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November 5, 2004

Mr. Gregory F. Jenner
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120 MT
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

The Honorable Mark W. Everson
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, DC 20224

Dear Acting Assistant Secretary Jenner and Commission Everson:

I am pleased to submit the New York State Bar Association Tax Section's Report No.1070.

This report requests additional guidance from Treasury on the "sourcing" of cancellation of indebtedness ("COD") income realized upon the discharge of cross-border debt. The determination of source is primarily relevant to three groups of taxpayers: First, foreign debtors engaged in a U.S. trade or business. A determination that COD income is U.S. source income will in this case generally mean that the income is also "effectively connected" with the conduct of the U.S. trade or business and therefore subject to U.S. net basis tax. Second, foreign debtors *not* engaged in a U.S. trade or business. A determination that COD income is *not* U.S. source income will in this case mean that it is not subject to gross basis U.S. withholding tax even if it is deemed to be "fixed or determinable" income ("FDAP"). Third, U.S. debtors engaged in business both within and without the United States. The determination of what portion of the COD income is foreign source will in this case affect the computation of the foreign tax credit limitation.

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Our principal recommendations are as follows:

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

- **Alternative #1:** Treasury might require the foreign debtor to source COD income by reference to the interest expense source rules (i.e., Temp. Reg. § 1.861-9T or Treas. Reg. § 1.882-5), treating the COD income as U.S. or foreign source in the same ratios that interest expense of the foreign debtor reduced effectively connected gross income during pre-discharge periods.
- **Alternative #2:** Treasury might require the foreign debtor to source COD income in the following order and priority: first, to the extent attributable to previously deducted but unpaid interest, according to the source of the foreign debtor's gross income that those deductions offset; second, to the extent that the discharged debt was "booked" in the United States, to the United States; otherwise to the residence of the foreign debtor.

The argument for Alternative #1 is that the source rules for interest expense allocate such expense by apportioning the underlying debt, and the arguments against Alternative #1 are that COD income should not be viewed as necessarily related to the U.S. business activities of the foreign debtor based upon fungibility principles and that it may attract treaty-based challenges from eligible foreign debtors. The arguments for Alternative #2 are that it is less vulnerable to any such challenge and probably more likely to conform to the debtor's ordinary business expectations, and the argument against Alternative #2 is that it will tend to attract U.S. tax on COD income with respect to debt that did not generate a U.S. interest deduction.

In any case, we believe that Treasury should source *all* COD income of a U.S. debtor in accordance with the principles of the interest expense source rules of Temp. Reg. § 1.861-9T, which generally follow the theory that money is fungible.

We do not believe Treasury should seek to impose any outbound withholding tax on COD income of a foreign debtor not engaged in a U.S. trade or business. We therefore think it appropriate to source such COD income as foreign source income, by reference to the debtor's residence. We also think that Treasury should modify Treas. Reg. § 1.1441-2(d)(2) to ensure its consistency with this approach and to clarify when (if ever) COD income is FDAP.

We appreciate your consideration of our recommendations. If you have any questions or comments regarding this report, please feel free to contact us and we will be glad to discuss or assist in any way.

Respectfully submitted,



Lewis R. Steinberg
Chair

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