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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
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Person To Contact:
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Date:
February 08, 2006

TY:

Taxpayer =

Individual A =

Sole Proprietorship B =

Corporation C =

Corporation D =

Trustee E =

Country X =

Date 1 =

Dear _____ :

This is in response to your request for a private letter ruling dated, August 11, 2005, requesting rulings under sections 862, 871, and 1441 of the Internal Revenue Code ("Code") concerning amounts to be distributed by Taxpayer pursuant to a bankruptcy settlement agreement between Individual A and Corporation C.

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 the request for rulings, it is subject to verification on examination. The information submitted for consideration is substantially as set forth below.

FACTS

Individual A is a nonresident alien, who operates and owns Sole Proprietorship B in Country X. Sole Proprietorship B imports sporting goods for sale and use solely in Country X. All of Sole Proprietorship B's employees reside in Country X. Taxpayer represents that Sole Proprietorship B has never engaged in a U.S. trade or business.

Corporation C, a domestic corporation, entered into a contract with Sole Proprietorship B under which Sole Proprietorship B was the exclusive distributor of Corporation C's sporting equipment in Country X. Prior to the termination date of the contract, Corporation C and Sole Proprietorship B extended the contract for an additional four years. During the course of the contract period Corporation C's assets were acquired by Corporation D, a domestic corporation.

Corporation D continued to supply Sole Proprietorship B with sporting equipment. Corporation D entered into an arrangement for the manufacture of sporting equipment for sale to Sole Proprietorship B.

On Date 1, Corporation D terminated the distributorship agreement and stopped supplying sporting equipment to Sole Proprietorship B. Sole Proprietorship B filed suit in an State District Court against Corporation C and Corporation D, alleging that the termination of the distributorship agreement was wrongful. Following initiation of the suit, Sole Proprietorship B dismissed the case pursuant to Rule 41(A)(1)(a) of the Rules of Civil Procedure. A later suit was initiated by Sole Proprietorship B in a U.S. District Court against Corporation C and Corporation D.

Subsequent to the U.S. District Court case, Corporation D filed a voluntary petition for relief under chapter 7 of the Bankruptcy Code. Individual A filed a claim in the bankruptcy case for breach of contract and incorporated by reference all the claims and causes of action asserted in his State Court and U.S. District Court cases.

Under a settlement agreement entered into by all the parties involved in the bankruptcy case, Individual A will receive a cash settlement from the former owners of Corporation D and Trustee E, the trustee of the bankruptcy estate of Corporation D in complete satisfaction of their claims.

Amounts owed to Individual A under the bankruptcy settlement agreement will be paid into Taxpayer's trust account. Taxpayer is the attorney representing Individual A in the bankruptcy settlement.

RULING REQUESTED

Taxpayer is requesting a ruling that the payments to be distributed by Taxpayer to Individual A pursuant to the bankruptcy settlement agreement constitutes income from without the United States under section 862(a)(6) and that no withholding is required under section 1441.

LAW AND ANALYSIS

Section 871 of the Code generally imposes a tax of 30 percent on the amount received by a nonresident alien individual from sources within the United States as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income, but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.

Section 1441(a) of the Code provides, in general, for a withholding of tax at a 30 percent rate on certain income from sources within the United States of a nonresident alien individual.

With regard to the taxation of a settlement payment made to a nonresident alien individual, the nature of the item for which the settlement payment is substituted controls the characterization of the payment. *U.S. v. Gilmore*, 372 U.S. 39 (1963). Similarly, the source of the item for which a settlement payment is substituted controls the source of the payment. Rev. Rul. 83-177, 1983-2 C.B. 112. In Rev. Rul. 83-177, a foreign partnership formed by two nonresident aliens, which was not engaged in a U.S. trade or business, filed suit for breach of contract against a domestic corporation. All of the services to be performed by the foreign partnership pursuant to the agreement were to be performed outside of the United States. Rev. Rul. 83-177 holds that the amount paid under the settlement agreement representing principal is foreign source income under section 862(a)(3) and is therefore neither subject to tax under section 871(a) nor withholding under section 1441(a).

Section 862(a)(6) of the Code provides that gains, profits, and income derived from the purchase of inventory property (within the meaning of section 865(i)(1)) within the United States and its sale or exchange without the United States shall be treated as an income from sources without the United States.

For purposes of determining the source of the settlement payment, the amount of principal received pursuant to the settlement agreement depends upon the nature of the item for which the bankruptcy claims settled. The bankruptcy claims settled the alleged wrongful breach of contract under which Sole Proprietorship B was the distributor of Corporation D's sporting equipment in Country X. The purchase of sporting equipment

within the United States for sale and use in Country X would constitute foreign source income. I.R.C. §862(a)(6).

When payments are made to Individual A in satisfaction of a breach of contract where the underlying income would be income from sources without the United States under section 862(a)(6), the principal payments made in settlement of that obligation will also be considered payments made from sources without the United States.

Accordingly, based solely on the facts submitted and the representations made, we conclude that payments of principal received by Individual A under the settlement agreement are foreign source income under section 862(a)(6) and, therefore, are neither subject to tax under section 871(a) nor to withholding at source under section 1441(a). The interest portion of the payment must be sourced according to the source of interest rules.

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

This 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 letter must be attached to any U.S. income tax return to which it is relevant.

Karen A. Rennie
Senior Technical Reviewer, Branch 1
Office of Chief Counsel
(International)

cc: