

TAX SECTION

New York State Bar Association

Report on Proposed Regulations Relating to
the Allocation of Interest And Other Expenses
for Foreign Tax Credit and Certain Other Purposes

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This report of the Committee on Foreign Activities of U.S. taxpayers comments on Regulations proposed on September 11, 1987 (hereinafter, the "Proposed Regulations")* with respect to the allocation and apportionment of interest and other expenses for foreign tax credit and certain other purposes.**

I: Introduction

Regulations issued prior to the Tax Reform Act of 1986 (hereafter, the "prior Regulations") took the general view that money was fungible and, with a narrow exception for non-recourse debt, that interest expense was therefore allocable to all of the borrower's activities and assets, generally in proportion to its foreign and domestic assets or, within limits, in proportion to its foreign and domestic income. Interest expense was allocated and apportioned on a corporation-by-corporation basis, however, notwithstanding that consolidated returns were filed. Other

* 52 Fed. Reg. 34580 (September 11, 1987).

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expenses were also generally allocated and apportioned on a corporation-by-corporation basis.

Section 864(e)

Subject to transitional rules, Section 864(e) of the Internal Revenue Code, added by the Tax Reform Act of 1986, in effect amends the prior Regulations to provide that the interest expense of an "affiliated group" must be allocated and apportioned "as if all members of [the] group were a single corporation."* Stock and intra-affiliated group loans are disregarded, and the allocation is made on the basis of the tax book value or fair market value of the group's assets, not its gross income. The basis of stock in an unaffiliated corporation in which the group owns at least 10% of the voting power is adjusted for the issuer's earnings and profits.

The affiliated group rule also applies to expenses other than interest which are not "directly allocable or apportioned to any specific income producing activity." In allocating and apportioning interest or any other deductible expense, assets producing income that is wholly (as in the case of interest on tax-exempt bonds) or partially (as in the case of dividends eligible for the partial dividends received deduction) exempt are wholly or partially excluded.

Under an exception to the affiliated group apportionment rule, a bank or a thrift (a so-called "financial institution"), together with any other bank or thrift that would otherwise be in the affiliated group, is treated as part of a separate affiliated

* The prior Regulations were issued to under Section 861(b), which generally provides for the proper allocation and apportionment of expenses between U.S. and foreign source income and among statutory groupings of foreign source income.

group if its business is not predominantly with related persons or their customers and it is required by State or Federal law to be operated separately from any other non-financial institution. The exception applies to interest but not other expenses. Under the Technical Corrections Act, a financial institution would, to the extent provided in Regulations, include a bank holding company or a subsidiary of a bank holding company that was predominantly engaged in a banking, financial or similar business.

II: SUMMARY OF COMMENTS

The Proposed Regulations provide useful guidance with respect to a large number of issues under Section 864(e), including the effect of borrowings by partnerships and the scope of the special rule for certain nonrecourse indebtedness. Although we have taken issue with a number of the rules in the Proposed Regulations, we commend the Internal Revenue Service for the evident effort made to implement Section 864(e) in a comprehensive way.

Our Report generally follows the sequence of the Proposed Regulations and, like the Proposed Regulations, assumes enactment of the Technical Corrections Act. We have generally not commented on provisions of the Proposed Regulations relating to DISCs and FSCs. In summary of what is set out at length hereafter, our principal comments are as follows:

(1) The rules relating to the asset methods of apportionment should not require consistency among related taxpayers, other than members of an affiliated group or individuals filing joint returns. Guidance should be provided with respect to the circumstances under which fair market value

apportionment will be accepted, and a new election to switch to fair market value apportionment should be given taxpayers for the first taxable year beginning after 1986.

(2) Assets of a Section 936 corporation which produce income eligible for a credit should be treated as tax-exempt assets.

(3) Regulations should be issued to implement the rule, set out in the legislative history, that would prevent sales and other transactions within a consolidated group from increasing the tax basis of assets for purposes of apportioning interest.

(4) The loss from a sale of receivables should not be treated as interest expense, and a purchase of recourse receivables that is financed with nonrecourse debt should be eligible for the rule that provides for a direct allocation of interest expense on certain nonrecourse indebtedness.

(5) A number of changes should be made to the special rule for certain nonrecourse debt, including clarification that interest on such debt will be allocated solely against the income from the collateral, clarification of the definition for that purpose of "property", expansion of the rule for interim financing, elimination of the prohibition on third party recourse, modifications to the related party transaction rules and expansions to the rules for refinancings and post-construction permanent financings.

(6) Regulations should be issued under Section 864(e)(7)(B), relating to integrated financial transactions, and should provide rules that taxpayers (as well as the Internal Revenue Service) may rely on.

(7) Interest incurred by individuals to purchase a primary residence should not be apportioned to the individual's gross income, the calculation of the \$5,000 de minimis exception should be clarified and it should be made clear whether the rules for individuals also apply to trusts and estates (or, if that is not the case, what rules do apply to estates and trusts).

(8) The rules relating to partnership borrowings should provide a functional definition of a general and a limited partner, should reconsider the rule that invariably treats a less than 10% interest held by a corporate general partner as a "passive" interest, and should look to the partner's basis for its partnership interest (rather than the partnership's basis for its assets) in apportioning interest by the tax book value method.

(9) The rules relating to borrowings by corporations should define "assets" for the purpose of determining whether assets are single or multiple category assets, should not eliminate from the apportionment fractions assets that "contribute equally to the generation on all income" or have "no directly identifiable income yield," and should apportion interest on the basis of the use of assets (rather than the income produced).

(10) We do not believe that Congress contemplated the Regulations that would include in an affiliated group corporations that would otherwise be excluded by the definition in Section 864(e)(5).

(11) Regulations should provide that life insurance and non life insurance companies that are affiliated are members of the same affiliated group (whether or not there has been 5 years of affiliation or an election to form a single affiliated group)

but should in such a case ensure that life and non-life companies that are ineligible to file consolidated returns are no worse off for being treated as members of the affiliated group than if such returns had been filed.

(12) Changes should be made to the rules that allocate the assets and interest expense of a bank holding company between financial and nonfinancial groups in order to properly attribute the assets and interest expense of the bank holding company between the two groups.

(13) Regulations should implement Section 864(e)(6), relating to the allocation of expenses not directly allocable or apportioned to any specific income producing activity.

(14) The rules relating to affiliated groups not filing consolidated returns should be changed, so that the loss recharacterization is not limited to income of other members within the same limitation category as the loss (which might put the group in a better position than if consolidated returns had been filed).

(15) Interest on debt within the affiliated group should be eliminated (not allocated to the class of gross income in which the lending member includes the interest income).

(16) The earnings and profits adjustments for more than 10% owned affiliates should be modified in a number of respects, including limiting the adjustments (for example, to post-1962 earnings and profits), making the adjustments with respect to indirectly owned affiliates, and not treating all disproportionate contributions as disguised transfers.

(17) The attribution of the book or tax value of stock of a controlled foreign corporation should be simplified and there should be no attribution to separate limitation categories of stock of related but not affiliated domestic corporations.

(18) The rule that matches third party interest expense against interest income from controlled foreign corporations should be eliminated.

(19) The Regulations relating to the transitional rules should define related party debt, exclude non-interest bearing debt, calculate the reduction for paydowns on a monthly basis, focus on transitional interest expense rather than transitional debt, specify when average rather than month-end debt should be used, and clarify the application of the transitional rules when interest is suspended, capitalized or specifically allocated.

III: Methods of Asset Apportionment

(Prop. Regs. §1.861-8(c)(2))

Proposed Regulations §1.861-8(c)(2) sets out the two methods of asset apportionment (tax book and fair market value) that, under other provisions of the Proposed Regulations, must be used by corporations and ordinarily by individuals as well in apportioning interest expense. We have three comments on these rules, as follows:

(1) Proposed Regulations §1.861-8(c)(2) provides that the choice between apportionment on a tax book or fair market value basis, once made, must be consistently followed by the

taxpayer and all related parties within the meaning of Section 267(b).^{*} We question the scope of the consistency requirement. Why should there be consistency between, for example, a father and son? In addition, it is not clear how this will work -- suppose one related party uses fair market value and other tax book, who will prevail?, Suppose one party becomes related to another because of changes in the value of the stock? It seems to the Committee that, in the case of corporations, the consistency requirement should be limited to members of the same affiliated group and that there should be no consistency requirement in the case of individual taxpayers filing separate returns. The election for an affiliated group filing consolidated returns would be a consolidated return election; the final Regulations under Section 864(e) should specify which election controls when there are different elections by members of an affiliated group that does not file consolidated returns.

(2) The final Regulations should provide guidance as to how a taxpayer seeking to use fair market value apportionment may establish the fair market values to the satisfaction of the Commissioner, i.e., the circumstances under which an election to apportion on the basis of fair market values might be invalidated. For example, to what extent will appraisals be required as a condition to fair market value apportionment? While the Internal Revenue Service should retain the right to question on audit specific fair market values, the final Regulations should prescribe the circumstances under which the inquiry will involve adjustments to values as opposed to the validity of the overall election to apportion on a fair market value basis. While the prior Regulations were silent on this point, guidance is

^{*} The rules would also arguably require consistency of method for allocations made for different purposes -- e.g., in apportioning the interest expense of an affiliated group and in determining the earnings and profits of a related controlled foreign corporation.

important because of the increased importance of apportionment on the basis of asset values.

(3) A choice to switch from fair market to tax book value apportionment should be given to taxpayers for the first taxable year beginning after 1986. Because of the extensive changes in the rules for apportioning interest, a taxpayer should not be stuck with an election of fair market value apportionment made under the prior Regulations. It might also be appropriate to specify how an election to use a method of apportionment should be made.

IV: Tax-Exempt Assets
(Prop. Regs. §1.861-8(d)(2))

Section 864(e)(3) provides that a "tax-exempt asset" and income from such an asset "shall not be taken into account" for the purposes of allocating and apportioning interest or any other deductible expense and that a "similar rule" shall apply with respect to that portion of any dividend eligible for the dividends received deduction and to a portion of any stock that corresponds to the deduction allowed for dividends on the stock.*

In the case of interest expense, Section 864(e) in effect attributes the ownership of tax-exempt assets solely to equity, i.e., assumes that no debt was incurred or continued to purchase or carry any tax-exempt asset or the portion of any

* Although Section 864(e)(3) says that tax-exempt assets and income are to be excluded in allocating and apportioning interest and other deductible expenses, the Proposed Regulations take tax-exempt income into account in allocating deductions that are definitely related to a class of income. The result is correct, but this is inconsistent with the statute (unless it can be justified under the "except as provided in regulations" language of Section 864(e)).

stock corresponding to the deduction allowed for dividends on the stock.

Excluding assets which do not produce taxable income (and thus do not contribute to the denominators of the fractions which limit the foreign tax credit) seems correct where the related interest expense has also been excluded, but otherwise it is ordinarily a harsh rule (and contrary to the basic concepts that money is fungible) since it allocates the related interest expense to the assets that remain.* In an extreme case, where the tax exempt assets exceed the taxpayer's equity, the assets used in apportioning interest expense will be less than the debt that is taken into account.

In most cases this is taken care of by Proposed Regulation §1.861-8(e)(2)(iii), which provides that interest expense disallowed under Sections 265, relating to interest on debt incurred or continued to purchase or carry tax exempt obligations, is not subject to allocation or apportionment. Where Section 265 does not apply (because, for example, of the administrative de minimis rule or the grandfather exceptions to Section 265(b)), however, it is arguable, as a foreign tax credit matter, that there should be a direct allocation of a portion of the taxpayer's interest expense to the income produced by any tax exempt or other asset that is excluded from the apportionment formula. While the failure to do so can be justified as a way of ameliorating deficiencies in provisions of the Code, such as Section 265, that are generally intended to disallow a deduction for interest expense attributable to tax exempt income, the resulting additional disallowance applies only to U.S. taxpayers with foreign operations. The exclusion of tax exempt assets thus,

* In the case of a foreign corporation, when the shoe is on the other foot, Prop. Regs. §1.861-8(d)(2)(iii) provides that assets that produce income not effectively connected with a U.S. business (and such income) are not "tax-exempt".

in effect, disallows deductions to multinational businesses in circumstances where purely domestic enterprises would have suffered no tax detriment.*

Definition

The Proposed Regulations define exempt income as income that is "in whole or in part" either "exempt, excluded or eliminated" for Federal income tax purposes, and tax exempt assets as any asset the income from which qualifies as exempt income.** Apart from obligations described in Section 103, however, there are no examples in the Proposed Regulations, and further clarification of the definition would be useful.*** The specific statement that assets and income of a Section 936 corporation are not tax exempt suggests that income that is effectively not taxed, because of related credits or deductions, may in other cases be regarded as tax exempt. We do not think that should be the rule, except (as discussed below) in the case of Section 936 corporations and FSCs.

Section 246A

The preamble to the Regulations asks whether interest that reduces the dividends received deduction under Section 246A of the Code should be taken into account in apportioning interest expense. It follows from what is said above that the Committee

* For example, a financial institution that incurs \$100 of interest expense to carry \$500 of tax-exempt securities and \$500 of domestic taxable securities might be entitled to deduct \$50 of interest under the grandfather exceptions to Section 265(b)(2), but if the taxable assets consist of a foreign operating subsidiary worth \$250 and \$250 of domestic debt securities, the institution may lose the benefit of one half (as opposed to one quarter) of its interest deduction as a result of the failure to take account of its tax-exempt assets in apportioning interest.

** Prop. Reg. §1.861-8(d)(2)(ii).

*** Prop. Reg. §1.861-8(g), Example 24(ii).

thinks that such interest expense should be allocated solely to the resulting increase in taxable income. This is consistent with the legislative history of the Act as enacted.* In addition, the Technical Corrections Bill would, in new Section 864(e)(7)(D), specifically authorize regulations providing for the direct allocation of interest expense in the case of indebtedness resulting in a reduction to the dividends received deduction under Section 246A.

Section 936 Corporations; FSCs

The Committee questions the rule in Proposed Regulations §1.861-8(d)(2)(iii) which excludes the assets of a Section 936 corporation from the definition of "exempt assets", notwithstanding that the income of a Section 936 corporation is (through the operation of the credit allowed by Section 936(a)) generally exempt from Federal income tax. Under Section 904(b)(4), the foreign source income produced by such assets is not taken into account for purposes of foreign tax credit limitations. The inclusion of assets that produce such excluded income in the apportionment fraction takes away much of the benefit granted under Section 936 to investments in Puerto Rico and other possessions because it results in the apportionment of additional interest expense to foreign source income from wholly unrelated activities, and we question whether this was intended by Congress.**

* See Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (1987) (hereinafter referred to as the "Blue Book") at 949.

** See, e.g., footnote 10 on page 947 of the Blue Book.

Consideration should also be given in the Final Regulations to providing specifically that a portion of the stock of an FSC, and the dividends therefrom, are tax exempt assets and income. Failure to do so will invariably create a foreign source loss in the FSC separate limitation basket and might also be regarded as inconsistent with the purposes of the FSC provisions. This can be accomplished by providing under Prop. Reg. Section 1.861-8(d)(2)(ii)(B) that dividends eligible for the dividends received deduction under Section 245(c) and a corresponding portion of the stock in a FSC are tax-exempt income and assets.

Application of Valuation Rule to Tax Exempt Assets

Under Proposed Regulations §1.861-8(e)(2)(viii)-(C), the asset method of apportionment is generally based on a beginning-year and year-end average of book or market values unless that results in a "substantial distortion". There will be a natural incentive to not hold tax-exempt assets on the two valuation dates (and this will be relatively easy to arrange in the case of marketable securities). Some refinement of the valuation rule might therefore be appropriate for tax exempt assets.

Transfers Within the Group

Related to the treatment of tax exempt assets is the treatment of increases in the tax basis of assets that result from sales and other "deferred intercompany transactions" that do not currently affect the taxable income of an affiliated group that files consolidated returns.

While the legislative history of Section 864(e) says that Congress "intended that regulations provide appropriate safeguards to prevent" basis step-ups within a consolidated

group,^{*} the treatment of deferred intercompany transactions is not addressed by the Proposed Regulations. Thus, the Proposed Regulations would permit a taxpayer that apportions interest expense on the basis of tax book values and files consolidated returns to use the higher tax basis resulting from a sale of appreciated property by one member of the affiliated group to another.

It seems to the Committee that, for the purposes of apportioning of interest expense, the final Regulations should allow a step up in the basis of assets only to the extent that a corresponding amount of income has been recognized by the seller.^{**} (This rule would not apply, however, to step-downs in basis, notwithstanding that the loss from the sale has been deferred or suspended, since there is no indication in the legislative history that tax basis was to be adjusted in such a case.)

V: Treatment of Receivables

(Prop. Regs. §1.861-8(e)(2)(ii) and (iv))

The Proposed Regulations provide two rules with respect to accounts receivable ("receivables"): (1) The loss on the sale of a receivable generated in the ordinary course of business is treated as interest expense for purposes of allocation and apportionment and (2) the interest expense on a nonrecourse loan incurred to purchase the recourse receivables of a third party is excepted from the rules treating qualifying nonrecourse purchase

^{*} See Blue Book at 951-2.

^{**} This would be consistent with Prop. Regs. §1.861-8(d)(2)(i) which treats deferred income as exempt until recognized.

money debt as definitely related to specific property.*

For the reasons set forth below, we think both rules should be eliminated from the final Regulations.

Treatment of Receivables Sales

Proposed Regulations §1.861-8(e)(2)(ii) treats the excess of the face amount of a receivable over the amount received therefor as interest expense. We question whether this was contemplated by the enactment of Section 804(e).

To begin with, we do not regard sales of receivables as abusive per se. Since the allocation of interest expense under Section 864(e) is based on the taxpayer's assets, there is an incentive for taxpayers to dispose of relatively liquid assets, such as receivables, and pay down (or not incur) debt to carry those assets. This follows naturally from the use of assets as the basis for allocation and it is not apparent to the Committee why it should be regarded as abusive. To be sure, some purported "sales" of receivables may be simply secured loans to the "seller" (depending on facts such as the liability for customer defaults), but the loss in such a case would be interest expense under case law principles without regard to regulations issued under Section 864(e).

Nor can the treatment of the loss be justified as a matter of theory. While one element of the loss sustained on a sale of a receivable is an "interest factor" (i.e., the time value of the delay in the payment of the receivable), of equal or greater importance are the risk of customer.

* Prop. Regs. §§1.861-8(e)(2)(ii) and (iv)(E)(2).

default and the purchaser's cost of administering and collecting the receivables; and the "interest factor" does not result from a borrowing by the seller but is attributable to the fact that the tax basis of an asset, contrary to principles followed in other areas (such as under Sections 483 and 1274), is not discounted to reflect the interest to be earned by the seller on the asset. It is not compensation paid by the seller for the use of borrowed money but an overstatement of the seller's assets (arising from an overstatement of income by an amount which, in a precise world, should be treated as interest income to be accrued over the period before the account receivable is collected).

To take a simple example, assume an accrual basis corporation sells inventory for \$100, due 30 days later but with a \$2 discount if payment is made within 10 days. The seller would normally include \$100 in gross receipts* and, if it then sold the receivable for, say, \$95, it sustains a "loss" of \$5. This loss is attributable to two things -- first, the risk of customer default and the cost of administering and collecting the receivable; and, second, to the fact that as a matter of tax accounting \$100 (not \$98) was included in gross receipts at the time of sale. Put differently, had the taxpayer sold inventory for, say, \$98 plus \$2 of interest if payment was not received for 30 days, the "loss" would be \$3 and would be solely attributable to the risk of default.

The Proposed Regulations thus make the treatment of a sale of receivables depend in part on the form of the seller's inventory transaction -- i.e., on whether interest is charged or stated as a cash discount. They also turn what would normally

* See Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934); Rev. Rul. 72-292, 1972-1 C.B. 67. In neither Spring City nor Rev. Rul. 72-292, however, was it clear that accrual of \$100 would be required if a prompt payment discount was allowed.

have been a domestic source expense into interest that may be apportioned to foreign source income and thus put taxpayers which sell receivables in a worse position than if they had retained the receivable and borrowed the maximum loan value (since any costs of collection or losses on a default would, in the case of a domestic receivable, have been U.S. source deductions*).

The prior Regulations did not treat a loss on the sale of a receivable (or any other asset) as interest expense and there is nothing in the legislative history of Section 864(e) that suggests a change was contemplated by Congress. To the contrary, the legislative history says that the determination of what is interest is to be based on a substantive analysis of whether it is interest.** And the ongoing dispute with respect to the treatment of receivables sales for other purposes (e.g., in Sections 864(d) and 956(b)(3)***) indicates that Congress was sufficiently aware of receivables sales to have dealt with the problem under Section 864(e) had it wanted to do so. Nor has case law ever treated the loss on a sale of receivables as interest.

* See Prop. Regs. §1.861-8(e)(2)(viii)(B).

** Blue Book at 947-48. See also S. Rep. 99-313, 99th Cong., 2d Sess. (1986) at 353.

*** Section 864(d) treats income on certain receivables acquired from related parties as interest income for specified purposes; and Section 956(b)(3) treats certain receivables due from U.S. persons and acquired from related persons as "United States property" for purposes of the rules relating to investments in United States property.

There may, of course, often be only a very fine distinction between a sale of receivables and a secured loan (and, as noted above, our comments are directed only at transactions that are treated as sales under general principles). Under these circumstances, the Internal Revenue Service might consider taking a clear position as to when a transfer of receivables is or is not a sale or, indeed, might seek legislation that provides a general rule for transfers of receivables. Any such position or rule, however, ought to apply across the board and not simply for the purposes of allocating and apportioning expenses for foreign tax credit and certain other purposes. To have a special rule in that area will add to the proliferation of rules that treat the same transaction differently for different purposes.

Debt Incurred to Purchase Recourse Receivables

Proposed Regulations §1.861-8(e)(2)(iv)(A)(3) provides that the rule which permits the allocation of interest on certain nonrecourse debt solely to the income from the collateral does not apply where there is recourse against a third party, and Proposed Regulations §1.861-8(e)(2)(iv)(E)(2) specifically disqualifies recourse receivables. Where recourse receivables are purchased, therefore, they will always be taken into account in the apportionment of the purchaser's interest expense, notwithstanding that the purchase may have been made with nonrecourse debt that otherwise satisfies the nonrecourse debt rule.*

* Because of the "purchase" requirement of Prop. Regs. §1.861-8(e)(2)(iv)(A)(1), which is unchanged from the prior Regulations, there would not seem to be any way that borrowings by the taxpayer which generated receivables could satisfy the nonrecourse debt rule.

The nonrecourse debt rule of the prior Regula-

The nonrecourse debt rule of the prior Regulations, which is what Congress intended to continue, did not exclude recourse receivables (or other obligations as to which there was recourse against a third party).^{*} For the reasons set forth below (see Nonrecourse Debt - Third Party Recourse), we think the prohibition on third party recourse ought to be eliminated generally and as it applies to recourse receivables.

VI: Disallowed, Suspended or Capitalized Interest
(Prop. Regs. §1.861-8(e)(2)(iii))

Capitalized Interest

Under Proposed Regulations §1.861-8(e)(2)(iii)(A), interest expense that is permanently disallowed (for example, by Section 265)) is not subject to allocation or apportionment. In addition, Proposed Regulations §1.861-8(e)(2)(iii)(B) provides that interest which is capitalized under Section 263A is allocated and apportioned as part of, and in the same manner as, the cost of goods sold or the relevant depreciation deduction. The Proposed Regulations do not provide rules, however, for the allocation and apportionment of interest expense which is capitalized on an elective basis under Section 266 of the Code or under the "full absorption method" of accounting for the cost of goods sold.^{**} We believe that the final Regulations should clarify that such interest expense is also allocated and apportioned as part of,

^{*} We note in any event that the purchase of recourse receivables should not be under "Cross collateralization" since the lender's rights are against a third party, not the borrower.

^{**} Under Section 266, a taxpayer may elect to capitalize interest expense on a loan incurred to purchase personal property. Reg. §1.266-1(b)(1). Under Reg. §§1.471-11(c)(1) and (2), a taxpayer may under certain circumstances include an allocable portion of its interest expense in inventory costs.

and in the same manner as, the cost of goods sold or the relevant depreciation deductions.

Proposed Regulations §1.861-10(c)(6) reduces the tax book or fair market value of an asset during its construction period by the principal amount of any debt in respect of which the interest is capitalized under Section 263A. The theory of this rule, which seems logical to us, is that the property was financed with debt the interest on which was capitalized and that, under these circumstances, it is appropriate to remove a corresponding portion of the tax book or fair market value of the asset from the apportionment fractions. At the point at which the interest becomes currently deductible, the asset is treated like any other or, put differently, the Proposed Regulations revert to the fungibility rule. If, as we have suggested, the rule which excludes capitalized interest from allocation and apportionment is extended to interest capitalized under Section 266 or as part of the full absorption method of accounting, a similar adjustment would be appropriate in such cases.

Suspended Interest Expense

Proposed Regulations §1.861-8(e)(2)(iii)(D)(1) provides for the allocation and apportionment of interest expense that is suspended under the passive activity loss rules of Section 469. Such interest expense is allocated and apportioned in the subsequent taxable year in which it may be deducted as though it were incurred in such subsequent taxable year. Proposed Regulations §1.861-8(e)(2)-(iii)(D)(2) provides rules for determining what portion of a suspended passive loss that is deducted in a subsequent taxable year consists of passive interest expense. Specifically, the portion of the taxpayer's aggregate suspended interest expense that is treated as deducted

in a subsequent taxable year is determined by multiplying such aggregate suspended interest expense by the percentage of the taxpayer's aggregate suspended passive losses that become deductible in such subsequent taxable year. In other words, the Proposed Regulations aggregate all of the taxpayer's suspended interest expense and all of the taxpayer's suspended passive losses for purposes of characterizing its deductions, without reference to the specific businesses in respect of which the expenses are incurred.

This approach is not consistent with the treatment of passive losses mandated by Section 469. Under Section 469, deductions which are disallowed for the year in which they are incurred may be deducted in the next succeeding taxable year, provided that they are not likewise disallowed in such subsequent taxable year by reference to the amount of net income derived from the passive activity with which they are connected. If the taxpayer disposes of his entire interest in a passive activity, moreover, the disallowed expenses related to that activity are deductible in full. No portion of such expenses remain suspended by reference to the taxpayer's aggregate passive activities.

Thus, suppose a taxpayer has interests in two passive activities. The interest in Passive Activity A generates \$100 of suspended interest expense in year one. The interest in Passive Activity B generates \$100 of suspended non-interest expenses in year one. Under Section 469(g), the disposition of either interest in year two results in the deduction of all of the expenses relating to that interest. Under the Proposed Regulations, however, the disposition of either interest in year two would result in the deduction of \$50 of suspended interest expense from Passive Activity A and \$50 of the suspended non-interest expense from Passive Activity B.

Proposed Regulations §1.861-8(e)(2)(iii)(D) likewise provides, by reference to Proposed Regulations §1.861-8(e)(2)(v)(C), that suspended interest expense which is deducted in a subsequent taxable year is apportioned "on the basis of the individual's passive activity assets." While this language is not entirely clear, it suggests that the taxpayer's passive assets are aggregated for this purpose and that an allocable portion of suspended interest expense must be deducted against income from unrelated passive activities. Under Section 469, however, suspended interest expense is deducted solely against income from the passive activity to which it relates. In the taxable year in which a taxpayer disposes of its interest in a passive activity, suspended interest expense relating to that activity is deducted first against income or gain from that activity and only then against income from other passive activities. Section 469(g).

VII: Bonds Issued at a Premium

The Proposed Regulations do not contain any rule for the treatment of bonds issued at a premium. Regs. §1.61-12(c)(2) requires an issuer to amortize into income the excess of the issue price of a debt obligation over its stated redemption price (excluding any portion thereof attributable to a commission feature) over the life of the obligation. It does not, however, authorize the issuer to treat such amortization as a reduction in the amount of its interest payments. A technical corrections to the Tax Reform Act of 1986 would clarify that the premium which the holder of a debt obligation amortizes out of income is not treated as an interest deduction but rather as an offset to the interest income on the bond. The issuer of the obligation should likewise be entitled to treat the premium as an offset to the amount of interest paid on the bond and we think the final Regulations should so provide. Otherwise the issuer would be

required to allocate overstated interest deductions among its worldwide activities.

VIII: Nonrecourse Debt

(Prop. Regs. §1.861-8(e)(2)(iv))

Overview

Prior Regulations treated interest on certain nonrecourse debt as definitely related to specific property.* According to the Blue Book (which reflects the Ways and Means and Senate Finance Committee Reports),

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

The nonrecourse debt rule of the prior Regulations was rarely important because of the ability to solve apportionment problems by the use of separate corporations. Because of the enactment of Section 864(e), the need to improve the rule is evident and we thus support many of the changes made by the Proposed Regulations, including particularly those which address situations (such as refinancing and post-construction financing) which were not addressed in the prior Regulations. We doubt that the nonrecourse debt rule of the prior Regulations was really workable in most cases and accordingly disagree with those commentators on the Proposed Regulations who have suggested that no changes whatsoever should be made to that rule. Some changes to the nonrecourse debt rule of the prior Regulations, however,

* Treas. Reg. §1.861-8(e)(2)(iv).

** Blue Book at page 947.

add new restrictions which do not appear to have been contemplated by Congress.*

General Rule

Proposed Regulation §1.861-8(e)(2)(iv)(A) provides that, if the existence of certain specified facts and circumstances is established, "the deduction for interest shall be considered directly allocable solely to the class of gross income which a specific property generates, has generated, or could reasonably be expected to generate." This language does not allocate interest on qualifying nonrecourse debt directly to the gross income generated by the property subject to such debt (which is clearly contemplated**) but instead allocates such interest to the class of gross income generated by such property. If the taxpayer has other gross income in the same class but in different statutory or residual groupings, the interest on nonrecourse debt secured by a specific property would have to be apportioned among such groupings. Although Regs. §1.861-8(e)(2)(iv) contains substantially similar language, the allocation of interest expense directly to the gross income generated by the specific property subject to the nonrecourse debt is accomplished by Regs. §1.861-8(e)(2)(iv)(B), which states that " . . . the interest deduction shall be allocated solely to the gross income derived from the specific property and

* The legislative history suggests that Congress contemplated an expansion, not a contraction, of the nonrecourse debt rule. See, e.g., Blue Book at 947, stating that "Congress did not intend to preclude [the Internal Revenue Service] from treating other debt, including recourse debt, as definitely related to specific property"

** See e.g., clause (ii) of the Example in Prop. Reg. §1.9-61-8(e)(2)(vi)(E); see also Prop. Reg. §1.861-8(e)(2)(iv)(F).

apportioned accordingly." It is recommended either that such language, which was omitted from the Proposed Regulations, be restored or that the first sentence of Proposed Regulations §1.861-8(e)(2)(iv)(A) be modified by deleting the words "class of." The second approach omits the intermediate step of allocating the interest expense to a class of gross income, which step must -- if direct allocation to income generated by the specific property subject to the nonrecourse debt is the objective -- be followed by apportionment among the statutory and residual groupings in the class solely by reference to the income derived from, such property. This intermediate step does not appear to serve any function, and it would simplify the regulation if the second approach were adopted. Where the "specific property" consists of several items, it may be necessary in some cases to allocate the debt among such items. In such cases, if tracing is not possible, a rule similar to that found in Regs. §1.956-1(e)(1) for allocating the debt among the various items would make sense.

Definition of Property

The Proposed Regulations set forth five conditions that must be met in order for interest expense to qualify for direct allocation. The first of these conditions is similar to that set forth in current Regs. §1.861-8(e)-(2)(iv)(A)(1), except that the Proposed Regulations create some confusion by using the term "identified property," rather than "specific property," the term used earlier in Proposed Regulations §1.861-8(e)(2)(iv)(A).^{*} Of the two terms, "identified property" seems preferable, since it implies (consistent with the comments which follow) that a

^{*} Note also that Prop. Reg. §1.861-8(e)(2)(iv)(B) uses "specific property," while Prop. Reg. §1.861-8(e)-(2)(iv)(E) flips back to "identified property."

nonrecourse loan is tested with respect to the property identified in the financing documents (and not with respect to each item of property as it may be defined for other tax purposes).

It would be useful for the Regulations to provide an explicit definition of "property" for the purposes of Proposed Regulations §1.861-8(e)(2)(iv). In general, we believe that the definition should include any group of assets (whether or not consisting of separate items of "property" as determined for other tax purposes) if they would normally be financed as a single unit.

For example, it has generally been understood by practitioners that the reference in the prior Regulations to "specific property" did not prohibit the use of nonrecourse debt either to finance a facility consisting of various items of property or to finance the acquisition of a number of items of property (e.g., five rail cars). Such situations should qualify for direct allocation treatment, so long as the tests of the Proposed Regulations are satisfied when the various items are treated in the aggregate as the "specific property" (or "identified property," as the case may be).

Another example of the need for a definition relates to mineral properties. Under Section 614, there is a narrow definition of "property" in the case of oil, gas and other minerals;* application of that rule for purposes of Section 864(e) would effectively exclude any oil, gas and other mineral

* Under which, for example, a taxpayer's interest in a single or gas well may consist of several properties; and which may be affected by elections made by the taxpayer.

property from the nonrecourse debt rule.* It is unlikely that this was intended.

The final Regulations should consider whether shares of stock of a related corporation should not be specifically excluded from the definition of "property" (since otherwise the nonrecourse debt rule could apply to interest on a borrowing that looked to the related corporation's assets generally).

Debt Incurred to Maintain Property

The Proposed Regulations, unlike the existing Regulations, do not permit debt incurred for the purpose of "maintaining" property to qualify for direct allocation. While this result seems correct for repairs the cost of which is currently deductible, it should be possible to finance the cost of expenditures chargeable to capital account with respect to the property, which, as a technical matter, might not necessarily constitute "improvements," with nonrecourse debt that can qualify for direct allocation. Accordingly, it is suggested that Proposed Regulations §1.861-8(e)(2)(iv)(A)(1) be amended to read as follows: "... purchasing or improving, or making other expenditures properly chargeable to capital account with respect to, specific property".** This would be a clarification of the prior Regulations and therefore would not be inconsistent with the Congressional intent to continue those Regulations.

* Regs. §1.614-1(a)(1) provides that the property definition applies "for purposes of subtitle A", although Section 614 itself says that the definition is only for depletion purposes.

** A conforming change would be necessary in Prop. Reg. §1.861-8(e)(2)(iv)(A)(2).

Interim Financing

The effect of Proposed Regulations §1.861-8(e)-(2)(iv)(A)(2) is to require that debt, in order to qualify for direct allocation, must be incurred at the time of the purchase or improvement of the specific property. Because of the volatility of debt markets and the complexity of certain financings, however, it is not always possible to arrange acceptable long-term financing as of the date on which property is purchased. In ordinary commercial practice, debt placed on a property after its purchase may, in some circumstances, be treated as purchase money debt. For example, for purposes of §1110 of the U.S. Bankruptcy Code, which grants special treatment to certain purchase money lenders, it is generally believed that debt placed on qualified property within a reasonable period (perhaps as long as a year) after its purchase may qualify for such special treatment if there was a clear intention at the time of purchase to subject the property to debt within such period.

Regs. §1.897-1(o)(2)(iii), which sets forth the manner in which property is to be valued for purposes of Sections 897, 1445 and 6039C of the Code, takes account of the foregoing concerns by treating debt obtained after the completion of purchase or construction as secured purchase money debt -- which is treated as a specific charge against the collateral and reduces its value -- if such debt is "obtained in replacement of construction loans or other short-term debt within one year of the acquisition or completion of the property." Proposed Regulation §1.861-8(e)(2)(iv)(D) contains a similar rule for debt obtained by a taxpayer who constructs property. We recommend that a taxpayer who purchases property should be treated in a similar manner under the Proposed Regulations.

The Proposed Regulations require that the loan proceeds be used to "purchase or improve the identified property." The use of such proceeds to pay other costs of acquiring property (e.g., brokerage and professional fees) and of arranging the financing, or of other costs that are capitalized, should also be permitted.

For the foregoing reasons, we believe that nonrecourse debt which is incurred within one year (or if longer, within 10% of the remaining estimated useful life of the property) after the purchase, improvement or (as set forth above) maintenance of property and which does not exceed the sum of (a) the purchase price or the cost of the improvement or the maintenance and the related acquisition, etc. costs and (b) the costs of arranging the financing should be able to qualify for direct allocation if either (1) the proceeds are used to pay off temporary financing incurred to purchase the property or finance the improvement or maintenance or (2) the taxpayer otherwise establishes that permanent long-term financing was contemplated at the time of purchase, improvement or maintenance.

Third Party Recourse

Proposed Regulation §1.861-8(e)(2)(iv)(A)(3) is intended to limit direct allocation to secured debt that is nonrecourse to the borrower. The logical frame of reference for this purpose would be the borrower, and the inquiry should be whether other assets of the borrower or the borrower's general credit are directly or indirectly subject to the claims of the creditor with respect to the debt. The Proposed Regulations, however, approach the issue from the frame of reference of the lender and inquire as to whether the lender has recourse to other property, the borrower or any third party. This will prevent debt subject to certain forms of third-party credit enhancement (e.g., bank

guarantees, letters of credit or arrangements involving guaranteed investment contracts) from qualifying for direct allocation, even though such credit enhancement involves no direct or indirect recourse against the borrower or any of its assets other than the specific property securing the debt and may, for that matter, be obtained or created by a third party not acting on behalf of the borrower. Such credit enhancement arrangements are, in some cases, essential to arranging long-term financing. So long as such arrangements do not permit any direct or indirect recourse (either by the lender or the party providing the credit enhancement) to the borrower or assets of the borrower other than the specific property (or to a related party or its assets), we believe that such arrangements should not prevent debt from qualifying for direct allocation.*

The Committee is also concerned that the third-party recourse rule of the Proposed Regulations might be interpreted to disqualify nonrecourse borrowings on account of features present in almost any nonrecourse borrowing -- for example, provisions entitling lenders to insurance proceeds in the event of the complete or partial destruction of the property or assignments for the benefit of the lenders of contracts to sell the output from the property (which may have an inherent value at the time of assignment).**

One minor clarification in the language of Proposed Regulations §1.861-8(e)(2)(iv)(A)(3) should also be made. It is

* Excessive payments to parties providing credit support, which may suggest abuses, will be limited by Prop. Regs. §1.861-8(e)(2)(iv)(A)(4) and can in any event be dealt with by recharacterizing the transaction.

** In this connection, the exclusion of assets as to which there is third party recourse is not consistent with the rule as a whole, since debt incurred to purchase leased property can qualify, notwithstanding that the lease is a long-term net lease from a third party. See Prop. Regs. §1.861-8(e)(2)(iv)(A)(3).

ordinarily contemplated that the nonrecourse lender can look to the revenues generated by, and proceeds from the sale of, the specific property for repayment of the loan. (This clarification was partially made in the first sentence of Proposed Regulations §1.861-8(e)(2)(iv)(E) (but the reference there, which is to "income from the property," should have been to "revenue," since nonrecourse loans are commonly secured by assignments of gross revenues and the use of the word "income" might imply that only net income may be used.)

To reflect the foregoing comments, Proposed Regulations §1.861-8(e)(2)(iv)(A)(3) should be amended to read as follows:

(3) The borrower is not obligated on a recourse basis for, and no property of the borrower other than the specific property (or any revenues or proceeds from, or any lease or other interest in, the specific property) is security for, payment of the principal and interest on the loan or, in the case of a loan backed by a letter of credit or other credit enhancement device from a third party, for any reimbursement or other payment obligation to such third party relating to any payment of principal or interest on the loan.

Treatment of "Clawbacks"

It is common in nonrecourse financing to provide that not all of the revenues from the collateral must be used currently to pay interest and principal but that the borrower has personal liability to the extent of the revenues that are not so used. In concept, this simply extends to a longer period what in fact may generally happen in any interest period, i.e., that until a payment is required to be made, the borrower may use the revenues from the property and, to the extent of such use, is

liable to the lenders. Such a clawback is not inconsistent with the Proposed Regulations (since the lender still looks solely to the property, or the revenues therefrom, that secures the debt), but it would be useful to clarify that it will not disqualify the borrowing from the nonrecourse indebtedness rule.

Comments on Proposed Regulations

§§1.861-8(e)(2)(iv)(A)(4) and (5)

The regulations- should clarify whether the requirement of Proposed Regulations §1.861-8(e)(2)(iv)(A)(4) must be met throughout the life of the debt or only when the debt is incurred. It has generally been understood that this condition, which is identical to the condition in the prior Regulations, must be satisfied only at the time indebtedness is incurred. To confirm this understanding, the words "At the time the indebtedness is incurred, it" should replace "It" at the beginning of Prop. Reg. §1.861-8(e)(2)(iv)(A)(4). The reference to "return (cash flow) on or from the property" in Proposed Regulation §1.861-8(e)-(2)(e)(A)(4) could usefully be clarified to indicate that only directly allocable out-of-pocket expenses are charged against revenue in arriving at this amount (and that it does not, for example, require deduction of income taxes or like indirect expenses of the borrower).

With respect to Prop. Reg. §1.861-8(e)(2)(iv)(A)(5), the restrictions on the use or disposition of the property may be contained in certain collateral agreements or, in the case of leased property, in the lease itself, and are not necessarily contained in the loan agreement. Accordingly, we suggest that "loan agreement" be changed to "financing documents."

Related Party Transactions

Proposed Regulation §1.861-8(e)(2)(iv)(A) prohibits debt incurred (1) from a related person or (2) to purchase property from a related person from qualifying for direct allocation. The prior Regulations had no such automatic disqualification with respect to related parties and we believe that automatic disqualification presents serious problems.

First, the Proposed Regulations fail to provide any definition of "related" and "unrelated" persons for his propose. In other contexts, the Proposed Regulations have used the definition in Section 267(b). If this is to be used here, however, it should be clarified how Section 267(b) applies to ongoing transactions (e.g., what happens if, after a loan is made, the lender becomes a related party because the value of its stock fluctuates).

Second, there are cases in which a prohibition on debt borrowed from, or borrowed to finance purchases from, related persons is clearly inappropriate. For example, if property subject to a nonrecourse loan from an unrelated party is transferred from one member of an affiliated group to another member, the transferee might well be viewed as having incurred the debt from the unrelated party for the purpose of purchasing property from a related person. There is no reason to disqualify the debt however, to the extent that the nonrecourse debt on the property is not increased. In addition, if one member of an affiliated group acquires property from a nonmember for resale to a second member of the group, there is no legitimate purpose to be served by prohibiting nonrecourse debt from qualifying for direct allocation. We believe that the final Regulations might deal with these (and other appropriate cases) by permitting

property subject to nonrecourse debt to be transferred within an affiliated group without affecting the status of the nonrecourse debt and permitting the nonrecourse financing of property acquired from other members of the affiliated group if the property had not been used or placed in service by any other member of the group (or other related person) at the time the debt was incurred.

Economic Significance

Proposed Regulation §1.861-8(e)(2)(iv)(B) provides that debt will not qualify for direct allocation if the transaction lacks "economic significance". This modifies the corresponding provision of the prior Regulations, by deleting the reference to "motive", and thus removes the suggestion that "economic significance" is a subjective rather than objective test. It is nonetheless unclear what evil the "economic significance" requirement is aimed at, given that debt must meet the restrictive conditions set forth in Proposed Regulations §1.861-8(e)(2)(iv)(A) to qualify for direct allocation. If those conditions are met, it is hard to see how economic significance could be lacking. If there is concern that, as a result of arrangements between the lender (or a provider of credit enhancement) and the borrower or affiliates of the borrower, the conditions set forth in Proposed Regulations §1.861-8(e)(2)(iv)(A) may not be satisfied in substance, this concern should be addressed more specifically.*

* We think it would be a mistake, however, to set out rigid rules in the final Regulations -- e.g., that there can never be economic significance if the loan to value ratio exceeds a specified ratio.

Refinancings

Proposed Regulation §1.861-8(e)(2)(iv)(C) confirms that debt which is refinanced continues to qualify for direct allocation if certain conditions are met. With respect to the first of these conditions, we believe it is generally appropriate to limit the amount of refinanced debt qualifying for direct allocation to the principal amount outstanding prior to refinancing that qualified for direct allocation, with one minor exception. In the case of leased property, as well as in other cases, it is sometimes contemplated that, if the original debt is refinanced, the costs of the refinancing (which may include a premium to retire the outstanding debt) may be paid out of the proceeds of the refinancing, with the result that the principal amount of the refinanced debt would exceed the principal amount of the old debt by an amount equal to such costs.

In their present form, the Proposed Regulations appear to disqualify refinanced debt in full if the principal amount is increased. This is an extremely harsh penalty -- it would be more appropriate to disqualify only the additional principal borrowed in the refinancing. In addition, the drafters of the Proposed Regulations should consider permitting direct allocation with respect to the full amount of refinanced debt when such amount exceeds the outstanding principal amount of the old debt by a de minimis amount. (If refinancings costs can be borrowed, a de minimis rule would among other things help avoid arguments as to what constitutes a refinancing cost.)

The second condition applicable to refinancings, set forth in Proposed Regulations §1.861-8(e)(2)(iv)(C)(2), prohibits the term of the new debt from exceeding the term of the old debt. This limitation can be questioned in a case where the longer term

of the refinancing could have been obtained in the first instance (and the shorter maturity was not attributable to the unavailability of a longer maturity), but using that test to limit the term of any refinancing has the disadvantage of forcing the Internal Revenue Service to make the factual determination of whether the longer term could have been obtained in the first instance.

We believe, in any event, that an exception should be made to the rule that limits the term of the new debt to the term of the old debt for cases where the term is extended by a de minimis amount (e.g., by up to 10% of the remaining term). Such a de minimis exception presents little opportunity for tax avoidance and could be important to a borrower who must make some minor alterations on outstanding debt to fit the requirements of the new lender.*

Proposed Regulation §1.861-8(e)(2)(iv)(C)(2) uses the word "term," which could be construed as referring to the final maturity date of the debt. In the Proposed Regulations relating to original issue discount, the concept of weighted average maturity is used, and the Service should consider whether that concept, modified as necessary, would be appropriate in the present context as well.** In any event, Proposed Regulations §1.861-8(e)(2)(iv)(C) should be more explicit as to what it requires. Does a taxpayer run afoul of its requirements if it

* This assumes adoption of our recommendation above under Interim Financing, since we believe it would be appropriate to permit a refinancing that occurs within a specified period after the purchase of property to qualify for direct allocation without regard to whether the term of the debt is extended.

** The rules for determining weighted average life in Prop. Reg. §1.1273-1(a)(3)(ii)(A) tend to shorten the average life of a debt instrument, since they take account only of "full years" and thus may disregard payments made in the first or last years, and they should be used only if modified to eliminate these distortions.

refinances a 30-year self amortizing debt obligation with a 20-year balloon financing? If so, does it violate (C)(1) or (C)(2), and to what extent?

Finally, it would appear that the refinancing rule applies only once, i.e., that a refinancing of a refinancing does not qualify. This follows from the requirement that the refinancing be of a loan that meets the requirement that it be incurred for the purpose of purchasing or improving identified property. That seems to be an oversight which should be corrected (particularly in light of the fact that the post-construction financing rule does permit refinancings of construction period loans).

Post-Construction Permanent Financing

Special rules are provided for post-construction permanent financing, which would otherwise not qualify for direct allocation under Proposed Regulations §§1.861.8(e)-(2)(iv)(A)(1) and (2).

Proposed Regulations §1.861-8(e)(2)(iv)(D), which currently refers to "constructed property," would be clearer if such reference were changed to "property that is constructed, reconstructed or erected by the taxpayer."* It would also be logical for the definition of "construction" to be expanded so that it covers (1) mineral properties (i.e., permanent financing obtained after the exploration and development stage) and (2) improvements and (as we have suggested above under Debt Incurred to Maintain Property) maintenance. In addition, the Proposed Regulation twice uses the concept of financing being "obtained,"

* See Regs. §1.48-2(b)(1) for a description of when property is considered to be constructed, reconstructed or erected by the taxpayer.

rather than "incurred." If the intent was to permit debt to qualify if a commitment is obtained within the one-year period, this should be made explicit.

Under Proposed Regulations §1.861-8(e)(2)(iv)(D)(3), the proceeds of the financing must be "used to repay construction loans, to pay amounts owed to contractors for the construction of the property or to refinance temporary post-construction financing." We believe that there are cases where the tracing approach may be too restrictive. We suggest that a rule requiring that (a) the loan be incurred within a year after the property is placed in service and (b) the principal amount not exceed the costs of construction and the related costs described in the preceding paragraph would be more appropriate.

If a tracing approach is followed, however, a definition of the terms "construction loans" and "post-construction financing" should be provided. The definitions presumably would require that the purpose of the loan be to pay specified costs and that the loan proceeds be so used. In addition, the Proposed Regulations do not take all relevant costs into account for purposes of the post-construction permanent financing rules. In particular, the use of loan proceeds to pay land acquisition costs and "soft costs" (e.g., brokerage and professional fees) should be permitted. Even if it is not permitted, a financing should not be disqualified completely merely because it exceeds the cost of construction. Only the excess of the financing over the cost of construction should be disqualified.

Cross-collateralization

The purpose of Proposed Regulations §1.861-8(e)-(iv)(2)(E) is obscure. If this Regulation is intended to limit

direct allocation to nonrecourse debt secured by specific property, it is redundant in light of Proposed Regulations §1.861-8(e)(2)(iv)(A)(3), which we commented on above. Moreover, the second sentence -- which refers to credit enhancement devices ordinarily provided by third parties -- has nothing to do with cross-collateralization, which refers to a situation in which other specific property serves as collateral for repayment of a loan. As discussed above in the comments on Proposed Regulations §1.8618(e)-(2)(iv)(A)(3), such credit enhancement devices should be permitted so long as the recourse against the borrower is not expanded beyond the specific property. Accordingly, we believe that the first two sentences of this provision should be deleted.

The third and fourth sentences of Proposed Regulation §1.861-8(e)(2)(iv)(E) deal with situations in which collateral is substituted under a loan contract. Again, these situations have nothing to do with "cross-collateralization," and, if these are the only provisions of Proposed Regulations §1.861-8(e)(2)(iv)(E) that are retained, a more appropriate title would be "Substitution of collateral." In addition, we believe it should be clarified that debt will not be disqualified from, direct allocation treatment under this provision as a result of substituting or replacing parts or as a result of replacing property that was the subject of a casualty loss. Such provisions are commonly found in nonrecourse loan agreements.

Treatment of Partial Recourse Indebtedness

The nonrecourse indebtedness rule in the Proposed Regulations is an "all-or-nothing" rule under which any form of credit enhancement or right by the lender to obtain payment of any part of the indebtedness other than from the collateral will

disqualify the indebtedness.* Thus, for example, indebtedness which is recourse to the obligor as to interest only, or as to principal only,** would be disqualified in its entirety; so would a loan that made the borrower liable up to a stated amount in the event of a default where the value of the property securing the debt is less than the remaining unpaid indebtedness.

* See Prop. Regs. §§1.861-8(e)(2)(iv)(A)(3) and (4) and 1.861-8(e)(2)(iv)(E)(1).

** See, e.g., Follender v. Commissioner, 89 T.C. No. 66 (Oct. 28, 1987) (indebtedness was recourse with respect to principal only).

We think that consideration should be given to allowing partial recourse borrowings to qualify to the extent of the nonrecourse portion, at least where the recourse and nonrecourse portions can be readily identified. The approach could be similar to that in Rev. Rul. 84-118,^{*} where, for purposes of determining the amount of a limited partner's share of a partnership liability under Regs. §1.752-1(e), the indebtedness was split into its recourse and non-recourse portions.^{**} Similar results have been reached under the at-risk rules of Section 465.^{***}

A partial recourse rule may be particularly important in leveraged lease transactions. In leveraged lease transactions, the lease of property securing what would otherwise be specific property indebtedness may provide for little or no rent payments

* 1984-2 C.B. 20.

** In the Ruling a limited partnership borrowed \$350x purchase money debt secured by real property. In the event of default the general partner would be liable for up to \$150x if the property were of insufficient value to satisfy the note. The ruling holds that the debt is nonrecourse to the limited partnership to the extent of \$200x.

*** See, e.g., Melvin v. Commissioner, 88 T.C. 63 (Jan. 12, 1987) (limited partner was not at risk with respect to excess of amount of partnership's borrowing over his proportionate share because of recourse obligations of other partners to make capital contributions).

during a brief interim lease period at the commencement of the transaction. In such event, the owner-lessor would not receive the cash flow necessary to meet the initial interest payments on the debt incurred to purchase the property, even though the lessor fully anticipates a sufficient cash flow over the life of the lease to meet the lessor's obligations under the debt. In this case the lessor's obligations to make the initial debt service payments may be seen as an equity investment in the property. Disqualification of the entire indebtedness as specific indebtedness because of this limited recourse payment by the borrower appears to us to be unduly harsh.

Similarly, in certain leveraged lease transactions, the owner-lessor may make principal payments (typically between 5 and 10 percent of the property's cost) in the early years of the lease that, together with the aggregate interest payments at that time, are greater than the aggregate rentals at the time of such payment. Again, such payments are merely a form of deferred equity investment. The borrower could have complied with the rules provided in the Proposed Regulations by deferring principal and/or interest payments in the first case, and not making the larger principal payments in the second case and foregoing the most economically beneficial results.

In the case of indebtedness which, as discussed above, involves a borrower making payments greater than the cash flow during initial period of the indebtedness, but in which the overall return will be sufficient to enable the borrower to service the debt, we recommend that the regulations adopt a de minimis rule, that where such payments do not exceed a stated amount (e.g., ten percent of the total scheduled payments of principal and interest) they will not cause the debt to fail to be specific property indebtedness. In the alternative, a

proportionality rule similar to that discussed above would be advisable (i.e., the debt would not be considered specific property debt during the period in which it is anticipated that the borrower will make payments on the debt that are larger than the corresponding cash flow on the property).

We also note that in certain cases what would otherwise qualify as specific property indebtedness may provide for recourse to the obligor or a third party in the event of certain specified contingencies. Regulations applicable to other provisions of the Code apply a likelihood test to determine whether the contingency is material.* We suggest that the Proposed Regulations provide that: (1) recourse to a borrower which is contingent upon an event which is unlikely to occur shall not otherwise cause the debt to fail to qualify as specific property debt; and (2) upon the occurrence of such a contingency, the indebtedness will cease to qualify as specific property debt only to the extent that payments by the borrower are in the nature of payments under a deficiency judgment (i.e., the excess of such payment over the property's then fair-market value).

Assets or Income for Purposes of Apportioning other Interest Expense

The second sentence of Proposed Regulations §1.861-8(e)(2)(iv)(F) states that, in apportioning interest expense under a gross income method, "gross income shall be reduced by income to which interest expense is directly allocated to income derived from specific property under this paragraph (e)(2)(iv)."

* See Prop. Reg. §1.465-6(c) and (e) Ex. (3) (borrower is not at risk if likelihood of the contingency occurring is such that the taxpayer is effectively protected against loss); Prop. Treas. Reg. §1.1275-4(b)(1) (in determining whether a payment under a debt instrument is contingent, "remote and incidental contingencies may be disregarded").

This rule might be interpreted to exclude from gross income all of the income from a property subject to nonrecourse debt that qualifies for direct allocation, even if the gross income from such property exceeds the amount of directly allocated interest expense. We assume that this result is not intended and that the language should read as follows: "gross income shall be reduced by an amount equal to the amount of interest expense which is directly allocated to income derived from specific property under this paragraph (e)(2)(iv) and which does not exceed such income derived from specific property."

Retroactivity

The Proposed Regulations are proposed generally to be applicable to taxable years beginning after 1986. In light of the fact that various provisions of Proposed Regulations §1.861-8(e)(2)(iv) are more restrictive than the provisions of Regs. §1.861-8(e)(2)(iv), a taxpayer that incurred debt prior to the date on which these regulations are issued in final form should be able to rely on the existing Treasury Regulations at the taxpayer's option. Such a rule would avoid frustrating the legitimate expectations of taxpayers who relied on the stated Congressional intent not to change the treatment of nonrecourse debt that the current Treasury Regulations treat as definitely related to specific property.

VIII: Integrated Financial Transactions

(Prop. Regs. §1.861-8(e)(2)(iv)(G))

The Proposed Regulations do not implement Section 864(e)(7)(B), which authorizes Regulations to provide for the "direct allocation of interest expense incurred to carry out an

integrated financial transaction to any interest (or interest-type income) derived from" the transaction.

It seems clear that Congress envisioned the integrated transaction rules as a shield for taxpayers unfairly affected by the general fungibility principle, and not solely, if at all, as an anti-abuse provision.* This is consistent with the one specific example provided by the legislative history, "a debt-financed acquisition of foreign currency debt obligations."** For all taxpayers other than financial services businesses, a direct allocation of interest expense against interest derived from a portfolio investment is likely to have beneficial foreign tax credit effects.***

Developing a workable definition of "integrated financial transactions" is difficult. For example, a definition that looks solely to the borrower's intention to reinvest the borrowed funds at an assured spread would effectively insulate all financial intermediaries from the new rules, a result plainly not intended by Congress. A comprehensive definition is important, however, since according integrated treatment only to

* "Congress believed that it was appropriate for the Secretary to identify in regulations other circumstances where taxpayers can trace interest expense or debt incurred to acquire assets in certain integrated financial transactions." Blue Book at 945. [Emphasis supplied.]

** Blue Book at 948.

*** An allocation of interest expense against interest derived from a domestic investment will increase the relative proportion of foreign source income, and thereby free up foreign tax credits; a direct allocation against interest derived from a foreign portfolio investment (which will not itself be subject to any foreign tax) similarly will increase the relative proportion of foreign source general limitation income, with essentially the same consequences.

a few specific transactions* or classes of taxpayers** would avoid the need to make difficult choices only at the expense of substantial unfairness.

The Committee suggests that consideration be given to issuing regulations under Section 864(e)(7)(B) that would permit taxpayers to identify as integrated financial transactions some or all of the following classes of transactions in which the application of other statutory integration principles, or the circumstances of particular financing structures, clearly indicate that direct allocation of interest expense is appropriate:

1. Transactions involving the use of special-- purpose vehicles to securitize financial assets or to create new synthetic assets. In some cases, the creator of a pool of financial assets (e.g., home mortgages or credit card receivables) for sale retains ownership of the vehicle organized to hold the pool of assets. Such a retention may be necessary or desirable, for example, to enhance the credit quality of the interests sold to the public by creating a subordinated interest retained by the seller or to assure the debt characterization of the securities sold to the public. The factors that determine whether a financial

* For example, "in-substance" defeasance transactions of the type described in Rev. Rul. 85-42, 1985-1 C.B. 36. Such transactions, while entitled to integrated treatment, are essentially isolated and by themselves would hardly justify the grant of authority in Section 864(e)(7)(B).

** Thus, an attempt to resolve the special difficulties presented by banks and securities firms (which conduct businesses that may be said to consist in large part of arbitrage between borrowers and lenders) by excluding them entirely from the integrated transaction rules would not appear to be appropriate or necessary.

institution retains such an equity interest in a securitization vehicle are essentially unrelated to foreign tax credit considerations. As a practical matter, such ownership interests are treated in the marketplace as if they represented ownership of the net value of the equity interest. For example, the owner of a trust with \$100 of mortgages subject to \$99 of public debt considers itself to own an asset worth \$1, not a \$100 asset subject to a \$99 liability. Consideration should be given to providing that the interest on debt obligations issued by a corporation or trust that is used exclusively to facilitate such a securitization transaction is not allocable to an "owner's" other business activities and to permitting interest on the debt obligations to be allocated exclusively against the income from the related pool of assets.*

2. Transactions in which interest subject to allocation should be adjusted to take account of other transactions entered into primarily to reduce the risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made by the taxpayer. This category would include any transaction that would, under principles similar to Sections 1256(e) and 988(d), be treated as a hedge.

3. Defeasance transactions of the type referred described in Rev. Rul. 85-42 in which Government securities

* Similarly, in some instances a special-purpose subsidiary of a commercial paper dealer may be used exclusively to issue debt obligations backed by the credit of a third party unrelated to the dealer, and lend the proceeds to that third party at a spread that represents a fee rather than a lender's profit. Such issuers, even if consolidated with the parent dealer, should not be viewed as incurring costs that are allocable against the dealer's other activities.

are placed in trust to pay interest and principal on specific outstanding debt securities.

4. Other transactions, in which the nature of the assets financed, the special legal status of the financing technique, or practical constraints imposed by the nature of the business activities being financed require the conclusion that general fungibility principles should not apply. Certain kinds of inventory financings (such as repurchase agreements used to carry the inventories of government securities dealers) might be appropriately included.

IX. Apportionment Rules for Individuals

(Prop. Regs. §1.861-8(e)(2)(v))

In general, the Committee approves of Proposed Regulations §1.861-8(e)(2)(v), which apportions the interest expense of individuals by reference to the definitions of interest expense set out in Section 163(h) of the Code. The Committee questions, however, why "qualified residence interest" (i.e. interest on indebtedness secured by an individual's primary residence) is apportioned to all of the individual's gross income, regardless of the circumstances. The Committee does not think that interest on indebtedness incurred to purchase, construct or refinance a purchase or construction of a primary residence should be apportioned to an individual's gross income, since the amounts which an individual spends on shelter are no more related to his gross income than amounts he spends on food, clothing or other personal items.* The deduction for such interest expense is in the nature of a subsidy for home ownership

* No non-recourse indebtedness exception is available for such interest, regardless of whether the loan is recourse, because the lender does not look to income produced by the property for satisfaction of the loan.

and should not be diluted under Section 864(e), i.e., should not result in a reduction in the amount of foreign taxes which an individual may credit against U.S. tax. The Committee agrees, however, that an individual who uses his home as collateral for a loan may be required to apportion the resulting interest expense in reduction of all of his gross income on the theory that money is fungible.

In addition to the foregoing, we have the following comments on Proposed Regulations §1.861-8(e)(2)(v):

(1) It would be useful to clarify whether the \$5,000 de minimis rule, which eliminates the need for an individual to apportion interest expense unless the individual has more than \$5,000 of gross foreign source income, is calculated before or after any exclusion under Section 911, i.e., whether foreign source income that is excluded under Section 911 counts against the \$5,000.

(2) Since trusts and estates may be allowed a foreign tax credit (wholly apart from the credit allowed to beneficiaries in respect of taxes paid on income taxable to the beneficiaries), the final Regulations should indicate whether that credit is to be calculated under the rules applicable to individuals -- specifically, whether trusts and estates can benefit from the \$5,000 de minimis rule. If trusts and estates are not to be treated as individuals for purposes of the proposed regulations, then final Regulations should specify the rules applicable to trusts and estates.

X: Partnership Borrowings
(Prop. Regs. §1.861-8(e)(2)(vi))

In the case of borrowings by partnerships, the Proposed Regulations provide, in general, that a partner takes into account the partner's "distributive share" of partnership interest expense, including a share of interest on any qualifying nonrecourse debt. With respect to the partnership assets to be taken into account by the partners and the allocation of partnership interest expense, the Proposed Regulations distinguish between what might be called passive partnership interests (defined as partnership interests of less than 10%,^{*} other than a general partnership interest not held by a corporation) and other partnership interests. In the case of a non-passive interest, there is a look through, i.e., the partner takes into account a share of the gross assets of the partnership equal to the share of net assets that would be received on a liquidation of the partnership^{**} and the partner's share of partnership interest expense is allocated, together with all other interest, on the basis of these and other assets. In the case of a passive interest, there is generally no look through, but instead the partner takes into account the partnership interest as an asset and allocates the partner's distributive share of interest solely to that asset. This distinction generally parallels the treatment of partnership interests for the purposes of the look through rules provided in the proposed Section 904 Regulations, except that under the Proposed Regulations a less than 10% general partner's interest held by a

^{*} For this purpose a partner's percentage interest in a partnership is determined under Regs. §1.897-1(e)(2)(ii), relating to FIRPTA.

^{**} As set out in Regs. §1.897-1(e)(2)(ii).

corporation is a passive interest although held in the ordinary course of the partner's active trade or business.^{***}

The partnership rules are an improvement over the prior Regulations, which provided no guidance, and we have only a few comments on these rules, as follows:

(1) Where the partnership is not formed under a Uniform Act (e.g., is a foreign partnership), it may not always be clear who is the general partner for purpose of the distinction drawn by the regulations between non-corporate general and limited partners, and it would be useful if the regulations defined this distinction in a functional way, i.e., as a partner that has management rights or personal liability for partnership obligations or both.

(2) It is not clear why a less than 10% general partnership interest should not be subject to a look through rule in the case of a corporation but should be when held by an individual. A general partnership interest of less than 10% is not necessarily an investment. At a minimum, we suggest that a general partnership interest of less than 10% not be treated as a passive interest when it is held in the ordinary course of the partner's business. This would parallel the rule in Proposed Regulations §1.904-7(i)(2).

(3) It is not clear why the tax basis of the assets that are taken into account by a partner that uses the tax book value method of apportionment should be the partnership's basis rather than the basis that reflects the higher or lower basis of the partner in its partnership interest. Wherever possible, book apportionment should be based on the taxpayer's balance sheet.

^{***} See Prop. Regs. §§1.904-7(i)(1) and(2).

(4) If, contrary to our suggestion, the tax basis of the partnership's assets is to be taken into account in apportioning interest under the tax book value method of apportionment, clarification is needed of the way in which this rule will operate when the partnership's basis for its assets reflects contributions of appreciated and depreciated property by the partners, i.e., will each partner have a share of the partnership's basis in all assets equal to the share determined under Regs. §1.897-1(e)(2)(ii)? Will Section 704(c) apply? Will Section 743(b) adjustments be specifically allocated?

A partner's distributive share of partnership interest expense is determined under Section 704(b) and thus may reflect special allocations and shifts in overall allocations; likewise, a partner's "percentage interest" in the partnership and "pro rata share of partnership assets" may change during a year. It would be useful to have examples that illustrate the application of the rules in such cases. This might be done by cross-reference to the Regulations under Section 704(b) -- e.g.,

"A partner's distributive share of partnership interest expense will reflect allocations given effect under Section 704 (b). See, e.g., Example (2), (15), (20), (21), (22) and 23 of Regs. §1.704-1(b)(5).^{*} Shifts will likewise be taken into account in determining the partner's percentage interest in the partnership and share of partnership assets."

XI: Borrowings by Corporations

(Prop. Regs. §1.861-8(e)(2)(vii), (viii) and -9(c))

Proposed Regulations §§1.861-8(e)(2)(vii) and 1.861-9(c) set out the basic rule that interest expense of a corporation must be apportioned on the basis of assets and that, where the

* These are the only examples that involve interest expense.

corporation is a member of an affiliated group, this must be done as though all members of the affiliated group were a single corporation. There are several points that are unclear, however, as follows:

(1) With the exception of interest on qualifying nonrecourse debt and a limited class of interest expense incurred by individuals, we understand the Proposed Regulations to require that interest expense be apportioned on the basis of assets. It would therefore be appropriate to eliminate language in the Proposed Regulations that might suggest that there are other exceptions -- For example, Proposed Regulations §1.861-8(e)(2)(viii)(A)(2) which says that the asset method will "ordinarily be accepted by the Commissioner".

(2) Proposed Regulation §1.861-8(e)(2)(viii)(D) divides assets based on whether and what kind of gross income they generated -- i.e., among those which generate income in a single grouping, those which generate income in multiple groupings, and those which generate no identifiable income or contribute equally to all categories of income. In order to make this system of categories work, there must be a definition of assets which, in the case of tangible personal property, looks to the predominant character of a facility or group of assets -- e.g., which does not lead to disputes as to whether a factory must be divided up between components (such as the factory floor, the machines, the cafeteria, office equipment, the parking lot, the executive offices).

(3) Proposed Regulation §1.861-8(e)(viii)(D) provides that assets that produce "no directly identifiable income yield" or "contribute equally to the generation of all income" are excluded from the fractions that apportion interest expense.

The exclusion of assets that "contribute equally" is confusing. In the first place, it is not clear whether it is meant to reach assets that contribute "proportionately" or "equally" to the statutory and residual groupings. If the former, it serves no purpose since, if there is such an asset, the result will be the same whether the asset is or is not taken into account. If the latter, it is distortive since the exclusion of an asset that contributes "equally" to statutory and residual groupings of income that are already disproportionate will materially affect the apportionment of interest expense.

More fundamentally, only in the rarest cases will an asset contribute "equally" (or "proportionately") to the generation of all income, and it is much more likely that there will be some variation in relative contributions, however small. Under these circumstances, we see no purpose in preserving in the final Regulations the rule that excludes assets that "contribute equally" to the generation of an income.

The exclusion of assets that produce "no directly identifiable income yield" is also troublesome since it is not clear how that determination will be made. The Proposed Regulations assume that "assets used in general and administrative functions" are in this category. But what is a "general" or "administrative" function? And why do such assets

invariably have "no directly identifiable income yield"?* In the absence of clear and specific guidance, the exclusion of assets without a "directly identifiable income yield" is likely to be a source of continual dispute; and, because of the difficulties of definition, we would on balance recommend that the rule be deleted in the Final Regulations.**

(4) In the case of assets that generate income within more than one "grouping of income," Proposed Regulations §1.861-8(e)(viii)(D) in effect allocates the book or fair market value of the asset in proportion to the gross income derived from the asset in the taxable year in each of the groupings. Assuming, as we have suggested, that assets with no directly identifiable income yield are not eliminated, the book or market value of assets that do not generate income within a single category will have to be allocated on the basis of the use or function of the asset in the taxpayer's business and rules will have to be developed to identify goodwill with specific operations.

XII: Affiliated Group Rules

(Prop. Reg. §1.861-9)

Scope

Section 864(e)(1) provides that the foreign source taxable income of an affiliated group will be determined by

* Likewise, in particular cases, purchased "goodwill," which the Proposed Regulations also assume has "no directly identifiable income yield" may in fact relate to specific operations and therefore have such a yield.

** To be sure, it is not always easy to allocate the value of an asset used in connection with more than one category between or among the categories, but this difficulty is not avoided by eliminating assets with no directly identifiable income yield.

allocating and apportioning interest expense as if all members were a single corporation, and Section 864(e)(5) defines an "affiliated group." Proposed Regulations §1.861-9(b) provides that these rules apply only for the purposes of the foreign tax credit limitations (i.e., Sections 904 and 907) and the FSC and DISC provisions of the Code and specifically provides that the rules do not apply for purposes of calculating Subpart F income of a controlled foreign corporation or income of a foreign corporation that is effectively connected with a U.S. trade or business.

The authority to so limit the affiliated group rules was plainly contemplated.* The specific exclusion of the computation of the Subpart F and effectively connected income is confusing, however, since foreign corporations would not in any event be members of an affiliated group, and we suggest that it be deleted from the final Regulations.

Definition

Section 864(e)(5) provides, largely by reference to Section 1504, a definition of affiliated group for the purposes of Section 864(e), and Proposed Regulations §1.861-9(a) follows that definition closely. Nonetheless, the preamble to the Proposed Regulations states that further regulations will be issued to preclude disaffiliation in certain cases, including where the stock held outside of the affiliated group has voting rights that are disproportionate to its value, where domestic operations are conducted through a foreign corporation, and where

* Blue Book at 947.

the stock held outside of the affiliated group is owned by a related foreign corporation.

We doubt that Congress contemplated the issuance of the further Regulations referred to in the preamble, even in the three cases specifically referred to. The statute explicitly defines an affiliated group and nothing in the legislative history suggests that a broader definition was contemplated.*

Life Insurance Companies

The Proposed Regulations reserve the treatment of life insurance companies. The apparent issue is whether life insurance companies are included in a single affiliated group with non-life companies from the inception or only upon the taxpayer's election. Life insurance companies are, under Section 1504(c), a separate affiliated group with other life insurance companies unless, at the election of the taxpayer and after 5 taxable years of affiliation, the life insurance company is included in the affiliated group of non-life companies.

It would seem to the Committee that life insurance companies should be included in the same affiliated group with non-life companies, whether or not there has been an election to do so or the five taxable years of affiliation have elapsed. Subject to the specific exemption for financial institutions, the basic intent of Section 864(e) is to group all United States corporations that are affiliated, so that the foreign tax credit calculation would not be affected by which member borrowed.

* Indeed, the House-passed version of the Tax Reform Act of 1985 would have, in effect, included foreign affiliates in the group, and this was explicitly rejected in the final bill.

Inclusion of life insurance companies with non-life companies would be consistent with this purpose.

If our recommendation is adopted, however, special provisions will be needed for life insurance companies which cannot file on a consolidated basis with the non-life members of the affiliated group to prevent "mismatching" of foreign tax credit limitations and foreign taxes actually paid. For example, if group apportionment reduces the foreign source income of the life (or non-life) group to zero, the group should still be permitted to credit foreign taxes it could have credited had it filed on a consolidated basis. See Affiliated Groups Not Filing Consolidated Returns below.

Financial Institutions

Section 864(e)(5)(B) provides that a financial institution (i.e., a bank or thrift) shall, under certain circumstances, be treated as a separate affiliated group, together with any other member of the affiliated group that is such a financial institution. Under amendments to be made by the Technical Corrections Act, a bank holding company and any subsidiary of a bank holding company predominantly engaged in a banking, financing or similar business may also be treated as a financial institution to the extent provided in Regulations. The effect of these amendments will, in many if not most cases, be to limit greatly the size of the nonfinancial group.

Pursuant to Section 864(e)(5)(B), Proposed Regulations §1.861-9(d)(4) provides that banks and thrifts that are members of an affiliated group and are described in §864(e)(5)(B) are a separate affiliated group; that a subsidiary of a bank holding company is likewise a financial institution if it is

predominantly engaged in a banking, financing or similar business; and that a bank holding company is, in effect, a member of both the financial and nonfinancial groups with its interest expense to be prorated between the two groups.

We have the following comments on these Regulations:

(1) While a bank or thrift, i.e., an organization described in Section 581 or 591, is a financial institution only if, among other things, its business is predominantly with persons other than related persons or their customers, the Proposed Regulations do not, as they could, impose the same requirement on a subsidiary of a bank holding company that is engaged in a banking, financial or similar business.

(2) It is not clear whether the proration of the interest expense of a bank holding company between the two groups is to be based on the tax book or fair market value of their respective assets -- presumably it should be based on the method of apportionment used by the two groups with respect to their interest expense, but this should be made clear. It should also be made clear that interest expense of a bank holding company which is specifically allocated under the Proposed Regulations (for example, under the nonrecourse indebtedness rule) is not so prorated.

(3) The penultimate sentence of Proposed Regulations §1.861-9(d)(4)(iii) seems to suggest that the full amount of the interest expense must be apportioned among the assets of each group. We assume that only the amount of interest prorated to a group is apportioned among that group's assets.

(4) Proposed Regulations §1.861-9(d)(4)(iii) says that directly held assets of a bank holding company (other than stock of affiliates and assets without an identifiable income yield or which contribute equally to the generation of all income) "shall be treated as owned by the nonfinancial group and the financial group" for the purposes of computing each group's apportionment fractions. This double attribution, if intended, is distortive because it doubles up the amount of interest that may be allocated to these assets. Why shouldn't the holding company's assets be attributed to the two groups in proportion to the amount of indebtedness of the holding company that is attributed to each group? Or in proportion to the assets in the two groups? (The assets attributed to the two groups should in any event exclude any assets with respect to which there is a specific allocation and apportionment of interest.)

(5) It is presumably intended that loans between the financial and nonfinancial groups be treated under Proposed Regulations §1.861-9(e) in the same manner as loans within an affiliated group, but this could usefully be clarified. The present reference in Proposed Regulations §1.861-9(d)(4)(iv) to Proposed Regulations §1.861-9(e) is obscure since the referenced provision relates only to loans between members of an affiliated group as defined in Proposed Regulations §1.861-9(d) and the function of Regulations §1.861-9(d)(4) is to create two separate affiliated groups out of one.

(6) It would be useful to provide definitions of when business is conducted "predominantly" with a class of persons and the meaning of a "banking, financing or similar business". (There are definitions of the latter in Reg. §1.864-4(c)(5), Reg. §1.954-2(d)(2)(ii) and Prop. Reg. §1.904-4(c).)

XIII: Expenses Other Than Interest

In addition to interest expense, the affiliated group allocation and apportionment rule applies, under Section 864(e)(6), to other expenses that are "not directly allocable or apportioned to any specific income producing activity". Apart from the rules relating to the effect of tax-exempt assets and income, which apply to any deductible expense, the Proposed Regulations provided no guidance with respect to expenses that are not directly allocable or apportionable. Issues that might be addressed by Regulations included the following:

(1) What expenses are not "directly allocable and apportioned to any specific income producing activity"? The legislative history refers to "general and administrative expenses" and gives as an example the salary of the president of a holding company.*

(2) The method for the allocation and apportionment of such expenses. Section 864(e)(2), which requires that allocations and apportionments be made on the basis of assets is limited to interest expense, and the legislative history apparently contemplates that non-directly allocable/apportionable expenses may, as under prior Regulations, be based on other deductions or

* See Blue Book at 948-49.

on income.*

(3) How the affiliated group rule will be applied to such expenses. The legislative history apparently contemplates an allocation based on a "look through" to the activities of members of the affiliated group owned by the corporation that incurs the expense and, as an illustration, allocates the general and administrative expenses of a holding company between foreign and U.S. source income on the basis of the activities of the holding company's domestic subsidiaries.**

(4) The application of other concepts to non-directly allocable/apportionable expenses. For example, where such expenses are included in inventory costs under new Section 263A, they should not be subject to separate allocation or apportionment.

XIV: Controlled Foreign Corporations

The preamble to the Proposed Regulations states that consideration is being given a rule which, for purposes of apportioning the interest expense of an upper-tier controlled foreign corporation, would disregard the portion of its stock in a lower-tier controlled foreign corporation that is treated as an asset producing Subpart F income, lest upper-tier interest expense be allocated to dividend income that is never received because it is included in the gross income of a U.S. parent. A more accurate rule, however, would allocate upper-tier interest expense to lower-tier Subpart F income, as if the Subpart F income had been distributed to the upper-tier subsidiary before being included in the gross income of the U.S. parent. Otherwise

* Id.

** Id.

lower-tier Subpart F income is overstated and upper-tier income is understated, because interest expense on funds borrowed by the upper-tier subsidiary to invest in the lower-tier subsidiary is not allocated to income produced by the lower-tier subsidiary.

XV: Affiliated Groups Not Filing Consolidated Returns

(Prop. Regs. §1.861-9(g))

Section 864(e) requires that the allocation of interest and other deductible expenses be made on an affiliated group basis, whether or not consolidated returns are filed by the affiliated group, and the legislative history specifically contemplates that regulations will provide for the resourcing of income and other adjustments where no consolidation returns are filed by an affiliated group.*

The absence of consolidated returns makes a difference where one or more members incurs interest expense that is disproportionate to its shares of overall or separate limitation foreign source income. Proposed Regulation §1.861-9(g) deals with this by sourcing interest expense on the basis of the affiliated group's assets, as required by Sections 864(e)(1) and (2); and, where that creates (or increases) a loss in any member's "limitation category" (defined to include domestic source as well as overall limitation and separate basket foreign source income), resourcing the other members income in the loss category. With the exception noted below, the general effect is to put the members in no better a position than if consolidated returns had been filed, which is what was intended by Congress. They may be in a worse position, because the foreign source income and foreign taxes will not be totalled in the absence of consolidated

* Blue Book at 957.

returns, but this is not inconsistent with the statute and can be regarded as the price of not filing consolidated returns. Our only suggestions are

(1) Proposed Regulations §1.861-9(g)(2)(ii) limits loss recharacterization to "the taxable income of other members within the same limitation category as the loss." This means, for example, that there is no recharacterization of a passive foreign loss incurred by one corporation unless other corporations in the group have passive income, notwithstanding that other corporations have foreign source income in other limitation categories, including the overall limitation basket. This seems to conflict with the legislative history,^{*} which would not permit the other members to credit more foreign taxes paid on overall limitation income than they could have if consolidated returns had been filed. If consolidated returns had been filed, the passive loss would have reduced the group's overall foreign source limitation income under Section 904(f)(5), and

(2) It should be made clear that interest that is specifically allocated under the nonrecourse debt rule of Proposed Regulations §1.861-8(e)(2)(iv) (or the partnership rule of Proposed Regulations §1.861-8(e)(2)(vi)) is not subject to resourcing under Proposed Regulation §1.861-9(g),^{**}

* See the example set out on page 951 of the Blue Book.

** Put differently, the second sentence of Step 1 would only apply to interest not specially allocated.

XVI: Debt between Members of the Affiliated Group

(Prop. Regs. §1.861-9(e))

The Proposed Regulations provide that the interest expense on a loan from a member of the same affiliated group must be allocated to the same "class of gross income" as the class of income in which the lender includes the interest income (i.e., is to be allocated to interest income), but in apportioning interest Proposed Regulations §1.861-9(e)(1) eliminates affiliated group debt as an asset. The simple elimination of the interest expense and interest income would be a more consistent and direct way of dealing with the borrower's interest expense.* The Regulations could still provide, (as the Proposed Regulations do) that interest on a loan made by an unaffiliated lender which makes a back-to-back borrowing from an affiliate must be apportioned to the same class of income in which the interest income is included.

XVII: Adjustments for Certain Assets

(Prop. Regs. §1.861-10)

Basis Adjustment for Stock in

Non-Affiliated 10% Owned Corporations

Proposed Regulation §1.861-10(b) provides that, for purposes of allocating and apportioning interest expense based on the tax book value of assets, the basis in stock of certain 10% owned corporations is to be adjusted annually to reflect the earnings and profits of such corporations accumulated during the period the taxpayer held such stock. We have several comments regarding such basis adjustment.

* Notwithstanding the allocation of the interest to a class of gross income, an example indicates that the interest expense is automatically allocated to domestic source income. See Example (1) of Prop. Regs. §1.861-9(e)(5).

First, the Proposed Regulations call for basis to be adjusted by earnings and profits accumulated since 1913 (reduced by distributions). Neither the statute nor its legislative history mandates looking back as far as 1913 for the calculation of accumulated earnings and profits. The statute does not address whether the earnings adjustment is to be applied only prospectively; it merely speaks of earnings and profits "attributable to such stock and accumulated during the period the taxpayer held such stock." The legislative history is inconclusive on this point. In light of the lack of clear legislative mandate, the regulations should take an approach that is both practical and suited to Congress's overall goal, namely the elimination of the distortive effects of the tax book value method.

The calculation of an earnings and profits figure based on activity since 1913 would be burdensome in the case of a 10% owned domestic corporation as well as in the case of a 10% owned foreign corporation, but in the latter case, the task may be impossible to perform. Although some U.S. taxpayers, for many years, may have determined foreign earnings and profits for the limited purposes of claiming the foreign tax credit, many U.S. taxpayers will now be faced for the first time with the task of reconstructing foreign earnings and profits for as many as 65 years. In many cases, the data necessary to reconstruct earnings and profits, particularly in the case of non-controlled foreign corporations, will simply be unavailable. Although taxpayers, with respect to all 10% owned foreign corporations, may elect to substitute financial earnings for earnings and profits, such financial data must be adjusted to U.S. generally accepted accounting principles ("GAAP"), and in many cases variations from GAAP methodology will be unknown.

As others have suggested, the drafters of the regulations should seriously consider limiting the adjustment to stock basis to post-1962 earnings and profits.* In light of the inflation experienced during the last quarter century, a single generation's earnings and profits is more than enough. In order to mitigate any possible impact of such a rule on the fisc, the use of post-1962 earnings and profits should apply both to foreign and domestic 10% owned corporations.

The limitation of basis adjustment to post-1962 earnings is particularly appropriate because many taxpayers will already be familiar with such a post-1962 figure due to its relevance under Subpart F. Where a domestic or foreign corporation's post-1962 and pre-1987 accumulated earnings and profits is not practically knowable, a reasonable estimate thereof, based on financial earnings, should be allowed. Moreover, the use of such estimated figures should be allowed on a year-by-year and company-by-company basis. With respect to post-1986 taxable years, taxpayers should generally have available the data necessary to perform earnings and profits calculations. In the case of minority ownership of corporations, however, it is unclear whether taxpayers will always have access to data concerning post-1986 earnings and profits. In cases where taxpayers cannot, after reasonable effort, secure post-1986 earnings and profits figures, an estimate of earnings and profits, based on financial statement earnings, should also be allowed.

* See, e.g., Comments of Tax Executives Institute, Inc., reprinted in Tax Notes Today, May 21, 1987. See also Letter of Francis J. Walsh, discussed in Tax Notes Today, July 2, 1987 (advocating adjustment solely for post-1986 earnings and profits and citing Treas. Reg. §1.1502-32 for precedent regarding prospective application of earnings adjustment).

Second, Proposed Regulations §1.861-10(b)(1) provides for an earnings and profits adjustment to the basis of stock (in a 10-percent owned corporation) that is owned directly by the taxpayer (although the definition of a 10-percent owned corporation is based on indirect ownership). Does this mean there is no adjustment for the earnings and profits of foreign subsidiaries that are held through partnerships and trusts? If so, the regulation appears to conflict with the Blue Book, which states that the adjustment applies "to stock of foreign corporations that is not directly held by U.S. taxpayers but that is indirectly 10-percent owned by U.S. taxpayers."

Third, the Proposed Regulations call for basis in 10% owned corporations to be increased by a pro-rata portion of any disproportionate contribution made by other shareholders. Regulation 1.351-1(b)(1) contemplates that some disproportionate contributions are in fact disguised gifts or compensation payments to non-contributing shareholders.* In such cases, the true nature of a transaction as a gift or compensation payment will prevail for tax purposes. The Proposed Regulations under section 861 go beyond Regulations §1.351-1(b)(1) and treat, for purposes of expense allocation, all disproportionate contributions as disguised transfers to non-contributing shareholders. There is no theoretical or other justification for such treatment of all disproportionate contributions (and we think it generally undesirable to have rules here that differ from those used elsewhere in the Internal Revenue Code, i.e., in Regulations §1.351-1(b)(1)). In certain cases, a shareholder will make a disproportionate contribution solely to benefit the corporate transferee; in such an event, it is anomalous to

* See generally Rev. Rul. 74-329, 1974-2 C.B. 269; G.C.M. 39355.

adjust the stock basis of non-transferring shareholders for expense allocation purposes. Moreover, to the extent the disproportionate contribution increases the transferee corporation's earnings power, non-transferring shareholders will eventually account for their pro-rata share of such benefit through the earnings and profits adjustment to stock basis.

Fourth, there should be definitive rules for the translation of accumulated earnings and profits to U.S. dollars when a foreign corporation's functional currency is not the U.S. dollar. Although the Proposed Regulations contain some rules regarding translation, they are ambiguous and incomplete. For example, it is unclear at what time and at what rate pre-1987 earnings and profits or financial statement earnings are to be translated.

Fifth, the definition of the term "10% owned corporation" contained in Proposed Regulations §1.861-10(b)(2) appears to be improperly drafted. Under the definition contained in the Proposed Regulation, a "10% owned corporation" is a foreign or domestic corporation "which is not included within an affiliated group" and "[i]n which members of the affiliated group own directly or indirectly 10 percent or more of the total combined voting power of all classes of stock entitled to vote." (Emphasis added.) Under this definition, a domestic corporation owned 90% by affiliated group A and 10% by affiliated group B would not be a "10% owned corporation" with respect to group B because the corporation is a member of an affiliated group, namely group A.

Sixth, it should be made clear that stock basis in a 10% owned corporation is to be adjusted to reflect solely corporate level earnings. Since the Proposed Regulations require adjustment

in respect of "earnings and profits attributable to ... stock," one could read the regulations to require the double counting of earnings, such as in cases where a foreign corporation has undergone a reorganization and there are both corporate level earnings and earnings attributable under the section 367(b) regulations to exchanged stock.

Seventh, it is not clear whether the rule of attribution in Proposed Regulations §1.861-10(b)(2)(ii) is intended to limit the meaning of "directly or indirectly" in §1.861-10(b)(2)(i)(B). Is there, for example, attribution from corporations to shareholders but not from shareholders to corporations? In view of the complexity and uncertainty of attribution rules, the Committee believes that the definition of indirect ownership should be tied to a Code provision containing established authority, such as Section 958(b).

Attribution of Expense to Separate Limitation Categories

Proposed Regulation §1.861-10(c) requires taxpayers to attribute the book or tax value of stock of a controlled foreign corporation to the various separate limitation categories based on an analysis of the value or basis of each asset owned by the controlled foreign corporation for the relevant taxable year. In the case of tiered controlled foreign corporations, the Proposed Regulations require a further analysis of the lower-tier controlled foreign corporation's assets. As others have commented, the approach of the Proposed Regulations is impractical.* An annual valuation analysis of each asset owned by

* See Letter of Wayne S. Kaplan, reprinted in Tax Notes Today, September 24, 1987; Comments of Tax Executives Institute, Inc., reprinted in Tax Notes Today, May 21, 1987.

a controlled foreign corporation would be immensely time consuming and expensive. Attribution to the separate limitation categories should follow a practical rule, such as the one suggested in the preamble to the Proposed Regulations, namely attribution based on the relative amounts of gross income of a controlled foreign corporation within each separate limitation category. Section 864(e)(7)(C) provides ample authority for such an approach in the final regulations. Moreover, such an approach would comport with legislative intent, as evidenced by the statement in the House and Senate Reports: "The Committee does not believe that a general statutory requirement of annual valuation of assets is practical or administrable."*

Proposed Regulations §1.861-10(c)(2) provides that the tax book value or fair market value of stock in non-affiliated controlled domestic corporations (i.e., between 50 and 80 percent owned) must be attributed to the various separate limitation categories on the basis of the tax book value of the assets of such domestic corporations. Attribution of domestic stock basis or value to the separate limitation categories, however, would appear to be improper, because the dividend income received with respect to the stock will be U.S. source. So long as the corporation is not affiliated, and thus cannot be included in a consolidated return, and income from the investment is treated, as U.S. source, there would appear to be no possible abuse that would justify apportioning interest expense of the parent

* Report of the Committee on Ways and Means, H.R. Rep. No. 426, 99th Cong., 1st Sess. (December 7, 1985) at 376; Report of the Senate Finance Committee, Senate Rep. No. 313, 99th Cong., 2nd Sess. (May 29, 1986) at 349.

against foreign source income simply because the corporation has foreign assets. The drafters of the Proposed Regulations should clarify the rationale for including rules regarding the attribution of domestic stock basis or value to the separate limitation categories.

Related Controlled Foreign Corporation Debt Assets

Under Proposed Regulation §1.861-10(c)(4), the total debt of related controlled foreign corporations owed to members of a U.S. affiliated group constitutes a debt asset only to the extent such debt exceeds the total debt from third party lenders to the U.S. affiliated group. To the extent that such foreign debt is disregarded in apportioning the affiliated group's interest expense, an amount of the total affiliated group interest expense on third-party debt equal to the interest income generated by the disregarded controlled foreign corporation debt is allocated solely to the interest income generated by the debt.*

The method of allocation set forth in the Proposed Regulation goes beyond the authority provided by Congress to directly allocate interest expense where necessary to prevent

* In requiring such an automatic specific allocation, the allocation provision of section 1.861-10(c)(4) is unlike the principal allocation provisions of the Internal Revenue Code. These provisions allocate and apportion interest expense either by reference to the purpose for which the debt was incurred, by tracing the disposition of the proceeds, by apportioning interest expense ratably or by a combination of these methods. See I.R.C. §265(a)(2) (allocation by reference to purpose); §265(b)(2) (pro rata allocation); Treas. Reg. §1.163-8T (allocation by tracing); Treas. Reg. §1.857-3 (tracing and pro rata allocation).

taxpayers, from defeating the purposes of Section 864(e).^{*} In addition, such a departure from allocation of interest expense based upon the concept of fungibility disrupts the symmetry of allocation of interest expense between U.S. assets and foreign assets. Finally, the Proposed Regulation's treatment of interest expense on third-party indebtedness appears to be based on assumptions that do not accord with economic reality.

Accordingly, our Committee concludes that it is inappropriate to require automatic, specific allocation of interest expense on third-party indebtedness of an affiliated group to the interest income generated by related controlled foreign corporation debt. Such specific allocation of interest expense to interest income derived from related controlled foreign corporation debt is appropriate only where the nonrecourse debt rules of Proposed Regulations §1.861-8(e)(2)(iv) would apply or where the interest expense is incurred, and the interest income is derived, as part of an integrated financial transaction.^{**}

Section 864(e) requires allocations of interest expense to be made on an asset basis. Congress adopted this rule because, in its opinion, the deduction for interest relates more closely to the amount of capital utilized or invested in property than to the gross income generated therefrom. Consistent with this approach, Congress specifically adopted the theory of the regulations (as they read prior to their amendment) that allocation and apportionment of interest expense be based on the

^{*} Blue book at 948.

^{**} Rules regarding integrated financial transactions are explicitly reserved in the Proposed Regulations. See Prop. Reg. §1.861-8(e)(2)(iv)(G).

concept of the fungibility of money. The House Committee Report states that:

[w]ith limited exceptions, the committee believes that is appropriate for taxpayers to allocate and apportion interest expense on the basis that money is fungible. In this respect the committee is adopting the theory of the Treasury Regulations governing the allocation of interest expense (see Treas. Reg. sec. 1.861-8(e)(2)(i)).*

The Treasury Regulation cited in the House Committee Report, Reg. §1.861-8(e)(2)(i), presents the theory behind allocation and apportionment based on the concept of fungibility:

[t]he method of allocation and apportionment for interest set forth in this subparagraph is based on the approach that money is fungible and that interest expense is attributable to all activities and property regardless of any specific purposes for incurring an obligation on which interest is paid. This approach recognizes that all activities and property require funds When money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes and it is reasonable to attribute part of the cost of borrowing to such other purposes.

Neither the Code nor the legislative history of Section 864(e) suggests that Congress intended any general exceptions from the rule of allocation of interest expense based upon fungibility. In fact, quite the opposite is true. The legislative history indicates that Congress intended only "limited exceptions" from allocation and apportionment of interest expense on the basis of the rule of fungibility. An example of the limited exception to which the legislative history refers is the rule found in Proposed Regulation §1.861-8(e)(2)(iv) allowing specific allocation in the case of certain nonrecourse borrowing. Where a taxpayer would attempt specifically to allocate interest

* Report of the Committee on Ways and Means, H.R. Rep. No. 426, 99th Cong., 1st Sess. (December 7, 1985). See also The Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (May 7, 1987) at p. 944.

expense to a class of gross income generated by U.S. property, the taxpayer will not succeed in making such an allocation unless the taxpayer can structure the financing so that it meets five rigorous criteria. On the other hand, Proposed Regulation §1.861-10(c)(4) ensures a broad allocation of interest expense directly to a class of income generated by foreign property. No criterion need be met in order for this allocation to be made.

The drafters of Proposed Regulation §1.861-10(c)(4) appear to have been concerned with a case in which a related controlled foreign corporation is in need of capital and its U.S. parent, rather than cause the controlled foreign corporation to borrow from a third-party lender, provides such capital by borrowing in the U.S. and making a "back-to-back" loan to the controlled foreign corporation. The U.S. parent may prefer to enter into the back-to-back loan arrangement because the interest income will constitute foreign source income that will be general limitation income (provided the controlled foreign corporation does not have significant amounts of separate limitation assets). Although the U.S. group will have additional interest expense, such expense (absent the rule of Proposed Regulation §1.861-10(c)(4)) will be allocated only in part to foreign source income. (On the other hand, the U.S. group will also have an additional foreign source asset, which will increase the amount of its overall interest expense that is apportioned to foreign source income.)

The effect of Proposed Regulation §1.861-10(c)(4) is to place the U.S. parent, for purposes of the section 904 limitation, in the position it would be in had the controlled foreign corporation borrowed directly from a third-party lender. As a result, the U.S. affiliated group is likely to have a lower foreign tax credit limitation than would be the case had the general fungibility rule been followed.

To a certain extent, section 904(d)(3) encourages the making of loans to related controlled foreign corporations by generally characterizing interest income with respect to such a loan as general limitation income. Congress could have chosen to characterize such interest income as passive, but it instead chose to make it, in most cases, general limitation income. This was done presumably to permit the reduction of foreign income taxes through the withdrawal of foreign earnings on a tax deductible basis. Proposed Regulation §1.861-10(c)(4) is at odds with this aspect of section 904(d)(3). Furthermore, Congress rejected a rule which would have brought foreign corporations into a worldwide consolidated group for purposes of allocating interest expense. Thus, interest expense on direct borrowings by controlled foreign corporations is allocated entirely against foreign income, while such interest would have been partially allocated to domestic income had a worldwide consolidated group concept been employed. In these circumstances, it seems inappropriate for the Regulations to establish a rule which will likely always operate against the taxpayer.

The drafters of Proposed Regulation §1.861-10(c)(4) have assumed that, instead of providing capital to a controlled foreign corporation through a back-to-back loan arrangement, a U.S. parent could just as easily have caused

the controlled foreign corporation to borrow. This assumption denies business reality. There will often be legitimate business reasons for entering into a back-to-back loan arrangement. For example, U.S. interest rates may be lower than foreign interest rates. As another example, covenants in existing loan documents may prohibit direct borrowing by a subsidiary. Finally, borrowing by a U.S. parent may be advantageous because of the parent's superior credit rating.

For the reasons discussed above, the Committee believes that the Proposed Regulation's treatment of interest expense on third-party indebtedness represents too great a departure from the rule of allocation and apportionment based on fungibility and results in an unintended sanction on the exercise of sound business judgment. The Committee believes that departure from the fungibility of money rule should be permitted only where the nonrecourse rules would apply or where interest expense and income can genuinely be viewed as arising out of the same integrated financial transaction.

XVIII: Transitional Rules

(Prop. Regs. §1.861-11)

Proposed Regulations §1.861-11 implement the general transition rules to Section 864(e). Our comments on these are as follows:

(1) Proposed Regulations §1.861-11(d) provides that "related party debt", and paydowns of such debt, are not taken into account in computing transitional relief. As a consequence such debt does not count against the different "phase-in amounts" and paydowns of such debt do not reduce such amounts. The Proposed Regulations do not, however, define "related party debt", and we would suggest that the definition be by reference

to the affiliated group (so that all debt taken into account for apportionment purposes, including debt to wholly-owned foreign subsidiaries, is included).^{*} This seems to be intended by the Technical Corrections Act.^{**}

(2) The legislative history also says that "only interest-bearing indebtedness is considered as debt outstanding on any specified date" for purposes of the transition rules.^{***} Thus, for example, non-interest bearing payables are excluded. The exclusion of non-interest bearing debt should be reflected in the final Regulations, but for this purpose the rules of Section 483 and 1271 et seq. should be taken into account in determining whether debt is interest bearing.

(3) While paydowns reduce the amount of debt eligible for transitional relief, it is clear from the legislative history of the Technical Corrections Act^{****} that this is computed month-by-month, not annually, and that reductions in debt as of the end of a month do not reduce the phase-in amounts for prior months. Under Proposed Regulations §1.861-11(c) (7), however, the calculation is made annually, so that paydowns made at the end of the year reduce the phase-in amount for the whole year. This should be corrected in the final Regulations.

^{*} This is particularly important for those corporations that had sure market debt outstanding through Netherlands Antilles Finance subsidiaries. The rule is presumably based on references in the legislative history to "outstanding debt," "third party debt," borrowings from "unrelated lenders" and debt owned to "parties related to" the borrower. See Blue Book at 989-956.

^{**} See Staff of the Joint Committee on Taxation, Description of the Technical Corrections Act of 1987 (H.R. 2636 and S.1350) (1987) at 189-195.

^{***} Blue Book at 952.

^{****} See Staff of the Joint Committee of Taxation, Description of the Technical Corrections Act of 1987 (H.R. 2636 and §.1350) (1987) at 189.

(4) The focus in the Proposed Regulations on year-end debt might be interpreted to mean the portion of a taxpayer's interest expense that is eligible for transitional relief in any entire year is determined by use of a fraction of which the denominator is the debt at year-end, notwithstanding changes in the amount of the debt during the year. This produces the wrong results -- e.g., the unavailability of transitional relief because of a year-end increase in debt. We believe this could be avoided if the final Regulations focused on the amount of transitional interest rather than the amount of transitional debt and, to determine eligible interest expense, used a fraction, the numerator of which was a transitional interest expense and the denominator of which was a total interest expense.

(5) The legislative history of the Technical Corrections Act^{*} authorizes regulations that would use the average amount of debt outstanding in any month, in lieu of the month-end amount, where month-end levels are not representative. The Proposed Regulations do not exercise this authority. We would suggest that the final Regulations require the use of average monthly balances in, say, cases where the month-end balance is more than 110% of the average monthly balance.

(6) The Regulations should clarify whether the transitional rules are affected if interest is disallowed, suspended or capitalized or is specially allocated (for example, pursuant to the non recourse debt rules). Since the purpose of the transitional rules is to phase-in the application of Section 364(e) to interest expense, it is arguable that the benefits of the phase in should not be used up by debt in respect of which there's no current interest deduction or which is not subject to the new affiliated group allocation rule.

* Id. at 189.