Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:OHI:CIN:TL-N-4451-99
GRShuler

date:

to: Chief, Examination Division, Ohio District
Attn: Carl R. Schneider

from: District Counsel, Ohio District, Cincinnati

subject: [redacted]
Applicability of I.R.C. § 133(a)(3)

We received your correspondence on July 17, 1999 (supplemented by a memorandum dated October 13, 1999 and additional information on October 21, 1999, November 8, 1999 and November 17, 1999) in which you requested assistance relating to [redacted].

ISSUES

1. Whether a corporation whose primary business consists of arranging the financing of purchases for third parties in the form of conditional sales contracts (leases with end of lease purchase option for as little as a $1.00) but which also engages in other loan-type activities is "actively engaged in the business of lending money" as that term is used in section 133(a)(3)?

2. May [redacted] exclude [redacted]% of interest income received under the Employee Stock Ownership Plan and Trust Loan Agreement?

CONCLUSIONS

At this time we do not sufficient information about [redacted] to offer a legal opinion on the issues. In addition, as explained below, these are issues of first impression which we would like to coordinate with the National Office.

FACTS

As we currently understand the facts, [redacted] is a subsidiary of the [redacted]. Its primary business is providing lease financing services. In lease financing, as practiced by [redacted], [redacted] financed the purchase of an item for another party by use of "conditional sales contracts." Through the "conditional sales contracts," the goods are leased but can be purchased for one dollar at the end of the lease. For tax purposes, the lease payments were treated by [redacted] partially as recovery of loan principal and partially as interest income.

[redacted] also engages in other financial transactions, including a complex transaction which gives rise to the revenue agent's questions. On [redacted], [redacted] entered into multiple agreements with unrelated third parties. In an Employee Stock Ownership Plan and Trust Loan Agreement ("ESOP Loan Agreement"), [redacted] loaned $[redacted] to [redacted] Employee Stock Ownership Plan and Trust ("ESOP") in [redacted]. The ESOP loan agreement allows for one or more term advances up to an aggregate principal amount of $[redacted]. Pursuant to this agreement, [redacted] loaned an additional $[redacted] to the ESOP in [redacted].

The ESOP purchased [redacted]% of the outstanding capital stock of [redacted] for $[redacted] ("ESOP Sponsor"). The ESOP sponsor paid [redacted], a wholly owned subsidiary of the ESOP sponsor ("ESOP Subsidiary"), a guaranty fee of $[redacted] in consideration of the ESOP Subsidiary's guarantee to [redacted] to make payments in full of the ESOP Obligations and/or agreement to purchase the ESOP notes. In addition, the ESOP Sponsor made a contribution to capital to the ESOP Subsidiary in the amount of $[redacted]. Then the ESOP Subsidiary purchased "conditional sales contracts" from [redacted] for $[redacted]. [redacted] continued to administer and service the "conditional sales contracts" on behalf of the ESOP Subsidiary.

In their [redacted] and [redacted] annual reports, [redacted] divided its "loan receivables" into the following categories: (1) loans to partnership affiliates; (2) loans to Employee Stock Ownership Plans; (3) loans secured by equipment and real property; and (4) first mortgage loans on business and residential properties.

[redacted] reported interest income from the ESOP loan agreement in the amounts of $[redacted] and $[redacted] for the [redacted] and [redacted] tax years, respectively. Relying on I.R.C. § 133, [redacted] excluded [redacted]% of this interest income, or $[redacted] and $[redacted] for [redacted] and [redacted], respectively.

ANALYSIS

I.R.C. § 133 was repealed by the 1996 Small Business Act. See P.L. 104-188. Under the former section 133, gross income did not include 50% of interest income received by a qualified commercial lender with respect to a securities acquisition loan during the exclusion period. Effective August 20, 1996, this preferential treatment was eliminated from securities acquisition loans absent a binding commitment before July 10, 1996.

A "qualified lender" included a bank,[1] an insurance company,[2] a corporation actively engaged in the business of lending money,[3] or a regulated investment company.[4]

A securities acquisition loan was either (1) any loan made to a corporation or to an Employee Stock Option Trust and Plan to the extent that the loan proceeds were used to acquire employer securities for the plan or (2) any loan to a corporation to the extent that, within 30 days, employer securities were transferred to an Employee Stock Option Trust and Plan in an amount equal to the proceeds of the loan and the securities were available to the Employee Stock Option Trust and Plan participants within one year of the date of the loan. Former I.R.C. §§ 133(b)(1)(A) and (B). A loan is not a securities acquisition loan if it is made between an Employee Stock Option Trust and Plan and either the employer of any employees covered by the Employee Stock Option Trust and Plan or a related corporation. Former I.R.C. § 133(b)(2)(B).

In order to qualify as a securities acquisition loan, the term of the loan could not have exceeded 15 years. Former I.R.C. § 133(b)(1). The interest exclusion applied only to interest accrued during the excludible period. Former I.R.C. § 133(e)(1). Generally, the exclusion period was a seven year period beginning on the date of the original securities loan. Former I.R.C. § 133(e)(2)(A).

We assume all the qualification for a securities acquisition loan have been met. The question on which we focus on is whether [redacted] is a "qualified lender."
[redacted] is not a bank, an insurance company or a regulated investment company. Therefore, [redacted] may be a "qualified lender"

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[1] Former I.R.C. § 133(a)(1). See I.R.C. § 581.

[2] Former I.R.C. § 133(a)(2). See I.R.C. §§ 801-847.

[3] Former I.R.C. § 133(a)(3).

[4] Former I.R.C. § 133(a)(4). See I.R.C. § 851.

only if it is a "corporation actively engaged in the business of lending money." A corporation is actively engaged in the business of lending money if it lends money to the public on a regular and continuing basis (other than in connection with the purchase by the public of goods and services from the lender or a related party). Temp. Treas. Reg. § 1.133-1T. If a predominant share of the original value of the loans the corporation makes to unrelated parties are securities acquisition loans, the corporation is not actively engaged in the business of lending money. Temp. Treas. Reg. § 1.133-1T.

You have sent us detailed information concerning the transaction involving the ESOP. Nevertheless, the determination of whether a corporation is "actively engaged in the business of lending money" is a factual determination based upon a broader examination of the business activities of the "lending" corporation.

Our initial legal research revealed very little National Office guidance as to the proper interpretation of the term "actively engaged in the business of lending money." Because of that lack of published guidance, we contacted John Ricotta (CC:EBEO), the National Office contact person for section 133. Mr. Ricotta indicated that the Service has not previously looked at the meaning of "actively engaged in the business of lending money." As such, this is an issue of first impression. We believe that this is an important issue which must be resolved at the National Office level. We believe it would be improper for us to offer a legal opinion on the phrase "actively engaged in the business of lending money." [redacted] may be "actively engaged in the business of lending money" because of the conditional sales contracts or because of the other business activity it engages in, or a combination of the two.

Whether [redacted] was "actively engaged in the business of lending money," whatever the legal definition of that term, will depend greatly on the specific facts of how [redacted] did business in [redacted] and [redacted]. At this time we do not have enough information about [redacted] to determine whether they were "actively engaged in the business of lending money." If you intend to continue to pursue this issue, it is imperative that you completely examine and explain all aspects of [redacted]'s business, as well as the business of its various divisions. In addition, because this is a case of first impression, we would request Field Service Advice from the National Office.

If you have any questions, please contact the undersigned at (513) 684-3211.

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By: _____
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Attorney