

TAX SECTION

New York State Bar Association

Report on Regulations Under Sections 163(j)

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TAX SECTION

New York State Bar Association

January 25, 1994

Hon. Leslie B. Samuels
 Assistant Secretary (Tax Policy)
 Department of the Treasury
 Room 3120 MT
 1500 Pennsylvania Avenue, N.W.
 Washington, D.C. 20220

Hon. Margaret Richardson
 Commissioner
 Internal Revenue Service
 1111 Constitution Avenue, N.W.
 Room 3000
 Washington, D.C. 20224

Dear Assistant Secretary Samuels
 and Commissioner Richardson:

Enclosed is a report of the Tax Section of the New York State Bar Association relating to issues to be addressed in regulations under Sections 163 (j) and 7701 (1) of the Internal Revenue Code, as in effect after the adoption of the Revenue Reconciliation Act of 1993.

The report's chief draftsman was Willard B. Taylor.

We hope that the report will be of assistance in drafting regulations under these statutory provisions.

Your truly,

Peter C. Canellos

PCC:gsh
 Enclosure

cc: Cynthia G. Beerbower, Esq.
 Neil Z. Auerbach, Esq.
 Peter V.Z. Cobb, Esq.

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January 24, 1994

Report with respect to issues to be addressed by
Regulations under Sections 163 (J) and 7701 (1)

This report, prepared by an ad hoc committee of the Tax Section of the New York State Bar Association^{1/}, considers issues that might be addressed by Regulations or other guidance under the amendments made to Section 163(j) of the Internal Revenue Code by the Revenue Reconciliation Act of 1993 and under new Section 7701(1) of the Internal Revenue Code. We consider these issues in a single report because, as set forth below, one of the principal contexts for the application of the Internal Revenue Service's back-to-back loan rulings is under Section 163(j).

Summary of statutory provisions. Effective for taxable years beginning after December 31, 1993, the Revenue Reconciliation Act amended Section 163(j) of the Internal Revenue Code to extend the definition of "disqualified interest" to interest on third party debt guaranteed by a related person and to eliminate the "grandfather" for interest on debt incurred on or before July 10, 1989. A guarantee is broadly defined by the statute, and the legislative history expands that definition even further. Section 7701(1), effective on the date of the enactment of the Revenue Reconciliation Act, authorizes the issuance

^{1/} Consisting of William L. Abrams, Reuven S. Avi-Yonah, Howard J. Barnet, Jr., Alan S. Berlin, Thomas A. Bryan, James W.C. Canup, John A. Corry, John J. Creed, Robert Feinschreiber, Stephen P. Foley, Mitra Forouhar, Gary M. Friedman, David M. Goldman, Alan W. Granwell, Michael Hirschfeld, Richard A. Horodeck, Jonathan T. Lebow, Byungkwon Lim, Pinchas Mendelson, Deborah L. Paul, R.J. Ruble, Michael J. Rufkahr, Ian Schachter, Lawrence E. Shoenthal, Philip H. Spector, Andrew Sperling, Esta E. Stecher and Willard B. Taylor, who was the principal draftsman. Helpful comments were received from Peter C. Canellos, Carolyn Joy Lee, Emily S. McMahon, Stephen L. Millman and Michael L. Schler.

of Regulations that may recharacterize any "multiple-party financing transaction" as directly among any two or more parties if recharacterization is appropriate to prevent tax avoidance. Without limiting the scope of this authority, the legislative history describes as "appropriate" published Internal Revenue Service rulings with respect to back-to-back loans and also a technical advice memorandum issued with respect to a back-to-back financing involving equity.^{2/}

We support the effort to provide guidance in Regulations with respect to back-to-back loans and other multi-party financing transactions. The Tax Section has previously recommended a comprehensive approach to these issues.^{3/}

I - Issues to be addressed under Section 7701(1)

We turn first to issues that might usefully be addressed by Regulations or other guidance under Section 7701(1). In a summary of what is set out below:

(a) Consideration should be given to limiting the specific operating rules of the Section 7701(1) Regulations to enumerated provisions of the Internal Revenue Code. These would include, for example, the determinations of whether (i) U.S. withholding tax is due under Sections 1441 and 1442 on payments of U.S. source income and (ii) there is an investment by a controlled foreign corporation in United States property under Section 956. Other specific provisions of the Internal Revenue Code might also be identified, and the Regulations could provide

^{2/} These are Rev. Rul. 84-152, Rev. Rul. 84-153, Rev. Rul. 87-89 and Tech. Adv. Mem. 9133004 (May 3, 1991).

^{3/} See New York State Bar Association Tax Section, Report on Proposed Regulations Under Section 163(j), Tax Report #701 (October 23, 1991).

for the addition of other provisions (on a prospective basis) by ruling or announcement. While the specific rules in the Section 7701(1) Regulations would not apply for purposes of other Internal Revenue Code provisions, the Regulations might restate case law anti-conduit principles and expressly state that no implication as to the Internal Revenue Service's ability to recharacterize transactions under such case law principles should be drawn from the existence of specific rules in the Regulations with respect to enumerated sections of the Internal Revenue Code.

(b) A multi-party financing transaction for the purposes of Section 7701(1) should be defined as a transaction involving more than two parties in which one party is financed and two of the parties are related to, or acting in concert with, each other. Acting in concert could include a case where the party had actual knowledge that it was dealing with a conduit arrangement intended to avoid U.S. withholding taxes. The recharacterization authorized by Section 7701(1) would disregard the parties that are unrelated or not acting in concert for purposes of applying the specifically enumerated provisions of the Internal Revenue Code. The character of the transaction (e.g., as debt or equity) would be determined on the basis of the component of the overall transaction to which the U.S. person was a party. If a party was related to at least one other party, no case-by-case determination whether tax avoidance is involved would be required; if it was not, but there was another party acting in concert with that party, it might be appropriate to require some showing of tax avoidance. Recharacterization should not impose withholding obligations on a U.S. person that deals with an unrelated person which is a conduit for a third party if the U.S. person is neither related to, nor acting in concert with, the third party.

(c) While a multi-party financing transaction may involve equity and the licensing or leasing of property, in addition to back-to-back loans, a mere guarantee should in general not be regarded by the Section 7701(1) Regulations as equivalent to a borrowing by the guarantor.

(d) Different standards should be used in different contexts in applying Section 7701(1). For purposes of determining whether there has been an investment in United States property, we would suggest that the "would-not-have-been-made-or-maintained-on-the-same-terms" standard of Revenue Ruling 87-89 be modified to incorporate a requirement of a material economic difference in terms. A statutory or contractual right of offset would conclusively establish such a difference. For purposes of withholding tax in a non-treaty context, it might be appropriate to use the same standard. Alternatively, the Regulations might apply a simple rule which treats an arrangement as a conduit if it involves a statutory or contractual right of offset but not otherwise. A third approach would be to apply whatever rule is applied in the tax treaty withholding context, as discussed in paragraph (g) below.

(e) The recharacterization provided for in the Section 7701(1) Regulations should ordinarily relate only to the treatment of the parties who are related or acting in concert under the specific Internal Revenue Code provision involved. Put the other way around, it should generally not affect the tax treatment of an intermediary that is unrelated to and not acting in concert with the party ultimately financed.

(f) Since the purpose of Section 7701(1) is to prevent tax avoidance, taxpayers should not be entitled to rely on Regulations issued under that Section, but would be as entitled in this area as in any other to assert that the sub

stance of a transaction differs from its form and governs its tax consequences. In addition, any treaty or other rule that would apply to the transaction as recharacterized by the Internal Revenue Service should be available to the taxpayer.

(g) There are arguments for giving a U.S. income tax treaty ratified after the issuance of the Section 7701(1) Regulations precedence over the Regulations. Alternatively, in this and any other treaty context, the Regulations might use a more fully worked out version of the "complete dominion and control" test of Aiken Industries and Revenue Rulings 84-152 and 84-153 or it might replace or supplement that test with a base erosion test derived from tax treaties.

(h) Ensuring compliance with Section 7701(1) Regulations involves no special issues that justify new forms or other special compliance procedures. As a simplification measure, consideration might be given to exempting small transactions from the conduit rules.

(i) Regulations under Section 7701(1) should generally apply to transactions entered into after the date such Regulations are proposed but should not impose withholding obligations in respect of payments made before the Regulations are issued as Final Regulations.

In more detail our suggestions with respect to Regulations under Section 7701(1) are as follows:

1. Purposes for which Section 7701(1) will apply. The first question is whether the purposes for which a "multi-party financing transaction" may be recharacterized should be limited to specific provisions of the Internal Revenue Code or the

Regulation should state its application more generally (e.g., "for the purposes of any tax imposed by title 26").

Internal Revenue Service rulings and Regulations have heretofore used conduit principles only in four specific contexts. The published and private Internal Revenue Service rulings with respect to back-to-back loans have recharacterized multi-party financing transactions solely for purposes of determining whether (1) interest was subject to U.S. withholding tax^{4/} or (2) a borrowing by a U.S. person was an investment in United States property by a controlled foreign corporation under Section 956 of the Internal Revenue Code.^{5/} The legislative history of Section 163(j), as well as the Proposed Regulations under that Section, provide for the recharacterization of multi-party financing transactions for the purposes of that section,^{6/} and the interest allocation and apportionment Regulations permit the Internal Revenue Service to disregard "back-to-back loans" that are ultimately between members of the same affiliated group.^{7/}

^{4/} See Rev. Rul. 84-152, Rev. Rul. 84-153 and Rev. Rul. 87-89. See also Tech. Adv. Mem. 9133004 (May 3, 1991). Aiken Industries, Inc. V. Commissioner, 56 T.C. 925 (1971), also involved the U.S. withholding tax on interest.

^{5/} Rev. Rul. 87-89. See also Regs. §§ 1.864-8T(c) (3) (iv) and 1.956-3T(b)(2)(iv).

^{6/} See Conference Committee Report, Statement of the Managers, H.R. 3299, released November 21, 1989, issued as CCH Special 6, STANDARD FEDERAL TAX REPORTS No. 50, Extra Edition, November 22, 1989, pp. 66-67 and Prop. Regs. § § 1.163(j)-1(f), stating that

"[A]rrangements, including the use of partnerships or trusts, entered into with a principal purpose of avoiding [section 163(j)] ... shall be disregarded or recharacterized to the extent necessary to carry out the purposes of section 163(j)".

^{7/} Regs. § 1.861-11T(c)(3).

Serious consideration should be given to limiting the specific rules in the Section 7701(1) Regulations to enumerated provisions of the Internal Revenue Code. These would include the determination of whether there has been an acquisition of United States property for purposes of Section 956, whether U.S. withholding tax is due on interest, dividends and royalties under Sections 1441 and 1442 and, except as discussed in part II below, whether interest paid by a U.S. person is subject to Section 163(j). The list would thus be longer than what so far has been covered by the published Internal Revenue Service rulings since it would include withholding tax on dividends and royalties as well as interest and would include investments in United States property other than debt obligations. It may be appropriate to add other specific sections of the Internal Revenue Code to the list^{8/} and to reserve the option of identifying other sections by a Revenue Ruling or other statement^{9/}. Before extending conduit principles developed in the foreign area to domestic issues, however, the purposes and principles underlying those issues should be evaluated carefully and any rules should be coordinated with the tax policies and business practices relevant in such areas.

^{8/} Other contexts in which it makes a difference to whom interest is paid include Section 163(e)(3) (original issue discount on obligations held by a related foreign party) and Section 267(a) (3) (deductibility of losses and matching of income and expense in transactions between related parties).

^{9/} See, e.g., Prop. Regs. § 1.7872-5(b)(15), relating to exemptions from Section 7872.

Regulations under Section 7701(1) would not, of course, displace anti-abuse rules under the sections specifically enumerated^{10/} or under any provision not enumerated^{11/}, and the Section 7701(1) Regulations should expressly state that there is a case law anti-conduit concept and that the absence of a specific set of rules in the Regulations with respect to any particular provision of the Internal Revenue Code creates no inference as to the ability of the Internal Revenue Service to assert that a multiparty financing transaction should be recharacterized under such general case law principles for the purposes of that provision. There are many contexts in which "conduit" arrangements have been recharacterized by the courts.^{12/}

There are three reasons for this recommendation.

First, the application of Section 7701(1) Regulations for all purposes of title 26 will create substantial uncertainty, particularly if the Regulations apply to purely domestic

^{10/} See, e.g., Rev. Rul. 76-192 applying Regs. § 1.956-1(b)(3) to find that there was an investment in United States property when one foreign subsidiary made a deposit with a foreign bank, that bank made a loan to another foreign subsidiary and the second foreign subsidiary made a loan to the U.S. parent. See also. Rev. Rul. 80-362 (back-to-back patent royalties).

^{11/} Such as Regs. § 1.861-11T(e)(3).

^{12/} See, e.g., Court Holding Co. v. Commissioner, 324 U.S. 331 (1945) and Waterman Steamship Corp. v. United States, 430 F.2d 1185 (5th Cir. 1970), where the Court said that "the corporation was a mere conduit for passing the payment through to the seller". 430 F.2d at 1191. There are also different formulations of the test to be applied. Thus, in P.R. Farms Inc. v. Commissioner, 820 F.2d 1084 (9th Cir. 1987), the Court said (820 F.2d at 1087) that it would not treat a related entity as a conduit

if (1) the parties to transactions respect formal distinctions between the entity and others, (2) the entity exists for a valid business purpose, and (3) the transaction in question is incident to the entity's business.

transactions and/or recharacterization affects parties other than the party that is ultimately financed.

To take an example, if A issues debt to B with a return indexed in part to the value of property and, in turn, lends on an unindexed basis to C and hedges its exposure to the value of the index with D, application of the would-not-have-been-made-or-maintained standard of Rev. Rul. 87-89 could arguably result in B being treated as a direct party to the transactions with C and D, resulting in substantially different tax consequences to B and, possibly, to A. If A, B, C and D are all unrelated domestic taxpayers, we see no reason why these and other "repackaging" transactions should be affected by the Section 7701(1) Regulations. If A was foreign and B was domestic, the Section 7701(1) Regulations might recharacterize the transaction for purposes of Section 956 and Sections 1441 or 1442.

In recommending that Section 7701(1) be limited to specified sections of the Internal Revenue Code, we recognize that Section 7701(1) will likely be limited in other ways – for example, it may not apply unless at least two parties who are related or acting in concert are involved and/or there is a specific determination that tax avoidance is present^{13/}. We nonetheless conclude that taxpayers should not have to worry about the possible impact of that Section except in the specific areas identified by the Internal Revenue Service as areas of concern. The fact that a particular section of the Internal Revenue Code was not listed in the Section 7701(1) Regulations

^{13/} See "3. when will transactions be recharacterized" below.

would not limit the ability of the Internal Revenue Service under case law principles to recharacterize a transaction as conduit financing or otherwise for purposes of that section.

Second, the standard for recharacterizing a multi-party transaction as one directly between two or more of the parties may differ according to the purpose of the particular Internal Revenue Code section involved. The "would-not-have-been-made-or-maintained-on-the-same-terms" test of Rev. Rul. 87-89, for example, may be appropriate for determining whether there is an investment in United States property but not for determining whether U.S. withholding tax is due on payments made to a nonresident alien or foreign corporation. Who is or is not "related" may also vary from one section to another -- a 10% or greater shareholder is ineligible for the exemption for "portfolio interest" but a greater degree of equity ownership is required to be a related person for purposes of Sections 163(j) and 956.

Third, while Section 7701(1) is plainly not by its terms limited to any particular part of the Internal Revenue Code (and indeed applies to "prevent avoidance of any tax imposed by" title 26), the focus of the legislative history is the sort of transactions previously dealt with by published Internal Revenue Service rulings. Limiting the Regulations to specific provisions, although certainly not required, would be consistent with this focus -- the withholding tax and investments in United States property are the only contexts in which the legislative history discusses the scope of the Section 7701(1) Regulations; there is no mention of purely domestic transactions.

We have set out above some of the specific provisions of the Internal Revenue Code that might be dealt with by the Section

7701(1) Regulations. There are, of course, situations which, although arguably involving "conduits", might be better dealt with by Regulations under more specific provisions of the Internal Revenue Code. By way of illustration, we do not think Regulations under Section 7701(1) are the best way to deal with so-called leveraged ownership FSC transactions, i.e., transactions in which, in order to get a full deduction for interest expense on debt incurred in connection with the acquisition of leased property, the debt is incurred by a U.S. subsidiary that owns the stock of the FSC and contributes the proceeds of the debt to the capital of the FSC. A better way to deal with the issues involved in such transactions would be by Regulations defining "exempt foreign trade income" of a FSC and in the Regulations relating to the allocation and apportionment of interest expense.

If, contrary to our suggestion, the Section 7701(1) Regulations do not limit the specific operating rules to enumerated Sections of the Internal Revenue Code, it will be necessary to limit their scope in other ways -- most likely, by requiring, as the courts have, a case-by-case determination of tax avoidance. That may restrict the position taken by the Internal Revenue Service in the published rulings under Sections 956, 1441 and 1442, which do not as such require such a case-by-case determination of tax avoidance.

The balance of this Report assumes that the Section 7701(1) Regulations will recharacterize transactions only for the purposes of specifically enumerated provisions of the Internal Revenue Code.

2. Definition of a "multi-party financing arrangement".
As the committee understands the term, a "multi-party financing

transaction" is a transaction that involves more than two parties and finances the operations of one, and the "recharacterization" authorized by Section 7701(1) is to disregard the role of one or more of the related or unrelated parties and treat the transaction as directly between the party that is ultimately financed and the party that ultimately provides the financing, either directly or through its credit. The paradigm is the financing described in Rev. Rul. 84-152, i.e., a borrowing by a U.S. corporation from an affiliated foreign finance company that is treated for withholding tax purposes as made by the U.S. corporation directly from the lender to that foreign affiliate. The standard to be applied in determining whether recharacterization is appropriate is discussed below in "3. When will transactions be recharacterized?"; in addition, the committee believes that in defining a multi-party financing, the Internal Revenue Service should consider the following:

(a) If the issue is a liability for withholding tax under Section 1441 or 1442, the party ultimately financed should be related to, or acting in concert with, at least one of the other parties. This was the case in the two published Internal Revenue Service rulings with respect to withholding taxes and, since withholding taxes are economically borne by the payor (not the recipient of income), it seems to us to be an essential component of the definition of a multi-party financing transaction in determining whether there is a withholding tax liability under Sections 1441 and 1442. Acting in concert could include a case where the U.S. person that is ultimately financed has actual knowledge that it was dealing with a conduit arrangement set up to avoid U.S. withholding taxes. Since an investment in United States property or a loan or guarantee for purposes of Section 163(j) almost always will involve a person related to the party ultimately

financed¹⁴/, the application of Section 7701(1) for purposes of those Sections will generally incorporate this limitation as well.

By way of illustration, we do not see why the Section 7701(1) Regulations should require a U.S. person to withhold on interest paid to an unrelated foreign lender that borrows on its own credit, or with the guarantee of a person unrelated to the U.S. person, from another foreign lender unrelated to the U.S. person in a case where the U.S. person was not involved in the structuring of the arrangement and not otherwise acting in concert and did not have actual knowledge that it was dealing with a conduit arrangement set up to avoid the residual U.S. withholding tax on interest. It is not realistic to require a U.S. borrower to be satisfied, on pain of a withholding tax liability, that an unrelated foreign lender is not a conduit for a loan provided by a person unrelated to the U.S. borrower. Conversely, if either of the foreign lenders was related to, or operating in concert with, the U.S. borrower, or the U.S. borrower actually knew that the foreign lender was a conduit set up to eliminate the residual U.S. withholding tax on interest, it would be appropriate to recharacterize the transaction as a loan directly from the ultimate lenders to the U.S. borrower if it meets the standard (See "4. When will transactions be recharacterized?" below) for recharacterization.

The Section 7701(1) Regulations should, however, impose liability on the foreign person, under Section 871 or Section 881, notwithstanding that the U.S. payor is excused from any responsibility to withhold. This is appropriate, given the language and purposes of Section 7701(1), although there are

¹⁴/ There are cases, however, in which an investment in United States property does not include stock or an obligation of a related person.

obvious issues as to how the foreign person's liability will be enforced as a practical matter.

The definition of who is or is not "related" for this purpose will vary with the particular section^{15/}. It may be appropriate to define a guarantee for the purpose of determining when a party's involvement as guarantor is sufficient to meet the requirement that at least two of the parties to the transaction be related.

While for withholding tax purposes the party ultimately financed would have to be related to, or acting in concert with, another party, the party ultimately providing the financing would not.^{16/} If there is a party related to the party ultimately financed, no specific determination of tax avoidance would be required to recharacterize the transaction; if there was a party apparently acting in concert with the party ultimately financed, however, it might be appropriate, before recharacterizing the transaction, to require a showing that, on all the facts and circumstances, there was tax avoidance.

^{15/} see Sections 871(h)(10) defining a "10-percent shareholder" for purposes of the exemption for portfolio interest and 163(j)(4) defining a related person for purposes of that section. There are other, sometimes different definitions of related in, e.g., Sections 163(e)(3) and 954(c).

^{16/} See Rev. Rul. 84-152 in which a finance subsidiary of a foreign parent issued debt and lent the proceeds to a sister U.S. corporation. Although the foreign parent "arranged to have" the finance subsidiary "issue" the debt, there was apparently no parent guarantee.

(b) The financing transaction need not be a debt financing,^{17/} but, in addition to back-to-back loans, could also include financings where one or more of the components of the transaction was equity in a corporation or in a partnership and could, in appropriate circumstances, include the licensing or leasing of intangible or tangible property. For example, if a controlled foreign corporation lent to an unrelated corporation which, in turn, bought stock of the controlled foreign corporation's U.S. parent, that could be an investment in United States property within the meaning of Section 956 if it met the standard for recharacterization; likewise, a license by a foreign corporation to a U.S. corporation of intangible property purchased with the proceeds of debt could be treated as made directly from the lenders if it met the standard for recharacterization. The role of a guarantee under Section 7701(1) is discussed in II - Issues to be addressed under Section 163(j) below.

(c) Recharacterization should not be restricted by the Internal Revenue Code's treatment of the transaction for purposes other than the purpose for which Section 7701(1) applies. If a partnership borrows to fund a loan to a U.S. corporation, and the U.S. corporation and the lenders are related or acting in concert, it should make no difference in applying

^{17/} Not limiting Section 7701(1) Regulations to back-to-back loans would be consistent with the statement in the legislative history that "[it is intended] that [Section 7701(1)] apply not solely to back-to-back loan transactions, but also to other financing transactions. For example, ... transactions involving debt guarantees or equity investments". See House Ways and Means Committee Report No. 103-11, H.R. 2141, released May 19, 1993, issued as CCH Special Number 6, STANDARD FEDERAL TAX REPORTS No. 22, Extra Edition, May 20, 1993 p. 292.

say, Section 163(j) that for purposes of Subchapter K the partnership is a partnership or that the partnership is adequately capitalized and the debt would therefore generally be respected as debt of the partnership.

3. When will transactions be recharacterized? In setting out the circumstances in which Section 7701(1) Regulations will apply, it seems to the committee that there are two questions, as follows:

First, recharacterization is contemplated only when "appropriate to prevent the avoidance of any tax imposed by" title 26. This could be implemented by testing each particular transaction for a tax avoidance motive^{18/}, but it is difficult in many cases to say whether tax avoidance or a business purpose drives a transaction and it would be preferable, therefore, to identify such transactions on an objective basis. This is a further reason for restricting the specific operating rules in the Section 7701(1) Regulations to specific provisions of the Internal Revenue Code and to transactions in which at least two of the parties are related or are acting in concert. The presence of two or more persons which are related should be enough if one is the party ultimately financed; if there are not two or more related persons, but there is a person acting in concert with the party ultimately financed, it might be desirable to require some showing that, on all of the facts and circumstances, there was tax avoidance.

^{18/} See Regs. § 1.1504-4 (b) (2), which considers options to be exercised for the purposes of determining whether there is an affiliated group if the option would otherwise "result in the elimination of a substantial amount of federal income tax liability". See also Regs. § 1.108- 2(c) and Prop. Regs. § 1.382-4(d)(2).

Second (and regardless of how the determination of motive is determined), it will be necessary to set out the standard for determining when a transaction may be appropriately recharacterized.

A. U.S. withholding tax on payments to treaty country residents. In cases involving U.S. withholding tax on payments of U.S. source interest to treaty country residents, the test under Rev. Rul. 84-152 and Rev. Rul 84-153, which is essentially derived from Aiken Industries, is whether the intermediary has "complete dominion and control" over the interest received.^{19/} The choice of a standard in this context essentially involves the issue of the relationship between Section 7701(1) and tax treaties and is discussed in Section 8 below.

B. Other cases. In cases not involving U.S. withholding tax on payments to a treaty country resident, the standard in Rev. Rul. 87-89, which is now incorporated in the Regulations relating to acquisitions of related party receivables^{20/}, is whether the loan to the ultimate borrower would not have been made or maintained on the same terms in the absence of the loan by the ultimate lender -- if not, there is an investment in United States property and, where no tax treaty applies, U.S. withholding tax on payments made to a foreign person. For this purpose, there is a presumption that a loan would not meet the test if there is a statutory or contractual right of offset. The would-not-have-been-made-or- maintained-on-the-same-terms test

^{19/} As the legislative history of Section 7701(1) notes, Tech. Adv. Memorandum 9133004 interprets the complete dominion and control test as in effect not requiring that the intermediary's payments be pursuant to any legal obligation. The Technical Advice Memorandum involved a case where interest was received and invariably paid out as dividends, and the Memorandum concludes that the subsidiary was "no less a conduit for funds because payments to the parent were in the form of dividends".

^{20/} Regs. §§ 1.864-8T(c) (3) (iv) and 1.956-3T(b) (2) (iv).

encompasses a case where the loan (or other financing) could not have been made or maintained at all without the loan (or other financing) made by the ultimate lender, as well as a case where the terms of the transaction with the party ultimately financed differ because of the financing by the party ultimately providing the financing. It is a tough rule that apparently tolerates no variation, however small, in the ultimate loan on account of the first loan.

The legislative history of Section 7701(1) authorizes the issuance of Regulations that simply incorporate the standard of Rev. Rul. 87-89.^{21/} We would, however, suggest replacing this standard with several different rules, depending on the context.

First, where the issue is investment in United States property under Section 956 of the Code, we believe that a modified form of Revenue Ruling 87-89 standard would be appropriate. As modified, the rule would catch any transaction in which there was a statutory or contractual right of offset or in which the economic terms of the transaction involving the United States person are materially affected by the transaction involving the controlled foreign corporation. Whether differences are meaningful might be determined by standards similar to the "significant modification" rules in the proposed regulation under Section 1001.^{22/} The taxpayer would have the burden of proving that the difference were not meaningful.

^{21/} See House Ways and Means Committee Report No. 103-11, H.R. 2141, released May 19, 1993, issued as CCH Special Number 6, STANDARD FEDERAL TAX REPORTS No. 22, Extra Edition, May 20, 1993 p. 290-92.

^{22/} Prop. Reg. 1.1001(e).

The arguments for modifying the standard are that, except where there is a right of offset, the existing would-not-have-been-made-or-maintained-on-the-same-terms test requires Internal Revenue Service agents to make sophisticated judgments as to what would have happened had something else not occurred. This ought to be avoided, if possible, and making the presumption in Rev. Rul. 87-89 conclusive but otherwise narrowing the circumstances in which there will be a recharacterization will to some extent do this. In addition, the would-not-have-been-made-or-maintained-on-the-same-terms test is a much more stringent rule than that applied by Regulations issued in other, arguably similar, contexts. The "disguised sale" Regulations, for example, generally adopt a "but for" test in determining whether there has been a disguised sale of property by a partner to a partnership.^{23/}

Second, in the non-treaty withholding context, there are several possible options. One approach would be to use the standard suggested for Section 956. It might, however, be unreasonable to impose withholding tax burdens on the United States persons based upon whether the terms of certain foreign transactions materially altered the economic terms of the transaction to which the United States person is party. As noted, applying the "would-not-have-not-been-made-or-maintained-on-the-same-material-terms" standard would require the Internal Revenue Service agents and withholding agents to make sophisticated judgments as to what would have happened if something else had not occurred. This seems to be an unreasonable burden in a withholding context. It is also arguable that imposing such a standard in this context would make the rules

^{23/} see Regs. § 1.707-3(b)(1)(i). Like Section 7701(1), Section 707(a)(2)(B) recharacterizes "indirect" transactions as "direct" transactions.

applicable to conduit transactions considerably tougher, in certain circumstances, than rules which may be applied to guarantees.^{24/}

By way of illustration, if a U.S. corporation borrows from unrelated foreign lenders, and interest on the debt is exempt from U.S. withholding tax as portfolio interest, notwithstanding that the debt is guaranteed by the corporation's foreign parent, should interest paid by the U.S. corporation to an unrelated bank be treated as paid to the foreign parent simply because the foreign parent has made a deposit with the bank that is not subject to a right of offset and results in the debt of the U.S. subsidiary bearing a lower rate of interest? To be sure, in the deposit case the foreign parent has advanced funds, but it is not obvious why this should be decisive and we therefore suggest that a less stringent test than the Rev. Rul. 87-89 test (as modified for materiality) be considered if the issue is the U.S. withholding tax on interest.

A third approach might be to apply in the non-treaty context whatever rule is applied in a treaty context. Certainly, there is a strong argument that the rule with respect to non-treaty withholding should not be more liberal than the rule applicable in the tax treaty context. Accordingly, the treaty standard could be used in non-treaty withholding situations or it could be an additional standard which would also have to be satisfied if either of the previously mentioned alternative standards was adopted.

^{24/} withholding tax on payments to non-treaty country residents is largely relevant only in determining whether interest is free from U.S. withholding tax as "portfolio interest" (since, where no treaty is involved, there would be a 30% withholding tax on dividends and interest).

The appropriate standard under Section 163(j) is discussed in "II - Issues to be addressed under Section 163 (j)" below.

4. Guarantees. The legislative history indicates that Section 7701(1) Regulations may apply to guarantees.^{25/} Except in egregious cases,^{26/} guaranteed debt is generally treated as debt of the nominal borrower, not of the guarantor. It is unclear precisely what the legislative history contemplates, but we urge caution in changing this general rule and generally treating a guarantee as a borrowing by the guarantor for Section 7701(1) purposes.

There are already rules for direct and indirect guarantees in the Regulations under Section 956 of the Internal Revenue Code^{27/} and a statutory guarantee rule for purposes of Section 163(j). Nothing further seems to be required for the purposes of those sections. Treating a guarantor of debt as the borrower for U.S. withholding tax purposes does not seem to us to be justified by any particular abuse. To take a simple example, if a U.S. corporation guarantees debt of its foreign subsidiary and as a result of the guarantee the debt is treated under the Section 7701(1) Regulations as debt of the U.S. parent for U.S. withholding tax purposes, the interest may or may not be subject to U.S. withholding tax, depending on whether it is "portfolio interest". Assuming that the foreign subsidiary is adequately capitalized, there is no abuse that justifies that result.

^{25/} The House Report says that "it would be within the proper scope of the provision ... to issue regulations dealing with multiple-party transactions involving debt guarantees" See House Ways and Means Committee Report No. 103-11, H.R. 2141, released May 19, 1993, issued as CCH Special Number 6, STANDARD FEDERAL TAX REPORTS No. 22, Extra Edition, May 20, 1993 p. 292.

^{26/} See, e.g., Plantation Patterns v. Commissioner 462 F.2d 712, 722 (1972).

^{27/} See Reg. § 1.956-2 (c) (1).

Likewise, if a U.S. subsidiary borrows on the strength of a guarantee by its foreign parent, it makes no sense to treat the debt as debt of the foreign parent for U.S. withholding tax purposes, assuming that the U.S. subsidiary is adequately capitalized, and to do so seems completely inconsistent with Congress' perception that, apart from the enactment of Section 7701(1), it was necessary to amend Section 163(j) to cover guaranteed debt.^{28/}

5. Effect of Recharacterization. The recharacterization authorized by Section 7701(1) is to disregard intermediaries and treat the transaction as "directly" between or among two or more of the parties. Where the transaction is a back-to-back loan, recharacterization would simply treat the loan as made to the ultimate borrower by the ultimate lender, as set out in Rev. Rul. 84-152 and 84-153. Where not all the pieces are the same (e.g., are not both debt), recharacterization should be based on the transaction to which the U.S. taxpayer is a party since it is that transaction that determines the U.S. taxpayer's contractual rights and obligations -- if, for example, a foreign corporation lends to a U.S. corporation out of the proceeds of equity, and it is determined that the transaction should appropriately be recharacterized as one between the U.S. corporation and the shareholders of the foreign corporation, recharacterization should treat the U.S. corporation as borrowing from those shareholders, and not issuing equity, assuming that the financing would be treated as debt if it had been from those shareholders.

^{28/} The interest on the debt of the U.S. subsidiary would, of course, be subject to Section 163(j).

Likewise, if the foreign corporation licenses a U.S. corporation to use property that it has acquired with debt, and it is determined that the transaction should appropriately be treated as between the U.S. corporation and the creditors of the foreign corporation, recharacterization should treat the U.S. corporation as licensing from those lenders, not as borrowing.

6. Effect of recharacterization on third parties.

Related to the issue of whether Section 7701(1) Regulations should limit recharacterization to specific provisions of the Internal Revenue Code is the issue of whether recharacterization should affect third parties unrelated to, and not acting in concert with, the related parties involved.

Suppose, for example, that an Australian, Canadian or Swiss parent corporation makes a deposit with a foreign bank and the U.S. branch of that foreign bank then lends to a U.S. subsidiary. Should the foreign bank otherwise be affected by the conclusion that the loan is between the U.S. subsidiary and the foreign parent for purposes of imposing U.S. withholding tax on interest at the 10%, 15% or 5% rate provided in the relevant treaties, or that the interest was paid to the foreign parent for purposes of Section 163(j)? The same issue may come up if the foreign corporation is a controlled foreign corporation and the U.S. borrower is a United States shareholder of that corporation.

It seems to the committee that the recharacterization authorized by Section 7701(1) should generally have no effect on an unrelated intermediary unless that intermediary actively promotes itself as such -- specifically, in the cases described above, it should not affect the conclusion that the foreign bank has borrowed from the foreign parent and its U.S. branch has lent to the U.S. subsidiary. Among other things, recharacterizing the

transaction for purposes of determining the treatment of the intermediary might impose on the intermediary responsibility as a withholding agent with respect to United States source interest payments, and it seems to the committee that this is inappropriate. While the bank may institutionally know that the foreign corporation's deposit supported its loan to the U.S. corporation, it is unlikely that it considered the U.S. tax issues involved and we see no reason why it should be forced to do so on penalty of otherwise being regarded as a withholding agent.

In addition, if the standards for recharacterization differ depending on whether the issue involves Section 163(j), Section 956 or the U.S. withholding tax, the treatment of the intermediary would be affected by considerations wholly unrelated to its role. Thus, if our recommendation is not adopted, the treatment of a financial intermediary might differ depending on whether the issue affecting an unrelated U.S. person was Section 956 or Section 163(j).

We understand that our recommendation may be contrary to the Proposed Regulations relating to the determination of the interest expense of a foreign bank corporation that does business in the United States through a branch or otherwise^{29/}, but the Tax Section has criticized that example^{30/}, and the committee believes that the determination of whether an intermediate party should be disregarded for the purposes of applying U.S. withholding tax or determining whether there is an investment in

^{29/} Prop. Regs. § 1.882-5(f), Example (2), would, if adopted, net the deposit and the loan in determining the foreign bank's "booked" liabilities for purposes of "step 3" of its calculation of deductible interest expense.

^{30/} See New York State Bar Association Tax Section, Report On Proposed Regulations Section 1.882-5, Tax Report #733 (August 26, 1992).

United States property does not require that the intermediate party be disregarded for purposes of determining its own treatment of the transaction for tax purposes.

7. Should taxpayers be entitled to rely on Regulations issued under Section 7701(1)? The Internal Revenue Service's position on whether a taxpayer can rely on the published back-to-back loan rulings is unclear^{31/}; and, as the case law has evolved, a taxpayer is generally entitled to disavow the form of its transaction if it can adduce "strong proof" that such form is inconsistent with its substance of the transaction^{32/} or, even without "strong proof", if the form is ambiguous^{33/}. Since Section 7701(1) Regulations are intended to recharacterize transactions only when "appropriate to prevent avoidance" of tax, however, it would seem to follow that a taxpayer should not be entitled to rely on such Regulations to recharacterize a financing transaction as directly between the ultimate provider of funds and the ultimate user.

While we conclude, for the reasons indicated, that taxpayers should not be able to rely on the Regulations issued under Section 7701(1) to disavow the form of a transaction, they should be as entitled in the area of multi-party financings as in any other to adduce "strong proof" that the form of a transaction is inconsistent with its substance or, if the form is ambiguous, that the transaction should be given effect in accordance with

^{31/} Rev. Rul. 87-89 states that its "holdings do not provide a taxpayer the right to compel the Internal Revenue Service to disregard the form of its transactions for Federal income tax purposes", citing Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134 (1974). There is no similar statement, however, in Rev. Rul. 84-152 or Rev. Rul. 84-153.

^{32/} See, e.g., Coleman v. Commissioner, 87 T.C. 178

^{33/} See, e.g., Patterson v. Commissioner, 810 F.2d 562 (6th Cir.1987); Elrod V. Commissioner, 87 T.C. 1046 (1986).

the substance under case law principles. In addition, if the Internal Revenue Service's published rulings with respect to back-to-back loans remain outstanding for periods prior to the issuance of Regulations, a taxpayer should be entitled to rely on those rulings to the same extent as the Internal Revenue Service. The contrary statement in Rev. Rul. 87-89 that its holdings "do not provide a taxpayer [such a] right" does not reflect current law on the ability of a taxpayer to assert that a transaction should be given effect in accordance with its substance. If a transaction is recharacterized by the Internal Revenue Service, a taxpayer should, of course, be entitled to apply whatever treaty or other rule applies to the transaction as recharacterized -- if a U.S. source royalty paid by a U.S. corporation to a U.K. corporation is treated as paid to an Australian corporation, for example, the rate of withholding should be the 10% rate provided in the U.S.-Australian treaty, not the 30% rate that applies in the absence of a treaty.

8. Relationship with tax treaties. The legislative history of Section 7701(1) is silent on the relationship between Regulations issued under that Section and provisions of U.S. income tax treaties, although it does sanction the two published rulings, Rev. Rul. 84-152 and Rev. Rul. 84-153, which construed the words "derived ... by" in Article VIII of the U.S. Netherlands tax treaty, and the decision in Aiken Industries, which construed the words "received by" in the since-terminated U.S.-Honduras income tax treaty.

The relationship between Section 7701(1) and U.S. tax treaties will be an issue in cases where the Regulations disregard an intermediary treaty country resident for purposes of determining the U.S. withholding tax on payments to that resident and the party ultimately financed is related to or acting in

concert with one or more of the parties involved in the transaction³⁴/. Treaties will ordinarily not be an issue if such a resident is disregarded for purposes of determining whether there is an investment in United States property for purposes of Section 956³⁵/ or whether interest paid to that resident is subject to Section 163(j), since disregarding an intermediary treaty country resident for those purposes would ordinarily not be inconsistent with the treaty.

There is an argument that withholding tax rules in a tax treaty should take precedence over Section 7701(1) Regulations if the treaty country resident is the beneficial owner of the item of income³⁶/ and the treaty is ratified after the issuance of Regulations under Section 7701(1). Why shouldn't this be the case if the Senate, with knowledge of the Section 7701(1) Regulations, has chosen to ratify a treaty that does not include appropriate anti-conduit measures? It can be argued, however, that the recharacterization of conduit arrangements is a general principle of tax interpretation that should be left to the domestic tax system and should not become an item of tax treaty negotiation. This is not an easy issue -- on the one hand, newer treaties specifically address "conduit" arrangements³⁷/; on the other hand, treaties ordinarily do not affect, for example, the Court Holding doctrine or cases dealing with the classification of instruments as debt or equity simply because these issues could have been covered in the interpretative sections of the treaties.

³⁴/ This assumes adoption of our recommendation in 2(a) above is adopted.

³⁵/ See Situation 3 of Rev. Rul. 87-89.

³⁶/ In the case of interest, we would not regard the treaty country resident as the beneficial owner if it had a right to offset its liability to another person by the loan to the U.S. person.

³⁷/ See Article 26(8) (m) of the U.S.-Netherlands tax treaty, defining "conduit" companies.

The standard for recharacterization must also be determined when Section 7701(1) regulations are to be applied in a tax treaty context. One approach would be to adopt "the complete dominion and control" test of Aiken Industries and the two published rulings. If this approach is adopted, the scope of the test must be spelled out in more detail. To take an example, if a foreign corporation, as a relatively small part of its operations, borrows and, more or less at the same time, lends to a related U.S. person on terms which, as in the two published rulings, differ somewhat from the terms of the borrowing, how will the "complete dominion and control" test work? Neither Aiken Industries nor the two published rulings provide any guidance outside of the simple case in which the loan is indisputably identified with the borrowing. Answers to this and similar questions could be provided through a series of examples or through the statement of principles for determining whether there is "complete dominion and control" of the item of income by the recipient.

Consideration could also be given, however, to substituting for, or supplementing, the Aiken Industries standard by a test tied to the "base erosion" test in the limitation of benefits articles in tax treaties. This test is designed to reach entities which, on an overall basis, act principally as conduit for non-treaties parties. Under this approach, the Regulations might apply the base-erosion test of the limitations on benefits article of a particular tax treaty,^{38/} notwithstanding that it was ratified before the issuance of the Regulations, or the Regulations might develop a base-erosion test in the Regulations.

^{38/} Treaties with base erosion tests would include, for example, Article 28(1) (e) of the U.S.-German tax treaty, Article 17(1)(g) of the U.S.-Spanish tax treaty, and Article 26(1) (d) and (5) of the U.S.-Netherlands tax treaty, but not Article XV of the U.S.-Luxembourg tax treaty or Article 16 of the U.S.-U.K. tax treaty.

The typical limitation on benefits article that includes a base-erosion test requires that, to qualify for treaty benefits, the foreign corporation must either be publicly traded in the foreign country or the United States or that there be some ownership of the foreign corporation by residents of the treaty country or the United States and that the gross income of the foreign corporation not be used in "substantial part", directly or indirectly, to meet "liabilities" to persons not resident in that country or the United States.^{39/} The base-erosion test differs from the "complete dominion and control" or other transaction-based test, therefore, in that it applies to the overall gross income of the recipient, rather than on an item-by-item basis.^{40/}

The use of a base-erosion test would mean, for example, that interest payments to a treaty-resident foreign corporation that borrowed and lent on back-to-back terms to a U.S. corporation would not be treated as made to the ultimate lenders unless the foreign corporation flunked the base-erosion test.

In favor of a base-erosion test, it can be argued that the use of a particular treaty's base erosion test would avoid overriding the terms of the treaty and, in addition, that a base-erosion test is a better measure of whether there is an abuse than the complete dominion and control test of Aiken Industries and the two published rulings. The "complete dominion and control" test has the merit of preventing conduit arrangements in

^{39/} In the case of the recently-ratified U.S.-Netherlands tax treaty, it is that "less than 50 percent of" the Netherlands corporation's "gross income is used, directly or indirectly, to make deductible payments in the current taxable year" to such persons. Definitions of gross income and deductible payments are provided.

^{40/} There is no indication, however, that the result would have been any different under a base-erosion test than it was in Rev. Rul. 84-152, Rev. Rul. 84-153 or Aiken Industries.

cases where the treaty country resident is not solely or largely used as a conduit. The other arguments in favor of a complete dominion and control test go as follows:

First, it might be argued that allowing an entity to participate openly as a conduit in a particular transaction merely because it satisfies a base-erosion test on an overall basis is inconsistent with the recognition in the legislative history of Section 7701(1) of a transaction-based conduit concept based on Aiken Industries. Accordingly, there would seem to be a need to have some residual transaction-based conduit concept to supplement the reference to the limitations on benefits rule. One possibility would be to require that the tax treaty party be the "beneficial owner" of the income under general tax principles of ownership, turning on benefits and risks of ownership⁴¹/. That standard is not necessarily clearer than Aiken Industries, however, and, to the extent the standards differ, it is hard to see why Congress would have opted for a standard weaker than Aiken Industries.

Second, as noted above, the limitation on benefits article of many treaties excludes from review under the base-erosion test certain publicly traded entities. Obviously, if the limitation of benefits article is to have any utility in preventing conduit transactions, there would be serious problems in not applying the base-erosion test simply because a tax treaty recipient was publicly traded. On the other hand, to require the publicly traded tax-treaty recipient entity to demonstrate compliance with a base-erosion test for purposes of satisfying an anti-conduit rule under Section 7701(1) regulations might create

⁴¹/ As noted, a right of offset would presumably mean that there was no beneficial ownership.

an insuperable burden which would seem to be contrary to the exclusion of publicly traded entities from the base-erosion test.

Both of these arguments, if accepted, militate in favor of applying base erosion in a careful manner outside of the context of the particular treaty and would seem to call for at least some residual transaction-based anti-conduit rule along the lines of Aiken Industries or some other doctrine.

If a base-erosion test were applied in the Section 7701(1) Regulations, certain adjustments would need to be made. In some base-erosion tests, liabilities include only items that are deductible under the foreign tax law and thus, ordinarily, do not include dividends. This seems to the committee to be appropriate^{42/}, since treaties are generally entered into only with countries that impose meaningful corporate taxes and there should be no abuse if the U.S. source income is taxed to the foreign recipient. In cases where no deduction was allowed for dividends, therefore, we would not follow the Technical Advice Memorandum referred to in the legislative history of Section 7701(1). Tax systems that integrate corporate and shareholder taxes by allowing a credit to shareholders for corporate taxes might be regarded as effectively permitting a deduction for this purpose if the credit was allowed to foreign shareholders.

9. Compliance. The U.S. tax system assumes that taxpayers will file returns that comply with the law, and this assumption provides the principal assurance that there will be compliance with the Section 7701(1) Regulations. Put differently, we see no need for additional forms to enforce compliance and, as noted, we do not think that intermediaries should be treated as

^{42/} It may have been the case that the offsetting dividends were deductible in Tech. Adv. Mem. 9133004.

withholding agents for the purposes of enforcing Section 7701(1) unless they promote themselves as such. The transactions that the committee would subject to Section 7701(1) will ordinarily be subject to the reporting requirements of Sections 6038, 6038A or 6038C.

Consideration might be given to excepting small transactions from the Section 7701(1) Regulations -- for example, loans with a principal amount not exceeding \$100,000 (or whatever is perceived as "small"). The structuring of a multi-party financing transaction is a fairly sophisticated transaction and it is unlikely that loans with a small principal amount have been structured with tax avoidance in mind. Aggregation would, of course, be appropriate where there are loans or other transactions between the same parties made within a short time span (e.g., six months or a year) of the loan or other transaction under consideration.

10. Effective date. Regulations under Section 7701(1) should generally apply to transactions entered into on or after Regulations are proposed. If the transaction was entered into after the issuance of the Proposed Regulations, however, and involves ongoing payments (e.g., of interest or other amounts that may possibly be subject to U.S. withholding tax), the Regulations should not apply for withholding tax purposes to such payments until 30 days after they are adopted as final Regulations. If the Regulations are issued as Temporary Regulations, they should not apply to transactions entered into prior to the issuance of the Temporary Regulations and, if the transaction was entered into after the issuance of the Temporary Regulations and involves ongoing payments, should not apply for withholding tax purposes to payments pursuant made before 30 days

from the issuance of the Temporary Regulations. Transactions excluded from the new regulations would be governed by prior law.

We make these recommendations with the understanding that Section 7701(1) is viewed as a priority by the Treasury and the Internal Revenue Service. The issues that Section 7701(1) addresses, however, have been around for many years and there is no emergency that justifies an effective date earlier than that described above. The skimpy guidance in the legislative history as to what might be provided in such Regulations does not justify a different result.^{43/} Prospectivity would also be consistent with the position taken by the Internal Revenue Service with respect to Rev. Rul. 84-152 and Rev. Rul 84-153.^{44/}

The legislative history of Section 7701(1) describes the Internal Revenue Service's published and private rulings with respect to back-to-back financings as "appropriate" and also says that "[i]n legislating in this area, it is not the intent of the committee to cast a negative inference on positions taken by the IRS under present law".^{45/} We question what weight will be given to this as legislative history -- it is the statement of a later Congress with respect to previously-enacted law. Consideration might be given to including in the Regulations a statement that the enactment of Section 7701(1) has no bearing at all on what the law was prior to the enactment of Section 7701(1).

^{43/} See House Ways and Means Committee Report No. 103-11, H.R. 2141, released May 19, 1993, issued as CCH Special Number 6, STANDARD FEDERAL TAX REPORTS No. 22, Extra Edition, May 20, 1993 p. 290-92.

^{44/} See Rev. Rul. 85-163.

^{45/} House Ways and Means Committee Report No. 103-11, H.R. 2141, released May 19, 1993, issued as CCH Special Number 6, STANDARD FEDERAL TAX REPORTS No. 22, Extra Edition, May 20, 1993 p. 291-92.

II - Issues to be addressed under Section 163(j)

1. The first question to be addressed under the amendments made by the Revenue Reconciliation Act of 1993 to Section 163(j) is the effect to be given to the statement in the legislative history that a guarantee "includes an arrangement reflected in a 'comfort letter', regardless [of] whether the arrangement gives rise to a legally enforceable obligation".^{46/} There is no definition of a comfort letter, in the legislative history or elsewhere, and the term could be construed to include virtually any written communication to a lender in which a foreign person related to a U.S. borrower acknowledges the financing without expressly disavowing any legal moral or responsibility.^{47/} If the term is given that broad meaning, all of the issues that would otherwise be involved in defining a "guarantee" for purposes of Section 163(j) -- whether, for example, there is a "conditional" guarantee if a foreign parent's sale of the shares of a U.S. subsidiary is an event of default under the subsidiary's debt instruments -- will be irrelevant since any sort of contractual link to a related foreign person, no matter how limited, should logically be caught.

While the legislative history provides a plausible basis for Regulations that would define a guarantee to include

^{46/} House Ways and Means Committee Report No. 103-11, H.R. 2141, released May 19, 1993, issued as CCH Special Number 6, STANDARD FEDERAL TAX REPORTS No. 22, Extra Edition, May 20, 1993 p. 249.

^{47/} See Blake, Brink, Link and Walsh, "Four Perspectives on the Comfort Letter, The Journal of Commercial Bank Lending, October 1979, in which the banker involved states that "Comfort letters [are] also referred to as keepwell letters or letters of support, responsibility, recognition, willingness or awareness" and that they range from simple acknowledgements ("We understand that you are considering financing arrangements for" our subsidiary) to letters that provide moral undertakings ("we hereby agree to cause our subsidiary to fulfill its obligations to you").

any written communication to a lender in which a foreign person related to a U.S. borrower acknowledges a financing, our concern is that, without some limitation, the practical effect will be to create a virtually irrebuttable presumption that all third-party debt of a foreign-owned U.S. corporation is guaranteed. In evaluating the need to include undertakings that are not legally enforceable, it should be borne in mind that the definition in the statute ("any arrangement under which a person assures, on a conditional or unconditional basis, the payment of another person's obligations") and in the balance of the legislative history (e.g., "any form of credit support") is already very broad.^{48/}

2. Related to the definition of a guarantee for purposes of Section 163(j) is the question of whether the multi-party financing Regulations under Section 7701(1) should apply for purposes of Section 163(j) or whether, in the alternative, separate rules should be set out under Section 163(j). Multi-party financings and guarantees perform some substantially similar functions, (i.e., credit enhancement) but differ in that guarantees do not supply the lender with funds to on-lend, unlike a conduit financing transaction. If the definition of a guarantee for purposes of Section 163(j) encompasses any 'comfort letter' or other non-enforceable communication, even a tough standard like the would-not-have-been-made-or-maintained test of Rev. Rul. 87-89 may be too lenient a test for determining whether a back-to-back loan exists for purposes of Section 163(j). By way of illustration, if a "comfort letter" is treated as a guarantee, it would not make much sense to conclude that interest paid by a U.S. corporation to an unrelated bank was not disqualified

^{48/} If the letter of comfort rule is limited, then Regulations should address conditional guarantees; guarantees of assets, rather than liabilities; partial guarantees (e.g., of principal but not interest); and the priority of guarantees.

interest if the foreign parent had made a deposit with the bank, notwithstanding that the borrowing by the U.S. subsidiary would have been made and maintained on the same terms had there been no deposit. Although it might be argued that the indirect provision of funds by a related party makes a difference, attaching this much significance to this seems inconsistent with the generally prevailing notion of fungibility of money and would not seem to support radically different treatment for guarantees and conduit financings.

3. One of the two exceptions from the rule that treats interest on guaranteed debt as disqualified interest is for a case "where the interest ... would have been subject to a net basis tax if the interest had been paid to the guarantor"⁴⁹/. This might, conceivably, cover a case where a U.S. branch of a foreign bank guaranteed the indebtedness of a U.S. subsidiary. There are, however, no rules that would clearly identify the circumstances in which wholly-notional interest would be regarded as effectively connected with the U.S. branch, and therefore subject to tax on a net basis; and, apart from consistency with the premise of Section 163(j) that interest subject to tax on a net basis should not be disqualified interest, we can think of no good reason to exclude interest on such guaranteed debt from the definition of disqualified interest. This exception applies only "in ... circumstances identified by" the Internal Revenue Service and we see no reason to identify any such circumstances.⁵⁰/

⁴⁹/ Section 163(j)(6)(D)(ii)(I).

⁵⁰/ The legislative history expresses concern that this provision might be used to avoid Section 163(j), stating that

The committee is concerned, however, that the hypothetical nature of such a test, if not designed properly, might tempt taxpayers to take aggressive reporting positions. Therefore, the committee intends that the Secretary have broad discretion to limit the scope of the exception to cases where the Secretary is fully satisfied that taxpayers are prevented from engaging in tax avoidance schemes

4. The second exception is for a case where the U.S. borrower "owns a controlling interest in the guarantor"^{51/}. This is presumably justified by the thought that, since the net assets of the guarantor are in any event available to the borrower's creditors, it therefore makes no sense to treat a controlled subsidiary's guarantee as a guarantee for the purposes of Section 163(j). It is the case, however, that interest paid to the subsidiary on a direct loan is under the Proposed Regulations subject to Section 163(j)^{52/}, and consistency with the exception for guarantees by subsidiaries would suggest that this part of the Proposed Regulations might be changed.

House Ways and Means Committee Report No. 103-11, H.R. 2141, released May 19, 1993, issued as CCH Special Number 6, STANDARD FEDERAL TAX REPORTS No. 22, Extra Edition, May 20, 1993 p. 249.

^{51/} Section 163 (j) (6) (D) (ii). Since a guarantee by a controlled foreign corporation of the debt of a U.S. borrower is an investment in United States property under Section 956, it would be unusual for there to be such a guarantee.

^{52/} Prop. Regs. §§ 1.163(j)-1, -2.