REPORT #650

TAX SECTION

New York State Bar Association

COMMITTEE ON U.S. ACTIVITIES OF FOREIGN TAXPAYERS
REPORT ON SECTION 163(j) OF THE
INTERNAL REVENUE CODE

March 14, 1990

Table of Contents

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The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Goldberg:

I enclose our Report on issues that might be covered by Regulations issued under Section 163(j) of the Code, enacted in 1989 to disallow in certain circumstances a current deduction for interest paid to related persons.

A summary of the issues we have identified is set out on pages 4 through 7 of the Report. While we have tried to deal with these issues in a relatively comprehensive fashion, we think you should consider whether Regulations should be comprehensive or limited to those issues you determine to be most important. Answering by Regulations all the issues raised by Section 163 (j) will be an enormous task for the Service and the Treasury and just as much of a burden on those required to read and interpret comprehensive Regulations.

We also call your attention to our concern (discussed on pages 62 et seq. of the Report) about the issuance of Regulations that would extend the disallowance rule of Section 163 (j) to interest on third party debt guaranteed by a related party. It is not clear to us whether the focus in such cases should be on whether the interest on guaranteed third party debt is taxable to the third party lender or would have been taxable if paid to the guarantor or, once that choice has been made, whether satisfactory rules for distinguishing between “good” and “bad” guaranteed third party debt can be developed. Particularly because the legislative history provides no guidance on these questions we believe there are significant arguments for not issuing regulations directed to this issue.

Very truly yours,

Arthur A. Feder
Chair

Enclosure

cc: The Honorable Kenneth W. Gideon
Assistant Secretary of the Treasury
for Tax Policy 3120 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Abraham N.W. Shashy, Esq.
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Steven Lainoff, Esq.
Associate Chief Counsel, International
Internal Revenue Service.
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Philip Morrison, Esq.
International Tax Counsel
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Marlin Risinger, Esq.
Attorney Advisor Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Dan Rostenkowski
Chairman, House Ways and Means Committee
1102 Longworth Building
Washington, D.C. 20515

The Honorable Lloyd Bentsen
Chairman, Senate Finance Committee
United States Senate
205 Dirksen Building
Washington, D.C. 20510

The Honorable Ronald A. Pearlman
Chief of Staff
Joint Committee on Taxation
1015 Longworth Building
Washington, D.C. 20515

Tax Report #650

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON U.S. ACTIVITIES OF FOREIGN TAXPAYERS

REPORT ON SECTION 163(j) OF THE INTERNAL REVENUE CODE

March 14, 1990

Report on Section 163 (j) of the Internal Revenue Code

This report, prepared by an ad hoc Subcommittee of the Committee on U.S. Activities of Foreign Taxpayers of the Tax Section*, comments on issues that might be addressed by Regulations under Section 163(j) of the Internal Revenue Code.

1. Introduction

In general, Section 163(j), added by the Omnibus Budget Reconciliation Act of 1989,** disallows some or all of the deduction allowed to corporate taxpayers for interest paid or accrued on post-July 10, 1989 indebtedness to "related persons", including foreign shareholders owning more than 50 percent by vote or value of the stock of the corporation, if

(a) the related person is either not subject to United States tax on the interest or is subject to a treaty-reduced rate of United States tax?

* Consisting of Kimberly S. Blanchard, S. Douglas Borisky, Peter A. Glicklich, James A. Guadiana, Debra G. Gutwillig, Kenneth S. Kail, Richard 0. Loengard, Michael L. Schler, Esta E. Stecher, Lewis R. Steinberg, Suzanne L. Sykora, Willard B. Taylor, Mary Sue Teplitz, John C. Vlahoplus, and Annette S. Werner. The principal draftsman was Willard Taylor. Helpful comments were received from M. Bernard Aidinoff, Renato Beghe, William L. Burke, Peter C. Canellos, John A. Corry, Arthur A. Feder, Sherwin Kamin, Bruce E. Kayle, Richard M. Leder, Robert J. McDermott, James M. Peaslee, Kenneth R. Silbergleit, David R. Tillinghast, and Ralph 0. Winger.

** P.L. 101-239, 103 Stat. 2106 [hereinafter cited as the "1989 Act"].

(b) the corporation’s debt to equity ratio as of the close of the taxable year (and on such other days during the year as may be prescribed by Treasury Regulations) exceeds 1.5 to 1; and

(c) the corporation has “excess interest expense”, defined as the excess of total interest expense, net of any interest income (“net interest expense”), over the sum of (i) 50 percent of adjusted taxable income (i.e., taxable income computed without regard to net interest expense, net operating loss carryovers, and any deduction allowable for depreciation, amortization, or depletion) and (ii) any excess of 50% of adjusted taxable income over net interest expense in the prior three years, to the extent not previously absorbed.

Where interest is subject to a reduced rate of withholding tax under a treaty, only the portion of the interest that corresponds to the reduction will be regarded as tax-exempt.

The purpose of Section 163(j) is to limit the deduction allowed for interest paid by U.S. corporations to controlling foreign shareholders, although in form it also applies to interest paid to related domestic tax-exempt persons. Its structure was shaped, however, by Congress’ desire, on the one hand, not to violate anti-discrimination provisions of U.S. tax treaties by limiting the disallowance to foreign-owned U.S. corporations and, on the other, to avoid the political difficulties (evident from the failure to adopt final Section 385 Regulations) of enacting a limitation on deductible interest that would apply to domestically controlled U.S. corporations as well.

To resolve these conflicting pressures, Congress made the disallowance in Section 163(j) turn on whether the interest is exempt from tax. This has led to a number of difficulties, including uncertainty as to whether, if Regulations extend Section 163(j) to guaranteed third party debt, it will apply if interest paid to the guarantor would have been exempt, notwithstanding that interest paid to the third party lender is fully taxable.

2. Issues That Might be Addressed by Regulations

Although relatively brief, Section 163(j) is a microcosm of the complexity of current tax law. It creates a number of new concepts of substantial complexity (“disqualified interest”, “adjusted taxable income”, “net interest expense”); requires other calculations not generally required by the Code, such as a corporation’s debt to equity ratio; creates new carryover items (e.g., excess limitation and interest not deductible under Section 163(j)); and generally touches on every context in which the interest deduction is important, including, for example, the calculation of the branch profits tax imposed by Section 884.

We have in this Report tried to address Section 163(j) comprehensively and have identified the issues set out below. Answering in Regulations all the issues raised by Section 163(j) would be an enormous undertaking by the Internal Revenue Service, however, and just as much of an imposition on those compelled to read and interpret the Regulations. Consideration might be given under these circumstances to addressing only those issues considered to be most important, recognizing that this may leave taxpayers and the Internal Revenue Service at risk with respect to unanswered questions.

The following issues are discussed in this report:

1. Whether Section 163(j) applies only for the purposes of determining the deductibility of interest expense by a U.S. corporation or also for other purposes, such as the calculation of personal holding company income, foreign personal holding company income and accumulated taxable income. See pages 7-8.

2. Whether interest income and expense includes foreign exchange gains and losses and market discount and the extent to which interest income and expense will include "interest equivalents". See pages 8-10.

3. Whether related party interest income will directly reduce related party interest expense. See page 10.

4. Whether capitalized interest will be regarded as interest expense when allowed as a deduction through depreciation or otherwise (and, if so, how it will be identified). See pages 10-12.

5. How to coordinate Section 163 (j) with the reduction in the dividends received deduction in Section 246A. See pages 12-13.

6. How to coordinate the passive loss rules with the disallowance of interest under Section 163(j). See page 13-14.

7. Whether, in addition to the net operating loss carryover, capital loss and other carryovers should be added back to taxable income in computing adjusted taxable income. See page 14.

8. Whether deductions for depreciation and other items that are added to taxable income to arrive at adjusted taxable income will be subtracted from gain recognized on a sale or other disposition of the related asset. See pages 15-16.

9. Whether, apart from depreciation and the items listed in Section 163(j)(6)(A)(i)(III), other non-cash deductions (and non-taxable cash receipts) should be added to taxable income to arrive at adjusted taxable income. See pages 16-17.

10. Whether life insurance companies otherwise excluded from the definition of an affiliated group by Section 1504(b)(2) should be included for purposes of the calculation of adjusted taxable income and otherwise. See page 17.

11. Whether there should be any adjustment to gain realized on the sale of capital assets other than that referred to in 8. above and to the extent necessary to prevent “stuffing”. See pages 17-18.

12. Whether an excess of 50% of adjusted taxable income over interest expense for years prior to the effective date of Section 163(j) may be carried forward. See page 19.

13. Whether financial statement values may be used in lieu of adjusted basis to determine assets for purposes of the 1.5 to 1 debt to equity ratio safe harbor of Section 163(j)(2)(A)(ii). See pages 21-25.

14. If financial statement values may not be used to determine assets for purposes of the debt to equity safe harbor, whether there should be “push down” accounting for acquisitions

of the stock of a subsidiary; adjustments to the basis of stock of corporations not included in the affiliated group to reflect increases and deficits in retained earnings; and whether investments in partnerships should be taken into account by looking at the basis in the partner's partnership interest or in the partner's share of the partnership's assets. See pages 25-33.

15. How debt should be defined in determining debt to equity ratios, including the treatment of defeased debt, contingent liabilities, short-term liabilities, insurance company reserves, commercial financing liabilities and banks and finance business. See pages 33-36.

16. Whether an "anti-stuffing" rule is needed to prevent distortions in the calculation of debt to equity ratios or of adjusted taxable income. See pages 36-38.

17. Whether the determination of whether a partnership is "related" should be made at the partnership level. See pages 36-37.

18. Whether there should be a de minimis exception, similar to that applicable to partnerships, in the case of regulated investment companies and real estate investment trusts with de minimis holdings by tax-exempt shareholders. See pages 38-40.

19. How an acquisition should affect an excess limitation or disallowed interest carryforward of the acquired corporation. See pages 40-42.

20. Whether interest is to be treated as tax-exempt when paid to a controlled foreign corporation or other entity whose income is taxed to U.S. shareholders. See pages 42-43.

21. How to identify the portion of its U.S. interest expense that is payable to related persons when a foreign corporation carries on business in the United States through a branch or otherwise. See pages 44-48.

22. Whether "excess interest" expense of a foreign corporation that carries on business in the United States through a branch or otherwise should be treated as paid to a related person for purposes of Section 163(j). See pages 48-52.

23. What rules should apply in determining whether there is a back-to-back loan from a related person and whether any such rule should also apply for withholding tax purposes. See pages 56-62.

24. Whether the Regulations need address cases to which Plantation Patterns would apply; what, if anything, should be said with respect to guaranteed third-party debt that is not treated as equity under the holding in that case; and related issues, such as what constitutes a guarantee and the treatment of back-to-back guarantees. See pages 62-68.

25. What standard should be used to determine when a modification of terms will cause a loan to lose its grandfathered status and whether a modification which reduces aggregate interest expense should have this consequence. See pages 68-71.

3. Scope of Section 163(1)

Section 163(j) disallows a current deduction for interest "under this chapter", i.e., for all income tax purposes. If the intent of Section 163(j) is to limit the reduction in U.S. corporate income tax (and, presumably, alternative minimum tax) attributable to the deduction of interest paid to tax-exempt related parties, it would be useful to make it clear that the disallowance is only for that purpose and, for example, does not affect the calculations under Section 535, defining accumulated taxable income; Section 545, defining undistributed personal holding company income; and Section 556, defining undistributed foreign personal holding company income. It might also be questioned whether it should apply for purposes of calculating, under Section 952, the subpart F income of a foreign corporation paying interest to a related person, although the application of Section 163 (j) in such a case could affect the taxable income of U.S. shareholders.

In addition, since interest paid by non-corporate taxpayers is not subject to Section 163(j), that section should not apply to interest paid by an S corporation and that might usefully be stated in Regulations. (Related to this is the treatment of interest paid by a partnership having C corporation partners. Presumably, such a partner's distributive share of interest expense would be treated as paid by the partner for purposes of Section 163(j).)[*]

Regulations could also usefully clarify that interest that is not currently deductible nonetheless reduces earnings and profits since it represents a real outlay. This would be consistent with the rule for excess operating losses, capital losses and charitable contributions.[**]

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[*] See H.R. Rep. No. 247, 101st Cong., 1st Sess. (1989) [hereinafter cited as "House Report"] at 1243.

[**] See Rev. Rul. 75-515, 1975-2 C.B. 117, 118; and I.T. 3253, 1939-1 C.B. 178.

4. Interest Income and Expense

For the purposes of Section 163(j), interest is presumably calculated and determined under normal tax rules and thus will include original issue discount, as determined under Section 1272 et seq. Regulations under Section 988(a)(2) should specify the extent to which foreign exchange gain and loss will be treated as interest income or expense under Section 163(j), and we believe that Regulations under Section 1276(a)(4) should treat market discount as interest income for this purpose. Interest income and interest expense should also be adjusted for amortized bond premium, and interest income should include "acquisition discount" as defined in Section 1283(a)(2).

A. Interest Equivalents. Section 163(j)(6)(B) authorizes adjustments to "net interest expense" for purposes of the provision, and the legislative history* indicates that one possible adjustment would be to add and subtract interest equivalents. The treatment of both income and expense as an "interest equivalent" is addressed in Temp. Reg. § 1.954-2T(h), relating to income equivalent to interest for purposes of the definition of foreign personal holding company income under Section 954(c)(1)(E), and Temp. Reg. § 1.861-9T(b), relating to the allocation and apportionment of interest expense. We suggest that Regulations under Section 163(j) incorporate these principles, modified to reflect Notice 89-90** and comments

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* See H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. (1989) [hereinafter cited as "Statement of Managers"] at 566-67, stating that . . .

> "the conferees understand that regulations could reduce net interest expense where all or a portion of income items not denominated as interest are appropriately characterized, in the Treasury's view, as equivalent to interest income. The conferees expect that an amount would not be so characterized unless it predominantly reflects the time value of money or is a payment in substance for the use or forbearance of money. Similarly, . . . Treasury might choose to increase net interest expense, under regulations, by all or a portion of expense items not denominated interest but appropriately characterized as equivalent to interest expense."

** 1989-33 I.R.B. 1 (Aug. 14, 1989).

previously made by the Tax Section,* and (since there is no reason for special treatment) to extend to dealers the treatment afforded other corporations. While there may be somewhat different issues involved in determining interest equivalents under these other Regulations, it would be unnecessarily complex to develop a different definition of interest equivalents for the purposes of Section 163(j).

B. Related Party Interest Income. While interest expense is reduced by interest income in determining net interest expense, there is no offset of interest paid to related parties by interest received from related parties. If, for example, a corporation has $100X of interest expense, of which $75X is related party interest expense, and $25X of interest income from related parties, the potential disallowance under Section 163(j) is $75X, not $50X. It might be considered whether this is in all cases appropriate -- for example, whether interest paid to a related party should not be reduced by interest received from the same party in determining the amount of interest paid to related parties or, indeed, whether interest received from all related parties should not be netted against interest paid to all related parties.

C. Interest Not Currently Deductible. Under other provisions of the Internal Revenue Code, interest may be deferred (for example, by Section 163(e)(3)) or capitalized (for example, by Section 263 or Section 263A). The legislative history of

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* See the Tax Section’s Report on Regulations Relating to the Definitions of a Controlled Foreign Corporation, Foreign Base Company Income, and Foreign Personal Holding Company Income (February 13, 1989), reprinted in Tax Notes Today, February 21, 1989, and its Report on Temporary Section 861 Regulations Concerning Allocation of Interest and Other Expenses (December 21, 1988).

Section 163(j) assumes that these provisions apply before Section 163(j) or, put the other way around, that Section 163(j) applies last, only to interest that would otherwise be deductible, and it suggests in such a case that interest which is capitalized or deferred be taken into account for purposes of Section 163 (j) at the time a deduction would otherwise be allowed.*[*]

Since the purpose of Section 163 (j) is to limit deductions, deferring consideration of interest that is not otherwise currently deductible until it becomes deductible generally makes sense. The legislative history notwithstanding, however, we question whether capitalized interest (as opposed to interest that is simply deferred) should be taken into account when it becomes deductible. To begin with, the deduction allowed at that time is not as such for interest. Wholly apart from that technical point (which in any event is explicitly rejected by the legislative history), the difficulty of identifying the interest component may be substantial. It will be necessary, for example, to have rules to determine: when interest that is capitalized and included in inventory or in the basis of depreciable property is allowed as a

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[*] See House Report at 1244, stating that . . .

> "In any case involving a debt instrument having original issue discount that is held by a foreign person, where the operation of section 163(e)(3) causes deductions for interest expenses to be delayed until the interest is actually paid, the bill takes such interest expenses into account at the time deductions are allowed by section 163(e)(3). Similarly, where other provisions of current law (such as sections 263, 266, 267(a) and 469) cause deductions for interest expenses to be delayed, the bill takes such interest expenses into account at the time deductions are allowed by such provisions."

deduction through the gross income exclusion for cost of goods sold or the deduction allowed for depreciation; if a capital asset is sold at a gain or a loss, whether interest capitalized and included in its basis is to be regarded as allowed as a deduction at that time; and how capitalized interest that is treated as allowed as a deduction in any year will be handled if for that year there is a net operating or capital loss. To be consistent, interest capitalized in years prior to the effective date of Section 163(j) would have to be taken into account as interest expense when allowed as a deduction. All of this will require records that permanently identify and trace capitalized interest as such. We recognize that some interest will escape Section 163(j) if that Section does not apply to capitalized interest, but we believe the leakage does not justify the complexity of identifying and tracing capitalized interest.

D. Disallowed Interest. Other provisions of the Internal Revenue Code, such as Section 265 or Section 279, permanently disallow a deduction for interest. As a logical extension of the legislative history referred to above, such interest should never be taken into account under Section 163(j).

E. Coordination with Other Provisions. Where the determination of interest expense is relevant for other purposes, such as the allocation and apportionment of interest expense for foreign tax credit and other purposes under Section 861, interest deferred under Section 163(j) would be taken into account when it becomes deductible under that Section. This follows from Section 163(j)(1)(B), which provides that interest deferred under Section 163(j)(1)(A) “shall be treated as disqualified interest paid or accrued in the succeeding taxable year”.

More difficult is the relationship between Section 163(j) and Section 246A. Although Section 246A does not disallow a deduction for interest, where debt is treated as financing the ownership of portfolio stock under that Section there is a corresponding reduction in the dividends received deduction. One approach would be to say that in this case Section 163(j) should apply first -- that is, if interest is not currently deductible under Section 163(j) the related debt should not result in a reduction of the dividends received deduction. The difficulty of this approach, however, is that the interest may become deductible in a year in which there is no longer any dividends received deduction to disallow and, given that possibility, there does not seem to be any alternative to applying both Section 246A and Section 163(j) at the same time and to both disallowing the interest and reducing the dividends received deduction.

Rules might be provided to coordinate Section 163(j) with the passive activity loss limitation rules. If so, the passive loss rules should be applied first, and then Section 163(j). The passive loss rules should then be reapplied but, in order to avoid a circularity problem, Section 163(j) should not be reapplied.

For example, assume a closely-held corporation has $200X of rental income, $150X of interest expense to a related tax-exempt party, $60X of rental expense and $90X of depreciation expense. There would be $200X of allowable deductions (consisting of $100X of interest expense, $40X of rental expense and $60X of depreciation expense) and a passive loss of $100X (consisting of $50X of interest expense, $2OX of rental expense and $3OX of depreciation expense). The adjusted taxable income would be $160X ($200X less $40X allowable rent expense) and, accordingly, the $100X interest deduction allowable under the passive loss rules would be limited to $80X by Section 163(j). The corporation would then be permitted to deduct an additional $20X of rent and depreciation expense ($8X and $12X, respectively). Its passive loss would remain at $100X, but would consist of $7OX interest expense, $12X rent expense, and $18X depreciation expense.

5. Adjusted Taxable Income

The disallowance under Section 163(j) is limited to “excess interest expense”, which is the excess of net interest expense over 50% of “adjusted taxable income” plus any excess limitation carryover. Section 163(j)(6)(A)(ii) authorizes Regulations that will adjust the statutory definition of adjusted taxable income.

A. Carryforwards. Adjusted taxable income is computed without regard to any net operating loss under Section 172 and thus carryforwards and carrybacks of net operating losses have no impact on the calculation of a corporation’s excess interest expense. Absent regulations under Section 163(j)(6)(A)(ii), however, other carryovers, such as the capital loss carryover, are taken into account and thus adjusted taxable income must be adjusted to reflect any such carryforward or carryback to the taxable year. If the purpose of adding back a net operating loss is primarily to measure interest expense against cash flow, by reflecting that loss in adjusted taxable income for the year in which generated (or not at all, if the loss exceeded adjusted taxable income), it would be consistent to take other items which give rise to carryovers into account when generated.[*]

[*] Capital gains and losses would have to be adjusted pursuant to our recommendation in 2(B)(ii) below.

B. Non-cash Deductions. Section 163(j)(6)(A)(i)(III) provides that adjusted taxable income is computed without regard to any deduction for depreciation, amortization, or depletion; and, in describing how Regulations under Section 163(j)(6)(A)(ii) might modify the definition of "adjusted taxable income", the Statement of the Managers explains that "the conferees intend that any modified definition will add back non-cash deductions to earnings generated by operations . . . ."[*]

In this connection, we recommend that

(i) Under Section 163(j)(6)(A)(i)(III), the items added back to taxable income should include all depreciation of intangible personal property (including depreciation or amortization of patents, trade secrets, copyrights and covenants not to compete), recovery deductions and depreciation of tangible personal or real property, amortization of organizational expenses, and depletion deductions (whether cost depletion or percentage depletion).

(ii) Because deductions for depreciation, amortization and depletion are to be added back to taxable income,

[*] Statement of Managers at 566. According to Kenneth W. Gideon, Assistant Secretary of the Treasury for Tax Policy, the definition of "adjusted taxable income" against which the interest deduction limitation is measured is modified by the statute (and is to be further modified by regulations) "to reflect more closely actual cash flow". Letter from Kenneth W. Gideon to Keijino Koyama, dated December 18, 1989 (reprinted in Tax Notes International, January 24, 1990). Treasury apparently believes such an approach to be appropriate because an unrelated lender would be apt to look at cash flow and asset levels to determine whether to lend money. See Matthews, "U.S. and U.K. Branches of I FA Meet to Discuss Common Concerns", September 18, 1989 edition of Tax Notes at 1320 (summarizing the remarks of Peter Barnes, Associate International Tax Counsel, Department of the Treasury).

gains recognized upon the disposition of the assets that gave rise to the deductions should be subtracted from taxable income to the extent that such gains are attributable to such deductions allowed while the assets were held by the taxpayer or a member of the taxpayer’s affiliated group. The adjustment would be made for depreciation, etc. taken in any year in which it could affect the calculation of adjusted taxable income for purposes of Section 163(j) -- in other words, if our recommendation in 6(A) below is accepted, the three taxable years prior to the first taxable year beginning after July 10, 1989, as well as taxable years beginning after that date. To be consistent, for purposes of Section 163 (j), an adjustment would also have to be made to the investment adjustment rules in Regulations § 1.1502-32 and -32T.

This subtraction will entail additional recordkeeping, but without such a rule adjusted taxable income would be overstated in the year the assets (or the stock of a subsidiary holding the assets) were sold because, for purposes of the modified adjusted taxable income calculation, asset basis would not have been reduced on account of such deductions.

(iii) Apart from the foregoing adjustments, which generally follow from the direction in Section 163(j)(6)(A)(i)(III), we question whether there should be further adjustments to a corporation’s taxable income in order to more closely approximate its cash flow. There are many non-cash deductions as well as cash receipts that are not income, but adjusting taxable income for these items will completely divorce the concept used in Section 163(j)(2)(B)(i)(II) to measure deductibility from taxable income, which is what determines the corporation's tax liability. Indeed, as a policy matter, it might be questioned whether Congress should have added back depreciation, amortization, or depletion to taxable income except to the extent that the allowable deductions exceed those allowed for earnings and profits purposes.

By way of example, the deduction allowed for compensation paid in stock does not require any cash outlay; on the other hand, we assume that taxable income would not be increased when stock is sold for cash, although that increases cash flow. Other examples of non-cash deductions and non-taxable cash receipts are the dividends received deduction, increases in insurance company reserves, unearned premiums of insurance companies, and tax-exempt interest. Apart from our suggestion in 5(A) above, we would not favor making adjustments for these or any other non-cash deduction (or non-taxable cash receipts) except to the extent required by Section 163(j)(6)(A)(i)(III).

(iv) Section 163(j)(6)(C) requires that, in the case of corporations that form part of an affiliated group within the meaning of Section 1504(a), adjusted taxable income be determined on a consolidated basis, regardless of whether such corporations file a consolidated return. For this purpose, consolidated taxable income should be computed as provided in Treas. Reg. § 1.1502-11, but with the adjustments referred to above.[*] In addition, for purposes of Section 163(j) any life insurance company that would otherwise be excluded from an affiliated group by reason of

[*] See House Report at 1248.

Section 1504(b)(2) should be treated as a member of the affiliated group.

C. Sales of Capital Assets. The direction in the legislative history to disregard the proceeds of "certain" capital asset dispositions is unclear,* but we think that this should be limited to the recapture of deductions for depreciation, depletion and amortization, as recommended in B(ii) above, and to "stuffing", i.e., to the appreciation existing at the time of a contribution of any asset to the corporation from a related person. See "Anti-Abuse Rules" in 9. below. Including all other income from asset sales in adjusted taxable income gives taxpayers some ability to time the receipt of income but we see no simple and practical alternative to using that standard.

D. Other Adjustments. Regulations might address the treatment of income of a foreign corporation that is not effectively connected with a U.S. trade or business but is subject to U.S. withholding tax. We assume that such income will not be taken into account in determining adjusted taxable income and net interest expense.

Regulations might also make it clear that adjusted taxable income for purposes of Section 163(j) is the pre-dividends paid deduction taxable income of a regulated investment company or real estate investment trust.

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* See Statement of Managers at 566, stating that "[T]he conferees intend that any modified definition [of adjusted taxable income] . . . would disregard, for example, the proceeds of certain capital asset dispositions." A Treasury representative has indicated that the reference authorizes Treasury to ignore a return of capital even though an unrelated lender would take this cash flow into account (International Fiscal Association Meeting, New York City, December 4, 1989 - Tax Notes, December 11, 1989, p. 5).

If there are exclusions from assets and liabilities for the purposes of calculating a corporation's debt to equity ratio, consideration might be given to corresponding adjustments to income and expense for purposes of calculating both adjusted taxable income and net interest expense.*

6. Carryforward of the Excess Limitation

Under Section 163(j)(2)(B)(ii), if 50% of adjusted taxable income exceeds net interest expense, there is an "excess limitation" which is carried forward for three years and added to 50% of adjusted taxable income to determine whether there is "excess interest expense" in a carryforward year. Any "excess limitation" remaining after the third year is lost.

A. Pre-Effective Date Years. The excess limitation carryforward was added in conference to smooth out the effect that fluctuating income might otherwise have on the allowance of interest deductions. There is a one-sidedness to allowing an excess limitation carryforward from pre-effective date years, given that there was no potential disallowance of interest expense in those years. Nonetheless, we believe that, on balance, given the purposes of the carryforward (and the statement in Section 163(j)(2)(B)(ii) that a corporation with an excess limitation for "any" year may carry that excess limitation forward), a corporation may have an excess limitation in a taxable year beginning on or before July 10, 1989 that can be carried forward to later taxable years (subject to the three-year rule).

* Cf. Sections 279(c)(5)(B) and (C).

If a carryforward is allowed, all of the adjustments to taxable income required by Section 163(j)(6)(A) for post-effective taxable years would have to be made to taxable income for pre-effective date taxable years.

B. Other Excess Limitation Issues. The Regulations might confirm that:

(i) There is no requirement that a corporation must otherwise be subject to Section 163(j) (for example, have a debt to equity ratio in excess of 1.5 to 1) in order to have an excess limitation for a year. The carryforward operates independently from the debt to equity “safe harbor” of Section 163(j)(2)(A)(ii).

(ii) An excess limitation is automatically carried forward and reduces excess interest expense in three succeeding years, even if in a carryforward year the corporation would have no amount of excess interest expense disallowed (either because its debt to equity ratio is 1.5 to 1 or less or because no disqualified interest was paid or accrued in such year). Although the statute could be more explicit on this point, this interpretation is consistent with the language of Section 163(j)(2)(B)(ii) and the notion that the excess limitation carryforward operates independently of the debt to equity ratio rules.

7. Carryforward of Disqualified Interest

Disqualified interest that is disallowed by reason of Section 163(j)(1)(A) in any year is carried forward and treated as disqualified interest paid or accrued in the succeeding year under Section 163(j)(1)(B). Although the statute is not as specific as it might be, the legislative history makes clear that the carryover amount is treated as interest expense for purposes of calculating "net interest expense" in the carryover year.[*] This point might be confirmed in the Regulations.

As in the case of disqualified interest for the current year, disqualified interest which is carried forward is fully deductible in the carryover year as long as the corporation has no excess interest expense in such year. If the corporation has excess interest expense in the carryover year, but is not subject to the disallowance rule because its debt to equity ratio has been reduced below 1.5 to 1, the same conclusion is reached under Section 163(j)(1)(A).

Suppose the party that has received the interest is no longer related in a year to which disqualified interest is carried? Since nondeductible interest is "treated as disqualified interest" paid in succeeding years, the interest continues to be subject to Section 163(j). In the absence of a Regulation so requiring, however, it will be less certain that original issue discount that is deferred under Section 163(e)(3) will be so limited in the year it is paid if the obligation is not then held by a related person, notwithstanding that a different rule would apply under Section 163 (j) to any interest paid on the obligation.[**]

8. Calculation of Debt to Equity Ratios

Section 163(j) applies in a particular year, pursuant to Section 163(j)(2)(A)(i), only to those corporations with debt to equity ratios in excess of 1.5 to 1 at the close of the year or on such other days during the year as may be prescribed by

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* House Report at 1247.

** Regulations under Section 267(a)(2) preserve the related party taint despite subsequent uncoupling.

Regulations. The 1.5 to 1 safe harbor reflects the conferees' understanding that this is less than the median debt to equity ratio of U.S. corporations.*

We have doubts about the statistical basis for the conferees' understanding. We have found no publicly available statistics which relate levels of corporate debt to the adjusted basis of assets. The Statement of Managers refers to debt-to-equity ratios, not ratios of debt to tax basis. Finally we are not sure that the "median" of debt-to-equity ratios is a sound basis for such an analysis.

The "Fortune 500" listing for 1988 makes us even more skeptical of the statistical basis for the conferees' understanding.** The overall ratio of liabilities to stockholder's equity for all United States Fortune 500 industrial corporations is 1.98 to l.*** of the largest 100 corporations on that list, 49 have liability to stockholder's equity ratios in excess of 1.5 to 1 and 41 of the smallest 100 companies on the list exceed the ratio. The number of these corporations which would fail the statutory 1.5 to 1 test is probably far larger than indicated, since the tax basis of a corporation's assets is generally lower than the amount at which the assets are carried for financial statement purposes.

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* See Statement of Managers at 567, stating that "The conferees understand that the median debt-equity ratio for U.S. corporations is generally measured as less than 1.5 to 1."

** Fortune, April 24, 1989, page 354 et seq.

*** This Fortune 500 listing excludes banks, insurance companies and other financial intermediaries, which generally have very high debt to equity ratios.

A. Use of Adjusted Basis.

Under Section 163 (j)(2)(C)(i), the debt to equity ratio of a corporation or affiliated group is to be determined by using the adjusted tax basis of assets, but with the “adjustments” prescribed in Regulations under Section 163(j)(2)(C)(iii). The use of adjusted basis for determining a corporation’s debt to equity ratio raises a number of problems.

We recognize that there may be significant doubt as to whether Section 163(j)(2)(C)(iii) authorizes a basic departure from the adjusted basis rule in Section 163(j)(2)(C)(iii). However, for the reasons that follow we believe that Regulations under Section 163(j)(2)(C)(iii) should permit the use of an alternative to adjusted basis, such as financial statements (possibly defined by reference to Section 56(f)(3), relating to “applicable financial statements”). Alternatively, a corporation should at least be permitted to “push down” the basis for stock acquired in a “qualified stock purchase” (as defined in Section 338) to step up or step down the tax basis of the acquired corporation’s assets to the cost of the stock (plus the acquired corporation’s pre-existing liabilities) to determine the combined group’s debt to equity ratio after the acquisition. Although the financial statements used under Section 56(f)(3) are for the purposes of determining financial statement income, not debt to equity ratios, many of the issues (e.g., the choice of financial statements, adjustments to exclude corporations that are not members of the affiliated group, etc.) are the same as those involved in using financial statements for purposes of Section 163(j), and the Section 56(f) Regulations[*] answer many of the questions that will come up if financial statements are to be used to determine debt to equity ratios under Section 163(j).

If it is concluded that Section 163(j)(2)(C)(iii) does not justify so radical a departure from the adjusted

basis rule in Section 163(j)(2)(C)(i), we would recommend that a technical correction be sought.

The first and most fundamental reason for our proposal is that the purpose of the debt to equity ratio is to measure thin capitalization.[**] Lenders determine whether a corporation is thinly capitalized and whether its debt is likely to be repaid, however, on the basis of the fair market value of assets, not their tax basis, which is largely historical. The tax basis of the corporation’s assets is relevant to the lender only to the extent that a sale of assets might create a corporate tax liability. It is a poor measure of value. Because of percentage depletion or other allowances made on the grounds of particular tax policies, the adjusted basis of a corporation’s assets may substantially understate value; similarly, because of the restrictions on write-downs that have nothing to do with value (such as the rule that generally prohibits the amortization of goodwill and other intangibles with indefinite lives), adjusted basis may in other cases substantially overstate value.

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[*] Temp. Reg. § 1.56-1T. See also the use of financial statements in Treas. Reg. § 1.897-2(g)(1)(iii)(C) and, for the purposes of defining indebtedness, Treas. Reg. § 1.279-5(e).

[**] See the Statement of Managers at 569.

The discrepancy between basis and value is particularly acute where one corporation has acquired the stock of another and there has been no Section 338 election. For example, assume p, which has no assets other than cash, acquires the shares of S and that S has no liabilities and

assets with a value of $150 and a tax basis of zero. Assume that the price is $150 and that P has financed the purchase with $75 of equity and $75 of debt. It seems absurd on these facts to say that the P/S group has an infinite debt to equity ratio since it has $75 of debt and no assets. The P/S group should plainly be treated as having assets of $150 and debt of $75 and a debt to equity ratio of 1 to 1.

The acquisition case provides an independent reason for our proposal since, if tax basis is used to calculate debt to equity ratios, whether an acquisition is of stock or assets will create a sharp disparity in result.

Apart from acquisitions of stock, the use of adjusted basis is likely to consistently understate the value of stock of foreign subsidiaries (and the stock of any other corporation not included in the affiliated group for purposes of Section 163(j)(6)(C)). This was an issue specifically addressed by Congress in Section 864(e)(4), which generally reflects changes in earnings and profits in the basis of stock of corporations not included in the affiliated group but owned to the extent of 10% or more.

The apparent basis for using the adjusted tax basis of assets, rather than their fair market value, to determine debt to equity ratios is to facilitate Internal Revenue Service audits. While the use of financial statements for this purpose will undoubtedly involve complexities not involved in the use of adjusted basis, many of these have been resolved by the Regulations under Section 56(f).

If financial statements are not used to determine debt to equity ratios, consideration should be given to the adjustments to the strict use of adjusted basis that were made by the now-withdrawn Section 385 Regulations, and to whether there should be an adjustment, similar to that prescribed by Section 864(e)(4), to the adjusted basis of a 10% or greater interest in the stock of corporations that are not members of the affiliated group. The Section 385 Regulations* represented the most thoughtful attempt to determine debt to equity ratios using adjusted tax basis and we think that they deserve close consideration if our proposal with respect to financial statements is not adopted. Under those Regulations, a corporation's debt to equity ratio was determined by comparing its liabilities to the adjusted basis of its assets, but with the following special rules:

(a) Liabilities excluded "trade accounts payable, accrued operating expenses and taxes, and other similar items", and a corresponding amount was deducted from the adjusted basis of the corporation's assets.

(b) The adjusted basis of the corporation's assets was reduced by reserves for bad debts and "similar asset offsets".

(c) The adjusted basis of trade accounts receivables to a cash basis taxpayer was their face amount less an appropriate reserve for uncollectibles.

(d) Equity was increased at the end of the year by any net operating loss sustained during the year.

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* 45 Fed. Reg. 86,438, 86,443 (1980). The discussion refers only to the final Section 385 Regulations.

(e) In the case of a corporation that was a bank, or a corporation primarily engaged in the lending or finance business, as defined in Section 279(c)(5), adjustments were made in accordance with the principles of Section 279(c)(5)(A), _i_._e_., to reduce liabilities and assets by the amount of indebtedness owed to the corporation that arose out of its lending or finance business.

(f) In the case of an insurance company, insurance reserves were treated in the same way as trade accounts payable, _i_._e_., as reducing liabilities and assets by the same amount.

(g) Liabilities incurred under a commercial financing agreement (such as an automobile floor plan) to buy inventory were treated as trade accounts payable if secured by the item and due on or before sale of the item.

B. Treatment of Acquisitions. In addition, if financial statements are not used to determine debt to equity ratios, the particular problem of corporate acquisitions could be dealt with by “pushing down” any difference between the basis of shares and the basis of the underlying assets. We recognize, however, that a push down rule will involve complexities and opportunities for dispute.

As to complexities, since the debt to equity ratio is to be determined by reference to adjusted tax basis, P would be required initially to determine the fair market value of each S asset, and thereafter to reduce the hypothetical stepped-up or stepped-down basis of each asset for depreciation and amortization, in the same manner as if a Section 338 election had been made with respect to the acquisition. This would require a separate set of books solely for Section 163(j). As to opportunities for disputes, while the determination of the aggregate fair market value of the S assets is relatively straightforward and objective (based on the purchase price for S’s stock plus S’s underlying liabilities), the determination of the amount to be allocated to each asset would be determined in the first instance by the taxpayer and may involve the very same types of valuation disputes that Congress apparently wished to avoid by basing debt to equity ratios on adjusted tax basis. In particular, and unlike the usual case, the acquiror will have an incentive to allocate the bulk of the hypothetical step-up in asset value to goodwill and other nondepreciable and long-lived assets (since this will preserve the effect of the step-up for the longest possible time). Furthermore, even when the S stock is sold by a single seller (as opposed to the public), the seller’s tax and economic position in a stock sale will be unaffected by the allocation and an agreement between the parties would not be at arm’s length.

It might be possible to base debt to equity ratios on a pushed down asset basis and also to achieve relative simplicity by the use of some arbitrary rule -- for example, requiring that the resulting initial stock basis must be adjusted (on a straight-line basis) over a period of years reflecting a reasonable debt amortization period (perhaps 10 or 15 years). Of course, the adjusted stock basis would still be increased or decreased from time to time by profits, losses, and distributions from and contributions to the corporation, although amortization of the basis would be based on the original purchase price. Push down accounting could be limited to recent acquisitions -- for example, those after the July 10, 1989 effective date or within the three years preceding the first taxable year beginning after July 10, 1989 and taxable years beginning after that date.

Even such an arbitrary rule will not eliminate all difficulties. For example, if an asset held on the acquisition date is depreciated or distributed in kind (or sold), the theoretically correct adjustment to the stock basis would require knowledge of the hypothetical basis the asset would then have had if the original acquisition had been an asset acquisition. The Regulations could adopt a rule stating that while only actual depreciation would be taken into account to reduce stock basis, no gain on dispositions of such originally held assets would increase such stock basis, all losses on such assets would reduce such basis, and all distributions would reduce stock basis in an amount equal to the current fair market value of the asset (without increase by the Section 311 gain on the asset to the target). The case of a Section 332 liquidation of the target is more difficult, and we see no good alternative to a return to underlying asset basis (disregarding post-acquisition depreciation) in that situation. While the latter result is unfortunate, it is probably no more unfortunate to the taxpayer than is the resulting loss in the high stock basis for other reasons (e.g., if the business is ever sold).

We are not in favor of allowing an acquiring corporation in calculating its debt to equity patio after an acquisition of stock to exclude acquisition debt to the extent of the appreciation in the subsidiary’s assets at the time of the acquisition. This approach would produce results that are inconsistent with the underlying purpose of the debt to equity ratio calculation and economic reality.

For example, assume that P acquires S for $100 and that S’s assets have a fair market value of $100 and an adjusted tax basis of $25. P finances the acquisition with $75 of debt and $25 of equity. P has no other assets or liabilities. As an economic matter, the group’s debt to equity ratio after the acquisition will be 3:1 (i.e./$75/$25). If P is allowed to exclude the $75 of debt, however, P will be treated as if it acquired S only with equity funds. In fact, even if P borrowed $90, if $75 of debt were excluded the group would be deemed to have $25 of assets, $15 of liabilities, and thus equity of $10, satisfying a 1.5 to 1 debt to equity ratio. These results are obviously wrong.

An alternative approach would take debt into account only in the same proportion that the basis of S's assets bears to their value. For example, if the target's assets had a basis of $25 and value of $100, and P's acquisition was financed with $60 of debt and $40 of equity, under this approach only 25% of the debt, or $15, would be taken into account. The P/S group would be deemed to have $25 of assets and $15 of debt, for a debt to equity ratio of 1.5 to 1, which is the right answer based on $60 of debt and $40 of equity.

However, this approach results in extreme pro-taxpayer distortions when P is a pre-existing corporation with assets and liabilities. Suppose P has $80 of assets and $40 of liabilities, and wishes to acquire S (with assets having a tax basis of $20 and value of $100). The correct economic answer is that to maintain a 1.5 to 1 ratio after the acquisition, P can additionally borrow up to $68 of the $100 purchase price (giving the P/S group assets of $180 and liabilities of $108). However, under the suggested proportionality rule, P could borrow the entire $100 purchase price, since it would then be deemed to have assets of $100 ($80 plus $20) and liabilities of $60 ($40 plus $20), and would have a nominal debt to equity ratio of 1.5 to 1. In reality, P would then have assets of $180 and liabilities of $140, for a ratio of 3.5 to 1, but this would be irrelevant and all interest would be fully deductible. This result is obviously unacceptable.

In addition, even if this proportionality approach could be limited to the case where the P/S group had no pre-existing assets, the formula does not eliminate the complexities of the push down approach. Thus, it will presumably be necessary to add debt back in later years if assets are sold and gain recognized since otherwise the debt to equity ratio will be understated. (To illustrate, if S in the second preceding paragraph were to sell its assets, assets would be increased by $74.50 (assuming a 34% tax), liabilities would be $59.50, and the debt to equity ratio would be $15 to $59.50 unless $45 of debt were added back.)

C. Investments in Partnerships. If debt to equity ratios are based on the adjusted basis of assets, rather than financial statements, a further problem is the treatment of an investment in a partnership -- specifically, whether a corporate partner should take into account its basis in the partnership or a share of the partnership's basis in its assets and how a corporate partner should determine its share of partnership liabilities.

There are two problems in using the partnership's basis in its assets: first, the difficulty of determining the partner's share of that basis (because of shifting partnership allocations or adjustments required under Section 704(c)), and, second, that the partnership's basis may not reflect the partners' basis in their interests. These issues were faced, but not adequately resolved, in the regulations relating to the allocation and apportionment of interest expense for foreign tax credit and certain other purposes.*

Using the partner's basis in its partnership interest, rather than a share of the partnership's basis in its assets, is the simplest and most sensible approach. The asset for purposes of Section 163(j) would then be the basis in the partnership interest (including the partner's share of liabilities included in that basis), and the debt for purposes of Section 163(j) would be the debt of the partnership included in such basis.

A variation of this approach (which would, however, result in a variation from the use of adjusted basis) might be

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* See the Tax Section's Report on Temporary Section 861 Regulations Concerning Allocation of Interest and Other Expenses (December 21, 1988).

adopted in the case of a partner that contributes appreciated or depreciated assets (or where the partnership's assets are otherwise booked up under Treas. Reg. § 1.704-l(b)(2)(iv)(g) to reflect unrealized appreciation or depreciation) to a partnership that maintains capital accounts in accordance with the Section 704 Regulations. In this case, a corporate partner's debt to equity ratio would be determined by taking into account its share of the partnership's liabilities and its book capital account increased by its share of liabilities. For example, if P contributes assets having a fair market value of $100 and an adjusted tax basis of $25 to a partnership, and another party contributes $100 of cash to the partnership, and each receives a 50% partnership interest in exchange therefor, we believe that P should be allowed to treat its partnership interest as having an adjusted basis of $100 for purposes of calculating its debt to equity ratio. This approach could be limited to cases involving partnerships among unrelated partners and could be made optional.

Since contributed property must be booked into the partnership's capital accounts at fair market value and since the capital accounts ultimately control the amount of cash and property each partner is entitled to receive from the partnership, a partner's capital account provides an objective standard, assuming that the partners are otherwise unrelated, for determining the fair market value (net of liabilities) of the contributed assets. Since the capital accounts will also be charged with the amount of book depreciation, amortization or depletion allocated to the partner, they will continue to reflect the partner's overall net equity investment in the partnership over time. Furthermore, since the capital accounts will already be maintained for other purposes, adoption of this approach will not require a corporation to keep an entirely different set of books solely for purposes of determining its debt to equity ratio.

D. Indebtedness.

Section 163(j) does not define "indebtedness" except to state that it includes accrued original issue discount, and the legislative history adds nothing other than to state that the 1.5 to 1 safe harbor was based on the conferees' understanding that the median debt to equity ratio for U.S. corporations is less than 1.5 to 1. There is, of course, no statutory reason why Regulations defining indebtedness could not use financial statement indebtedness (which is what the Section 279 Regulations do*).

If, as we have suggested, financial statements are used to determine assets, they would also be used to determine liabilities. We would recommend, however, that financial statement liabilities and assets be adjusted to include any interest bearing debt and related asset that is not included on the financial statements, other than defeased debt and the related assets, and, in addition, to make the adjustments described in (i), (iii), (vi) and (vii) below. If financial statements are not used, these adjustments should still be made and the Regulations might also make the adjustments described in (ii), (iv) and (v) below.

(i) Certain Short-Term Liabilities. As noted, the Section 385 Regulations specifically excluded trade accounts payable, accrued operating expenses, taxes and similar items from debt, but such items were netted against an equivalent amount of assets in determining equity. Such short-term liabilities were treated in this manner since such items "vary during the ordinary course of business in a way that is largely beyond the control of shareholders", and their inclusion would make it difficult for a taxpayer to compute its debt to equity ratio with certainty. It is our view that trade payables and similar short term liabilities should not be treated as indebtedness for purposes of Section

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* Treas. Reg. § 1.279-5(e)(1).

163(j) and that there should generally be a corresponding reduction in assets.

(ii) Defeased Debt. For financial accounting purposes, “defeased” debt (i.e., debt as to which a pool of liquid assets has been transferred to a trustee for repayment) and the related assets are removed from the balance sheet. For tax purposes such debt is not viewed as having been extinguished unless the debtor is legally released from the obligation. The issue is not specifically addressed by either Section 385 or Section 279, although the Section 279 Regulations would seem to exclude defeased debt since they define indebtedness by the use of generally accepted accounting principles.[*] The financial accounting approach seems reasonable for purposes of Section 163(j).

(iii) Insurance Reserves. The Section 385 Regulations treated insurance reserves of an insurance company as trade accounts payable and thus excluded them and a corresponding amount of assets from the debt to equity ratio calculation. We understand that, under financial accounting principles, such reserves are ordinarily reflected as liabilities on the balance sheet. The issue is not as such addressed by Section 279 (although, as noted, the Section 279 Regulations generally look to financial statements to define debt).

For a number of reasons we believe that insurance reserves should not be treated as indebtedness for purposes of Section 163(j). First, such reserves seem more in the nature of the operating structure of the business rather than its capital structure, and it is difficult to view them as an equity substitute. Moreover, as such reserves are not interest bearing

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[*] Treas. Reg. § 1.279-5(e)(1). We would not, however, favor excluding nonrecourse debt and the related assets, notwithstanding that they may be excluded for financial statement purposes.

(although an increase in reserves is deductible), it would seem inconsistent with Section 163(j) to include them in the debt to equity computation. Consistent with the Section 385 Regulations, insurance reserves should be excluded from debt and a corresponding amount of assets removed from the debt to equity ratio calculation on the theory that the reserves are for claims of policyholders rather than the leveraging of an investment in the company.

(iv) Contingent Liabilities. The Section 385 Regulations did not address the treatment of contingent liabilities. Section 279 includes in indebtedness contingent liabilities such as (a) those arising out of discounted notes, (b) the assignment of accounts receivable, and (c) guarantees of liabilities, but (in accordance with the financial statement definition of debt) only if the contingency is likely to become a reality. This approach, which was intended to reflect financial statement treatment, seems sensible to us.

(v) Amortizable Bond Premium. The Section 385 Regulations included unamortized bond premium in indebtedness. We understand that for financial accounting purposes such premium is taken into account as debt and thus would presumably also be taken into account for purposes of Section 279. In our view the unamortized portion should be taken into account for purposes of determining the debt to equity ratio. This would be consistent with the treatment of original issue discount under Section 163(j)(2)(C)(ii).

(vi) Commercial Financing Liabilities. Under the Section 385 Regulations, if inventory was financed under a commercial financing agreement, the commercial financing liability would have been treated in the same manner as a trade payable -- i e., the liability would be netted against the inventory which secures it. Where such financing closely resembles a trade payable, treating it in a similar manner does not seem unreasonable; and whatever rule applies, financed receivables should be given the same treatment. See the discussion of trade payables in (i) above.

(vii) Banks and Other Financial Institutions. Banks and other financing businesses will inevitably fall out of the 1.5 to 1 debt to equity ratio, but at least where their principal income is interest they will be able to offset interest expense with interest income in determining net interest expense. Will this be sufficient? If the income of the finance company is not in the form of interest (e.g., is rental income), it may not be. Both Section 279 and the Section 385 Regulations would have excluded debt incurred in the ordinary course of a banking, lending or finance business and an equivalent amount of assets in determining debt to equity ratios.

9. Anti-Abuse Rules

Consideration should be given to “anti-stuffing” and other anti-abuse rules.

Specifically, even a temporary reduction of a corporation’s debt to equity ratio to below 1.5 to 1 “as of the close of the taxable year” will permit the corporation to deduct all of the current year’s and prior years’ disqualified interest. Given this pressure, Treasury should exercise its authority under Section 163(j)(7)(A) to design an anti-abuse provision that would disregard temporary reductions of a corporation’s debt to equity ratio where avoidance motives can reasonably be inferred. Such a provision might be modelled upon the Treasury’s approach to an analogous “anti-stuffing” problem in the branch profits tax area[*] or under the now withdrawn Section 385 Regulations.[**] Alternatively, it may be sufficient to prescribe, under Section 163(j)(2)(A)(ii), additional testing dates during the year to determine whether the corporation’s debt to equity ratio meets the safe harbor. For example, the debt to equity ratio might be based on an average of four quarterly ratios.

The possibility of artificial increases to adjusted taxable income might also be considered, although on balance we believe this could be handled under existing Section 482 principles (such as National Securities Corporation v. Commissioner, 137 F.2d 600 (3d Cir. 1943), cert, denied. 320 U.S. 794 (1943)) and does not require Regulations. For example, consider a foreign corporation that has both a U.S. branch with little or no related party interest expense and a U.S. subsidiary with substantial related party interest expense. The branch has certain low basis assets which it intends to sell. In order to increase the adjusted taxable income of the U.S. subsidiary so as to utilize a substantial carryover of disallowed interest expense, the foreign corporation might transfer these low basis assets to the U.S. subsidiary as a contribution to capital prior to sale. The gain in such a case should, we believe, be allocated to the branch and would thus not

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[*] See Treas. Reg. §§ 1.884-1T(d)(13)(iii), (e)(3).

[**] See withdrawn Prop. Reg. § 1.385-6(g)(5)(vi), stating that debt to equity ratios shall be computed without regard to distortions created by a temporary contribution to equity or any similar contrivance.

serve to allow the use of the subsidiary’s interest deduction.

10. Partnerships

Whether interest paid or accrued to a partnership is paid or accrued to a “related” person is generally determined by looking at the partnership’s relationship with the corporation, not the relationship between, the partners and the corporation. This seems wrong, since it means: that interest paid to a partnership in which a related person does not have a greater than 50% interest in either the capital or profits will not be treated as paid to a related person. Specifically, if no related person has a 50% or greater interest in a partnership that lends to a corporation, none of the interest paid to that partnership will be regarded as paid to a related person.*

* The partnership would be related to the corporation only as set out in Section 267(b)(10), i.e., only if the same persons owned more than 50% in value of the paying corporation and more than 50% in the capital or profits interest of the partnership.

11. Other Pass-Through Entities

The determination of whether interest is paid or accrued to a related party is made by looking at the recipient, whether or not it is a “pass-thru entity”; but, if the recipient is a “pass-thru entity” the determination of whether the interest is tax-exempt is made by looking at the owners of the entity.* Although not defined in Section 163(j), a “pass-thru entity” for purposes of that Section would be a regulated investment company or a real estate investment trust.**

There are at least two problems in the application of Section 163(j) to “pass-thru entities” other than partnerships.

The first problem is that the effect of these rules is to treat interest as disqualified even though the interest of the tax-exempt holder in the corporation paying the interest is nominal -- for example, if a U.S. corporation pays interest to a related regulated investment company, a tax-exempt person holding a less than 1% interest in the regulated investment company would be treated as receiving disqualified interest. We would recommend that a rule similar to that in Section 163(j)(4)(B)(i), relating to partnerships, apply and that interest paid to a “pass-thru entity” not be treated as paid to a related party (except to the extent that a tax-exempt recipient is related in its own

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* See the second sentence of Section 163(j)(5)(A) which provides that a rule similar to that in the first sentence of (A) will apply to determine whether interest is tax-exempt.

** See House Report at 1246. Since an S corporation cannot have a tax-exempt shareholder, it should not be a “pass-thru entity” for the purposes of Section 163(j).

right to the payor) unless the interest of tax-exempt persons in the entity is 10% or more.

The second problem is that, as a practical matter, there is really no way for a corporation to know in most cases whether shareholders of a regulated investment company

or a real estate investment trust are tax exempt and no amount of certification is likely to provide a solution.

12. Effect of Acquisitions

Section 163(j) creates carryforwards for two items: (i) disqualified interest and (ii) excess limitation.*

There is a need for guidance on the effect of an acquisition of a corporation that has a carryforward of either of these items. For example, a corporation that is acquired may have an excess limitation for each of the three years preceding an acquisition of its stock by another corporation. The corporation will have to determine whether that excess can be used in determining the deductibility of the corporation's interest expense and of the interest expense of other members of its new affiliated group.

Other than Section 269, nothing in the Code prevents a corporation whose stock is acquired from using previously-generated carryforward items in determining the deductibility of its own interest expense. Similarly, unless Regulations to the contrary are issued, Section 163(j)(6)(C), which treats all members of an affiliated group as a single corporation, would seem to permit

* There may also be a carryforward of interest that has been deferred (for example, by Section 163(e)) and not taken into account for purposes of Section 163(j).

carryforwards to be used by other members of the affiliated group of which the corporation becomes a member. Where the assets of the corporation are acquired in a tax-free reorganization, however, there would be no carryover of

Section 163(j) attributes in the absence of Regulations under, or possibly an amendment to, Section 381.

The resolution of these issues raises the same issues, and thus the same enormous complexity, that are involved in the treatment of net operating loss and other carryovers.

In determining the effect of an acquisition of the corporation or its assets on these items a distinction should be drawn between the continued use of the item by the corporation that generated the carryover and its use by other members of an affiliated group of which it becomes a member. We therefore recommend that:

1. A corporation with carryforwards should be allowed to use those items in determining the deductibility of its own interest expense so long as there is no stuffing or other transaction that has the effect of allowing the deductions when they would not otherwise be allowed. Section 269 would apply to the use of disqualified interest carryforward, and disqualified interest would presumably be an item of built-in loss for purposes of Section 382; in the absence of Regulations, however, it is not clear that either Section 269 or Section 382 would prevent the use of an excess limitation carryover -- for example, leveraging up an acquired corporation that had an excess limitation carryover.

Similar rules should apply where a corporation’s assets are acquired in a tax-free acquisition and the acquiring corporation has no significant other assets – for example, where a corporation is acquired in the usual Section 368(a)(2)(D) reorganization.

2. There is no reason why carryovers under Section 163(j) should be taken into account in determining the deductibility of interest expense of other members of an affiliated group of which the corporation becomes a member. A similar rule should apply where a corporation’s assets are acquired in a tax-free acquisition and the acquiring corporation has significant other assets; while in such a case it might be equally reasonable to apportion the allowance, any apportionment may be more complex than the problem would justify.

While it seems to us, therefore, that the rules with respect to Section 163(j) carryovers should generally follow the rules that apply to net operating loss carryovers, any Regulations that so provide will inevitably be complex. The rules will, for example, have to deal with defects in applying Section 269 to an excess limitation carryforward (i e., liability as opposed to asset “stuffing”). In addition, if carryovers will not be available to other members of an affiliated group, will the rules look at the separately computed adjusted taxable income and debt to equity ratio of the subsidiary, even though the affiliated group as a whole has no adjusted taxable income and a 2-to-l debt to equity ratio?

13. Definition of Tax-exempt Interest

Under Section 163(j)(5)(B), interest is tax-exempt if no tax is imposed by subtitle A with respect to the interest, irrespective of whether that is the case because the recipient is exempt from tax under Section 501(a) or Section 892 or otherwise or because the interest is not taxable under Section 871 or 881 or is exempt from tax under a tax treaty.[*] Where interest is subject to a treaty- reduced rate of tax, it is regarded as tax exempt to the extent of the reduction -- for example, if the rate is reduced to 5%, as it would be in the case of a Swiss corporation, 25/30ths of the interest would be regarded as tax-exempt.

The legislative history indicates that interest is not to be regarded as tax-exempt if it "is currently included under section 951 in the gross income of a U.S. shareholder . . . ."[**] This seems to us to provide an enormous opportunity for complexity, but if this rule is incorporated in Regulations at all, it should likewise apply (i) to interest that is subject to U.S. tax because included in income of a United States person under Section 551 or Section 1293[***] or because it is considered to be included in dividends paid to a U.S. shareholder (using rules similar to those in Section 904(d)(3)) by a controlled foreign corporation, and (ii) to interest paid to a regulated investment company or real estate investment trust that is distributed by the recipient as a dividend if the dividend is subject to tax. The treaty reduction rule in Section 163(j)(5) would be applied to dividends paid by a regulated investment company or real estate investment trust.

If a recipient is "related" during only part of a year, we assume that only interest paid or accrued during that part of

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[*] Interest income of a private foundation would not be tax-exempt because the tax levied upon such foundations under Section 4948 is an excise tax imposed by subtitle D, not an income tax imposed by subtitle A.

[**] House Report at 1244.

[***] Cf. Notice 89-84, 1989-31 I.R.B. 8 (July 31, 1989), relating to Section 163(e).

the year will be regarded as paid or accrued to a related person.

14. Coordination with Branch Tax

Section 163(j)(7)(C) authorizes regulations to coordinate the application of Section 163(j) with the branch tax imposed by Section 884.

A. Identification of Liabilities Underlying "Disallowed Interest". The fundamental problem with applying a limitation on deductibility of interest by a foreign corporation that is engaged in trade or business in the United States arises from the fact, illustrated below, that a foreign corporation's interest deduction is based upon the assumption that all of its funds are "fungible". In contrast, the limitation under Section 163(j), and similar rules, such as Section 163(e)(3), assume that interest can be traced to a particular liability.

Treas. Reg. § 1.882-5 provides a formula to determine the interest deduction of a foreign corporation that is engaged in a U.S. trade or business. Under that formula, the ratio of the foreign corporation's worldwide liabilities to its worldwide assets[*] is multiplied by its U.S. trade or business assets. The result is deemed to be the foreign corporation's "U.S. connected liabilities". An interest factor is then applied to the amount of "U.S. connected liabilities" to determine the foreign corporation's

[*] As an alternative to use of an "actual ratio", a foreign corporation can apply a "fixed ratio", which is 95% for corporations involved in a banking, financing or similar business, and 50% for all other corporations.

interest deduction.[*] Thus, for example, assume that a foreign corporation has assets of $1000, $600 of which are used in its U.S. business, and has total liabilities of $500, which bear interest at 10%.[**] Assume further that $300 of the liabilities are owed to related foreign lenders, and that the remaining $200 of liabilities, from unrelated lenders, has been reflected on the books of FC's U.S. business. Under Treas. Reg. § 1.882-5, the foreign corporation's U.S. connected liabilities would be $300 (or $500/$1000 times $600), and its U.S. interest expense, before the application of Section 163(j), would be $30.

Since the application of the formula in Treas. Reg. § 1.882-5 simply provides the amount of otherwise- deductible interest, it should come as no surprise that specific limitations on the deductibility of interest on particular liabilities may cause a problem to foreign corporations.

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[*] In general, an average interest rate is determined each year for the liabilities "shown on the books of the U.S. trade or business" for that year (the "average U.S. connected interest rate"), and that rate is applied to the "U.S. connected liabilities". However, if (i) the "U.S. connected liabilities" exceed the liabilities shown on such books, and (ii) the foreign corporation has more than a de minimis amount of U.S. dollar liabilities on the books of its offices and branches outside the U.S., then (iii) an average interest rate is determined for such other U.S. dollar liabilities (or, in lieu thereof, a reasonable approximation may be used, e.g., with reference to LIBOR for an appropriate maturity), and (iv) the average U.S. connected rate is applied to the liabilities shown on the books and the rate described in (iii) is applied to the excess "U.S. connected liabilities".

[**] In this example, for the sake of simplicity, all figures are expressed in U.S. dollars and the effective interest rate is assumed to be the same on all of FC's liabilities.

There appear to be at least three ways to apply a liability-specific interest disallowance rule to a foreign corporation doing business in the United States. These methods are described briefly below in order to contrast their effects.

One approach (resulting in maximum disallowance) would be to disallow all deductions for interest paid or incurred on indebtedness included in the disallowed category. Assume in the preceding example that the related foreign lenders are not subject to any U.S. tax on the interest because they are "qualified residents" of a relevant treaty country.[*] The maximum disallowance method would treat all $300 of the foreign corporation's U.S. connected liabilities as related-party debt (causing all $30 of its U.S. interest expense to be subject to the Section 163(j) limitation).

A second approach ("proportionate disallowance") would be to consider a proportionate amount of the foreign corporation's U.S. connected liabilities as being from exempt related parties and thus as potentially subject to the Section 163(j) limitation. The proportion could be determined by the percentage of the foreign corporation's external borrowings that would have been subject to the Section 163(j) limitation if the foreign corporation were a U.S. corporation. In the example, $18 of interest expense (interest on 60% of the foreign corporation's U.S. connected liabilities,

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[*] See generally Section 884(f)(3).

i.e., 60% of $300*), would be subject to disallowance under Section 163(j).

A third approach, which we recommend, would be to adopt rules similar to those applicable for purposes of Section 884(f). It appears that Congress intended to adopt this third approach, and we recommend that the substantive rules of Section 884(f) generally apply for purposes of Section 163(j).**

Section 884(f)(1)(A) provides that interest "paid by a U.S. trade or business" of a foreign corporation is to be treated as if it were paid by a domestic corporation. Such interest may be subject to withholding when it is paid. Temp. Reg. § 1.884-4T(b) provides detailed rules for identifying such indebtedness. Under the Temporary Regulations, interest is considered "paid by a U.S. trade or business" if, for example, the loan on which the interest is paid is identified as a U.S. liability on the foreign corporation's books or if the liability is secured predominantly by U.S. effectively connected assets or gives rise to certain non-deductible interest related to those assets.***

Under Temp. Reg. § 1.884-4T(b)(5), if 80% or more of the assets of a foreign corporation constitute "U.S. assets" as that term is defined for purposes of Section 884 (see Temp. Reg. § 1.884-1T), the entire amount of otherwise determined excess

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* 60% equals $300/$500 x 100%.

** See Section 163(j)(7)(C). See House Report at 1248, stating that ". . . the determination . . . of disqualified interest . . . and net interest expense would take into account only . . . deductions allocable" to the U.S. business.

*** See also Notice 89-80, 1989-30 I.R.B. 10

interest is considered to have been paid by the foreign corporation's U.S. trade or business.* Where the 80% rule applies, the same liability identification method used for purposes of Section 884(f) should apply for purposes of Section 163(j). We reiterate our recommendation made in a previous report on the branch profits tax, however, that the pro rata identification method of Temp. Reg. § 1.884-4T(b)(5) be replaced with a specific identification method as in Temp. Reg. § 1.884-4T(b)(6).**

In the example above, interest on $200 of the foreign corporation's liabilities might be considered to have been paid by the FC's U.S. trade or business since $200 of liabilities was reflected on its books. Since none of the $200 is debt to related foreign persons, interest on the $200 (or $20) would not be subject to the Section 163 (j) limitation. However, the foreign corporation also has "excess interest" for the purposes of Section 884(f)(1)(B) (i.e., "Section 884(f)(1)(B) excess interest") since its deductible interest ($30) exceeds the $20 of interest it is considered to have paid. There is the further question, therefore, of whether some or all of the foreign corporation's excess interest of $10 is subject to the Section 163(j) limitation.

B. Treatment of Section 884(f)(1)(B) Excess Interest. Section 884(f)(1)(B) provides that, to the extent the amount of interest allowable as a deduction under Section 882 exceeds the amount of interest treated as paid by a U.S. trade or business under Section 884(f)(1)(A), a foreign corporation will be liable for tax (i.e., the tax on such "excess interest") as if the excess interest were interest paid to such foreign corporation by a wholly owned domestic subsidiary of the foreign corporation on the last

* The Temporary Regulations also include disallowed interest, including capitalized interest, in this calculation.

** See New York State Bar Association Tax Section, Report on Temporary Branch Profits Tax Regulations (Dec. 8, 1988), reprinted in Tax Notes Today (Dec. 12, 1988)(the "Branch Profits Tax Report") at 39-41.

day of the foreign corporation's taxable year.[*] The tax on excess interest is imposed on a hypothetical payment of interest to the foreign corporation by a hypothetical wholly owned U.S. subsidiary under Section 884(f)(1)(B). Is this characterization to be followed for purposes of determining the identity of the payee of such interest under Section 163(j)? If so, it would be clear that the interest would be considered paid or accrued to a related foreign person.[**] Whether or not the interest would be considered disqualified interest would depend upon whether the interest would also be fully subject to U.S. tax under Section 884(f)(1)(B) or, under an applicable income tax treaty, the foreign corporation was exempt from tax on the Section 884(f)(1)(B) excess interest.[***]

While Section 884(f)(1)(B) treats excess interest as a hypothetical payment to the foreign corporation, the Conference Committee Report to the Tax Reform Act of 1986 (at 11-648 - 11-649) suggested that the Regulations may provide for Section 884(f)(1)(B) excess interest to be treated as incurred on each type of external

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[*] There is some potential circularity inherent in the computation of excess interest and the application of the various interest-disallowance rules. To avoid such circularity, it appears that the amount of the interest deduction available to a foreign corporation must initially be computed without regard to the disallowance rules.

[**] See Sections 163(j)(4)(A), 267(b)(3) and 267(f).

[***] A treaty could also provide a reduced rate of tax on the excess interest. See Temp. Reg. § 1.884-4T(c)(3)(i).

borrowing by the foreign corporation, such as bank deposits.* The Temporary Regulations issued under Section 884 do not follow this suggestion, presumably for reasons of simplicity and administrative convenience. Notice 89-80, 1989-30 I.R.B. 10, indicates, however, that at least in the case of bank deposits, the final Regulations will ignore the fictional subsidiary-to-parent characterization of the interest payment and will instead give effect to the actual borrowings of the foreign corporation and any exemptions from tax that may apply thereto.

To the extent the final Section 884(f) Regulations provide an allocation of the Section 884(f)(1)(B) excess interest to specific liabilities, this allocation should apply, as well, for purposes of Section 163(j). Even if the Section 884(f) Regulations do not provide for an allocation of excess interest to specific liabilities, however, it would seem that identification of interest with liabilities should be undertaken for purposes of Section 163(j). Otherwise a foreign corporation with no actual related party borrowings could be subject to the Section 163(j) interest disallowance rules.**

Identification of interest with liabilities for purposes of Section 163(j) does not involve the complexity and administrative burden that identification for Section 884(f) purposes would require. Identification for Section 884(f) purposes requires an examination of all possible exemptions that could apply to each non-Section 884(f)(1)(A) liability (i.e., non-U.S. trade or business liability), necessitating an analysis of the portfolio

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* See discussion in Branch Profits Tax Report at 34-35.

** In the example, this would be the case if none of the $500 of liabilities were to related parties, and the $10 of excess interest were treated as paid to a hypothetical parent.

interest rules, the bank deposit rules, the effectively connected rules, all relevant treaties, and any other possible exemptions. By contrast, identification for Section 163(j) purposes merely requires that a foreign corporation determine which of its non-U.S. trade or business liabilities are owed to unrelated persons, a relatively simple determination.

Although ambiguous, the legislative history to Section 163(j) seems to support the view that the Section 884(f)(1)(B) excess interest should be allocated to specific liabilities for purposes of applying Section 163(j).[*] In order to prevent abuse by taxpayers, however, rather than permitting the foreign corporation to specifically allocate the excess interest to non-U.S. trade or business liabilities owed to unrelated persons, the regulations should require a proration of the non-U.S. trade or business liabilities.

As an illustration, assume that the foreign corporation in the example above is a United Kingdom company and, therefore, its $10 of Section 884(f)(1)(B) excess interest qualifies. for a treaty exemption from U.S. tax. Since all $300 of non-U.S. trade or business liabilities are owed to related foreign persons, the full $10 could be treated as disqualified interest subject to Section 163(j). If, however, only $150 of the non-U.S. trade or business liabilities were owed to related foreign persons, only $5 ($10 x 150/300) of the Section 884(f)(1)(B) excess interest should be treated as disqualified interest subject to Section 163 (j). Furthermore, if no portion of the $300 of liabilities were owed to related foreign persons, no portion of the $10 of excess interest should be treated as disqualified interest.

[*] The House Report at 1248 states that Regulations shall treat the tax on excess interest under Section 884(f)(1)(B) as imposed on the "recipient" and require that the exempt status of the interest recipient be determined prior to the application of the deduction disallowance rules.

C. <u>“Interest Shortfall”</u>. In circumstances in which the deduction allowed under Treas. Reg. § 1.882-5 is <u>less</u> than interest deemed paid under the branch profits tax regulations, there is an “interest shortfall”. Any such shortfall is, under the Temporary Regulations, used to reduce the amount of interest considered paid by a U.S. trade or business, in the order set forth in Temp. Reg. § 1.884-4T(b)(6).[*] Presumably, the same rule would be applied for purposes of the Section 163(j) limitation; however, serious consideration should be given to the recommendation in the Branch Profits Tax Report, at 42-44, that, rather than adjusting the interest considered paid by the foreign corporation’s U.S. business, there should be a carryover of the interest shortfall.

D. <u>Accrual vs. Payment Dates</u>. The rules under Treas. Reg. § 1.882-5 generally take into account the foreign corporation’s method of accounting for interest. A separate determination must be made under Section 163(j), however, concerning <u>when</u> the relationship between the borrower and the lender is to be determined.

E. <u>Carryovers of Disallowed Interest of a Foreign Corporation</u>. If interest expense of a foreign corporation is disallowed under Section 163(j), the excess is treated as disallowed interest paid in the next succeeding year.

The legislative history indicates that Regulations will provide that the deduction will not be subject to the excess interest tax of Section 884(f)(1)(B) “to the extent that it is attributable to interest [which was treated as paid by a U.S. trade

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[*] Under the branch profits tax Regulations, disallowed interest is also included in this calculation.

or business under Section 884(f)(1)(A)] in the year the interest was paid or incurred".[*] This is clearly correct. For similar reasons, however, it would be incorrect to suggest from this language in the legislative history that carryovers of disqualified interest that were treated as "excess interest" under Section 884(f)(1)(B) may again be tested under the substantive Section 884(f)(1)(B) rules. This should be clarified in the regulations.

F. Pre-Existing Indebtedness. Section 163(j)(3)(B) excludes from the term "disqualified interest" any interest paid or accrued under indebtedness with a fixed term which was issued on or before July 10, 1989, or issued after such date pursuant to a written binding contract in effect on that date and all times thereafter before the indebtedness was issued.[**] Application of this rule will require identification of liabilities with respect to which a foreign corporation's deduction for interest will not be subject to the Section 163(j) limitation. To the extent interest is considered attributable to interest "paid by" the U.S. trade or business of the foreign corporation under the Section 884(f)(1)(A) rules discussed above, and thus traced to particular liabilities, those liabilities should be considered in determining whether the interest may potentially be excluded from the Section 163(j)

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[*] See House Report at 1248-49.

[**] Section 7210(b)(2) of the 1989 Act similarly provides that in the case of any demand loan, or other loan without a fixed term, which was outstanding on July 10, 1989, interest on such loan, to the extent attributable to periods before September 1, 1989, shall not be treated as disqualified interest for purposes of Section 163(j).

limitation.* Similarly, in determining whether any Section 884(f)(1)(B) excess interest is attributable to excluded indebtedness, the same identification rules that apply for purposes of the general Section 163(j) limitation should apply here as well.

G. The Section 884(a) Branch Tax. Section 884(a) imposes a tax equal to 30% of the "dividend equivalent amount" of a foreign corporation. The term "dividend equivalent amount" is defined as the foreign corporation's effectively connected earnings and profits for a taxable year, as adjusted for certain increases and decreases in its "U.S. net equity". The legislative history** to the 1989 Act indicates that only income that is effectively connected with a U.S. trade or business, and deductions allocable thereto, are to be taken into account in determining the Section 163(j) limitation. This seems clearly correct.

The legislative history also indicates that regulations will provide that a payment of interest which is disallowed under Section 163(j) will not give rise to a decrease in a foreign corporation's "U.S. net equity" for purposes of Section 884(a) until the deduction is allowed. If, as suggested above, any interest deduction disallowed under Section 163(j) nevertheless reduces earnings and profits currently, a foreign corporation's dividend equivalent amount will reflect a reduction in its effectively connected earnings and profits immediately rather than as and when the interest deduction is ultimately allowed, and no

* The amount of any such excluded interest may depend upon either the actual interest rate on the debt or, perhaps, on any averaging convention used for purposes of Section 884(f)(1)(A) and/or Section 163(j).

** See House Report at 1248.

special adjustment to U.S. net equity appears to be required. Alternatively, if a current earnings and profits reduction is not permitted, it would appear that, in order to give effect to Congress' intent, an <u>upward</u> adjustment in U.S. net equity over what it would otherwise have been will be required for interest that is disallowed under Section 163(j), with such adjustment presumably to be reversed when the deduction is allowed. Under this alternative view, unless there were to be such an upward adjustment, U.S. net equity would generally reflect a decrease for the disallowed interest automatically either as reduction in U.S. assets or as an increase in U.S. liabilities. Under this alternative view, an amendment to the Section 884 regulations would be required to reflect this special adjustment to U.S. net equity.

By way of illustration, assume that at the beginning of the year a foreign corporation has U.S. net equity of $1000 and $300 of accumulated effectively connected earnings and profits not previously subjected to the branch profits tax because they were reinvested in the U.S. business. In the current year, the foreign corporation has adjusted taxable income of $100 and $200 of disqualified interest. Pursuant to Section 163(j), only $50 of the $200 is currently deductible, and the foreign corporation has taxable income of $50. In addition, the $100 out-of-pocket loss reduces the foreign corporation's U.S. net equity to $900.*

If the full $200 of interest expense reduces earnings and profits (and, thus, effectively connected earnings and profits), there is no need to adjust the U.S. net equity in order to avoid a branch profits tax. This is because the dividend equivalent amount will be 0 (negative $100 effectively connected earnings and profits for the year plus $100 decrease in U.S. net equity).

If, however, a reduction in earnings and profits is permitted for only $50 of the interest expense, the foreign corporation will have current year effectively connected earnings and profits of $50. In order to avoid an inappropriate branch profits tax on this $50, as well as on $100 of previously accumulated effectively connected earnings and profits (on account of the $100 reduction in U.S. net equity), the $150 of disallowed interest expense should be treated as a U.S. asset. Then, rather than being reduced by $100, the U.S. net equity would be considered to have been increased by $50.

15. Back-to-Back Loans

A. Legislative History. The legislative history makes it clear that Regulations are to treat back-to-back loans as directly from the ultimate lender, at least where the result would be to apply Section 163(j) to interest.**

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* For ease of illustration, this example ignores income taxes.

** See House Report at 1246, stating that, "Under current law, back-to-back loans that have no substance are collapsed. See Rev. Rul. 84-152, 1984-2 C.B. 381, Rev. Rul. 84-153, 1984-2 C.B. 383, and Rev. Rul. 87-89, 1987-2 C.B. 195. The bill directs the Secretary to issue such regulations as may be appropriate to prevent the avoidance of the purposes of the bill. The committee intends that such regulations will treat back-to- back loans through third parties (whether related or unrelated), as well as similar arrangements, like direct loans to related parties.

One approach that the Regulations might take with respect to back-to-back loans would be to say nothing -- in other words, to leave the matter to the published rulings, which would presumably apply for the purposes of Section 163(j) as well as for the purposes stated therein. Because the rulings in this area do not apply consistent criteria, we think it might be better for regulations to specifically address the treatment of back-to-back loans but, as noted below, we believe any such project should consider developing a single formulation of back-to-back loan rules for purposes both of Section 163(j) and for the purposes of determining whether the interest is subject to withholding tax.

Of the rulings on back-to-back loans cited in the legislative history, Rev. Rul. 84-152, 1984-2 C.B. 381, and Rev. Rul. 84-153, 1984-2 C.B. 383, concerned back-to-back loans through an Antilles subsidiary that were structured to take advantage of the exemption under the U.S.-Antilles Tax Convention for interest paid to an Antilles corporation.*

* In Rev. Rul. 84-152, 1984-2 C.B. 381, a Swiss parent with a U.S. and an Antilles subsidiary loaned funds to its Antilles subsidiary at an annual interest rate of 10 percent and the Antilles subsidiary in turn loaned the funds at an 11 percent rate to the U.S. subsidiary, which required a significant increase in working capital. The Antilles subsidiary was not sufficiently liquid to make the loan to the U.S. subsidiary without the funds from the Swiss parent. Similarly, in Rev. Rul. 84-153, 1984-2 C.B. 383, an Antilles subsidiary of a U.S. parent issued bonds to foreign persons in public offerings and loaned the proceeds (at a rate of interest one percentage point higher than the rate payable on the bonds) to a U.S. subsidiary of its U.S. parent, which required funds for working capital. The U.S. subsidiary made timely interest payments to the Antilles subsidiary who in turn made timely interest payments to the bondholders.

The Service concluded that the interest was not “derived” by the Antilles affiliate because the affiliate lacked dominion and control over the interest received by it and that the primary purpose for using the Antilles subsidiary was to obtain the benefits of the U.S.-Antilles tax treaty. The third ruling, Rev. Rul. 87-89, 1987-2 C.B. 195, addressed three different fact patterns involving back-to-back loans, principally through banks, and determined under what circumstances a lender will be considered to have made a direct loan to a related borrower for purposes of the withholding tax on interest and the rules relating to investments in United States property.* The Service held that the

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* In the first situation, a foreign corporation organized in a country that does not have an income tax treaty with the United States deposited 100x dollars as a demand deposit in an unrelated foreign bank organized and engaged in business in a country with an income tax treaty with the United States under the terms of which interest paid by a U.S. person to a resident of that country is exempt from U.S. income tax. The foreign bank loaned 80x dollars to the foreign corporation's U.S. subsidiary for expanding its business. The difference between the interest paid by the bank and that it charged to the U.S. corporation was less than one percent. This interest rate would have been different absent the foreign corporation's deposit. The second situation in the ruling was the same as the first except that the entity in which the foreign corporation deposited funds was not a bank and was organized in the same country as the foreign corporation and the deposit was in the nature of a long-term, short-term, or demand loan. In the third situation, a foreign subsidiary of a U.S. operating company deposited 100x dollars as a demand deposit in an unrelated foreign bank organized and engaged in business in a country with an income tax treaty with the United States under the terms of which interest paid by a U.S. person to a resident of that country is exempt from U.S. income tax. The bank loaned 8 0x dollars to the U.S. parent for use in expanding its business. The difference between the interest paid by the bank and that it charged to the U.S. corporation was less than one percent. This interest rate would have been different absent the foreign corporation's deposit.

determination of whether a deposit with a bank or a loan to an unrelated party should be collapsed with a loan by the bank or unrelated party to an affiliate of the depositing or lending corporation (and treated as a loan between the affiliated corporations) was based upon whether the deposit and loan are "independent transactions" which would be the case if the loan from the bank "would be made or maintained on the same terms irrespective of" the deposit.

B. Discussion. The Internal Revenue Service's published rulings with respect to back-to-back loans involve a number of difficult issues, including, for example, why there should be such a sharp distinction drawn between back-to-back loans and related party guarantees. Since the use of the back-to-back rulings for purposes of Section 163(j) is specifically endorsed by the legislative history, it can be argued that these issues are irrelevant under that Section of the Code, but we think the better view is that these issues should be addressed if Regulations are issued and that there should be a single formulation of the back-to-back loan rule for both Section 163 (j) and withholding tax purposes.

By way of illustration, if a foreign parent (P) deposits money in a U.S. bank and the bank loans money to P's U.S. subsidiary, the application of Section 163(j) requires a determination of whether the interest will for purposes of that Section be treated as paid to P and of whether the interest will be subject to U.S. withholding tax under Section 882 and 1442. We do not see how the two issues can sensibly be dealt with separately.

If, as we recommend, any Regulations on back-to- back loans provide a single formulation of the rule for Section 163(j) and withholding tax purposes, comments should be solicited on this subject generally and any Regulations should initially be issued in proposed form with an opportunity for comment.

If our recommendation that Regulations deal generally with back-to-back loans is not adopted, we have the following suggestions with respect to what Regulations might say with respect to back-to-back loans under Section 163(j).

Of the rulings cited in the legislative history, we believe that the more specific standard of Rev. Rul. 87-89 is preferable. We note, however, that its test (whether the loan would not have been made or maintained but for the deposit or other backup loan) is much easier to state than to apply and that it would therefore be useful for Regulations to set out the criteria that might be regarded as evidencing that fact. In addition, in order to avoid the application of Rev. Rul. 87-89 to normal banking relationships, we think that there should be modifications to this rule to exclude, for example, a case where the loan that backs up the loan to the U.S. corporation is a bank deposit and is relatively small in comparison to the loan.

As suggested by Rev. Rul. 87-89, the presence of a contractual or legal right of offset should constitute presumptive evidence that the loan would not have been made on the same basis without the deposit. This should not be conclusive, however, since in complex banking relationships the presence of a right of offset may not necessarily establish that the loan would not have been made without the deposit.

Of course, back-to-back loans can occur in situations other than bank loans as in the second situation in Rev. Rul. 87-89. For example, a non-bank may borrow money from a foreign parent corporation and lend the funds (either directly or through another affiliate) to a U.S. subsidiary of the foreign corporation.

Assuming that the rates or terms on the loan to the U.S. subsidiary are different as a result of the foreign parent making a loan to the accommodation party, interest payments should be subject to Section 163 (j) and the above standard should apply to these loans.

Although the authority to issue Regulations set out in Section 163(j)(7)(A) relates to the avoidance of Section 163 (j), we think the standard of Rev. Rul. 87-89 should also apply to interest payments to related parties where such payments are part of a back-to-back loan from an unrelated lender. This is consistent with the legislative history.* A foreign parent corporation may establish a non-U.S. corporation to act as a financing vehicle for its world-wide operations -- for example, a Netherlands parent corporation may establish a Netherlands finance subsidiary to issue debt in the Euro-market and in the United States to unrelated third parties. The debt would typically be guaranteed by the parent corporation. The Netherlands finance subsidiary would onlend the funds to both U.S. and non-U.S. affiliates on substantially the same terms as those of the third-party debt. Tested under the standard of Rev. Rul. 87-89, the rate and terms of the loan to the U.S. affiliate are dependent upon the rates and terms of the public debt. As a result, interest paid by the U.S. affiliate to the Netherlands finance subsidiary should be treated as a direct loan from the public to the U.S. affiliate that is guaranteed by the Netherlands parent corporation, and not treated as an affiliate loan since in substance the interest paid by the U.S. affiliate is

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* See Rev. Rul. 84-153, cited in the legislative history.

paid to the public.[*]

The legislative history of Section 163(j) provides that the Internal Revenue Service may require statements from foreign controlled U.S. corporations to the effect that interest is not paid pursuant to back-to-back loan or like arrangements. Claiming a deduction for interest is in effect such a statement,[**] and we do not see the need for anything more.

16. Guarantees.

More troubling than back-to-back loans is the proper treatment of guarantees and similar credit enhancements which, we believe, persent issues quite different than those presented by back-to-back loans. While we have set out below issues that need to be addressed if Regulations with respect to guarantees are issued, we believe there are significant arguments for not issuing such Regulations.

There are two reasons for not issuing Regulations in this area. First, we are concerned that any Regulations issued will have the effect of preventing the use of guarantees for commercial (as distinguished from tax avoidance) reasons unless they contain clear and fairly balanced tests for establishing when a guarantee will cause a loan to fall within Section 163(j). We are not optimistic that guidelines of general applicability meeting these criteria can be developed. The preparation of such guidelines will raise the same intractable issues that were encountered (but not conquered) in drafting regulations under Section 385. Second, as discussed below, the fact that Section 163 (j) does not apply to all related party loans but only to those from tax-exempt persons makes it

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[*] See House Report at 1245.

[**] In addition, reporting of transactions with related foreign persons is required by Section 6038A.

difficult to formulate sensible rules for applying the section to guaranteed loans that are not recharacterized as loans from the guarantor for all federal income tax purposes.

A. Plantation Patterns. To begin with, interest on guaranteed debt that is treated as equity under Plantation Patterns* and like cases is, wholly apart from Section 163(j), not deductible, and we see no need to say anything in Regulations under Section 163(j) about guaranteed debt that is already treated as equity. These cases, however, have treated guaranteed debt as equity only in the most extreme cases and provide little protection against the use of guarantees as a substitute for direct loans from a related party.

B. Other Guaranteed Debt. With respect to other guaranteed debt, the Statement of Managers provides that Section 163(j)

> is not to be interpreted generally to subject third-party interest to disallowance whenever . . . a guarantee [to reduce the cost of third-party borrowings] is given in the ordinary course. On the other hand, the conferees do not intend to preclude Treasury from disallowing interest on a guaranteed

* See Plantation Patterns, Inc. v. Comm'r, 462 F.2d 712, 721 (5th Cir. 1972), cert, denied, 409 U.S. 1076 (1972), in which a corporation with a debt to equity ratio of 30 to 1 borrowed funds with guarantees from its individual shareholder and his controlled investment corporation; after such borrowings, the borrowing corporation's debt to equity ratio was approximately 150 to 1. The court held that the loan was to be treated as made to the shareholder who in turn contributed the proceeds to the corporation.

third- party debt, in appropriate circumstances where the use of guaranteed third-party debt is a device for avoiding the earnings stripping rules . . . .[*]

The statement construes the Treasury's authority under Section 163(j)(7)(A) to issue such regulations "as may be appropriate to prevent the avoidance of the purposes of" Section 163(j) -- in other words, to treat interest on guaranteed debt as paid to a related party only when the guaranteed debt was incurred to avoid Section 163(j).

Since the authority to issue Regulations on guaranteed third-party debt is in Section 163(j)(7)(A), it follows that the first step is to determine the purpose of Section 163(j). Section 163(j)(7)(A) only authorizes regulations "to prevent the avoidance of the purposes of" Section 163(j). This is not a simple inquiry.

The deductibility of interest under Section 163 (j) turns on whether the interest is tax-exempt to the recipient. The purpose of the guarantee rule, therefore, might have been to disallow interest deductions where (a) the interest was not subject to U.S. tax in the hands of the recipient or (b) the interest would not have been taxed if paid to the guarantor.

Both views have their problems and we make no recommendation as to which should be followed.

Under the first view (the "tax-exempt recipient" approach), interest paid on third-party guaranteed debt would not be subject to Section 163(j) if the recipient were a U.S. bank or other lender (or a foreign bank subject to U.S. withholding tax at a 30% rate). This view would be consistent with the notion that Section 163(j) was directed at the erosion of the corporate tax basis, but its adoption would result in a sharp differentiation

[*] Statement of Managers at 567.

between guaranteed debt from U.S. and foreign lenders and have the peculiar consequence of discriminating against unrelated lenders that are covered by U.S. tax treaties.

Under the second view (the “tax-exempt guarantor” approach), interest would be subject to Section 163(j) if it would have been tax-exempt had it been paid to the guarantor. As a consequence, for example, interest paid to a U.S. bank might be subject to Section 163(j) if the loan were guaranteed by a U.K. parent but not if it were guaranteed by a Saudi Arabian parent. In each case the interest would have been subject to U.S. tax in the hands of the bank, but in the first it may also be non-deductible by the issuer because the guarantor is covered by a tax treaty that eliminates withholding on interest that is not portfolio interest. Although the same rule would apply to debt guaranteed by a U.S. tax-exempt investor, thus avoiding any treaty violation, the result is likely to be regarded by U.S. treaty partners as absurd.

Under tax exempt guarantor approach, it would also be necessary to deal with the common practice of multiple, or “cross”, guarantees –- e g., to determine how the rule would apply if there were two guarantors and the interest that would be paid to one was exempt but the interest that would be paid to the other was not.

The Treasury is already aware, we believe, of growing skepticism by our treaty partners of the value of tax treaties with the united States. The disillusionment is attributable to recent treaty overrides and, perhaps even more so, to attempts at even broader overrides. Regulations which use the status of a related guarantor or of an unrelated lender to determine if interest is “tax-exempt” can only increase the cynicism of foreign countries about the value of tax treaties with the United States. The long run economic cost to the United States of such a loss of confidence may be far higher than any revenue gains that will be produced by Section 163(j).

We are aware that a number of foreign countries have rules that apply different, more stringent rules to the deductibility interest on debt held by foreign shareholders and that some take the view that these rules do not violate tax treaties with the United States. This may suggest that the long run solution to some of the difficulties outlined above would be to develop a standardized treaty approach to the treatment of shareholder debt, including shareholder- guaranteed debt.

When a choice has been made between these two approaches, the next step is to determine when guaranteed debt will be subject to Section 163 (j) and when it is not since, as noted at the outset, the Statement of Managers does not authorize regulations that treat all guaranteed debt as subject to Section 163(j) and specifically indicates that a guarantee given in the ordinary course to reduce interest rates will not be so regarded.

What is needed, if Regulations on guaranteed debt are issued, is a clear line since in the absence of certainty borrowers may be forced to do what Congress sought to avoid, i.e., borrow without a guarantee at a higher rate in order to be certain of deductibility. This is an issue that Congress did not come to grips with and as a consequence the legislative history provides no guidance whatsoever on how that line should be drawn.

If Regulations are issued at all under these circumstances, one approach would be to state, as a general rule, that interest on guaranteed third-party debt would not be subject to Section 163 (j) if on all the facts and circumstances the borrower could have incurred the debt without the guarantee, albeit at a higher interest rate and with different financial covenants;

and, in addition, to try to establish presumptions and safe harbors using objective criteria such as the corporation’s debt to equity ratio at the time of borrowing, its projected earnings to interest coverage, other factors that would be regarded as important by unrelated lenders, the presence or absence (and the amount) of unguaranteed third-party debt and other objective indications of the corporation’s ability or inability to borrow on an unguaranteed basis. Objective criteria should obviously be developed only with the assistance of banks and other members of the financial community.

Thus, for example, Regulations might specify that interest on guaranteed debt would not be subject to Section 163(j) if the issuer could have borrowed the same amount without the guarantee, albeit at a higher interest rate and with more onerous financial covenants; and that it would always be regarded as meeting that test if the issuer had a specified debt to equity ratio and projected a specified earnings to interest coverage or had an amount of unguaranteed third-party debt that was significant in relation to its guaranteed debt or was otherwise able to show (for example, by credible third-party evidence) that the principal function of the guarantee was to reduce the interest rate and that substantially the same amount could have been borrowed on substantially the same terms (albeit at a different interest rate) without a guarantee. Conversely, Regulations might specify that guaranteed debt would presumptively be subject to Section 163(j) if the issuer had a debt to equity ratio and/or projected an earnings to interest coverage that fell below stated ratios and there was no other objective evidence to show that the borrowing could not have been made without the guarantee.

In addition, if the Regulations extend Section 163(j) to guaranteed debt, they should address the definition of a guarantee (e.g., the extent to which it will include a pledge of the assets or stock of another corporation) and back-to-back guarantees.

C. Effective Date. Finally, any Regulations that extend Section 163(j) to guaranteed debt should, as indicated in the legislative history,* apply only to debt issued after the date the Regulations are issued. Until that time, Plantation Patterns will be the only relevant rule. In view of the substantial uncertainty as to what Congress contemplated and the importance of clear and certain rules, moreover, we believe that any such Regulations should be issued in proposed form in the first instance.

17. Effective Date/Grandfathered Debt

A. In General. Section 163(j) generally applies to interest paid or accrued in taxable years beginning after July 10, 1989, but Section 163(j)(3)(B) provides that the term “disqualified interest” excludes interest paid or accrued on fixed-term debt “issued” on or before July 10, 1989, or issued after such date pursuant to a written, binding contract in effect on that date and all times thereafter.

The House Report states that “a written contract between related parties will only be treated as binding on a particular date if it could have been enforced on that date (whether on the basis of reliance or otherwise) by an unrelated party”. We assume that this means that the binding effect of a related-party contract will be tested under the legal standards that would be applied between unrelated parties. Since most loan agreements preclude third-party benefits or reliance by their terms, this interpretation of the binding contract test seems less strained than one that would regard a related-party contract as binding only

* Statement of Managers at 567.

if an unrelated third party could enforce the debtor's obligation to repay the related lender.

General guidance with respect to the "binding contract" rules in the 1989 Act is given in Notice 90-6,* including that an otherwise binding contract will not be regarded as not binding because "it is subject to a condition outside the control of the parties". We interpret this to mean that a written contract to issue debt will not be considered unenforceable merely because laws respecting creditors' rights and bankruptcy may limit such enforceability.

B. Modification of Grandfathered Debt. The House Report states that "debt instruments that are renegotiated, assumed, reissued, extended, modified, or otherwise revised after July 10, 1989, shall be treated . . . as new debt instruments that were not outstanding on July 10, 1989".* Legal precedents developed under Section 1001 contain analogous tests for distinguishing taxable exchanges of debt from mere modifications of a debt instrument.** With the qualification set out below, we suggest that the rules applied under Section 163(j) be conformed to the rules applicable under Section 1001.

The approach to debt modification should be governed by a policy to discourage the creation of additional earnings stripping potential. Thus, if debt is modified in a manner that produces less disqualified interest over time, such a modification should not be treated as an issuance of new debt for purposes of Section 163 (j), even if the modification would be a taxable exchange under Section 1001. For example, if the term of a grandfathered debt instrument

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* See House Report at 1249.

** See Rev. Rul. 73-160, 1973-1 C.B. 365; Rev. Rul. 56 435, 1956-2 C.B. 506, mod. by Rev. Rul. 81-169, 1981-1 B. 429; Rev. Rul. 87-19, 1987-1 C.B. 249; Rev. Rul. 89-122, 1989-47 I.R.B. 6 (Nov. 20, 1989).

is shortened, or if the interest rate thereon is reduced, the debt should not be treated as modified for purposes of these rules, assuming no other offsetting changes.

C. Demand loans. Section 7210(b)(2) of the 1989 Act provides a special effective date provision for demand loans outstanding on July 10, 1989. The term "disqualified interest" excludes interest paid or accrued on such demand loans for periods before September 1, 1989. According to the House Report, this extension was provided to allow the refinancing of corporate capital structures employing demand debt.[*] Given this legislative history, should the debt modification rules permit the refinancing of demand debt with related party fixed-term debt without the loss of the benefit of the grandfather provisions? This is hot clear, since the provision might also have been intended to permit unrelated party refinancing without the disallowance of interest received through September 1 or the date of refinancing. In any event, there will be the further, question of the date by which the refinancing should occur. The legislative history suggests that it must be before September 1, 1989, but fairness might permit refinancing prior to enactment of the 1989 Act.

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[*] See House Report at 1250.