

Part III - Administrative, Procedural, and Miscellaneous

Request for comments on regulations that may be adopted on interest allocation.

Notice 2001-59

SECTION 1. PURPOSE

This Notice requests comments on whether the interest expense allocation and apportionment rules of 1.861-9T, 1.861-10T and 1.882-5 of the Income Tax Regulations should be modified to provide integrated treatment (such as netting of interest expense and income and/or assets and liabilities) of certain financial transactions.

SECTION 2. THE INTEREST EXPENSE ALLOCATION RULES OF SECTIONS 864(e) AND 882(c)(1)(A)

Section 864(e) requires taxpayers that are members of an affiliated group to allocate and apportion interest expense as if all members of such group are a single corporation, and based on assets rather than gross income. The basic approach of the interest allocation rules is that because money is fungible, most borrowing contributes to the financing of all of an affiliated group's activities and property. Thus, gross interest expense generally is allocated based on all the assets of an affiliated group, regardless of the specific purpose for any particular borrowing. See 1.861-9T(a).

Section 882(c)(1)(A) provides that a foreign corporation engaged in a trade or business within the United States is allowed deductions in computing its tax liability under 11 only to the extent that the deductions are connected with the conduct of such trade or business. Section 882(c)(1)(A) further provides that the proper allocation and

apportionment of deductions for this purpose shall be determined as provided in regulations prescribed by the Secretary. Pursuant to 1.882-5(a)(1)(i), foreign corporations must apply the interest expense allocation rules of 1.882-5, rather than those of 1.861-9T, to determine the amount of interest expense that is deductible under 882(c)(1)(A). The interest allocation rules of 1.882-5, like the rules of 1.861-9T, allocate interest expense based on the value of assets.

Although interest expense generally is allocated and apportioned based on all assets, 864(e)(7)(B) provides that the Secretary shall prescribe regulations as may be necessary and appropriate to carry out the purposes of such section, including regulations providing for the direct allocation of interest expense incurred to carry out an integrated financial transaction to any interest (or interest-type income) derived from such transaction. See also Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 99th Cong., 2nd Sess. 948 (1987) (In the case of an integrated financial transaction such as a debt-financed acquisition of foreign currency debt obligations or similar arbitrage transactions, the Act authorizes the Secretary to provide for the direct allocation of interest expense incurred on funds borrowed to acquire these assets against income from the assets involved in the integrated transaction, if appropriate.) Sections 1.861-10T(c) and 1.882-5(a)(1)(ii) provide for direct allocation of interest expense on a borrowing to income generated by an asset if certain conditions are met. The value of any asset to which interest expense is directly allocated under these rules then is reduced to take into account the principal amount of the indebtedness to which the directly allocated interest relates (for purposes of applying the general rules for the allocation and

apportionment of interest expense not subject to the direct allocation rules). See 1.861-10T(d)(2), 1.861-9T(g)(2)(iii), and 1.882-5(a)(1)(ii)(A). These rules for integrated financial transactions do not apply, however, to interest expense and indebtedness of a financial services entity as that term is defined in 1.904-4(e)(3). See 1.861-10T(c)(2)(vi).

SECTION 3. RELATED FINANCIAL INSTRUMENTS

Treasury and the Service are considering whether to provide in certain circumstances for the direct allocation of interest expense to income and for adjustments to the value of assets to reflect directly allocated liabilities. Such circumstances may include situations in which a taxpayer holds financial instruments that, although formally separate, are economically closely related. One possible example is the case of a financial institution that maintains a matched book of securities repurchase (repo) and reverse repurchase (reverse repo) transactions, which are treated as secured loans that give rise to interest expense (in a repo) and interest income (in a reverse repo) for federal tax purposes. See, e.g., Rev. Rul. 74-27, 1974-1 C.B. 24. Similar issues may arise in the case of other financial instruments, including instruments that do not produce interest expense or interest-type income, but for which netting of the assets and the liabilities may be appropriate (e.g. notional principal contracts).

SECTION 4. REQUEST FOR COMMENTS

Comments are requested on whether 1.861-9T, 1.861-10T and 1.882-5 should be modified to apply integrated treatment (such as netting of interest expense and income and/or assets and liabilities) to other financial transactions and, if so, the circumstances

in which such integrated treatment should apply. In particular, comments are requested on: (1) whether the rules for integrated financial transactions in 1.861-10T(c) should be made applicable to financial services entities; (2) whether the definition of an integrated financial transaction should be expanded; (3) the criteria that should apply in determining whether financial transactions are sufficiently related to make integrated treatment appropriate; and (4) the administrative and record keeping requirements that may be appropriate. Comments also are requested regarding whether an integrated or similar approach for related financial transactions is appropriate under other provisions of the Code. See, e.g., 1.1296-6(i) of the Proposed Income Tax Regulations.

SECTION 5. SUBMISSION OF COMMENTS

Taxpayers may submit comments to: CC:ITA:RU (OGI-130836-01), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:ITA:RU (OGI-130836-01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by submitting comments directly to the IRS Internet site at http://www.irs.gov/tax_regs/reglist.html.

DRAFTING INFORMATION

The principal author of this notice is Kenneth Christman of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in its development. For further information regarding this notice contact Kenneth Christman at (202) 622-3870 (not a toll-free call).