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Internal Revenue Service

Department of the Treasury

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Washington, D.C. 20224

Person to Contact:

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Refer Reply To:
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Date: July 27, 1999

Taxpayer =

US1 =

F1 =

F2 =

Country A =

Country B =

L1 =

L2 =

Date A =

Date B =

Date C =

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Date D =

Year A =

Year B =

X =

Y =

Amount A =

Amount B =

Amount C =

Amount D =

Amount E =

Amount F =

Amount G =

Product A =

Product B =

This is in response to your letter, dated August 10, 1998, requesting a ruling as to whether payments made pursuant to the terms of a bankruptcy plan are subject to withholding under Section 1442 of the Internal Revenue Code. The information you submitted for consideration is summarized below.

The ruling contained in this letter is predicated upon the facts and representations submitted and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the ruling request. Verification of the factual information, representations, and other data may be

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required as part of the audit process.

I. FACTS

On Date A, US1, a domestic corporation, agreed to purchase all the issued and outstanding stock of Taxpayer. At the time, US1 was, and still is, a wholly owned subsidiary of F2, a corporation organized under the laws of Country A. In turn, F2 was, and still is, a wholly owned subsidiary of F1, a limited liability corporation organized under the laws of Country B. The acquisition was financed through a syndicate of banks and finance companies, including L1, as both lender and agent, and L2, under the terms of two agreements dated Date B. This syndicate is collectively referred to as "Lenders."

From 1989 to the mid-1990s, F1 sold Product A to Taxpayer for conversion into Product B in the United States. The sales were made pursuant to a supply agreement dated Date A (the "Supply Agreement"). The Lenders were contractual third party beneficiaries of the agreement. With regard to payment terms, the Supply Agreement provided for "payment at sight," though the parties could mutually agree on credit terms of up to 90 days. When financial circumstances rendered it difficult for Taxpayer to remit "at sight," F1 made it a practice to grant the 90 day term. Taxpayer did not execute promissory notes when F1 extended credit and, instead, reflected it on its books as "open account indebtedness." The Supply Agreement did not provide for, nor did Taxpayer pay, any stated interest on the indebtedness.

Typically, a U.S. company buying goods from a foreign vendor must post an irrevocable letter of credit (LC) as payment. However, Taxpayer's financial situation left it difficult, or impossible, to obtain an LC. Consequently, F1 generally arranged for payment by presenting Taxpayer with a bill of exchange which Taxpayer would accept ("Trade Acceptance")--thereby agreeing to pay the stated amount within the stipulated term. In effect, Taxpayer's acceptance made the bill of exchange the equivalent of a promissory note. At times, F1 would sell the Trade Acceptances, at a discount and generally with recourse to F1, to various banks located in Country B. The Trade Acceptances did not bear interest and initially carried a thirty (30) day term. However, as Taxpayer's financial condition and liquidity deteriorated, F1 gradually extended the Trade Acceptance terms to one hundred and eighty (180) days.

In light of Taxpayer's fiscal problems, the Lenders and Taxpayer amended and restated the original loan documents. Specifically, on Date C, an amended agreement was executed whereby the Lenders agreed to refrain from filing an involuntary bankruptcy petition against Taxpayer in exchange for heightened restrictions on the types of payments that Taxpayer could make. However, the amended agreement generally permitted payment to F1 for goods purchased in the ordinary course of business. Additionally, F1 gave a guaranty to the Lenders which obligated it to make capital contributions to

Taxpayer, upon demand by L1, in the event Taxpayer could not make loan payments as they matured.

Over the course of the next several years, the parties amended the loan documents two additional times. In the final amendment, the Lenders found it necessary to place restrictions on the payments from Taxpayer to F1. For example:

1) F1 agreed, unconditionally, that Taxpayer would continue to remit no more than X% of the total of all new invoiced purchases for payment on outstanding payables until such time that F1 had provided Taxpayer with Amount A of new product to be purchased by Taxpayer;

2) F1 and Taxpayer agreed to diligently pursue the refinancing of certain loans; and

3) F1 agreed to permit Taxpayer to maintain aggregate trade credit ranging from Amount B to Amount C. Further, if the loans weren't repaid by a certain date, F1 agreed to allow an aggregate trade credit of no less than Amount C.

Eventually, Taxpayer became unable to make all its payments on the outstanding Trade Acceptances. At first, F1 advised the Taxpayer the order in which to pay the outstanding acceptances. F1, as guarantor, also paid some of the Trade Acceptances that were now held by the banks.

Taxpayer's financial condition continued to deteriorate and, in Year A, it engaged an investment banker to arrange the sale of the company. In Year B, Taxpayer began negotiating the sale of substantially all its, and its subsidiaries, operating assets. (Taxpayer also owned 100% of the capital stock of three major subsidiaries.) The parties executed a formal Asset Purchase Agreement on Date D. The agreement was negotiated with the understanding that Taxpayer would promptly file a Chapter 11 bankruptcy petition. The following day, Taxpayer and its subsidiaries each filed a Chapter 11 bankruptcy petition. Taxpayer then changed its corporate name for the purpose of managing the liquidation.

Subsequently, Taxpayer's principal creditors, F1, US1, and the Lenders, entered into an Intercreditor Agreement whereby all parties agreed to, among others, support the following actions: (i) L1 providing debtor in possession financing; (ii) F1 having an allowed claim of Amount D; (iii) L2 being paid Amount E; and (iv) L1 being paid in full.

The bankruptcy court approved the terms of the Asset Purchase Agreement. Thereafter, Taxpayer and its subsidiaries filed a joint plan, which the bankruptcy court confirmed. The subsidiaries were then merged or liquidated into Taxpayer who, in turn, sold substantially all its assets, including the right to its tradename.

In connection with Taxpayer's bankruptcy proceeding, F1 filed a proof of claim alleging that Taxpayer owed Amount F relating to the extensions of credit, including: (i) amounts owed to F1 from sales to Taxpayer on open account; (ii) amounts owed to F1 under Trade Acceptances F1 reacquired as guarantor; and (iii) amounts owed directly to banks located in Country B. Though the details are admittedly unclear to Taxpayer, it appears that F1 acted on behalf of certain banks located in Country B in submitting the Amount F claim.

Taxpayer objected to the claim on the ground that it failed to account for indebtedness of F1 to Taxpayer. F1 did not oppose Taxpayer's objection and, accordingly, the bankruptcy court entered an order that reduced F1's claim to Amount D. For purposes of this ruling request, we assume that F1 will receive a distribution of Amount G under the plan, which represents Y cents on the dollar. Further, we assume that the bankruptcy claim by F1 consists of "on account" credit, Trade Acceptances it reacquired, and Trade Acceptances held by the banks in Country B.

II. RULING REQUESTED

Taxpayer requests a ruling that the amount paid to F1, pursuant to the bankruptcy plan, is not subject to withholding under section 1442 of the Internal Revenue Code (the Code).

III. LAW AND ANALYSIS

In general, section 881 of the Code imposes a tax of 30% on amounts received by a foreign corporation from sources within the United States as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodic payments. Section 1442 requires the payor to deduct and withhold the 30% imposed by section 881 at the source. The issue, here, is whether any portion of the bankruptcy claim that Taxpayer will pay to F1 is subject to tax under section 881, (i.e., whether any portion of the bankruptcy claim is original issue discount (OID) or imputed interest under sections 1274, 483, or 7872 of the Code).

To make that determination, the relevant debt instrument must first be identified. For purposes of the OID rules, section 1275(a)(1)(A) defines a debt instrument as "a bond, debenture, note, or certificate or other evidence of indebtedness." Regulation § 1.1275-1(d) further defines a debt instrument as any instrument or contractual arrangement that constitutes indebtedness under general principles of federal income tax laws.

F1's bankruptcy claim consists, in part, of various amounts owed to F1 from sales on open account credit or under negotiated and discounted Trade Acceptances reacquired by F1 as guarantor. The sales arose from an arrangement between F1 and Taxpayer by which F1 sold Product A to Taxpayer in return for deferred payment. Thus, each indebtedness, constituting the ultimate claim, represents an indebtedness issued for nonpublicly traded

property.

Given the facts, the relevant debt instrument could be viewed as either the entire contractual arrangement between F1 and Taxpayer (i.e., the Supply Agreement) or a series of individual arrangements between F1 and Taxpayer (i.e., the Trade Acceptances). Regulation § 1.1275-2(c)(1), which is generally effective for debt instruments issued after April 4, 1994, requires the aggregation of debt instruments for purposes of the OID rules where the debt instruments are issued in connection with the same transaction or series of related transactions (determined based on all the facts and circumstances). Although most of the Trade Acceptances and open account indebtedness were issued prior to this date, we believe that a general facts and circumstances test would be applied to determine whether each Trade Acceptance constitutes a separate debt instrument.

Under the terms of the Supply Agreement, payment was either due "at sight" or in accordance with the credit terms agreed upon by the parties. Therefore, the Supply Agreement permitted the extension of credit but did not, itself, evidence the extension of credit. Moreover, each Trade Acceptance was separately negotiated and contained varying credit terms, depending on Taxpayer's financial condition at the time of negotiation. Accordingly, the Trade Acceptances should not be aggregated for purposes of determining whether the debts include an OID or imputed interest component.

a. OID under § 1274 or imputed interest under § 483

Section 1274 of the Code imputes OID on certain debt instruments issued in consideration for the sale or exchange of property where some or all of the payments under the debt instrument are due more than six months after the date of the sale or exchange. Section 1274(c)(1)(B). While the regulations under section 1274 generally do not provide rules for calculating payment due dates, the regulations under section 1272, which pertain to short term debt obligations, are helpful in determining the payment due dates for the Trade Acceptances and open account indebtedness at issue. Specifically, § 1.1272-1(f)(2) provides that the maturity date of a debt instrument is the last possible date that the instrument could be outstanding under its terms.

Based on information provided by the taxpayer, none of the Trade Acceptances were extended beyond 180 days. Further, the terms of the Trade Acceptances indicate that the due dates were within six months of the sale or exchange. Because all the payments are due within six months, the Trade Acceptances and open account indebtedness are not debt instruments to which section 1274 applies.

Similarly, the Trade Acceptances are not debt instruments to which section 483 applies. The Code limits the application of section 483 to payments that are due more than six

months after the date of the sale or exchange to which they relate under a contract–

(i) under which some or all of the payments are due more than 1 year after the date of the sale or exchange, and

(ii) under which there is total unstated interest.

Again, given the information provided by the taxpayer, no payment is due more than one year from the sale or exchange. Accordingly, the Trade Acceptances and open account indebtedness are not subject to section 483.

b. Imputed interest under section 7872

Section 7872 imputes interest on certain below-market loans, such as gift loans, corporate-shareholder loans, compensation-related loans, and other tax avoidance loans. Section 7872(c)(1). A "below market loan" is defined under section 7872(c)(1) as any loan if:

(A) in the case of a demand loan, interest is payable on the loan at a rate less than the applicable Federal rate, or

(B) in the case of a term loan, the amount loaned exceeds the present value of all payments due under the loan.

In the instant case, the Trade Acceptances and open account indebtedness do not provide for any stated interest. Therefore, unless otherwise excepted, the Trade Acceptances and open account indebtedness constitute below-market loans.

Section 1.7872-5T of the temporary regulations contains a list of below-market loans that are exempt from section 7872 because the interest arrangements do not have a significant tax effect on the federal tax liability of the borrower or the lender. Specifically, under 1.7872-5T(b)(10), a below-market loan made to or from a foreign person is exempt from section 7872 provided that the requirements of paragraph (c)(2) are met. Section 1.7872-5T(c)(2) provides that:

> Section 7872 shall not apply to a below-market loan (other than a compensation-related loan or a shareholder-corporation loan where the borrower is a shareholder that is not a C corporation as defined in section 1361(a)) if the lender is a foreign person and the borrower is a U.S. person unless the interest income imputed to the foreign person (without regard to this paragraph) would be effectively connected with the conduct of a U.S. trade or business within the meaning of section 864(c) and the regulations thereunder and not exempt from U.S. taxation under a treaty.

Thus, to the extent the interest component to the debt, if any, is not effectively connected with the conduct of a U.S. trade or business, section 7872 does not apply.

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c. Amounts Paid to F1 on Behalf of Banks in Country B

The facts indicate that Taxpayer will remit a portion of the bankruptcy claim to F1 on behalf of the banks in Country B. That portion represents amounts owed to banks in Country B for the Trade Acceptances negotiated by F1 to the Banks. At the time of negotiation, F1 discounted each Trade Acceptance. Given the facts, the acquisition discount created is not subject to withholding under chapter 3 of the Code. *Cf.* § 1276(a)(4).

IV. CONCLUSION

Based on the taxpayer's representations, the terms of the "on account" credit and Trade Acceptances, and the subsequent negotiation of certain Trade Acceptances to the banks in Country B, we have determined that:

a. There is no OID or interest imputed under sections 1274 or 483 because no payment is due more than six months from the sale or exchange;

b. The "on account" credit and Trade Acceptances are considered below market loans. However, they are specifically exempted from section 7872 provided that the interest component, if any, is not effectively connected to a U.S. trade or business; and

c. The discount created, in this case, on the subsequent negotiation of the Trade Acceptances by F1 to the banks in Country B is not subject to chapter 3 withholding.

Accordingly, we conclude that, because there is no U.S. source interest or OID component to the payment from Taxpayer to F1, and the discount created by F1's subsequent negotiation of certain Trade Acceptances to the Banks in Country B is not subject to chapter 3 withholding, the entire amount paid to F1, pursuant to the bankruptcy plan, is not subject to withholding under section 1442 of the Code.

No opinion is expressed as to the income tax consequences of the transaction described above under section 482 of the Code or the regulations thereunder. This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited as precedent.

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