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Memorandum

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subject: Interest Payable in Stock of Related Foreign Corporation and Section 864(e)

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer	=	
Business X	=	
Business Y	=	
USCorp 1	=	
USCorp 2	=	
ForCorp 1	=	
Country X	=	
Amount Y	=	

Percent 1	=	
Percent 2	=	
Date 1	=	
Date 2	=	

ISSUE

Whether, in the case of a loan the interest on which is optionally payable in stock of a related foreign corporation, in determining Taxpayer's interest expense allocation and apportionment for foreign tax credit purposes under section 864(e) of the Internal Revenue Code, the adjusted basis of shares in the related foreign corporation should be reduced by the principal amount of the loan pursuant to Temp. Treas. Reg. § 1.861-12T(f).

CONCLUSION

No. In determining Taxpayer's interest expense allocation and apportionment for foreign tax credit purposes,[1] the adjusted basis in the shares of a related foreign corporation should not be reduced by the principal amount of a loan the interest on which is optionally payable in stock of that foreign corporation.

FACTS

Background

Taxpayer is the domestic common parent of an affiliated group of corporations that file a U.S. consolidated federal income tax return. Taxpayer, its affiliated corporations, and other indirectly owned entities are engaged in Business X both inside and outside the United States. Taxpayer and its affiliated corporations are engaged in Business Y solely in the United States. Other relevant members of Taxpayer's consolidated group include USCorp 1 and USCorp 2. USCorp 2 owns all of ForCorp 1; it owns Percent of the stock of ForCorp 1 directly and Percent through a wholly-owned disregarded entity. ForCorp 1 is a foreign corporation for U.S. federal income tax purposes but treated as a limited partnership under the law of Country X.

As part of its planned foreign expansion, Taxpayer implemented a financing structure to fund the purchase of certain foreign assets. Taxpayer lent funds to USCorp 2 under the terms of a loan agreement ("Loan Agreement") authorized in an amount up to Amount Y. Taxpayer subsequently contributed the Loan Agreement to USCorp 1. USCorp 1

[1] Also for other statutory groupings governed by section 861, including section 199.

continued to loan funds to USCorp 2 under the terms of the Loan Agreement. USCorp 2 transferred borrowed funds down a chain of controlled entities for ultimate use in a planned expansion of foreign business activities.

Pursuant to the Loan Agreement, USCorp 2 promises to pay USCorp 1 the outstanding principal amount of up to Amount Y and all accrued but unpaid interest accrued thereon, by Date 1. The interest rate payable on the note for each annual interest period is calculated by reference to a London Inter-Bank Offered Rate ("LIBOR") based formula.

Payments of interest are made in U.S. dollars or, at the option of USCorp 2, in limited partnership units of ForCorp 1, that are characterized as equity for U.S. federal income tax purposes, for a value equal to the amount of interest payable on the annual interest payment date. Special terms apply regarding the valuation of such ForCorp 1 units. If any interest is not paid on the relevant interest payment date, USCorp 2 shall be entitled to add any such accrued interest to the principal amount outstanding under the note. USCorp 2 may, without penalty or premium, prepay principal and accrued interest.

Taxpayer's Income Tax Treatment

For federal income tax purposes, Taxpayer determined that interest deductions on the loan are disallowed under section 163(l) because USCorp 2 has the option to pay the interest with limited partnership units of ForCorp 1. Taxpayer further determined that the corresponding interest income accruing to USCorp 1 should be treated as tax-exempt interest under the intercompany transaction rules in Treas. Reg. § 1.1502-13. Finally, for purposes of allocating and apportioning interest expense, Taxpayer took the position that Temp. Treas. Reg. 1.861-12T(f) applies to reduce USCorp 2's adjusted basis in the ForCorp 1 shares by the principal amount of the loan, resulting in a decrease in the amount of interest expense that is allocated and apportioned to foreign source income and consequently resulting in an increase in foreign source taxable income and a greater section 904 limitation. The taxpayer took this position on its tax return for the fiscal year ending Date 2.

LAW AND ANALYSIS

Section 163(l)

Section 163(a) generally allows a deduction for all interest paid or accrued within the taxable year on indebtedness. However, section 163(l) provides that no deduction shall be allowed for any interest paid or accrued on a disqualified debt instrument. Under section 163(l)(2), the term "disqualified debt instrument" means any indebtedness of a corporation which is payable in equity of the issuer or a related party or equity held by the issuer (or any related party) in any other person. Section 163(l)(3) provides special rules for determining whether indebtedness is payable in equity of the issuer or any other person for purposes of section 163(l)(2). For purposes of section 163(l), under section 163(l)(6), a person is a related party with respect to another person if such

person bears a relationship to such other person as described in sections 267(b) or 707(b).

Here, Taxpayer owns, through its wholly-owned domestic subsidiaries, 100 percent of the stock of USCorp 1 and USCorp 2. USCorp 2 owns 100 percent of the stock of ForCorp1. Pursuant to section 1563, Taxpayer, USCorp 1, USCorp 2, and ForCorp1 are members of a parent-subsidiary controlled group and should be considered related parties for purposes of sections 267(b) and 163(l). The interest under the terms of the Loan Agreement is payable in cash or, at the option of USCorp 2, in partnership units of ForCorp 1 that are characterized as equity for U.S. federal income tax purposes and that have a value equal to the amount of the interest payable on the interest payment date. Therefore, a substantial amount of the interest is payable at the option of the issuer, USCorp 2, in equity of a person related to USCorp 2, namely ForCorp 1. Therefore, we agree that the Loan Agreement is a "disqualified debt instrument" for purposes of section 163(l) and that no deduction to USCorp2 is allowed for interest paid or accrued on the Loan Agreement.

Treas. Reg. § 1.1502-13

Treasury Reg. § 1.1502-13 provides rules for taking into account items of income, gain, deduction, and loss of consolidated group members from intercompany transactions (intercompany transaction regulations). The purpose of the intercompany transaction regulations is to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability). Treas. Reg. § 1.1502-13(a)(1).

One of the principal rules within the intercompany transaction regulations is the matching rule under Treas. Reg. § 1.1502-13(c). The matching rule provides that S (the member transferring property or providing services) and B (the member receiving the property or services) are generally treated as divisions of a single corporation for purposes of taking into account their items from intercompany transactions. Treas. Reg. § 1.1502-13(a)(6). The separate entity attributes of S's intercompany items and B's corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation, and the intercompany transaction were a transaction between divisions. Treas. Reg. § 1.1502-13(c)(1)(i). Generally, the attributes of B's corresponding item control the attributes of S's intercompany item. Treas. Reg. § 1.1502-13(c)(4)(i). Under the redetermination rule, S's intercompany item may be redetermined to be excluded from gross income or treated as a noncapital, nondeductible amount depending on the treatment of B's corresponding item. Treas. Reg. § 1.1502-13(c)(6).

In this case, USCorp 2's interest expense, as the corresponding item, governs the treatment of the interest income of USCorp 1. Accordingly, because the interest

deduction paid or accrued on the note is disallowed for USCorp 2, the corresponding interest income on the note is treated as tax-exempt income of USCorp 1.

Sections 901, 904, and Temp. Treas. Reg. § 1.861-12T(f)

Under section 901 a domestic corporation may elect to claim a credit for the amount of any income, war profits, and excess profits taxes paid or accrued during a taxable year to any foreign country or to any possession of the United States. Section 904 limits the amount of the foreign tax credit to the pre-credit U.S. tax on the foreign source taxable income. The section 904 limitation is calculated separately for different categories of foreign source income. Section 904(d).

In order to compute the section 904 limitation, taxpayers must first determine their taxable income from domestic and foreign sources by deducting the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. Sections 861(b), 862(b), and 863(a). In the case of interest expense, allocations and apportionments must be made on the basis of assets rather than gross income. Section 864(e)(2). Treasury Reg. §§ 1.861-9 through 1.861-12 and Temp. Treas. Reg. §§ 1.861-9T through 1.861-13T set forth the rules for the allocation and apportionment of interest expense using the asset method.

Under the asset method, the taxpayer apportions interest expense to the various statutory groupings of income based on the average total value of assets within each such grouping for the taxable year, as determined under the regulations. Temp. Treas. Reg. § 1.861-9T(g)(1)(i). A taxpayer may elect to determine the value of its assets on the basis of either the tax book value or the fair market value of its assets. Temp. Treas. Reg. § 1.861-9T(g)(1)(ii).

Temporary Treas. Reg. § 1.861-12T(f)(1) provides a special rule for adjusting the value of assets funded by disallowed interest. In the case of any asset in connection with which interest expense accruing at the end of the taxable year is capitalized, deferred, or disallowed under any provision of the Code, the adjusted basis or fair market value (depending on the taxpayer's choice of apportionment methods) of such an asset is reduced by the principal amount of indebtedness the interest on which is so capitalized, deferred, or disallowed.

Temporary Treas. Reg. § 1.861-12T(f)(2) provides the following example to illustrate this rule:

> X is a domestic corporation which uses the tax book value method of apportionment. X has $1000 of indebtedness and $100 of interest expense. X constructs an asset with an adjusted basis of $800 before interest capitalization and is required under the rules of section 263A to capitalize $80 in interest expense. Because interest on $800 of debt is

> capitalized and because the production period is in progress at the end of X's taxable year, $800 of the principal amount of X's debt is allocable to the building. The $800 of debt allocable to the building reduces its adjusted basis for purposes of apportioning the balance of X's interest expense ($20).

Taxpayer uses the tax book value method for interest allocation and apportionment. The stock of ForCorp 1 is characterized as an asset which generates foreign source income for purposes of Temp. Treas. Reg. § 1.861-9T(g)(3). For purposes of allocating and apportioning interest expense, Taxpayer takes the position that Temp. Treas. Reg. § 1.861-12T(f) applies to reduce the adjusted basis of the shares of ForCorp 1 by the principal amount of the indebtedness the interest on which was disallowed under section 163(l). Taxpayer argues that Temp. Treas. Reg. § 1.861-12T(f) applies because the reason for disallowing the interest is the provision of the loan making the interest payable in shares of ForCorp 1, and therefore the interest was disallowed "in connection with" the shares of ForCorp 1.

We disagree. Taxpayer's interpretation of the language "in connection with" is overbroad in this case. Temporary Treas. Reg. § 1.861-12T(f) requires more of a connection between the principal amount of the loan on which the interest is disallowed and the asset whose basis is being reduced for interest allocation and apportionment purposes, in this case, the shares of ForCorp 1.

This principle is illustrated in the example provided in Temp. Treas. Reg. § 1.861-12T(f)(2) involving the capitalization of interest under the Uniform Capitalization rules of section 263A. Those rules require, among other things, the capitalization of interest costs on debt that is related to the production costs of certain qualified property. The relation of the debt to the production costs is determined either by a direct tracing approach or an avoided cost approach or both. See section 263A(f)(2)(A)(i) and (ii). In the example in Temp. Treas. Reg. § 1.861-12T(f)(2), $800 of the indebtedness of the taxpayer is tied under section 263A to the $800 adjusted basis in its asset, reflecting the construction costs of the asset, and the interest on that $800 of indebtedness is accordingly capitalized under that section. The basis in the asset is then reduced under Temp. Treas. Reg. § 1.861-12T(f)(1) for purposes of interest expense allocation and apportionment by an amount equal to the $800 of indebtedness that was allocable to that asset under section 263A. Basis is reduced because to the extent a portion of interest and underlying indebtedness has been specifically tied to an asset (or portion thereof) it would be inappropriate to further allocate and apportion other interest to that asset (or portion thereof).

The principles encapsulated in Temp. Treas. Reg. § 1.861-12T(f) and its example do not apply to Taxpayer's facts. Rather, in this case the interest was disallowed solely as a result of the provision in the Loan Agreement providing USCorp 2 the option to pay interest expense with the equity of a related party, ForCorp 1. USCorp 2 could have achieved the same result (interest disallowance) by making the interest optionally

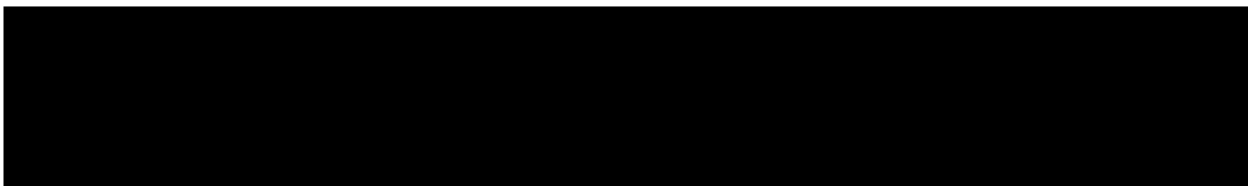
payable using equity in itself or any other related party. The amount of the indebtedness on which interest is disallowed under section 163(l) is not tied in any way to an amount of basis in shares of ForCorp 1. The interest is disallowed regardless of whether or not the proceeds are contributed to or otherwise invested in ForCorp 1. By way of comparison, interest is capitalized under section 263A by a tracing method and an avoided cost method that connects the loan principal with the production costs of a specific asset being produced. The only necessary relationship between the shares of ForCorp 1 and the disallowed interest under section 163(l) is that USCorp 2 may pay interest with shares of ForCorp 1, which is the result of a gratuitous condition in the Loan Agreement entered into between related parties.

Additionally, Taxpayer’s overly broad interpretation of the “in connection with” language of Temp. Treas. Reg. § 1.861-12T(f)(1) is not in keeping with the general policies of the interest allocation and apportionment rules of section 864(e). Temporary Treas. Reg. § 1.861-9T(a) states that the “method of allocation and apportionment for interest is based on the approach that money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid.” Congress endorsed the fungibility principle in the last major consideration of the interest expense rules in 1986. Specifically, the House Ways and Means Committee Report states that “[w]ith limited exceptions, the committee believes that it is appropriate for taxpayers to allocate and apportion interest expense on the basis that money is fungible.” H.R. Rep. No. 99-426, at 374 (1986). See also S. Rep. No. 99-313, at 348 (1986) (mentioning qualified nonrecourse indebtedness exception); H.R. Conf. Rep. No. 99-841, at II-606 (1986) (mentioning integrated financial transactions exception).

Three of these limited exceptions to the general rule that interest is a fungible expense and must be apportioned to all assets of the taxpayer are set forth in Reg. § 1.861-10T. Each of these exceptions is drafted narrowly with numerous requirements and exceptions. As a result, these exceptions apply only in very limited situations.

The narrowness in the application of these three exceptions establishes the intent that any exception to the general policy of fungibility should be applied only in limited circumstances. Consistent with this intent, we believe Temp. Treas. Reg. § 1.861-12T(f) must be similarly read to provide only a narrow exception to the general policy of fungibility. In contrast, Taxpayer’s interpretation of Temp. Treas. Reg. § 1.861-12T(f) would, as discussed above, result in an inappropriately broad exception to fungibility.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



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Please call if you have any further questions.

By: _______________________________
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