FP, a corporation organized in country N, owns all of the stock of DS, a corporation organized in the United States. Country T, but not country N, has an income tax treaty with the United States. The treaty exempts interest, rents and royalties paid by a resident of one state (the source state) to a resident of the other state from tax in the source state.

On December 1, 1994 FP creates a special purpose subsidiary, FS. On that date FP capitalizes FS with $1,000,000 in cash and $10,000,000 in debt from BK, a Country N bank. On January 1, 1995, C, a U.S. person, purchases an automobile from DS in return for an installment note. On August 1, 1995, DS sells a number of installment notes, including C’s, to FS in exchange for $10,000,000. DS continues to service the installment notes for FS.

The C installment note now held by FS (as well as all of the other installment notes now held by FS) and the FS note held by BK are financing transactions, and together constitute a financing arrangement.