

Internal Revenue Service

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Attn:

Department of the Treasury

Washington, DC 20224

Person to Contact:

Identifying Number:

Telephone Number:

Refer Reply To:

CC:DOM:IT&A:2 – PLR-122716-98

Date: August 4, 1999

Legend:

Parent =

X =

Group =

Dear Sir or Madam:

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

FACTS

Parent is the common parent of an affiliated group of corporations that files a consolidated return. X, a subsidiary of Parent, acts as a financing subsidiary for Parent and the other members of the Group. X's primary mission is to provide financial services to all members of the Group and its customers to facilitate the sale of Group products and services. X provides the means for the Group's customers to obtain products and services through long-term leasing or financing.

The Group's customers include various state and local governmental units. The Group will provide products and services to governmental units in exchange for tax-exempt obligations in the form of financing leases. Each lease will relate to property or services with respect to which, under state law, the governmental unit is the lessee and a Group member is the lessor. Parent represents that each lease will constitute a loan (or an installment sale) for federal income tax purposes, and that each lease will qualify as a tax-exempt obligation under § 103. To the extent the leases are not originated with X as lessor, the leases, immediately upon execution, will be transferred by the other members of the Group to X. No member of the Group is a dealer in tax-exempt obligations.

X will acquire the tax-exempt obligations (i.e., the financing leases) (i) in payment for providing products and services that are exclusively those of the Group to governmental units, (ii) through the financing of services and products of the Group as well as the services and products of other vendors that are being provided to governmental units as part of a larger service package, and (iii) through the financing of products that are entirely unrelated to those provided by the Group.

Members of the Group in general obtain the funds necessary to carry on their businesses from the public debt markets, retained earnings, capital contributions, and borrowings from third party, nonaffiliated members. X obtains the funds necessary to carry on its business from capital contributions, retained earnings, and borrowings from other members of the Group and third party lenders. Parent represents that none of the interest expense at issue in this ruling request can be traced directly to the purchase of tax-exempt obligations.

RULINGS REQUESTED

You have requested that we rule as follows:

- (1) In determining whether loans made by third party lenders to members of the Group are directly or indirectly incurred to provide funds for such members of the Group to purchase or carry tax-exempt obligations, the rules of Rev. Proc. 72-18, 1972-1 C.B. 740, will be applicable.
- (2) In determining whether loans made by a member of the Group to X are directly or indirectly incurred to provide funds for X to purchase or carry tax-exempt obligations, the rules of Rev. Proc. 72-18 will be applicable.
- (3) For purposes of determining whether a Group member's investment in tax-exempt obligations is insubstantial under § 3.05 of Rev. Proc. 72-18, only the tax exempt obligations directly held by that member will be taken into account.
- (4) In applying § 3.05 of Rev. Proc. 72-18 with respect to loans made to X, tax-exempt obligations acquired in it the ordinary course of business in payment for services performed for, or goods supplied to, governmental units that cannot by their terms be resold will not be included in the amount of tax-exempt obligations that are considered to be held by X .
- (5) If the interest deductions of X with respect to loans made by other members of the Group are disallowed under § 265, the intercompany income derived from the loans made to X by such other members will be redetermined to be excluded from the gross income of such other members under § 1.1502-13(c)(6)(ii)(A) of the Income Tax Regulations.

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, 1972-1 C.B. 740, sets forth 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 in incurring or continuing each item of indebtedness. Such purpose may be established either by direct or circumstantial evidence.

Section 3.02 of the revenue procedure 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 the revenue procedure 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 facts and circumstances supports a reasonable inference that the purpose to purchase or carry tax-exempt obligations exists.

Section 3.05 of the revenue procedure provides that generally, when a taxpayer's investment in tax-obligations is insubstantial, the purpose to purchase or carry tax-exempt obligations will not ordinarily be inferred in the absence of direct evidence. For 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 2 percent of the average total 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.

Section 1.1502-12 requires that, with certain exceptions not relevant here, each corporation included in a consolidated return compute its income "in accordance with the provisions of the Code covering the determination of taxable income of separate corporations."

Section 1.1502-13(c)(6)(ii)(A), which applies generally with respect to transactions occurring in years beginning on or after July 12, 1995, provides with regard to interest on intercompany debt that a lending member's intercompany item is redetermined to be excluded from gross income to the extent that the borrowing member's corresponding item is a deduction and, in the taxable year the item is taken into account, it is permanently and explicitly disallowed. For example, deductions that are disallowed under § 265 of the Code are permanently and explicitly disallowed.

Under § 1.1502-12, each member of the group is required to determine its taxable income in accordance with the provisions of the Code, with certain exceptions there listed. The exceptions do not include § 265. In order to apply the provisions of § 265(a)(2), each member is required to apply Rev. Proc. 72-18, including § 3.05.

CONCLUSIONS

(1) In determining whether loans made by third party lenders to members of the Group are directly or indirectly incurred to provide funds for such members of the Group to purchase or carry tax-exempt obligations, the rules of Rev. Proc. 72-18 will be applicable.

(2) In determining whether loans made by a member of the Group to X are directly or indirectly incurred to provide funds for X to purchase or carry tax-exempt obligations, the rules of Rev. Proc. 72-18 will be applicable.

(3) For purposes of determining whether a Group member's investment in tax-exempt obligations is insubstantial under § 3.05 of Rev. Proc. 72-18, only the tax exempt obligations directly held by that member will be taken into account.

(4) In applying § 3.05 of Rev. Proc. 72-18, with respect to loans made to X, tax-exempt obligations acquired in the ordinary course of business by X in payment for services performed for, or goods supplied to, governmental units that cannot by their terms be resold will not be included in the amount of tax-exempt obligations that are considered to be held by X.

(5) If the interest deductions of X with respect to loans made by other members of the Group are disallowed under § 265, the intercompany income derived from the loans made to X by such other members will be redetermined to be excluded from the gross income of such other members under § 1.1502-13(c)(6)(ii)(A).

Caveats:

A copy of this letter must be attached to any income tax return to which it is relevant. Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in

this letter. Specifically, we express no opinion as to whether borrowing from third party lenders by X or by other Group members may be for the purpose of purchasing or carrying of tax-exempt obligations by X. See H Enterprises Int'l v. Commissioner, 105 T.C. 71 (1995), and H Enterprises Int'l v. Commissioner, T.C.M. 1998-97.

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

Sincerely,

Assistant Chief Counsel
(Income Tax & Accounting)

By _____
Robert A. Berkovsky
Chief, Branch 2