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

DATE:	May 25, 2001
MEMORANDUM FOR	CARYL K. SHARP TEAM MANAGER IE GROUP 1622
FROM:	Jacob Feldman Special Counsel CC:INTL
SUBJECT:	Interest Paid by No Longer-existing DISCs Pursuant to Post-1984 Deficiency Distributions under Section 992(c)

This Chief Counsel Advice responds to your memorandum dated August 21, 2000. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Entities

CorpA =
DISC1 =
DISC2 =
DISC3 =
DISC4 =
DISC5 =
SubA =
SubB =
SubC =
SubD =
Appeals OfficeA =

Dates

Date1	=	
Date2	=	
Date3	=	
Date4	=	
Date5	=	
Taxable YearA	=	
Taxable YearB	=	
Taxable YearC	=	
Taxable YearD	=	
Taxable YearE	=	

Amounts

Amount1	=	
Amount2	=	
Amount3	=	
Amount4	=	
Amount5	=	
Amount6	=	
Amount7	=	
Amount8	=	

ISSUE 1

Whether interest paid under section 992(c)(2)(B) by the successor to a domestic international sales corporation or by the parent of a liquidated domestic international sales corporation on behalf of the no longer-existing domestic international sales corporation in connection with a deficiency distribution under section 992(c) may be deductible on the consolidated return of the successor or parent corporation and its subsidiaries.

ISSUE 2

Whether section 265(a)(1) disallows interest expense deductions with respect to interest paid pursuant to section 992(c)(2)(B) for taxable years beginning after December 31, 1984.

CONCLUSION 1

No. Interest paid under section 992(c)(2)(B) by the successor to a domestic international sales corporation or by the parent of a liquidated domestic international sales corporation on behalf of the no longer-existing domestic international sales corporation in connection with a deficiency distribution under section 992(c) may not be deductible by the parent or successor. However, such interest may be deductible by the no longer-existing domestic international sales corporation in the pre-1985 taxable year in which the corporation is deemed to pay such interest.

CONCLUSION 2

Yes. Based on the facts in this case, section 265(a)(1) disallows interest expense deductions with respect to interest paid pursuant to section 992(c)(2)(B) for taxable years beginning after December 31, 1984.

FACTS

CorpA is a subchapter C corporation. CorpA-DISCs1 through 5 (collectively “the CorpA-DISCs”) were wholly owned, directly or indirectly, domestic subsidiaries of CorpA during Taxable Years A through B. During these taxable years, the CorpA-DISCs each had in place a valid election to be treated as a domestic international sales corporation (“DISC”) pursuant to section 992(b) and, in all respects except one, continuously maintained its status as a DISC in accordance with the requirements under section 992(a).

The CorpA-DISCs did not satisfy the assets test under section 992(a)(1)(B) at all times during Taxable Year A through Taxable Year B. Failure to satisfy the assets test rescinds a corporation’s DISC status, exposes the corporation to taxation, and renders the DISC provisions inapplicable to the gross receipts of such corporation. I.R.C. §§ 991 and 992. During Taxable Years A through B, one or more of the five DISCs in this case failed the assets test.

DISC1 was liquidated into its parent, CorpA, pursuant to a Certificate of Ownership and Merger dated Date1. On Date2, DISC2 changed its name to SubA and reported its taxable income on a consolidated return with its parent, CorpA, for all taxable years after Date3. DISC3 was liquidated into its parent SubB pursuant to a merger on Date4. SubB reported its income on a consolidated return with its parent, CorpA, for all years involved in this case. DISC4 was liquidated into its parent SubC pursuant to a dissolution on Date5. SubC reported its income on a consolidated return with its parent, CorpA, for all years involved in this case. DISC5 was liquidated into its parent SubD pursuant to a dissolution on Date4. SubD reported its income on a consolidated return with its parent, CorpA, for all years involved in this case. The liquidations of CorpA-DISCs1, 3, 4, and 5 all occurred during the same taxable year. For purposes of this advice, and for simplicity, the term “the CorpA group” hereinafter refers to CorpA and members of CorpA’s consolidated group, including SubA, B, C, and D.

In resolution of an examination for Taxable Years A through B, the CorpA group and Appeals OfficeA agreed that the CorpA-DISCs owed and would make actual and deemed deficiency distributions totaling $Amount1 pursuant to section 992(c)(1). The DISCs made the deficiency distributions pursuant to settlement agreements. The settlement agreements specified that the deficiency distributions would be treated as made out of accumulated DISC income and would, therefore, reduce accumulated DISC income.

The settlement agreements also required the DISCs to make interest payments pursuant to section 992(c)(2)(B) with respect to the deficiency distributions totaling $Amount2. The settlement agreements did not specify the source of the interest payments. The deficiency distributions and interest payments were made as follows:

Taxable Year of Payment	Deficiency Distribution	Interest Payment
Taxable YearC	$Amount3	$Amount6
Taxable YearD	$Amount4	$Amount7
Taxable YearE	$Amount5	$Amount8

The CorpA group included the distributions as income in the years received.[1] The CorpA group also claimed interest deductions on its consolidated return in the years it paid the interest. Examination disagrees with the taxpayer's taking of deductions on its consolidated return with respect to the section 992(c)(2)(B) interest payments.

The Service asserts that the interest is deemed paid by the DISCs in the years that the related deficiency distributions are deemed made by the DISCs. In other words, the Service argues that the interest is deemed paid by the DISCs prior to 1985. Alternatively, the Service argues that the interest payments are not deductible by any taxpayer under section 265(a)(1) because the interest expenses at issue are allocable to income that is wholly exempt from United States income taxation.

LAW AND ANALYSIS

I. Deductibility of Section 992(c)(2)(B) Interest Payments under the Domestic International Sales Corporation Provisions

A. Domestic International Sales Corporations Generally

[1] See Rev. Rul. 76-499, 1976-2 C.B. 235, holding that a deficiency distribution is included in the income of a DISC's shareholder in the year received, even though the purpose for such distribution was to qualify the corporation as a DISC for a previous taxable year.

A corporation that qualifies as a DISC is not subject to income tax.[2] I.R.C. § 991. A portion of a DISC's earnings and profits ("E&P") is taxed to its shareholders as a "deemed distribution" in the taxable year earned by the DISC. I.R.C. § 995. See also Staff of Senate Finance Committee, Report on Tax Reform Act of 1976, 92d Cong., 2d Sess. 292, reprinted in 1976-3 vol.3 C.B. 49, 330; Staff of Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976, 290, reprinted in 1976-3 vol.2 C.B. 1, 303-304 (both documents providing an example of DISC tax deferral). Income tax on the remaining E&P is deferred until the DISC makes an actual distribution of such E&P to its shareholders. Id.

The portion of a DISC's E&P that is deemed distributed under § 995 is called "previously taxed income." I.R.C. § 996(f)(2). Most DISC E&P during a taxable year that are not categorized as previously taxed income are called "DISC income." I.R.C. § 996(f)(1).[3] The total deferred DISC income of all prior years that remains undistributed in a DISC is called "accumulated DISC income." Treas. Reg. § 1.996-3(b)(1).

Generally, a shareholder that receives an actual distribution from a DISC excludes the distribution from its gross income to the extent the distribution is paid out of previously taxed income. I.R.C. § 996(a)(3). The shareholder includes the distribution in its gross income to the extent the distribution is paid from accumulated DISC income. Id. This rule ensures that a DISC's shareholders are taxed no more than once with respect to any portion of the DISC's E&P.

B. Deficiency Distributions and Interest Payments

To qualify as a DISC for a taxable year, a domestic corporation must have in place a valid election to be treated as a DISC under section 992(b) and must meet several criteria including an assets test under section 992(a)(1)(B). Under the assets test, the adjusted basis of a corporation's "qualified export assets" at the close of a taxable year must equal or exceed 95% of the sum of the adjusted basis of all of the corporation's assets at the close of the taxable year. I.R.C. § 992(a)(1)(B).[4] If a corporation fails the assets test, it will still be deemed to have

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[2] A DISC is a pass-through entity.

[3] A DISC may also have a third category of income called "other earnings and profits" which consists of any E&P that does not qualify as either previously taxed income or DISC income. I.R.C. § 996(f)(3). We are unaware of the presence of other earnings and profits in this case.

[4] See I.R.C. § 993(b) and Treas. Reg. § 1.993-2(a) for a list of property that constitutes qualified export assets.

satisfied the assets test if it makes a pro rata distribution of property to its shareholders after the close of the taxable year. I.R.C. § 992(c)(1). The amount of the distribution must equal the fair market value of the assets that were not qualified export assets on the last day of the taxable year of disqualification. I.R.C. § 992(c)(1)(B). This corrective distribution is called a “deficiency distribution.” Treas. Reg. § 1.992-3(a).

Deficiency distributions are made first out of accumulated DISC income to the extent thereof under section 996(a)(2)(A). Deficiency distributions are treated as being made before any other actual or deemed distributions during a taxable year under section 996(c). Therefore, deficiency distributions are fully taxable to a DISC's shareholders. See H.R. Rep. No. 92-533, at 62 (1971), reprinted in 1972-1 C.B. 498, 531. The deficiency distribution provision under section 992(c) requires the distribution of all non-export assets of the DISC to ensure that a DISC's non-qualified E&P do not receive DISC treatment.

If a corporation makes a deficiency distribution more than 8½ months after the close of the taxable year with respect to which the deficiency distribution was made, the corporation must also make a payment to the Secretary of the Treasury within 30 days of the deficiency distribution.[5] I.R.C. § 992(c)(2)(B). The section 992(c)(2)(B) payment is an amount equal to 4½% of the deficiency distribution multiplied by the number of taxable years between the year of the disqualification and the year of the distribution. Id. Section 992(c)(2)(B) states that such payments are treated as interest for all purposes of the Internal Revenue Code (“the Code”).

Section 992(c) makes clear that the corporation that is required to pay the interest is the potentially disqualified DISC. Section 992(c)(1)(B) refers to

> a corporation which for a taxable year does not satisfy a condition specified in paragraph (1)(A) (relating to gross receipts) or (1)(B) (relating to assets) of subsection (a) shall nevertheless be deemed to satisfy such condition for such year if it makes a pro rata distribution of property after the close of the taxable year to its shareholders (designated at the time of such distribution as a distribution to meet qualification requirements) with respect to their stock in an amount which is equal to[,] if the condition of subsection (a)(1)(B) is not satisfied, the fair market value of those assets which are not qualified export assets on the last day

[5] A deficiency distribution restores a corporation's DISC status only if the corporation's failure to pass the assets test is due to reasonable cause. I.R.C. § 992(c)(2)(A). The settlement agreements render the question of reasonable cause irrelevant in the instant case.

of such taxable year.

Section 992(c)(2)(B) provides that "the corporation pays" an amount that is treated as interest – the interest that is the subject of this advice.[6] The reference to "a corporation" under section 992(c)(1)(B) can only be to the potentially disqualified DISC. The reference to "the corporation" under section 992(c)(2)(B), which is required to make a payment that is treated as interest, can only be to the potentially disqualified DISC referred to under section 992(c)(1)(A).

C. The Deficit Reduction Act of 1984, Exempt Accumulated DISC Income, and the Treatment of Post-1984 Deficiency Distributions

The Deficit Reduction Act of 1984 ("the Act") ended most DISC activity and substantially replaced the DISC provisions with the foreign sales corporation ("FSC") provisions.[7] Pub. L. No. 98-369, 98 Stat. 494 (1984). The Act treats the E&P of corporations that qualified as DISCs on December 31, 1984, and that was characterized as accumulated DISC income as described under section 996(f)(1) as previously taxed income and, thus, not includible in the income of the DISC's shareholders when actually distributed. Id. at § 805(b)(2)(A). Because the Act became effective after December 31, 1984, post-1984 distributions by a DISC from accumulated DISC income are excluded from a shareholder's gross income even though the amount was not actually previously taxed. Staff of Joint Committee on Taxation, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 1 (Comm. Print 1984); I.R.C. § 996(a)(3). Therefore, a DISC's accumulated DISC income that was not taxed to shareholders prior to 1985 will never be taxed, provided that the DISC qualified as a DISC on December 31,

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[6] The full provision under section 992(c)(2)(B) reads as follows:

> The conditions under paragraph (1) shall be deemed satisfied in the case of a distribution made under such paragraph if the corporation pays, within the 30-day period beginning with the day on which such distribution is made, to the Secretary, if such corporation makes such distribution after the 15th day of the 9th month after the close of the taxable year, an amount determined by multiplying (i) the amount equal to 4½ percent of such distribution, by (ii) the number of its taxable years which began after the taxable year with respect to which such distribution is made and before such distribution is made. For purposes of this title, any payment made pursuant to this paragraph shall be treated as interest.

[7] Modified DISC provisions remain in effect but are materially different from the DISC provisions at issue in the instant case.

1984. The portion of a DISC's income that is treated as previously taxed income under the Act has been called "exempt accumulated DISC income."[8]

Because qualification as a DISC on December 31, 1984, is a prerequisite for exempt accumulated DISC income ("EADI") under section 805(b)(2)(A) of the Act, a DISC that failed the assets test under section 991(a)(1)(B) must make a deficiency distribution to ensure that all of its post-1984 distributions are tax exempt under the Act.

Temp. Treas. Reg. § 1.921-1T(a)(9)(Q&A 11) provides additional guidance regarding the operation of the deficiency distribution mechanism in the context of a post-1984 deficiency distribution pursuant to an audit. The regulation provides that a post-1984 distribution

> shall be treated as made out of accumulated DISC income which is not previously taxed income because it will be treated as distributed prior to December 31, 1984 to the DISC's shareholders.

Temp. Treas. Reg. § 1.921-1T(a)(9)(Q&A 11). Under this rule, the Service regards the distribution as made prior to the Act.

D. Post-1984 Deficiency Distribution Deemed Distributed by DISC

As discussed above, section 992(c)(1) makes clear that a corporation that attempts to retain its DISC status is the entity that makes a deficiency distribution, i.e., the DISC. Similarly, section 992(c)(2)(B) requires that the same corporation, i.e., the DISC, makes the interest payment with respect to a late deficiency distribution. Under Temp. Treas. Reg. § 1.921-1T(a)(9)(Q&A 11), the requirement that the DISC itself makes the deficiency distribution applies even in the case of a post-1984 deficiency distribution,

> notwithstanding the fact that after December 31, 1984 the former DISC is a taxable corporation under subchapter C, has elected to be treated as an interest charge DISC, or has been liquidated, reorganized or

[8] See, e.g., Prop. Treas. Reg. § 1.996-9(a)(1); see also Temp. Treas. Reg. § 1.921-1T(a)(6)(Q&A 6) (providing the same exemption rule for post-1984 distributions of accumulated DISC income as described in Prop. Treas. Reg. § 1.996-9(a)(1), but without using the term "exempt accumulated DISC income").

> is otherwise no longer in existence.[9] (Emphasis added).

The purpose of a deficiency distribution is to remove non-export assets from the DISC by means of a distribution taxable to the shareholders. Even if a DISC is no longer in existence, it is deemed to have made the deficiency distribution in a taxable year prior to 1985 – the year for which the corporation seeks to maintain its DISC status.

E. Treatment of Post-1984 Section 992(c)(2)(B) Interest Payments

As stated above, section 992(c)(2)(B) payments are treated as interest. A corporation that makes a late deficiency distribution must make a section 992(c)(2)(B) interest payment within 30 days of the deficiency distribution in order for the deficiency distribution to correct the DISC disqualification. I.R.C. § 992(c)(2); Treas. Reg. § 1.992-3(c)(4)(i). The interest payment is

> intended to reflect the fact that the tax owing on the [deficiency] distribution (from the shareholder), in effect, has been deferred from the year in which the distribution should have been made until the year in which it actually is made.

S. Rep. No. 92-437, at 96 (1971), reprinted in 1972-1 C.B. 559, 612-613. In short, section 992(c)(2)(B) interest paid by a DISC compensates the Treasury for the deferral of tax owed by the DISC's shareholders on a late deficiency distribution.

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[9] The full provision under Temp. Treas. Reg. § 1.921-1T(a)(9)(Q&A 11) reads as follows:

> (9) Deficiency Distributions.
>
> Question 11: With respect to an audit adjustment made after December 31, 1984, may a deficiency distribution be made, and if so, in what manner may it be made?
>
> Answer 11: A deficiency distribution may be made notwithstanding the fact that after December 31, 1984 the former DISC is a taxable corporation under subchapter C, has elected to be treated as an interest charge DISC, or has been liquidated, reorganized or is otherwise no longer in existence. However, such deficiency distribution shall be treated as made out of accumulated DISC income which is not previously taxed income because it will be treated as distributed prior to December 31, 1984 to the DISC's shareholders.

Because a late deficiency distribution has no remedial effect for a DISC without an accompanying timely interest payment to the Treasury, the interest payment is, in effect, a necessary adjustment of the deficiency distribution and, thus, the rules that apply to the deficiency distribution apply also to the interest paid by the DISC.

The discussion above demonstrates that Temp. Treas. Reg. § 1.921-1T(a)(9)(Q&A11) requires a post-1984 deficiency distribution to be treated for tax purposes in the same manner as it would have been treated prior to 1985. Furthermore, such distribution is deemed made by the DISC even if the DISC no longer exists at the time of the distribution. Because a section 992(c)(2)(B) interest payment occurs only as a result of – and is a necessary adjustment of – a related deficiency distribution, an approach similar to the one that applies to post-1984 deficiency distributions under Temp. Treas. Reg. § 1.921-1T(a)(9)(Q&A 11) should also apply to post-1984 interest payments. In short, post-1984 interest payments should be deemed made prior to 1985 by the DISC regardless of whether the DISC or its successor actually made the interest payments.

F. DISC Taxable Income

Although a DISC does not pay taxes, it determines its taxable income each year "in order to determine, for example, the amount deemed distributed for that taxable year to its shareholders." Treas. Reg. § 1.991-1(b)(1). A DISC determines its taxable income in the same manner as if it were a domestic corporation that did not elect to be treated as a DISC. Id. For instance, a DISC may take deductions with respect to net operating loss carrybacks and carryovers as well as capital loss carrybacks and carryovers. Treas. Reg. § 1.995-2(e). DISCs take deductions with respect to gross income.

Therefore, DISCs may deduct interest expense pursuant to section 163(a) which allows deductions for interest, generally. Furthermore, section 163(a) allows deductions for interest paid on taxes. See, e.g., Estate of Bahr v. Commissioner, 68 T.C. 74, 77 (1977). A pre-1985 section 992(c)(2)(B) interest payment by a DISC would entail the following tax consequences: 1) the DISC's taxable income would decrease as a result of the interest expense deduction; 2) the DISC's E&P would decrease as a result of the outlay of cash and, thus, properly reflect the decrease in taxable income; 3) total distributions to the DISC's shareholders would decrease; and, 4) the shareholders would owe fewer taxes.[10]

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[10] Any such redetermination of DISC taxable income would require that the statute of limitations for making claims for refund under section 6511 remains open for the taxable year in which the redetermination is made. We have not been provided information regarding whether the statute of limitations for the pre-1985 taxable years involved in this case remain open.

Although the CorpA-DISCs were no longer in existence at the time the interest payments were made, Temp. Treas. Reg. § 1.921-1T(a)(9)(Q&A11) treats the interest payments as a necessary adjustment of the deficiency distributions and as made by the CorpA-DISCs. However, The CorpA group, which actually paid the interest on behalf of the no longer-existing CorpA-DISCs, may not take deductions for such interest expenses. See, e.g., Crouch v. United States, 692 F.2d 97, 99 (10th Cir. 1982) (standing for the proposition that a taxpayer may deduct interest payments under section 163 only if the interest is with respect to debts of the taxpayer); see also, True v. United States, 93-2 U.S.T.C (CCH) ¶50,461, 89,427 (D. Wyo. 1993) (following a similar analysis as the Crouch court but in the context of section 162 business expense deductions incorrectly claimed by individual partners who paid interest on a tax deficiency on behalf of their debtor partnership).

II. Application of Section 265 Disallowance of Deductions Provision to Section 992(c)(2)(B) Interest Payments Otherwise Deductible by DISCs

A. Section 265 Generally

Another legal basis on which to deny the deductions for the section 992(c)(2)(B) interest payments claimed by The CorpA group is the application of section 265(a)(1) to the deductions. Section 265(a)(1) provides, in part, that no deduction shall be allowed for any amount otherwise allowable as a deduction that is allocable to one or more classes of income other than interest (whether or not any amount of income of that class is received or accrued) wholly exempt from the taxes imposed by subtitle A of the Code. As pertains to this case, the four conditions precedent for a disallowance of deductions under section 265(a)(1) are as follows: 1) an otherwise allowable deduction; 2) a class of income other than interest; 3) the class of income must be wholly exempt; and, 4) the deduction must be allocable to the wholly exempt income.

We have already established two of the four conditions precedent to the applicability of section 265(a)(1). First, but for the potential applicability of section 265(a)(1), interest paid under section 992(c)(2)(B) would be deductible under section 163(a). Second, the type of income involved here, EADI, is a class of income other than interest.[11] The remaining two criteria for the applicability of section 265(a)(1), addressed below, are wholly exempt income and allocability of otherwise deductible expenses to such wholly exempt income.

B. Wholly Exempt from Tax Requirement

[11] As noted above, EADI is exempt accumulated DISC income – the accumulated DISC income that the Deficit Reduction Act of 1984 exempted from income to the extent of post-1984 distributions.

Income is not wholly exempt from tax if recognition of the income is merely deferred or if the income is recognized by one of the two parties essential to a transaction. See Cotton States Fertilizer Co. v. Commissioner, 28 T.C. 1169 (1957), acq., 1958-2 C.B. 4 (trade or business deductions allocable to tax-deferred involuntary conversion under statutory predecessor of section 1033 not disallowed under statutory predecessor of section 265(a)(1)); Commissioner v. McDonald, 320 F.2d 109 (5th Cir. 1963) (predecessor of section 265(a)(1) does not disallow a corporation's deduction for state income taxes upon gain realized but not recognized by corporation selling assets pursuant to a plan of complete liquidation under pre-1987 version of section 337; although the corporation could escape taxation permanently, shareholders that received liquidating distributions were subject to tax); Commissioner v. Universal Leaf Tobacco Co., 318 F.2d 658 (4th Cir. 1963) (predecessor of section 265(a)(1) does not disallow corporation's deduction for state income taxes on gain from receipt of a liquidating distribution received from its subsidiary that was not recognized under section 332); see also Rev. Rul. 63-233, 1963-2 C.B. 113 (announcing that the Service will follow McDonald and Universal Leaf Tobacco).

Prior to January 1, 1985, the portion of DISC income not subject to the deemed distribution rules was tax-deferred but not tax-exempt. However, assuming a DISC qualified on December 31, 1984, section 805(b)(2)(A) of the Act changed the character of accumulated DISC income from deferred to wholly exempt.

This change from deferral to total exemption is reflected in the accompanying legislative history. The Conference Report's description of the Senate amendment states:

> Under the Senate amendment, tax is forgiven on accumulated DISC income. This forgiveness will apply only to actual distributions made after December 31, 1984, by a DISC (or former DISC) that is a qualified DISC on December 31, 1984.

H.R. Conf. Rep. No. 861, 98th Cong. 2d Sess. 974 (1984); see also H.R. Conf. Rep. No. 861 at 977.

In addition, in explaining the provisions of the Act, the Senate Finance Committee print states:

> Accumulated DISC income which is derived before January 1, 1985, will be exempt from tax. This result is achieved by treating such income as previously taxed income.

Senate Committee on Finance, Deficit Reduction Act of 1984 – Explanation of Provisions Approved by the Committee on March 21, 1984, S. Print 169 (Vol. I), 98th

Cong., 2d Sess. 659 (1984). See also Staff of Joint Committee on Taxation, 98th Cong., 2d Sess. General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 1068 (1984).

Because a DISC is a pass-through entity, EADI will also never be taxed at the DISC level. Accordingly, because it will never be taxed at either the shareholder or the DISC level, EADI is “wholly exempt from tax” within the meaning of section 265(a)(1).

C. Allocability of Expense to Wholly Exempt Income Requirement

Rev. Rul. 83-3, 1983-1 C.B. 72, modified, Rev. Rul. 87-32, 1987-1 C.B. 131, held that section 265 applies in the following two situations: (1) when otherwise deductible expenses are incurred for the purpose of earning or producing tax-exempt income, and (2) when tax-exempt income is earmarked for a specific purpose and deductions are incurred in carrying out that purpose. In both situations, the expenses are allocable to tax-exempt income and, thus, are subject to total or partial disallowance.

Rev. Rul. 83-3 rests on the proposition, enunciated by the Supreme Court of the United States, that the Code should not be interpreted to allow the practical equivalence of double deductions absent a clear declaration of Congressional intent to the contrary. United States v. Skelly Oil Co., 394 U.S. 678 (1969), 1969-1 C.B. 204.

The purpose, motivation, and effect of the CorpA group’s payment of the section 992(c)(2)(B) interest expense was to preserve its subsidiaries’ DISC status, which enables The CorpA group to earn wholly exempt EADI. This fundamental nexus between the EADI earned by the CorpA-DISCs and the interest expense paid by The CorpA group falls within the scope of any reasonable interpretation of the ‘allocable to’ requirement. See Manocchio v. Commissioner, 78 T.C. 989, 995 (1982), aff’d on other grounds, 710 F.2d 1400 (9th Cir. 1983).

The fact that the CorpA-DISCs earned the EADI prior to the years in which the section 992(c)(2)(B) interest was deemed paid by the CorpA-DISCs is irrelevant in determining that the interest expense is allocable to the EADI. Stroud v. United States, 906 F. Supp. 990 (D.C.S.C. 1995), aff'd in part and vacated in part without published opinion, 94 F.3d 642 (4th Cir. 1996), and Anclote Psychiatric Center, Inc. v. Commissioner, T.C. Memo. 1998-273 (1998), aff'd without published opinion, 190 F.3d 541 (9th Cir. 1999).

D. Total or Partial Disallowance of Interest Deduction

Section 265(a)(1) requires a total disallowance of deductions if all of the deductions are allocable to wholly exempt income and requires only a partial disallowance of deductions if a portion of the deductions are allocable to nonexempt income. See Treas. Reg. § 1.265-1(c) (providing that, if an expense or an amount otherwise allowable is indirectly allocable to both a class of nonexempt income and a class of exempt income, a reasonable proportion thereof determined in the light of all the facts and circumstances in each case shall be allocated to both the nonexempt income and the exempt income).

In this case, two situations in which interest may not relate to tax-exempt income are possible. The first situation would occur if an actual distribution were made out of accumulated DISC income after the year for which the deficiency distribution had been made and prior to January 1, 1985. In that case, the section 992(c)(2)(B) interest payments would be allocable to nonexempt income to the extent of such distribution. We do not believe that the CorpA-DISCs made such distributions in this case.

The second situation relates to the taxable year of the failure of the assets test. A deficiency distribution not only prevents the recapture of accumulated DISC income but also protects DISC status in the year of the failure. In the absence of a deficiency distribution, the disqualified DISC is taxable as a domestic corporation on income that it earned for the taxable year of the failure. See Addison Int'l, Inc. v. Commissioner, 887 F.2d 660 (6th Cir. 1989); Rocky Mountain Assocs. Int'l, Inc. v. Commissioner, 90 T.C. 1231 (1988); Jet Research, Inc. v. Commissioner, T.C. Memo. 1990-463 (1990). If the disqualified DISC were treated as a C corporation, an 80% dividend received deduction under section 243(a) (as it existed during the years in issue) would have applied to distributions made during the taxable year of the failure. Because these actual distributions would have been subject to only one level of tax whether or not the section 992(c)(2)(B) interest was paid, these distributions are disregarded in calculating the section 265(a)(1) disallowance. However, to the extent that the distributions made during the taxable year of the failure are not covered under section 243(a) (that is, 20% of the distributions), payment of the section 992(c)(2)(B) interest avoided a double level of taxation. Therefore, a portion of the section 992(c)(2)(B) interest is allocable to a class of nonexempt income under section 265(a)(1). See Treas. Reg. § 1.265-1(c).

E. Disallowance of Deduction for Expense Deemed Paid by Taxpayer but Actually Incurred by Another Party

The final question is whether the section 265(a)(1) analysis above – which assumes an actual payment of section 992(c)(2)(B) interest by the taxpayer that claims deductions for such interest and that receives the wholly exempt income – also applies in the case of a taxpayer that claims deductions for section 992(c)(2)(B) interest that it was deemed to pay under Temp. Treas. Reg. § 1.921-1T(a)(9)(Q&A 11) but which was actually paid by another person.

We believe that a deduction may be disallowed under section 265(a)(1) even if the person that has the liability for the expense (or that is treated as having that liability) is not the recipient of the income. Although we have not found supporting authority under section 265(a)(1) that is directly on point, authority does exist regarding an analogous issue under section 265(a)(2). In H Enterprises Int'l, Inc. v. Commissioner, T.C. Memo. 1998-97, aff'd per curiam, 183 F.3d 907 (8th Cir. 1999), the Tax Court held that, under section 265(a)(2) – which mandates the disallowance of interest on indebtedness incurred or continued to purchase or carry tax-exempt bonds – the proscribed purpose was found where a subsidiary borrowed money to enable the parent to purchase tax-exempt bonds. In affirming the Tax Court's opinion, the Eighth Circuit stated:

> [T]he Tax Court held, answering the central question of law presented by this case, that the fact that the indebtedness incurred by a company (Waldorf) different from the company (H Enterprises) that purchased the tax-exempt obligations . . . was not fatal to the Commissioner's position. Waldorf was at all times controlled by H Enterprises, and both the incurring of the indebtedness and the payment of the dividend by Waldorf to H Enterprises [to allow H Enterprises to purchase tax-exempt obligations] was in accordance with a preplanned purpose.

Id., 183 F.3d at 908. At least one court has made a similar finding of prohibited purpose where a husband borrowed funds with which his wife purchased tax-exempt bonds. See Drybrough v. Commissioner, 376 F.2d 350 (6th Cir. 1967); see also Rev. Rul. 79-272, 1979-1 C.B. 124 (analysis and holding similar to H Enterprises).

III. Conclusions

The CorpA-DISCs failed the section 992(a)(1)(B) assets test during several taxable years. To retain their DISC status and have the benefit of EADI, the CorpA-DISCs made section 992(c) deficiency distributions to their shareholders pursuant to settlement agreements with the Service. The deficiency distributions were deemed paid by the CorpA-DISCs in a pre-1985 taxable year under Temp. Treas. Reg. § 1.921-1T(a)(9)(Q&A 11) even though the CorpA-DISCs were no longer in existence at the time their shareholders included the deficiency distributions in gross income.

Because the CorpA-DISCs' shareholders included the deficiency distributions in gross income several years after timely deficiency distributions had been due, the CorpA-DISCs were also required to make interest payments to the Secretary in order for the deficiency distributions to have effect and, thus, cure their disqualification under the assets test.

The DISC provisions and regulations are silent regarding the treatment of post-1984 section 992(c)(2)(B) interest payments by no longer-existing DISCs. The only purpose of the interest payments was to give effect to the deficiency distributions. Deficiency distributions permitted under section 992(c)(1) and the accompanying interest payments required under section 992(c)(2)(B) and Treas. Reg. § 1.992-3(c)(4)(i) are integrally related and should be treated similarly. Therefore, the interest payments in this case should be considered to be a necessary adjustment of the deficiency distributions. As a necessary adjustment of the deficiency distributions, the interest payments were deemed paid by the CorpA-DISCs in a taxable year prior to 1985 under Temp. Treas. Reg. § 1.921-1T(a)(9)(Q&A 11) even though The CorpA group made the actual interest payments in post-1984 taxable years.

Because the CorpA-DISCs are deemed to have paid the section 992(c)(2)(B) interest payments, the CorpA-DISCs, not the CorpA group, may deduct such interest expenses, provided such deductions are otherwise permitted. Furthermore, case law provides that the CorpA group may not take deductions for expenses that it incurred on behalf of the CorpA-DISCs. Such interest expense deductions of the CorpA-DISCs, if allowed, would apply to the taxable year prior to 1985 in which the CorpA-DISCs were deemed to make the interest payments.

In addition, the interest is, for the most part, disallowed under section 265(a)(1). The benefit to the taxpayer of making the deficiency distributions and interest payments at issue in this case was the preservation of EADI status for the CorpA-DISCs' post-1984 accumulated DISC income. EADI is wholly exempt income because it is not taxed either at the DISC level or the shareholder level. Therefore, the interest expense deductions, except as discussed above, constituted deductions allocable only to wholly exempt income as described in section 265(a)(1).

As a result, neither the CorpA-DISCs nor the CorpA group may claim deductions for the interest payments at issue in this case, except to the extent set forth in section II.D., above.

Please call 202-874-1490 if you have any further questions.

DISCLOSURE STATEMENT

EFFECT ON PRIVILEGES, SUCH AS THE ATTORNEY-CLIENT PRIVILEGE. If DISCLOSURE BECOMES NECESSARY, PLEASE CONTACT THIS OFFICE FOR OUR VIEWS.

By: ______________________________
Jacob Feldman
Special Counsel
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