REPORT #701

TAX SECTION

New York State Bar Association

Report on Proposed Regulations

Under Section 163(j)

October 23, 1991

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October 24, 1991

The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20024

Dear Commissioner Goldberg:

I am enclosing a report prepared by an Ad Hoc Subcommittee of our Committee on U.S. Activities of Foreign Taxpayers commenting on regulations proposed under section 163(j), which relates to so-called "earnings stripping".

We would be pleased to discuss the report with you or members of your staff.

Very truly yours,

James M. Peaslee
Chair

Enclosure

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Tax Report #701

October 23, 1991

Report on Proposed Regulations Under Section 163(j)

Introduction

This report, prepared by an ad hoc subcommittee of the Tax Section's Committee on U.S. Activities of Foreign Taxpayers,* comments on regulations proposed on June 12, 1991 under Section 163(j) of the Internal Revenue Code of 1986, as amended (the "Code"), relating to so-called "earnings stripping".

In a prior report,** we commented on issues that might be addressed in regulations issued under Section 163(j). Many of our suggestions were adopted in the proposed regulations. In this report we have generally addressed only new issues raised by the proposed regulations.

In summary of what is set out in more detail below, our principal recommendations are as follows:

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* This report was prepared by an ad hoc committee consisting of Howard B. Adler, Howard Barnet, Jr., Thomas A. Bryan, Michael Dinkes, Robert J. Firestone, James A. Guadiana, David P. Hariton, Deborah Jung Jacobs, Arthur L. Kimmelfield, Mark L. Lubin, Deborah Paul, Philip Rogers, Kevin Rowe, R.J. Ruble, Karen Sakanashi, Ian S. Schachter, Lawrence E. Schoenthal, Cynthia R. Shoss, Kenneth R. Silbergleit, Esta E. Stecher, Mary Sue Teplitz, John C. Vlahoplus, John B. Wade III, Earl S. Zimmerman and Willard B. Taylor, who was the principal draftsman. Helpful comments were received from John A. Corry, William L. Burke, James M. Peaslee, Richard L. Reinhold, Michael Schler, David R. Tillinghast and Ralph O. Winger.

** Report on Section 163 of the Internal Revenue Code, dated March 14, 1991 and reprinted in Tax Notes (June 18, 1990) at page 1495.

(1) Because a corporation's debt-to-equity ratio is generally determined year by year and only at year end, it seems reasonable to limit the deduction for disqualified interest carried to a year in which a corporation has a 1.5-to-1 or better debt-to-equity ratio to the corporation's excess limitation for that year. It is also appropriate to reduce an excess limitation carried forward to a year by 50% of that year's adjusted taxable loss.

(2) There should be a single definition of "interest equivalents" for purposes of Section 163(j), Section 954(c)(1)(E) and the interest allocation and apportionment regulations and, as between the definitions in existing regulations, the definition in the interest allocation and apportionment regulations seems to us to be the better one.

(3) We question whether the rule that treats substitute payments as interest equivalents should be limited to those described in Section 1058(b) and also whether it would not be appropriate to distinguish between substitute payments in respect of dividends and substitute payments in respect of interest.

(4) We question whether adjustments to taxable income to reach adjusted taxable income, other than those specifically mandated or implied by the statute, are worthwhile and, in particular, whether there should be adjustments for changes in net payables and receivables.

(5) We continue to question whether the rules for determining whether interest paid to a partnership is "related person interest" are sufficient to prevent abuse.

(6)Consideration might be given to relieving a corporation from the anti-rollover, anti-stuffing and like rules in Prop. Regs. § 1.163(j)-3 if it elects to use more frequent determination dates to determine its debt-to-equity ratio.

(7) The anti-rollover rule in Prop. Regs. § 1.163(j)-3(b)(4) should be limited to cases when the corporation had a less than 1.5 to 1 debt-to-equity ratio prior to the reduction in liabilities, and it should be made clear that the anti-stuffing rule in Prop. Regs. § 1.163(j)-3(c)(5)(i) will not disregard assets contributed to the capital of a corporation on a substantially permanent basis, even though solely for the purposes of decreasing the corporation's debt-to-equity ratio to 1.5-to-1 or below.

(8) In determining the debt to equity ratios of financial institutions, consideration should be given to the special rules in Section 279(c)(5) and also to defining assets that may be excluded under those rules to include assets that, although not indebtedness, are generated in the ordinary course of the corporation's banking or financing business (such as property subject to net lease).

(9) The regulations should clarify the operation of Prop. Regs. §§ 1.163(j)-2(g)(3) and -4(c), which determine whether interest is paid to a related party by testing relatedness on the date of accrual but whether it is subject to tax by testing on the date of receipt or accrual by the payee.

(10) Consideration should be given to treating interest paid to a controlled foreign corporation or passive foreign investment company as subject to U.S. tax to the extent of the amount that would be taxable to U.S. shareholders if such

interest were currently distributed or, alternatively, in the case of a controlled foreign corporation, the amount of the controlled foreign corporation's income that is regarded as subject to U.S. tax should not be reduced by allocable expenses of the controlled foreign corporation.

(11) We question whether the definition of an affiliated group should be expanded to include any group that would be affiliated under the constructive ownership rules of Section 318 and, if the final regulations nonetheless so provide, whether the constructive ownership and other rules for determining whether there is an affiliated group shouldn't be the same for purposes of Section 163(j) as they are for purposes of Section 904(i) and the interest allocation and apportionment regulations.

(12) We question whether interest paid by a corporation that is included in an affiliated group with a corporation that is related to the payor can, or should, be treated as paid to a related party if the payor is not itself related to the recipient.

(13) Consideration should be given to making the fixed stock write off method available to a corporation that is acquired by a foreign or other corporation not eligible to be includible in a consolidated return.

(14) The fixed stock write off method does not properly deal with dividends in kind or sales by the target within the group or acquisitions of less than all of the target corporation's stock. We agree, however, that it is inappropriate, to make adjustments for post-acquisition earnings of the target corporation.

(15) We are not in favor of imposing a conformity requirement on the use of the fixed stock write off method and we believe it should be extended to tax-free stock and asset acquisitions.

(16) With respect to the rules relating to carry-forwards of excess limitation and disqualified interest following an acquisition or Section 381(a) transaction, it is not clear to us (a) why there should be no allocation of any part of an excess limitation carry-forward to a member of a consolidated group that is acquired, (b) whether the built-in loss rules in Regs. § 1.1502-2 and Section 382 are sufficient to prevent trafficking unless applied without regard to the net built-in loss limitations, or (c) whether an excess limitation carry-forward of the transferor corporation should be eliminated in a Section 381(a) transaction if the exception in Section 384(b) would have applied.

(17) When a deduction for interest is allowed under Section 469, but not under Section 163(j), we continue to believe that the Section 469 limitation should be recomputed.

(18) In the case of a foreign corporation doing business in the United States directly through a branch or otherwise, we continue to believe that "excess interest" should be treated as related party interest only in proportion to non-effectively connected liabilities to related persons. If this is rejected, a "shortfall concept", as suggested in our branch profits report, should be set out.

(19) The test for determining whether debt was issued pursuant to a binding contract, and is therefore grandfathered,

should be based on whether the agreement, if between unrelated parties, would have been enforceable.

1. Proposed Regulations § 1.163(j)-1

Prop. Regs. § 1.163(j)-1 provides a generally straightforward explanation of the operation of Section 163(j), and our only comments are as follows:

(a) Carry-forward of disqualified interest. Prop. Regs. § 1.163(j)-1(c)(2) provides that disqualified interest which is carried forward to a year to which Section 163(j) does not apply, because the corporation has a 1.5-to-1 or better debt to equity ratio, is nonetheless deductible only to the extent that the corporation has an excess limitation in the carry-forward year.[*] While this is difficult to reconcile with Section 163(j)(1)[**], Section 163(j)(7) authorizes regulations to carry out the purposes of Section 163(j) and it seems to us that this limitation on disqualified interest carry-forwards is reasonable, given that debt-to-equity ratios are determined year by year and generally only at year end. Without such a limitation, otherwise suspended interest deductions would become fully deductible in any year in which the corporation had, at year end, a 1.5-to-1 debt-to-equity ratio, and that seems too easy a way out.[***]

(b) Anti-avoidance rule. Prop. Regs. § 1.163(j)-1(f) includes a general anti-avoidance rule that turns on whether a

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[*] See also Prop. Regs. § 1.163(j)-1(g), Example 3(ii).

[**] Section 163(j)(1)(B) provides that disallowed interest is carried forward and treated as disqualified interest in the succeeding year, and Section 163(j)(1)(A) disallows a deduction for disqualified interest only if Section 163(j) "applies to [the] corporation for [the] taxable year".

[***] Another approach, however, might be to allow the deduction after the 1.5-to-1 debt-to-equity ratio had been met for two years.

principal purpose of an arrangement is to avoid the application of Section 163(j). We question whether this adds anything to specific statutory rules, such as Section 269, or judicial doctrines, such as the sham transaction and substance over form doctrines -- in other words, whether reliance on this provision in the proposed regulations will give the Internal Revenue Service any power that it does not already have.[*]

(c) Effect of adjusted taxable loss on excess Limitation carry-forward. Prop. Regs. § 1.163(j)-1(d) provides, by reference to Prop. Regs. § 1.163(j)-2(f)(4)(ii), that an adjusted taxable loss in one year reduces an excess limitation carry-forward that may be carried to that year. Since only 50% of adjusted taxable income is taken into account in determining whether there is an excess limitation, however, it seems to us that only 50% of the adjusted taxable loss should reduce an excess limitation carry-forward.[**] With that modification, this regulation is consistent with the terms of Section 163(j)(2)(B)(i)(II) and strikes a fair balance with Prop. Regs. § 1.163(j)-2(f)(4)(iii), which provide that an adjusted taxable loss does not carry-forward and reduce the taxpayer's excess limitation in a later year.

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[*] In addition, it is an extremely broad rule and would seem to apply when a principal purpose of any element of a transaction was to avoid Section 163(j).

[**] Assume, for example, that in year 1, a corporation has adjusted taxable income of $100X, and has interest expense of $20X. The corporation's excess limitation carry-forward is $30X ($100X/2 - $20X). If in year 2 the corporation has an adjusted taxable loss of $30X, its $3OX excess limitation carry-forward would be eliminated under the Proposed Regulations. We believe the excess limitation carry-forward should be reduced only to $15X, which is the amount of excess limitation carry-forward that would result if year 1 and year 2 were combined (($100X - $30X)/2 - $20X).

2. Proposed Regulations § 1.163(j)-2

We have the following comments on Prop. Regs. § 1.163(j)—2, which provides definitions (e.g., "exempt person related interest" and "excess interest expense") for the purposes of Section 163(j):

(a) Definition of interest income and expense. it could usefully be provided in Prop. Regs. § Sections 1.163(j)-2(e)(1) and (2) that an amount treated as interest or original issue discount under any provision of the Internal Revenue Code will be treated as interest for purposes of Section 163(j).*

(b) Interest equivalents. The proposed regulations generally reserve the definition of interest equivalents,** and it is our understanding that, consistent with our prior report, consideration is being given to the development of a single definition that would be used for purposes of Section 163(j), Section 954(c)(1)(E) and the interest allocation and apportionment regulations.

A single definition is more important than reflecting in several rules the marginally different purposes of the underlying statutes. There is no need in this connection to stick with the definitions found in the temporary foreign personal holding company income and the interest allocation and apportionment regulations.*** While our prior report suggested that the Section

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* For example, the interest income or expense created by significant non periodic payments under notional principal contracts.

** As we understand the preamble, these rules, when issued, will be prospective except in the case of transactions entered into for the purposes of avoiding the rules of Section 163(j).

*** Temp. Regs. § 1.954-2T(h) and Temp. Regs. § 1.861-9T(b), modified to reflect Notice 89-90.

163(j) regulations should incorporate their principles, that suggestion was made in the context of the possibility that yet a third definition might be developed for purposes of Section 163 (j).

A single definition of interest equivalents ought to reconcile the different definitions in the temporary foreign personal holding company income and the allocation and apportionment of interest expense regulations. Thus, Temp. Regs. § 1.954-2T(h)(1) provide that interest equivalents include (i) an investment in which the payments, cash flows or return predominantly reflect the time value of money (such as receipts under an interest rate swap), (ii) payments that are in substance for the use or forbearance of money and (iii) any income from the acquisition and collection or disposition of factored receivables, while Temp. Regs. § 1.861-9T(b) provides that an item of expense or loss is an interest equivalent only if the taxpayer secures the use of funds for a period of time and the expense or loss is substantially incurred in consideration of the time value of money.

Of the two approaches, it seems to us that the one in Temp. Regs. § 1.861-9T is better, i.e., that there should be an interest equivalent only where there is both the transfer of funds and a return measured by the time value of money, and that interest equivalents should not include fees or expenses that are merely measured by the time value of money.* Solely for purposes of the definition of foreign personal holding company income, it would also be necessary to include, as the statute requires,

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* If regulations ultimately integrate notional principal contracts with a hedged borrowing or loan, of course, receipts under the swap would be taken into account in determining interest income or expenses from the debt instrument.

"income from commitment fees (or similar amounts) for loans actually made".[**] We also believe that the single definition should be used in all Treasury regulations that adopt the interest equivalence concept.

Interest equivalents should be taken into account in determining both the interest expense and interest income of a corporation.

(c) Substitute payments. Prop. Regs. § 1.163(j)-2(e)(6) treats substitute payments between related parties that are described in Section 1058(b), relating generally to securities loans, as interest expense. Treating substitute payments as interest equivalents seems appropriate. Different considerations may apply to substitute payments in respect of dividends, since they are not measured by a principal amount, although we recognize that this distinction has generally not been made and that substitute payments are generally part of the cost to a borrower of securities of obtaining the use of funds.[*] Whether applicable to payments in respect of interest or payments in respect of both interest and dividends, however, we question why the substitute payment rule should be limited to transactions between related parties, to interest expense (as opposed to interest expense and income) and to securities loans that meet the sometimes technical requirements of Section 1058.[**]

** See Section 954(c)(1)(E) of the Code. The rules conforming the definition of interest equivalents should also cross reference the rules on non-periodic payments under notional principal contracts.

* Cf. Sections 163(d)(3)(C), 263(g)(2) and 265(a)(5).

** It also seems to us to be inappropriate to include such payments in a separate section of the proposed regulations since substitute payments should be dealt with in the context of interest equivalents (as they are for purposes Temp. Regs. § 1.954-2T).

(d) <u>"Adjusted taxable income"</u>. The proposed regulations require that the net operating loss deduction allowed by Section 172, the charitable contribution carryover allowed by Section 170(d)(2) and any deduction on account of a capital loss carryover or carry-back be added to taxable income for the purposes of computing adjusted taxable income. Consistent with these rules, it would be appropriate to add any deductions allowed in the current year on account of expenses incurred in other years and to subtract those deductions from adjusted taxable income in the year incurred. In particular, we have in mind amounts taken into account currently under Sections 267(f)(2)(B), 404(a)(5), 465(a)(2), 469(b) and 704(d), but there surely are other appropriate instances that should be covered. This seems to us to be implied by the statutory add-back for net operating loss carry-forwards. Considerations of complexity may, on the other hand, argue against such a rule.

Under Prop. Regs. § 1.163(j)-2(f)(3), depreciation, amortization and depletion that is allowed or allowable for taxable years beginning after July 10, 1986 must be subtracted from taxable income when the property is sold or disposed of. While this may seem unfair if depreciation in prior years required to be added back to taxable income in those years simply increases an excess limitation and the property is sold after the three year excess limitation carry-forward expires unused, correcting any unfairness might involve reopening prior years or tracing (or otherwise allocating) gain to previous allowances and expired excess limitations. This justifies the absence of an exception for such a case.

In our prior report we questioned whether there should be any adjustments in computing adjusted taxable income other than the two provided for, or implied by, Sections

163(j)(6)(A)(i)(II) and (III) -- that is, net operating loss and other carryovers (including the items referred to in the first paragraph of this Section (d)) and depreciation, depletion and amortization. The proposed regulations nonetheless make a number of other adjustments in order to reach the equivalent of "cash flow".*

We question whether these other adjustments are appropriate. Some items appear to be omitted (such as increases in insurance company reserves and FSC commissions), and no provision is made for the possibility of additional items created by changes in the income tax laws or regulations. The addition of net increases in payables and decreases in receivables, and the corresponding reductions for net decreases and net increases, introduces calculations and new definitions (i.e., "accounts payable" and "accounts receivable") that would otherwise not have to be made or used and thus an unnecessary level of complexity.

(e) "Related persons". In our prior report, we said that the determination of whether interest paid to a partnership was paid to a related person is made under Section 163(j)(4) by looking at whether the partnership is related to the payor, with the consequence (wrong, in our view) that interest paid to a partnership would not be treated as interest paid to a related

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* To the extent that items listed in the category of "subtractions" are intended to be corollaries of items listed in "additions", it may be useful to cross reference. For example, subclause (i) might be amended to read:

> "With respect to the sale or disposition of property (including a sale or disposition of property by a partnership), any depreciation, amortization or depletion deductions of a kind included in subsection (2)(iii), (iv) or (v) and which were allowed for the taxpayer's taxable year beginning after July 10, 1986 with respect to such property."

person unless persons related to the corporation owned more than 50% of the capital or profits interest in the partnership, notwithstanding that the partners included persons who were plainly "related" to the corporation.* Absent a case covered by the anti-abuse rules in Prop. Regs. § 1.163(j)-1(f) or 1.163(j)-2(g)(2) or a statutory amendment, it seems to us that the Internal Revenue Service is exposed to partnership structures that circumvent the rules of Section 163(j).

For the purposes of determining whether interest is related person interest, "interest expense . . . shall be treated as accruing daily under principles similar to [those in] section 1272(a)".** Not all interest accrues on a daily basis under that Section, however -- specifically, "contingent" interest may in effect accrue on a cash basis under Prop. Regs. § 1.1275-4. We assume that there is no intention to change this rule.

3. Proposed Regulations § 1.163(i)-3

While a corporation's debt-to-equity ratio is determined on the last day of its taxable year, notwithstanding the authority to use more frequent determination dates, there are rules which disregard certain assets and liability reductions and, as noted above, the Proposed Regulations also provide that a disqualified interest carry-forward may be deducted in a carry-forward year (even one in which the corporation has a 1.5-to-1 or lower debt-to- equity ratio) only to the extent that the corporation has an excess limitation in that year.

* By way of illustration, if a U.S. corporation that was wholly owned by a foreign corporation borrowed from a partnership in which the foreign corporation was a 50% or less partner, the interest on the loan would not be related party interest.

** Prop. Regs. § 1.163(j)-2(g)(3).

(a) Possible alternative to anti-rollover, etc. rules. These modifications to the general year-end determination date rule are complex, as discussed hereafter, and the complexity might be reduced if corporations were given an election to use more frequent determination dates and, in such a case, were not subject to the anti-rollover or anti-stuffing rules or to the rule in Prop. Regs. § 163(j)-1(c)(2) that limits the deduction for a disqualified interest carry-forward to a year in which the corporation has at year- end a 1.5-to-1 or lower debt-to-equity ratio.

(b) Anti-rollover rule. An "anti-rollover" rule in Prop. Regs. § 1.163(j)-3(b)(4) disregards reductions in debt within the last 90 days of the taxable year to the extent that liabilities are increased in the first 90 days of the following year. This rule seems to us to be overly broad and will no doubt disregard normal changes in year-end liabilities -- shouldn't it be limited to cases where there is some evidence of an intent to manipulate the year-end determination date?

In addition, the scope of the liability reduction rule is unclear. The apparent purpose is to prevent a corporation from bringing itself within the 1.5-to-1 safe harbor by year end liability reductions. Suppose, however, that, prior to the liability reduction, the corporation is within the safe harbor -- for example, has $30X of assets, consisting solely of cash, liabilities of $15X and equity of $15X and that, within the last 90 days of a taxable year, it pays down $10X of debt which it re-borrows at the start of the following year. Is it appropriate to conclude that the corporation's debt-to-equity ratio is $15X to $5X (i.e., $20X less $15X) and that it no longer meets the safe harbor?

(c) Subjective anti-stuffing rule. An "anti-abuse" rule in Prop. Regs. § 1.163(j)-3(c)(5)(i) disregards assets acquired for the principal purpose of reducing the debt-to-equity ratio. Does this apply if, with that purpose, cash or assets are contributed to the corporation on a permanent basis? To take an extreme case, suppose a corporation is organized and, on the advice of its tax advisers, starts business with a 1.5 to 1 or better debt-to-equity ratio -- is its initial capital to be forever disregarded?

(d) Transfer/Retransfer rule. Prop. Regs. § 1.163(j)—3(c)(5)(ii) disregards assets transferred to the corporation by a related party within 90 days before the end of a taxable year if there is a transfer of the same or similar assets to the same or another related person within the first 90 days of the next year. This does not apply to the extent that there is full consideration, in cash or property other than stock or rights of the issuer, for "a transfer".

The scope of the full consideration requirement is unclear. Do both, or only one, of the transfers have to be for full consideration? The final regulations should make it clear that only one transfer need be for full consideration. For example, suppose that a corporation buys an asset for its value from a related person and then distributes the asset as a dividend to the same or another related party. The purchase for value does not affect the corporation's net equity and therefore is not "stuffing".[*] Similarly, if a parent contributes an asset to a subsidiary and the subsidiary later sells the asset to a related party for full consideration, there has been no

[*] The dividend's effect on net equity is the same as it would have been absent the purchase. The dividend is therefore not relevant to the issue of "stuffing".

"stuffing" because the subsidiary retains the value of the capital contribution.

(e) Financial institutions and insurance companies. The preamble to the Proposed Regulations asks for comments on how the debt and assets of financial institutions and insurance companies should be determined and the effect of reserves on those determinations.

With respect to banks and other financial institutions, it seems to us that the principal issues are the calculation of the debt-to-equity ratio and the determination of net interest expense. It is unlikely that a bank or other financial institution will ever meet the 1.5-to-1 debt-to-equity ratio and also probable that such a corporation may have income which, although not technically interest, is sufficiently similar to warrant being treated as interest income for purposes of Section 163(j). We suggest, therefore, that in determining the debt to equity ratios of financial institutions, consideration be given (i) to the special rules in Section 279(c)(5), which excludes from assets indebtedness owed to the corporation that arises in the ordinary course of a banking or financing business (and a corresponding amount of liabilities and earnings and interest expense) and also (ii) to defining assets that may be excluded for this purpose to include assets that, although not indebtedness, are generated in the ordinary course of the corporation's banking or financing business (such as property subject to net lease).

Applying Section 279(c)(5) principles, as so modified, to banks and other financial institutions may largely exclude them from Section 163(j), and this possible result should be

taken into account in evaluating whether such a rule is advisable.

Reserves for bad debts should reduce the basis of assets for purposes of determining the corporation's debt-to-equity ratio.

4. Proposed Regulations § 1.163(j)-4

(a) Exempt interest. Interest will be related party interest if accrued to a related party,* but the determination of whether the interest is subject to U.S. tax (and thus is "exempt related person interest expense") is made on the date that the tax would be imposed.** The rule seems to miss the possibility that debt will be sold or otherwise transferred after interest has accrued and before it is paid -- in any event, it is unclear how the rules work when the two dates differ. It seems to us that the determination should be based on whether the accrued interest, if paid to the seller at the time of sale, would have been subject to tax.

Suppose, for example, that a foreign related party not subject to U.S. tax on interest sells an obligation to a taxable U.S. person after interest on the obligation has accrued but before the interest has been paid (and thus become subject to withholding).*** One possibility is to say that the previously accrued interest is exempt, and thus subject to Section 163(j),

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* Prop. Regs. § 1.163(j)-2(g)(3).

** Prop. Regs. § 1.163(j)-4(c). More precisely, the date on which the interest is "received or accrued by the payee, whichever is relevant under normally applicable U.S. tax principles".

*** See Sections 871(a)(1) and 881(a) of the Code, each imposing tax on "the amount received".

because interest accrued prior to a purchase is generally not taxable to a purchaser.[****] If this is what the proposed regulations had in mind, it might usefully be stated explicitly and/or illustrated by example. To take another example, suppose an obligation issued at a discount to a related foreign party is sold after discount has accrued, but before it is paid. Is it the theory of the Proposed Regulations that the discount accrued to the date of sale is exempt from tax because its tax treatment is determined, under Sections 871(a)(1)(C) and 881(a)(3), at the time of sale?

(b) Interest paid to controlled and certain other foreign corporations. Prop. Regs. § 1.163(j)-4(d) generally excludes from exempt interest the net amount of related person interest income of a foreign corporation that is currently included in income by a U.S. shareholder under the controlled foreign corporation, foreign personal holding company or passive foreign investment company provisions.[*] While it makes no difference for this purpose that the interest is, because of foreign tax credits, effectively not taxable to the shareholder,[**] expenses of the foreign corporation attributable to the interest income reduce the amount that is regarded as

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[****] In the reverse situation, when debt held by an unrelated party is sold to a related party, the accrued interest or discount is not subject to Section 163(j) because of the rule in Prop. Regs. Section 1.163(j)-2(g)(3).

[*] Contrary to the suggestion made in our prior report, the Proposed Regulations net related party interest income against related party interest expense only when the related party interest is paid by a controlled foreign corporation to the U.S. corporation, or a member of its affiliated group, and is allocated for foreign tax credit purposes against related person interest income received by the controlled foreign corporation. Prop. Regs. § 1.163(j)—4(d)(1)(iv).

[**] Thus, net interest income that would have been included but for the high tax kickout of Temp. Regs. § 1.954-1T(d) and § 954(b)(4) is treated as subject to U.S. tax, as is the amount of any Section 78 gross-up for taxes attributable to related party interest. Prop. Regs. §§ 1.163(j)-4(d)(1)(i) and (v).

subject to U.S. tax, and related party interest income of a passive foreign investment company is not regarded as subject to U.S. tax unless included in income because the shareholder has made a qualified electing fund election.

Our prior report suggested that the complexity of rules that treat interest paid to foreign corporations as subject to U.S. tax because includible in the income of U.S. shareholders might justify not issuing regulations in this area at all. This still seems to us to be a valid concern.* How, for example, is a U.S. corporation to know how much of the interest paid to a related foreign corporation has been included in income by U.S. shareholders?

If the final regulations nonetheless provide for exclusions, it seems to us that they might take a less literal, and much simpler, approach and provide that interest paid to a controlled foreign corporation is subject to U.S. tax to the extent of the amount that would be taxable to U.S. shareholders if distributed as a dividend. In effect, the regulations would rely on the operation of the controlled foreign corporation provisions of the Internal Revenue Code to ensure U.S. taxation. Alternatively, they should not reduce the amount to be treated as subject to tax by expenses of the controlled foreign corporation. The legislative history is not dispositive of this question and, from a policy point of view, there seems to be no viable distinction between interest that is effectively exempt because of deductible expenses or because of foreign tax credits.**

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* This part of the Proposed Regulations might in all events usefully be illustrated by examples.

** Cf. Prop. Regs. § 1.267(a)-3, relating to amounts paid to related foreign persons, which does not defer deductions for amounts includible in the income of a controlled foreign corporation, foreign personal holding company or passive foreign investment company.

Along the same lines, we question whether the exclusion for interest paid to a passive foreign investment company should be limited to cases where a shareholder has made a qualified electing fund election. The interest charge under the passive foreign investment company rules ultimately puts a U.S. shareholder in substantially the same position as if the income of the foreign corporation had been distributed and taxed currently. Shouldn't the interest charge justify excluding any related party interest income of a passive foreign investment company to the extent of the amount that would be distributed to U.S. shareholders if current income were distributed currently?*

5. Proposed Regulations § 1.163(j)-5

(a) Definition of an affiliated group. As contemplated by Section 163(j)(6)(C), Prop. Regs. §§ 1.163(j)-5(a)(2) and (b) treat members of an affiliated group, whether or not filing consolidated returns, as a single corporation and provide implementing rules. Prop. Regs. § 1.163(j)-5(a)(3) goes further, however, and provides that a corporation that is not a member of an affiliated group will be so treated if it is an includible corporation (within the meaning of Section 1504(b)) and at least 80% in voting power and value of its stock is considered owned, under Section 318, by another includible corporation.** Thus, for example, while two separate consolidated groups owned by one foreign parent are not members of the same affiliated group within the meaning of Section 1504(a), they would be treated as

* To carry this one step further, interest paid to a foreign corporation that was not a controlled foreign corporation or passive foreign investment company might be regarded as subject to U.S. tax to the extent that the foreign corporation pays dividends to U.S. shareholders in the current year.

** Our prior report recommended that insurance companies, otherwise excluded from the rules treating affiliated corporations as one taxpayer, be treated as members of the affiliated group for purposes of the Section 163(j) rules.

one taxpayer under Section 163(j)(6)(C) by virtue of the Proposed Regulations.[*]

Section 163(j)(6)(C) limits the one taxpayer rule to "[a]ll members of the same affiliated group (within the meaning of Section 1504(a))". While there is general regulatory authority in Section 163(j)(7)(A) to issue regulations that will prevent avoidance of the purposes of Section 163(j), and legislative history that supports the position that an affiliated group cannot be broken by inserting non-includible corporations in the chain of ownership,[**] we question whether this grant of authority contemplated that, in every case, there would be such a basic variation in the words of the statute. We would suggest that the expansive definition of an affiliated group in Prop. Regs. § 1.163(j)-5(a)(3) not apply to separate affiliated groups unless there is a clear plan to avoid Section 163(j) by the creation of separate groups.

Applying the one taxpayer rule to otherwise non-affiliated companies requires the use of the methodology provided for non-consolidated affiliated groups and thus vastly expands the application of the complex rules set out in Prop. Regs. § 1.163(j)-5(c) for calculating, aggregating and allocating net

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[*] Prop. Regs. § 1.163(j)-5(a)(3)(ii), Example.

[**] The House Report (H.R. No. 247, 101st Cong., 1st Sess. (1989) at 1248) does say that

> In cases where a group of commonly controlled U.S. corporations would constitute an affiliated group but for the inclusion within the group of one or more entities other than includible corporations..., the committee intends for regulations to treat all U.S. corporations that are members of such a group as a single taxpayer where such treatment is appropriate in order to carry out the purposes of the bill or to prevent avoidance of the purposes of the bill.

interest expense, adjusted taxable income, excess limitation carry-forward, disallowed interest expense carry-forward, excess interest expense and current excess limitation to and among non-consolidated companies. The preamble to the Proposed Regulations asks how the non-consolidated group rules might be simplified -- certainly, limiting the expansive definition to abusive transactions will ensure that other taxpayers will not be burdened with the administrative complexity of complying with the one taxpayer rule.

(b) Definition of non-affiliated members of the group. Regulations relating to the allocation and apportionment of interest expense also purport to expand the affiliated group to include non-affiliated groups and, for certain foreign tax credit purposes, there is a specific statutory expansion in Section 904(i) of the Internal Revenue Code. Like Prop. Regs. § 1.163(j)-5(a)(3), these rules were attempts to prevent the avoidance of statutory rules, but their scope differs. Thus, ownership of 80% in value or voting power is enough to require inclusion under the interest allocation and apportionment regulations;* and the constructive ownership rules applied for purposes of those regulations and under Section 904 (i) are the narrower rules in Section 1563(e), not those in Section 318. If the definition of an affiliated group is expanded in Section 163(j) by regulations, it would make sense to have a single set of rules for all three purposes.

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* Temp. Regs. § 1.861-11T(d)(6) and Notice 88-91.

(c) Definition of related person interest paid by an affiliated group. Prop. Regs. § 1.163(j)-5(b)(3) provides that interest expense will be exempt related person interest expense if it would be so classified had it been paid by any member of a group filing consolidated returns, and Prop. Regs. § 1.163(j)-5(c)(2)(ii)(C) applies the same rule to an affiliated group not included in the same consolidated return.

Suppose that a subsidiary, owned to the extent of 80% in value and voting power by its parent, pays interest to an individual who is a 51% foreign shareholder of the common parent. The shareholder is not related to the payor within the meaning of Section 267(b), which is the operative Code section, and treating the interest as related person interest does not seem to be compelled by the direction in the statute to treat all members of an affiliated group "as one taxpayer".

(d) Fixed Stock write-off method. While the proposed regulations generally eliminate intra-affiliated group investments in determining whether the group has a 1.5-to-1 or better debt-to-equity ratio, an exception is made for shares acquired in certain "qualified stock purchases".

In such a case, under the "fixed stock write-off method", an affiliated group may elect to calculate its assets for Section 163(j) purposes by reference to the "special basis" of the acquiring corporation in the target's stock, rather than by reference to the target's basis in its assets. The special basis is generally cost plus target and target affiliate liabilities outstanding on the date of the acquisition. The special basis is amortized ratably over a period of eight years, or, in the case of a target that owns "long-lived" assets, fifteen years. The special basis is increased under the rules of

Section 358 for property contributed to the target and decreased by the fair market value of any property distributed (or transferred to certain affiliates in non-recognition transactions) by the target. After electing the fixed stock write-off method, a group may for a later year elect to cease to use the method and thereafter determine assets by reference to the inside basis of the target's assets.

We have the following comments on the special basis election.

(i) Definition of a qualified stock purchase. The special basis election is available only for a "qualified stock purchase" by a corporation that is an "includible corporation", as defined in Section 1504(b), and thus would exclude a purchase by a foreign corporation or by a life insurance company not covered by the special rule in Section 1504(c).

Consideration should be given to adjusting the target's basis in its assets in such a case.* Suppose, for example, that a foreign corporation, directly or through a U.S. holding company created for the purpose and capitalized solely with equity, purchases for $100X the shares of a U.S. corporation that has liabilities of $100X and assets with no tax basis. Under the Proposed Regulations, if the acquisition is made directly, the target has an infinite debt-to-equity ratio; if it is made through a U.S. holding company, the target/holding company's debt-to-equity ratio is 1-to-1. Why should there be such a

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* This would be particularly appropriate if, as the preamble suggests may be the case, the fixed stock write off method is extended to tax-free asset acquisitions.

difference?[**] We recognize that there is in such a case no specific authorization similar to the authority provided by Section 163(j)(7)(B) to issue regulations that will make "adjustments in the case of corporations which are members of an affiliated group".

(ii) Period of write off. While the proposed regulations permit an acquiring corporation to take advantage of a stock basis that exceeds inside asset basis, the benefit is limited because of the short eight-year write-off period that will generally apply and the failure to increase the basis by the target's retained earnings. It will as a result be beneficial for most taxpayers to cease to use the fixed stock write-off method before the eight-or fifteen-year write-off period is over.

(iii) Coordination with Prop. Regs,§ 163(i)-5(d)(3)(iii). In the case of a dividend in kind of appreciated property from a target corporation to the acquiring corporation, the basis rules are not properly coordinated with Prop. Regs. § 163(j)-5(d)(3)(iii). Under -5(e), the special basis is reduced by the value of the distributed property, but under -5(d)(3)(iii), in the case of a transaction between members of an affiliated group in which gain or loss is deferred under Treas. Regs. §§ 1.1502-13, -13T, -14 or -14T, the adjusted basis of an asset involved in such a transaction is reduced for Section 163(j) purposes by the amount of any deferred intercompany gain not taken into account.

Suppose a parent corporation pays $200 for the stock of a target, elects the fixed stock write-off method (a "special

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** An extension of the fixed stock write-off method to such acquisitions would, of course, not be in the part of the Proposed Regulations relating to affiliated groups.

basis target”), and that the target has one asset with fair market value of $200 and basis of $0 and no liabilities. If the target distributes the asset, the parent's basis in that asset for Section 163(j) purposes is its general basis of $200,* minus the $200 deferred gain, or $0. The special basis of parent in target is decreased under -5(e)(2)(ii) by the fair market value of the distributed property, or $200. The distribution thus creates a net decrease of $200 in the Section 163(j) equity of the group. Applying the basis reduction rule of -5(d)(3)(iii) to deferred gain arising from a dividend from a special basis target would correct this problem but would give the parent an asset with a basis that might be written off over a period longer than the eight-year write-off period that would apply if it were held by the special basis target. An alternative solution would be to reduce the parent's special basis in the target only by the basis of the distributed asset.

(iv) Purchases of assets from special basis targets. Nor do the basis rules work properly when appreciated assets are purchased from targets. Suppose, in the above example, that the parent purchased the asset from the target for $200 cash. Special basis is not adjusted in such a case, because special basis is only adjusted for contributions and distributions. The parent's aggregate basis in its assets is affected, however. Before the asset purchase, the parent had a basis of $200 in the stock and $200 in cash. After the transaction, the parent's basis in the stock is still $200, but its basis in the asset is $200 less the $200 deferred gain, or $0. The net result is a $200 decrease in the group's asset basis. The rule proposed in the preceding paragraph should be extended to avoid this result.*

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* See Section 301(d) of the Code; Regs. § 1.1502-31.

* Distributions and intergroup sales of depreciated assets do not raise these issues.

(v) Acquisition of less than all of a target. When the acquiring corporation acquires less than all of the target's stock, the Proposed Regulations reach results that may not have been intended.

First, there is no "gross up" of special basis in such a case. For example, if a parent purchases 80% of the stock of a target (with no liabilities) for $80, the special basis would be $80. Absent the special election, however, the basis of all of the underlying assets is taken into account. If the target has liabilities, moreover, all of the liabilities are added to the special basis even though the parent owns 80% of the stock.

Second, even though the special basis only includes the actual purchase price for the 80% of target stock, basis is apparently reduced -- this is not entirely clear -- by the full amount of any distribution, including any distribution to minority shareholders. In the above example, if the target distributed $80 of cash, $64 to the parent and $16 to other stockholders, the special basis would appear to be reduced under the Proposed Regulations by $80, the total distribution, to $0. The parent's asset basis would also be increased by $64, the amount of cash distributed, for a net reduction in the group's equity of $16.

If these anomalies are considered serious, the problem could be addressed either (1) by grossing up the special basis upon acquisition of a less-than-100% interest by an amount equal to the value of the target not purchased by the parent or (2) by reducing special basis upon distributions only by the value of the property received by members of the affiliated group. We recognize the difficulty of creating a basis for Section 163(j)

purposes greater them both the actual stock basis and the underlying asset basis. We suggest that the distribution adjustment rule should be modified to reduce special basis only in the amount of the fair market value of the property distributed to members of the affiliated group.

(vi) Absence of an adjustment for post-acquisition earnings of a special basis target. The Proposed Regulations make no positive basis adjustment for post-acquisition earnings of the target.[*] This result is theoretically correct to the extent that post-acquisition earnings in fact represent "built-in gain" of the target, since that gain is already reflected in the special stock basis and should not again increase such basis when recognized. Like the loss disallowance regulations,[**] the Proposed Regulation in effect embodies an irrebuttable presumption that all post acquisition earnings arise from the recognition of built-in gain and so should not result in a basis increase in the purchased stock.

For example, suppose an acquiring company purchases the stock of a target for $200, and the target has one asset with fair market value of $200 and basis of $0 and no liabilities. The special basis is $200. If the $200 built-in gain of the target is recognized through a sale of the asset, the special basis should not be increased because the special basis of $200 already reflects the built-in gain of $200. If, by contrast, the asset is sold for $300 and the proceeds generate another $100 of taxable

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[*] To this extent, the Proposed Regulations create an incentive in favor of distributions of property. If an asset owned by the target generates profits, there is no increase in special basis for the additional underlying asset basis arising from such profits, but if the asset is distributed and generates profits, the additional basis will increase the group's aggregate basis.

[**] Treas. Regs. § 1.1502-20.

income to the target, that $100 of income is economically a $100 increase in the equity of the target and logically should be reflected in equity for Section 163(j) purposes.

As illustrated by the controversy with respect to the loss disallowance regulations, however, it is difficult to compose a rule that would give the taxpayer the benefit of a basis increase for post-acquisition earnings of the target other them built-in gains, yet still protect the Internal Revenue Service against unjustified basis increases arising from the recognition of built-in gains. There is no simple alternative to the proposed approach of adjusting special basis only for contributions and distributions. We thus believe that the proposed regulations are right on this issue.

(vii) Making the election. The Proposed Regulations provide that an election to use the fixed stock write-off method must be made with the return for the year in which the acquisition is made* and as a consequence provide no guidance on how to elect with respect to acquisitions made in taxable years beginning after July 10, 1989 for which returns have already been filed or on whether an election may be made for taxable years beginning on or before July 10, 1989.

(viii) Possible conformity requirement. The preamble to the Proposed Regulations asks whether there should be a conformity requirement to prevent taxpayers from electing the fixed stock write-off method only when the special basis would exceed the target's inside asset basis. A conformity requirement

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* Prop. Regs. § 1.163(j)-5(e)(4).

would be largely meaningless if a taxpayer could, as under the Proposed Regulations, elect out of the special rule at any time and apply the general rule to any particular acquisition. The opportunity to elect out is essential, however, given the short write off period. We would oppose a conformity requirement since any meaningful conformity requirement would necessarily eliminate the election out.

(ix) Non-taxable acquisitions. The preamble to the Proposed Regulations asks whether the special basis election should be extended to non-taxable asset and stock acquisitions.

It seems to us that there is no particular reason to limit the method to acquisitions that are taxable to the shareholders of the target (whether such acquisitions are for stock or other property) and that, so long as the consideration given in the acquisition can be valued, and thus that the cost of the acquired shares can be ascertained, the fixed stock write-off method should be available. We assume that this treatment would be limited to reorganizations and would not, for example, be extended to assets acquired in a like-kind exchange and also that it would not apply to related party transactions (i.e., to permit related parties to write up assets for purposes of Section 163(j) without the recognition of gain).

6. Proposed Regulations § 1.163(i)-6

Prop. Regs. § 1.163(j)-6 sets forth the effect of an acquisition on the two carry-forwards created by Section 163(j) —- that is, on disallowed interest and excess limitation. The rules, and our comments, are as follows:

(a) Excess limitation. If the acquired corporation was included in a consolidated return, Prop. Regs. § 1.163(j)-5(b)(6)(ii) provides that no part of any consolidated excess limitation will carry over (i.e., will go with the acquired corporation). A contrary rule applies to disallowed interest,[*] and it is not clear to us why there should be a difference. An allocation to a departing member of a consolidated group's disallowed interest or excess limitation carry-forward will to some extent be arbitrary, but that is no more true in the case of an excess limitation carry-forward than a disallowed interest carry-forward; and the failure to make an allocation to the departing member does not cure the possible distortions.

(b) SRLY limitations. Both excess limitation and disallowed interest carry-forwards are in effect subject to the separate return limitation year, or SRLY, limitations -- a disallowed interest carry-forward because it is a built in deduction that is potentially subject to Regs. § 1.1502-15[*] and an excess limitation carry-forward because of Prop. Regs. § 1.163(j)-6(b)(1), which limits the amount of an excess limitation carry-forward from a non-affiliation year to the corporation's separately computed excess interest expense.[**]

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[*] See Prop. Regs. § 1.163(j)-5(b)(6)(i).

[*] Prop. Regs. § 1.163(j)-6(a)(3).

[**] If all members of a group with an excess limitation carry-forward become members of the new group, the limitation is calculated on the basis of the separately computed excess interest of the entire acquired group. If more than one but less than all members are acquired, there is, under Prop. Regs. § 1.163(j)-5(b)(6)(ii), no excess limitation carry-forward.

It seems to us that the SRLY rule in Regs. § 1.1502-15 should be applied to disallowed interest without regard to the threshold exception in Regs. § 1.1502-15(a)(4), both because it makes no sense to have the limitation on disallowed interest depend on whether the corporation has a built-in loss with respect to its assets (i.e., an excess of basis over value) and because it means that different rules apply to disallowed interest and excess limitation carry-forwards. Some form of de minimis rule or threshold for the application of the SRLY limitations, applicable to both disallowed interest and excess limitation carry-forwards and tailored to the amount of the carry-forward (rather than, say, the presence of a built-in loss) might be appropriate.

(c) Sections 382 and 384. Disallowed interest carry-forwards may also be subject to Section 382 if there is a change in control. While Section 384 does not as such apply to an excess limitation carry-forward of an acquiring corporation, since it is not an item of built-in gain, the Proposed Regulations provide that an excess limitation carry-forward of an acquiring group may not be used against disallowed interest carry-forwards of an acquired corporation or, put differently, the disallowed interest carry-forward of an acquired corporation may only be used to the extent of the excess limitation of the new group for the carry-forward year.*

Section 382 may not be sufficient to prevent trafficking in corporations with disallowed interest carry-forwards. Its restrictions on built-in deductions apply only if the tax basis of the corporation's assets exceeds their value (i.e., has a "net unrealized built-in loss" above the threshold amount set out in

* Prop. Regs. § 1.163(j)-6(a)(1); Prop. Regs. § 1.163(j)-6(a)(4), Example.

Section 382(h)). There is no particular reason why a corporation with a disallowed interest deduction would have such a net unrealized built-in loss. As noted, some form of threshold for the application of the change in control limitation, possibly related to the amount of the carry-forward (rather than, say, the presence of a built-in loss) might be appropriate.

While the restriction on the use of excess limitation carry-forwards against the disallowed interest carry-forward of an acquired corporation generally appears to be appropriate, it does not seem correct in a case where the acquired corporation has an excess limitation in a carry-forward year. We suggest that the corporation should be allowed in such a case to use its pre-affiliation disallowed interest expense to the extent of its separately computed excess limitation in a post-affiliation year.

(d) Excess Limitation Carry-forward. The Proposed Regulations assume that both excess limitation and disallowed interest will carry-forward in a merger or other Section 381(a) transaction, but provide that the excess limitation carry-forward in such a case will be zero and that the disallowed interest carry-forward will be subject to the same limitation as if shares of the transferor had been acquired, *i.e.*, will be limited in any year to that year's excess limitation without regard to excess limitation carry-forwards from years prior to the Section 381(a) transaction.

Since Section 381(a) does not as such apply to excess limitation or disallowed interest carry-forwards, it seems to us that an express statement that there will be a carry-forward of disallowed interest under Section 381(a), subject to the stated limitations, would be desirable.

Eliminating any excess limitation carry-forward following a Section 381(a) transaction generally makes sense -- in effect it replicates the consequences under Section 384 if the carry-forward were an item of recognized gain. If this is the intent, however, the rule should apply only where the surviving corporation, or its affiliated group, has a disallowed interest carry-forward and there should be an exception equivalent to that provided in Section 384(b).

(e) Section 269. Although not mentioned in the Proposed Regulations, Section 269 could presumably apply to limit excess limitation and disallowed interest carry-forwards. Since Section 269 is limited to asset transfers, a specific anti-avoidance rule in the Proposed Regulations disregards interest expense on loans incurred by such a member if it does not use the proceeds, i.e., prevents the "stuffing" of liabilities into an acquired corporation that has an excess limitation carryforward.[*]

7. Proposed Regulations § 1.163(i)-7

Prop. Regs. § 1.163(j)-7 sets out the relationship between Section 163(j) and other provisions of the Internal Revenue Code that defer or disallow a deduction for interest expense.

(a) General rule. Prop. Regs. § 1.163(j)-7 provides, as a general rule, that interest expense is not considered "paid or accrued," and, in effect, not treated as "exempt related person interest expense," until such interest would be deductible but for Section 163(j).[**]

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[*] Prop. Regs. § 1.163(j)-6(b)(3).

[**] Prop. Regs. §§ 1.163(j)-7(a), 1.163(j)-2(a).

(b) At-risk and passive activity loss rules. The Proposed Regulations provide that the at-risk rules of Section 465 and the passive loss rules of Section 469 apply before Section 163(j), in effect treating interest disallowed under those sections as "paid or accrued" for Section 163(j) purposes at the time it is allowed.[***] If exempt related person interest is allowed under Section 469 but disallowed under Section 163(j), the Proposed Regulations do not reapply Section 469 and as a consequence the corporation's allowable passive deductions for the year will be less than its passive income.

We believe that this rule is inappropriate and possibly invalid. It is not only inconsistent with the passive loss rules, but would put the corporation in a worse position under Section 469 simply because its passive deductions consist in part of exempt related person interest expense. Since the passive loss regulations generally require that other provisions be applied before Section 469,[*] and the legislative history to Section 163(j) also indicates that other provisions should be applied before Section 163(j), we suggested the following approach in our prior report: first apply the passive loss rules, then Section 163(j) and then reapply the passive loss rules. The Proposed Regulations reject the reapplication of the passive loss rules as a final step.

[***] Prop. Regs. §§ 1.163(j)-7(b)(3), 1.163(j)-7(c), Example 3.

[*] Temp. Regs. § 1.469-2T(d)(1), (6) and (8).

The effect of the Proposed Regulations is to prevent a closely-held corporate taxpayer from using current year passive deductions to offset current year passive income[**] and to impose more onerous taxation than if the taxpayer were capitalized with equity rather than related party debt.

Assume, for example, that a closely-held U.K. company forms a U.S. subsidiary to acquire real property in the U.S. at a cost of $15,000,000 and that the U.K. company capitalizes the U.S. subsidiary with $5,000,000 of equity and $10,000,000 of debt bearing interest at 10%. Assume also that the annual gross rents from the property are $1,000,000 and that the annual operating expenses are $1,000,000.

Under the Proposed Regulations, the U.S. subsidiary will have taxable income of $250,000, interest deferred under Section 163(j) of $250,000, and $1,000,000 of deferred passive loss ($500,000 allocable to operating expenses and $500,000 allocable to interest expense), determined as follows: Under the passive activity loss provisions of Section 469, only $1,000,000 of the U.S. subsidiary's total expenses are allowable as deductions. These consist of $500,000 of operating expenses and $500,000 of interest expense. $500,000 of operating expenses and $500,000 of interest expense are deferred passive losses. Under Section 163(j), the U.S. subsidiary's adjusted taxable income is $500,000 (gross rents of $1,000,000 less $500,000 of operating expenses),

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[**] In Example 3 of Prop. Regs. § 1.163(j)-7(c) the taxpayer had excess passive deductions (determined without regard to related party interest expense) of $500X, but was required to report $200X of taxable income for the year from its passive rental activities. This is particularly striking when one considers that the taxpayer had no portfolio income so that the abuse at which Section 469 is aimed in the case of a closely held corporation (offsetting portfolio income with passive losses) was not present.

and, accordingly, the U.S. subsidiary's interest deduction for interest paid to its parent is limited to $250,000. The U.S. subsidiary is required to pay tax on $250,000 of income from its passive rental activities, even though it has $500,000 of additional current year operating expenses (as well as $750,000 of additional interest expense for the year, $250,000 of which is deferred under Section 163(j) and $500,000 of which is deferred under Section 469).

Had the U.S. subsidiary been capitalized solely with equity, no tax would be due since it would have no taxable income ($1,000,000 gross rents minus $1,000,000 operating expenses). Similarly, no tax would be due under the approach advocated in our prior report since adoption of our recommendation would permit $250,000 of additional operating expenses to offset the $250,000 of taxable income.

We urge that this recommendation in our prior report be considered. We are not calling for the redetermination of the amount of passive loss, but merely suggesting that, after the amount of the passive loss is computed, Section 163(j) be taken into account before determining which items of deduction are available to offset current income and which items of deduction make up the passive loss. All that is needed is a coordination of Section 163(j) with the rules of Temp. Regs. § 1.469-1T(f)(2)(ii) for determining the composition of the passive loss.

In the example above, we would first determine the amount of the passive loss ($1,000,000) under Temp. Regs. § 1.469-2T(b) by subtracting the total operating expenses ($1,000,000) and interest expense ($1,000,000) from the gross rents ($1,000,000), and this amount would not be re-determined. After applying Section 163(j) to determine that only $250,000 of

related party interest expense is available to offset the rental income, we would then determine that $750,000 of operating expenses also offset the rental income and that the $1,000,000 deferred passive loss consists of $250,000 of operating expenses and $750,000 of related party interest expense (which also continues to be subject to the restrictions of Section 163(j)).

(c) Section 246A. With respect to the interaction of Sections 163(j) and 246A, we agree that Section 246A be applied first and that any reduction in the dividends received deduction reduce interest expense taken into account under Section 163(j).[*] The final regulations should specify how the amount of the reduction is calculated where a taxpayer has issued two or more portfolio debt instruments not all of which generate exempt related person interest. This is not dealt with by Section 246A since it is not necessary to know for purposes of that Section which particular debt financed the acquisition of portfolio stock.

8. Proposed Regulations § 1.163(1)-8

(a) Definitions in Prop. Regs. § 1.163(1)-8(c). In general, Prop. Regs. § 1.163(j)-8(c) defines "net interest expense", "adjusted taxable income", "excess interest expense" and "excess limitation" for a foreign corporation that is engaged in U.S. trade or business by reference to the foreign corporation's effectively connected income and related deductions.[*] In light of the complexity of the rules governing the determination of the effectively connected income of a

[*] Prop. Regs. § 1.163(j)-7(b)(5).

[*] The second sentence of Prop. Regs. § 1.163(j)-8(b) erroneously states that "excess interest expense" is defined in Prop. Regs. 5 1.163(j)-8(c)(2). The correct citation is Prop. Regs. § 1.163(j)-8(c)(4).

foreign corporation, it would be useful if the final regulations contained examples illustrating each definition.

(b) Determination of interest paid to a related person by a U.S. trade or business. Generally, Prop. Regs. § 1.163(j)-8(d) provides that the amount of interest paid, or deemed paid, by a foreign corporation to a related person equals the sum of (a) the amount of interest paid by a U.S. trade or business of a foreign corporation under Section 884(f)(1)(A) to a related person and (b) the excess interest of the U.S. trade or business described in Section 884(f)(1)(B). This report will treat each of these separately.

(i) Interest described in Section 884(f)(1)(A). In general, we believe that this part of the definition of related party interest reflects the correct approach. As with the definitions in Section 1.163(j)-8(c) of the Proposed Regulations, however, the determination of the interest paid by the U.S. branch of a foreign corporation is quite complex and examples should be included in the final regulations.

For example, Temp. Regs. § 1.884-4T(b)(6)(ii) permits a U.S. branch of a foreign corporation to elect to specify that certain liabilities described in Temp. Regs. § 1.884-4T(b)(1)(i) do not give rise to interest paid by a U.S. trade or business, if the sum of the interest deductions of the branch determined under Regs. § 1.882-5 and the interest attributable to certain liabilities described in Regs. § 1.884-4T(b)(1)(iv) is less than the interest that is paid and accrued by the U.S. branch. The general rule in the Proposed Regulations under Section 163(j) would permit a foreign corporation to exercise the election in a manner which excludes interest paid by the U.S. branch to related persons, thereby avoiding the potential disallowance of an

interest deduction under Section 163(j). We believe this result correctly reflects the principle that Section 163(j) should be the last restriction on the deductibility of interest to apply and suggest that the final regulations include an example, perhaps by reference to Example 2 of Temp. Regs. § 1.884-4T(b)(6)(iii), indicating that this is the intended result.

(ii) Interest Described in Section 884(f)(1)B). Generally, Section 884(f)(1)(B) provides that the excess of the interest deduction of a foreign corporation determined under Treas. Regs. § 1.882-5 over the amount of interest treated as paid by the U.S. branch of the foreign corporation under Section 884(f)(1)(A) is treated as interest paid to the foreign corporation by a wholly owned domestic corporation. Prop Regs. § 1.163(j)-8(d) treats any such "excess interest" as interest paid to a related party.

As we said in our prior report, this rule could result in the application of the interest disallowance rules of Section 163(j) to a foreign corporation that has no related party debt. It has no direct support, and seems inconsistent with some statements, in the legislative history.

If the regulations nonetheless persist in treating excess interest as related person interest for purposes of Section 884(f)(1)(B), computation of excess interest under Section 884(f)(1)(B) will have a major impact on the application of Section 163(j). Under these circumstances, we feel it is particularly important for the branch profits tax regulations to incorporate an interest shortfall concept in the determination of Section 884(f)(1)(B) excess interest, as suggested originally at pages 42-44 of our Branch Profits Tax Report.

Assume, for example, that in year 1 a Canadian company has effectively connected gross income of $500X, actual interest paid by its U.S. trade or business (all to unrelated persons) of $500X, and other expenses of $100X, and that its interest deduction determined under Treas. Regs. § 1.882-5 is limited to $400X. Since there is no related person interest expense, Section 163(j) will not apply, and the Canadian company will have taxable income of zero ($500X gross income less $400X interest expense less $100X of other expenses). Pursuant to Temp. Regs. § 1.884-4T(b)(6), the amount of interest considered to be paid by the Canadian company's U.S. business (and therefore the amount of interest deemed to be from U.S. sources) is reduced by $100X from $500X to $400X.

Assume that in year 2 the Canadian company again has $500X of effectively connected gross income and $100X of other expenses, but has only $300X of interest expense paid by its U.S. trade or business but is entitled to a deduction of $400X on account of interest expense pursuant to Treas. Regs. § 1.882-5. The Canadian company will have $100X of Section 884(f)(1)(B) excess interest ($400X minus $300X), which the Proposed Regulations treat as related person interest. For purposes of Section 163(j), the Canadian company will have adjusted taxable income of $400X ($500X gross income less $100X of other expenses). Since the actual interest paid by the Canadian company to unrelated persons ($300X) exceeds one-half of its adjusted taxable income ($200X), no portion of the $100X of deemed related person interest expense would be deductible. Accordingly, the Canadian company would have $100X of taxable income to report in the U.S.

If the income and deductions in year 1 and year 2 had all arisen in a single year, there would be no § 884(f)(1)(B)

excess interest and there would be no U.S. tax liability. The gross income would be $1,000X, the interest paid by the U.S. trade or business would be $800X, and the other expenses would be $200X; the Treas. Regs. § 1.882-5 interest deduction would equal the interest paid by the U.S. trade or business ($800X), so that there would be no Section 884(f)(1)(B) excess interest.

The interest shortfall concept would permit the same result in the example above where the income and deductions arise over a two-year period. Instead of reducing the interest paid by the U.S. trade or business in year 1 from $500X to $400X, the $100X shortfall from year 1 would carry over to year 2 and reduce the amount of Section 884(f)(1)(B) excess interest in year 2 from $100X to 0. This concept is analogous to the excess limitation carry-forward provided by Section 163(j)(2)(B)(ii).

(c) Determination of the debt-to-equity ratio of a foreign corporation. Generally, Prop. Regs. § 1.163(j)-8(e) provides that the debt-to-equity ratio of a foreign corporation equals the ratio of (a) the worldwide liabilities of the foreign corporation for purposes of Treas. Regs. § 1.882-5(b)(2) to (b) the worldwide assets of the foreign corporation for purposes of Section 1.882-5(b)(2) of the Temporary Regulations minus the worldwide liabilities. Both the worldwide liabilities and worldwide assets are adjusted in accordance with the rules of Prop. Regs. § 1.163(j)-3.

We believe the statement of the rule for determining the debt-to-equity ratio of a foreign corporation in the Proposed Regulations is far too brief and likely to cause confusion. As a general observation, the final regulations should state the rule for determining the debt-to-equity ratio of a foreign corporation in far more detail and include examples illustrating the rules.

Under Treas. Regs. § 1.882-5, a foreign corporation can determine the value of its worldwide assets under any reasonable measure of fair market value as well as by reference to their adjusted basis under Section 1011. We believe that the final regulations should specify that a foreign corporation can determine its debt-to-equity ratio for purposes of Section 163(j) by using the fair market value of the corporation's assets. This seems particularly important in light of the difficulty of determining the U.S. adjusted tax basis of assets of a foreign corporation that are not used in a U.S. trade or business.* Given the difficulties likely to be faced by foreign corporations in determining the adjusted basis of their non-U.S. assets, we think the final regulations should permit a foreign corporation to use the book value of its assets as reported on certain financial statements for purposes of determining its debt-to-equity ratio under Section 163(j).

Section 1.163(j)-3(d) of the Proposed Regulations provides that for purposes of determining the debt-to-equity ratio of a corporation, the dollar value of assets and liabilities of qualified business units with functional currencies other than the dollar is determined by using the spot exchange rate for the relevant currency on the last day of the taxable year of the corporation for which the debt-to-equity ratio is determined. We think this is the wrong result because it does not adequately address the potential volatility of foreign exchange rates.

* We note that Prop. Regs. § 1.163(j)-8(e) will create an incentive for foreign parents to operate in the U.S. through foreign subsidiaries in order to use the fair market value of assets to determine the debt-to-equity ratio.

The final regulations should, in certain circumstances, permit the use of an average of the daily exchange rates during the taxable year. Since the debt-to-equity ratio is determined on the basis of the worldwide assets and liabilities of a foreign corporation, a foreign corporation with various qualified business units using different functional currencies could obtain an aberrational debt-to- equity ratio as a result of a sudden change in the exchange rate used by a qualified business unit at the end of the taxable year. The potential distortion resulting from a sudden dramatic change in exchange rates would be ameliorated by permitting use of an average of prevailing rates throughout the year.

Arguably, allowing the use of an average of exchange rates for the taxable year would be more consistent with Treas. Regs. § 1.882-5, which uses an average of the values of the assets of a foreign corporation determined in dollars at regular intervals during the taxable year, for the formula that generates a foreign corporation's interest deduction. Use of an average exchange rate would also be more consistent with the rule for translating the earnings of a non-dollar qualified business unit of a U.S. corporation into dollars.[*] Thus, we recommend that final regulations should sanction the use of an exchange rate in determining the debt-to-equity ratio that represents an average of the daily exchange rates over the taxable year for which the determination is made.

(d) Coordination with the branch profits tax. Prop. Regs. § 1.163(j)-8(g) provides that the disallowance and carry-forward of an interest deduction pursuant to Section 163(j) will

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[*] *See* Notice 89-74, 1989-1 C.B. 739 (earnings of non-dollar QBU of U.S. corporation translated into dollars using weighted average exchange rate for taxable year).

not affect either the calculation of the effectively connected earnings and profits or the U.S. net equity of a foreign corporation under Temp. Regs. § 1.884-1T(f) and (c), respectively. We believe this is the correct approach. In light of the complexity of the rules in this area, however, the final regulations should contain more detail and additional examples.

The Proposed Regulations also fail to address the relationship between the excess interest tax under Section 884(f)(1)(B) and the carry-forward of disallowed related party interest under Section 163 (j). The proposed regulations could be read (along with Section 884(f)(1)) such that disallowed related party interest that is carried forward and deducted in a subsequent taxable year results in an increase in the excess interest of the foreign corporation in the later taxable year. For purposes of Section 884(f)(1)(B), the excess interest of a foreign corporation generally equals the difference, if any, between the interest deduction allowable under Section 882 and the interest treated as paid by the U.S. branch of the foreign corporation under Section 1.884-4T(b) of the Regulations. The confusion arises because it is unclear if interest that is carried forward under Section 163(j) would be treated as interest deductible under Section 882 for purposes of the foregoing test in Section 884(f). As a result of the silence of the Proposed Regulations, it appears that if disallowed interest is deductible in a subsequent taxable year, the excess interest could be increased in the subsequent taxable year even if the disallowed interest was treated as paid by a U.S. branch in the earlier taxable year under Temp. Regs. § 884-4T(b). We believe this result is inconsistent with the legislative history, which calls for regulations to provide that an interest deduction attributable to a Section 163(j) carry-forward will not be subject to the excess interest tax to the extent it is

attributable to interest treated as paid by a U.S. branch under Section 884(f)(1)(A) in the year in which the carry-forward arose.[*] The final regulations should provide that for purposes of determining the excess interest of a foreign corporation for a taxable year to which disallowed related party interest is carried forward, the previously disallowed interest is treated as interest paid by a U.S. branch if it was paid by the U.S. branch in the earlier year.

Conversely, the final regulations should clarify that a foreign corporation will have Section 884(f)(1)(B) excess interest to the extent that its allowable interest deduction for the taxable year exceeds the amount of interest treated as paid by its U.S. branch under Section 1.884-4T(b) of the Regulations during the taxable year, even if a deduction for all or a portion of the interest paid by its U.S. branch is disallowed under Section 163(j). Such interest, however, should not again be taken into account in determining the amount of excess interest in the year in which the deduction is ultimately allowed.

9. Proposed Regulations § 1.163(1)-10

Prop. Regs. § 1.163(j)-10 sets out grandfathering rules for the application of Section 163(j).

(a) When Grandfathered status is lost. Under Prop. Regs. § 163(j)-10, when an obligation is modified, or there is a change in obligor that is not excepted, a grandfather obligation shall be treated thereafter as a new obligation. This provision seems to mean that such treatment (and the concomitant loss of grandfathered status) would commence as of the date on which the

[*] See the House Report at 1248-49.

obligation is modified, rather than as of the date on which the modified terms become effective (if different). We believe that final regulations should follow the rule set forth in the House Report, which is that the loss of grandfathered status would occur as of the effective date of the new terms. This could be accomplished by replacing the word "thereafter" in Prop. Regs. § 1.163(j)-10(b)(1)(iii)(A) with the language "(as of the effective date of the modified terms)." If, notwithstanding our request, the Treasury decides to reject the approach expressed in the House Report, it should do so in a more obvious manner.

(b) Definition of Modifications. Prop. Regs. § 1.163(j)-10(b)(1)(iii)(B)(1) generally treats a grandfathered obligation as modified if (i) its maturity is extended or (ii) it is revised in a manner that would give rise to a deemed exchange under Section 1001 of the Internal Revenue Code but not if the deemed exchange results solely from, the substitution of a new obligor in a Section 368(a) reorganization on a Section 332(a) liquidation.* We assume that, subject to the anti-abuse rule in Prop. Regs. § 1.163(j)-10(b)(1)(iii)(B)(3), these rules are exclusive -- that is, that there will be no modification absent an exchange under Code Section 1001 or an extension of maturity if the anti-abuse rule does not apply. This would certainly be our recommendation.

(c) Binding Contracts. In our prior report, we assumed that a statement in the House Report that a written contract between related parties would be treated as binding only if it could have been enforced by an unrelated party would be taken to mean that the binding effect of related party contracts would be

* Our prior report recommended that the grandfathered status of an obligation not be lost as the result of a modification that involves reduced earnings-stripping potential, such as a reduction in the interest rate. This approach was not adopted.

tested under the legal standards that would be applied between unrelated parties. Instead, Prop. Regs. § 1.163(j)-10(b)(1)(ii)(B)(1) provides that a written contract between related persons shall only be treated as binding on a particular date if it was enforceable on that date by an unrelated third party. This will rarely be the case since it would be unusual for a third party to have an enforceable interest in an agreement, say, by a foreign parent corporation to lend money to its wholly-owned U.S. subsidiary. This seems to us to be wrong.

(d) Application of transition rules to foreign corporations. Section 163(j) does not apply to interest paid or accrued on fixed term indebtedness issued on or before July 10, 1989 (or after such date, pursuant to a binding contract in effect on that date). The final regulations should provide guidance as to how foreign corporations can identify indebtedness eligible for the grandfather rule. Providing reasonable guidelines for identifying debt eligible for the grandfather rule is particularly important in light of the Proposed Regulations' treatment of excess interest described in Section 884(f)(1)(B).