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CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR SPECIAL TRIAL ATTORNEY, MIDSTATES REGION
CC:MSR

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL
(FIELD SERVICE) CC:DOM:FS

SUBJECT: QUALIFIED LIABILITIES AND TRACING RULES

This Field Service Advice responds to your memorandum dated September 14, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

A:
B:
C:
D:
E:
F:
G:
H:
I:
J:
K:

Date 1:
Date 2:
Date 3:
Date 4:

Date 5:
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State 1:

Country 1:
Country 2:

ISSUES

1. Was Section VI of Notice 89-35, 1989-1 C.B. 675, which modified the “single account” and “15-day rules” of Temp. Treas. Reg. § 1.163-8T(c)(4)(iii)(B) still in effect during 1994?
2. Under the “any account of the taxpayer” rule set out in Notice 89-35, can the taxpayer’s loan be allocated to the subsidiary’s expenditure, and must that subsidiary be members of taxpayer’s consolidated group?
3. Do the “any account” and “30-day rules” of Notice 89-35 apply to debt refinancing as defined at Treas. Reg. § 1.163-8T(e)?
4. Is an intercompany loan an “investment expenditure . . . properly chargeable to capital account” for purposes of the debt allocation rules of Treas. Reg. § 1.163-8T?

5. In a disguised sale of a partner's stock in a subsidiary, do intercompany loans to a subsidiary, constitute capital expenditures "with respect to the property transferred" under Treas. Reg. § 1.707-5(a)(6)(i)(C)?
6. In a disguised sale of a partner's stock in a subsidiary, do capital expenditures of the subsidiary incurred and paid by the subsidiary constitute capital expenditures "with respect to the property transferred" under Treas. Reg. § 1.707-5(6)(i)(C)?
7. Whether the commercial paper liabilities assumed by A are "qualified liabilities" under Treas. Reg. § 1.707-5(a)(6)(i)(C)?

CONCLUSIONS

1. Yes.
2. Under Section VI of Notice 89-35 it would not be appropriate to treat the account of a subsidiary (even if the member of the same consolidated group) as an account of the taxpayer for purposes of the "same account" rule.
3. The "any account" and "30 day" rule would apply to debt refinancing proceeds only to the extent that the proceeds are not allocable to the repayment of the preexisting debt.
4. Treas. Reg. § 1.163-8T(j)(1)(iii) applies in a very narrow context and does not provide any authority for a broad treatment of intercompany loans.
5. No, however, the partners in this disguised sale are F, C and B and it is not apparent that they loaned money to their lower-tier subsidiaries. The origin of the funds with K, does not change this analysis.
6. Yes, if the capital expenditure can be traced to a contribution by the subsidiary's parent. If the expenditure has no relation and cannot be traced to the liability of the parent which is assumed, then it is not a qualified liability.
7. If taxpayer can show that for F and C the proceeds of the debt were contributed to the lower-tier subsidiaries which in turn used the money on capital expenditures, then the taxpayer may be able to establish that these are qualified liabilities. If the taxpayer can show that for B the proceeds of the debt were used for the acquisition of E, then the taxpayer may be able to establish that it was a qualified liability.

FACTS

A is a limited liability company taxable as a partnership and subject to TEFRA procedures. A was formed on or about Date 1 by B, as #1 percent partner, and D, as #5 percent partner. B and D contributed their interests in E to A on or about Date 2.

On or about Date 3, F, transferred stock in G, a State 1 corporation which owned a power plant in Country 1, to A for a partnership interest. On that same date, C transferred the stock of H, a Country 2 company which in turn owned the stock of I and J, both Country 2 companies operating power plants in the Country 2, to A for a partnership interest.

All partners are affiliated with K and may or may not join in the K consolidated return. B, F and C will be referred to as Intermediate Subsidiaries. It is not clear that F and C were the historic owners of the lower-tier subsidiaries; B in particular, acquired its lower-tier subsidiary recently from K.

It appears that C and F subsequently contributed their respective interests in A to B. B was then owned in the following percentages: #2 percent K, #3 percent C, #4 percent F, and #5 percent D. A assumed $1 of B's liabilities. It is our understanding that the Intermediate Subsidiaries assumed the liabilities in connection with either their acquisition or their development of the lower-tier subsidiaries. These liabilities originally were assumed by F, C and B from K.

The assumption agreements provide as follows: The assumption agreement dated Date1, between K, A, and B provides that whereas K assigned to B, and B in turn, assigned to A #6 shares of E, and K issued $2 of commercial paper allocated to those shares, that B assumed the liability in connection with the transfer of shares to A, and A then assumed the liability for the indebtedness.

The assumption agreement dated Date 4 between F and A provides that whereas F assumed $3 in indebtedness of commercial paper issued by K and F has transferred to A #9 shares of G, that A assumed the liability for the $3 million indebtedness, the refinancing of the existing debt.

The assumption agreement dated Date 3 between K, C and A provides that whereas C assumed $4 of indebtedness of commercial paper issued by K, and C has transferred to A #7 shares of H, that A assumed the liability for the $4 million indebtedness, the refinancing of the existing debt.

At all times, however, K remained the sole obligor of the commercial paper obligations.

A and B participated in an initial public offering (IPO) of approximately #8 percent of A's partnership interests on or about Date5. The IPO was structured so that B was offering shares that it currently held and A was offering shares in itself. B apparently received $5 for the shares that it sold and A received $6 for the shares that it offered. A used $1 of the proceeds to retire the commercial paper liabilities that it had assumed and used the remainder of the proceeds to redeem D's partnership interest. A authorized a distribution of $7 to B on or about Date 5.

The Commissioner issued an FPAA to A on Date 6 attacking the transaction under a disguised sale theory. The primary theory was that certain liabilities of K did not constitute "qualified liabilities" within the meaning of § 1.707-5(a)(6)(i)(C). The taxpayer concedes that it was a disguised sale but disputes that the liabilities were not "qualified liabilities."

A's tax matters partner, B, filed a Petition for Redetermination on Date 7 in the Tax Court.

LAW AND ANALYSIS

Issue 1

Treas. Reg. § 1.707-5(a)(6)(i)(C) indicates that for purposes of the disguised sale analysis, a liability that is assumed or taken subject to by a partnership in connection with a transfer of property to the partnership is a qualified liability if the liability is allocable under the rules of Treas. Reg. § 1.163-8T to capital expenditures with respect to the contributed property. A qualified liability has preferential tax treatment to an ordinary liability. Under the facts of the present case, the Intermediate Subsidiaries have contributed stock in corporate subsidiaries to A. Taxpayer has raised the argument that the liability represented by the commercial paper is allocable to capital expenditures within the lower-tier subsidiaries contributed to A.

Treas. Reg. § 1.163-8T of the temporary regulations provides rules for determining the character of interest expense for purposes of sections 163(d), 163(h) and 469. Treas. Reg. § 1.163-8T(c)(1) provides that debt is allocated to expenditures in accordance with the use of the debt proceeds. Treas. Reg. § 1.163-8T(c)(4)(iii)(B) provides, among other things, that a taxpayer may treat any expenditure made from an account within 15 days after debt proceeds are deposited in such account as made from such proceeds. Treas. Reg. § 1.163-8T(c)(5)(i) provides a similar rule with respect to debt proceeds received in cash.

Section VI of Notice 89-35, 1989-1 C.B. 675, (which expands the guidance contained in Notice 88-20, 1988-1 C.B. 487, and Notice 88-37, 1988-1 C.B. 522) modified the single account and 15-day rules to provide that in the case of debt proceeds deposited in an account, taxpayers may treat any expenditure made from any account of the taxpayer, or from cash, within 30 days before or 30 days after debt proceeds are deposited in any account of the taxpayer as made from such proceeds to the extent thereof. Section III of Notice 89-35 provides that taxpayers may rely on the guidance with respect to debt proceeds received in cash or deposited in an account after December 31, 1987, and on or before the date on which further guidance is published. To date, no further guidance under Treas.

Reg. § 1.163-8T has been published. Therefore, Section VI of Notice 89-35 was still in effect during 1994.

Issue 2

It does not appear to be appropriate to allocate a liability of a taxpayer to a subsidiary's expenditure under the "any account of the taxpayer" rule. Specifically, the debt of the corporate parent should not be allocated to expenditures paid out of a subsidiary's bank account. Section VI of Notice 89-35 provides considerable freedom to taxpayers in determining the proper tracing of debt proceeds. In particular, Notice 89-35 modifies the general rule of Temp. Treas. Reg. § 1.163-8T(c)(4)(ii)(B) to provide that the debt proceeds may be allocated to an expenditure out of any account of the taxpayer made within 30 days before or after the proceeds are deposited in an account of the taxpayer. However, this freedom does not extend to permit the loan proceeds of one taxpayer (K) to be allocated to the expenditures of other taxpayers (the Intermediate Subsidiaries).

The taxpayer has apparently represented that the proceeds of the commercial paper were either lent or contributed to the Intermediate Subsidiaries by K. Therefore, the only expenditure that the proceeds of the commercial paper may be traced to under Treas. Reg. § 1.163-8T and Notice 89-35 would be the use that K made of the proceeds. That is, the proceeds of the loans may be traced to either intra-company loans or capital contributions to Intermediate Subsidiaries.

To the extent that K lent the proceeds to the Intermediate Subsidiaries, the Intermediate Subsidiaries would have obtained debt proceeds that could conceivably be traced to capital contributions to the lower-tier subsidiaries. In such a case, the Intermediate Subsidiaries could presumably refinance their obligation to K by assuming K's obligation under the original commercial paper. If A then assumed the Intermediate Subsidiaries' obligations under the commercial paper when it received the contributions of the interests in the lower-tier subsidiaries, then it is theoretically possible that the assumed liability under the commercial paper could be traced to capital expenditures with respect to the contributed property. Assuming, the Intermediate Subsidiaries did not contribute the original loan proceeds to the lower-tier subsidiaries, but rather loaned the money to the subsidiaries, such intercompany loans would not be considered capital expenditures.

Issue 3

District Counsel essentially asks whether a new debt can be traced to the repayment of an old debt so that the refinancing rules apply. The "any account" and "30-day rules" of Notice 89-35 apply to debt refinancing as defined in Treas. Reg. § 1.163-8T(e) in a limited manner.

Treas. Reg. § 1.163-8T(e)(1) specifically indicates that to the extent proceeds of any debt (the "replacement debt") are used to repay any portion of a debt, the replacement debt is allocated to the expenditures to which the repaid debt was allocated. The amount of replacement debt allocated to any such expenditure is equal to the amount of debt allocated to such expenditures that was repaid with proceeds of the replacement debt. To the extent proceeds of the replacement debt are used for expenditures other than repayment of a debt, the replacement debt is allocated to expenditures in accordance with the rules of this section. These provisions indicate that a taxpayer only has flexibility to allocate the amount of the replacement debt that is not used to repay the original debt. Treas. Reg. § 1.163-8T(e)(1) does not permit any flexibility in the allocation of the portion of the replacement debt that is used to repay the original debt; that portion must be allocated to the expenditures that the original debt was allocated to.

An additional issue has arisen as to whether a debt incurred within 30 days of the repayment of a preexisting debt may be treated as a refinancing within the meaning of Treas. Reg. § 1.163-8T(e) of the original debt. Assuming the proper tracing can be shown, it appears appropriate to treat the new debt as a refinancing of the original debt. There is no indication in Treas. Reg. § 1.163-8T(e) that a refinancing for tracing purposes must be a formal refinancing (that is an arrangement where proceeds of a replacement debt are conveyed directly to retire a pre-existing debt). Treas. Reg. § 1.163-8T(e)(1) merely states that:

> To the extent proceeds of any debt (the "replacement debt") are used to repay any portion of a debt, the replacement debt is allocated to the expenditures to which the repaid debt was allocated.

This general statement only requires that the taxpayer be able to trace the proceeds of the replacement debt to an expenditure to repay the original debt. In the absence of any indication to the contrary, it should be presumed that the normal rules of Treas. Reg. § 1.163-8T (as augmented by Notice 89-35) would be used to determine whether the proceeds of the replacement debt can be traced to a repayment of the original debt. Therefore, a taxpayer could treat replacement debt as a refinancing of an original debt if the proceeds of the replacement debt could be traced to a repayment within 30 days (out of any account) of the original debt.

<u>Issues 4, 5, and 6</u>

Advice has been requested on the proper interpretation of Treas. Reg. § 1.163-8T(j)(1)(iii). That section indicates, in part, that:

> [A]n expenditure to make a loan is treated as an expenditure properly chargeable to capital account with respect to an asset, and for

> purposes of paragraph (j)(1)(i)(A) of this section any repayment of the loan is treated as a disposition of the asset.

Because Treas. Reg. § 1.707-5(a)(6)(i)(C) refers to a liability that is allocable to capital expenditures, the theory has been advanced that Treas. Reg. § 1.163-8T(j)(1)(iii) mandates that intercompany loans be treated as capital expenditures. This does not appear to be the proper interpretation of Treas. Reg. § 1.163-8T(j)(1)(iii). Treas. Reg. § 1.163-8T(j)(1) addresses the reallocation of debt when the debt had been allocated to a capital expenditure. In particular, when an asset is sold, any debt that had been allocated to that asset must be reallocated when the proceeds of the disposition are used for another expenditure. The language of Treas. Reg. § 1.163-8T(j)(1)(iii) must be viewed in this context, that is debt proceeds that are in turn used to make a loan must be reallocated when the loan is repaid. Treas. Reg. § 1.163-8T(j)(1)(iii) cannot be relied upon for any broader authority as to the nature of intercompany loans.

Intercompany loans to a subsidiary should not constitute capital expenditures "with respect to the property transferred" under Treas. Reg. § 1.707-5(a)(6)(i)(C). However, the partners in this disguised sale are F, C and B and it is not apparent that they loaned money to their lower-tier subsidiaries. The origin of the funds with K, does not change this analysis.

Capital expenditures of the subsidiary incurred and paid by the subsidiary constitute capital expenditures "with respect to the property transferred" under Treas. Reg. § 1.707-5(6)(i)(C), but only if the capital expenditure can be traced to a contribution by the subsidiary's parent. If the expenditure has no relation and cannot be traced to the liability of the parent which is assumed, then the liability is not a qualified liability.

Issue 7

The question of whether these liabilities constituted qualified liabilities necessarily turns upon the determinations outlined above. If the Intermediate Subsidiaries contributed rather than lent money to their lower-tier subsidiaries, then the assumed liability could be traced to capital expenditures with respect to the contributed property. However, if the Intermediate Subsidiaries loaned money to their lower-tier subsidiaries, then this type of intercompany loan would not be a capital expenditure and taxpayer would not have satisfied the tracing rules of Treas. Reg. § 1.163-8T. Moreover, even if the Intermediate Subsidiaries can show that the money was contributed to the lower-tier subsidiaries, B must also trace the proceeds of the replacement debt, albeit, within the confines of the 30 day rule. It is B's burden to show how the Intermediate Subsidiaries used the proceeds of the loans.

Alternatively, we believe this transaction may be viewed in ways that reach results more in accord with the substance of the transaction, (such as the transfer of the #8 percent interest to the public partners). We look forward to working further with you to develop this substance over form approach.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

Please call if you have any further questions.

By: ______________________________

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