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NYSBA

June 22, 1999

The Hon. Bill Archer
Chair, House Ways & Means Committee
1236 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Archer:

We enclose herewith the following reports dealing with various proposals that were included in the Administration's Budget Proposal for fiscal year 2000, filed on February 1, 1999:

1. <u>Report on Proposed Amendments to the Market Discount Rules of Section 1276-78</u>

   In this Report, we support the proposal to require all accrual basis taxpayers to include market discount income as it accrues with a number of specific suggestions for adopting a broader de minimis rule, limiting the amount of market discount required to be included and certain other technical comments dealing with coordination with other sections.

2. <u>Report on Proposed Modification of Tax Provisions Related to Debt for Debt Exchanges</u>

   In this Report, we support the denial of the deduction for repurchase premium in debt for debt exchanges, the requirement to include the value of contingency payments in the issue price of the new debt received in debt for debt exchanges, and the proposal to shift the determination of gain recognition on certain debt for debt exchanges from the principal amount of the securities issued and exchanged to the issue price of such securities.

3. Report on Certain Proposals Relating to Foreign Activities of U.S. Taxpayers

In this Report, we support proposals to prevent mismatching of deduction and income in transactions with related foreign persons and the proposal to accelerate the effective date of the "look through" rule for dividends from "10/50 companies." With respect to the recapture of overall foreign losses on disposition of stock in controlled foreign corporations, we suggest as an alternative that consideration be given to amending the Section 864(e) rules for apportioning interest expense.

We would be pleased to discuss these Reports with you and your staff at your convenience.

Very truly yours,

Harold R. Handler, Esq.
Chair

Enclosure

cc: James D. Clark, Esq.

NEW YORK STATE BAR ASSOCIATION TAX SECTION REPORT[1] ON PROPOSED LEGISLATION TO AMEND THE MARKET DISCOUNT RULES OF SECTIONS 1276-78[2]

I. Introduction

This Report comments on the President's fiscal year 2000 budget proposal to modify the existing income accrual rules with respect to debt instruments[3] that bear market discount ("MD bonds").[4] The proposal would require all accrual basis taxpayers acquiring MD bonds on or after the date of enactment to include market discount in income as it accrues. In essence, the proposed rule seeks to treat MD bonds held by accrual basis taxpayers in the same manner as bonds issued with original issue discount ("OID bonds"). We support the proposal but are concerned with the complexities and administrative burdens it will create. Accordingly, we recommend the adoption of a broader de minimis rule and the use of only a single limit on accrual based on the AFR. We also recommend using an adjusted AFR-based limit in the case of tax-exempt debt. Finally, we note two conforming changes that will be required if the proposal is adopted.

II. Current Law

Market discount bonds generally include all bonds, debentures, notes, certificates and other evidences of indebtedness other than U.S. savings bonds, installment obligations subject to Section 453B and obligations with a fixed maturity of one year or less from date of issue.[5] Subject to a de minimis rule, market discount equals the excess, if any, of a bond's stated redemption price at maturity (or, in the case of an OID bond, the bond's revised issue price) over the holder's basis in the bond immediately after acquisition.[6] The de minimis rule, which is similar to the OID de minimis rule, treats a bond as having no market discount if the amount of such discount is less than 1/4 of 1% of the bond's stated redemption price at maturity multiplied by the complete number of years to maturity, measured from the date of acquisition by the holder.[7]

In the case of a bond issued at par, market discount equals the difference between the principal amount of the bond and the holder's basis in the bond immediately after its acquisition. In the case of an OID bond, market discount equals the difference

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[1] Prepared by Dickson G. Brown, Linda Z. Swartz, William S. Dixon, and David H. Schwartz, with helpful comments from Harold R. Handler, Robert A. Jacobs, and Michael L. Schler.

[2] All section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[3] For simplicity, all debt instruments are referred to herein as bonds.

[4] Department of the Treasury, General Explanations of the Administration's Revenue Proposals, at 121 (February 1999).

[5] Sections 1278(a)(l), (3).

[6] Sections 1278(a)(2)(A), (B).

[7] Section 1278(a)(2)(C).

between the bond's revised issue price[8] and the holder's basis in the bond immediately after its acquisition.[9] Thus, bonds purchased after original issuance at a price less than the principal amount of the bond, or, in the case of an OID bond, at a price less than the bond's revised issue price, will bear market discount.[10]

The current market discount rules, which were enacted in 1984 and amended in 1986 and 1993, treat gain (but not loss) realized on the disposition of a bond (including gain realized at maturity) as ordinary income to the extent of accrued market discount ("AMD").[11] Although market discount technically accrues on MD bonds, and holders of MD bonds are required to determine and record the amount of market discount accrued during each tax year, holders are not required to include accrued discount in income as it accrues. Holders have several options with respect to calculating the amount of AMD on a MD bond. Under the default rule, AMD equals the ratable amount of the discount accrued over the holder's holding period using a straight-line method; holders can elect to calculate AMD using constant yield principles.[12] Holders may also opt to include market discount in income as it accrues, in which case the basis of each MD bond held by an electing holder with respect to such bond is increased by the amount of accrued market discount included in gross income.[13] It is likely that most taxpayers other

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[8] Section 1278(a)(4). The "revised issue price" of a taxable bond equals the sum of the issue price of the bond and the aggregate amount of the OID includible in the gross income of all holders for periods before the acquisition of the bond by the taxpayer, determined without regard to Sections 1272(a)(7) or 1272(b)(4). The revised issue price of a tax-free bond equals the sum of the issue price of the bond and the aggregate amount of the OID accrued pursuant to Section 1272(a), determined without regard to Section 1272(a)(7), during the periods before the taxpayer acquires the bond. Id.

[9] Section 1278(a)(2)(B). It is not clear whether the price paid for a bond takes into account any accrued, but unpaid, interest when calculating market discount in order to determine whether a bond constitutes a MD bond. See David Garlock, Federal Taxation of Debt Instruments, 13-4 n.8 (3d ed. Supplemented through 1998). The Committee believes that a holder's basis in a MD bond should not include any amount paid on account of accrued, unpaid interest for this purpose.

[10] Decreases in the market value of a bond can generally can be attributed to one or more of the following three factors: (1) increase in the general level of interest rates, (2) increase in the credit spread assigned by the market to the issuer of the bond, and (3) a partial repayment of principal. Only the first two factors produce market discount.

[11] Section 1276(a)(1).

[12] Section 1276(b)(1), (2). A holder makes a separate election for each bond. Once made, the election may not be revoked. The constant yield method is more complex, but generally produces a more taxpayer favorable result (i.e., less ordinary income and more capital gain) on dispositions of MD bonds prior to maturity because less interest accrues in earlier years than under the straight-line method.

[13] Section 1278(b). This election, once made, applies to all MD bonds acquired by the holder on or after the first day of the tax year to which such election applies and is not revocable without the consent of the Secretary. Sections 1278(b)(2), (3).

than regulated investment companies (e.g., open-end mutual funds that hold bonds) do not elect to include market discount in income as it accrues.

III. Proposed Rule

Subject to certain limitations, the President's proposal would require all accrual basis holders of MD bonds to include market discount in income as it accrues. The proposal would limit the amount of market discount such holders must accrue as follows: the yield on a MD bond for purposes of calculating the amount of includible market discount accruals would be limited to the greater of (i) the MD bond's original yield-to-maturity plus 5% (the "original yield test"), or (ii) the relevant AFR when the holder acquired the MD bond plus 5% (the "AFR test"). The proposal would not alter any of the market discount rules currently applicable to issuers or cash basis holders of MD bonds.

In general, the proposal would consistently treat accrual basis holders of market discount and OID bonds. The Committee supports this consistent treatment in light of the fact that, in each case, the discount generally reflects the fact that the bond bears a below-market coupon and compensates the holder accordingly for the use of money (i.e., interest). By contrast, under current law, a holder is typically advantaged by purchasing a MD bond rather than an otherwise identical OID bond of the same issuer at first issue because market discount is not subject to tax as it accrues, and a holder of a MD bond does not risk recognizing ordinary income attributable to accrued discount and capital loss upon disposition.[14]

IV. Specific Comments on the Proposed Rule

A. Adoption of Broader De Minimis Rule

Although the Committee generally supports the inclusion of the interest element of market discount in accrual basis holders' income as it accrues, the Committee also concurs with Congress' conclusion in 1984 that the current accrual of market discount will impose considerable administrative burdens. The legislative history makes clear that although Congress viewed market discount as economically equivalent to OID, it nevertheless chose not to require the current accrual of market discount for reasons of "administrative complexity."[15] Congress again considered, and again did not enact, a

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[14] Under current law, a holder of a MD bond that subsequently declines in value, will not recognize interest income and will have a capital loss on disposition. By contrast, a holder who disposes of an OID bond at a loss will experience a character mismatch, because such a holder will accrue OID as ordinary income notwithstanding the subsequent sale at a loss.

[15] See H.R. Rep. No. 432, Part 2, 98th Cong., 2d Sess. 1170 (1984); S. Rep. No. 169, 98th Cong., 2d Sess., Vol. 1 at 155.

proposal requiring the current accrual of market discount in 1987.[16] We believe the current proposal, like the prior proposed legislation, would clearly create significant administrative complexity for MD bond holders, and we expect those burdens to be greatest for holders acquiring OID bonds after initial issuance at a discount.

Accordingly, if market discount is to be accrued currently, the Committee recommends expanding the de minimis exception in order to provide a better balance between the proper accrual of income and the significant administrative burdens attendant to such accrual. More specifically, we recommend that "de minimis market discount" be defined as an amount of market discount equal to 1% of principal on a bond for each full year remaining to maturity as measured on the date of acquisition.[17] We believe this type of de minimis rule would permit the accrual of all significant amounts of market discount, while avoiding the complexity that necessarily accompanies current accrual for small amounts of discount.

Other alternatives for consideration include the adoption of an "aggregate" de minimis exception, although we believe such a rule would be impractical. One such rule might disregard market discount in any year in which the aggregate market discount in a holder's[18] portfolio is less than a threshold amount. Another rule might use a threshold based on aggregate market discount accruing in such taxable period, rather than the aggregate discount present in a holder's portfolio. Such exceptions might disregard market discount only in taxable periods for which an aggregate threshold is not exceeded, or might permanently disregard some or all market discount with respect to bonds acquired in years in which an aggregate de minimis threshold is not exceeded. Each of these exceptions would entail what we believe to be an unacceptably high level of complexity for holders as a result of calculations that they would be required to perform, potentially on an annual basis, and would add an unreasonable administrative burden on the IRS, which would be charged with policing the calculations.

B. <u>Limitations on Market Discount Accrual.</u>

The Committee strongly supports limiting the amount of market discount that accrual basis holders are required to include in income. We agree with the Joint

[16] The Senate declined to adopt the House of Representatives bill that would have generally required current accrual, and the bill was dropped in conference. Omnibus Budget Reconciliation Act of 1987, H.R. 3545, 100th Cong., 1st Sess., § 10118 (1987); H.R. No. 391 at 1056-57, 100th Cong., 1st Sess. (1987); H.R. Rep. No. 495 at 932-33, 100th Cong., 1st Sess. (1987).

[17] For example, a bond purchased at 95% of face value six years prior to maturity would be treated as having no market discount, and therefore would not constitute a MD bond.

[18] Customary attribution rules would be required to prevent certain holders from utilizing new entities to create new de minimis market discount. For example, affiliated groups of corporations could be treated as a single holder with a single portfolio, and a holder of MD bonds through a flow-through entity, such as a partnership or limited liability company, could be allocated the portion of the entity's market discount equal to the holder's proportionate interest in the flow-through entity.

Committee's statement that, in some cases, some (or even all) of such discount may represent an equity-like participation in the business of the borrower rather than a surrogate for interest.[19] In those cases, the Committee believes it would be inappropriate to require accrual basis holders of such MD bonds to currently accrue such market discount.[20]

It is therefore important to analyze whether each of the "greater of" AFR and original yield tests appropriately excludes from current accrual the portion of market discount that is akin to an equity interest in the issuer.[21] The Committee believes that the AFR test, which utilizes the same principles as the high yield debt obligation ("HYDO") rules[22] to determine the portion of market discount that should be viewed as interest, is generally appropriate with respect to taxable bonds. By contrast, as discussed below, it is not clear that the original yield test properly captures only the "interest-like" portion of market discount, particularly with respect to high yield bonds. As a result, and in the interest of limiting complexity, we recommend that the original yield test be eliminated.

1. AFR Test

The AFR test generally establishes a reasonable limit on the amount of market discount that accrual basis holders of taxable bonds will be required to include in income. If, as we recommend, the original yield test is eliminated, we recommend that the AFR test be modified to limit the yield of a market discount bond for purposes of accrual calculations to an amount equal to the AFR on the acquisition date plus 6%, rather than 5%. With this modification, we believe the AFR test will serve the dual

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[19] Joint Committee on Taxation, Description of Revenue Proposals Contained in the President's Fiscal Year 2000 Budget Proposal, at 207 (February 22, 1999).

[20] The proposal, like current law, would not produce a technically accurate accrual of market discount on convertible (and exchangeable) bonds, because the yield on such bonds is calculated based on the bond's stated redemption price, which includes the value of the equity-like conversion element of the bond. As a policy matter the Committee does not believe that market discount should properly be accrued with respect to such equity-like features. However, we also realize that the calculation necessary to exclude these features would subject holders to additional valuation costs and would add significant complexity to market discount calculations. As a result, in large part because we understand that only a relatively small amount of market discount is generally attributable to the equity-like features of convertible and exchangeable bonds, we do not recommend employing a separate, more accurate test for determining market discount with respect to such bonds.

[21] Depending on the facts and circumstances, either test may serve as the effective limit on the accrual of market discount. For example, when the AFR increases by more than the credit spread on a bond after issuance and before its acquisition by a subsequent holder, the AFR test will produce the operative limit on market discount accrual. By contrast, when the AFR increases by an amount less than the credit spread before acquisition, the original yield test will produce the operative limit.

[22] Section 163(e), (i).

purposes of the proposed AFR and original yield tests. First, the modified AFR test will achieve parity with the OID rules, by insuring that any portion of the market discount that would be treated as interest under the HYDO rules if the debt were newly issued on the date of acquisition will be included in income as it accrues.[23] Second, because the test utilizes the AFR on the acquisition date rather than on the date of original issue, accrued market discount will appropriately include any portion of the increase in yield attributable to changes in the AFR between issuance and acquisition.

In the case of tax-free bonds, however, the Committee is concerned that the AFR test would require holders to accrue market discount that represents an speculative-like return. This result would obtain because the AFR test compares the yield on a tax-free MD bond to a rate based on the pre-tax yield on a basket of taxable securities with higher coupons. As a result of the inflated benchmark rate, the AFR test would usually serve as the operative limit on market discount accrual with respect to tax-free bonds. We would therefore recommend the adoption of an adjusted AFR test for tax-free bonds that utilizes a tax-free benchmark rate that adjusts the AFR by an appropriately lower amount, such as 3%.

2. Original Yield Test

Under the original yield test, market discount that represents an equity-like, rather than interest-like, return may be includible in the income of holders of both taxable and tax-free bonds. For example, holders acquiring high yield bonds after issuance could be required to accrue as interest amounts that would be recharacterized as dividend income under the HYDO rules. In particular, the original yield test is likely to require the accrual of an equity-like return when the AFR decreases after a bond is issued, because in that case at least part of the market discount is typically attributable to a decrease in the credit quality of the issuer. Under these circumstances, part or all of a holder's repayment risk would be similar to that of an equity holder.

For example, assume an OID bond is issued with a 10% yield when the applicable AFR is 7%. If the fair market value of the bond subsequently declines to reflect a yield to maturity of 18%, and the applicable AFR remains 7%, the original yield test will limit the market discount accrual. Under that test, the yield for purposes of determining the amount of includible market discount would be 15%. This result obtains even though the bond is clearly a highly speculative investment when it is acquired. Under the original yield test, 800 of the 1100 points of the credit spread are effectively taxed as interest. By contrast, if the original yield at issuance had been 18%, rather than 10%, only 600 points of the credit spread would have been treated as interest under the AFR-based HYDO rules. This latter alternative is clearly more consistent with the proposal's intent to accrue only "interest-like" discount.

Accordingly, the Committee recommends that the original yield test be eliminated, and that the modified AFR test described above serve as the sole limit on

[23] Under the HYDO rules, if the yield on a HYDO exceeds the AFR by more than 6 percentage points, a portion of the total return on the debt instrument is not deductible as interest by the issuer. Section 163(e).

market discount accruals.[24] If an original yield test is nonetheless to be employed, such a test should be based on the increases (if any) in AFR in order to impose current tax only on the interest component of market discount as it accrues, and properly exclude the equity-like portion of market discount from current accrual. We believe that limiting yield for purposes of the original yield test to a bond's original yield plus the increase (if any) in the applicable AFR (measured from the date of issuance until the date a MD bond is acquired by a secondary holder) would fairly measure the amount of interest-like discount. Under this test, if a bond was issued with an original yield to maturity of 14% when the applicable AFR was 7% and was later acquired at a yield of 18% when the AFR was 8%, the modified original yield test would limit the yield to 15% (14% plus 1%).

C. Coordination with Other Sections.

1. Section 988 Rules.

If the proposal is adopted, the market discount rules for accrual basis holders must be coordinated with the Section 988 rules. The rule contained in Treasury Regulation Section 1.988-2(b)(11), which currently provides that holders electing to include market discount in income as it accrues must translate AMD into functional currency at the average exchange rate for the accrual period, and must determine exchange gain or loss in accordance with Treasury Regulation Section 1.988-2(b)(3) might be extended to all accrual basis holders of MD bonds.

2. Section 1278(b) Election.

As discussed above, under current law a holder may elect under Section 1278(b) to include market discount in income as it accrues.[25] The character of any gain realized upon disposition of a MD bond by such an electing holder will be capital, provided that the bond was held as a capital asset for all applicable periods. The proposal effectively renders this election moot for accrual basis taxpayers. Accordingly, the Committee recommends that a corresponding technical change be made to restrict the election to cash basis holders.

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[24] As discussed above, we believe that the modified AFR test generally identifies the portion of market discount that should properly be accrued. However, in certain circumstances where a large amount of market discount reflects a troubled obligation on which there is no reasonable expectation of payment, the holder should not be required to accrue income. We disagree with the position taken by the IRS in TAM 9538007 (June 13, 1995) that the common law "doubtful collectibility" exception for accrual basis taxpayers, see, e.g., Corn Exchange Bank v. United States, 37 F.2d 34 (2d Cir. 1930), does not apply to accrual of OID. Moreover, even the IRS's position in TAM 9538007 does not necessarily preclude the application of the "doubtful collectibility" exception to accrual of market discount, because such application would not result in the inconsistent treatment of holders and issuers that would exist in the OID context, where issuers would be deducting OID that holders would not be including in income.

[25] Supra note 13.

NEW YORK STATE BAR ASSOCIATION TAX SECTION REPORT ON PROPOSED LEGISLATION TO AMEND CERTAIN DEBT-FOR-DEBT EXCHANGE RULES[1]

I. Introduction

This Report comments on the President's fiscal 2000 budget proposal to modify and clarify certain rules relating to debt-for-debt exchanges.[2] The proposal would (i) require accrual basis taxpayers to amortize any repurchase premium in a debt-for-debt exchange over the term of the new debt instrument; (ii) provide that where the new debt is contingent and neither the new or old debt is publicly traded, the issuer must include the value of the contingent payments in determining the issue price of the new debt; and (iii) require a holder participating in a debt-for-debt exchange as part of a reorganization to treat as "other property," for purposes of determining the amount of the holder's recognized gain, the excess of the issue price of the new debt over the adjusted issue price of the old debt, except that if either the old or new debt is publicly traded, this amount would be limited to the excess of the issue price of the new debt over the fair market value of the old debt.

The Committee believes in general that the debt-for-debt exchange rules should achieve consistency between the treatment of issuers and holders. This consideration, along with others discussed in this Report, forms the basis for several recommendations. The Committee supports the denial of deductions for repurchase premium arising in a debt-for-debt exchange. The Committee supports the proposal requiring issuers to include the value of contingent payments in determining the issue price of the new debt in a debt-for-debt exchange. The Committee supports the proposal modifying the determination of gain recognized by holders participating in a debt-for-debt exchange and imposing a cap on this amount equal to the difference in the fair market value of the debt instruments; however, we believe that this rule should not be limited to exchanges that constitute reorganizations.

II. Current Law

A. Repurchase Premium and Issuance Premium

When a debt instrument is repurchased by the issuer at a premium, the issuer generally deducts the excess ("repurchase premium") of the repurchase price over the adjusted issue price of the debt as interest for the taxable year in which the repurchase occurs. When a

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[1] Prepared by Dickson G. Brown, Linda Z. Swartz, William S. Dixon, and David H. Schwartz, with helpful comments from Kathleen Ferrell, Harold R. Handler, Richard L. Reinhold, and Michael L. Schler.

[2] Department of the Treasury, General Explanations of the Administration's Revenue Proposals, at 125 (February 1999).

debt instrument is issued at a premium, the issuer allocates the issuance premium to accrual periods using a constant yield method and offsets the interest deduction for each accrual period by the amount of bond issuance premium allocated to that period.[3]

If the issuer repurchases the debt via a debt-for-debt exchange, the repurchase price is the issue price of the new debt (reduced by any unstated interest within the meaning of section 483[4]). If either debt instrument is publicly traded, the repurchase premium is immediately deductible. However, if neither of the debt instruments is publicly traded, the repurchase premium must be amortized over the term of the newly issued debt instrument as if it were original issue discount ("OID").[5] These rules apply without regard to whether the debt instruments exchanged qualify as "securities" and the debt-for-debt exchange thereby constitutes a reorganization subject to section 356.

B. Discharge of Indebtedness

Unless otherwise excluded, income from discharge of indebtedness ("COD income," for "cancellation of debt") is generally included in gross income.[6] When an issuer repurchases debt for an amount less than the debt's adjusted issue price, the issuer recognizes COD income in the amount of the excess of the adjusted issue price over the repurchase price.[7] If the issuer repurchases the debt in a debt-for-debt exchange, the repurchase price is the issue price of the new debt.[8] These rules apply without regard to whether the debt instruments exchanged qualify as "securities" and the debt-for-debt exchange thereby constitutes a reorganization subject to section 356.[9]

C. Contingent Payments

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[3] Treas. Reg. § 1.163-13. Bond issuance premium is the excess of the issue price of the debt instrument over its stated redemption price at maturity.

[4] All section references are to the Internal Revenue Code of 1986, as amended ("the Code").

[5] Treas. Reg. § 1.163-7(c).

[6] Section 61(a)(12).

[7] Treas. Reg. § 1.61-12(c)(2)(ii).

[8] Section 108(e)(10)(A).

[9] Before the Revenue Reconciliation Act of 1990 (Pub. L. No. 101-508), which repealed old section 1275(a)(4) and added the current section 108(e)(10), a special rule for determining issue price in the case of a debt-for-debt exchange by a corporate issuer pursuant to a plan of reorganization established a floor on the issue price of the new debt equal to the adjusted issue price of the old debt.

If the new debt in a debt-for-debt exchange provides for contingent payments and neither debt instrument is publicly traded, then the holder includes the fair market value of the contingent payments in determining the amount realized in the exchange.[10] However, the issuer does not include the fair market value of the contingent payments in determining the issue price of the new debt.[11]

D. Reorganization Exchanges

In a debt-for-debt exchange that constitutes a recapitalization or other reorganization, the holder recognizes gain only to the extent of the fair market value of property that the holder receives other than stock or securities in a corporation that is a party to the reorganization ("other property").[12] Such "other property" specifically includes the fair market value of the excess of the principal amount of the new debt over the principal amount of the old debt.[13] However, so long as the old debt and new debt have equal principal amounts, the holder recognizes no gain on the exchange, even if the issue price of the new debt exceeds the adjusted issue price of the old debt (thereby giving rise to a repurchase premium for the issuer, as described above).[14]

E. Debt Modification

The regulations under section 1001 provide that gain or loss is realized "from the exchange of property for other property differing materially either in kind or in extent . . . ."[15] When debt is restructured, a modification in the terms of the debt may be deemed to constitute the issuance of new debt which is being exchanged for the old debt so as to give rise to such a recognition event on the part of the holder and the issuer. A "significant modification" of a debt

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10 Treas. Reg. § 1.1001-1(g)(2)(ii). Thus, the amount realized is the issue price of the debt instrument increased by the fair market value of the contingent payments payable on the debt instrument. This rule does not apply to a debt instrument if the fair market value of the contingent payments is not reasonably ascertainable. However, only in "rare and extraordinary cases" will the fair market value of the contingent payments be treated as not reasonably ascertainable.

11 Treas. Reg. § 1.1274-2(g).

12 Section 356(a).

13 Section 356(d)(2)(B).

14 Although this is certainly the plain meaning of the statute, commentators have questioned whether the comparison required is truly principal amounts or may instead be issue price and adjusted issue price. See, e.g., Garlock, Federal Income Taxation of Debt Instruments, at 17-120 n. 367 (Aspen Law & Business, 1998 Supp.).

15 Treas. Reg. § 1.1001-1(a).

instrument constitutes such an exchange.[16] The regulations provide guidance as to what constitutes a "significant modification,"[17] the effect of which is that a so-called "hair trigger" standard applies to debt modifications, rendering exchange treatment likely even upon slight changes in the terms of the debt.

III. Proposal

The President's proposal would effect three changes to current law with respect to debt-for-debt exchanges:

(1) The proposal would require issuers to amortize any repurchase premium, regardless of whether either of the debt instruments are publicly traded, over the term of the new debt instrument, as if it were OID. Thus, the proposal would expand the rule currently applicable to repurchase premiums in cases where neither of the debt instruments is publicly traded and apply that rule to publicly traded debt.

(2) The proposal would require issuers to take into account any contingent payments provided for by the new debt where neither the new debt nor the old debt is publicly traded, by adding the fair market value of the contingent payments to the issue price of the new debt. Thus, the proposal would conform the treatment of issuers upon such exchanges with the treatment of holders, who currently include the value of such payments in determining the amount realized in the exchange.

(3) The proposal would change the amount of gain recognized by holders in a debt-for-debt exchange that constitutes a reorganization. Rather than the fair market value of the difference in principal amounts, the excess of the issue price of the new debt over the adjusted issue price of the old debt would be the "other property" that is recognized, except that if either of the debt instruments is publicly traded, the recognizable amount would be capped by the excess of the issue price of the new debt over the fair market value of the old debt. The effect of the cap is that no gain would be recognized in reorganization debt-for-debt exchanges, because presumably the fair market value of what is given up will equal the fair market value of what is received.

IV. Comments

A. Repurchase Premium

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16 Treas. Reg. § 1.1001-3(b).

17 Treas. Reg. § 1.1001-3(e). The regulations contain five specific rules that address (i)changes in yield, (ii) changes in the timing of payments, (iii) changes in the obligor or security, (iv) changes in the nature of the debt, and (v) changes in accounting or financial covenants. Where none of the specific rules is applicable, a general rule provides that a modification is significant only if, based on all the facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant.

The Committee shares the concern expressed by the Treasury Department ("Treasury") that the current repurchase premium rules may invite abuse on the part of issuers whose cost of borrowing has declined, by in effect accelerating their future interest deductions through a debt-for-debt exchange even though in substance their debt position has not changed. A superficially similar, but conceptually distinct, concern was expressed by Treasury in 1994 upon the promulgation of the final regulations requiring issuers to amortize the repurchase premium where neither debt instrument is publicly traded.[18] Due to the flexibility inherent in determining the issue price for nontraded debt,[19] Treasury believed that issuers could inappropriately accelerate deductions if allowed an immediate repurchase premium deduction upon such an exchange. This concern reflected the implicit view that it is conceptually sound for a repurchase premium to be immediately deductible upon a debt-for-debt exchange (but that, in the case of nontraded debt, the concern was that valuation issues would make the amount susceptible to distortion).

In the case of publicly traded debt, by contrast, there is no risk that the issue price of the new debt will be distorted, as its issue price will equal its fair market value. Rather, the targeted abuse is the refinancing of debt by issuers for no other reason than to take advantage of the fact that the adjusted issue price of the old debt does not reflect its subsequent appreciation in value (due to a subsequent drop in interest rates, for example) and thereby obtain an artificial deduction which does not correspond to a substantive alteration of the issuer's debt position. The Committee supports the denial of a deduction in these circumstances.

For this reason, the Committee in a prior report on certain debt-for-debt exchanges recommended a rule that would eliminate this artificial premium and reduce the issue price of the new debt by the amount that would have otherwise been deductible.[20] We believe that this rule achieves the same result as the proposal but in a manner that may be simpler. Where appreciated debt is exchanged for debt with the same principal amount, under the proposal the issuer would have an amortizable repurchase premium offsetting a corresponding amortizable issuance premium for the new debt. The effect would be the same as if there were no repurchase premium and no issuance premium. Where appreciated debt is exchanged for debt

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18 T.D. 8517, 59 F.R. 4799, 4800 (Feb. 2, 1994).

19 Under Section 1273(b)(3), when either of two debt instruments exchanged is publicly traded, the issue price of the new debt generally will equal its fair market value or the fair market value of the old debt. Under section 1274, when neither of the debt instruments is publicly traded, the issue price of the new debt generally will equal either its stated principal amount (if the new debt has adequate stated interest) or (if not) the sum of all payments due under the new debt discounted by the applicable federal rate.

20 The 1995 New York State Bar Association proposal with respect to debt-for-debt exchanges that constitute reorganizations would have reduced the issue price of the new debt to the adjusted issue price of the old debt (assuming the two debt instruments were of equal fair market values). See "NYSBA Sees Flaws in Treatment of Debt Securities Received in Corporate Reorganizations," 95 TNT 31-25, February 15, 1995.

with a higher principal amount, under the proposal the issuer would have an amortizable repurchase premium, whereas under the Committee's suggested rule there would be no repurchase premium but an equivalent stream of OID deductions[21] (as a result of the OID created in the new debt by the reduction in new debt's issue price).

Neither the President's proposal nor the Committee's recommendation maintain the symmetry that exists under current law, at least with respect to publicly traded debt, between the issuer's treatment of debt exchanged at a premium (immediate deduction) and debt exchanged by the issuer at a discount (recognition of COD income). However, the Committee believes that the inconsistency that would arise under the Committee's recommendation (or, for that matter, under the proposal) is more indicative of a need to amend the COD rules as well, to prevent the recognition of gain without substantive changes in debt position.[22]

B. Contingent Payments

The Committee supports the proposal requiring issuers to include the value of contingent payments in determining the issue price of debt received in a debt-for-debt exchange where neither of the debt instruments is publicly traded. We agree with the Joint Committee's statement that the current treatment of issuers can result in an overstatement of the issuer's COD income and fail to reflect the true economics of the exchange.[23] The proposal addresses this concern and appropriately provides for consistent treatment of issuers and holders.

C. Gain Recognition by Holders

The proposal would require holders participating in a debt-for-debt exchange in the context of a reorganization to compare, in determining the amount of gain recognized, the issue price of the new debt and the adjusted issue price of the old debt. The Committee believes that this shift from principal amounts to issue prices is necessary and appropriate in view of the conformity it would provide with current OID principles. The proposal recognizes that using the reference point of "principal amount" for debt instruments results in overlooking amounts that are economically equivalent to interest or bond premium.

As in the case of repurchase premium, the Committee believes that the exchange of debt instruments having equal values is not an appropriate recognition event and that holders

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[21] See section 163(e)(1).

[22] The proposal and the Committee's recommendation also raise broader questions about the proper scope and application of section 1001 and whether it is being applied too broadly under the current "hair trigger" rule. See infra note 26.

[23] Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal, at 215 (Feb. 22, 1999).

should not recognize gain upon such exchanges.[24] Therefore, the Committee supports the cap imposed under the proposal on the amount recognized by holders equal to the difference in the fair market values of the new debt and the old debt.

However, the Committee believes that this rule should not be restricted to exchanges that qualify as recapitalizations or other reorganizations. As explained above with respect to the deductibility of the repurchase premium, the reason nonrecognition is appropriate upon such exchanges is that no real substantive change has occurred in the parties' debt positions. Thus, neither the Committee's recommendations nor the President's proposal with respect to limiting the deductibility of the issuer's repurchase premium were limited to exchanges that constitute reorganizations. The Committee believes that holders should similarly be entitled to nonrecognition treatment without regard to whether the exchange qualifies as a reorganization and free of the vagaries of whether the debt-for-debt exchange involves securities.[25] For example, the Committee does not believe that different results should obtain depending upon whether the issuer refinances its debt six years before maturity or four years before maturity (or whatever period prevents qualification as a security), even though the debt instruments deemed exchanged in the latter case may not satisfy the definition of "securities" under the reorganization rules. Therefore, the Committee recommends that the proposal providing for nonrecognition by holders upon a debt-for-debt exchange should apply to any exchange where the debt instruments exchanged are of equal fair market values.[26]

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[24] This is the effect today of the current excess principal amount rule where identical principal amounts are exchanged.

[25] In order to qualify for the nonrecognition provision relating to reorganizations, "stock or securities" in a corporation a party to the reorganization must be exchanged for "stock or securities" in such corporation or in another corporation that is a party to the reorganization. Section 354(a)(1). While no statutory definition of the term "stock or securities" is provided, notes of ten years or more in duration are generally treated as securities, while notes with maturities shorter than five years are less likely to be treated as securities. See, e.g., Rev. Proc. 79-14, 1979-1 C.B. 496; D'Angelo Assocs. v. Commissioner, 70 T.C. 121 (1978). However, because no bright-line test exists for what constitutes a security, the "facts and circumstances" nature of the inquiry can cause uncertainty.

[26] The Committee recognizes that its reluctance to treat such debt-for-debt exchanges as recognition events runs counter to the "hair trigger" test under section 1001. See supra note 21. For this reason, and in view of our overriding preference for consistent treatment of issuers and holders, we considered an alternative regime in which such exchanges would constitute recognition events for both parties. Issuers would be entitled to an immediate repurchase premium deduction, as under current law, but holders would recognize gain even if the exchange constituted a reorganization, contrary to the proposal's fair market value cap. This alternative regime would effect a major change in the taxability of current transactions and accordingly was not recommended by the Committee at this time.

REPORT ON ADMINISTRATION'S BUDGET PROPOSALS RELATING TO FOREIGN ACTIVITIES OF U.S. TAXPAYERS

This Report* comments on the proposals (the "Proposals") contained in the President's Fiscal Year 2000 Budget Proposal** relating to (i) the mismatching of deductions and income inclusions in transactions with related foreign persons, (ii) changes to the foreign tax credit limitation category for dividends from " 10/50 companies" and (iii) recapture of overall foreign losses on dispositions of stock in a controlled foreign corporation.

In summary of what is set out in more detail below:

1. We support the Proposal to amend Sections*** 163(e)(3) and 267(a)(3) to prevent mismatching of deductions and income inclusions in transactions with related foreign persons, although we note that the proposed changes could also be achieved through amendment of the Treasury regulations under those sections.

2. We support the Proposal to accelerate the effective date of the look-through rule for dividends from "10/50 companies".

3. With regard to the Proposal to require recapture of overall foreign losses upon disposition of stock in a controlled foreign corporation, we suggest consideration be given instead to amending the Section 864(e) rules for apportionment of interest expense

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* The report was prepared by the Tax Section's Committee on Foreign Activities of U.S. Taxpayers. The principal authors of the report were Ross Macdonald and Emily McMahon. Helpful comments were received from Samuel Dimon, Charles Kingson and Robert Jacobs.

** Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2000: Analytical Perspectives* (H. Doc. 106-3, Vol III).

*** All Section references herein are to sections of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise noted.

so that they take into account indebtedness incurred by a foreign subsidiary. If the Proposal is adopted, however, we have provided certain technical comments.

1. PROPOSAL TO PREVENT MISMATCHING OF DEDUCTIONS AND INCOME INCLUSIONS IN TRANSACTIONS WITH RELATED FOREIGN PERSONS.

This Proposal would amend Sections 163(e)(3) and 267(a)(3) to provide that deductions for original issue discount, interest and other expenses accrued but unpaid (whether by U.S. or foreign persons) to related controlled foreign corporations ("CFCs"), passive foreign investment companies ("PFICs") or foreign personal holding companies (" FPHCs") would be allowable only to the extent that the amounts accrued by the payor are, for U.S. tax purposes, reflected in the income of the direct or indirect U.S. owners of the related CFC, PFIC or FPHC.*

Sections 163(e)(3) and 267(a)(3) currently provide that original issue discount, interest and other expenses owed by a taxpayer to a related foreign person may not be deducted until paid, with certain exceptions. In each case, the relevant regulations further provide that a deduction will be allowed for amounts owed to a CFC, PFIC or FPHC at the time those items are includible in the income of the CFC, PFIC or FPHC. See Treas. Reg. §§ 1.163-12(b)(3) and 1.267(a)-3(c)(4). The Proposal is aimed at certain transactions the Treasury believes are designed to allow taxpayers inappropriately to take advantage of the current regulations by accruing deductions to related CFCs, PFICs, or FPHCs without the U.S. owners of those entities taking into account at the same time an amount of income for U.S. tax purposes that corresponds to the accrual (*e.g.*, due to disproportionate allocations of income among U.S. and foreign shareholders).

The Committee believes the Proposal would be an appropriate

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* The Proposal would provide an exception for amounts accrued under circumstances where payment of the amount accrued occurs within a short period after accrual and the transaction giving rise to the payment is entered into by the payor in the ordinary course of a business in which the payor is predominantly engaged. The Proposal would also grant regulatory authority to provide additional exceptions.

modification to the rules of Sections 163(e)(3) and 267(a)(3), consistent with the intent of those sections and the regulations thereunder. We suggest, however, that the Proposal be clarified to provide that a deduction is allowable before payment for amounts owed to a CFC, PFIC or FPHC only to the extent that the amounts accrued are treated as taxable income of the obligor itself or a related person. In other words, the obligor should not be allowed a deduction (before payment) for accrued amounts that are includible in the income of other U.S. owners of the CFC, PFIC or FPHC if those other U.S. owners are unrelated to the obligor. In addition, an obligor should not be allowed a deduction (before payment) for accrued amounts that are not taxable income to the obligor or related person, *e.g.*, in the case of a U.S. owner that is related to the obligor but is a tax-exempt entity.

We also note that the existing exceptions for amounts paid to CFCs, PFICs and FPHCs are provided in the regulations, rather than in the statute, and we see no reason the Proposal could not be implemented by means of an appropriate regulatory change. Treas. Reg. § 1.267(a)-3 was issued under the broad grant of regulatory authority already provided in Section 267(a)(3), and this regulation clearly could be revised under that same grant of authority. Further, although Section 163(e)(3) does not contain a similar grant of specific regulatory authority, we do not believe that the absence of such a grant should preclude the Treasury from revising Treas. Reg. § 1.163-12(b)(3) in a manner intended to clarify its scope.

2. PROPOSAL TO CHANGE "10/50" FOREIGN TAX CREDIT BASKET.

This Proposal would simplify the foreign tax credit rules applicable to dividends from 10/50 companies. A "10/50 company" is a foreign corporation in which a U.S. shareholder owns more than 10 percent of the stock by vote and which is not a CFC. The Proposal would accelerate the effective date previously provided by the Taxpayer Relief Act of 1997 (P.L. 105-34) (the "1997 Act") to Section 904(d)(4) and make certain other changes discussed below. The Committee strongly supports these proposed changes.

The Tax Reform Act of 1986 (P.L. 99-514) (the " 1986 Act") made fundamental changes to the foreign tax credit rules of the Code, including establishing a series of "baskets" for different types of income. The stated objective of these changes was to reduce the opportunity of U.S. taxpayers to cross-credit higher-taxed foreign source income against lower-taxed foreign source income. *See* General Explanation of the Tax Reform Act of 1986 at 862 (1987). The baskets were set forth in Section 904(d) and included a basket covering dividends received by a U.S. shareholder from a 10/50 company. Under this regime, dividends received by the taxpayer from each 10/50 company were subject to a separate foreign tax credit limitation. *See* Section 904(d)(1)(E) and (d)(2)(E). As a practical matter, this meant that U.S. taxpayers could not cross-credit lower-taxed dividends from one 10/50 company against higher-taxed dividends from a second 10/50 company. Depending upon the taxpayer's circumstances, this credit limitation could place a U.S. taxpayer in an excess foreign tax credit position.

In contrast, the 1986 Act permitted "look-through" treatment for CFCs. Under the look-through rules contained in Section 904(d)(3), a dividend received from a CFC was treated, not as passive income, but instead as income in a separate category in proportion to the ratio of the portion of the earnings and profits attributable to income in that category to the total amount of earnings and profits. Thus, if a CFC engaged in an active business, and paid a dividend to a U.S. shareholder, that dividend income would be treated as general limitation income under Section 904(d)(1)(I). Similarly, if the CFC were engaged in shipping, the dividend would be placed in the shipping income basket of Section 904(d)(1)(D).*

When the Tax Reform Bill of 1986 was under initial consideration, both the House and the Senate contemplated "look-through" treatment for both CFCs and other related foreign persons (*i.e.*, 10/50 companies). This look-through treatment would have

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* Not only were dividends entitled to look-through treatment, but certain additional types of payments (*e.g.*, royalties, rents and interest) received by the U.S. shareholder from its CFC were entitled to similar look-through treatment. Section 904(d)(3)(A). This rule was justified because these payments often served as surrogates for dividends as a means of removing earnings from a foreign corporation. By treating payments other than dividends analogously to dividends for foreign tax credit purposes, the payments would not be discouraged and, because the payments were often deductible, providing look-through treatment for the payments would reserve for the United States more of the pre-credit U.S. tax on these foreign earnings than the payment of dividends.

* *See, e.g.*, H.R. Rep. No. 426, 99th Cong., 1st Sess. 340-41 (1985); S. Rep. No. 313, 99th Cong., 2d Sess. 313-14 (1986).

covered both dividends and other types of passive payments.* The Conference Committee, however, drew the sharp distinction between the foreign tax credit treatment applicable to CFCs and non-CFCs described above, which led to the disadvantageous treatment applicable to 10/50 companies. The Conference Committee gave two principal reasons for adopting a separate basket for dividends from each 10/50 company. First, although CFCs effectively constituted units of a worldwide business, lesser percentages of ownership were considered not to create enough commonality of U.S. ownership to treat the foreign corporations as units of a worldwide business. Second, the Conference Committee had administrative concerns regarding obtaining tax and income information from foreign corporations that were not majority owned by U.S. shareholders.** These rationales were subsequently subjected to substantial criticism.***

The 10/50 basket caused U.S. taxpayers, particularly those who entered into foreign joint ventures, to be placed in a much worse situation than if they had acquired a greater than 50 percent interest in the foreign corporation. Sometimes, the U.S. taxpayer would take steps to transmute its interest in a 10/50 company into an interest in a CFC. For example, a U.S. taxpayer could transmute an interest in a 50/50 joint venture into an interest in a CFC by purchasing stock in its joint venture counterparty if the stock in that party was publicly traded. *See* Treas. Reg. § 1.957-1(c), Ex. 9. Even where the joint venture partner was not publicly traded, a similar result could be achieved by giving to each of the joint venturers call rights with respect to stock in the joint venture entity. *See* Pr. Ltr. Rul. 8936016 (June 8, 1989). Other methods also accomplished the same result. Thus, U.S. taxpayers who had often previously struggled to avoid CFC status for their foreign affiliates now embraced it to avoid 10/50 basket treatment.

In 1997, the House Ways and Means Committee proposed that the existing

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* *See, e.g.*, H.R. Rep. No. 426, 99th Cong., 1st Sess. 340-41 (1985); S. Rep. No. 313, 99th Cong., 2d Sess. 313-14 (1986).

** H.R. Rep. No. 841, 99th Cong., 2d Sess. (1986) at II-582. The Conference Committee also felt it could eliminate the application of the look through rules to 10/50 companies because the new passive foreign investment company ("PFIC") rules would minimize cross crediting of passive income against active income.

*** *See, e.g.*, Davis & Lainoff, "U.S. Taxation of Foreign Joint Ventures," 46 *Tax Law Rev.* 165 at 223-24 (1991).

law applicable to 10/50 companies be revised to provide a single foreign tax credit limitation to apply to dividends received by the taxpayer from all 10/50 companies (except 10/50 companies that also qualified as PFICs). H.R. Rep. No. 148 at 526-27 (1997). This provision was to be effective for taxable years beginning after December 31, 2001.

The Conference Committee subsequently further refined the provision so that in the case of dividends from a 10/50 company paid out of earnings and profits accumulated in a taxable year beginning before January 1, 2003, a single foreign tax credit limitation would generally apply to all dividends from all 10/50 companies (except those also qualifying as PFICs). In addition, any dividend from a 10/50 company paid out of earnings and profits accumulated in a taxable year beginning after December 31, 2002 would be treated as income in a foreign tax credit limitation category in proportion to the ratio of the earnings and profits attributable to income in that category to the total earnings and profits. Thus, for earnings and profits arising during taxable years after December 31, 2002, a taxpayer would be entitled to treatment analogous to that of a taxpayer that received dividends from CFCs. Accordingly, if a 10/50 company were engaged in the active conduct of a manufacturing business, the dividend received by the U.S. taxpayer would be subject to the general limitation basket of Section 904(d)(1)(I). An ordering rule provided that distributions would be treated as made from the most recently accumulated earnings and profits. Thus, the 1997 Act changes not only solved the problem of lack of cross-crediting for dividends from multiple 10/50 companies; it promised a future where the dividends would be placed in their appropriate basket under a look-through regime similar to that originally proposed by the House and Senate bills in 1986.

While reaction to these changes was generally favorable, the dual structure was complex. Depending upon the circumstances, a post-2002 taxpayer could receive dividends to which look-through treatment applied, as well as dividends subject to 10/50 treatment. The Administration has accordingly recommended the application of the look-through rules be effective for tax years beginning after December 31, 1998. Moreover, under the Proposal, the look-through approach would apply, regardless of the year in which the earnings and profits out of which the dividend was paid were accumulated.

The Committee strongly supports the Administration's proposal to accelerate the effective date to tax years beginning after December 31, 1998 and to extend the look-through rule to all earnings and profits amounts. We believe that this change would significantly simplify the application of the foreign tax credit rules. The Proposal would also provide a grant of regulatory authority to deal with distributions out of earnings and profits of a 10/50 company for periods prior to the taxpayer's acquisition of the stock, and we agree that this regulatory authority is clearly necessary to prevent abuse. We note, in addition, that another Administration proposal would, among other things, eliminate the tax attributes of a foreign entity at the time it becomes relevant for U.S. tax purposes and, if this proposal is enacted as well, it would help to reduce the potential for abuse of the 10/50 company Proposal. We suggest, therefore, that the grant of regulatory authority under the Proposal (and any subsequent Regulations issued thereunder) take into account whether the attribute-elimination proposal is adopted and, if so, its final form. If that other proposal is not adopted, then the regulatory authority under the 10/50 company Proposal may need to be broader than it otherwise would be.

3. PROPOSAL TO RECAPTURE OVERALL FOREIGN LOSSES UPON A DISPOSITION OF CONTROLLED FOREIGN CORPORATION STOCK.

This Proposal would expand the scope of the overall foreign loss ("OFL") recapture rules of Section 904(f) to apply to a taxpayer's disposition of stock in a CFC.

Under Section 904(f)(1), any taxpayer who sustains an OFL for a taxable year is required to treat a portion of the taxpayer's foreign source taxable income in each succeeding taxable year as U.S. source taxable income. The amount of foreign source taxable income that must be re-sourced under this rule is equal to the lesser of (i) the amount of the taxpayer's OFL (to the extent not previously recaptured in prior taxable years) or (ii) 50 percent (or such larger percentage as the taxpayer may choose) of the taxpayer's foreign source taxable income for the succeeding taxable year. An OFL for this purpose is the amount by which the taxpayer's gross foreign source income for the taxable year is exceeded by the sum of the deductions properly apportioned or allocated thereto (with certain exceptions). The effect of Section 904(f)(1) is to reduce the taxpayer's foreign tax credit limitation in years after the year in which an OFL is sustained to recapture the benefit the taxpayer derived in that OFL-sustaining year from using its OFL to reduce tax payable on its U.S. source taxable income.

Under existing Section 904(f)(3), a U.S. taxpayer that disposes of property that has been used predominantly outside the United States in a trade or business is deemed (with certain exceptions) to receive and recognize foreign source taxable income from the disposition (even if the disposition would otherwise qualify for nonrecognition) in an amount equal to the lesser of (i) the excess of the fair market value of the property over the taxpayer's adjusted basis in the property and (ii) the amount of the taxpayer's OFLs for the current taxable year and prior taxable years that have not been recaptured previously. This amount of deemed foreign source taxable income is then treated as U.S. source taxable income to the extent of the taxpayer's previously unrecaptured OFLs under the recapture rule of Section 904(f)(1) (without regard to the 50 percent limitation). The effect of Section 904(f)(3) is thus broader than that of Section 904(f)(1) in that Section 904(f)(3) not only re-sources foreign source gain that is recognized in a taxable disposition but also requires recognition of foreign source gain (which is then re-sourced to the U.S.) in a disposition that otherwise would qualify for nonrecognition.

Under existing Section 904(f)(3), stock is not treated as trade or business property for purposes of the recapture rules. The Proposal would amend Section 904(f)(3) to treat stock of a CFC as trade or business property for this purpose so that, when a U.S. taxpayer disposes of CFC stock, the OFL recapture rule would apply. The stated rationale for the Proposal is that a taxpayer's ownership of CFC stock can contribute to an OFL by increasing the proportion of the taxpayer's interest deductions that are allocated against foreign source income under Section 864(e) and Treas. Reg. § 1.861-9T. If, however, the taxpayer subsequently disposes of the CFC stock (for example, by distributing the CFC stock to its shareholders), the OFL (or portion thereof) attributable to the taxpayer's ownership of the CFC stock may never be recaptured under current law. The Proposal is intended to change this result and conform the treatment of a CFC stock disposition with the treatment of a disposition of trade or business property that a taxpayer holds directly through a foreign branch.

As a preliminary matter, we note that the primary rationale given for the Proposal -- that ownership of CFC stock can contribute to an OFL by increasing the amount of interest expense allocated against foreign source income -- derives from the "water's edge fungibility" approach of Section 864(e) under which interest expense of a U.S. affiliated group is allocated and apportioned on a groupwide basis and foreign subsidiaries are excluded from the group. Under Section 864(e), the interest expense of a foreign subsidiary is allocated and apportioned (where relevant for U.S. tax purposes) on a separate entity basis, while stock of the foreign subsidiary is treated as a foreign asset that attracts an allocation of the U.S. group's interest expense. The effect of this "water's edge fungibility" approach in most cases is to over-allocate interest expense of the U.S. group against foreign source income, because the allocation of interest expense to the foreign subsidiary stock does not take into account any interest expense incurred directly by the foreign subsidiary. In other words, the foreign subsidiary is presumed to be financed entirely by the U.S. group, whereas the foreign subsidiary, in fact, may have financed itself.

Although a complete analysis of Section 864(e) is beyond the scope of this report, we believe a review of those rules -- with a view to developing rules more appropriate to the financial structure of U.S. multinational enterprises - - would be preferable to adopting the Proposal, which merely reinforces the " water's edge fungibility" approach. We recognize that the limitations of the "water's edge fungibility" approach were generally known when Section 864(e) was adopted in 1986, and that Congress rejected at that time a "worldwide fungibility" approach that would have taken foreign subsidiary debt into account. We also recognize that any amendment to Section 864(e) along these lines would have a revenue cost. More recently, however, the Treasury has acknowledged that economic developments since 1986 may warrant revision of the basic rules governing the taxation of U.S. multinationals, and the Treasury is currently engaged in a review of subpart F. We suggest that Section 864(e) be included in the scope of that review. If Section 864(e) were revised in a manner that takes into account foreign subsidiary indebtedness, the situation at which the Proposal is aimed - - the creation of OFLs through allocation of interest expense against CFC stock - would be far less likely to occur.

As a technical matter, whether or not existing Section 864(e) rules are retained, we agree the Proposal would reduce disparities between the treatment of foreign branch and foreign subsidiary operations. Our comments on the technical aspects of the Proposal follow:

(1) We believe the Proposal should be limited to a disposition of CFC stock by a taxpayer that is a U.S. shareholder (within the meaning of Section 951(b)) of the CFC. Given that the intent of the Proposal is to conform the treatment of U.S.

taxpayers that operate overseas in subsidiary form with that of U.S. taxpayers operating in branch form, it would be inappropriate to apply the OFL recapture rules to a U.S. taxpayer that has only a portfolio-type investment in the stock of a foreign corporation that qualifies as a CFC by virtue of the ownership of other U.S. shareholders.

(2) If the Proposal is enacted, we believe it would be appropriate also to amend Section 904(f)(3) to provide that a contribution of foreign trade or business property to a CFC will not be a disposition that triggers OFL recapture to the extent the transaction otherwise qualifies for nonrecognition under Sections 351 and 367(a).* Under current law, such a contribution would trigger OFL recapture under Section 904(f)(3). If, however, a subsequent disposition of the CFC stock would trigger OFL recapture under the Proposal, there would seem to be no compelling reason for the initial contribution to serve as a trigger if gain would not otherwise be recognized on the contribution. Any unrecognized gain would be reflected in the taxpayer's basis in the CFC stock, and OFL recapture could occur when that gain was later recognized upon disposition of the stock. Although recapture would be deferred, it would be consistent with the intent of the Proposal -- to conform the treatment of foreign branches and foreign subsidiaries -- that recapture not be triggered on an otherwise tax-free conversion from one form to the other.

(3) For the same reason, Section 904(f)(3)(C), which provides an exception for dispositions of property to a domestic corporation in a distribution or transfer described in Section 381(a), should also apply to a liquidation of a CFC into its U.S. parent -- to the extent the liquidation otherwise qualifies for nonrecognition treatment under Sections 332 and 367(e)(2) and the CFC property remains in a foreign branch.

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* In particular, if previously deducted branch losses were recaptured on the contribution under Section 367(a)(3)(C), then Section 904(f)(3) would apply to the recapture amount. (This would most likely require amendment of Section 367(a)(3)(C)(ii)(II), which currently provides that Section 904(f)(3) takes precedence.) However, Section 904(f)(3) would not apply if Section 367(a)(3)(C) did not apply (and gain was not otherwise recognized under Section 367), *e.g.*, where the taxpayer has an OFL, but the particular branch being incorporated is profitable.

(4) Similarly, we believe the Proposal should be limited so that a transfer of the stock of a CFC to another CFC in a transaction in which the taxpayer's basis in the transferred CFC stock is reflected in the basis of the stock of the transferee CFC -- for example, a Section 351 contribution of stock in one CFC to a second CFC, or a merger of one CFC into a second CFC owned by the same U.S. taxpayer -- should not trigger OFL recapture. These transactions should not present an opportunity for avoidance of the OFL recapture rules, given that a subsequent disposition of the stock in the transferee CFC will trigger OFL recapture under the Proposal.