

Application of Sections 265(a)(2) and 246A in Multi-Party Financing Arrangements; Request for Comments

Announcement 2004-44

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: The IRS and Treasury Department are soliciting comments and suggestions regarding the scope and details of regulations (REG-128572-03) that may be proposed under section 7701(f) of the Internal Revenue Code to address the application of sections 265(a)(2) and 246A in transactions involving related parties, pass-through entities, or other intermediaries.

DATES: Written or electronic comments must be submitted by August 5, 2004.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-128572-03), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-128572-03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC or sent electronically, via the IRS Internet site at www.irs.gov/reg or via the Federal eRulemaking Portal at www.regulations.gov (IRS and REG-128572-03).

FOR FURTHER INFORMATION CONTACT: Concerning submissions, LaNita Van Dyke, (202) 622-7180; concerning the notice, Avital Grunhaus, (202) 622-3930 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 163(a) generally allows a deduction for all interest paid or accrued within the taxable year on indebtedness. Section 265(a)(2), however, provides that

no deduction shall be allowed for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income taxes.

Generally, section 246A reduces the dividends received deduction under section 243, 244, or 245(a) to the extent that the portfolio stock, with respect to which the dividends are received, is debt-financed. Stock is treated as debt-financed if there is indebtedness directly attributable to the stock investment.

Section 7701(f) provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to prevent the avoidance of the provisions of the Internal Revenue Code that deal with (1) the linking of borrowing to investment, or (2) diminishing risk, through the use of related persons, pass-thru entities, or other intermediaries.

Concurrent with the publication of this advance notice of proposed rulemaking in the **Federal Register**, the IRS and Treasury are issuing Rev. Rul. 2004-47, 2004-21 I.R.B. 941, which provides guidance on the application of section 265(a)(2) to disallow a portion of interest incurred by one member of an affiliated group when it transfers borrowed funds to another member of the group that is a dealer in tax-exempt bonds. In the circumstances described in *Situations 1* and *2* of that ruling, the funds borrowed by one member are directly traceable to the funds the borrowing member transfers to the dealer member. Under Rev. Proc. 72-18, 1972-1 C.B. 740, the application of section 265(a)(2) to these facts requires a determination of the borrowing member's purpose for incurring or continuing each item of indebtedness. The revenue ruling holds that the purpose of the borrowing member is determined by reference to the use of the borrowed funds in the business of the dealer member to whom the funds are made available. This conclusion is based on *H Enterprises International v. Commissioner*, 75 T.C.M. 1948 (1998), *aff'd per curiam*, 183 F.3d 907 (8th Cir. 1999). The result is a disallowance of the borrowing member's interest expense under section 265(a)(2).

In *H Enterprises*, a parent and a subsidiary were members of the same consolidated group of corporations. The subsidiary declared a dividend and, a few

days later, borrowed funds and immediately used part of those funds to make the dividend distribution to the parent. A portion of the distributed funds was disbursed to two investment divisions of the parent, which used the funds to acquire investments including tax-exempt obligations and corporate stock. The court held that a portion of the indebtedness was incurred to purchase and carry tax-exempt obligations for the purpose of section 265(a)(2) and that a portion of the indebtedness was directly attributable to the purchase and carry of portfolio stock for the purpose of section 246A.

The transactions described in *Situations 1* and *2* of Rev. Rul. 2004-47 and the transaction before the court in *H Enterprises* all involve funds borrowed by one member of an affiliated group that can be directly traced to funds transferred to another member of the group.

In contrast to the transactions described in *Situations 1* and *2*, in the transaction described in *Situation 3* of Rev. Rul. 2004-47, the borrowed funds are not directly traceable to the funds transferred to the dealer member, and there is no other direct evidence linking the borrowed funds to the funds transferred to the dealer member. The revenue ruling holds that in these circumstances, section 265(a)(2) will not be applied to disallow interest expense of the borrowing member.

Other situations may not be so clear. For example, funds may be transferred among the members of an affiliated or consolidated return group in a variety of ways that make it difficult to match borrowed funds with particular investments or other uses. Furthermore, certain taxpayers may affirmatively seek to avoid application of the rules of sections 265(a)(2) and 246A by using related parties, pass-thru entities, or other intermediaries in a manner that obscures the linkage between borrowing outside of the affiliated group and the purchase or carry of investments within the group.

During the course of developing Rev. Rul. 2004-47, the IRS and Treasury began preliminary consideration of possible regulations that might be adopted under the authority granted by section 7701(f) to provide clearer rules for matching borrowings and investments and for administering more effectively the purposes of section 265(a)(2). For example, Treasury

and IRS are considering a rule that would permit taxpayers to trace proceeds of borrowings to specific taxable investments or other specific uses but would apply a *pro rata* approach to determine the use of proceeds of borrowings that are not traceable to a specific use. This would differ from a general rule requiring a *pro rata* allocation of borrowings among all available uses, such as the rule in section 265(b) applicable to financial institutions.

The IRS and Treasury also are considering whether to adopt regulations under section 7701(f) for purposes of section 246A (dealing with debt financing of portfolio stock).

The IRS and Treasury are requesting comments on whether regulations should be adopted under section 7701(f) for purposes of applying section 265(a)(2) or section 246A and, if so, the approach that should be taken in such regulations. Specifically, the IRS and Treasury are inviting comments on the approach of supplementing a specific tracing rule with a *pro rata* allocation rule, as well as suggestions for alternative approaches. Comments addressing the possible adoption of regulations for purposes of section 246A should take into account any differences in approach that may be required under section 7701(f) because section 246A defines portfolio indebtedness by reference to indebtedness “directly attributable to” portfolio stock, while section 265(a)(2) refers to indebtedness “incurred or continued to purchase or carry” tax-exempt obligations. Persons making comments may also wish to address the mandate in section 246A(f) to adopt regulations providing for interest disallowance, rather than disallowance of the dividends received deduction, when indebtedness is incurred by a person other than the person receiving dividends.

SPECIAL ANALYSIS

This advance notice of proposed rule-making is not a significant regulatory action for purposes of Executive Order 12866, “Regulatory Planning and Review.”

Mark E. Matthews,
*Deputy Commissioner for
Services and Enforcement.*