Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FS:MAN:3:POSTF-136826-02
RLPeacock

date: 9/17/02

to: Robert C. Skiba, Territory Manager
Large and Mid-Size Business Division (Financial Services)
Attn: George D'Avi, Manager (Team 1034)

from: Area Counsel
(Financial Services: Manhattan)

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subject: [redacted]
Taxable years [redacted], [redacted] and [redacted]

This memorandum supplements our August 19, 2002, advice. We have further discussed the August 19, 2002, memorandum with the office of the Associate Chief Counsel, Financial Institutions and Products, who expressed concern regarding our reliance on I.R.C. § 1274 in determining the adequacy of the interest rate charged by [redacted] on the promissory note issued to it by its foreign parent.

I.R.C. § 1274 only applies to debt instruments issued for nonpublicly traded property. Here, although the note references I.R.C. § 1274 as the applicable code section to use to determine the annual interest rate, the note was issued in exchange for cash.

Alternatively, I.R.C. §§ 482[1]/ and/or 7872 could apply to test whether the note had adequate stated interest. I.R.C. § 7872 may apply to the Note because the Note is between related parties: a foreign parent (borrower) and its U.S. subsidiary (lender). But see, Prop. Treas. Reg. 1.7872-5(c)(2)(explaining that I.R.C. § 7872 section generally does not apply where loan is between foreign lender and U.S. borrower, or where both the lender and borrower are foreign).

I.R.C. § 7872(f)(2) provides, that, for term loans, "the applicable Federal rate shall be the applicable rate in effect under section 1274(d) (as of the day on which the loan was made), compounded semiannually." Although I.R.C. § 7872(f)(2)(A) references I.R.C. § 1274(d), the determination of which AFR applies is made under I.R.C. § 7872 and the regulations

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[1]/ Because this issue has not been developed, we have not considered the application of I.R.C. § 482 to this case.

thereunder. For example, Prop. Treas. Reg. 1.7872-10(a)(3) provides rules for options to extend the maturity of a debt instrument. Under Prop. Treas. Reg. 1.7872-10(a)(3), it appears that the Note would be treated as a series of term loans that have a term of one year and one day. Therefore, the short-term AFR would be the appropriate test to determine whether the Note has adequate stated interest under I.R.C. § 7872.

Although the treatment of the option to extend in Prop. Treas. Reg. 1.7872-10(a)(3) appears to conflict with I.R.C. § 1274(d)(3), which requires that options to renew or extend the debt instrument be considered when determining the term of the debt instrument, the position of the Office of Chief Counsel is that the proposed regulations under I.R.C. § 7872 govern your situation.

Should you have any questions regarding this matter, please contact me at (212) 436-1335.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

ROLAND BARRAL
Area Counsel
(Financial Services: Manhattan)

By: _____
ROBIN L. PEACOCK
Attorney (LMSB)

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FS:MAN:3:POSTF-136826-02
RLPeacock

date: 8/19/02

to: Robert C. Skiba, Territory Manager
Large and Mid-Size Business Division (Financial Services)
Attn: George D'Avi, Manager (Team 1034)

from: Area Counsel
(Financial Services: Manhattan)

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subject: [redacted]
Taxable years [redacted], [redacted] and [redacted]

UIL No. 1274.05-00

INTRODUCTION

This memorandum responds to your request for assistance dated July 9, 2002. This memorandum should not be cited as precedent. Specifically, you have asked our office to determine whether [redacted] ("[redacted]") had unreported interest income in the amounts of $[redacted], $[redacted], and $[redacted] for the taxable years 1991, [redacted], and [redacted], respectively, based on [redacted] improper application of the Applicable Federal Rate ("AFR") of interest, pursuant to I.R.C. § 1274(d), to a Promissory Note ("Note") issued to [redacted] by its parent company.

ISSUE

Whether [redacted] has additional interest income in the amounts of $[redacted], $[redacted], and $[redacted] for the taxable years [redacted], [redacted], and [redacted], respectively, because it used the incorrect AFR in computing the interest income it received on a Note.

BACKGROUND

This opinion is based upon the facts set forth herein. It might change if the facts are determined to be incorrect. If the facts are determined to be incorrect, this opinion should not be relied upon. You should be aware that, under routing procedures which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for

review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office, which should be in approximately 10 days. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

Revenue Agent Sid Baum is currently examining [redacted] for the taxable years ending December 31, [redacted], December 31, [redacted], and December 31, [redacted].

On its returns, [redacted] reported interest income in the amounts of $[redacted], $[redacted], and $[redacted], for the taxable years [redacted], [redacted], and [redacted], respectively. The interest income is attributable to annual payments made to [redacted] from [redacted], [redacted] parent company located in [redacted] ("[redacted]"), pursuant to the terms of a Note.

On [redacted], [redacted] issued a Note for $[redacted] to [redacted][1]/. The Note provided, in part,

[redacted].

The Note also provided that [redacted] would make an annual interest payment to [redacted] on December 31, [redacted], and each subsequent December 31st (or the preceding business day if December 31st was not a business day) if the Note was extended. The interest rate paid by [redacted] to [redacted] was "equal to the Applicable federal rate within the meaning of Section 1274 of the Internal Revenue Code and the regulations thereunder at the date hereof plus ½% or if the Maturity Date is extended, the Applicable federal rate on the annual anniversary of the date hereof plus ½%."

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[1]/ On [redacted], [redacted] assigned the Note to [redacted], formerly [redacted].

As of December 31, [redacted], [redacted] made payments on the Note reducing the balance to $[redacted].

During [redacted], [redacted] and [redacted], [redacted] made annual interest payments to [redacted] pursuant to the terms of the Note. In computing its interest income for those taxable years, [redacted] reported the interest it received on the Note using the Federal short-term rate in effect each year.

The revenue agent concluded that the term of the Note was longer than 3 years, and that, therefore, [redacted] should have reported interest on the Note using the Federal mid-term rate plus ½%. The revenue agent applied the Federal mid-term rate because, as of [redacted], [redacted] and [redacted], the Note was outstanding for more than 3 but less than 9 years[2]/. Accordingly, applying the Federal mid-term rate plus ½%, the revenue agent determined that [redacted] had additional interest income for the taxable years [redacted], [redacted] and [redacted] in the amounts of $[redacted], $[redacted], and $[redacted], respectively.

DISCUSSION

Our office must examine whether the revenue agent properly applied the Federal mid-term rate in determining the amount of interest income that [redacted] should have reported from the Note for [redacted] through [redacted]. The resolution of this issue turns on the definition of the "term" of the Note.

I.R.C. § 1274, which is referenced in the Note as the source for determining the appropriate interest rate, deals with the application of the Original Issue Discount ("OID") rules to certain debt instruments issued in exchange for property. Here, however, the revenue agent has indicated that the traditional OID analysis does not apply, because there is no difference between the Note's issue price and the stated redemption price at maturity. In addition, [redacted] is actually paying the interest on the Note each year. It appears that the drafters of the Note simply intended to use I.R.C. § 1274 as a reference for determining the appropriate interest rate on the Note.

I.R.C. § 1274(d)(1) addresses how to determine which AFR applies:

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[2]/ We do not know if [redacted] paid the Note in full subsequent to [redacted]. The revenue agent has considered the term of the Note as of [redacted] through [redacted], the taxable years at issue. For purposes of this memorandum, therefore, we will assume that the long-term rate does not apply.

In the case of a debt instrument with a term of:	The applicable Federal rate is:
Not over 3 years	The Federal short-term rate
Over 3 years but not over 9 years	The Federal mid-term rate
Over 9 years	The Federal long-term rate

I.R.C. § 1274(d)(3) provides, "[i]n determining the term of a debt instrument for purposes of this subsection, under regulations prescribed by the Secretary, there shall be taken into account options to renew or extend." (emphasis added)

Based on the plain language of I.R.C. § 1274(d), the term of the Note is greater than the one year and one day contemplated by the taxpayer. Although the Maturity Date is one year and one day from [redacted], the Maturity Date was automatically extended every year at least through [redacted]. Because I.R.C. § 1274(d)(3) provides that, in determining the term of the Note, options to extend are considered, it appears that the Note had a term of over 3 years but less then 9 years during [redacted], [redacted] and [redacted]. Therefore, the revenue agent correctly applied the mid-term AFR in determining the amount of interest income attributable to [redacted] for the taxable years at issue.

Taxpayer's Position

Initially, the taxpayer, in rejecting the agent's preliminary analysis that the Federal long-term rate should apply, noted, "if the Examining Agent believes a rate other than the short-term rate should be used by reference to the Note's term, it would seem reasonable to use the mid-term rate, since at December 31, [redacted] the Note would have been outstanding for [redacted] years."

Nonetheless, the taxpayer has advanced the following theories in support of its use of the Federal short-term rate.

First, the taxpayer explained that, while the note was not fully paid as of [redacted] through [redacted], [redacted] had made the requisite annual interest payments as required by the Note. The taxpayer explained that, "[f]urther, in order to avail itself of the extension option, [[redacted]] was required to pay interest as of December 31 of each year to which the extension is to apply." (emphasis in original)

This theory is unpersuasive. The revenue agent does not dispute that [redacted] made the requisite annual interest payments on the Note. Simply because [redacted] made interest payments each year does not mean that the term of the Note is for one year. The term of the Note is defined in section 1274(d)(3), and includes options to extend.

Second, [redacted]'s reasoned that the term of the Note was one year because [redacted] had to act at each extended Maturity Date. If [redacted] failed to act, the Note would become due and payable at the prescribed Maturity Date. Based on this reasoning, [redacted]'s determined that I.R.C. § 1274(d)(3) did not apply.

This theory is also unpersuasive. The key premise underlying [redacted] theory that the Note has a term of one year and one day is that the Note terminated annually unless [redacted] notified [redacted] that it wished to extend the Note. This interpretation is contrary to the express language of the Note, however, which provides that the Note extended automatically each year unless [redacted] notified [redacted] London otherwise. The Note was automatically extended each year from [redacted] through [redacted] by [redacted] inaction, not by any action of [redacted].

Finally, in a letter dated [redacted] ("[redacted] letter"), the taxpayer opines that the Note is really a series of one-year notes. In support of this position, the taxpayer, relying on I.R.C. § 1274(d)(3), explains,

[redacted].

[redacted]

[redacted].

Contrary to the taxpayer's assertion, regulations have been issued under I.R.C. § 1274. Proposed regulations were issued in 1986. See 51 Fed. Reg. 12022 (4/8/86). Proposed regulations were issued again in 1992. See 56 Fed. Reg. 8308 (2/28/91). Then, in 1994, the final OID regulations were issued. See 59 Fed. Reg. 4799 (2/2/94)[3]/.

The OID regulations do address the effect of options to extend contained in debt instruments. In fact, the regulations provide special rules for determining the yield and maturity of a debt instrument where the debt instrument contains an option that would require payments to be made on an alternative payment schedule (e.g., an option to extend). See Treas. Reg. § 1.1272-1(c)(5). Specifically, where there is an option to extend,

> an issuer is deemed to exercise or not exercise an option or combination of options in a manner that minimizes the yield on the debt instrument, and a holder is deemed to exercise or not exercise an option or combination of options in a manner that maximizes the yield on the debt instrument.

Id.

The treatment of options to extend set forth in the regulations has no bearing in this case, because the issue price and the yield to maturity are identical.

In its [redacted] letter, the taxpayer disregards the language of I.R.C. § 1274(d)(3), which provides that options to renew or extend are taken into account when determining the term of a debt instrument, because the regulations do not specifically define "extension" and "option to renew" as used in I.R.C. § 1274(d)(3).

Where neither the Code section nor the regulations define a term, courts will "accord those words their ordinary meaning." Allen v. U.S., 976 F.2d 975, 976 (5th Cir. 1992)(citing Boyd v. U.S., 762 F.2d 1369 (9th Cir. 1985)). The ordinary meaning of

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[3]/ These final regulations were later amended by T.D. 8674 (6/14/96).

"extend" is "to spread or stretch forth" or "to stretch out to fullest length." Merriam-Websters Collegiate Dictionary 410 (10th ed. 1993). Similarly, the ordinary meaning of "renew" is "to make like new" or "to do again." Merriam-Websters Collegiate Dictionary 987 (10th ed. 1993).

Here, the term of the Note was automatically extended every year from [redacted] through at least [redacted]. Because section 1274(d)(3) requires that extensions be considered when determining the term of the Note, the term was greater than 3 years but less than 9 years. The proper rate of interest to apply is therefore the Federal mid-term rate.

Should you have any questions regarding this matter, please contact me at (212) 436-1335.

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ROLAND BARRAL
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By:_____
ROBIN L. PEACOCK
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