Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Number: **200110024**
Release Date: 3/9/2001
Index No.: 265.04-00

Person to Contact:
Marilyn E. Brookens, ID No. 50-00819
Telephone Number:
(202) 622-4920
Refer Reply To:
CC:ITA:2 – PLR-125680-00
Date: December 1, 2000

LEGEND:

X =

S =

Dear

This responds to your letter of , as supplemented by your letter of requesting a private letter ruling (PLR) under § 265(a)(2) of the Internal Revenue Code. The ruling requested is, in summary, that X's implementation of the transaction described below as it relates to certain government deferred payment agreements (DPAs) will not affect PLR 8826014, issued to X on March 30, 1988.

FACTS:

Background:

The represented facts underlying the request for the prior PLR are incorporated by reference and reiterated in abbreviated form below.

X is a publicly-held corporation organized under the laws of S and is engaged directly and through its subsidiaries in selling its products to customers, including state and local governments. Some of X's sales to customers are in the form of deferred payment transactions, with X taking back DPAs. A DPA provides for stated interest on the unpaid principal balance.

X accepts DPAs from state and local governments on terms substantially the same as those offered to other customers, except that: (1) the interest rates charged are lower to reflect that interest paid on state and local obligations is exempt from federal income tax under § 103(a)(1); and (2) government DPAs include "nonappropriation" clauses, which release a government entity from its payment obligations in the event the entity fails to receive approval for the funds necessary to meet those obligations.

In X requested a PLR under § 265(a)(2) concerning its proposed acceptance of government DPAs that contain a contractual restriction against subsequent transfer. The anti-assignment provision would bar any transfer, sale, or assignment of the DPA

to any other party. Any violation of this clause would render the contract void. X represented that it would comply with the anti-assignment clause and that the DPAs would not be pledged as security in any financing arrangement. On March 30, 1988, X received a PLR (the "prior PLR") concluding, based on the facts and representations presented, that no portion of X's deduction for interest paid or accrued will be disallowed under § 265(a)(2) because it acquires DPAs in the ordinary course of business from selling products to customers that issue obligations the interest on which is exempt under § 103(a)(1).

Additional Facts Represented by X:

In its current submission X makes the representations set forth below.

In reliance on the prior PLR X has continued to engage in transactions of the type described above. The earlier-represented facts: (1) have continued to be in effect since the issuance of the prior PLR, and (2) will continue to be in effect as to government DPAs acquired after the date the proposed transaction described below is completed.

As a result of a recent significant deterioration in its financial situation, X's normal means of obtaining funds needed for operations have become severely restricted. To obtain immediate operating funds, X is planning various transactions that it would never have considered in the past, including a proposed transaction involving the previously-described government DPAs.

X currently is the only person entitled to receive the payments of principal and interest on the government DPAs it owns. X proposes, with respect to the majority of such DPAs in its portfolio, to assign to a newly formed partnership its rights to receive all such payments of principal and interest. At the same time that X makes this assignment, unrelated investors would contribute cash to the partnership in an amount equal to approximately percent of the principal amount of the assigned DPAs. X would then immediately receive both an interest in the partnership and the contributed cash, while the investors would receive interests in the partnership.

After making the assignment, X would continue to hold the DPAs and to bill the state and local governmental purchasers in its own name. The government entities, which would continue making payments on the DPAs directly to X, will also continue to have all their rights against X with respect to the products giving rise to the DPAs. X believes that under both the law of S (which governs the vast majority of the DPAs at issue), and the laws of other states (which govern the remaining DPAs at issue), the proposed transaction does not violate the anti-assignment clause because that transaction does not affect the obligations of the government entities under the DPAs. X will remit to the partnership the principal and interest it collects on the DPAs, and the partnership (rather than X) will be reported as the owner of all rights to the collected principal and interest. With respect to principal payments on the DPAs, the unrelated investors will have the right to receive an amount equal to their original cash

contributions. The investors will also have the right, with respect to the DPA interest income received by the partnership, to receive a specified percentage rate of return on their cash contributions. X will be entitled, due to its partnership interest, to receive the balance of the DPA principal and interest.

For federal income tax purposes X will report its assignment of the collection rights to the partnership in part as a sale and in part as a contribution to capital. Under § 707(a)(2)(B) and § 1.707-3(c)(1) of the Income Tax Regulations, X will treat the assignment as a sale, at fair market value, of the portion of the DPAs' collection rights equaling the amount of cash X will receive from the partnership immediately after the assignment. X will treat its assignment of the remaining portion of the DPAs' collection rights as a contribution to capital, which will be nontaxable under § 721(a) because made in exchange for a partnership interest.

RULING REQUESTS:

X requests a ruling that implementation of the proposed transaction described above will not affect the prior PLR as to the following categories of government DPAs:

(1) Completed DPAs. These are prior-year DPAs on which all principal and interest already have been collected by X and on which X has performed all its obligations. They will not be included in the portfolio of DPAs that will be the subject of the proposed transaction.

(2) Existing DPAs that will not be included in the portfolio. Collection on these will straddle the date of the completed transaction. That is, before, during, and after the proposed transaction is implemented, X (rather than the partnership) is and will be the sole taxpayer entitled to collect, retain, and make use of the principal and interest on this category of DPAs. Only a minority of existing government DPAs are in this category.

(3) Existing DPAs that will be included in the portfolio. Collection on these will straddle the completed transaction. X will be entitled to collect, retain, and make use of all principal and interest that it collects up until immediately before the proposed transaction is completed. Immediately after the proposed transaction is completed, X will assign its rights to collect the principal and interest to the partnership in exchange for cash and a partnership interest. As to these DPAs, X requests a ruling that, with respect to X’s collection, retention, and use of all principal and interest, the prior PLR is not affected by completion of the proposed transaction.

(4) Newly created DPAs. These are DPAs that are created after the proposed transaction is completed. They will not be included in the portfolio.

X does <u>not</u> request a ruling on whether the prior PLR will be affected by the partnership's collection rights, which will exist once the proposed transaction is completed and the collection rights to principal and interest on the category (3) DPAs are assigned to the partnership.

LAW AND ANALYSIS:

Section 103(a) and (c)(1) generally exclude from gross income the interest on any state or local government obligation.

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) to certain taxpayers holding state and local obligations the interest in which is wholly exempt from federal income taxation. Section 3.04 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 where the totality of facts and circumstances establishes a sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations. Section 6.02 provides that the purpose to carry tax-exempt obligations can be inferred if a corporation continues indebtedness that it could discharge, in whole or in part, by liquidating its holdings of tax-exempt obligations.

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 will generally not be present if 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 6.03 is in the nature of a “safe harbor” provision, i.e., the inability to sell the tax-exempt obligations negates the application of § 265(a)(2).

The conclusion of the prior PLR, that X’s deduction for interest will not be disallowed by § 265(a)(2), was based on X’s business purpose in accepting the DPAs. The nonsalability of the DPAs negated the inference that X was using borrowed funds to carry tax-exempt obligations in contravention of § 265(a)(2). On the facts as represented, the prior PLR was a correct statement of IRS position.

X has represented that the only factual changes between issuance of the prior ruling and completion of the proposed transaction are those facts related to the proposed transaction itself. Accordingly, the proposed transaction has no effect on the four specific categories of government DPAs on which X has requested rulings. Because the first, second, and fourth categories of DPAs will not be included in the portfolio of those DPAs on which the collection rights are assigned to the partnership, these DPAs are governed by the prior ruling. The third category of DPAs also is governed by the March 30, 1988, ruling with respect to principal and interest collected by X prior to completion of the proposed transaction.

X has not requested a ruling concerning, nor do we rule on, the federal tax consequences, either to X or to the partnership, of the partnership’s post-transaction collection of principal and interest on those DPAs included in the portfolio.

CONCLUSION:

The implementation of the proposed transaction described in this ruling will not affect the prior ruling in PLR 8826014 with respect to the four categories of government DPAs, described above, on which X sought rulings.

CAVEATS:

This ruling is conditioned on the assignment of the collection rights to the government DPAs not violating the anti-assignment clauses of the affected DPAs.

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. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under § 6110 of the Internal Revenue Code.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any item discussed or referenced in this letter.

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

Sincerely,
Associate Chief Counsel
(Income Tax & Accounting)
By: Robert A. Berkovsky
Chief, Branch 2

Enclosures:
Copy of letter
Copy for § 6110 purposes

cc: