REPORT # 597

TAX SECTION

New York State Bar Association

Report on Temporary Section 861 Regulations
Concerning Allocation of Interest and Other Expense

December 21, 1988

Table of Contents

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TAX SECTION

New York State Bar Association

December 22, 1988

Temporary Section 861 Regulations on
Allocation of Interest and other Expense

Dear Commissioner Gibbs:

I enclose a report on Temporary Section 861 Regulations Concerning Allocation of Interest and Other Expense, prepared by our Committee on Foreign Activities of U.S. Taxpayers.

The report was prepared by Joseph J. Czajkowski, James A. Duncan, Gary Friedman, David P. Hariton, Wayne Merkelson, John A. Moran, Willard B. Taylor and Victor A. Zonana. Mr. Taylor was the principal draftsman. Helpful comments were received from Alan Granwell, Randall K.C. Kau and Andrew P. Solomon.

The report makes recommendations as to effective dates, rental expenses, interest equivalents, foreign currency losses, partnership expense allocation, foreign partners and nonresident individuals, assets without directly identifiable yield, nonrecourse debt, integrated financial transactions, affiliated groups, and expenses not directly allocable to specific income-producing activity.

As always, the Tax Section would be pleased to respond to questions concerning the

Report and to assist in the development of final regulations.

Sincerely

Herbert L. Camp

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Tax Report #597

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Temporary Section 861 Regulations Concerning Allocation of Interest and Other Expense

by the Committee on Foreign Activities
of U. S. Taxpayers

December 21, 1988

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Temporary Section 861 Regulations Concerning Allocation of Interest and Other Expense

December 21, 1988

This Report of the Committee on Foreign Activities of U.S. Taxpayers* comments on aspects of the Regulations** issued in proposed and temporary form on September 14, 1988 with respect to the allocation and apportionment of interest and certain other expenses for foreign tax credit and certain other purposes (hereafter, the “Temporary Regulations”) and on related proposed regulations (hereafter, the “Repro-posed Regulations”).***

We comment here principally on new issues raised by the Temporary and Reproposed Regulations and, apart from comments on the rules relating to nonrecourse debt and integrated financial transactions, have generally not repeated the comments that we previously made on the Regulations proposed on September 11, 1987 (hereafter, the “Proposed Regulations”).**** A number of the points we made

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* This report was prepared by Joseph J. Czajkowski, James A. Duncan, Gary Friedman, David P. Hariton, Wayne Merkelson, John A. Moran, Willard B. Taylor and Victor A. Zonana. Willard Taylor was the principal draftsman. Helpful comments were received from Alan Granwell, Randall K.C. Kau and Andrew P. Solomon.

** 53 Fed. Reg. 35467 (September 14, 1988).

*** 53 Fed. Reg. 525 (September 14, 1988).

**** New York State Bar Association, Tax Section, "Report on Proposed Regulations Relating to the Allocation of Interest and Other Expenses for Foreign Tax Credit and Certain Other Purposes", December 18, 1987.

in that Report, however, are as valid with respect to the Temporary Regulations as with respect to the Proposed Regulations and we urge that what we said in that Report be considered again before the issuance of final Regulations.

Our comments generally follow the sequence of the Temporary Regulations. In summary of what is set out at more length hereafter, our principal comments are as follows:

(1) The effective dates of the new requirements imposed on qualifying nonrecourse indebtedness, on the new rules for expenses other than interest, and, if they are issued, any regulations relating to the allocation of rental expense should be prospective, and thus these rules should not affect borrowings and leases entered into before the rules are issued.

(2) We question whether it is appropriate to provide by regulation for the allocation and apportionment of certain rental expense in the same manner as interest expense.

(3) The treatment as interest expense of a loss incurred in an integrated series of transactions which secures for the taxpayer the use of funds for a period should be limited to cases where the obligations of the taxpayer are in substance the same as those of a borrower of money.

(4) Rules that treat foreign exchange losses as interest expense should be issued under Section 988(a)(2), not Section 864(e), and should deal comprehensively with foreign exchange gains and losses.

(5) The rules with respect to partnerships should determine the share of partnership assets taken into account in

allocating interest expense on the basis of a partner's interest in assets, as determined under Regulations Sec. 1.897-l(e)(2)(ii), not on the basis of the partner's interest in partnership income for the year.

(6) In the allocation of interest expense to effectively connected income, nonresident alien individuals should have the option to choose rules similar to the rules of Regulations Sec. 1.882-5 which apply to corporations and, in addition, look-through rules, such as those that apply to greater than 10 percent corporate partners, should also apply to nonresident individual partners and less than 10 percent corporate partners.

(7) A rule treating all interest expense allocated to effectively connected income as U.S. source should not be adopted by regulations but only by legislative extension of the principles of Section 884(f) to individuals.

(8) The nonrecourse debt rules should be modified in a number of respects, including (i) to clarify that expenditures which are deductible, such as intangible drilling and development costs, may nonetheless be “improvements”, (ii) to provide that, under certain circumstances, stock and interests in partnerships and trusts may qualify for nonrecourse debt financing, (iii) to eliminate the requirement that assets must be “functionally related” and “geographically contiguous” to be part of an “integrated project”, (iv) to eliminate, or at least liberalize, the part of the cash flow requirement that excludes property if deductible expenses are significant, (v) to permit claw-backs, (vi) to eliminate the prohibition on third-party credit enhancement obtained by lenders (as opposed to borrowers), and (vii) to eliminate (at least where a borrowing finances improvements) the loan-to-value test in the Reproposed Regulations.

(9) The definition of integrated financial transactions should be expanded to include cases where the assumption that money is fungible will produce consequences that are unfair.

(10) Assets used in general and administrative functions should be taken into account in apportioning interest expense by prorating such assets on the basis of the classes of gross income they generate.

(11) The Temporary Regulations for determining what expenses are “not directly allocable or apportioned to any specific income-producing activity” go too far when they presume that any expense is within that category unless definitely related only to a “class of gross income” derived solely by the member incurring the expense.

1. Retroactivity issues, including the interpretation of “grandfather” rules

1. Although the Temporary Regulations differ in important respects from the Proposed Regulations, they are generally effective for taxable years beginning after December 31, 1986, and it may be questioned whether this effective date is fair in cases where the Temporary Regulations take a more restrictive view of Section 864 (e) than the Proposed Regulations. While certain of the rules are deferred by Temporary Regulations Sec. 1.861-8T(h) until taxable years commencing after December 31, 1988 (or 1987 in the case of the “netting” rule), many others are not, including, in the case of the special rule for nonrecourse indebtedness, the provision that excludes indebtedness incurred to purchase inventory and financial assets and the provision that excludes syndicated credit risks. We recommend that these changes

not apply to transactions entered into earlier than 30 days after the date of issuance of the Temporary Regulations.

2. The regulations should clarify that the operating costs test of Temporary Regulations Sec. 1.861-10T(b)(3)(ii) and the excess collateralization test of Reproposed Regulations Sec. 1.861-10(b)(4)(vii) are applied only at the time that indebtedness is incurred and under the rules in effect at that time, with the result that indebtedness incurred in taxable years beginning before December 31, 1988 will not be subject to these tests. Likewise, assuming that the Regulations clarify that the more specific 15% of total income test of Reproposed Regulations Sec. 1.861-10(b)(3)(iv) applies for taxable years beginning after December 31, 1989,* the regulations should clarify that this more specific rule does not apply to indebtedness incurred in taxable years beginning in 1989.**

3. The preamble to the Temporary Regulations states that the Internal Revenue Service is considering the adoption of a rule that would require the apportionment of rent under certain leases in the same manner as interest but that the Service “contemplates that such a rule would apply prospectively from the date of its promulgation.” It is unclear whether the quoted statement means that the regulations will apply (1) only to leases entered into after the issuance of the regulations or (2) to any lease, whenever entered into, but only to rent for periods subsequent to the

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* Informal conversations with the Internal Revenue Service indicate that the effective date of December 31, 1988 printed in the Reproposed Regulations is a typographical error.

** There is no similar lack of clarity in the "excess collateralization" rule of Reproposed Regulations Sec. 1.861-10(b)(12), since the loan-to-value test of that rule applies at the time the property is purchased or constructed.

issuance of the regulations. It seems to us that the regulations would not be prospective unless they exempted existing leases. Prospective application is particularly appropriate since the regulations, if issued, will be issued under Section 863(a) and thus, unlike regulations under Section 864(e), will be legislative regulations subject to the Administrative Procedure Act, 5 U.S.C. 553. Under that Act the public must be provided with 30 day's notice before a substantive rule becomes effective. 5 U.S.C. 553(d). The statement in the preamble that the Service is "considering" treating rent as interest in "certain" transactions that are similar in "certain" respects to financings is too vague to put taxpayers on notice as to what might be forthcoming.

4. The rule in the Temporary Regulations with respect to the treatment of losses sustained on sales of receivables is issued under Section 865(i), which authorizes regulations on the treatment of losses from sales of personal property. Since any such regulations are legislative regulations, subject to the Administrative Procedure Act, 5 U.S.C. 553, the rule should have been issued in compliance with the notice and effective date provisions of that Act.

5. The rules in Temporary Regulations Sec. 1.861-14T, relating to certain expenses other than interest, are generally applicable to taxable years beginning after December 31, 1986. We question whether (1) this effective date is fair, given that the subject matter of these Regulations was not covered in the Proposed Regulations, that in a number of respects the Regulations go beyond anything that might reasonably have been anticipated from the legislative history and that for most calendar year corporations the Temporary Regulations were issued long after the point at which they could be considered in filing returns for 1987, and (2) how the effective date will work, given that the Temporary Regulations

“reserve” on a number of important areas (such as the manner of determining when an expense is definitely related only to a class of gross income derived by one member).

2. <u>Treatment of Rental Expense -- Temporary Regulations Sec. 1.861-9(b)(4)</u>

The preamble to the Temporary Regulations states that the Internal Revenue Service is considering the adoption of a rule that would require the apportionment of rental expense incurred in certain transactions that are similar to financings in the same manner as interest expense. It was in fact rumored that such Regulations would have been included in the Temporary Regulations but for last minute reservations and would have apportioned rental expense on certain leases in the same manner as interest expense up to the amount of the lessor’s interest expense on debt incurred to purchase the asset leases. These leases would have included any sale and leaseback and any lease in which the rental payments equaled or exceeded interest and principal on the lessor's debt if the term of the lease was at least as long as the term of the debt.

In enacting Section 864(e), Congress in effect amended by legislation the regulations that had been issued under the general authority conferred by Section 863(a) to issue regulations allocating or apportioning items of income, expense, loss and deduction. Under these circumstances, we question whether it would now be appropriate, as the preamble suggests, to issue regulations under Section 863(a) which would in effect extend Section 864(e) to certain rental expense. To be sure, because it requires the allocation and apportionment of interest expense to all classes of a taxpayer's gross income, Section 864(e) will in some cases discourage taxpayers from incurring or continuing indebtedness to own assets which produce U.S. source income and encourage them to lease those assets instead, but this bias was apparent at the time the Tax Reform Act of 1986 was under consideration and, if it is a reason for changing the rules with respect to rental expense, should have been considered in connection with that Act or the Technical and Miscellaneous Revenue Act of 1988. An extension of Section 864(e) should be effected by legislation, not as an afterthought by the Internal Revenue Service.

If regulations are nonetheless to be issued, there are a number of issues that should be addressed, including the following:

1. Whether there should be a distinction (as it has been rumored there will be) between sale and leasebacks and other leases or simply a single standard for determining when a lease will be regarded as involving an interest-like expense.

2. How to identify the rental expense to be treated as interest, bearing in mind that the lessor may or may not have debt that is specifically associated with the lease (or, indeed, any debt at all) and that rental payments and prevailing rates of interest may change over the term of the lease.

3. How to determine the amount of the lessee’s asset for purposes of apportioning its interest expense and how to apply the tax book value rules to that asset over the term of the lease.

4. Whether the notional debt in a lease transaction should be treated as debt for purposes of the transitional and other rules, such as the qualified nonrecourse debt rule of Temporary Regulations Sec. 1.861-10T(b) and the excess related party Indebtedness rule of Temporary Regulations Sec. 1.861-10T(e).

3. <u>Interest Equivalents -- Temporary Regulations Sec. 1.861-9T(b)(l)</u>

Temporary Regulations Sec. 1.861-9T(b)(1) provides that any deductible expense or loss incurred in a transaction or series of integrated or related transactions which “secures [for the taxpayer] the use of funds for a period” will, if it is “substantially incurred in consideration of the entire value of money”, be allocated and apportioned in the same manner as interest expense. This is illustrated by an example in which a corporation sells borrowed gold for $1,000 and covers its redelivery obligation with a forward purchase of gold for $1,050, in effect securing the use of the proceeds of sale for the period until the forward settles and it must redeliver the gold.

The corporation in the example is in the same economic position (<u>i</u>.<u>e</u>., has the same financial obligations) as if it had borrowed $1,000, promising to repay $1,050; and it makes sense under these circumstances to treat the loss it will sustain on the forward and redelivery in the same manner as interest expense, notwithstanding that there is no lender (<u>i</u>.<u>e</u>., that none of the parties to the transaction has the rights and obligations of a lender of money).[*]

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[*] This may also be supported by the statement in the legislative history that "Congress did not intend that labels control whether expenses are interest expenses for [purposes of Section 864(e), but rather] that economic reality govern." See Joint Committee on Taxation, <u>General Explanation of the Tax Reform Act of 1986</u> (1987) at 947-8 (hereinafter referred to as the "Blue Book").

The general statement in the Temporary Regulations that an expense or loss is treated as interest expense if the transaction “secures [for the taxpayer] the use of funds for a period” might, however, be interpreted more broadly than the example. A more precise statement of the rule, conforming to the example, would limit it to transactions which secure for the corporation the use of funds for a period if the obligations of the corporation to persons who are not members of its affiliated group are in substance the same as those of a borrower of money. We recommend such a change.

Suppose the transaction described in the example had been carried out by two members of a group, one selling gold spot and the other entering into a forward purchase contract? While Temporary Regulations Sec. 1.861-11T(c) says that references to the “taxpayer” in the Temporary Regulations generally refer to the entire affiliated group, that would not extend to a case where one of the two corporations was a foreign corporation not described in Temporary Regulations Sec. 1.861-11T(d). In this respect the rule differs from the rule, discussed below, relating to certain hedged foreign currency borrowings, which covers cases where the borrowing and the hedge are effected by related parties.

It would also be useful to clarify the relationship between Temporary Regulations Sec. 1.861-9T(b)(1) and provisions of the Internal Revenue Code that specifically do not impute interest. Where property is sold and payment is to be made within 6 months, for example, there is no imputed interest under either Section 483 or Section 1274. For the sake of consistency and simplicity it should be provided that no interest will be imputed under Temporary Regulations Sec. 1.861-9T(b)(1) in any such case.

4. Foreign Currency Borrowings -- Temporary Regulations Sec. 1.861-9T(b)(2)

Temporary Regulations Sec. 1.861-9T(b)(2) provides that the net currency loss on a hedged nonfunctional currency borrowing in a “strong” foreign currency will be allocated and apportioned in the same manner as interest expense. The evident purpose is to prevent taxpayers from borrowing in a strong foreign currency in order to understate interest expense.

Foreign currency gains and losses will automatically be allocated and apportioned in the same manner as interest expense in the case of a “qualified hedging transaction” within the meaning of Notice 87-11 (or a transaction which the Internal Revenue Service treats as a qualified hedging transaction notwithstanding a failure to satisfy all of the requirements of Notice 87-11) without regard to whether the borrowed foreign currency is “strong” or “weak” in relation to the U.S. dollar. The rule in the Temporary Regulations, therefore, relates only to an imperfectly hedged transaction which for other purposes the Internal Revenue Service does not treat as a hedged transaction. Although the rule and the example indicate that the loss on the borrowing will be netted with the gain on the hedge, it is unclear how this rule will operate where the gain and the loss are recognized in different taxable years -- will gain recognized in a year subsequent to the year in which the loss is recognized reduce the interest expense for that subsequent year?

It seems to us that any rule with respect to foreign currency losses would more appropriately be issued under Section 988(a)(2), which provides generally that any foreign currency loss shall be treated as interest expense to the extent provided in regulations, and that the regulations under that Section should be more comprehensive and deal with the treatment of unhedged borrowings, foreign currency transactions other than borrowings, and whether foreign currency gain that is treated as interest income should offset foreign currency loss that is interest expense, at least when incurred in the same or a related transaction.

Although the apparent purpose of the special rule for hedged foreign currency borrowings is to prevent abuse, dealers in foreign currency and other taxpayers with extensive foreign exchange transactions may well be caught, notwithstanding that there was no intent to hedge a foreign currency borrowing or to understate interest expense. The rule, discussed in 3. above, with respect to the allocation of expenses and losses may also apply where transactions have the prescribed effect notwithstanding that there was no intention of borrowing (i.e., of "secur[ing] the use of funds for a period"); and the capacity of both rules to apply in unexpected situations is greatly increased because they apply to transactions entered into by different members of an affiliated group or by related parties. It might be appropriate under these circumstances to consider limiting the application of both rules to cases where there is an "integrated transaction" (along the lines of Proposed Regulations Sec. 1.954-2T(h), relating to income equivalent to interest).

5. Other Definitions

Apart from the rules which treat certain expenses and losses as interest equivalents, the Regulations should provide definitions of terms which might be the source of ambiguity or dispute. It is not clear, for example, whether and to what extent "interest expense" includes placement fees, other expenses of issuing debt, guarantee or credit enhancement fees, commitment fees, and Section 1058 payments. (If such payments are interest expense, they should, when received by a related party, be sourced in the same manner as related party interest income.) It is likewise not clear whether trade payables and other non-interest bearing liabilities constitute “indebtedness” for purposes of determining the debt-to-asset ratios of United States shareholders and their controlled foreign corporations under Temporary Regulations Sec. 1.861-10(e) or for purposes of the transition rules to be issued under Temporary Regulations Sec. 1.861-13 or whether trade receivables constitute assets for similar purposes.*

6. Partnerships -- Temporary Regulations Sec. 1.861-9T(e)

In the case of partnership borrowing, Temporary Regulations Sec. 1.861-9T(e) generally follows the approach taken in the Proposed Regulations. Each partner takes into account its “distributive share” of partnership interest expense, including a share of any interest expense specifically allocated under Temporary Regulations Sec. 1.861-10T. For a partner whose investment in the partnership is “passive” (i.e., less than 10 percent except in the case of a noncorporate general partner),** the distributive share of interest expense, other than interest expense that is specifically allocated under Temporary Regulations Sec. 1.861- 10T, is allocated directly to income from the partnership interest; for any other partner, the distributive share of

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* Interest rate swap payments are not interest (and are not incurred to secure the use of funds or in consideration of the time value of money, within the meaning of Temporary Regulations Sec. 1.861-9T(b)(1)) and thus would not be covered. See Internal Revenue Service Notice 87-4.

** See Temporary Regulations Sec. 1.861-9T(e)(4).

interest expense, other than interest that is specifically allocated under Temporary Regulations Sec. 1.861-10T, is taken into account in applying the general interest allocation and apportionment rules.

Changes made by the Temporary Regulations, however, raise new issues, as follows:

(a) The Temporary Regulations use the “partner’s interest in partnership income for the year” to determine its percentage interest in the partnership (and thus whether its interest is passive or not) and to determine its share of partnership assets*, but offer no guidelines to determine a partner's “interest in partnership income”.

To begin with, it is not altogether clear whether the reference to “partnership income” is a reference to partnership <u>gross</u> or <u>taxable</u> income. The example in Temporary Regulations Sec. 1.86l-9T(e)(5) suggests that the determination is based on gross income reduced by any interest expense which is directly allocable to particular types of income (<u>e</u>.<u>g</u>., under the rules of Temporary Regulations Sec. 1.861-10T(b)) but not by any other partnership expenses, including interest expense not so directly allocable.

To the extent that the rules are to parallel the look-through rules of the Section 904 regulations,** the choice of “interest in partnership income” as the determinant, rather than the Section 904 regulations' criteria of “beneficial interest (by value) in the partnership,” results in unnecessary divergence and, more fundamentally, the choice is inconsistent with the statutory mandate that all allocations and apportionments of interest expense

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* The Proposed Regulations used "interest in the partnership," which was cross-referenced to the rules under Regulations Sec. 1.897-l(e)(2)(ii).

shall be made on the basis of assets rather than gross income. [*] Where a partner's share of income for a particular period is disproportionate to his investment in the partnership and return on liquidation, it may distort the overall allocation of interest. We would therefore recommend that the final Regulations adopt the test of the Proposed Regulations and determine the share of partnership assets taken into account by a partner on its interest in the partnership assets, as determined under Regulations Sec. 1.897-1(e)(2)(ii).

As a further objection to allocating assets on the basis of partner's interests in income, we note that what “passive” partners take into account in apportioning their other interest expense is the partner's interest in the partnership,[**] not the partner's share of the partnership assets. Consequently, in any year, either more or less than the total tax book or fair market value of the partnership assets may be taken into account by the partners in the aggregate.

(b) While the Temporary Regulations provide useful guidance on the approach for tiered partnerships, the regulations would benefit from the insertion of an example.

We understand that the intended result is to give priority to the rules of Temporary Regulations Sec. 1.861-9T(e)(4), so that, in the case of a “passive” partner, interest expense which is allocated specifically to a partner's distributive share of partnership income (as apportioned to the various income categories) should retain that character when included in the distributive shares of interest expense of any of its partners that

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** Regulations Sec. 1.904-5(h)(1)
* Section 864(e)(2).

** Presumably this is still determined by Regulations Sec. 1.897-l(e)(2)(ii).

are partnerships. In this way, the interest expense of the higher tier partnership is reduced by the interest expense, if any, of lower tier partnerships allocated to it pursuant to Temporary Regulations Sec. 1.861-9T(e)(4) (hereafter, “(e)(4) Interest”). Partners of such higher tier partnership would then apportion the remaining interest expense according to Temporary Regulations Sec. 1.861-9T(e)(2), (e)(3) or (e)(4), whichever was applicable, and add to such apportioned interest their distributive share of the (e)(4) Interest. We do not believe that the current language achieves this result for a number of reasons:

(i) When it speaks of interest expense of a lower tier partnership being subject to Temporary Regulations Sec. 1.861 9T(e)(2), (3) or (4), the Temporary Regulations ignore the fact that these paragraphs, as currently drafted, apply only to individuals or corporations. Without a rule categorizing the higher tier partnership as either an individual or corporation for these rules it is not possible to determine, for example, if a higher tier partnership which is a less than 10 percent general partner should be treated as subject to (e)(3) or (e)(4). We do not believe that for these purposes partnerships should in all cases be treated as corporations. Consider, for example, a case where all partners of the higher tier partnership are individual general partners and the higher tier partner is a less than 10% general partner in the lower tier partnership.

(ii) The tiered partnership rules do not deal with an obvious means of circumventing the rules. This is best illustrated by an example, as follows:

> A, B and C are corporate general partners In a highly leveraged partnership, ABC, sharing income 9%, 9% and 82%, respectively. A and B are subject, therefore, to the rules of paragraph (e)(4). If A and B have no foreign source income other than from ABC, both will want to apportion some of the interest expense of ABC to their other assets. To achieve this result they set up partnership XY, in which they share income equally, and to which they contribute their interests in partnership ABC so that XY is now an 18% general partner of ABC. By this exercise, A and B instead can now apportion some of the interest expense of ABC to their other domestic assets since both the interest expense of ABC and of XY are governed by the rules of paragraph (e)(3).

We suggest that an attribution rule similar to that in Section 304(c) therefore be adopted.

7. <u>Nonresident Aliens and Foreign Partners -- Temporary Regulations Secs. 1.861-9T(d)(2) and 9T(e)(7).</u>

As a general matter, Temporary Regulations Secs. 1.861-9T(d)(2) and -9T(e)(7), relating to effectively connected income of nonresident aliens and foreign corporations, more properly belong in Regulations Sec. 1.882-5 or Regulations Sec. 1.873-1. In addition, certain areas need further clarification or modification as follows:

(a) <u>Foreign Corporate Partners</u>. For a foreign corporation whose interest in a partnership is 10 percent or more, the Temporary Regulations provide that Regulations Sec. 1.882-5 will be applied by taking into account the corporation's share of the assets, liabilities and interest expense of the partnership. For other foreign corporate partners, interest expense of the partnership will be apportioned at the partnership level as if such partnership were a foreign corporation. The interest in the partnership will be ignored in both cases for the purposes of Regulations Sec. 1.882-5. The Committee believes that the approach of the Temporary Regulations is inadequate for a number of reasons:

(1) No guidance is provided as to the “partnership liabilities that are deemed incurred directly” by a partner. Is it by analogy to the rules of Temporary Regulations Sec. 1.861-9T(e)(1) that percentage of the partnership liabilities as bears the same ratio to total liabilities as the partner's distributive share of partnership income bears to the total income of the partnership; (ii)the share of partnership liabilities taken into account in calculating each partner's basis pursuant to Regulations Sec. 1.752-l(e); or (iii) a share of the partnership's liabilities equal to the ratio of his distributive share of partnership interest expense to total partnership interest expense? Approach (iii) would be consistent with the determination for branch profits tax purposes of U.S. liabilities connected with the conduct of a U.S trade or business.[*]

(2) Treating a partner as holding a percentage of the partnership assets equal to the “partner’s interest in partnership income for the year” is distortive, as explained above, since it may apportion to that partner in any particular year a share of the assets of the partnership that is greater or less than that owned by the partner as an economic matter. We think it would be more appropriate to go back to the rule in the Proposed Regulations and use the partner's interest in partnership assets, determined under Regulations Sec. 1.897-l(e)(2)(ii). In addition, if a “partner's interest in partnership income for the year” is used, because the only relevant asset figures for purposes of Regulations Sec. 1.882-5 are those for assets effectively connected with a U.S. trade or business and those for assets not so connected, the determination of effectively connected assets could be made by multiplying the partner's share of assets so determined by the ratio of its effectively connected distributive share of partnership gross

[*] Regulations Sec. 1.884-1T(D)(9)(ii).

income for the taxable year to its distributive share of all partnership gross income for the taxable year.*

(3) The entity approach of Temporary Regulations Sec. 1.861-9T(e)(7) for less than 10 percent corporate partners which determines effectively connected income as if the partnership were itself a foreign corporation and does not treat an interest in such a partnership as an asset which generates effectively connected income is wholly unsatisfactory.

We believe that an unqualified look through rule (like that discussed in (1) and (2) above) should apply for less than 10 percent corporate partners so that each such partner can apportion any outside interest expense directly incurred by the partner and also the partner's share, if any, of interest expense deemed incurred by that partner under Temporary Regulations Sec. 1.861 9T(e)(1) and (2) against its share of the effectively connected income from the partnership. If such a rule is not adopted, a less than 10 percent corporate partner should at least be permitted to take into account for all Regulations Sec. 1.882-5 purposes the value of the partner's interest in the partnership (perhaps reduced by the partner's share of the partnership liabilities the interest

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* Regulations Sec. 1.884-1T(d)(9)(i). Query whether there should be a special allocation rule where, for example, a partner is specifically allocated income of the partnership from assets outside the U.S. and receives only such assets on liquidation.

expense on which is subject to Temporary Regulations Sec. 1.861 9T(e)(4)).

The Committee can see no justification for the present rule in Temporary Regulations Sec. 1.861-9T(e)(7) which discriminates against foreign corporate partners in a situation such as the following: A foreign corporation (“F”) has a less than 10 percent interest in partnership XYZ and an interest greater than 10 percent in partnership AB. Since F's interest in XYZ is not considered an asset which generates effectively connected income when F apportions, pursuant to Regulations Sec. 1.882-5, its share of the interest expense of AB, the effect will be to apportion more of the share of the interest expense of AB away from the effectively connected income of F than should be the case. The Committee sees no basis for so limiting the deductions to be taken against effectively connected income and would point out that this approach is also at odds with the general rule for domestic corporations which include the value of such less than 10 percent partnership interests for the purposes of apportioning all other interest expense of the partner.

(4) Because Section 875 applies with equal force to tiered partnership situations, the interest expense of any lower tier partnership will be treated as if paid by a U.S. corporation. Since the rules of Temporary Regulations Secs. 1.861-9T(e)(5) and (7) clarify that such interest expense would be taken into account for Regulations Sec. 1.882-5 purposes, we assume that under the rules of Regulations Sec. 1.884-4T(c)(2) any excess interest of a foreign corporation, for purposes of Section 884(f)(1)(8),

can now be reduced by the foreign corporation's distributive share of the interest expense of its lower tier partnership.

(b) Nonresident Individuals. Temporary Regulations Sec. 1.861-9T(d)(2) sets forth rules for determining interest deduction allowed to a nonresident alien individual in. determining effectively connected income. These presumably relate only to business interest of a nonresident alien, not to interest paid or accrued on indebtedness incurred or continued to purchase or carry property which gives rise to investment income taxed under Section 871(a)(1) and it would be useful for the Regulations to so state. With respect to business interest, in contrast to the rules applicable to foreign corporations, which multiply the U.S. assets by a certain ratio, Temporary Regulations Sec. 1.861-9T(d) determines the U.S.-connected liabilities, up to a limit, by direct tracing. Such liabilities are those liabilities entered on the books of the business and those secured by assets that generate such effectively connected income. Liabilities are not included to the extent they exceed 80 percent of the gross assets of the business or are secured by specific assets that are not part of the business.

We believe the rules of Regulations Sec. 1.882-5 better reflect the theory that money is fungible and that the rules in the Temporary Regulations are arbitrary. There is no reason to prefer the bright line tests adopted over all other formulae. In addition, the rules are unnecessarily restrictive in that (a) the liabilities must be entered on the books and records of the United States trade or business when incurred, and may not be shifted to the business at a later stage, and (b) securing the liabilities by a nonconnected asset automatically prevents a deduction for the interest on such a liability. We recognize, however, that the rules of Regs. Sec. 1.882-5 may be difficult for individuals to comply with and we therefore suggest that the rules in Temporary Regulations Sec. 1.861-9T(d) be retained but amended to provide an election for nonresident individuals to choose rules similar to Regulations Sec. 1.882-5.

The following situation illustrates one of the problems with the rules in Temporary Regulations Sec. 1.861-9T(d):

> Individual A engages in a U.S. trade or business through an office in New York. He earns $500x of effectively connected income through such office. In addition, he earns $100x of other U.S. source income from an unrelated activity that does not involve a U.S. trade or business. Unless any interest expense he pays to earn this $100x is booked in the office or collateralized by an asset of that operation, no deduction can be taken for such expense. The income, however, may be includible in gross if it is treated as effectively connected income under Section 864(c)(3).

The Committee does not believe that individual taxpayers should be prevented from taking such a deduction.

In the case of a nonresident alien individual who is a partner in a partnership, Temporary Regulations Sec. 1.861-9T(e)(7)(ii) provides that the partner's distributive share of the partnership interest expense will be effectively connected to the extent of the percentage of the partnership assets that generate effectively connected income, but that no interest expense directly incurred by the partner may be allocated and apportioned to the individual's distributive share of partnership effectively connected income.

The Committee does not believe that there is any basis for preventing the apportionment of outside interest expense of individual partners against each such partner's distributive share of partnership effectively connected income. Individuals should have the option to apply rule similar to Regulations Sec. 1.882-5, as suggested above, and should for such determination take into account their shares of the partnership's liabilities, assets and interest expense computed as suggested at (a)(1) and (2) above for foreign corporations.

The Service has announced that it is considering the adoption of a source rule for nonresident individuals that would treat any interest expense considered to be connected with effectively connected income as U.S. source income in the hands of the recipient. We believe that any such sourcing rule should be adopted only by a legislative extension of the principles of Section 884(f) to individuals.

Before adopting this sourcing rule (in either form), it should be remembered that special provisions are needed to deal with nonresident aliens considered to be engaged in a trade or business by virtue of being a partner in a United States partnership so engaged. Since the interest paid by such partnership will already be sourced in the United states, the partner's distributable share of such interest should be excluded from the application of the new rules.

8. Assets Without Directly Identifiable Yield -- Temporary Regulations Sec. 1.861-9T(g)(3)

Temporary Regulations Sec. 1.861-9T(g)(3) defines assets without directly identifiable yield” to include both assets which produce no directly identifiable income yield and assets used in “general” and “administrative” functions. These assets are not taken into account in determining a taxpayer's apportionment fraction because they “cannot alter the ratio of assets within the various groupings of income.” It continues to be unclear precisely what assets are regarded as having “no directly identifiable income yield” or what is a “general” or “administrative” function, and in the absence of guidance this is likely to be a source of continual dispute.

Moreover, it is in many cases wrong to assume, as the Temporary Regulations do, that assets which produce no directly identifiable income yield or which are used in general and administrative functions contribute equally to the generation of all of the taxpayer's income. Such assets may contribute primarily or solely to the production of either U.S. or foreign source income, and their exclusion from the numerator and denominator of the apportionment fraction may therefore be a distortion. Suppose, for example, that a taxpayer borrows $200 million to construct a corporate headquarters to facilitate the conduct of an active trade or business in the United States. The taxpayer owns substantial amounts of stock in foreign corporations and earns substantial amounts of foreign source dividends. Although the taxpayer controls some (but not all) of these corporations, none of the decisions relating to how they conduct their businesses are made in the United States. In such a case the corporate headquarters does not contribute equally to the generation of the taxpayer's foreign source dividends. Under Section 864(e), the taxpayer apportions a substantial part of the interest expense on its $200 million borrowing to foreign source dividends notwithstanding that the proceeds of the borrowing are not used to generate such dividends because the proceeds of the borrowing are treated as fungible. The taxpayer is denied the corresponding right to include a $200 million U.S. asset in its apportionment fraction, however, under the Temporary Regulations. Instead the asset is removed from the apportionment fraction as if the interest expense on the borrowing had been allocated directly to the income produced by the asset. Put differently, it is simply not true that prorating the value of this asset, which produces no directly identifiable income yield, cannot alter the ratio of assets within the various groupings of income.

The Committee believes that an asset which produces no directly identifiable income yield should be prorated among the various categories of a taxpayer's gross income for purposes of apportioning the taxpayer's interest expense and that the taxpayer should be permitted (and required) to exclude for this purpose any gross income which is clearly not generated by the asset. This rule would be similar to the one found in Temporary Regulations Sec. 1.861-14T(c)(2) concerning the apportionment of an expense other than interest expense which is not directly allocable and apportion able to any specific income-producing activity but which is allocable to the gross income of fewer than all of the members of the affiliated group. Under Temporary Regulations Sec. 1.861 14T(c), the assets of any member of the group to which such an expense does not relate are excluded from the group apportionment fraction for purposes of apportioning that expense to various categories of gross income.

9. Nonrecourse Debt -- Temporary Regulations Sec. 1.861-10T(b)

A. Overview

Regulations issued prior to the 1986 Act treated interest on certain nonrecourse debt as definitely related to specific property and,[*] according to the Blue Book (which reflects the Ways and Means and Senate Finance Committee Reports),

> [t]he Act does not change the treatment of nonrecourse debt that the current regulation treats as definitely related to specific property.[**]

The Proposed Regulations clarified several of the nonrecourse debt provisions in the Prior Regulations and also provided guidance on items such as refinancing and post-construction financing. In our comments on the Proposed Regulations, we stated that we supported many of the changes made by the Proposed Regulations, but also that other changes added restriction not contemplated by Congress. In reviewing the Temporary Regulations, we believe that the drafters have gone substantially further, not only in providing clarification and guidance but also in adding restrictions not contemplated by Congress.

B. General Rule

Temporary Regulations Sec. 1.861-10T(b)(1) provides that, in the case of qualified nonrecourse indebtedness, "the deduction for interest shall be considered directly allocable solely to the gross income which the property acquired, constructed, or improved with the proceeds of the indebtedness generates, has generated, or could reasonably be expected to generate." The Temporary Regulations, by deleting the words "class of" from the phrase "directly allocable solely to the gross income," clarify that qualifying interest expense is to be traced directly to

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[*] Prior Regulations Sec. 1.861-8(e)(2)(iv).

[**] Blue Book at page 947.

the income from the property financed with the nonrecourse debt and need not be apportioned among the different statutory or residual groupings within a class of gross income. [*]

C. Definition or Qualified Nonrecourse Indebtedness

Temporary Regulations Sec. 1.861-10T(b)(2) sets forth the five basic conditions that must be met for interest expense to qualify for direct allocation.[**]

The Temporary Regulations add the term "constructing" to the first of the five conditions, i.e., direct allocation is allowed where the "borrowing is specifically incurred for the purpose of purchasing, constructing, or improving the identified property ..." This addition does not, however, appear to expand the availability of direct allocation compared with the Proposed Regulations, as the Proposed Regulations elsewhere set forth rules for the qualification of post-construction permanent financing.[***]

The Temporary Regulations, like the Proposed Regulations, do not permit debt incurred for the purpose of "maintaining" property to qualify for direct allocation and in this respect differ from the prior regulations. In determining whether debt is incurred for the purpose of "maintaining" property (which does not

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[*] This clarification is consistent with that recommended in the Tax Section's comments on Proposed Regulations Sec. 1.861-8(e)(2)(iv)(A).

[**] These five conditions generally follow the five conditions set forth in the Proposed Regulations which, in turn, generally followed the five conditions set forth in the prior regulations. See Proposed Regulations Sec. 1.861-8(e)(2)(iv)(A) and prior Regulations Sec 1.861 8(e)(2)(iv)(A).

[***] Proposed Regulations Sec. 1.861-8 (e)(2)(iv)(D).

qualify) or for the purpose of "improving" property (which does qualify), the appropriate standard should be whether or not the expenditure creates a long-lived improvement. In applying this standard, the fact that the expenditure can be expensed for federal tax purposes (e.g., intangible drilling costs or mine development expenditures) should not prevent an expenditure from being considered an improvement. The Regulations should also clarify that such a borrowing qualifies regardless of whether the property is actually improved (e.g., even though the well comes up dry).

D. Identified Property

Unlike the Proposed Regulations, the Temporary Regulations, in Sec. 1.861-10T(b)(2)(i), explicitly limit the non-recourse indebtedness exception to the financing of identified property that is either "depreciable tangible property or real property with a useful life of more than one year or ... amortizable intangible personal property with a useful life of more than one year," and they also specifically exclude "financial assets" and inventory. They also, in Temporary Regulations Sec. 1.861-10T(b)(8)(i), in effect limit the assets that can be financed as a unit to an "integrated project", defined as "functionally related and geographically contiguous assets" used by the taxpayer in the same trade or business.

As a matter of structure, it would be preferable to have a single provision that defines "identified property" and also imposes whatever limitations are to be imposed on the type and number of assets that can qualify for the special rule on nonrecourse financing. There is no reason for requiring taxpayers to review several sections of the Regulations to determine if an asset or group of assets is of a type which qualifies for nonrecourse financing.

Our prior Report recommended that stock in a related party not be treated as property eligible for qualified nonrecourse borrowing. We made this recommendation because permitting stock of a related corporation to collateralize a qualified nonrecourse borrowing has the potential for allowing nonrecourse financing of multiple unrelated assets (i.e., the assets held by the related corporation). The Temporary Regulations go much further, however, and exclude any nonrecourse financing of stock, debt, or an interest in a partnership or trust. This may present a real obstacle in a case where the seller will only sell stock or partnership interests (and a purchase of the underlying assets is not feasible), and it seems to us to be altogether unnecessary in a case where the stock, partnership or trust interest is a relatively small interest acquired as an investment. What we would recommend is as follows:

1. The qualified nonrecourse debt rule should be available for an acquisition of shares of stock or partnership interests that are more than an investment (i.e., consist of a significant interest) if the rule would have applied to a nonrecourse financing of all of the underlying assets of the corporation or partnership -- for example, where the only asset of the issuer of the shares of stock is a single net leased building.

2. The qualified nonrecourse debt rule should be available for an acquisition of a financial asset that is simply an investment (i.e., a small interest in shares of stock or a partnership interest, and any debt obligation or interest in a trust).

The integrated projects rule in Temporary Regulations Sec. 1.861-10T(b)(8)(i) would appear to provide that a multiple asset acquisition qualifies only if the assets are “functionally related and geographically contiguous."[*] These requirements are too restrictive and would not, for example, seem to cover a fleet of rail cars (because they are not functionally related or, necessarily, geographically contiguous) or, necessarily, a single plant or facility (since that might be separated by a road or other intervening property and thus not be regarded as geographically contiguous). It may also produce anomalies when applied to natural resources. For example, if a single mineral property is separated on a grid basis into ten separate interests, the acquisition of all ten interests by a taxpayer would presumably qualify; however, if the taxpayer purchased only five of the interests and all of the interests were not geographically contiguous; the acquisition would presumably not qualify.

In our prior Report on the Proposed Regulations, we suggested that financings of multiple assets should qualify if the separate assets would normally be financed as a single unit. That still seems to us to be the better rule, but if the final Regulations try for a more rigid definition it should at least permit a single loan to cover (1) substantially similar assets normally financed as a unit (such as rail cars, fleets of automobiles, etc.), whether or not the assets are entirely fungible and (2) to cover facilities and mineral properties that are operated as part of an integrated business activity, whether or not all components are geographically contiguous.

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[*] Another interpretation is that the multiple assets need be functionally related and geographically contiguous only if any of those assets are not part of the "identified property" that is purchased, constructed or improved.

E. Cash Flow Defined

The prior regulations and the Proposed regulations had as a requirement (the fourth of the five basic requirements) that it be reasonably assumed that cash flow from the property would be sufficient to service the nonrecourse debt.[*] The Temporary Regulations, applying a similar test, require that the cash flow from the property be reasonably expected to be sufficient in the first year as well as in each subsequent year to fulfill the terms and conditions of the loan agreement with respect to the amount and timing of payments of interest and principal.[**]

In what may be the most controversial change in the nonrecourse debt rules, Temporary Regulations Sec. 1.861 10T(b)(3)(i) provides that the cash flow test will not be met “if a significant portion [of the cash flow] is derived from activities such as sales, labor, services, or the use of other property.” The Reproposed Regulations quantify “significant portion” with a 15 percent rule, i.e., a significant portion of revenue will be considered to be derived from sales, labor, services, or the use of other property, “if operating costs other than interest with respect to the property exceed 15 percent of the total income

[*] Prior Regulations and Proposed Regulations **Sec**. 1.861 8(e)(2)(iv)(A)(4**).**

[**] Temporary Regulations Sec. 1.861-10T(b)(2)(iv). As we read this rule, the "reasonable expectation" test need be satisfied only at the time the indebtedness is incurred and also permits financings that provide for no payments of interest and/or principal in one or more years (such as in a balloon financing), so long as the accumulated cash flow is reasonably expected to be sufficient to make the scheduled payments.

derived from the property in the taxable year."[*] In applying this rule, the term "operating costs" is to include "only expenses that are deductible solely under Section 162."

If, as some suggest, this change is designed to limit direct allocation to net leased property,[**] there is a significant issue as to whether the restriction conflicts with the Congressional direction "not [to] change the treatment of nonrecourse debt that the current regulation treats as definitely related to specific property." There is no indication of which we are aware that the prior regulations were limited to net leased property.[***]

The concern that apparently led to the redefinition of cash flow was that the cash flow from property operated by the taxpayer will ordinarily exceed the cash flow from net leased property since it will include any return on the taxpayer's operating costs.[****] Even if this concern justifies a departure from

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[*] Reproposed Regulations Sec. 1.861-10(b)(3)(iv).

[**] The introductory explanation of the Temporary Regulations, while not specifically mentioning real estate or net leases, indicates that qualified nonrecourse indebtedness is intended to be limited to purchase money financing of assets that do not involve significant activity of the owner to generate income and that can reasonably be expected to self-finance.

[***] The Internal Revenue Service issued a favorable private letter ruling in February, 1988 with a nonrecourse financing in a non-real estate lease situation. See PLR 8819063.

[****] There should be no concern that debt secured by property which the taxpayer operates will be recourse debt, given the restrictions in the regulations on any form of personal recourse other than warranties of maintenance.

the Congressional direction to continue the nonrecourse debt rule in the prior regulations, it does not support a blanket exclusion of all property that is not net leased. The concern can just as well be dealt with by limiting the cash flow that can be considered to (a) the fair rental value of the property on a net leased basis or (b) gross cash flow less a multiple (e.g., 110 percent) of operating expenses.

One result of the redefinition of cash flow is that the purchase of natural resource properties is effectively excluded from direct allocation treatment. The “operating costs” level for oil and gas properties is typically above the 15 percent range; the percent is considerably higher in the case of secondary and tertiary recovery projects. In any nonrecourse acquisition of natural resource properties (whether oil and gas, coal, timber, etc.) where the lender can look only to the acquired property and the cash flow there from as security, the fact that the borrower needs to expend funds to extract or sever the natural resource does not mean that the cash flow is other than from the property. Accordingly, if an operating costs test is to be used, we would recommend that the final regulations adopt a considerably higher percentage level (e.g., in the 40 percent range).

In excluding from direct allocation treatment those financings where a significant portion of the cash flow is derived from labor or services, Temporary Regulations Sec. 1.861 10T(b)(3)(i) states: “Thus, revenue derived from the sale or lease of inventory or of similar property does not constitute cash flow from the property....” This quoted language is confusing in that it inexplicably links all inventory sales to labor-intensive activity. In the case of a mineral property, where all revenue is from the sale of the mineral, a literal reading of this inventory rule would appear to preclude direct allocation even if the 15-percent operating costs rule is satisfied.* The final regulations should clear up this ambiguity.

Assuming the redefinition of cash flow is not changed, the regulations also should clarify whether Section 162 expenses that are required to be capitalized into inventory are to be included in applying the operating costs rule. A literal interpretation of Treasury Regulations Sec. 1.162-1(a) (which provides that no expense item shall be treated as a Section 162 business expense to the extent that it is used by the taxpayer in computing the cost of inventory) would indicate that Section 162 expenses capitalized into inventory are <u>not</u> included for these purposes.

F. <u>Clawbacks</u>

In our prior Report, we recommended clarification that “clawbacks” not disqualify a borrowing from the nonrecourse indebtedness rule. Under the typical clawback arrangement, cash flow from the identified property in excess of current debt service is credited to a notional clawback account; if future cash flows are insufficient at any time to service the debt, the lender can look to the funds in the notional clawback account for payment of interest or principal. We continue to think that clawbacks

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* A rule denying direct allocation where the revenue is derived from the sale of inventory would appear to conflict with PLR 8819063. In that ruling, the nonrecourse loan was to be repaid from the sale of property.

are consistent with the concept of nonrecourse financing and should be permitted.[*]

G. Cross Collateralization and Credit Enhancement

The Proposed Regulations treated any recourse beyond the identified property as “cross collateralization” which, if present, would preclude direct allocation.[**] The Temporary Regulations differentiate between recourse against other assets of the borrower (cross collateralization) and recourse against third parties (credit enhancement), but deny direct allocation if either is present.[***]

Temporary Regulations Sec. 1.861-10T(b)(7) defines credit enhancement as “any device, including a contract, letter of credit, or guaranty, that expands the creditor's rights, directly or indirectly, beyond the identified property ....” The Temporary Regulations further provide that the “acquisition of bond insurance or any other contract of suretyship by an initial or subsequent holder of an obligation will constitute credit enhancement.”

In our comments on the cross collateralization provisions in the Proposed Regulations, we stated that the proper frame of reference should be the borrower (and whether other assets of the

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[*] As we interpret the Temporary Regulations, they will permit a "rollover" provision, i.e., an agreement which provides that some payments of interest and/or principal will be made only if there is cash flow and, if cash flow is insufficient in any year, provides that lenders will be paid out of cash flow in future years.

[**] Proposed Regulations Sec. 1.861-8(e)(2)(iv)(E).

[***] Temporary Regulations Sec. 1.861-10T(b)(4)(ii) and (iii).

borrower are subject to the claims of the lender) rather than the lender (who might have recourse against third parties). Nevertheless, the Temporary Regulations, like the Proposed Regulations, focus on the recourse of the lender. In an attempt to police the subsequent actions of a lender in a nonrecourse financing, the Temporary Regulations require that the loan documents specifically prohibit the acquisition by the lender of bond insurance or any similar form of credit enhancement.[*] The Temporary Regulations also prohibit the "syndication of credit risk," an arrangement whereby a primary lender obtains the commitment of a secondary lender to bear a portion of the primary lender's credit risk on a loan.[**]

It is questionable whether a rule which purports to prohibit nonrecourse lenders from obtaining credit enhancement will have any effect. What are the borrower's remedies if the prohibition is violated by a lender? Once funds have been advanced, the lender's obligations have been fully executed, and the usual loan agreement would impose obligations at that point only on the borrower, not the lender.

H. Insurance

Temporary Regulations Sec. 1.861-10T(b)(8)(ii) clarifies that the purchase of third-party casualty and liability insurance

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[*] Temporary Regulations Sec. 1.861-10T(b)(4)(iii).

[**] Temporary Regulations Sec. 1.861-10T(b)(7)(iii). The Temporary Regulations do permit, however, the "sale of loan participations," defined as "an arrangement in which one primary lender divides a loan into several portions, sells and assigns all rights with respect to one or more portions to secondary lenders, and does not remain at risk in any manner with respect to the portion assigned."

on the collateral does not constitute credit enhancement.[*] Similarly, a contractual agreement by the taxpayer to self-insure the collateral does not constitute cross collateralization. This provision on self-insurance presumably covers arrangements where the taxpayer insures the collateral with a “captive” insurance company.[**]

It would be helpful for the final regulations to clarify that, following the destruction or loss of identified property, the replacement of such property by the insurer (whether a third-party or self-insurer) would not disqualify an otherwise qualifying nonrecourse loan from direct allocation treatment.

I. Excess Collateralization

Reproposed Regulations Sec. 1.861-10(b)(4)(vii) and (b)(12) provides that direct allocation will not be allowed if the nonrecourse financing transaction involves “excess collateralization is defined on the basis of a loan-to-value test: if the amount of the nonrecourse loan is less than 60 percent of the value of the property acquired, the loan will be deemed to involve excess collateralization; if the loan amount exceeds 80 percent of the value, the loan will be deemed not to involve excess collateralization; if the loan amount is within the 60-80 percent

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[*] This rule confirms the result reached in PLR 8819063 dealing with insurance coverage in a nonrecourse financing.

[**] The Service has for several years viewed insurance through a captive insurance subsidiary as self-insurance. See Rev. Rul. 77-316, 1977-2 C.B. 53.

range, excess collateralization will be determined on the basis of all the facts and circumstances.

In our prior Report on the “economic significance” rule in the Proposed Regulations, the Tax Section recommended against the adoption of rigid rules on economic significance -- “e.g., that there can never be economic significance if the loan to value ratio exceeds a specified ratio.” Unfortunately, the reproposed regulations specifically adopt a rigid loan-to-value rule. As discussed below, we continue to believe that a loan-to-value rule is a mistake.

The Committee believes that the loan-to-value test discriminates against higher-risk projects. The amount that a lending institution is willing to lend on a nonrecourse basis to finance a project depends in large part on the risks involved. Traditional real estate nonrecourse financings will likely qualify under the above-described loan-to-value rule since lenders can readily calculate an almost-certain cash flow. But in other industries where the risks are greater, lenders are not willing to lend the same percentage of project costs. Even within an industry the lending levels can vary. For example, within the oil and gas industry, an on-shore project to develop known reserves can achieve a far higher level of nonrecourse financing than can an offshore, deepwater project where the reserves are uncertain. From a tax policy point of view, it is difficult to see why traditional, “safe” investments should be treated more favorably than riskier ventures.

We recommend that the excess collateralization rule be deleted. We believe that it is best to let market factors establish the appropriate loan-to-value ratios without the imposition of rigid tax restraints, and that the "economic significance" requirement was sufficient to prevent abuse.

If the loan-to-value requirement is not eliminated altogether, it should in any event either not apply at all to loans made to finance improvements or the "value of the property" should be limited to the value of the improvement. In such a case the lenders will, of course, require that the loan be collateralized by the whole property, not just the improvement, and application of the loan to value test to the entire property will mean that loans incurred to finance improvements can never qualify, except in the unusual case where the value of the unimproved property is less than 40 percent of the value of the improved property.

The regulations should clarify whether, in the case of a loan providing for stated interest that is above or below market, the amount of the loan is its face amount or its issue price, as determined for example under Section 1274.

J. Refinancings

The Temporary Regulations,[*] like the Proposed Regulations,[**] permit a refinancing of nonrecourse debt to qualify for direct allocation treatment. Unlike the Proposed Regulations, the Temporary Regulations allow de minimis extensions of the nonrecourse debt that is refinanced. Temporary Regulations Sec. 1.861-10T(b)(9) allows the principal amount of the new indebtedness to exceed by up to five percent the remaining principal amount of the original indebtedness and the term of the new indebtedness to

[*] Temporary Regulations Sec. 1.861-10T(b)(9).

[**] Proposed Regulations Sec. 1.861-8 (e)(2)(iv)(C).

exceed by up to six months the remaining term of the original indebtedness.

The Temporary Regulations, like the Proposed Regulations, would not appear to permit direct allocation in the case of multiple refinancings (i.e., a refinancing of a refinancing). The Tax Section sees no reason why a refinancing of a refinancing should not qualify for direct allocation treatment, and recommends that the final regulations affirmatively address this issue.

K. Post-Construction Permanent Financing

The Temporary Regulations, like the Proposed Regulations,* allow taxpayers a grace period to obtain nonrecourse financing for newly-constructed property. Temporary Regulations Sec. 1.861-10T(b)(10) provides that financing obtained within one year after the constructed property is placed in service will be qualified nonrecourse indebtedness if the financing does not exceed the cost of construction (and provided the other tests of Sec. 1.861-10T(b) are satisfied). In providing a one-year grace period for post-construction permanent financing, the Temporary Regulations apparently allow the taxpayer to self-finance during the construction period. This is an improvement over the Proposed Regulations which limited the one-year grace period rule to repayment of construction period loans and advances.

While this one-year grace period for nonrecourse financing of new construction is certainly appropriate, we question why a similar rule is not provided for acquisitions of property. In the case of newly-constructed property, a grace period is

* Proposed Regulations Sec. 1.861-8 (e)(2)(iv)(D).

appropriate since a lending institution might not feel comfortable making the loan prior to an inspection of the completed property. Similarly, in the case of asset acquisitions, lender inspection/approval might not be possible until after the sale has taken place. In situations where the existing property to be purchased needs to be improved or modified to generate the expected cash flow (for example, a building requiring rehabilitation), the lender might feel comfortable making a nonrecourse loan only after the subsequent improvements have been completed.

L. Related Person Transactions

Temporary Regulations Sec. 1.861-10T(d) provides that qualified nonrecourse indebtedness does not include indebtedness between related persons or indebtedness incurred from unrelated persons for the purpose of purchasing property from a related person. The Temporary Regulations specify that the related person definition in Section 267(b) is to apply for these purposes.[*]

Temporary Regulations Sec. 1.861-10T(b)(11) allows a transferee of property that is subject to qualified nonrecourse indebtedness to obtain direct allocation treatment on the assumption of such debt. It would be helpful for the final Regulations to clarify that a related person transfer (taxable or tax-free) of property subject to qualified nonrecourse indebtedness is not disqualified under the related person transactions rule.

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[*] While the Proposed Regulations contained similar related person restrictions, they did not provide any definition of related person for these purposes.

10. Integrated Financial Transactions -- Temporary Regulations Sec. 1.861-10T(c)

In our prior Report, we urged the issuance of direct allocation rules for integrated financial transactions that would provide meaningful relief for taxpayers faced with circumstances in which money is not fungible. Broad regulations with respect to integrated financial transactions could alleviate the unfair consequences of assuming that money is fungible in cases in which interest expense clearly represents a cost of carrying a particular asset or conducting a particular business activity, rather than a cost allocable to all of the taxpayer's assets and activities.

The Temporary Regulations deny integrated treatment to all but a limited class of leveraged investments. Temporary Regulations Sec. 1.861-10T(c) provides that an activity will not qualify for integrated treatment if it bears any relationship to the taxpayer's business or if the taxpayer is a financial services entity. It is unclear why leveraged investments unrelated to the borrower's business (which by definition will represent a peripheral activity) deserve special relief, and why integrated transactions conducted as part of a taxpayer's core business do not. The Treasury Regulations virtually preclude a U.S. multinational corporation from entering on a competitive basis into any business which requires the maintenance of highly leveraged inventories. Why, for example, should a U.S. auto manufacturer be precluded from providing its customers with vehicle financing unless it does so through a deconsolidated affiliate?

Apart from excluding any transaction that is “in any way” related to the operation or normal course of a taxpayer's trade or business, the Temporary Regulations exclude any transaction undertaken by a financial services entity and impose requirements relating to the time that the indebtedness and related investment are incurred or made, the time that each is due or matures and the form of income that may be earned from the investment. These will exclude all but rare transactions. Because of the requirement that income from the investment consist exclusively of interest or original issue discount, it is even unclear in the absence of Regulations under Section 988 whether “a debt-financed acquisition of foreign currency debt obligations,” which is the one example given in the legislative history, will qualify as an integrated financial transaction.*

We continue to believe that the Service should consider adoption of a facts and circumstances standard for determining whether integrated treatment is appropriate.**

11. Affiliated Group -- Temporary Regulations Sec. 1.861-11T(d)

Temporary Regulations Sec. 1.861-llT(d)(6) provides that an affiliated group will include any domestic or foreign corporation owned within the group to the extent of 80% or more in voting power or value if, in the case of a foreign corporation,

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* Blue Book at 948.

** For example, as discussed in the Committee's prior comment letter, interest expense incurred in respect of CMO equity owned by the taxpayer (in which the credit quality of the underlying assets of the CMO trust, and the effective segregation of those assets from the claims of the "owner's" creditors, permit leverage of up to 200:1), does not meaningfully represent a cost of producing the taxpayer's gross income.

more than 50% of its gross income for the taxable year is effectively connected with the conduct of a trade or business in the United States.* For this purpose, constructive ownership under Section 318 is taken into account.

We question whether the use of Section 318 will not lead to unintended consequences. For example, where a foreign parent owns two separate chains of U.S. corporations, both chains would be considered within the same affiliated group. The result would be the same if the foreign parent owned 80% in value of one chain and 50% in value of the other, notwithstanding that its voting stock interest was significantly less; or if the foreign shareholder was an individual.

Although the point seems reasonably clear, it would also be useful to state that the value and voting power determinations are made each year, with the consequence that a corporation initially not included in the group may in a later year be included if the relative value of the stock held within the group increases. The annual application of these tests would seem to follow from the absence of any statement to the contrary and from the fact that the 50% of gross income test is determined “for the taxable year.” It would also be useful to state when during a year the determination of value should be made.

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* As authority for the inclusion of these corporations, the preamble refers to Section 7701(f), authorizing Regulations "necessary or appropriate to prevent the avoidance of...provisions which deal with...the linking of borrowings to investment, or...diminishing risks... through the use of related persons." Any such Regulations would be legislative and thus subject to the notice and effective date provisions of the Administrative Procedure Act, 5 U.C.S. 553.

We note also that, for purposes of the value test, stock taken into account under Temporary Regulations Sec. 1.861-11T(d)(6) includes “all outstanding stock” and thus by its terms includes stock excluded from the definition by Section 1504(a)(4), i.e., non-voting, non-convertible stock that is limited and preferred as to dividends and in redemption.

12. Supportive Functions -- Temporary Regulations Secs. 1.861-8T(b)(3) and 1.861-14T

A. Overview

Section 864(e)(6) provides that, in general, expenses other than interest which are not directly allocable or apportionable to any specific income-producing activity or property shall be allocated and apportioned as if all members of the affiliated group were a single corporation. As an example, the legislative history points to the treatment of general and administrative expenses incurred by a U.S. parent holding corporation whose sole asset is 100 percent of the stock of a U.S. corporation that owns U.S. and foreign assets. In such a case, Congress did not think it necessarily appropriate to allocate and apportion all such expenses to U.S. source income. Instead, Congress believed it more appropriate, within the context of the separate company system that prevailed under prior law, to adopt a “look-through” approach for purposes of apportioning expenses incurred by the owner of the stock that are properly allocable to the class of income that includes dividends from such stock, whether or not paid, so long as this approach yields the same results that would obtain under a one-taxpayer approach.*

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* Blue Book at 946-47.

The legislative history also makes it clear that treating a U.S. affiliated group of corporations as if it were one taxpayer for expenses that are not directly allocable "does not change the prior law rules governing whether expenses are directly allocable"[**] and that no change was intended as to the treatment of items such as labor costs or costs of materials, which, to the extent they are elements of cost of goods sold, are generally not subject to allocation or apportionment.[***]

The Temporary Regulations provide for the following treatment of deductions which are supportive in nature (such as overhead, general and administrative, and supervisory expenses) and are not directly allocable or apportionable to any specific income-producing activity or property:

First, a determination must be made of what expenses are "supportive."

Second, a determination must be made as to whether the expense is not directly allocable or apportionable to any specific income-producing activity or property, which the Temporary Regulations provide will always be the case unless the taxpayer "affirmatively" establishes that the expense is "definitely related ...only to a class of gross income derived solely by the member" incurring the expense. The definitely related showing is to be made

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[**] Id. at 948.

[***] Id. at 949.

under Temporary Regulations Sec. 1.861-8T(b)(2), but this part of the Temporary Regulations is reserved.

Third, the expenses so identified must be apportioned according to apportionment fractions computed as if all members of the affiliated group that have the class of gross income to which the expense might be considered definitely related were a single corporation.

Fourth, in determining the apportionment fractions, the expenses may be allocated and apportioned along with other deductions to which they relate or, on some reasonable basis, directly to activities or property which generate, have generated or could reasonably be expected to generate gross income.

B. Scope of Temporary Regulations Sec. 1.861-14T

The rules in the Temporary Regulations for determining when expenses will be regarded as supportive expenses that are not directly allocable or apportionable to any specific income-producing activity or property raise the following principal issues:

1. The rules for determining what expenses are “supportive” and not directly allocable or apportionable to any specific income-producing activity are vague and are likely to be a continual source of disagreement between taxpayers and the Internal Revenue Service.

2. The formulation of the test as to when supportive expenses are not directly allocable to specific income-producing activities or property of the member incurring the expense is unduly broad, extending beyond Congressional intent and resulting

in what appears to be a mandatory application of the rules of Temporary Regulations Sec. 1.861-14T to such expenses, even in cases where allocation and apportionment on a "look-through basis" is not appropriate.

3. The presumption that supportive function expenses are subject to allocation and apportionment under Temporary Regulations Sec. 1.861-14T is not supported by the legislative history. In any event, if the presumption is retained, the final regulations should specify the standard of proof required to overcome it.

Expenses Covered.

In our prior Report, we suggested that the Regulations identify those expenses that are not "directly allocable and apportioned to any specific income-producing activity." The Temporary Regulations on one occasion refer to "supportive expenses, such as overhead, general and administrative and supervisory expenses."[*] Yet on another occasion, the category of "supportive expenses" is expanded to include "advertising, marketing and other sales expenses."[**] The reference to expenses "such as" eliminates any certainty as to what is intended to be covered.

[*] Regulations Sec. 1.861-8T(b)(3).

[**] Regulations Sec. 1.861-14T(e)(3).

We recognize that advertising, marketing and other sales expenses may, in certain circumstances, benefit more than one member of an affiliated group of corporations. This would be the case, for example, where a holding company that engages in no direct activities incurs advertising expenses to improve corporate "image." In such a case, the expenses should be allocated and apportioned among members of the affiliated group. On the other hand, advertising expenses incurred by a member to promote the sale of products it manufactures and sells (e.g., in a particular geographic location) should not be subject to allocation or apportionment under the rules of Temporary Regulations Sec. 1.861-14T. This again highlights the need to revise the tests applicable to determine whether a supportive expense is directly allocable to specific income-producing activities or property of the member incurring a supportive expense.

In addition, Temporary Regulations Sec. 1.861- 9T(g)(3) relating to the allocation of interest expense introduces the concept of "assets without directly identifiable yield", and it might be inferred that expenses related to such assets would by analogy be regarded as supportive. This should be addressed in the final Regulations.

Determination of Expenses Not Directly Allocable.

The Temporary Regulations focus on whether a supportive expense is "definitely related. . . . only to a class of gross income derived solely by the member which actually incurred the expense." The Temporary Regulations refer to Temporary Regulations Sec. 1.861-8T(b)(2) for the criteria to be applied to determine whether an expense is "definitely related". Although there are two examples in the Temporary Regulations in which expenses are determined not to be definitely related only to income of one member, the -8T(b)(2) Regulations themselves are reserved. Obviously, prompt guidance is required on this issue.

Under regulations promulgated prior to the Tax Reform Act of 1986, with few exceptions, virtually all deductions are definitely related to one or more classes of gross income. A deduction is considered definitely related to a class of gross income if it is incurred “as a result of, or incident to, an activity or in connection with property, which activity or property generates, has generated, or could reasonably have been expected to generate gross income.”* Because classes of gross income are fairly broad, it is quite likely that more than one member of an affiliated group will have similar classes of gross income. Thus, for example, a U.S. parent corporation (P) and its wholly- owned U.S. subsidiaries (S-l and S-2) may all be deriving gross income from business (manufacture and sale of product A). Assume that P and S-2 manufacture and sell only in the United States and that S-l derives both U.S. and foreign source income from the sale of product A. In such a case, the supportive expenses incurred by P, S-l and S-2 may be subject to allocation and apportionment because (1) the affiliated group is treated as a single taxpayer, and (2) under the Temporary Regulations (and assuming the “definitely related” approach of the pre-1986 Regulations is preserved), the expenses cannot be said to be definitely related <u>only</u> to a class of gross income that is derived <u>solely</u> by P, S-l or S-2.

The examples in the Temporary Regulations designed to illustrate the application of the rules governing the allocation and apportionment of expenses other than interest (including supportive expenses) appear to confirm that allocation and apportionment on an affiliated group basis will be required unless

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* Regulations Sec. 1.861-8 (b)(2).

the expense incurred by a member is definitely related to a class of income derived solely by such member.[**]

We submit that the approach of the Temporary Regulations is not supported by the legislative history of Section 864(e)(6). The General Explanation of the Tax Reform Act of 1986 notes specifically:

> "Treating a U.S. group as if it were one taxpayer for expenses that are not directly allocable, however, does not change the prior law rules governing whether expenses are directly allocable. As under prior law, expenses that a corporation at the lowest corporate tier (one with U.S. subsidiaries) incurs only to earn it own income (and not help affiliates earn income) are allocated to its income only for purposes of these rules."[*]

Under this approach, supportive expenses (such as general and administrative expenses, marketing expenses, etc.) incurred by P, S-1 or S-2 (in the example above) should not be subject to allocation and apportionment as if the affiliated group were a single corporation if it can be demonstrated that the expenses were incurred by a member to earn its own income (even if such income falls within the broad class of gross income generated by the other members of the affiliated group).

[**] Temporary Regulations Sec. 1.861-14T(j) examples (2) and (3) (general training program expenses) and example (4)(stewardship expenses). Example (5) of Regs. § 1.861-14T(j) deals with legal expenses incurred by a parent corporation (P) relating to the testimony of P employees in connection with a litigation to which a wholly-owned domestic subsidiary Y is a party. One of the facts assumed is that the expense is not allocable to specific income of Y. The conclusion in the example is that the legal expenses must be allocated and apportioned as if Y were the only member of the affiliated group because (1) the legal expenses are not definitely related solely to specific income-producing activities of property of P and (2) the expense is definitely related and allocable to the class of gross income which includes only gross income generated by Y.

[*] Blue Book at 947.

Even in the case of supportive expenses incurred by a parent corporation, the legislative history recognizes that such a parent corporation may incur some expenses that are allocable to its own specific income-producing activities (e.g., where the parent corporation (P in our example) conducts direct operations on its own behalf).*

We believe, therefore, that the test set forth in the Temporary Regulations should be revised. While we recognize the advantage of "bright line" tests, it may well be in this case that it is appropriate to resort to an examination of the facts and circumstances to determine whether a supportive expense incurred by a member of an affiliated group is directly allocable to specific income-producing activities or property solely of that member.

Presumption.

For similar reasons, we do not believe that a presumption against direct allocation to specific income-producing activities or property of a member is appropriate. The general rule that the taxpayer has the burden of proof in tax cases is sufficient and there is no need to resort to presumptions that can be rebutted by affirmatively establishing otherwise. Just what level of proof will be required in such a case is totally unclear. If the presumption is to be retained, the Regulations should address that issue.

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* Blue Book at 948.

C. Relation to Other Deductions

The Temporary Regulations do not explain how supportive expenses may relate to other deductions which can more readily be allocated to gross income. Neither, for that matter, did the prior Regulations.[*] The examples in the prior Regulations (Regulations Sec. 1.861-8(g) examples (19), (20) and (21)) deal with the allocation and apportionment of supportive deductions in the context of a single corporation, but none of the examples illustrates the "relationship of the supportive deductions" to other deductions. It would be helpful for the final regulations to provide guidance as to the criteria to be applied in relating supportive deductions to other deductions and for one of the reserved examples in Temporary Regulations Sec. 1.861-8T(g) to illustrate this principle.[**]

D. Additional Comments

1. The Temporary Regulations provide properly that Section 864(e)(6) does not apply to the computation of subpart F income of controlled foreign corporations, or to the computation of effectively connected taxable income of foreign corporations[***] Guidance is required, however, as to whether (and how) Section

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[*] Regulations Sec. 1.861-8(b)(3) (amended by the Temporary Regulations to delete its text, insert a reservation notice and a cross-reference, for guidance, to Regs. § 1.861-8T(b)(3)).

[**] Regulations Sec. 1.861-8T(b)(3) reference to examples (19) through (21) of Regs. § 1.861-8T(g).

[***] Temporary Regulations Sec. 1.861-14T(b)(2). The Service should address, promptly, the issue as to whether the regulations issued prior to the Tax Reform Act of 1986 will continue to apply to the determination of effectively connected taxable income of a foreign corporation engaged in trade or business within the United States. See Regulations Sec. 1.861-8(f)(1)(iv), 1.861-8(g) ex. (21).

864(e)(6) will apply to Section 936 corporations. Although such corporations are included within the definition of an affiliated group under Section 864(e)(5), the Temporary Regulations reserve as to the application of Section 864(e)(6) to the computation of combined taxable income of a possessions corporation and its affiliates.*

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* Temporary Regulations Sec. 1.861-14T(b)(3).