharacterizes certain below-market loans described in section 7872(c)(1) of the Code as two transactions: (1) a loan at the applicable Federal rate; and (2) a transfer from the lender to the borrower in an amount sufficient to fund the borrower's payments of interest at the applicable Federal rate.

Section 7872(c)(1)(C) provides that section 7872 applies to any below-market loan directly or indirectly between a corporation and a shareholder of such corporation.

Section 7872(c)(1)(D) provides that section 7872 applies to any below-market loan one of the principal purposes of the interest arrangements of which is the avoidance of any Federal tax.

Section 1.7872-5T(a)(1) of the Temporary Income Tax Regulations provides that section 7872 does not apply to the kinds of indebtedness listed in section 1.7872-5T(b) because the interest arrangements do not have a significant effect on the Federal tax liability of the borrower or the lender. However, section 1.7872-5T(a)(2) provides that if a taxpayer structures a transaction as a loan exempt under section 1.7872-5T(b) and one of the principal purposes of so structuring the transaction is the avoidance of Federal tax, then the transaction will be recharacterized as a tax avoidance loan described in section 7872(c)(1)(D).

Section 1.7872-5T(b)(12) provides that indebtedness subject to section 482 is exempt from the application of section 7872 during the interest-free period, if any, determined under section 1.482-2(a)(1)(iii) with respect to intercompany trade receivables described in section 1.482-2(a)(1)(ii)(A)(2).

Taxpayer has represented that the proposed advance payments are to be made as part of an arrangement entered into by Taxpayer and the Affiliates for the purpose of mitigating the impact of a shift of currency exchange risk as a consequence of a change of intercompany invoicing policy adopted by Parent. Based on this representation, indebtedness resulting from such advance payments is not structured with a principal purpose of tax avoidance and will not be recharacterized under section 1.7872-5T(a)(2) as tax avoidance loans described in section 7872(c)(1)(D) .

will continue, notwithstanding the cancellation, to the extent that the advance payment is applied to outstanding orders for goods reasonably expected to be provided within 3½ months of the date of the advance payment. The interest-free period will not be extended beyond its expiration date as originally established. The intercompany trade receivable will be satisfied when goods are provided under the substitute outstanding order to which the advance payment was applied.

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As discussed above, and based on Taxpayer's representations, advance payments pursuant to the proposed agreement will give rise to intercompany trade receivables described in section 1.482-2(a)(1)(ii)(A)(2) with an interest-free period determined under section 1.482-2(a)(1)(iii)(C). Accordingly, such indebtedness will be exempt under section 1.7872-5T(b)(12) from the application of section 7872 during the interest-free period.

CONCLUSIONS:

Based solely on the information submitted and the representations made, we rule as follows:

(1) Intercompany trade receivables within the meaning of section 1.482-2(a)(1)(iii) will arise upon the making of advance payments pursuant to the proposed agreement.

(2) The interest-free period for an intercompany trade receivable arising from an advance payment made by Taxpayer to an Affiliate pursuant to the proposed agreement will be determined under section 1.482-2(a)(1)(iii)(C) and thus will end with the third calendar month following the month of the advance payment. Interest income may be allocated to Taxpayer beginning on the first day of the fourth month following the month of the advance payment.

(3) Under section 1.7872-5T(b)(12), advance payments made pursuant to the proposed agreement will be exempt from the application of section 7872 during the interest-free period of intercompany trade receivables arising from such advance payments.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item, including but not limited to (1) the effect, if any, of an advance payment and of the concomitant shift of currency exchange risk on the appropriate transfer price in transactions between Taxpayer and Affiliates; (2) the tax consequences of any transaction between parties other than Taxpayer and Affiliates; and (3) whether any advance payment or other transaction is properly characterized as creating indebtedness for Federal income tax purposes under the principles of such court decisions as Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990), or otherwise.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

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A copy of this letter must be attached to any income tax return to which it is relevant.

Sincerely,

Steven A. Musher
Chief, Branch 6
Office of Associate Chief Counsel
(International)

cc: District Director,
Attn: Chief, Examination Division

Assistant Commissioner (International)
Attn: Director, Office of International Programs OP:IN:I