February 26, 2019

Hon. Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on the Definition of Interest in the Proposed Regulations under Section 163(j)

Dear Commissioner Rettig:

Enclosed please find comments on the definition of interest in the proposed regulations under section 163(j). These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Eric Solomon
Chair, Section of Taxation

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
William M. Paul, Acting Chief Counsel and Deputy Chief Counsel (Technical), Internal Revenue Service
Lafayette G. "Chip" Harter III, Deputy Assistant Secretary (International Tax Affairs), Department of the Treasury
Krishna P. Vallabhaneni, Acting Tax Legislative Counsel, Department of the Treasury
Doug Poms, International Tax Counsel, Department of the Treasury
Brett York, Associate International Tax Counsel, Department of the Treasury
Colin Campbell, Attorney-Advisor, Department of the Treasury
Ellen Martin, Tax Policy Advisor, Department of the Treasury
Bryan A. Rimmke, Attorney-Advisor, Department of the Treasury
Brenda Zent, Special Advisor, Office of International Tax Counsel, Department of the Treasury
Scott K. Dinwiddie, Associate Chief Counsel (ITA), Internal Revenue Service
Helen M. Hubbard, Associate Chief Counsel (Financial Institutions & Products), Internal Revenue Service
Daniel M. McCall, Deputy Associate Chief Counsel (International), Internal Revenue Service
Holly Porter, Associate Chief Counsel (PSI), Internal Revenue Service
Robert Wellen, Associate Chief Counsel (Corporate), Internal Revenue Service

Enclosure
These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Jeff Borghino, Craig Gibian, Robert Kantowitz and Michael Mou. Substantial contributions were made by Jerry Feige, Stefan Gottschalk, Elena Romanova and Michael Shulman. These Comments were reviewed by Lucy Farr of the Committee on Government Submissions and Lisa Zarlenga, the Chair of the Committee on Government Submissions.

Although members of the Section of Taxation may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.
I. Executive Summary

Section 163(j)\textsuperscript{1} was amended as part of Public Law 115-97 (the “Act”) enacted on December 22, 2017, and applies for taxable years beginning after December 31, 2017. Generally, amended section 163(j) limits a taxpayer’s annual deduction for business interest to the sum of (i) the taxpayer’s business interest income for such taxable year; (ii) 30 percent of the taxpayer’s adjusted taxable income (“ATI”) for such taxable year; and (iii) the taxpayer’s floor plan financing interest for such taxable year.

On December 28, 2018, the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) published a Notice of Proposed Rulemaking under section 163(j) (the “Proposed Regulations”).\textsuperscript{2} While the Proposed Regulations address numerous aspects of the application of section 163(j), these Comments will focus on the definition of “interest” set forth in Proposed Regulation section 1.163(j)-1(b)(20) and certain related issues.

We commend Treasury and the Service for acknowledging the difficulty in defining the term interest for this purpose and explaining the rationale for the approach that was selected. In this regard, Treasury and the Service have asked for comments regarding the overall approach, as well as comments on the treatment of certain more specific items and transactions, such as the proper treatment of cleared swaps and the treatment of fees paid in connection with lending transactions.

Our recommendations for defining interest for purposes of section 163(j) are summarized below and are discussed in more detail in Part III.D of these Comments:

A. We recommend that Treasury and the Service abandon the approach for the definition of “interest” set forth in the Proposed Regulations, because it will create confusion and significant compliance burdens for taxpayers, and instead rely on a more standard definition, such as the definition set forth in Proposed Regulation section 1.163(j)-1(b)(20)(i). In other words, we recommend that Treasury and the Service adopt the approach described as the second option considered in the Preamble. Such definition would also include amounts treated as interest with respect to swaps with significant nonperiodic payments as set forth in Proposed Regulation section 1.163(j)-1(b)(20)(ii)(A). Under this approach, the items set forth in Proposed Regulation section 1.163(j)-1(b)(20)(iii) would not be considered interest under the final Regulations.

\textsuperscript{1} Unless otherwise indicated, all “section” references are to the Internal Revenue Code of 1986, as amended (the “Code”), and all “Reg. §” and “Prop. Reg. §” references are to the Treasury regulations promulgated or proposed, respectively, under the Code, all as in effect on the date of these Comments.

\textsuperscript{2} 83 Fed. Reg. 67,490 (Dec. 28, 2018). The Proposed Regulations were released on November 26, 2018, prior to publication in the Federal Register.
B. While we acknowledge the concern that taxpayers may attempt to structure transactions to avoid the application of section 163(j), we caution against defining interest by relying on vague anti-avoidance or “catch-all” rules such as the ones currently found in Proposed Regulation section 1.163(j)-2(h) and Proposed Regulation section 1.163(j)-1(b)(20)(iv). Instead, we believe that Treasury and the Service should first rely on currently available rules and future administrative guidance or regulations to treat items as interest for all purposes of the Code where needed to curtail perceived abuses. Such an approach will result in treating an item as interest for all purposes of the Code, where appropriate, and will be less complex and provide greater certainty and consistency for taxpayers than limiting the deductibility of an item under section 163(j) while the item remains deductible under a different Code provision, such as section 162 or section 165.

C. To the extent that Treasury and the Service believe that the available tools for treating items as interest are not sufficient to ensure the proper administration of section 163(j), and therefore that some form of anti-avoidance or catch-all provision is necessary, we strongly urge that the scope of the currently proposed anti-avoidance rules be narrowed as they relate to the definition of interest. In this regard, we believe that any such rule should be applied with the following parameters:

1. First, Treasury and the Service should make clear that the general anti-avoidance rule currently in Proposed Regulation section 1.163(j)-2(h) does not apply to expand the definition of interest for purposes of section 163(j).  

2. Second, we suggest that Proposed Regulation section 1.163(j)-1(b)(20)(iv) be narrowed to set forth a standard similar to that in section 1258(c); that is, an otherwise deductible expense or loss would be considered subject to limitation as interest under section 163(j) only if, at the time of the relevant transaction or series of transactions that secure the use of funds for a period of time for the taxpayer, substantially all of the expense or loss was expected to be attributable to the time value of money. Further, we believe that any revised catch-all rule included in the final Regulations should be symmetrical, and therefore include items of income and gain, such as ordinary gain under section 1258, even though we are generally recommending that Proposed Regulation section 1.163(j)-1(b)(20)(iii) not be included in the final Regulations.

II. Background

For each taxable year, section 163(j)(1) limits a taxpayer’s deduction for “business interest” expense to the sum of (i) the taxpayer’s “business interest income” for such taxable year.
year; (ii) 30 percent of the taxpayer’s ATI for such taxable year; and (iii) the taxpayer’s floor plan financing interest for such taxable year. Section 163(j)(2) provides that the amount of any business interest not allowed as a deduction for any taxable year by reason of section 163(j)(1) will be treated as paid or accrued in the succeeding taxable year. The statutory language provides various other rules including, but not limited to, exemptions for certain small businesses and certain specific businesses, special rules for partnerships, and a definition of ATI. The definition of ATI contains the only specific grant of regulatory authority in section 163(j), stating in section 163(j)(8)(B) that ATI is “computed with such other adjustments as provided by the Secretary.”

A. Statutory Definition of Business Interest and Relevant Legislative History

For purposes of section 163(j), section 163(j)(5) defines “business interest” as “any interest paid or accrued on indebtedness properly allocable to a trade or business.” The definition of “business interest income” in section 163(j)(6) differs slightly, referring to “the amount of interest includable in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business.” In other words, the definition of “business interest” contains the modifier on indebtedness when referring to interest whereas the definition of “business interest income” does not contain such modifier.4

While the statutory language in section 163(j)(5) refers to interest paid or accrued on indebtedness, the Conference Report for the Act provides that “[a]ny amount treated as interest for purposes of the Internal Revenue Code is interest for purposes of [section 163(j)].”5

More generally, the House Report for the Act states: “The Committee believes that the general deductibility of interest payments on debt may result in companies undertaking more leverage than they would in the absence of the tax system. The effective marginal tax rate on debt-financed investment is lower than that on equity-financed investment.”6 The House Report also states that section 163(j) is intended to apply to larger businesses with greater leverage, because “such firms may pose the greatest societal costs in times of financial distress.”7

B. The Proposed Regulations

The Proposed Regulations are proposed to be effective for taxable years ending after the date that the Treasury decision adopting the Proposed Regulations as final Regulations is published in the Federal Register. Taxpayers, however, may rely on the Proposed Regulations for taxable years beginning after December 31, 2017, so long as the taxpayer and its related parties consistently apply the Proposed Regulations. We applaud Treasury and the Service for

4 While not a subject of these Comments, we note that the definitions of business interest and business interest income exclude investment interest and investment income, respectively, each within the meaning of section 163(d).
7 Id. at 248.
providing a delayed effective date, particularly in light of the complexities with the Proposed Regulations that point to the need for revision in the final Regulations, including those discussed in these Comments.

1. Definition of Interest

The Proposed Regulations provide an expansive definition of the term “interest” for purposes of section 163(j). In particular, Proposed Regulation section 1.163(j)-1(b)(20) provides that the term “interest” means any amounts described in one of four categories.

The first category (“Category One”) falls under the heading “In general” and describes interest as “an amount paid, received, or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement, including a series of transactions, that is treated as a debt instrument for purposes of section 1275(a) and §1.1275-1(d), and not treated as stock under §1.385-3, or an amount that is treated as interest under other provisions of the Code or the regulations thereunder.” The Proposed Regulations then provide a list of examples, including (i) original issue discount (“OID”); (ii) accrued market discount to the extent included by a holder; (iii) OID on a synthetic debt instrument arising from integration under Regulation section 1.1275-6; (iv) deductible repurchase premium; (v) deferred payments treated as interest under section 483; and (vi) amounts treated as interest under section 988.

The second category (“Category Two”) addresses swaps with significant nonperiodic payments. For “non-cleared swaps,” consistent with prior law, a swap with significant nonperiodic payments is treated as two separate transactions consisting of an on-market, level payment swap and a loan. The loan must be accounted for by the parties to the contract independently of the swap and the time value component associated with the loan is recognized as interest expense to the payor and interest income to the recipient. The Proposed Regulations reserve on the treatment of “cleared swaps,” which are defined in Proposed Regulation section 1.163(j)-1(b)(5) to include swaps that are cleared by certain derivatives clearing organizations and certain clearing agencies.

The heading for the third category (“Category Three”) is “Other amounts treated as interest.” The list of ten items that are to be treated as interest for purposes of section 163(j) under Category Three are summarized below:

(1) Ordinary income for issuers under Regulation section 1.163-13(d)(4) is treated as interest income of the issuer and amounts deducted as premium for holders under Regulation section 1.171-2(a)(4)(i)(A) are treated as interest expense of the holder;

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8 Prop. Reg. § 1.163(j)-1(b)(20)(i).
10 This treatment is consistent with the rules under Reg. § 1.446-3(g)(4) before it was amended by T.D. 9719 on May 8, 2015 (and corrected by 80 Fed. Reg. 61,308 on October 13, 2015).
Ordinary income for issuers and ordinary loss for holders on certain debt instruments is treated as interest income and expense, respectively, including certain amounts taken into account with respect to contingent payment debt instruments subject to Regulation section 1.1275-4(b), nonfunctional currency contingent payment debt instruments subject to Regulation section 1.988-6 and inflation-indexed debt instruments subject to Regulation section 1.1275-7;

Substitute interest payments described in Regulation section 1.861-2(a)(7) are treated as interest expense to the payor or interest income to the recipient;

Any gain treated as ordinary gain under section 1258 is treated as interest income;

Income, deduction, gain, or loss from a derivative, as defined in section 59A(h)(4)(A), that alters a taxpayer's effective cost of borrowing with respect to a liability of the taxpayer is treated as an adjustment to interest expense of the taxpayer;

Income, deduction, gain, or loss from a derivative, as defined in section 59A(h)(4)(A), that alters a taxpayer's effective yield with respect to a debt instrument held by the taxpayer is treated as an adjustment to interest income by the taxpayer;

Any fees in respect of a lender commitment to provide financing are treated as interest if any portion of such financing is actually provided, with a provision reserved to potentially address other debt-related fees;

Any debt issuance costs subject to Regulation section 1.446-5 are treated as interest expense of the issuer;

Any guaranteed payments for the use of capital under section 707(c) are treated as interest; and

The excess of the amount that a taxpayer collects on a factored receivable (or realizes upon the sale or other disposition of the factored receivable) over the amount paid for the factored receivable by the taxpayer is treated as interest income.

The fourth category ("Category Four") has the following heading: "Anti-avoidance rule for amounts predominantly associated with the time value of money."12 The substance of the rule provides: "Any expense or loss, to the extent deductible, incurred by a taxpayer in a transaction or series of integrated or related transactions in which the taxpayer secures the use of

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funds for a period of time is treated as interest expense of the taxpayer if such expense or loss is predominantly incurred in consideration of the time value of money.”

The Proposed Regulations also provide three examples intended to illustrate the application of the definition of the term “interest” for purposes of section 163(j). The first example involves the treatment of a securities lending transaction, and is explored in Part III.C.1 below. The second example involves a foreign currency borrowing and is discussed in Part III.C.2.b below. Finally, the third example is intended to illustrate the application of the “anti-avoidance” rule of Proposed Regulation section 1.163-1(b)(20)(iv) and is addressed in Part III.D.2 below.

In addition, Proposed Regulation section 1.163(j)-2(h) provides the following general anti-avoidance rule: “Arrangements entered into with a principal purpose of avoiding the rules of section 163(j) or the section 163(j) regulations, including the use of multiple entities to avoid the gross receipts test of section 448(c), may be disregarded or recharacterized by the Commissioner of the IRS to the extent necessary to carry out the purposes of section 163(j).” While this provision does not specifically refer to interest, there is no indication that, despite the detailed definition of interest in Proposed Regulation section 1.163(j)-1(b)(20), this rule could not be applied to treat amounts as interest for purposes of section 163(j) based on a principal purpose of the relevant arrangement.

2. The Preamble

The Preamble notes that “[t]here are no generally applicable regulations or statutory provisions addressing when financial instruments are treated as debt for federal income tax purposes or when a payment is interest,” so Treasury and the Service looked to case law and other guidance to come up with the general definition of interest and corresponding list of items treated as interest, including the Supreme Court case of Deputy v. Du Pont. The Preamble states that treating amounts that are closely related to interest as interest income or expense when appropriate to achieve a statutory purpose is not new, citing to Temporary Regulation section 1.861-9T and Regulation section 1.954-2.

The Preamble states that before deciding to take the approach described above, Treasury and the Service considered three options with respect to the definition of interest. The first option was not to provide a definition. Treasury and the Service were concerned that while this approach could reduce the compliance burden for taxpayers, this approach might create uncertainty and ultimately increase the burden on taxpayers and the Service because of “disputes and litigation about whether particular payments are interest for section 163(j) purposes.” A further concern was that not providing a definition could be distortive by not picking up an item

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13 Id.
17 Id. at 67,494.
that is “economically similar to interest income but that has not historically been so treated under general tax principles” and encouraging taxpayers to engage in transactions that would be contrary to Congressional intent in enacting section 163(j) to limit the deductibility of interest for businesses viewed as highly leveraged.18 As further justification for not taking this approach, the Preamble suggests that such an approach “may ignore the statutory language of section 163(j)(1)” which refers to limiting deductions “under this chapter” thus suggesting a limitation that goes beyond deductions for interest expense under section 163(a).19

The second option considered was to adopt a definition of interest, but limit the scope to cover amounts associated with conventional debt instruments and amounts treated as interest under the Code or regulations.20 The definition would have been similar to that found in Proposed Regulation section 1.163(j)-1(b)(20)(i). Treasury and the Service believed this approach would be distortive in that it would encourage taxpayers to engage in financing transactions that are similar economically to debt, but that do not create interest expense. The Preamble mentions income from the discount on receivables and substitute interest payments as examples of ordinary items that are “in substance” interest.21

Treasury and the Service explain why they chose the third option of a comprehensive definition of interest:

The final option considered and the one ultimately adopted in these proposed regulations is to provide a complete definition of interest that addresses all transactions that are commonly understood to produce interest income and expense, including transactions that may otherwise have been entered into to avoid the application of section 163(j). This approach has the advantage of also providing rules that clearly treat amounts as interest in appropriate cases. Although a comprehensive definition of interest requires an unavoidable degree of detail, the benefits of a detailed definition should decidedly outweigh any complexity that results. The proposed regulations also reduce taxpayer burden by adopting definitions of interest have already been developed and administered in §§1.861-9T and 1.954-2, and add several definitions of interest income that were suggested by commenters (such as the rules regarding amounts on contingent payment debt instruments in §1.163(j)-1(b)(20)(iii)(B)).22

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18 Id. (citing to H.R. Rep. No. 115-409, at 248).
19 Id.
20 Id. at 67,494.
21 Id.
22 Id. at 67,494-95. See also id. at 67,528.
Treasury and the Service have invited comments on the definition of interest found in Proposed Regulation section 1.163(j)-1(b)(20) and whether a different definition would be more appropriate for purposes of section 163(j).23

III. Discussion

A. Summary of Concerns and Recommendations

We recommend that Treasury and the Service abandon the expansive approach for the definition of “interest” set forth in the Proposed Regulations and instead rely on a more standard definition, such as the definition set forth in Proposed Regulation section 1.163(j)-1(b)(20)(i) (i.e., Category One), to capture expressly only those items that are treated as interest under the Code, the regulations or general U.S. federal income tax principles. This approach would be consistent with the second option set forth in the Preamble for defining interest considered by Treasury and the Service.

As discussed below, the current approach in the Proposed Regulations does not provide clear standards that are easily understood by reference to existing authorities on the definition of interest, and the inclusion of numerous categories of income and expense that are not otherwise treated as interest under section 163 (i.e., Category Three) raises serious administrability issues. Using a standard that generally includes only items otherwise considered interest income and expense for U.S. tax purposes, as recommended by these Comments, would be far better understood and would avoid these administrability issues. In addition, we believe that our recommended approach is more consistent with the statutory language and Congressional intent in enacting section 163(j) than the approach in the Proposed Regulations. In this regard, we believe that analogizing to Temporary Regulation section 1.861-9T and Regulation section 1.954-2 for purposes of defining interest under section 163(j) is inappropriate because of the differing policy considerations for those provisions.

Because a standard definition of interest would include items treated as interest under the Code and regulations, we believe it is appropriate to maintain Category Two (i.e., interest that results from significant nonperiodic payments on swaps being treated as loans).24

In addition, we believe that Treasury and the Service should attempt to apply the rules as symmetrically as possible. This makes sense because section 163(j) is essentially a net interest expense limitation. To that end, we acknowledge that Treasury and the Service have attempted to create some amount of symmetry with respect to the list of items in Category Three.

23 Id. at 67,495.

24 With respect to the treatment of cleared swaps, we recognize that the tax policy considerations relating to the application of section 163(j) to cleared swaps are meaningfully different than those addressed in our letter dated January 19, 2016, providing comments on proposed regulations under sections 446 and 956. American Bar Association Section of Taxation, Comments on the Temporary and Proposed Regulations Under Sections 446 and 956 Providing Embedded Loan Treatment for Certain Notional Principal Contracts (Jan. 19, 2016). A discussion of those considerations, however, is beyond the scope of these Comments.
We encourage the government to retain such symmetry where possible to the extent those items are treated as interest in the final Regulations.25

We do appreciate that a more narrow definition of interest for purposes of section 163(j) does not address the concern expressed in the Preamble regarding the possibility that taxpayers may attempt to avoid section 163(j) by engaging in transactions that are “essentially financing transactions”26 that do not produce items treated as interest. Further, we acknowledge the statement in the Preamble that it is difficult for Treasury and the Service to identify every type of transaction already in practice and to anticipate future innovations that result in transactions that they believe should be within the scope of section 163(j). However, we caution against the use of vague anti-avoidance rules as a means to prevent perceived abusive transactions that are intended to disguise interest. To the extent that Treasury and the Service believe that an anti-avoidance rule is essential for the proper administration of section 163(j), we provide suggestions in Part III.D.2, below, on how to improve the current anti-avoidance framework in the Proposed Regulations as it relates to the definition of interest.

B. Statutory Interpretation and Policy Considerations

1. Statute and Legislative History

As set forth above, section 163(j)(5) defines “business interest” as “any interest paid or accrued on indebtedness properly allocable to a trade or business.” The traditional and consistently accepted definition of interest is an amount paid or accrued in connection with indebtedness by the borrower as compensation to the lender in respect of the time value of the money borrowed, or, in the words of the Supreme Court quoted in the Preamble, “compensation for the use or forbearance of money.”27

Thus, Congress used the word “interest,” which has a well-established meaning in the tax law, dating back decades, and which does not include interest equivalents or amounts closely related to interest. Indeed, the holding in Deputy v. Du Pont that a short sale did not create indebtedness means that the Supreme Court has specifically held that substitute payments are not interest. As the Supreme Court stated:

25 However, we observe that the statutory language regarding the definition of business interest and business interest income is asymmetrical. In addition, issuers and holders of debt instruments do not currently enjoy completely symmetrical tax treatment with respect to amounts paid and received with respect to debt. For example, repurchase premium paid in connection with a debt retirement may give rise to capital gain for holders of the retired debt under section 1271 while resulting in ordinary interest expense for the issuer under Regulation section 1.163-7(c). As another example, the election to create a synthetic debt instrument under the rules of Regulation section 1.1275-6 is an election applicable only to the taxpayer and thus creates asymmetry. Therefore, while symmetry as a goal is laudable, it should not be viewed as an overarching goal.

27 Du Pont, 308 U.S. at 498. See also Old Colony R.R. Co. v. Commissioner, 284 U.S. 552, 561 (1932) (providing that the term “interest” is generally understood as “the amount which one has contracted to pay for the use of borrowed money”); United States v. Midland-Ross Corp., 381 U.S. 54 (1965) (citing Du Pont in concluding that original issue discount is interest for tax purposes).
In the business world “interest on indebtedness” means compensation for the use or forbearance of money. In absence of clear evidence to the contrary, we assume that Congress has used these words in that sense. In sum, we cannot sacrifice the “plain, obvious and rational meaning” of the statute even for “the exigency of a hard case.”

We observe that Treasury and the Service have cited the fact that section 163(j)(1), in providing the operative limitation under section 163(j), uses the phrase “amount allowed as a deduction under this chapter” to justify expanding the definition of interest beyond amounts deductible as interest under section 163. The term “business interest” is specifically defined in section 163(j)(5), and we do not believe that the use of a general phrase referring to “deductions under this chapter” in a different subsection can be construed as modifying the specific definition of “business interest.” Therefore, we do not believe that it imparts any ambiguity to the specific definition of interest in section 163(j)(5).

The legislative history is consistent with a limited definition and likewise shows a contrast with “old” section 163(j). The legislative history of the Act refers to “[a]ny amount treated as interest for purposes of the Internal Revenue Code,” lending further support to the proposition that the current statute covers interest only, and not interest equivalents and other stated or imputed costs of financing. While “old” section 163(j) did not address interest equivalents in the Code, its legislative history indicated that Treasury could issue guidance treating as interest income or interest expense “items not denominated as interest but appropriately characterized as equivalent to interest.”

2. Temporary Regulation Section 1.861-9T and Regulation Section 1.954-2

The Preamble states that Treasury and the Service looked to Temporary Regulation section 1.861-9T and Regulation section 1.954-2 for purposes of the expansive definition of interest in the Proposed Regulations. As stated above, we believe that because of the different policy considerations underlying those provisions, they do not provide a good starting place for defining interest for purposes of section 163(j).

In particular, Temporary Regulation section 1.861-9T provides rules for allocating and apportioning expenses between U.S. and non-U.S. sources, generally for the purpose of determining a taxpayer’s foreign tax credit limitations. Because of the fungibility of money, the

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29 We note that the current version of section 163(j) contains neither a specific grant of regulatory authority with respect to the definition of interest nor a broad grant of regulatory authority. The only specific grant of regulatory authority contained in section 163(j) relates to the definition of ATI set forth in section 163(j)(8)(B). This stands in contrast to many other statutes, and we believe that it reinforces that Congress intended to use the commonly understood definition of “interest.” We share concerns expressed by other taxpayers whether the broad definition of interest adopted by the Proposed Regulations is within the authority granted to Treasury and the Service in section 163(j).


drafters believed that the rules for allocating interest expense should differ from the general sourcing rules. Accordingly, the approach set forth for interest deductions allocates such expense to all of a taxpayer’s activities and property regardless of whether there was any specific purpose for incurring such expense. In this regard, expanding the rule for allocating interest expense to “interest equivalents” makes policy sense if such equivalents are also considered to be equally as fungible as traditional borrowings and not easily matched to a particular income-producing activity. The policy rationale behind Temporary Regulation section 1.861-9T, i.e. the fungibility of money, does not support the expanded definition of interest set forth in the Proposed Regulations.

Regulation section 1.954-2 defines foreign personal holding company income (“FPHCI”) under section 954(c) for purposes of determining the amount of a taxpayer’s subpart F income. The original purpose of subpart F was to ensure that U.S. shareholders of controlled foreign corporations (“CFCs”) did not improperly enjoy the benefits of deferral for certain types of income. For a variety of reasons, passive income earned by CFCs was of particular concern to the drafters of these rules. Importantly, section 954(c)(1)(E) (i.e., the statutory provision) includes as a category of FPHCI: “Any income equivalent to interest, including income from commitment fees (or similar amounts) for loans actually made.” Accordingly, it makes sense for the regulations to include a list of interest equivalents as a type of FPHCI, even if such amounts are not traditionally considered interest. Again, such a policy decision should not inform the definition of interest for purposes of section 163(j).

We also think that Treasury and the Service should not anticipate that taxpayers could readily apply the approach to the definition of interest in the Proposed Regulations because taxpayers and practitioners already have experience with Temporary Regulation section 1.861-9T and Regulation section 1.954-2. There are significant questions regarding the scope of those rules and in our experience, only a small number of taxpayers and practitioners currently have expertise in these rules. As a result, we do not believe that the tax community as a whole has developed a strong sense of how those rules are to be applied. In contrast, the traditional definition of interest is much more widely understood and applied in practice, even if questions remain. For these reasons, adopting this approach provides no administrability benefit or reduction in complexity over the other potential approaches considered in the Preamble. In fact, as discussed below, it is likely that the approach reflected in the Proposed Regulations would significantly increase complexity and compliance burdens as compared to a more traditional definition of interest.

In sum, we believe that the relevant policy considerations for determining which items are subject to limitation under section 163(j) (i.e., limiting interest expense deductions and reducing the incentive for higher leverage) are quite different from those that underlie rules for the allocation and apportionment of expenses and the determination of subpart F income. Stated differently, while the fungibility of money may provide a good policy rationale for allocating items of loss or expense that are similar to or closely related to interest in a particular manner for

32 The Act has changed dramatically the overall treatment of income earned by CFCs.
purposes of determining foreign tax credit limitations, the fungibility of money should not inform policy decisions regarding which items constitute interest for purposes of section 163(j). Likewise, denying deferral for items of income that are passive and similar in some respects to interest does not justify including such items in the definition of interest for purposes of section 163(j).

C. Discussion of Administrability and Other Concerns with Certain Items in Category Three

We set forth below our specific concerns with respect to certain of the items enumerated in Category Three, each of which raises unique issues that we believe further support our overall recommendation to change the approach adopted for defining interest in the Proposed Regulations. The discussion below focuses on the following items set forth in Category Three:

- Substitute interest payments;
- Derivatives affecting the cost of borrowing or causing yield adjustments;
- Commitment fees and debt issuance costs.

1. Substitute Interest Payments

Under Proposed Regulation section 1.163(j)-1(b)(20)(iii)(C), substitute interest payments would be treated as interest for purposes of section 163(j). As discussed above, treating such amounts as interest would be contrary to longstanding tax law in general, and specifically at odds with the holding in **Deputy v. Du Pont**. Because securities lending transactions do not create indebtedness under current law, it would be difficult as a general matter to say that substitute interest payments would be treated as interest.

**OECD, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2015 Final Report**, OECD/G20 Base Erosion and Profit Shifting Project (2015), available at [http://dx.doi.org/10.1787/9789264241176-en](http://dx.doi.org/10.1787/9789264241176-en). In particular, the BEPS Report suggests that a best practice rule would apply a fixed ratio limitation on interest expense, such as the one reflected in section 163(j), not only to “interest on all forms of debt,” but also to payments “economically equivalent to interest” and “expenses incurred in connection with the raising of financing.” *Id.* at 29. While this suggestion may find merit in a purely conceptual world where a full body of law and practice had not already developed, we do not believe that such statement supports creating complexity and upsetting decades of judicial and administrative precedent by treating certain non-interest items as interest for purposes of section 163(j).

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33 We acknowledge that the definition of interest found in the Proposed Regulations finds support in the OECD’s report setting forth recommendations for limiting base erosion involving interest deductions (the “BEPS Report”). OECD, *Limining Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (2015), available at [http://dx.doi.org/10.1787/9789264241176-en](http://dx.doi.org/10.1787/9789264241176-en). In particular, the BEPS Report suggests that a best practice rule would apply a fixed ratio limitation on interest expense, such as the one reflected in section 163(j), not only to “interest on all forms of debt,” but also to payments “economically equivalent to interest” and “expenses incurred in connection with the raising of financing.” *Id.* at 29. While this suggestion may find merit in a purely conceptual world where a full body of law and practice had not already developed, we do not believe that such statement supports creating complexity and upsetting decades of judicial and administrative precedent by treating certain non-interest items as interest for purposes of section 163(j).

34 Prop. Reg. § 1.163(j)-(b)20(iii)(C).

35 Prop. Reg. § 1.163(j)-(b)20(iii)(E) and (F).

36 Prop. Reg. § 1.163(j)-(b)20(iii)(G) and (H). These Comments do not specifically address the other items in Category Three. First, guaranteed payments for the use of capital under section 707(c) will be addressed separately in forthcoming comments from the Section of Taxation on the treatments of passthrough entities under section 163(j). Second, the items described in Proposed Regulation section 1.163(j)-1(b)(20)(iii)(A) and (B) have generated less controversy since the release of the Proposed Regulations. Third, the items in Proposed Regulation section 1.163(j)-1(b)(20)(iii)(D) and (J) relating to ordinary gain from section 1258 transactions and income or gain from factored receivables, respectively, would potentially be included in the revised catch-all category described below in our recommendations.
interest payments are closely related to interest. Instead, it would be reasonable to surmise that Treasury and the Service view substitute interest payments as a form of disguised interest.

One of the three examples in the Proposed Regulations is dedicated to the treatment of substitute interest payments. In Example 1 in Proposed Regulation section 1.163(j)-1(b)(20)(v), a taxpayer engaged in a manufacturing business, borrows U.S. Treasury bonds from a Bank and agrees to return to the Bank substantially identical bonds and to pay the Bank both (i) substitute interest payments and (ii) a fee for lending the bonds. Taxpayer then sells the bonds in exchange for cash and purchases a portfolio of corporate bonds. The example further states that taxpayer’s obligation to return the U.S. Treasury bonds is not collateralized and to assume that the transaction does not result in indebtedness for tax purposes (e.g., a repo transaction).

The example concludes that (i) the $60x of substitute payments made by taxpayer are treated as interest for purposes of section 163(j) under Proposed Regulation section 1.163(j)-1(b)(20)(iii)(C) and (ii) the $70x of interest generated by the purchased portfolio of corporate bonds is treated as interest income of the taxpayer.

It appears that the underlying concern is that if substitute interest payments are not treated as business interest expense for purposes of section 163(j), the taxpayer would be able to achieve what the government perceives as the economic equivalent of a financing by borrowing debt instruments and selling such instruments short. This effect may be even more pronounced if the proceeds are used to buy interest-generating assets, such that the taxpayer would increase its business interest income without a corresponding increase in business interest expense. Perhaps the fact that A is in the manufacturing business, rather than the financial services business, heightened that concern for Treasury and the Service.

Curiously, the example is silent with respect to the treatment of the securities lending fee. For a fully collateralized securities lending arrangement, such fee would likely be a small amount. An uncollateralized securities lending arrangement, however, would expose the securities lender to the credit risk of the securities borrower, and thus would likely be a more meaningful amount. In fact, the combination of the substitute interest payment and the securities lending fee could approximate the taxpayer’s overall cost of borrowing on an unsecured basis.

While the treatment of substitute interest payments as interest expense may not raise the same complexity and administrability concerns as some of the other items included in Category Three, as a policy matter it is a dramatic departure from current law. As a result, and for reasons described above, we believe that substitute interest payments should not be treated as interest per se for purposes of section 163(j). Nevertheless, we believe that treatment of substitute interest payments as interest may be warranted in more limited and prescribed circumstances. Factors that the government should consider in this regard may include (i) whether the securities loan is collateralized or uncollateralized; (ii) the type of bond being lent (e.g., Treasury bonds as compared to riskier corporate bonds); (iii) whether the borrowing of debt instruments is part of the taxpayer’s ordinary business activities; and (iv) whether the securities loan is maintained for all or substantially all of the debt instrument’s remaining term.
2. Items that Alter Effective Cost of Borrowing or Yield

Proposed Regulation section 1.163(j)-1(b)(20)(iii)(E) and (F) treats items from derivatives\(^{37}\) that alter a taxpayer’s effective cost of borrowing or yield as an adjustment to interest expense or interest income, as the case may be.\(^{38}\) As an initial matter, the application of this rule to all derivatives is extremely broad, in that it could apply to derivatives even in situations where the derivative does not hedge indebtedness. For example, read literally, Proposed Regulation section 1.163(j)-1(b)(20)(iii)(E) could apply to a derivative that is posted as collateral for a borrowing because the derivative could be viewed as altering the cost of such borrowing. Without a clearly defined scope, this rule would be difficult, if not impossible, to apply in practice.

As a result of the different considerations related to non-foreign currency derivatives and foreign currency derivatives, we discuss below our specific concerns and recommendations with respect to each separately. We then discuss necessary clarifications in the event that the final Regulations include these derivative items as an adjustment to section 163(j) interest.

a. Non-Foreign Currency Derivatives

Notwithstanding the government’s concern that taxpayers could enter into derivatives to disguise interest and circumvent section 163(j), we are not convinced that the perceived avoidance potential exists for non-foreign currency derivatives. In this regard, where all transactions are in a taxpayer’s functional currency, and the taxpayer has entered into a borrowing transaction with an unrelated party, the yield on the discrete borrowing likely reflects the correct pricing of the borrowing. The fact that a borrower or lender may decide to hedge some exposure through derivatives is not relevant to whether the borrowing or lending on its own reflects a true cost of the borrower’s leverage or the true interest income of the lender.

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\(^{37}\) For this purpose, the term derivative is defined by reference to section 59A(h)(4)(A), which defines a derivative as “any contract (including any option, forward contract, futures contract, short position, swap, or similar contract) the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to one or more of the following:

(i) Any share of stock in a corporation.

(ii) Any evidence of indebtedness.

(iii) Any commodity which is actively traded.

(iv) Any currency.

(v) Any rate, price, amount, index, formula, or algorithm.”

The term does not include the items described in (i)-(v) and provides an exception for certain insurance, annuity and endowment contracts.

\(^{38}\) Proposed Regulation 1.163(j)-1(b)(20)(iii)(E) provides: “For example, a taxpayer that is obligated to pay interest at a floating rate on a note and enters into an interest rate swap that entitles the taxpayer to receive an amount that is equal to or that closely approximates the interest rate on the note in exchange for a fixed amount is, in effect, paying interest expense at a fixed rate by entering into the interest rate swap. Income, deduction, gain, or loss from the swap is treated as an adjustment to interest expense. Similarly, any gain or loss resulting from a termination or other disposition of the swap is an adjustment to interest expense, with the timing of gain or loss subject to the rules of §1.446-4.”
Further, the inclusion of items from derivatives may increase or decrease interest expense or interest income, as the case may be, and there is no reason to believe that one outcome will be meaningfully more likely than the other. As a result, treating such derivative items as interest for section 163(j) purposes should not have the type of revenue impact that would justify the burden placed on taxpayers to comply with that treatment.

By capturing all derivative items that alter the cost of borrowing or the effective yield on debt, however, the Proposed Regulations create significant complexity. In the context of hedging transactions, the history and current law treat hedges as separate from the hedged item. As a result, although the hedging transaction economically adjusts the income, deduction, gain or loss on the hedged item, for tax reporting purposes, the income, deduction, gain or loss on the tax hedging transaction does not simply adjust the income, deduction, gain or loss on the hedged item. As a derivative is a separate transaction from the hedged item, the items of income, deduction, gain and loss from the hedge are not interest for federal income tax purposes even where the hedged item is a debt instrument.

The only exception to that treatment is an integrated transaction under Regulation section 1.1275-6. In that case, the combination of the debt and the hedge (the “Section 1.1275-6 Hedge”) produces a determinable yield to maturity and thus effectively functions like a single debt instrument. The election under Regulation section 1.1275-6 is generally at the option of the taxpayer, although the Commissioner may force integration in certain limited circumstances. In the context of an integrated transaction, the items from the Section 1.1275-6 Hedge are treated as interest (and specifically, OID). Outside of that context, where there may not be perfect matching of hedged items and the hedge, the separate treatment of derivative items should obtain and, accordingly, such items are properly considered not to be interest income or expense.

Treating all items on a derivative as adjustments to interest income or expense may lead to unintended and peculiar results, even in the simplest of cases. For example, assume a taxpayer holds a $100 fixed-rate debt instrument and hedges that debt instrument with an interest rate swap. If the debt increases in value to $110 due to changes in the interest rate, the swap has likely declined in value by a similar amount. If the debt and the swap are then disposed of, the gain on the debt is not interest income for purposes of section 163(j), but because the derivative altered the yield of the debt held by the taxpayer, under the Proposed Regulations, loss on the swap would be treated as an adjustment to the taxpayer’s actual interest income for purposes of section 163(j). In this case, economically, the derivative loss offsets the capital gain.

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40 A “Section 1.1275-6 hedge” under Regulation section 1.1275-6(b)(2) is any financial instrument if the combined cash flows of the financing instrument and the qualifying debt instrument permit the calculation of a yield to maturity (under the principles of section 1272), or the right to the combined cash flows would qualify under Regulation section 1.1275-5 as a variable rate debt instrument that pays interest at a qualified floating rate or rates (except for the requirement that the interest payments be stated as interest).

41 Reg. § 1.1275-6(c)(1) and (2).

42 The term “hedge” is used here in an economic sense as opposed to representing a tax hedge.
on the disposition of the debt instrument. Treating the loss on the derivative as an adjustment to interest income potentially whipsaws the taxpayer because the debt can give rise to capital gain in lieu of interest income.43

As perhaps an even more stark example, consider the results if an interest rate swap were to hedge the interest rate risk on debt where no interest deduction is allowed for the issuer (e.g., the debt is subject to section 163(j)). In that case, would the income, deduction, gain or loss on the swap be treated as an adjustment to interest expense even though section 163(j) would not apply to the interest expense on the debt because it is disallowed under another provision?44

Other types of complexity could arise in the context of aggregate hedging. A taxpayer could have multiple debt instruments outstanding and a single interest rate hedge where (i) a portion of the taxpayer’s interest expense is subject to section 163(j), (ii) a portion of the taxpayer’s interest expense is excepted from section 163(j) (e.g., by reason of a real property trade or business election), and (iii) the interest expense on at least one tranche of debt is not subject to section 163(j) because it is deferred or disallowed (e.g., the debt is subject to the rules for applicable high yield discount obligations). While the hedge would alter the taxpayer’s cost of borrowing, it is not clear how the adjustment to interest expense required by the Proposed Regulations with respect to income, deduction, gain or loss from the hedge would be apportioned among the various tranches of debt in such case.

These examples support our general recommendation that income, deduction, gain, or loss from a derivative should not be treated as an adjustment to interest expense for purposes of section 163(j). If this recommendation is not accepted, we suggest that the requirements under Regulation section 1.1275-6 be loosened so that taxpayers can more easily integrate a debt instrument and related hedging transactions to avoid the inconsistent treatment demonstrated above. This would create more certainty for taxpayers with respect to the overall amount of interest income and expense for each taxable year and potentially reduce some amount of the complexity and administrative burden described above. At the same time, Treasury could require integration in more cases where it is possible to calculate a yield to maturity.

b. Foreign Currency Derivatives

Based on the Proposed Regulations, it appears that Treasury and the Service are concerned that a taxpayer can borrow at a low interest rate in a strong currency and synthetically convert the interest rate into a higher interest rate in a weaker currency to reduce the amount of interest expense being subject to section 163(j). A similar concern, albeit in a different context, was the reason for the enactment of section 988(d).45

43 Conversely, if the debt were to decline in value as a result of interest rate changes, the taxpayer in the example would suffer a $10 capital loss. The offsetting $10 of capital gain on the swap would still be treated as an adjustment to interest income under the Proposed Regulations.

44 Under Prop. Reg. § 1.163(j)-3(b), section 163(j) applies after the application of provisions that subject interest expense to disallowance, deferral, capitalization, or other limitations, and business interest expense does not include interest expense that is permanently disallowed.

45 See H.R. Rep. No. 99-426, at 476 (1985) (“The committee is particularly concerned about hedging transactions where a taxpayer borrows in a weak currency and eliminates virtually all risk of currency loss by establishing
Another set of regulations that deals with the adjustments to cost of borrowing in nonfunctional currencies can be found under Temporary Regulation section 1.861-9T. As discussed above in Part III.B.2, the policy considerations under Temporary Regulation section 1.861-9T are very different from those under section 163(j). However, because the Treasury and Service appear to rely on Temporary Regulation section 1.861-9T as precedent for including currency gain or loss on hedging transactions as an adjustment to interest, these Comments will briefly discuss the application of those rules in the context of foreign currency denominated debt instruments.46

i. Section 988(d) and Regulation Section 1.988-5

Examples in the legislative history of section 988(d) involve a taxpayer who borrows in a weak currency (as compared to the U.S. dollar (“USD”)) and fully hedges the currency exposure on all interest and principal payments so that the taxpayer can compute a yield to maturity on the synthetic borrowing in USD terms.47 In that situation, Congress was concerned that, without integration treatment for the nonfunctional currency denominated borrowing and the related hedges, taxpayers would be able to deduct more interest expense in earlier years.48 While the examples in the legislative history address a taxpayer who borrowed in a weak currency, Congress also stated that “[a] similar rule would apply in the case of a fully-hedged borrowing in a strong currency (i.e., a currency with an interest rate lower than the dollar interest rate).”49 Treasury and the Service eventually promulgated Regulation section 1.988-5(a) under section 988(d) to implement the Congressional instruction.

Regulation section 1.988-5(a) only treats currency gains and losses as interest income and expense in a very narrow case. While a detailed discussion of the rules under Regulation section 1.988-5(a) is outside the scope of these Comments, it is important to note that Regulation section 1.988-5(a) generally allows taxpayers (and the government) to integrate a debt instrument and related hedging transactions to create a synthetic debt instrument for tax purposes if, inter alia, the taxpayer can compute the yield to maturity (under principles of section 1272) of the synthetic debt instrument when the hedge or hedges are entered into.50 The ability to calculate a yield to maturity is critical, because only in such a situation can the taxpayer ascertain its borrowing cost under the synthetic debt instrument; accordingly, those are the situations Congress intended to capture under section 988(d).

49 Id.
50 Taxpayers often enter into transactions described in Regulation section 1.988-5(a) in the normal course of their trade or business to manage the currency and interest rate risks.
Under section 988(b)(3), the amount of gain or loss on a foreign currency derivative is not bifurcated between the time value component and the currency component, even though time value is inherent in foreign currency derivative pricing. Without going into a detailed discussion of currency forward contract pricing, the forward exchange rate of a currency forward contract is determined by reference to the spot exchange rate and the interest rate differentials between the two currencies.\(^{51}\) A currency yielding a lower interest rate trades at a “forward premium” because it is traded at a higher price than the spot exchange rate. A currency yielding a higher interest rate trades at a “forward discount” because it is traded at a lower price than the spot exchange rate.\(^{52}\) Forward premiums and discounts are commonly referred to as “forward points.” In essence, forward points reflect the interest rate differentials between two currencies and represent the time value adjustment made to the spot exchange rate between two currencies to reflect a future settlement date.

Recognizing that forward points are embedded in foreign currency derivatives, Congress enacted section 988(b)(3) to treat the entire amount of foreign currency gain or loss on a currency derivative as exchange gain or loss.\(^{53}\) This policy decision was confirmed by Treasury and the Service under Regulation section 1.988-2(d).\(^{54}\) Specifically, under section 988(b)(3) and Regulation section 1.988-2(d)(4), forward points on currency forward contracts are treated solely as section 988 gain or loss. In summary, aside from an integrated transaction as described under section 988(d) and Regulation section 1.988-5(a), Congress chose not to impose an unnecessary compliance burden on taxpayers to separately account for forward points as interest on every currency derivative.\(^{55}\)

### ii. Temporary Regulation Section 1.861-9T(b)(1) & (2)

Temporary Regulation 1.861-9T(b) provides a few different subsections potentially applicable to a hedged nonfunctional currency denominated debt instrument and the related hedging transactions. These rules are unclear and have been subject to criticism.\(^{56}\) As a result,

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\(^{51}\) A simplified mathematical formula is as follows: Forward rate = Spot rate x \([(1+r_d)/(1+r_f)]\).  \(r_d\) = domestic interest rate and \(r_f\) = foreign interest rate.  See S. Rep. No. 99-313, at 440.

\(^{52}\) Id.


The Bill provides that any gain or loss from a section 988 transaction is a foreign currency gain or loss if the transaction is a disposition of nonfunctional currency or a forward contract, futures contract, option, or similar financial instrument with respect to a nonfunctional currency. This makes it clear that any gain or loss on such an instrument due to forward premium or forward discount is subject to the Act’s rules for foreign currency gains and losses, regardless of movements in the spot rates of exchange between the booking and payment dates. (Emphasis added.)  

See also H.R. Rep. No. 99-426, at 475 (“The committee intends that the regulations pertaining to hedging transactions be narrowly restricted to transactions that are substantially equivalent to U.S.-dollar denominated transactions.”).

\(^{54}\) See Reg. § 1.988-2(d)(4)(i), (iii), Ex. 1.

\(^{55}\) See also New York State Bar Association Tax Section Report No. 656, Reports on Section 988 Temporary Regulations (May 7, 1990).

\(^{56}\) See, e.g., Tax Executives Institute, Inc., Comments of Tax Executives, Inc. on Temporary and Proposed Regulations Relating to the Allocation and Apportionment of Interest and Other Expenses Under Section 864(e) of
we do not believe that these rules, especially the examples thereunder, should be the guiding principles for purposes of section 163(j) in the currency context.

Relevant to this discussion is Temporary Regulation section 1.861-9T(b)(2)(i), which applies to transactions in which a taxpayer borrows in a strong currency (at a lower interest rate) and enters into a hedging transaction (or a series of hedging transactions) that reduces the currency risk associated with such nonfunctional currency borrowing. If the taxpayer borrows in a strong currency (with the implication that such currency will continue to appreciate against the taxpayer’s functional currency), the Regulation assumes the taxpayer expects a currency loss when the interest and principal on the debt instrument are repaid. With that assumption, Temporary Regulation section 1.861-9T(b)(2)(i) provides that, if the currency hedging transaction “substantially diminishes” the taxpayer’s currency risk on the borrowing, any currency loss on the borrowing, increased or decreased by any currency gain or loss on the hedge, is apportioned in the same manner as interest expense, unless the taxpayer can demonstrate that the hedge relates to an exposure other than with respect to the debt instrument.

Temporary Regulation section 1.861-9T(b)(2)(i) by its terms applies only to a taxpayer borrowing in a strong currency (at an interest rate less than the prevailing rate in the taxpayer’s functional currency), and only where the taxpayer incurs a loss on the borrowing. By netting the currency gain or loss on the hedge against the currency loss on the borrowing, it appears that the regulation attempts to flush out the forward points on the hedges, which represent the time value component. However, it appears that the regulation does not achieve a correct economic and tax result because it takes the currency loss on the debt instrument into account only, and not currency gains. In other words, to flush out the forward points on the currency hedge and apportion them accordingly, Temporary Regulation section 1.861-9T(b)(2)(i) should net a taxpayer’s foreign currency gain or loss on the hedge against the foreign currency loss or gain on the interest and principal payments.

The next relevant rule is Temporary Regulation section 1.861-9T(b)(1)(i). That rule applies to any deductible expense or loss “incurred in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time … if such expense or loss is substantially incurred in consideration of the time value of money.” By its terms, expense or loss from a currency hedging transaction can be apportioned under this rule, but gain on the hedging transaction may not be. In response to comments to Temporary

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57 The low interest rate charged by the lender of the strong currency, compared to USD interest rates, reflects the anticipated appreciation of the foreign currency relative to the USD.

58 While the rationale for Temp. Reg. § 1.861-9T(b)(2)(i) is not expressly stated in the preamble, presumably, Treasury and the Service were concerned that, without such a rule, a domestic corporation could borrow at a reduced interest rate to reduce the amount of interest expense being apportioned between U.S. and foreign sources under section 864(e) while any currency gain or loss on the hedge generally would be U.S. source under the residence source rule of section 988(a)(3). See also Seth, Goldstein, James Gannon, Irwin Peter Halpern, & Janet Elsbernd, The Allocation and Apportionment of Deductions, BNA Tax Management Portfolio, 6640 T.M., at A-30.
Regulation section 1.861-9T(b)(2)(i), Treasury and the Service added Example 2 to Temporary Regulation section 1.861-9T(b)(1)(ii) in an attempt to demonstrate how a currency loss on a nonfunctional currency borrowing that is not subject to Temporary Regulation section 1.861-9T(b)(2)(i) can still be treated as an interest equivalent.  

However, Temporary Regulation section 1.861-9T(b)(1)(ii), Example 2 also appears to reach an incorrect economic and tax result. That example assumes that the GBP and USD interest rates are approximately equal and, therefore, the forward price on the GBP vis-à-vis the USD approximately equals the GBP/USD spot rate. If that is the case, the example’s conclusion that any net foreign currency loss on the debt and the hedge constitutes “a loss incurred substantially in consideration of the time value of money” is questionable. As discussed above, the difference between forward price and spot price (i.e., the forward points) represents time value, if the forward points on the swap contract are approximately zero, the net loss on the debt and the hedge is much more directly related to exchange rate movements than to the interest rate differentials between the two currencies.

iii. The Proposed Regulations

The Proposed Regulations provide an example (“Example 2”) that is meant to demonstrate how Proposed Regulation section 1.163(j)-1(b)(20)(iii)(E) and (F) would work in the currency context, but the example is unclear and could be misconstrued to derive an incorrect economic and tax result. Below is the full text of Example 2:

(1) Facts. A is a calendar year taxpayer that is engaged in a manufacturing business. In early 2019, A enters into the following transactions:

(i) A enters into a loan obligation in which A borrows Japanese yen from Bank in an amount equivalent to $2000x with an interest rate of 1 percent (at the time of the loan, the U.S. dollar equivalent interest rate on a loan of $2,000x is 5 percent); and

(ii) A enters into a foreign currency swap transaction (FX Swap) with Bank with a notional principal amount of $2000x under which A receives Japanese yen at 1 percent multiplied by the amount of Japanese yen borrowed from Bank (which for 2019 equals $20x) and pays U.S. dollars at 5 percent multiplied by a notional amount of $2000x ($100x per year). The FX Swap is not integrated with the loan obligation under §1.988-5.

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(2) Analysis. The FX Swap alters A’s cost of borrowing within the meaning of paragraph (b)(20)(iii)(E) of this section. As a result, for purposes of section 163(j), the $100x paid by A to Bank on the FX Swap is treated by A as interest expense and the $20x paid by Bank to A on the FX Swap is treated by A as a reduction of interest expense.62

As a threshold matter, it is unclear whether A in Example 2 entered into a cross-currency swap (within the meaning of Regulation section 1.988-2(e)(2) where A exchanged both interest and principal) or a notional principal contract that simply converts the JPY interest rate to a USD interest rate. Because Example 2 implicitly assumes that the FX Swap can be integrated under Regulation section 1.988-5, for purposes of this discussion, we will assume that the FX Swap referred to in Example 2 is a cross-currency swap.

One may read Example 2 to suggest that the entire foreign currency gain or loss resulting from a currency hedging transaction is used to reduce or increase the interest expense on the taxpayer’s nonfunctional currency borrowing. If that is the intended result, it would be contrary to the currency forward pricing principle discussed above. We will demonstrate this important point by expanding on Example 2.

Assume that, on January 1, 2019, when USD:JPY = 1:100, A borrows JPY200,000 from Bank (the “JPY Loan”). Also, assume the USD/JPY exchange rate does not fluctuate throughout the entire term of the JPY Loan. The JPY Loan bears an interest rate of one percent and has a maturity date of December 31, 2021. Further, assume that, at the issuance of the JPY Loan, the USD equivalent interest rate on a loan of $2,000 is five percent. Finally, assume that, on the same date, A enters into a cross-currency swap transaction (“Currency Swap”) with Bank. Under the Currency Swap, A is obligated to swap the amounts with the Bank based on Table A below.

Table A

<table>
<thead>
<tr>
<th>Date</th>
<th>A pays USD under the FX Swap</th>
<th>A receives JPY under the FX Swap</th>
<th>A receives in USD terms</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/2019</td>
<td>$100</td>
<td>¥2,000</td>
<td>$20</td>
</tr>
<tr>
<td>12/31/2020</td>
<td>$100</td>
<td>¥2,000</td>
<td>$20</td>
</tr>
<tr>
<td>12/31/2021</td>
<td>$100</td>
<td>¥2,000</td>
<td>$20</td>
</tr>
<tr>
<td>12/31/2021</td>
<td>$2,000</td>
<td>¥200,000</td>
<td>$2,000</td>
</tr>
</tbody>
</table>

One can gather from the table above that A’s total USD cost of borrowing on the JPY Loan (as altered by the Currency Swap) is $300. If A had integrated the JPY Loan and the Currency Swap under Regulation section 1.988-5(a), A would have been treated as having borrowed $2,000 with approximately a five percent interest rate.

However, assume that, instead of entering into a cross-currency swap, A enters into a series of forward contracts on January 1, 2019 to buy JPY and sell USD on each date the interest payment and the principal payment, respectively, on the JPY Loan is due. Table B below

62 Id.
demonstrates the approximate forward rates (in a perfectly efficient foreign exchange market) for such a series of forward contracts.

Table B

<table>
<thead>
<tr>
<th>Date</th>
<th>USD A pays under the forwards</th>
<th>JPY A receives under the forwards</th>
<th>JPY/USD Forward rate</th>
<th>Forward points</th>
<th>JPY A receives in USD terms</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/2019</td>
<td>$20.79</td>
<td>¥2,000</td>
<td>96.19</td>
<td>-3.81</td>
<td>$20</td>
</tr>
<tr>
<td>12/31/2020</td>
<td>$21.57</td>
<td>¥2,000</td>
<td>92.73</td>
<td>-7.27</td>
<td>$20</td>
</tr>
<tr>
<td>12/31/2021</td>
<td>$22.33</td>
<td>¥2,000</td>
<td>89.57</td>
<td>-10.43</td>
<td>$20</td>
</tr>
<tr>
<td>12/31/2021</td>
<td>$2,233.01</td>
<td>¥200,000</td>
<td>89.57</td>
<td>-10.43</td>
<td>$2000</td>
</tr>
</tbody>
</table>

As Table B illustrates, the total amount of interest and OID A pays in USD terms throughout the term of the JPY Loan (combined with the forward contracts) is approximately $300, which approximates what A pays in the Currency Swap example above. Because we have assumed that the JPY/USD exchange rates did not fluctuate over the duration of A’s JPY borrowing, the entire difference between what A pays under the forward contracts in USD and what A receives under the forward contracts in USD terms represents the forward points (i.e., the time value of interest rate differential between USD and JPY). Like in the Currency Swap example, A could integrate the JPY Loan and the forward contracts as a synthetic USD debt under Regulation section 1.988-5(a) that has a yield of approximately five percent.

These examples make it clear that A’s effective cost of borrowing in USD terms cannot be calculated simply by taking into account the entire foreign currency gain or loss on a forward contract in one period and reducing or increasing the interest expense for such period. Therefore, Example 2 can lead to the wrong economic and tax result. Moreover, Example 2 does not address common, but more complicated fact patterns, as discussed below.

iv. Substantial Tax Compliance Burden

In practice, because long-term cross-currency swaps and forward contracts are costly, many taxpayers hedge their nonfunctional currency debt instruments by executing rolling short-term (e.g., 30-day, 60-day, or 90-day) forward contracts. Specifically, A in the above examples could hedge the currency exposure with respect to interest and principal payments on its JPY Loan by executing rolling 30-day forward contracts to buy JPY and sell USD. This is a very different economic arrangement from those discussed in Tables A and B above. In this case, A cannot ascertain the yield to maturity in USD terms and, therefore, A does not know if it would be paying less or more in forward points over the next three years because the interest rates in the United States and Japan will fluctuate in a way that is not definitively predictable.63

If the standard under the Proposed Regulations is to capture all the forward points on hedges of interest and principal payments, under the above facts, A would need to wait until the

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63 Because the Proposed Regulations do not define what “alters” a taxpayer’s cost of borrowing, and because Example 2 addresses a hedge of interest only, it is unclear whether forward points related to hedges of principal payments are intended to be captured.
JPY Loan is paid off and all the forward contracts are settled to determine the amount of forward points that adjusted A’s cost of borrowing throughout the entire term of the JPY Loan. Stated another way, the taxpayer will not know until the maturity of the debt instrument and the settlement of all the currency hedges how much of its foreign currency gain or loss with respect to all of its short-term foreign currency hedges actually alters its cost of borrowing. This economic reality is wholly at odds with having to determine on a year-by-year basis how much foreign currency loss may or may not be limited by section 163(j).

Setting policy considerations aside, the broad language in the Proposed Regulations provides either incorrect or unduly burdensome results depending on its intended scope. We have explained that the time value component in a foreign currency derivative is captured by forward points. As demonstrated above, it is unclear what Treasury and the Service intended to capture under the Proposed Regulations. If Treasury and the Service intended to capture all foreign currency gain or loss (and not just forward points), the Proposed Regulations achieve the wrong economic and tax result. If, however, Treasury and the Service intended to capture only the forward points (whether such points relate to hedges on interest or principal), the Proposed Regulations would impose an enormous compliance burden on taxpayers.

Continuing from our example above, if A hedges on a loan-by-loan basis, to comply with the rules in the Proposed Regulations, A would need to, at the minimum, (i) track every single nonfunctional currency debt instrument and its related currency hedging transaction separately; (ii) track the forward points on each rolling forward contract and match them to the debt instrument it hedges over the term of such debt instrument; (iii) perform a yield to maturity analysis by assigning the forward points (assuming that the forward points on each forward contract are readily available) to each relevant debt instrument when each debt instrument is repaid; and (iv) compute the effect on A’s section 988 reportable transactions if an amount of currency loss on the hedge (that relates to forward points) is limited by section 163(j). If A made a mistake in computing the amount of section 988 loss that is limited under section 163(j), there could be significant consequences (including under the reportable transaction rules).64

To make matters worse, the entire process discussed above assumes that A has properly identified each of the forward contracts as a hedging transaction under section 1221(b) and Regulation section 1.1221-2. If A did not properly identify its hedging transactions, it would need to determine the effects of the straddle rules under section 1092 as well. For example, if a forward contract results in a section 988 loss (that relates to forward points) that is deferred, it is unclear how A should adjust its interest expense or income if the deferred section 988 loss is released in a later year. If A is a CFC, A would need to adjust its subpart F or global intangible low-taxed tested income based on the above analyses as well.65

The compliance burden is exacerbated if the forward points are not readily available to A. In that case, to determine the forward points on each forward contract, A needs to net the currency gain or loss on the forward contracts against the currency gain or loss on each related interest and principal payment over the life of each debt instrument. Even if A performs such

64 Reg. § 1.6011-4.
65 It is also unclear how any deferred currency loss under section 163(j) interacts with Reg. § 1.954-2(g)(2).
computation, there could still be an amount that is over- or under-stated because section 988 gain or loss on interest payments are computed by comparing the spot rate on the date the interest is paid to the average rate of the interest accrual period.66

So far we have demonstrated how cumbersome it would be to comply with the Proposed Regulations if a taxpayer hedges on a loan-by-loan basis. If a taxpayer hedges on an aggregate basis (which is very common because many taxpayers manage their foreign currency exposure by centralizing all currency risks in one entity), the tax compliance would be essentially impossible. For example, A in the above example can hold hundreds or thousands of foreign currency denominated trade and notes payables and receivables with different maturities and hedge the currency risk on an aggregate basis utilizing rolling short-term forward contracts. It would not be unusual for A to dynamically adjust its foreign currency hedges by putting on additional or offsetting forward contracts, options, collars, or cross-currency swaps. The complexity for taxpayers to track the forward points on hundreds of currency derivatives and match such forward points to hundreds (if not thousands) of nonfunctional currency denominated payables and receivables (some of which would be interest bearing and some not) is unfathomable.

v. Recommendation for Foreign Currency Derivatives

We believe that the undue burden associated with these situations far outweighs any possible policy objectives in terms of achieving accurate bifurcation of time value and currency movement in every currency derivative, especially when taxpayers cannot ascertain the yield to maturity on the debt instrument when the hedges are entered into. As discussed above, by enacting section 988(b)(3), Congress made it clear that any gain or loss on a foreign currency derivative is treated solely as section 988 gain or loss and the bifurcation approach is rejected. We do not believe that section 163(j) is the context where the Treasury and the Service should revisit this policy.

Based on the policy and administrative complexity reasons described above, we recommend, consistent with our general recommendation, that section 163(j) not apply to a taxpayer’s foreign currency hedging transactions. As discussed above, the government’s primary concern that foreign currency derivatives could be used by taxpayers to circumvent section 163(j) has already been addressed in Regulation section 1.988-5 in situations where such rules are applicable. If our recommendation not to include foreign currency derivative items in interest for purposes of section 163(j) (outside of an integrable transaction under Regulation section 1.988-5) is not adopted, the requirements under Regulation section 1.988-5 should be loosened so that taxpayers can more easily integrate their debt instruments and related hedging transactions. Otherwise, taxpayers would have no certainty of the section 163(j) treatment of their non-integrated derivatives in situations where the Service could later force integration but the taxpayer has no ability to elect integration treatment. For example, taxpayers should be able to integrate hedging transactions entered into with related parties with their debt instruments if the other requirements under the regulation are met.

66 Reg. § 1.988-2(b)(3), (4).
c. Other Clarifications

First, if our primary recommendation is not adopted, the final Regulations need to provide parameters for when a derivative “alters” a taxpayer’s effective cost of borrowing or effective yield, as the Proposed Regulations do not expound on how the term “alter” should be interpreted.

We do not believe that the intent behind these rules is to require taxpayers to examine every derivative they enter into, at any given time, to determine whether such derivative happens to “alter” the effective cost of borrowing on any debt payable or the effective yield on a debt receivable. For example, a domestic corporation may (i) hold EUR-denominated trade account receivables (that are not interest-bearing), (ii) issue USD-denominated interest-bearing debt instruments and (iii) enter into EUR-USD forward contracts to sell EUR for USD to hedge its EUR-denominated trade account receivables. Arguably, the EUR-USD forward contracts could have the effect of altering the U.S. corporation’s cost of borrowing on the USD-denominated debt instruments. We believe these kinds of incidental transactions should not be captured under section 163(j).

We recommend that the final Regulations precisely define (i) what standard is used to include a derivative in section 163(j), and (ii) how significant an effect a derivative needs to have on the cost of borrowing or effective yield to be included in the computation.67 For example, a derivative that constitutes a hedging transaction within the meaning of Regulation section 1.1221-2(b), or an integrable transaction under Regulation section 1.1275-6 or Regulation section 1.988-5, may be a good guideline in establishing the scope. Importantly, in the foreign currency context, the final Regulations need to clarify (i) which portion of the gain or loss from a foreign currency derivative (e.g., forwards, swaps, options, collars, etc.) affects the cost of borrowing or effective yield and (ii) when such gain or loss is taken into account for purposes of section 163(j). Finally, where the derivative does not reference one or more interest rates, the final Regulations should identify a clear standard as to whether, and to what extent, such derivative affects a taxpayer’s effective cost of borrowing or effective yield.

Second, regardless of whether our recommendation to Proposed Regulation section 1.163(j)-1(b)(20)(iii)(E) and (F) in the final Regulations is adopted, Treasury and the Service should clarify how the hedge timing rules under Regulation section 1.446-4 apply to taxable items of hedging transactions that relate to deferred interest. While this issue has previously existed for deferred interest, the increased frequency of deferred interest under new section 163(j) may magnify the issue. To the extent that interest expense deductions on indebtedness are deferred under section 163(j), there is an open question as to whether amounts otherwise

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67 A lack of clarity in this standard could lead to inconsistent positions taken among taxpayers. For example, as stated above, it is not clear whether a position in a derivative should be viewed to alter a taxpayer’s cost of borrowing if it is posted as collateral on a borrowing. The presence, or non-presence, of collateral inherently affects a taxpayer’s cost of borrowing. However, there may be no nexus between the terms of the derivative and the borrowing, and it may be the case that the position in the derivative is merely collateral security for the lender. While we do not believe the derivative in the example should be construed to alter the taxpayer’s cost of borrowing for purposes of section 163(j), a broad interpretation of the Proposed Regulations could treat taxable items from the derivative as an adjustment to interest expense.
includible or deductible under the hedging transaction should likewise be deferred to comply with the clear reflection standard under Regulation section 1.446-4.\textsuperscript{68} By analogy, the Service has ruled that the matching of income, deduction, gain, or loss from a hedging transaction with a compensation deduction subject to section 404(a)(5) clearly reflects income for purposes of Regulation section 1.446-4(b).\textsuperscript{69}

We recommend that Treasury and the Service clarify how the clear reflection standard is applied in the case of deferred interest expense. In particular, we recommend that regulations establish that section 163(j) does not alter the timing of taxable items from hedging transactions that are subject to Regulation section 1.446-4. The clear reflection of income standard under Regulation section 1.446-4 is a method of accounting that requires taxpayers to match the timing of hedging income, deduction, gain or loss to that of the hedged item. Section 163(j) has already strayed from clear reflection when it defers deductions for amounts actually paid or accrued, and thus we do not think that section 163(j) should supplant the timing rules provided in Regulation section 1.446-4(b). Therefore, we believe that it should be made clear that the clear reflection of income standard is met when the timing of hedging items is matched with the timing of the interest expense to which it relates,\textsuperscript{70} regardless of whether the deduction for such interest expense is then limited under section 163(j) or another interest deductibility limitation provision.

If Proposed Regulation section 1.163(j)-1(b)(20)(E) and (F) remain in the final Regulations, any such ordering rules must also provide clear guidance on hedges of aggregate risk. This is especially important in the foreign currency context because any deferred currency loss on a derivative under section 163(j) could affect the amount of section 988 loss a taxpayer is entitled to and, therefore, the taxpayer’s reportable transaction reporting obligation. A coordination rule with section 163(j) is also needed for taxpayers that are subject to a mark-to-market method of accounting (\textit{e.g.}, a section 475 dealer or a taxpayer that made an election under Proposed Regulation section 1.988-7).

3. \textbf{Commitment Fees and Debt Issuance Costs}

Consistent with our overall approach, we recommend that debt-related fees be treated as interest for purposes of section 163(j) only to the extent that such fees or costs constitute interest for U.S. federal income tax purposes.

\textsuperscript{68} In this regard, we note that language of Proposed Regulation section 1.163(j)-1(b)(20)(iii)(E) refers only to the timing for early terminations or other dispositions of a hedge and does not explicitly address either (i) current payments on hedges or (ii) whether such items should be matched to deferred interest for that period.

\textsuperscript{69} Priv. Ltr. Rul. 200415009 (Apr. 9, 2004). \textit{But see} Chief Couns. Adv. 201135030 (May 27, 2011) (concluding that gain or loss from an anticipatory interest rate hedging transaction could not be deferred to match the timing of cancellation of indebtedness (“COD”) income inclusion under section 108(i)). In its analysis, the Service stated, “there is no connection between the Hedge Gain and the COD income to require matching of the two in this case. . . . [T]he COD income does not appear to have arisen from changes in interest rate risk, and the purpose of the anticipatory Hedge was to manage interest rate risk.” \textit{Id}.

\textsuperscript{70} Reg. \S 1.446-4(e)(4), (5).
It would appear that the primary driver behind including these items in the definition of interest in the Proposed Regulations was the government’s desire to include amounts closely related to interest and potentially “disguised” interest. We do not believe that commitment fees and debt issuance costs represent “disguised” interest, and certain debt-related expenses (such as payments to third-party service providers) are not closely related to interest. In any event, for many of the reasons discussed above, we do not believe that, absent an anti-avoidance concern, such a policy goal justifies departing from the current U.S. federal income tax law treatment of these types of items.

That being said, we recommend that, in order to provide clarity in this area, the Service complete the project on its current Priority Guidance Plan entitled “Guidance on the treatment of fees relating to debt instruments and other securities.” In asking for comments in the Preamble and adding the debt-related fee project to its Priority Guidance Plan in 2017, the Service recognized the difficulty in properly characterizing the myriad costs/fees borrowers incur in connection with issuing debt. Adding to the characterization challenge is the inconsistent use of various names or labels for debt-related fees in commercial practice. Once that guidance is released, taxpayers will have a clearer view of the treatment of a variety of debt-related fees, and only those fees or costs that are ultimately determined to be interest (including OID) should be treated as interest for purposes of section 163(j).

Starting with debt issuance costs, we distinguish between fees that are paid to parties other than the lender(s) (“third-party expenses”) and those paid to the lender(s). As discussed below, the law regarding fees paid for third-party expenses, such as service fees to lawyers or accountants, is fairly well-settled and it would be hard to find a policy rationale for including such amounts as interest for purposes of section 163(j). The treatment of fees and other amounts paid by borrowers to lenders is a far more unsettled area of the law, and one of the reasons that the completion of the debt-related fee project is important.

Borrowers incur various third-party expenses, including fees paid to service providers, such as lawyers, underwriters (or arrangers), and accountants for facilitating the issuance of the indebtedness. For example, consider a company that incurred and paid legal fees to a law firm that represents it in the negotiation and execution of a borrowing transaction. The law firm provided legal services to the company, and the company paid the law firm for those services. The company did not borrow any funds or obtain any lending commitment from the law firm or any affiliate of the law firm. These debt issuance costs are required to be capitalized under Regulation section 1.263(a)-5(a)(9) and amortized over the term of the loan under Regulation section 1.446-5.

OID principles are used to amortize capitalized debt issuance costs over the term of the loan. To this end, Regulation section 1.446-5 provides that, “solely for purposes of determining the amount of debt issuance costs that may be deducted in any period, these costs are treated as if

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72 See, e.g., David H. Shapiro, Michael Yaghmour, and Ryan Schneider, A Tax Field Guide to Debt-Related “Fee” Income, 143 Tax Notes 1027, 1033 n.31 (June 2, 2014).
they adjusted the yield on the debt.” That is, although debt issuance costs are amortized using OID principles, they are not OID and are not deductible as interest expense. Rather, debt issuance costs are generally treated as ordinary and necessary business expenses that are deductible under section 162 in the period to which they are allocable.

Debt issuance costs that are represented by third-party expenses are not paid or incurred for the use or forbearance of money under a debt instrument. Accordingly, such items are not within the general definition of interest under federal income tax law that is discussed elsewhere in these Comments. Such amounts are not even closely related to interest, and we believe that it would be inappropriate to treat debt issuance costs as interest for purposes of section 163(j).

Where the amounts are instead paid to the lender, drawing the distinction between OID and debt issuance costs can be challenging in light of the lack of clear authority under the law. In this regard, with respect to amounts paid at the time of issuance to the lender, the OID regulations provide the following rule:

In a lending transaction to which section 1273(b)(2) applies, a payment from the borrower to the lender (other than a payment for property or for services provided by the lender, such as commitment fees or loan processing costs) reduces the issue price of the debt instrument evidencing the loan.

To the extent the payments reduce issue price, such amounts generally constitute OID on the debt instrument, which is includible/deductible over the term of the loan as interest income or expense. As a result, such amounts should clearly be treated as interest for purposes of section 163(j). For the amounts that are not treated as reducing the issue price, the precise treatment is less clear. Such amounts could be treated as payments for services, and thus subject to the rules for debt issuance costs in the same manner as third-party expenses. Such amounts could also be treated as payments for property. In either case, such amounts should not be treated as interest for purposes of section 163(j).

73 Reg. § 1.446-5(b)(1) (emphasis added).

74 The preamble to proposed regulations under Reg. § 1.446-4 provides that:

Existing law requires that capitalized transaction costs incurred to borrow money (debt issuance costs) be deducted over the term of the debt. For example, see Enoch v. Commissioner, 57 T.C. 781 (1972). The regulations do not propose to change this treatment. … However, in order to conform the rules for debt issuance costs with the rules for original issue discount, the proposed regulations generally require the use of a constant yield method to determine how much of these costs are deductible each year by the borrower. See proposed § 1.446–5.


75 Reg. § 1.1273-2(g)(2)(i).

76 Reg. §§ 1.163-7(a), 1.1272-1(a).
Turning to commitment fees, Proposed Regulation section 1.163(j)-1(b)(20)(iii)(G)(1) would treat as interest for purposes of section 163(j) any fees in respect of a lender commitment to provide financing if any portion of such financing is actually provided. Treating commitment fees as a type of interest would be inconsistent with prior guidance released by the Service on this topic and, perhaps more importantly, as discussed below, would be inconsistent with the substance of commitment fees. Commitment fees are paid to the lender(s) for the right to borrow in the future, and not for the current use or forbearance of money. Moreover, commitment fees are paid irrespective of whether any amounts are actually borrowed, and are not computed by reference to the amount borrowed. Accordingly, we believe that treating commitment fees as interest for purposes of section 163(j) is inappropriate unless the Service ultimately decides to treat commitment fees as interest for general tax purposes, which, for example, could be accomplished by amending Regulation section 1.1273-2(g).

As discussed above, certain fees paid to the lender reduce the issue price of the debt (and generally create OID). Notably excluded from the list of payments that reduce the issue price are commitment fees, which the wording of the regulation may suggest are a “payment for property” (although there is uncertainty in this regard). The approach of treating commitment fees as a payment to acquire a property right is consistent with Revenue Ruling 81-160. In Revenue Ruling 81-160,77 the Service stated that “[a] loan commitment fee in the nature of a standby charge is an expenditure that results in the acquisition of a property right, that is, the right to the use of money.” Noting the similarity of a commitment fee to an option premium, the Service ruled that: (1) the commitment fee was a capital expenditure when made, following the general rule for option premium, (2) if the borrowing right was exercised, the commitment fee would become a cost of acquiring a loan and would be deducted ratably over the term of the loan, and (3) if the borrowing right was not exercised, the taxpayer could be entitled to a loss deduction under section 165 when the right expired.78

It is not entirely clear under the option approach whether an upfront commitment fee can create OID on a debt instrument when drawn (although doing so would seemingly be inconsistent with Regulation section 1.1273-2(g)). This is an issue that should be addressed as part of the Service’s guidance project on debt-related fees. In the meantime, section 163(j) should not apply to commitment fees unless and until the Service determines that some or all of such fees is properly treated as interest (e.g., OID).79

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77 1981-1 C.B. 312.
78 Id. More recently, the Service addressed quarterly commitment fees in Field Attorney Advice 20182502F (Apr. 11, 2018), concluding that quarterly commitment fees were currently deductible as ordinary and necessary business expenses (and not as interest). While the rationale of the conclusion is somewhat at odds with Revenue Ruling 81-160, this conclusion is consistent with the view that commitment fees are not for the use or forbearance of money, but rather for the right to borrow (during the period).
79 While these rulings addressing payors of commitment fees may be reconcilable based on distinctions between the fees addressed, reconciling them with the Service’s historical position with respect to commitment fee recipients is more difficult. See, e.g., Rev. Rul. 70-540, 1970-2, C.B. 101, obsoleted in part by Rev. Proc. 94-29, 1994-1 C.B. 616 (ruling that the recipient of commitment fees includes such amounts when received).
While our recommendation is that commitment fees should not be included as an item of interest in the final Regulations, to the extent Treasury and the Service reject this recommendation, we believe that commitment fees should be treated as interest proportionately only to the extent of any draws. That is, it seems somewhat arbitrary (and inconsistent with the premise that such fees are “interest equivalents”) to treat the full amount of commitment fees as interest for purposes of section 163(j) if a taxpayer draws, for example, $50 million on a $500 million facility. Without suggesting that we approve of the inclusion of commitment fees in the definition of interest, we would suggest that only one-tenth of the commitment fees should be treated as interest for purposes of section 163(j) in the example above.

D. Anti-Avoidance Considerations

1. Recommended Approach

We do appreciate that a more narrow definition of interest for purposes of section 163(j) does not address the concern expressed in the Preamble regarding the possibility that taxpayers may attempt to avoid section 163(j) by engaging in transactions that are “essentially financing transactions” that do not produce items treated as interest. Further, we acknowledge the statement in the Preamble that it is difficult for Treasury and the Service to identify every type of transaction already in practice and to anticipate future innovations that result in transactions that they believe should be within the scope of section 163(j).

Accordingly, we have considered whether including a general anti-avoidance rule in the definition of interest would be appropriate to address these concerns. Due to many of the concerns set forth above with respect to an expanded definition of interest, including issues regarding complexity, administrability, the role of legal rights and obligations, symmetry and issues of statutory interpretation, we believe it would be difficult to craft language for an appropriate anti-avoidance rule. As a result, rather than include a comprehensive anti-avoidance rule to be included in the definition of interest in the final Regulations, we recommend that Treasury and the Service take an approach that would identify and target perceived abuse as it is found to arise.80 In this regard, one of the principles that we believe Treasury and the Service should adhere to with respect to defining interest for purposes of section 163(j) is to strive to treat any items characterized as interest for that purpose as interest for all purposes of the Code. In the discussion below, we distinguish between (i) situations not involving debt, or amounts defined as interest, in the first place, but where the transaction effectively creates disguised interest and (ii) situations where debt is already in place, but another transaction could be viewed as altering the effective borrowing cost or yield on such debt.

With respect to situations where Treasury and the Service believe that the transaction or series of related transactions should be treated as creating indebtedness, and thus interest, there are many examples that could be followed without promulgating a broad anti-avoidance rule in

80 Under this approach, Treasury and the Service should still make clear that Prop. Reg. § 1.163-2(h) does not apply for purposes of defining interest under section 163(j).
the section 163(j) Regulations. As discussed above, we believe it is appropriate to retain Category Two and treat significant nonperiodic payments on swaps as deemed loans that result in interest income and expense, and previously treated as such under Regulation section 1.446-3(g)(4). As another example, in Revenue Ruling 2008-1, the Service ruled that certain foreign currency exchange traded notes should be treated as debt for U.S. federal income tax purposes. In addition, in Schering-Plough Corp. v. United States the government successfully argued that a sale to a related foreign subsidiary of a payment stream under a swap with a third-party bank was in substance indebtedness.

As an example of why it is difficult to craft an appropriate anti-avoidance rule, in Notice 2008-2 Treasury and the Service announced that they were considering whether parties to certain prepaid forward contracts should be required to accrue income and expense during the term of the transaction, and whether such accrual should be considered interest income and expense for purposes of the Code. The issues raised in the Notice are challenging issues, but represent just one of the many circumstances in which the time value of money may be reflected in a transaction that is not evidently debt. As a result, we do not believe that it would be possible to employ a broad-based anti-avoidance rule in section 163(j) to curb perceived abuse without causing confusion and potentially disrupting ordinary market transactions that, while possessing a time value component, are not “essentially financings” with disguised interest.

We thus believe that Treasury and the Service, through future Regulations and administrative guidance, have the tools to combat perceived abuses by finding indebtedness, and interest, where appropriate and necessary. We further believe that the legal rights and obligations of the parties should be taken into account for this purpose, as opposed to simply relying on the notion of time value of money.

With respect to transactions that effectively alter borrowing costs or yield, we again note that we do not believe that Congress intended to require Treasury and the Service to create complexity for taxpayers in the name of arriving at what they perceive as a more precise amount of interest expense. That being said, Treasury and the Service already have the ability under Regulation section 1.1275-6 and 1.988-5 to integrate transactions, and thus effectively turn non-interest items into interest. If Treasury and the Service were to use their authority under those regulations to integrate indebtedness with the related transaction that alters borrowing costs or effective yield where appropriate (i.e., it is possible to calculate a yield to maturity), the result would be far less complex and confusing than the results described above in Part III.C.2.

2. Alternative Anti-Avoidance Rule

Proposed Regulation section 1.163(j)-1(b)(20)(iv) was included as an anti-avoidance rule, but functions in the manner of a catch-all provision for items of expense or loss that are not

81 2008-1 C.B. 248.
described in any of the first three categories of interest. In the event that Treasury and the Service believe that an anti-avoidance rule with respect to the definition of interest is necessary for the proper administration of section 163(j), we suggest a more narrow rule.

Our main concerns with an anti-avoidance or catch-all rule in the context of defining interest are (i) the fact that such a rule would likely ignore the legal rights and obligations of the parties because it is, by its nature, applying to items that are not interest for tax purposes and (ii) the potential added complexity and lack of consistency when an item is not treated as interest for all purposes of the Code. More specifically, we are troubled by the broad and vague nature of Proposed Regulation section 1.163(j)-1(b)(20)(iv) as written.

Consistent with our view that “interest” has a specific meaning in the tax law, we are concerned that an anti-avoidance rule that focuses solely on the time value of money without regard to the legal rights and obligations of the parties may encompass transactions that differ significantly from traditional indebtedness, even where a significant time value of money component is present. Thus, while Treasury and the Service seek to focus on transactions that are “essentially financings,” the rule as drafted in Proposed Regulation section 1.163(j)-1(b)(20)(iv) could extend to items of loss or expense that are quite different from traditional interest paid or accrued on indebtedness. Again, there is little evidence that Congress intended this result.

As discussed above, there are considerable administrative burdens associated with treating an item as interest for purposes of section 163(j), even though the item may be deductible under a different provision, such as section 162 or section 165. In particular, taxpayers likely do not separately track such items, and the inconsistent treatment as interest solely for purposes of section 163(j) would likely prove burdensome.

With respect to Proposed Regulation section 1.163(j)-1(b)(20)(iv) itself, our primary concern relates to the chosen standard. That is, the rule would apply to transactions where the expense or loss associated with the use of funds is predominantly incurred in consideration of the time value of money. We believe that standard is somewhat vague and would be difficult to apply in practice, which would potentially lead to inconsistent treatment among similar transactions. Perhaps more importantly, we do not believe the standard is high enough to capture only transactions that could be viewed as essentially financings. Many financial transactions have a time value component, such as options and forward contracts, and we do not believe that a transaction is essentially a financing transaction if significant other economic elements are present, such as the potential for gain or loss on an underlying reference asset.

We believe that the standard should be more in line with the standard found in section 1258(c); that is, an otherwise deductible expense or loss would be considered interest expense for purposes of section 163(j) only if substantially all of the expense or loss incurred for the use of funds for a period of time is expected to be attributable to the time value of money. We also
note that any such rule should be based on the expected result, as is the case with the application of section 1258(c), as opposed to the actual results of a transaction.\(^{84}\)

This standard would also be consistent with the facts in Example 3 in Proposed Regulation section 1.163(j)-1(b)(20)(v). In the example, A borrows gold from B and sells the gold to C for $1,000x. A then enters into a contract with D to purchase the same amount of gold six months in the future for $1,013x. The example states: “In exchange for the use of $1,000x in cash, A has sustained a loss of $13x on related transactions.” The example thus concludes that A’s loss of $13x is treated as interest expense for purposes of section 163(j) under Proposed Regulation section 1.163(j)-1(b)(20)(iv) because A secured the use of $1,000x and the loss is “predominantly associated with the time value of money.” With respect to the example, it is apparent that “substantially all” of the loss was associated with the time value of money and thus such transaction would be covered by the higher standard that we recommend if this type of catch-all rule is retained in the final Regulations.

Because this would be an objective rule, albeit with some amount of judgment to be exercised around the meaning of substantially all and “expected,” it should apply equally to the income side (i.e., essentially retaining income from section 1258 transactions as interest income and possibly other transactions, such as income from factored receivables). Accordingly, it would function as essentially a catch-all provision both on the expense and income side for items that are not otherwise generally treated as interest.

Further, we feel strongly that the intent-based anti-avoidance rule set forth in Proposed Regulation section 1.163-2(h) should not be applied for purposes of determining whether an item of income, deduction, gain or loss is treated as interest for purposes of section 163(j). Regardless of whether intent should play a role in the definition of interest, treating an item as interest in the first place must be based on objective, economic factors, such as time value of money considerations. Accordingly, the definition of interest, including any anti-avoidance or catch-all provisions, should be clearly laid out within the definition itself. Accordingly, we recommend that Treasury and the Service make clear that the general anti-avoidance rule currently in Proposed Regulation section 1.163(j)-2(h) does not apply to expand the definition of interest for purposes of section 163(j).

\(^{84}\) We have also considered whether any such rule should have a conjunctive intent test or an exception for ordinary course transactions. To the extent that an anti-avoidance rule is included in the final Regulations, we ask Treasury and the Service to consider whether it should be modified by an intent test (such as a principal purpose test) or otherwise provide an exception for ordinary course transactions.