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 rulemaking 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.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–128590–03]

RIN 1545–BC23

Special Consolidated Return Rules for the Disallowance of Interest Expense Deductions Under Section 265(a)(2)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 265(a)(2) that affect corporations filing consolidated returns. These regulations provide special rules for the treatment of certain intercompany transactions involving interest on intercompany obligations.

DATES: Written or electronic comments and requests for a public hearing must be received by August 5, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–128590–03), 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–128590–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the IRS Internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (indicate IRS and REG–128590–03).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Frances L. Kelly, (202) 622–7770; concerning submissions of comments and/or requests for a public hearing, Guy Traynor, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 265(a)(2)

Section 163(a) generally allows a deduction for all interest paid or accrued within the taxable year on indebtedness. Under section 265(a)(2), however, no deduction is allowed for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income taxes.

Rev. Proc. 72–18 (1972–1 C.B. 740) provides guidelines for the application of section 265(a)(2) to taxpayers holding tax-exempt obligations. Section 3.01 of the revenue procedure states that the application of section 265(a)(2) requires a determination, based upon all the facts and circumstances, of the taxpayer's purpose in incurring or continuing each item of indebtedness. Such purpose may be established by either direct or circumstantial evidence. Direct evidence includes direct tracing of borrowed funds to investments in tax-exempt obligations and the pledging of tax-exempt obligations as security for the indebtedness. To the extent that there is direct evidence establishing a purpose to purchase or carry tax-exempt obligations, the interest paid or incurred on such indebtedness may not be deducted. In certain other cases when an interest deduction is disallowed (for example, when amounts borrowed by a dealer in tax-exempt obligations are not directly traceable to tax-exempt obligations), section 7 of Rev. Proc. 72–18 sets forth a formula to calculate the disallowed interest deduction. That formula provides that the amount of the disallowed interest deduction is determined by multiplying the total interest on the indebtedness by a fraction, the numerator of which is the average amount during the taxable year of the taxpayer's tax-exempt obligations (valued at their adjusted bases), and the denominator of which is the average amount during the taxable year of the taxpayer's total assets (valued at their adjusted bases) minus the amount of any indebtedness the interest deduction on which is not subject to disallowance to any extent under Rev. Proc. 72–18.

In *H Enterprises International, Inc.* v. *Commissioner*, 75 T.C.M. (CCH) 1948 (1998), *aff'd*, 183 F.3d 907 (8th Cir. 1999), 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.

The court held that a portion of the subsidiary's indebtedness was incurred for the purpose of purchasing or carrying tax-exempt obligations (held in the parent's investment divisions) and, therefore, no deduction was allowed for the interest on this portion of the indebtedness under section 265(a)(2). To establish the required purposive connection under section 265(a)(2), the court reasoned that the activities of the parent corporation were relevant in determining the subsidiary's purpose for borrowing the funds. The court stated that if the analysis only focused on the borrower and not the transferee, then the purpose of the borrower corporation would always be acceptable, frustrating the legislative intent of section 265(a)(2).

Rev. Rul. 2004–47 (2004–21 I.R.B.) provides guidance on the application of section 265(a)(2) in a number of situations in which a member of an affiliated group borrows money from an unrelated party and transfers funds to another member of the group that is a dealer in tax-exempt obligations. In *Situation 4*, P and S are members of the same affiliated group but file separate tax returns. P borrows funds from L, an unrelated bank, and lends the borrowed funds to S, a dealer in tax-exempt obligations. S uses the borrowed funds in its business. The ruling examines the obligation from L to P and the obligation from P to S for the application of section 265(a)(2). With regard to the loan from L to P, P uses the borrowed funds to make a loan to S, and P separately accounts for the taxable interest income from the obligation. The ruling concludes that P does not have a purpose of using the borrowed funds to purchase or carry tax-exempt obligations within the meaning of section 265(a)(2). With regard to the loan from P to S, although the borrowed funds are not directly traceable to S's purchase or carry of tax-exempt obligations, the ruling concludes that section 265(a)(2) applies to disallow a deduction for a portion of S's interest expense. The portion of S's interest deduction that is disallowed is determined pursuant to the formula of section 7 of Rev. Proc. 72–18.

The Intercompany Transaction Regulations

Section 1.1502–13 prescribes rules relating to the treatment of transactions between members of a consolidated group. With respect to intercompany obligations, the intercompany transaction rules generally operate to match the debtor member's items with the lending member's items from the intercompany obligation.

Under § 1.1502–13(c)(6)(i), if section 265(a)(2) permanently and explicitly disallows a debtor member's interest deduction with respect to a debt to another member, the lending member's interest income is treated as excluded from gross income. See § 1.1502–13(g)(5), *Example 1*(d). In cases when a member of the group borrows from another member to purchase or carry tax-exempt obligations, and the lending member has not borrowed from sources outside of the group to fund the intercompany obligation, the result reached under the § 1.1502–13(c)(6)(i) exclusion rule is appropriate in that it reflects that intercompany lending transactions do not alter the net worth of the group and, thus, should not affect consolidated taxable income.

However, when the lending member borrows from a nonmember, the lending member lends those funds to the debtor member, and the debtor member uses those funds to purchase or carry tax-exempt obligations, the application of the § 1.1502–13(c)(6)(i) exclusion rule may produce inappropriate results. For example, assume P borrows $100 from L, a nonmember, for the purpose of lending the $100 to S under the same terms, and S's purpose for borrowing $60 of the intercompany loan from P is to purchase $60 of tax-exempt obligations. Under section 265(a)(2), a deduction would be disallowed for a portion of S's interest expense on the intercompany obligation and a portion of P's interest income would be excluded from P's gross income under § 1.1502–13(c)(6)(i). Accordingly, section 265(a)(2) may have no effect on the group's taxable income, even though the group has borrowed to purchase tax-exempt obligations.

Explanation of Provisions

The IRS and Treasury Department believe that, when a member's indebtedness to a nonmember is directly traceable to an intercompany obligation and another member of the group uses the funds borrowed from the nonmember to purchase or carry tax-exempt obligations, the net tax effect of these transactions for the group should be a disallowance of a deduction for interest under section 265(a)(2).

These proposed regulations reflect that when a member (P) borrows funds from a nonmember and lends all of those funds to another member (S) that uses those funds to purchase tax-exempt obligations, section 265(a)(2) will apply to disallow a deduction for the interest on S's obligation to P, not P's obligation to the nonmember. These proposed regulations provide that, if a member of a consolidated group incurs or continues indebtedness to a nonmember, that indebtedness to the nonmember is directly traceable to all or a portion of an intercompany obligation extended to a member of the group (the borrowing member) by another member of the group (the lending member), and section 265(a)(2) applies to disallow a deduction for all or a portion of the borrowing member's interest expense incurred with respect to the intercompany obligation, then § 1.1502–13(c)(6)(i) will not apply to exclude an amount of the lending member's interest income with respect to the intercompany obligation that equals the amount of the borrowing member's disallowed interest deduction. This override of the exclusion rule is subject, however, to a limitation. In particular, the amount of interest income not excluded cannot exceed the interest expense on the portion of the nonmember indebtedness that is directly traceable to the intercompany obligation. This limitation ensures that applying section 265(a)(2) to disallow an interest deduction with respect to an intercompany obligation that can be directly traced to nonmember indebtedness does not result in a worse overall tax position for the group than applying section 265(a)(2) to disallow a deduction for the interest paid to the nonmember.

Therefore, subject to the limitation discussed above, if the proceeds of P's borrowing from a nonmember can be directly traced to a P–S intercompany obligation and all or a portion of S's interest expense on the P–S intercompany obligation is disallowed as a deduction under section 265(a)(2), these proposed regulations require that all or a portion of P's interest income on the intercompany obligation not be excluded under § 1.1502–13(c)(6)(i).

In an Advance Notice of Proposed Rulemaking (REG–128572–03) in this issue of the **Federal Register**, the IRS and Treasury Department are soliciting comments regarding whether regulations under section 7701(f) should address the application of sections 265(a)(2) and 246A in transactions involving related parties, pass-thru entities, or other intermediaries, and suggestions as to the approach that should be taken by those regulations. It is possible that those comments and any regulations proposed under section 7701(f) will result in amendments to the rules set forth in these proposed regulations.

Proposed Effective Date

These regulations are proposed to apply to taxable years beginning on or after the date these regulations are published as final regulations in the **Federal Register**.

Special Analysis

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that these regulations will primarily affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Frances L. Kelly, Office of the Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.265–2 also issued under 26 U.S.C. 1502 and 7701(f). * * *

2. In § 1.265–2, paragraph (c) is added to read as follows:

§ 1.265–2 Interest relating to tax-exempt income.

* * * * *

(c) *Special rule for consolidated groups*—(1) *Treatment of intercompany obligations—(i) Direct tracing to nonmember indebtedness.* If a member of a consolidated group incurs or continues indebtedness to a nonmember, that indebtedness is directly traceable to all or a portion of an intercompany obligation (as defined in § 1.1502–13(g)(2)(ii)) extended to a member of the group (B) by another member of the group (S), and section 265(a)(2) applies to disallow a deduction for all or a portion of B's interest expense incurred with respect to the intercompany obligation, then § 1.1502–13(c)(6)(i) will not apply to exclude an amount of S's interest income with respect to the intercompany obligation that equals the amount of B's disallowed interest deduction.

(ii) *Limitation.* The amount of interest income to which § 1.1502–13(c)(6)(i) will not apply as a result of the application of paragraph (c)(1)(i) of this section cannot exceed the interest expense on the portion of the indebtedness to the nonmember that is directly traceable to the intercompany obligation.

(2) *Examples.* The rules of this paragraph (c) are illustrated by the following examples. For purposes of these examples, unless otherwise stated, P and S are members of a consolidated group of which P is the common parent. P owns all of the outstanding stock of S. The taxable year of the P group is the calendar year and all members of the P group use the accrual method of accounting. L is a bank unrelated to any member of the consolidated group. All obligations are on the same terms and conditions, remain outstanding at the end of the applicable year, and provide for payments of interest on December 31 of each year that are greater than the appropriate applicable Federal rate (AFR). The examples are as follows:

Example 1. (i) *Facts.* On January 1, 2005, P borrows $100x from L and lends the entire $100x of borrowed proceeds to S. S uses the $100x of borrowed proceeds to purchase tax-exempt securities. P's indebtedness to L is directly traceable to the intercompany obligation between P and S. In addition, there is direct evidence that the proceeds of S's intercompany obligation to P were used to fund S's purchase or carrying of tax-exempt obligations. During the 2005 taxable year, P incurs $10x of interest expense on its loan from L, and S incurs $10x of interest expense on its loan from P. Under section 265(a)(2), the entire $10x of S's interest expense on the intercompany obligation to P is disallowed as a deduction.

(ii) *Analysis.* Because section 265(a)(2) permanently and explicitly disallows $10x of S's interest expense, ordinarily $10x of P's interest income on the intercompany obligation would be redetermined to be excluded from P's gross income under § 1.1502–13(c)(6)(i). However, under this paragraph (c), § 1.1502–13(c)(6)(i) will not apply to exclude P's interest income with respect to the intercompany obligation in an amount that equals S's disallowed interest deduction with respect to the intercompany obligation. Accordingly, § 1.1502–13(c)(6)(i) will not apply to exclude P's $10x of interest income on the intercompany obligation and P must include in income $10x of interest income from the intercompany obligation.

Example 2. (i) *Facts.* The facts are the same as in Example 1, except that P incurs only $8x of interest expense on its loan from L.

(ii) *Analysis.* Section 1.1502–13(c)(6)(i) will apply to exclude only a portion of P's $10x of interest income on the intercompany obligation. Under paragraph (c)(1)(ii) of this section, the amount of P's interest income that § 1.1502–13(c)(6)(i) will not apply to exclude is $8x, the total interest expense incurred by P on its indebtedness to L. Consequently, P must include in income $8x of interest income from the intercompany obligation and § 1.1502–13(c)(6)(i) will apply to exclude $2x of interest income from the intercompany obligation.

(3) *Effective date.* The provisions of this section shall apply to taxable years beginning on or after the date these regulations are published as final regulations in the **Federal Register**.

3. Section 1.1502–13 is amended by:

1. Adding a sentence after the second sentence of paragraph (c)(6)(ii)(A).

2. Adding paragraph (c)(6)(iii).

3. Revising the first sentence of *Example 1*(d) of paragraph (g)(5).

The revisions and additions read as follows:

§ 1.1502–13 Intercompany transactions.

* * * * *

(c) * * *

(6) * * *

(ii) * * *

(A) * * * However, see § 1.265–2(c) for special rules related to the application of paragraph (c)(6)(i) of this section to interest income with respect to certain intercompany obligations the interest deduction on which is disallowed under section 265(a)(2). * * *

* * * * *

(iii) *Effective date.* The third sentence of paragraph (c)(6)(ii)(A) of this section shall apply to taxable years beginning on or after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

(g) * * *

(5) * * *

Example 1 * * *

* * * * *

(d) *Tax-exempt income.* The facts are the same as in paragraph (a) of this *Example 1*, except that B's borrowing from S is allocable under section 265 to B's purchase of state and local bonds to which section 103 applies and § 1.265–2(c) does not apply. * * *

* * * * *

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

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