New York State Bar Association

Tax Section

Report on Source, "Effective Connection"

of COD Income

in

Cross-Border Financings

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I. Introduction.

This report requests additional guidance from Treasury on the "sourcing" of cancellation of indebtedness ("COD") income realized upon the discharge of cross-border debt. The determination of source is primarily relevant to three groups of taxpayers: (i) foreign debtors[1] engaged in a U.S. trade or business; (ii) foreign debtors *not* engaged in a U.S. trade or business but subject to gross basis taxation in the U.S. on all or a portion of their "fixed or determinable" income ("FDAP"); and (iii) U.S. debtors engaged in business both within and without the United States. The first part of the report describes the various possible approaches for sourcing COD income in the cross-border context, how each approach might apply in practice, and whether the approach reaches an appropriate result as a policy matter. The second part of the report addresses the sourcing of COD income that is not "effectively connected" with any U.S. trade or business of the foreign debtor and whether such income is FDAP.

II. Summary of Recommendations.

Our principal recommendations are as follows:

1. In the case of a foreign debtor engaged in a U.S. trade or business, although the committee does not have a consensus view on the proper sourcing of COD income, we believe there are two viable alternatives:

- **Alternative #1:** Treasury might require the foreign debtor to source COD income by reference to the interest expense source rules (i.e., Temp. Reg. § 1.861-9T or Treas. Reg. § 1.882-5), treating the COD income as U.S. or foreign source in the same ratios that interest expense of the foreign debtor reduced effectively connected gross income

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[1] For this purpose, "foreign person" refers to a taxpayer other than a "U.S. person." Under Section 7701(a)(30), a U.S. person is (i) a citizen or resident of the United States, (ii) a domestic partnership, (iii) a domestic corporation, (iv) an estate the income of which is subject to U.S. federal income tax without regard to its source, or (v) a trust if a U.S. court is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust, or if the trust has a valid election in effect to be treated as a U.S. person.

during pre-discharge periods.

- **Alternative #2:** Treasury might require the foreign debtor to source COD income in the following order and priority: first, to the extent attributable to previously deducted but unpaid interest, according to the source of the foreign debtor's gross income that those deductions offset; second, to the extent that the discharged debt was "booked" in the United States, to the United States; otherwise to the residence of the foreign debtor.

2. Treasury should source *all* COD income of a U.S. debtor in accordance with the principles of the interest expense source rules of Temp. Reg. § 1.861-9T.

3. Treasury should source COD income of a foreign debtor not engaged in a U.S. trade or business by reference to the debtor's residence. Treasury should also modify Treas. Reg. § 1.1441-2(d)(2) to ensure its consistency with this approach and to clarify when (if ever) COD income is FDAP.[2]

III. COD As "Effectively Connected" Income.

A. Foreign Debtors

For foreign debtors engaged in a U.S. trade or business, the choice of source rule will generally determine if and the extent to which a foreign debtor will bear net basis taxation in the United States on COD income, either currently or in the future (depending upon whether the debtor is insolvent or under the jurisdiction of a U.S. bankruptcy court at the time of discharge).[3]

At least five discrete approaches, each with some degree of legal justification, could theoretically govern the sourcing of "cross-border" COD income:

- Apply the Interest Expense Sourcing Rules in their Entirety. This rule would source COD income according to the interest expense source rules, treating the COD income as U.S. or foreign source in the same ratios that interest expense of the foreign debtor reduced effectively connected gross income during pre-discharge periods.[4]

- Apply the Interest Expense Sourcing Rules to "Recapture" Previously Accrued and Deducted Interest Expense, then Source by reference to Residence or Books & Records. This rule would source COD income *first* according to the source of gross income that any accrued but unpaid interest reduced and *second* according to either

[2] This report does not address two other tax issues that often arise in this context, first, which assets of the foreign debtor are taken into account in the determination of "insolvency" of a foreign debtor under Section 108, and second, the treatment of foreign currency gain or loss to a foreign debtor upon the discharge of the debt.

[3] Section 108(a)(1)(A) and (B).

[4] The interest expense sourcing rules are set forth in Treas. Reg. § 1.882-5 for foreign corporations and Temp. Reg. 1.861-9T (and related rules) for all other taxpayers.

the residence of the debtor or, if the foreign debtor "booked" the discharged debt in the U.S., in the United States.[5]

- Tracing. This rule would source COD income in accordance with how the debtor originally deployed the proceeds of the borrowing.

- Place of Discharge. This rule would source COD income based upon *where* the debt was discharged.

- Residence of the Lender. This rule would source COD income based upon how the lender sourced the interest income on the debt during pre-discharge periods.

1. Alternative #1

The source rules for interest expense, whether they apply "fungibility" or "tracing" in a particular case, allocate interest expense by apportioning debt between the U.S. and non-U.S. business of the foreign debtor. It is primarily on this basis that the principles that govern the sourcing of interest expense should also apply to the sourcing of COD income.

Persons Other Than Foreign Corporations. Temp. Reg. § 1.861-9T provides for the sourcing of interest expense of U.S. and *non-corporate* foreign debtors. With certain significant exceptions (*e.g.*, those set forth in Temp. Reg. § 1.861-10T), Temp. Reg. § 1.861-9T generally apportions interest expense between foreign and U.S. source gross income based on the principle that "money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid."[6]

For example, suppose that a foreign person with no other assets earns $100 and borrows $100, investing half of the proceeds in the United States and the other half outside the United States. Which of the two businesses should be deemed to "bear" the interest expense on the loan? Should that determination depend upon where the foreign person borrowed the $100 or where it spent it? The fungibility principle would ignore these formalities on the theory that the borrowing allowed the foreign person to invest in *both* businesses. Accordingly, only 50% of the interest expense will shelter U.S. gross income regardless of *where* the foreign person borrowed the money or deployed the proceeds.

Temp. Reg. § 1.861-10T provides certain limited exceptions to this principle, requiring a "tracing" approach for interest expense attributable to certain assets that are either subject to "qualified nonrecourse indebtedness" (as defined in Temp. Reg. § 1.861-10T(b)(1)), or acquired in "integrated financial transactions" (as defined in Temp. Reg. § 1.861-10T(c)(2)).[7] In addition,

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[5] If the accrued but unpaid interest did not give rise to any U.S. tax benefit, then either residency or books & records would govern the entire source determination.

[6] Temp. Reg. § 1.861-9T(a).

[7] A tracing rule also applies to directly allocate third party interest of an affiliated group to the group's investment in related controlled foreign corporations in cases involving excess related person indebtedness.

special rules apply to individuals and partnerships.[8] In the case of a non-resident alien individual, for example, otherwise deductible interest expense may only shelter "effectively connected" gross income to the extent that the individual "booked" the debt in the United States or secured the debt by assets that generated effectively-connected income.[9]

Foreign Corporations. Like Temp. Reg. § 1.861-9T, Treas. Reg. § 1.882-5 also embraces the principle that money is fungible.[10] Although the principle is the same, Temp. Reg. § 1.882-5 implements fungibility under a distinct regime that in certain cases will produce different allocations of interest expense.

Under Treas. Reg. § 1.882-5, a foreign corporation that carries on a U.S. trade or business must characterize as U.S. source the product of its actual "booked" interest expense and a fraction, the numerator of which is its "U.S. Connected Liabilities" and the denominator of which is its U.S. booked liabilities.[11] In general, these regulations define a foreign corporation's U.S. Connected Liabilities as the product of the value of its U.S. assets and either an assumed ratio of 93% (50% for non-banks) or the actual ratio of the foreign corporation's worldwide debt to worldwide assets. They therefore treat a foreign corporation as "overleveraged" if that fraction exceeds '1' and "underleveraged" if that fraction is less than '1.' The "booked" interest expense is then adjusted up or down to reflect the "correct" amount of leverage.

For example, suppose a foreign corporation has a U.S. branch with U.S. assets of $300, worldwide assets of $1,000, worldwide debt of $400, U.S. booked liabilities of $200 and actual U.S. booked interest expense of $20 (assuming a 10% interest rate). Under Treas. Reg. § 1.882-5, the foreign corporation would have deductible interest expense of $12:

$$\text{U.S. Booked Interest Expense} \times \frac{\text{(U.S. Assets} \times \text{Worldwide Debt/Worldwide Assets)}}{\text{U.S. Booked Liabilities}}$$

$$= \$20 \times \frac{(\$300 \times (\$400/\$1000)}{\$200} = \$12$$

Because the foreign corporation in this example is deemed to be "overleveraged" in the United States, it must reduce its deductible interest expense from $20 to $12.[12] For debtors

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[8] See Temp. Reg. § 1.861-9T(d) (individuals, estates and certain trusts); Temp. Reg. § 1.861-9T(e) (partnerships).

[9] See Temp. Reg. § 1.861-9T(d)(2).

[10] See Dolan, Kevin, U.S. TAXATION OF INTERNATIONAL MERGERS, ACQUISITIONS AND JOINT VENTURES, § 5.04[4][b] (W,G &L, 2004). ("The objective of the regulations is to implement the general U.S. view of fungibility which dictates that the liabilities (and thus the equity) of a corporation equally support all of its assets wherever those assets are located"); Proposed Rules, Department of Treasury *26 CFR Part 1, Determination of Interest Expense and Deductions of Foreign Corporations,* 57 FR 15038, 15039 (1992). ("This paragraph implements the general principle of fungibility: That is, a U.S. asset is funded by debt and equity in the same proportion as the debt to equity ratio of the entire corporation.").

[11] There are special rules for banks that permit tracing similar to Temp. Reg. § 1.861-9T.

[12] Treas. Reg. § 1.882-5 deviates from this methodology in certain circumstances, employing a tracing approach similar to that set forth in Temp. Reg. § 1.861-10T described below.

subject to the general "fungibility" rule of Temp. Reg. § 1.861-9T, although the U.S. source interest expense is computed under a modified formula, the debtor still deducts only $12, not $20, of interest expense against U.S. source income.

$$\frac{\text{U.S. Assets}}{\text{Worldwide Assets}} \times \text{Worldwide Debt} \times \text{Interest Rate}$$

$$= \$300/\$1000 \times \$400 \times 10\% = \$12$$ [13]

In this example, therefore, Treas. Reg. § 1.882-5 and Temp. Reg. § 1.861-9T each reach the same result. The reason is that the fungibility principle allocates interest expense by apportioning worldwide indebtedness between U.S. and foreign businesses. In effect, each regime imputes a debt-to-equity ratio to the U.S. trade or business of the taxpayer equal to the actual (or presumed) debt-to-equity ratio of the taxpayer's business as a whole.[14]

Because COD income arises from *relief* of such indebtedness, the principles that apply to the sourcing of interest expense should arguably apply to COD income as well. Specifically, COD income might be viewed as relieving debt not only on the portion of the assets related to the activity with respect to which the debt proceeds were invested, but across *all* of the taxpayer's assets.

Some of our members believe that the fungibility principle was not designed to address the sourcing of COD income. Rather, as applied to interest expense, the principle serves as a mechanism to police "earnings stripping" through excessive U.S. leverage. A foreign debtor may seek to "strip" earnings from a U.S. business by lending to a U.S. subsidiary or by guaranteeing third party debt of a U.S. subsidiary, each of which will fall within the domain of

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[13] The foreign corporation would also report a U.S. interest deduction of $12 if, for example, it had only *a single dollar* of U.S. debt on its books:

$$10¢ \times \frac{(\$300 \times \$400/\$1000)}{\$1} = 10¢ \times \$120 = \$12$$

[14] The portion of a foreign person's total debt imputed to the U.S. will vary over time under the interest expense sourcing rules because it will reflect the ratio of the foreign person's worldwide debt to worldwide assets each year. The source rules that apply to interest expense should still produce an appropriate source allocation for COD income *so long as the adopted formula reflects the period over which the discharged debt was outstanding.* Assume, for example, that a foreign corporate debtor with a 10% borrowing rate incurs the following amount of worldwide and U.S. debt over a three year period and that it therefore allocates interest expense under Treas. Regs. § 1.882-5 as follows:

Year	WW Debt	US % of Assets	Debt Alloc. to US	US Interest	Non-US Interest
1	100	0.25	25	2.5	7.5
2	200	0.5	100	10	10
3	300	0.75	225	22.5	7.5
Total				35	25

If the debtor were to realize $100 of COD income with respect to debt issued at the beginning of year 3, it should allocate 35/60th of the COD to U.S. sources, which is the ratio of its U.S. source interest to worldwide interest over this period. That ratio also reflects the weighted average percentage of the debtor's worldwide debt allocated to the U.S. over the same period.

Section 163(j) of the Code. Alternatively, the foreign debtor may borrow through a U.S. branch, in which case Treas. Reg. § 1.882-5 will apply. In both cases, the concern is that the foreign debtor may "overleverage" its U.S. assets relative to its worldwide assets. The United States therefore responds by "exporting" the excess interest deductions from the U.S. business to the non-U.S. business, even though the home jurisdiction may not "import" those deductions.[15]

We note, however, that application of the fungibility principle to COD income may serve to redress any real or perceived prejudice associated with its application to interest expense during prior periods. Although such a rule may permit the United States to occasionally tax COD income on debt not reflected on the books and records of the U.S. business, it will often *exempt* COD income on debt actually incurred by the U.S. business. By contrast, a "booking" rule will often attract U.S. tax on COD income even though the foreign person was denied a U.S. interest deduction on the same debt.

Analogy to Treatment of COD Income under Temp. Reg. § 1.163-8T. In a purely domestic context, the IRS has ruled that COD income should be allocated between different activities according to the same methodology that governed the allocation of interest expense on the discharged debt. In Revenue Ruling 92-92, 1992-2 C.B. 103, the taxpayer recognized $200,000 of COD income when it satisfied a $1 million recourse liability with $800,000 of appreciated property. At the time of discharge, the taxpayer had allocated 60% of the debt to "passive activity" expenditures and 40% of the debt to other expenditures. The IRS therefore characterized $120,000 of the COD income as passive income. Although these regulations generally allocate debt under a "tracing" rather than a "fungibility" model,[16] the ruling is significant *not* for the chosen methodology, but the use of a *consistent* methodology for allocating COD income and interest expense on the same debt.

Finally, it should be noted that extending the principles of the interest expense sourcing rules to COD income should not introduce new compliance burdens for the typical foreign debtor, who will already have applied these rules during earlier periods to allocate interest expense.

2. Alternative #2

Rather than adhere to the principles of the interest expense sourcing rules in their entirety, Alternative #2 would instead confine their application to the "recapture" portion of the COD income. The foreign debtor would then source any remaining COD income by residence *unless* the foreign debtor "booked" the discharged debt in the United States, in which case the debtor would be required to source the COD income to the United States.

More specifically, it is possible to bifurcate COD income into two components. The first would reflect the portion of the COD income attributable to accrued but unpaid interest expense

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[15] See generally Shaviro, Daniel, *"Does More Sophisticated Mean Better? A Critique of Alternative Approaches to Sourcing the Interest Expense of U.S. Multinationals,"* 54 Tax L. Rev. 353 (2001).

[16] Temp. Reg. § 1.163-8T.

that the borrower took into account in reducing U.S. or foreign gross income.[17] The second would reflect the remaining balance, and should correspond to the forgiven portion of either the principal amount or the original "issue price" of the loan. As in the case of depreciation recapture, we believe the first component should follow the source of the accrued and unpaid interest to which it relates because it would merely recapture interest expense that the foreign person deducted but never paid.

We note, however, that we did not reach complete agreement on this point. Some committee members observed that COD income should not be viewed as "recapturing" accrued but unpaid interest expense merely because it increases the amount of such income. If, for example, debt originally issued at $100 accretes to $115 to reflect $15 of accrued but unpaid interest, but then declines in value to $100 by virtue of a rise in interest rates, the COD income of $15 that arises upon the repurchase of the debt will not be attributable to "forgiveness" of interest accruals but rather to changes in interest rates.[18] Other committee members even proposed *broadening* the "recapture" amount to subsume all accrued interest, not merely the unpaid portion thereof. These members argue that a recapture rule that would apply only to the unpaid portion of the accrued interest could produce different source consequences depending upon whether the debtor chose to remain current on its accrued interest by borrowing additional funds or instead allowed the interest to compound (in each case resulting in the same aggregate debt discharge).

On balance, however, we believe that the "recapture" portion of the COD income should reflect the portion thereof attributable to the accrued but unpaid interest.

Analogy to Sales of Depreciable Property. The "recapture" approach is also consistent with the principles underlying the source rules of Section 865 governing sales of depreciable property. The IRS generally invokes the tax benefit rule to require the recapture of amounts that a taxpayer deducted in a prior year when it is later established that the basis for that deduction is no longer true. One statutory incarnation of the tax benefit rule is Section 1245. Section 1245 generally recharacterizes gain on the sale of depreciable property as ordinary income to the extent of any prior depreciation on that property. The depreciation deduction is generally intended to approximate the decline in value of the depreciable property over time.[19] If, however, the assumption that the property will decline in value, either at all or at the assumed rate of depreciation, is proven false, Section 1245 will recast the prior depreciation deductions as ordinary income when the taxpayer realizes that higher value in a sale of the property.

The source rules of Section 865 apply a similar approach: when the taxpayer sells depreciable property, it must source any realized gain *first* according to the source of gross income to which the prior depreciation related. In so doing, Section 865(c) extends this statutory

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[17] The amount of the debtor's accrued and unpaid interest should be reduced by any interest subsequently disallowed by reason of Section 382(l)(5) or otherwise.

[18] Similarly, gain from termination of an interest rate swap generally receives residence-based sourcing under current law. Treas. Reg. § 1.863-7(b)(1).

[19] See S. Rep. No. 1881, 87th Cong., 2d Sess., reprinted in 1962-3 CB 707, 801.

application of the tax benefit rule to the sourcing rules.[20] After depreciation recapture, Section 865(a) sources any remaining gain on the basis of the seller's residence *unless* the seller is a foreign person with an office or other fixed place of business in the United States (a "U.S. OFPB") to which the gain is attributable. In that event, Section 865(e)(2) resources the gain to the United States.

With respect to the remaining portion of the COD income, the rules of Treas. Reg. § 1.882-5(d)(2) would presumably govern the determination of whether the debtor has "booked" the discharged debt in the United States (even when the debtor is not a foreign corporation). These rules generally treat a debt as a "U.S. booked liability" if it is properly reflected on the books of the U.S. trade or business.[21] The residence rule would apply, therefore, even when the foreign debtor has a U.S. OFPB to which it has imputed a *larger* portion of the debt under the interest expense sourcing rules.

The rationale for the second alternative is really threefold:

First, it is simple -- the United States would effectively source "excess" COD income in accordance with the debtor's actual books and records. A simple rule is often the better rule even when it occasionally produces imperfect results, in particular as applied to a class of income that is in many respects *sui generis*, tends to arise in extraordinary transactions rather than in the course of the regular business operations of the debtor, and is often not subject to immediate tax even when sourced to the United States by virtue of Section 108.

Second, a "water's edge" approach is more likely to conform to the debtor's ordinary business expectations. Under Alternative #1, a foreign debtor with a U.S. trade or business that discharges debt solely in connection with its non-U.S. operations may realize COD income subject to U.S. taxation. A French borrower, for example, may be surprised to learn that the discharge of debt it booked and deployed in France could realize a U.S. tax liability when it discharges that debt at a discount.[22]

Third, and perhaps most importantly, the approach is more likely to withstand scrutiny under any treaty-based challenge to its validity by eligible foreign debtors. Given that many

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[20] See also Section 865(d)(4), which incorporates Section 865(c) in sourcing gain from the sale of an intangible asset.

[21] Under Treas. Reg. § 1.882-5(d)(2), a liability is properly reflected on the books of the U.S. trade or business of a foreign corporation that is not a bank if (i) the liability is secured predominantly by a U.S. asset of the foreign corporation; (ii) the foreign corporation enters the liability on a set of books relating to an activity that produces effectively-connected income at a time reasonably contemporaneous with the time at which the liability is incurred; or (iii) the foreign corporation maintains a set of books and records relating to an activity that produces effectively-connected income and the IRS determines, based upon the facts and circumstances, that a direct connection or relationship exists between the liability and that activity.

[22] It should be recognized, however, that the foreign debtor may have claimed a prior U.S. tax benefit on that very same debt when it claimed a U.S. source interest deduction. Moreover, at least for foreign debtors that leverage their U.S. operations at higher than worldwide ratios, Alternative #1 will tend to have just the opposite effect of the effect described in this example -- COD income with respect to *U.S. booked* liabilities of the foreign debtor will often *escape* U.S. taxing jurisdiction.

foreign debtors that do business in the United States qualify for treaty protection, we think it is important that the principles for sourcing COD income not conflict with the principles that govern the determination of when income is deemed to be "attributable to" a permanent establishment. As described more fully below, a source rule that applies "fungibility" principles to a new category of income may do precisely that.

Assume, for example, that a French corporation ("FCorp") borrows $100 Euros in France. FCorp discharges the debt at zero, but with no prior accrual of interest. The French tax authorities may conclude that because FCorp borrowed the Euros in France and spent the proceeds in France, it should bear full French tax on the COD income. The United States, on the other hand, may impute a portion of the borrowing to the U.S. under the fungibility principle, and therefore a portion of the COD income. So FCorp would bear French tax on the COD income, potentially without a foreign tax credit for a U.S. tax that the French regard as bearing no relation to the United States. Alternatively, as described below, FCorp could contend that sourcing *any* of the COD to the U.S. violates the French treaty because none of the COD in this example is "attributable to" a U.S. permanent establishment.

The interest expense allocation rules purport to govern not only the deduction of interest expense by a foreign debtor engaged in a U.S. trade or business, but by a foreign debtor engaged in such business but permitted to claim the benefits of an applicable treaty. Under most treaties, a resident of a treaty jurisdiction that is engaged in a U.S. trade or business is taxable in the United States on the profits of that business only to the extent that those profits are "attributable to" a U.S. permanent establishment. In Revenue Ruling 89-115,[23] the IRS ruled that the interest expense allocation rules of Treas. Reg. § 1.882-5 applied to a U.K. bank even though the U.K. bank was eligible to claim the benefits of the U.K.-U.S. treaty because the treaty did not provide a conflicting rule. The IRS so ruled even though Article 7(3) of the U.K.-U.S. treaty provided that in determining the profits attributable to a permanent establishment --

> there shall be allowed as deductions those expenses that are incurred for the purpose of the permanent establishment, including a reasonable allocation of interest expense incurred for the purposes of the enterprise as a whole ...[24]

The ruling concluded that this language "cannot be interpreted to allow [the U.K. bank] to allocate and apportion interest in a manner other than that mandated by" Treas. Reg. § 1.882-5. In National Westminster Bank, plc v. U.S.,[25] however, the U.S. Court of Federal Claims disagreed. Finding that Article 7 of the U.K.-U.S. treaty "clearly contemplate[d]" that interest expense of a U.K. bank should be allocated *in the same manner* as any other deductible expense, the court held that the allocation of interest expense "should be as shown on the books of account of the permanent establishment, with necessary adjustments, as if the permanent establishment were a 'distinct and separate enterprise ... dealing wholly independently with' the foreign

[23] 1989-2 C.B. 130.

[24] Convention for the Avoidance of Double Taxation, Dec. 31, 1975, U.S.-U.K., Art. 7, paragraph 3.

[25] 44 Fed. Cl. 120 (1999).

enterprise."[26] On these grounds, the court held that the rules of Treas. Reg. § 1.882-5 were inconsistent with the 'separate entity' principle of Article 7 of the treaty.

It should be noted that the court did not directly reject the "fungibility" principle in these regulations, focusing instead on whether the U.S. branch could deduct interest expense on "intra-branch" loans from its head office and other branches. Nevertheless, it is difficult to construe the court's ultimate holding in any other way. The use of a foreign person's actual books and records as the baseline for determining the deductible interest expense of a permanent establishment is fundamentally at odds with the principle that debt is fungible and therefore benefits not only the business operations subject to the debt, but the worldwide operations of the foreign debtor as a whole. Moreover, courts have rejected the application of other Code provisions that embrace the "fungibility" principle as inconsistent with the "separate entity" principle that applies to a permanent establishment.

In Northwest Life Assurance Co. of Canada v. Comm'r,[27] for example, the IRS proposed that a U.S. branch of a foreign insurance company report as "effectively connected" investment income the income that a hypothetical percentage of the insurance company's aggregate investment assets would have generated. Specifically, section 842(b)(1) imputes as the minimum "effectively connected" investment income of a foreign insurance company the return that the "required U.S. assets" of the insurance company would have generated, which Section 842(b)(2) defines in accordance with fungibility principles very similar to those governing the allocation of interest expense.[28] But the Tax Court rejected that approach as inconsistent with Article 7(2) of the U.S.-Canada treaty --

> Whether the hypothetical amount of assets calculated pursuant to section 842(b) represents a reasonable estimate of the amount of assets petitioner would hold if it were a separate entity *misses the point;* that amount is simply extraneous to petitioner's operations ... We are not persuaded that the separate-entity principle is satisfied merely by starting with the real facts ... related to petitioner's permanent establishment but then incorporating *extraneous data that is inconsistent with the principle.*[29]

On these grounds, the Tax Court held that "section 842(b) cannot survive in the presence of the Canadian Convention."

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[26] Id. at 131.

[27] 107 T.C. 363 (1996).

[28] See H. Conf. Rept. 100-495 (1987) at 984, 1987-3 C.B. 193, 264 (emphasis added):

Certain types of assets and liabilities that must, in this process, be attributed in whole or in part to a U.S. trade or business may be particularly suitable for movement among various trades or businesses of a single foreign corporation, *may be fungible with assets and liabilities identified with other trades or businesses of the corporation*, or may be usable by more than one such trade or business simultaneously.

[29] The North West Life Assurance Co., 107 T.C. 363, 386-387 (emphasis added).

At least in the case of foreign debtors, therefore, a full-blown "fungibility" model for sourcing COD income could expose an entirely new class of income to treaty-based challenges. One potential basis for distinction, however, is that very few treaties explicitly address the host country's taxing jurisdiction over COD income. In Westminster, to the contrary, the court cited specific provisions of the treaty governing interest expense, later describing interest expense as "the most ordinary of expenses" for a banking enterprise.[30] COD income, on the other hand, tends to arise in extraordinary, nonrecurring transactions. It is possible, therefore, that a court would not construe the fungibility principle and the "separate entity" principle as in inherent conflict *as applied to COD income.* Given that at least one court has rejected fungibility in the specific context of interest expense, however, Treasury may nevertheless conclude that it would be imprudent to embrace that principle as a model for taxing "cross-border" COD income.

The principal objection to a "water's edge" approach to the sourcing of COD income is that U.S. and foreign debtors engaged in the same U.S. trade or business activities who incur equivalent levels of debt may bear materially different tax consequences after a discharge, at least in the United States. A foreign debtor, for example, may avoid U.S. taxation (and perhaps taxation in its home jurisdiction as well) on COD income even though a U.S. debtor in the very same situation may bear current or deferred U.S. taxation. But if (as is likely) the home jurisdiction sources debt discharge income on the more conventional basis of the debtor's books and records, a "fungibility" rule that applies only in the United States may require the foreign debtor to bear tax on the COD income in both jurisdictions, quite possibly with no credit for the U.S. tax liability on income that the home jurisdiction regards as wholly-unrelated to the foreign debtor's U.S. activities.

A second objection to a "water's edge" approach is that it rejects the fungibility principle even though its application to COD income rather than interest expense is likely to be *benign* in many cases. Although fungibility may permit the United States to occasionally tax "unrelated" COD income, it will actually tend to *export* COD income on debt actually "booked" in the United States when the foreign debtor is "overleveraged" in the U.S. under the interest expense source rules.

B. U.S. Debtors

Because the treaty-based and other "comity" related concerns are far less acute for U.S. debtors, who will be subject to U.S. tax without regard to whether the COD income is sourced abroad or in the United States, we recommend that Treasury require a U.S. debtor to source *all* COD income in accordance with the principles of the interest expense source rules of Temp. Reg. § 1.861-9T.

At least in the domestic context, we believe that the guiding principle should be consistency in methodology. Those who support the fungibility principle as applied to interest expense, on the one hand, should have no quarrel with its application to COD income. Those who object to the principle on policy grounds, however, often contend that it has the effect of *exporting* interest deductions to foreign jurisdictions even though any foreign jurisdiction that

[30] National Westminster Bank, 44 Fed. Cl. 120, 127-128.

follows a "water's edge" taxing regime is unlikely to import them. In such a case, the domestic borrower is therefore more likely to pay higher foreign taxes, but with a smaller foreign tax credit because the "exported" interest expense will have reduced foreign source income. Had the U.S. borrower instead borrowed through a foreign corporate subsidiary to fund its non-U.S. operations, the United States would not invoke the principle to *import* any of those interest deductions.

Even accepting the validity of this argument, however, employing a residence-based source rule at the time of discharge would only exacerbate the problem: if fungibility tends to export the interest deduction, residency will tend to import the COD income. As applied to COD income, fungibility will instead tend to *export* the COD income to the foreign jurisdiction, which is likely to ignore the income inclusion for the same reason that it ignored the interest expense. By sourcing the COD income abroad, therefore, fungibility should tend to *increase* the ratio of foreign to U.S. source income, freeing up foreign tax credits that were previously denied, arguably under conditions that allowed the "double taxation" of the same income.

C. Other Alternatives to Sourcing COD Income.

In addition to the approaches described above, we are aware of three other approaches as potential bases for determining the proper source of COD income.

1. Tracing. One such alternative is to "trace" the COD income to the original use of the borrowed proceeds. The Tax Court followed this approach in Big Hong Ng, et al. v. Comm'r,[31] a case involving a foreign corporation whose sole business activity consisted of the rental of a piece of U.S. real property. In Big Hong Ng, the taxpayer owed money to two related corporations, one domestic and one foreign. Rather than retire the debt, however, the taxpayer distributed its sole asset in liquidation. The Tax Court held that, since the taxpayer ceased doing business after the liquidating distribution, the debts were effectively discharged. The taxpayer then argued that any COD income resulting from the constructive discharge was neither U.S. source nor effectively connected income. The Tax Court rejected each of these arguments, holding that the COD income related to the U.S. rental activities and therefore gave rise to effectively connected income.

We note that the Tax Court in Big Hong Ng would probably have reached the same result under either Alternative #1 or #2 because the taxpayer in that case conducted all of its business activities in the United States. In other contexts, however, a tracing approach for COD income, in particular one that does not at least recapture the U.S. tax benefit of the prior interest deductions, is likely to produce significant mismatches if the debt is sourced under a different regime for purposes of determining U.S. source interest expense. For example, suppose a foreign corporation (FC) operates business A in the U.S. and business B outside of the U.S. and that each business has a value of $1,000. To fund business B, FC borrowed $500 at a 10% rate. Business A incurred no debt. Nevertheless, of the $50 of interest expense, FC would allocate $25 to shelter U.S. gross income under Treas. Regs. § 1.861-10T, reducing FC's U.S. tax liability by $8.75. If the lender then forgives the entire $500 of debt, the entire $500 of COD

[31] TC Memo 1997-248 (1997).

income would be sourced abroad. Accordingly, FC would never recapture the $8.75 of U.S. tax even though it never actually bore the expense.

2. The Place of Discharge Approach. Another alternative is to source the COD income based upon *where* the debt in question was repurchased at a discount or *where* the actions resulting in the debt relief occurred. The IRS first articulated this position in an old, and now obsolete, ruling.[32] In this ruling, the taxpayer was a foreign corporation that maintained an office in the United States in connection with a business it conducted outside the United States. The IRS ruled that the taxpayer realized COD income at the time it repurchased its bonds. Without elaborating, the IRS sourced the COD income in the United States because the taxpayer purchased the bonds in the United States. The Board of Tax Appeals followed this approach in Corporacion de Ventas de Solitrey Yoda De Chile v. Comm'r, 44 BTA 393 (1941), *rev'd on other grounds*, 130 F.2d 141, 29 AFTR 1074 (CA-2, 1942).

A foreign debtor, therefore, would report COD income as U.S. source if the actions taken in connection with the discharge occurred in the United States. Although such a rule has the virtue of simplicity, its inherent electivity would allow debtors to dictate the source of their COD income.

3. The Interest Income Consistency Approach. A final alternative is to source COD income in accordance with the source of the interest income *to the lender* on the debt during pre-discharge periods. Under these source rules, source typically depends upon the residence of the lender.[33] Under this approach, no portion of the COD income recognized by a foreign debtor would be U.S. sourced even though a portion of the interest expense may have previously sheltered effectively connected income because the foreign debtor had substantial business activities in the United States.

IV. Treatment of COD Income as FDAP Subject to Withholding and Gross Basis Taxation.

The treatment of COD income as FDAP is relevant for foreign debtors who bear U.S. taxation on a gross basis under Sections 871(a) and 881 of the Internal Revenue Code of 1986, as amended (the "Code"). If the COD income is "effectively connected" and not otherwise excludible under Section 108, the foreign debtor will be subject to net basis taxation under Sections 872(b) and 882 and, therefore, will not be subject to withholding under Sections 1441 and 1442. A textbook example of a case in which COD income is not effectively connected is the foreign investor who purchases U.S. stocks or securities with funds borrowed from a U.S. bank. Sections 881 and 882 tax FDAP income at a flat 30% or reduced treaty rate. To facilitate collection of the tax, Sections 1441 and 1442 impose a withholding obligation on the income, often without regard to whether and when the foreign person actually receives payment in cash or other property.[34] Typical examples of FDAP include dividends and interest, as well as rents

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[32] IT 3119, 1937-2 C.B. 227, obsoleted by Rev. Rul. 70-293, 1970-1 C.B. 282.

[33] Section 861(a).

[34] See, e.g., Treas. Reg. § 1.1441-3(c) ("constructive" dividends under Section 305); but see Treas. Reg. § 1.1441-2(b)(3) (accrued OID subject to withholding only to the extent of actual cash payments).

and royalties that are not "effectively connected" with a U.S. trade or business.[35]

Assuming a case in which COD income that is not attributable to U.S. trade or business is "fixed or determinable," therefore, its source will generally govern whether the income is subject to gross basis taxation. As described below, we believe that COD income of a foreign debtor should be sourced by reference to the debtor's residence.

Although COD income realized in an investment context does not fit neatly into any particular source rule of the Code, the perhaps closest analogy is gain from the sale of an investment asset, a class of income generally exempt from gross basis taxation.[36] Like the tax basis it has in an investment asset, a debtor has the economic equivalent of a "negative" tax basis in its funded liabilities. As these liabilities decline in value, whether by virtue of rising interest rates or a decline in credit quality, the net worth of the debtor will increase. The debtor will realize this "gain" if the debt is discharged at its fair market value.[37] More broadly, tax basis in investment assets is simply not relevant when the taxing jurisdiction is *gross* rather than *net.* First, the sale of an investment asset by a foreign person generally gives rise to foreign source income,[38] based upon the seller's residency. Second, a foreign investor may not shelter dividends, interest or other "fixed or determinable" income from gross basis taxation by all or any portion of the foreign investor's tax basis in the asset generating that income. If the foreign person borrowed money to fund the acquisition of an investment asset, therefore, the discharge of that liability should not itself attract gross basis taxation. The borrowing in question merely funded the investor's basis in the asset, and neither that tax basis nor the interest expense on the underlying borrowing reduced FDAP income.[39]

We also note that, without regard to the source determination, it is by no means clear that COD income of a foreign debtor is FDAP at all.[40] It certainly bears few if any of the hallmarks

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[35] Sections 871(a), 881(a) and 1441(b).

[36] See Section 871(a)(2); Treas. Reg. § 1.1441-2(b)(2)(i) (gains derived from sale of property not "fixed or determinable," subject to certain exceptions). A foreign person generally bears U.S. tax on capital gains only to the extent those gains are "effectively connected," including under Section 897.

[37] Compare Section 386(h)(6)(A); PLR 8932049 (May 16, 1989) (treating COD income as "built in gain" even though the definition of "net unrealized built-in gain" refers only to *assets* of the loss corporation).

[38] Section 865(a)(2).

[39] We note by analogy that insurance premiums paid to a foreign insurer and subject to the excise tax under Section 4371 are exempt from withholding. See Treas. Reg. § 1.1441-2(a)(7). The IRS initially concluded that such premiums were not "fixed or determinable," perhaps on the basis that a 30% withholding tax on such amounts is uneconomic because it fails to credit the deduction for the expected loss reserves associated with the premium. See Treas. Reg. § 1.1441-2(b)(2)(ii) (1997); T.D. 8734, I.R.B. 1997-44. Treasury later amended the regulations to treat such premiums as FDAP, but granted a specific exemption from withholding. See T.D. 8881, I.R.B. 2000-23. COD income is similar in this regard in the sense that gross basis taxation is likely to impose tax on amounts well in excess of the foreign debtor's economic income.

[40] Boris I. Bittker and James S. Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS, ¶ 15.03[4], n. 221; Peter H. Blessing, 905 T.M. (BNA), *Source of Income Rules*, A-114 (1992).

of income traditionally subject to withholding -- COD income is neither "fixed" nor "determinable," at least without specific knowledge of the debtor's solvency, and it is certainly neither "annual" nor "periodic" as those terms are commonly understood.[41] To the contrary, COD income by its very nature tends to arise in extraordinary, non-recurring transactions that usually terminate the debtor/creditor relationship.[42] In any event, COD income bears little resemblance to the more common forms of FDAP income, *e.g.*, dividends, interest, rents and royalties that are not "effectively connected."

Treas. Reg. § 1.1441-2(b)(l) defines FDAP to include all amounts "included in gross income under Section 61 (including original issue discount)" other than certain gains derived from the sale of property and any other category of income that the IRS determines is not FDAP by published guidance. Treas. Reg. § 1.1441-2(d)(2) further provides that a lender "who forgives any portion of [a] loan is deemed to have made a payment of income to the borrower under Treas. Reg. § 1.61-12 at the time the event of forgiveness occurs." On a literal reading of the regulation, therefore, Treasury appears to regard at least *certain* categories of U.S. source COD income as "fixed or determinable."[43] Even if the COD income in question is FDAP, however, the regulations excuse the withholding obligation on the deemed payment *if* the lender does not have custody or control over the borrower's money or property (excluding for this purpose, any payment made in partial settlement of the loan).[44]

Even here, however, the actual scope of Treas. Reg. 1.1441-2(d)(2), is not entirely clear. The regulation could be construed not to address the issue of whether COD income is "fixed or determinable" at all, but rather to clarify that a lender that is otherwise a withholding agent cannot avoid the obligation to withhold on *other* FDAP income by effecting "payment" in this manner. First, the characterization of the forgiveness as "payment" appears in the subsection of the regulations that excuses the withholding agent from the obligation to withhold when it does not have custody or control of property of the foreign person, not in the subsection of the regulations that defines "fixed or determinable." Second, Treas. Reg. § 1.61-12, to which this regulation refers, expressly includes as 'income from discharge of indebtedness' COD income that represents no more than a medium of payment,[45] even though the recipient of the payment would have no recourse to Section 108.

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[41] Although the regulations do clarify that these words are "merely descriptive" of the types of income potentially subject to gross basis taxation, they would seem to describe attributes that COD income rarely if ever possesses. Treas. Reg. § 1.1441-2(b)(1)(i).

[42] Cf. T.D. 8734 ("[w]ithholding on deemed distributions with respect to stock is not excused under [the Section 1441 regulations]. For these amounts, the IRS and Treasury believe that an exemption from withholding would be inappropriate in view of the ongoing investment or business relationship between the parties."). The basis for imposing withholding under Section 305, therefore, does not apply to COD income in its more common forms.

[43] In no event is COD income FDAP, however, unless it is "included in gross income" under Section 61, a determination that will depend upon whether Section 108 applies to the discharge in question. Treas. Reg. § 1.1441-2(b)(1).

[44] Treas. Reg. § 1.1441-2(d)(2).

[45] *See* Treas. Reg. § 1.61-12(a) (individual who performs services for a creditor who then cancels the individual's debt as consideration realizes income from compensation for services).

Example: A U.S. issuer sells its stock to a foreign person for $100, consisting of $50 of cash and a $50 note. Two years later, the U.S. issuer declares a dividend on its stock, of which $10 is otherwise payable to the foreign person. Assume that the foreign person is subject to withholding at a 30% rate on the dividend and that, rather than paying the $10 dividend to the foreign person, the U.S. issuer applies it in full to the $50 note.

Under Treas. Reg. § 1.1441-2(d)(2), the U.S. issuer in this example would be deemed to have made a payment to the foreign person even though it has retained the $10 in "forgiveness" of the loan, attracting a $3 withholding tax. In a typical bankruptcy or other debt restructuring, on the other hand, the debt is cancelled without regard to whether the lender took any affirmative steps to "forgive" the liability.

Third, if the withholding obligation is construed to apply to COD income arising in a bankruptcy or other debt restructuring, the logic of limiting the withholding obligation to lenders with custody of the borrower's property is difficult to discern because the lender in this situation will simply seize those assets in satisfaction of the debt. If the lender holds sufficient assets of the debtor to retire the debt, the borrower will not realize COD income. If the lender does not hold sufficient assets of the debtor, the lender will seize what is available, creating COD income but leaving no remaining assets to give rise to a withholding obligation."[46]

For the foregoing reasons, therefore, we believe that Treasury should source COD income of a foreign debtor not engaged in a U.S. trade or business by reference to the debtor's residence. We also recommend that Treasury modify Treas. Reg. § 1.1441-2(d)(2) to the extent necessary to ensure its consistency with this approach and to clarify when (if ever) COD income is FDAP.

[46] Treas. Reg. § 1.1441-2(d)(2).