Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

[Third Party Communication:
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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:INTL:B02
PLR-104867-04

Date:
February 02, 2005

In Re:

Legend

A	=
B	=
C	=
D	=
M months	=
N days	=
Country X	=
Country Y	=

Dear

This is in response to your letter dated January 26, 2004, as supplemented by additional submissions dated August 18, 2004, September 13, 2004, and September 28, 2004, requesting rulings on the proper treatment of certain inter-company receivables under sections 956 and 1442 of the Internal Revenue Code.

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

FACTS

A, a U.S. corporation, is the parent of a U.S. consolidated and worldwide group, and is engaged in the production of unique products which have few, if any substitutes. These products are manufactured via a complex, unique and delicate manufacturing process that requires long lead times.

The manufacturing process is conducted in two stages. The first stage is conducted by A in the United States. A then sells the product to C, a disregarded entity owned by B, a Country X subsidiary corporation of A. C conducts the second stage of the manufacturing process at its plant in Country Y and then sells the finished product to D, a U.S. wholly-owned subsidiary corporation of A.

Due to the long lead times, the delicate nature of the manufacturing process, and the fragile and unique nature of the final product, it is necessary for D to keep an M month supply of the finished goods in its warehouse in the United States to insure against an interruption in supply. Therefore, C and D would like to extend the payment terms so that D purchases the products up front and pays for the products when they are sold M months later. D would be required to pay C interest during the interim period.

RULING REQUESTED

D requests a ruling that an obligation of D (or any member of the consolidated group of which A or its successor is the parent) held by C (or any successor to its business or operations) arising from the purchase of products produced by C in Country Y will not constitute an investment in U.S. property for purposes of section 956 to the extent that (i) the amount of such obligations does not exceed the amount of inventory held in the United States at the end of each month when D closes its books, and (ii) such obligations are not outstanding for a period exceeding M months.

D also requests a ruling that D (or any member of the consolidated group of which A or its successor is the parent) will not be required, under section 1442, to withhold federal tax at the 30 percent rate imposed by section 881(a), or lesser rate imposed by any applicable treaty, on amounts that it will pay to C (or any successor to its business or operations) which represent interest on the intercompany obligations described in the above ruling request.

LAW AND ANALYSIS

(1) Section 956

Section 951(a) requires that a U.S. shareholder of a controlled foreign corporation who owns stock in such corporation on the last day of the corporation's taxable year include in its gross income various items including "the amount determined under section 956 with respect to such shareholder for such year (but only to the extent not excluded from gross income under section 959(a)(2)). Section 951(a)(1)(B). A "controlled foreign corporation" is any foreign corporation if more than 50% of the total combined voting power of all classes of stock of such corporation entitled to vote or more than 50% of the total value of the stock of such corporation is owned, directly, indirectly or constructively, by U.S. shareholders on any day during the taxable year of such foreign corporation. Section 957(a). A U.S. shareholder is a “United States person” who owns, directly, indirectly or constructively, 10% or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. Section 951(b). A “United States person” includes a domestic corporation. Sections 957(c) and 7701(a)(30).

The amount determined under section 956 with respect to any U.S. shareholder for any taxable year is generally the excess of such shareholder’s pro rata share of the average of the amounts of U.S. property held (directly or indirectly) by the controlled foreign corporation as of the close of each quarter of such taxable year over (i) the amount of previously taxed income described in section 959(c)(1)(A) with respect to such shareholder, or (ii) such shareholder’s pro rata share of the applicable earnings of such controlled foreign corporation. Section 956(a).

U.S. property is defined to include “an obligation of a United States person.” Section 956(c)(1)(C). Section 956(c)(2), however, provides certain exceptions to the definition of U.S. property. Specifically, section 956(c)(2)(C) provides that U.S. property does not include:

> any obligation of a United States person arising in connection with the sale or processing of property if the amount of such obligation outstanding at no time during the taxable year exceeds the amount which would be ordinary and necessary to carry on the trade or business of both the other party to the sale or processing transaction and the United States person had the sale or processing transaction been made between unrelated persons.

The regulations further provide that “[w]hether the amount of an obligation . . . is ordinary and necessary is to be determined from all the facts and circumstances in each case.” Treas. Reg. § 1.956-2(b)(1)(v). Unlike Treas. Reg. § 1.956-2T(d)(2)(i)(B), which excludes from U.S. property certain obligations arising from the provision of services and specifically provides that the amount of the obligation will be considered to be ordinary and necessary to the extent the receivables are paid within 60 days, Treas. Reg. §1.956-2(b)(1)(v) contains no such safe harbor.

In TAM 8114032, extended payment terms were held to be ordinary and necessary for purposes of Treas. Reg. §1.956-2(b)(1)(v) where alcohol, which required three years of aging before it could be sold, was purchased in advance by a U.S. distributor so that the distributor could use the LIFO accounting method, which was otherwise prohibited by law as long as the Canadian subsidiary owned the inventory. Payment was due in monthly installments until the alcohol was ready for sale and shipped to the U.S distributor. Pursuant to this payment method, it was expected that 85% of the parent’s obligation would be paid within three years and that 100% would be repaid within four years. In holding these payment terms to be ordinary and necessary, the TAM concluded that:

> Assuming that the new contract reflects a purchase price which unrelated persons might agree to, the entire amount of the obligation outstanding at the time during the taxable years in question was both ordinary and necessary to effectuate the purchase by [the U.S. parent] and the sale [by the CFC] of the base inventory because the amount of the obligation outstanding was reduced monthly as the base was blended with other alcohols and shipped to [the U.S. parent].

In this case, taxpayer has represented that, due to the long manufacturing lead times and the delicate and unique nature of the products, it is necessary to store M months of supply with the distributor. Furthermore, the taxpayer has represented that, due to the low margins typical of a distributor, it is both ordinary and necessary to provide M month payment terms to correspond with the actual sale of the products. Based on these representations, the M month obligations obtained by C in exchange for the sale of its products to D will not constitute an investment in U.S. property for purposes of section 956 to the extent that (i) the amount of such obligations does not exceed the amount of inventory held in the United States at the end of each month when D closes its books, and (ii) such obligations are not outstanding for a period exceeding M months.

(2) <u>Section 1441</u>

A foreign corporation is generally subject to a tax of 30 percent on U.S. source interest income that is not effectively connected with the conduct of a trade or business in the United States. Section 881(a). The payor of such income is required to withhold a 30 percent tax at the source. Section 1442(a). U.S. source interest income includes interest paid by a domestic corporation. Section 861(a)(1)(A). A payment on an original issue discount (OID) obligation is subject to the 30 percent tax to the extent that such OID accrued while the obligation was held by a foreign corporation. Section 881(a)(3)(B).

Under section 1273(a)(1), OID is defined as the excess of a debt instrument's stated redemption price at maturity over the issue price. A debt instrument's stated redemption price at maturity is the sum of all payments provided by the debt instrument other than qualified stated interest payments. Treas. Reg. § 1.1273-1(b). In the case of a debt instrument with a term that is not more than one year from the date of issue, no payments of interest are treated as qualified stated interest payments. Treas. Reg. § 1.1273-1(c) (5). Thus, obligations with a term of less than one year are treated as OID obligations.

For purposes of section 871 and 881, the term "OID obligation" does not include "[a]ny obligation payable 183 days or less from the date of original issue (without regard to the period held by the taxpayer). Section 871(g)(1)(B)(i). The section 1441 regulations clarify that "[i]nterest or original issue discount from sources within the

United States on certain short-term obligations described in section 871(g)(1)(B) or 881(a)(3) is exempt from withholding under section 1441(a)." Treas. Reg. §§ 1.1441-1(b)(4)(iv), 1.1442-1.

In this case, the proposed intercompany obligations will have a maximum term of N days, a period that is less than a year from the date of issue. Thus, such obligations are treated as OID obligations under section 1273 and Treas. Reg § 1.1273-1. However, under the exception for certain short-term obligations contained in section 871(g)(1)(B)(i), such obligations are excluded from the definition of OID for purposes of sections 871 and 881. Accordingly, interest payments on these obligations are not subject to tax under section 881(a) and are exempt from withholding tax under section 1441(a). Treas. Reg. §§ 1.1441-1(b)(4)(iv) and 1.1442-1.

Based on the information submitted and the representations made:

An obligation of D (or any member of the consolidated group of which A or its successor is the parent) held by C (or any successor to its business or operations) arising form the purchase of products produced by C in Country Y will not constitute an investment in U.S. property for purposes of section 956 to the extent that (i) the amount of such obligations does not exceed the amount of inventory held in the United States at the end of each month when D closes its books, and (ii) such obligations are not outstanding for a period exceeding M months.

D (or any member of the consolidated group of which A or its successor is the parent) will not be required, under section 1442, to withhold federal tax at the 30 percent rate imposed by section 881(a), or lesser rate imposed by any applicable treaty, on amounts that it will pay to C (or any successor to its business or operations) which represent interest on the intercompany obligations described in the above ruling request.

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

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

In accordance with the power of attorney on file with this office, a copy of this ruling is being sent to your first and second representatives.

Sincerely,

/s/ Valerie Mark Lippe
Senior Technical Reviewer, CC:INTL:2
Office of the Associate Chief Counsel
(International)

cc: