Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: April 24, 2008

to: Financial Products Specialist
(Large & Mid-size Business)

from: Field Attorney

subject:

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent. We have informally coordinated our advice on the application of Treas. Reg. §1.267(a)-3 and Article , the non-discrimination clause, of the U.S.- Country A treaty with CC:INTL:B1 and CC:INTL:B2.[1]

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

[1] This advisory opinion is based on the facts as set forth below and its application is dependent on the veracity of these facts. Please inform us if any of the facts set forth below are incorrect as it could materially change this advisory opinion.

Foreign Parent	=
U.S. Insurance Sub.	=
U.S. Sub.	=
State A	=
Country A	=
Year 1	=
Year 2	=
Year 3	=
Amount 1	=
Amount 2	=
Amount 3	=
Amount 4	=
Amount 5	=
Amount 6	=
Percentage 1	=
Section X	=

ISSUES:

I. **Whether the application of Treas. Reg. §1.267-3(a) to disallow interest deductions for interest accrued, but not paid, on the notes payable to its foreign parent violates the nondiscrimination provision of the U.S.- Country A tax treaty.**

II. **Whether Treas. Reg. §1.267-3(a) is valid as a permissible construction of the relevant statutory provisions.**

III. **Whether the fact that any interest due under the notes payable was not payable without the approval of the Superintendent of Insurance for the State of , and, as never received such approval, can the accrued interest even be considered a deductible expense at all because all events have not occurred which determine the fact of the liability.**

CONCLUSIONS:

I. **The application of Treas. Reg. §1.267-3(a) to disallow interest deductions for interest accrued, but not paid, on the notes payable to its foreign parent does not violate the nondiscrimination provision of the U.S.- Country A tax treaty because the provision specifically states that in this context the interest must be actually paid to the foreign resident and it was not; and Treas. Reg. §1.267-3(a) does not compel different tax treatment of corporations conditioned solely on**

the domestic or foreign status of the taxpayer corporation. This is evidenced by the fact that: (i) is treated similarly to a U.S. corporation that is on the cash method of accounting; (ii) is <u>not</u> comparably situated to a hypothetical U.S. corporation that is taxed on its world-wide income as would not be taxed in the U.S. on its world-wide income; and (iii) is <u>not</u> comparably situated to a U.S. corporation that is subject to U.S. tax as the interest accrues or even a foreign corporation that reports the interest as effectively connected with a trade or business in the U.S. and would be subject to tax as the interest accrues.

II. Treas. Reg. §1.267-3(a) is valid as a permissible construction of the relevant statutory provisions as found by the Tax Court in <u>Square D Co. and Subs v. Com'r</u>, 118 T.C. 299 (2002), the Third Circuit in <u>Tate & Lyle, Inc. v. Com'r</u>, 87 F.3d 99 (1996) and the Seventh Circuit in <u>Square D Co. and Subs v. Com'r</u>, 438 F.3d 739 (2006).

III. Because all interest due under the notes payable was not payable without the approval of the Superintendent of Insurance for the State of , and, as had never received such approval, the accrued interest cannot be considered a deductible expense at all as all the events have not occurred which determine the fact of the liability under Treas. Reg. § 1.461–1(a)(2).

<u>FACTS:</u>

or "taxpayer") is a wholly-owned subsidiary of), a U.S. Corporation, which in turn is % owned by), a Country A Corporation. During the tax years at issue, tax years ended and . had the following notes payable to :

Date Issued	Loan Amount	Interest Rate	Maturity Date
September 30,	$	5.75%	None
December 31,	$	5.25%	None
December 29,	$	5.00%	None
December 22,	$	6.00%	None

Each of the notes payable stated that "all such amounts to be paid or repaid will be subject to the prior approval of the Superintendent of Insurance of the State of pursuant to Section [2] of the Insurance Law.

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The taxpayer reported on its Form 8886, Reportable Transaction Disclosure Statement, for , that as of December 31, the Superintendent of Insurance for the had not approved the accrual or payment of interest related to these notes. The taxpayer further states: "[t]he taxpayer's position is that this amount is deductible since interest income has been accrued by the related party. This is contrary to Regulations 1.267(a)-3."

Similarly, the taxpayer reported on its Form 8886, Reportable Transaction Disclosure Statement, for , that as of December 31, the Superintendent of Insurance for the State of had not approved the accrual or payment of interest related to these notes. The taxpayer further states: "[t]he taxpayer's position is that this amount is deductible since interest income has been accrued by the related party. This is contrary to Regulations 1.267(a)-3."

accrued, deducted, but did not actually pay $ of interest in and $ of interest in on the notes payable.

LAW AND ANALYSIS:

I. Whether the application of Treas. Reg. §1.267-3(a) to disallow interest deductions for interest accrued, but not paid, on the notes payable to its foreign parent violates the nondiscrimination clause of the U.S.- Country A tax treaty.

Treas. Reg. §1.267-3(a) provides that a U.S. taxpayer may not take a deduction for interest owed to a related foreign person when such interest is accrued, but only when it is actually paid. [3] Under the plain language of this regulation, should not be allowed to deduct interest that it accrued, but did not yet pay, on the notes to .

The taxpayer argues that denial of the accrued interest deductions pursuant to Treas. Reg. §1.267-3(a) violates the non-discrimination provision of the U.S.- Country A Tax Treaty because it treats the interest accrued on the loan to , a Country A corporation, differently than it would treat the interest accrued on a loan to a U.S. corporation. Protest at p. 24. Specifically, the taxpayer states that "[t]he U.S.- Country A Treaty contains a non-discrimination provision in Article which is designed to provide that U.S. and Country A persons 'must be treated similarly' if they are 'comparably situated.'" Id.

The relevant portion of the non-discrimination clause, Article , of the U.S.- Country A Treaty states:

Article of the U.S.- Country A Tax Treaty, (emphasis added).

As discussed below, the taxpayer's position that Treas. Reg. §1.267-3(a) violates the nondiscrimination provision of the U.S.- Country A Treaty is erroneous for various reasons.

<u>The Term "Paid" Does Not Automatically include "Accrual"</u>

[3] Treas. Reg. §1.267(a)-3(b) states: "[d]eduction of amount owed to related foreign person--(1) In general. Except as provided in paragraph (c) of this section, section 267(a)(3) requires a taxpayer to use the cash method of accounting with respect to the deduction of amounts owed to a related foreign person. An amount that is owed to a related foreign person and that is otherwise deductible under Chapter 1 thus may not be deducted by the taxpayer until such amount is paid to the related foreign person. . ." (emphasis added.)

First, the taxpayer is arguing that the term “paid” should include “paid or accrued.” Protest at 26. However, the plain language of the nondiscrimination clause, as highlighted above, specifically states that interest ***paid*** by an enterprise of one State to a resident of the other State shall be deductible under the same conditions as if they had been *paid* to a resident of the first-mentioned State. The plain language of this provision is clear that the interest must be actually paid to the foreign resident. The treaty provision does not say “paid or accrued” nor does the Treasury Technical Explanation of the Convention Between the U.S. and the Country A

(the “Treasury Explanation”) indicate that the drafters of the treaty intended for “paid” to mean “paid or accrued” in this circumstance.

The U.S.- Country A Tax Treaty does not expressly define the term “paid.” However, Article of the treaty provides that in the applying the treaty, any term used but not defined in the treaty will have the meaning that it has under the law of the State who is imposing the tax unless the context requires otherwise. Article further states that if a term is defined under both the tax and non-tax laws of the State, the definition in the tax law will take precedence over the definition in the non-tax law. Thus, we must look to U.S. tax law first for the meaning of “paid” in this context where the U.S. is imposing the tax at issue.

The term “paid” is not explicitly defined in the Internal Revenue Code, however, we can look to the courts for guidance on the definition of “paid” for purposes of U.S. tax law. Specifically, the Board of Tax Appeals has stated that “[i]n common parlance the word ‘paid’ does not necessarily import an unpaid accrual.” Maryland Land & Transportation Corp. v. Com’r, 40 B.T.A. 1067, 1069 (1939)(holding that the petitioner’s argument that “dividends accrued” during a tax year should be deemed “dividends paid” for purposes of I.R.C. §351 would “frustrate the very purpose which the statute was intended to accomplish.”) The taxpayer would have you believe that the word “paid” inevitably implies “paid or accrued,” but as the Board of Tax Appeals has found in Maryland Land, that is not the common meaning.

Further, the Supreme Court has stated that in determining the meaning of language in the treaty context: “[t]he clear import of treaty language controls unless ‘application of the words of the treaty according to their obvious meaning effects a result inconsistent with the intent or expectations of its signatories.’ ” U.S. v. Stuart, 489 U.S. 353, 363 (1989) (citing Sumitomo Shoji America, Inc. v. Avagliano, 457 U.S. 176, 180, 102 S.Ct. 2374, 2377, 72 L.Ed.2d 765 (1982), quoting Maximov v. United States, 373 U.S. 49, 54, 83 S.Ct. 1054, 1057, 10 L.Ed.2d 184 (1963)). The Supreme Court’s position that the clear import of the treaty language controls further strengthens our argument that the plain language of the treaty should be respected and should not be read to expand the meaning of the term “paid” to something it was not specifically intended to include.

Therefore, based on the plain language of the treaty provision, the Supreme Court's position that the clear import of treaty language controls and the Board of Tax Appeals statement that "paid" does not import an unpaid accrual, Counsel believes that the taxpayer should not be able to insert "paid or accrued" as the meaning for the plain language of the treaty provision which states that the interest must actually be "paid" to the foreign resident.

is Treated Similarly to a U.S. Cash-Basis Taxpayer

Second, the taxpayer suggests that if it had accrued interest expense payable to a lender who was a domestic corporation the deduction would be permitted. This is an accurate description of the legal treatment if the domestic corporation used the accrual method of accounting. However, if a domestic corporation accrued an amount of interest to a related domestic person that used the cash receipts and disbursements method of accounting, the cash basis domestic corporation would not be allowed a deduction until it actually paid the interest to that person. Thus, domestic corporations making payments to related foreign corporations are effectively subject to the same "matching principle" as domestic corporations making payments to related domestic corporations: a deduction will be "allowable as of the day as of which such amount is includible in the gross income of the person to whom the payment is made." See I.R.C. § 267(a)(2).

In this case, the related foreign person, a Country A corporation, is taxed as if it were using a cash receipts and disbursements method of accounting, because the 30% gross basis tax liability of the Country A corporation, under I.R.C. § 881(a)(1), does not arise until the interest is paid by the domestic corporation to the Country A corporation. See Treas. Reg. §1.1441-2(e), "a payment is considered made when the amount would be includible in the income of the beneficial owner under U.S. tax principles governing the cash basis method of accounting." As a result, the interest expense paid to the related Country A corporation is deductible "under the same conditions" as if it had been paid to a resident of the United States that uses the cash basis method of accounting.

is not "Comparably Situated" to a U.S. Corporation that is Either Taxed on its World-Wide Income or a Corporation Taxed on its U.S. Source Interest

Third, the taxpayer correctly highlights that the non-discrimination provision of the U.S.- Country A Tax Treaty is designed to provide that U.S. and Country A persons "must be treated similarly" if they are "comparably situated." Protest at 24. The taxpayer even cites to the Treasury Explanation in support of its position. Id.

However, if one reads the Treasury Explanation regarding the nondiscrimination provision, it explains that Article is not a sweeping prohibition on any differences in tax treatment of U.S. and foreign corporations; rather, it forbids different tax treatment of such corporations only where the difference is conditioned on the domestic or foreign status of the taxpayer corporation. Treasury Explanation [4] It explains that the nondiscrimination provision applies only if the foreign and U.S. corporations are "comparably situated," and that corporations are not comparably situated if there is a tax-relevant difference in their situations. Id. Specifically, it provides that regardless of whether the language of Article refers to entities "in the same circumstances," "carrying on the same activities," or that are "similar,"

Id. By way of example, the Technical Explanation notes that different tax treatment would be justified where one person was taxable on worldwide income but the other was not, or if tax could be collected from one person at a later stage but not from the other. Id.

In our facts, had a tax-relevant difference in its situation as compared to a hypothetical U.S. corporation. The hypothetical U.S. corporation would be taxed in the U.S. on its world-wide income whereas would not be taxed in the U.S. on its world-wide income. As explicitly discussed in the Treasury Explanation, this is a tax-relevant difference that makes not comparably situated to a hypothetical U.S. corporation. Therefore, application of Treas. Reg. § 1.267-3(a) to disallow the interest deductions for interest accrued, but not paid to , would not violate the nondiscrimination provision of the U.S.- Country A Tax Treaty because it is not treating differently from a "comparably situated" U.S. corporation.

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[4] The relevant portion of the Treasury Explanation discussing is as follows:

Finally, under our facts, the difference in the timing of the interest deduction if paid to a domestic versus a foreign related person, the so-called “difference in treatment,” is directly related to another tax-relevant difference between a related Country A corporation and a hypothetical related domestic person. U.S. source interest payable to a Country A corporation is not subject to U.S. tax as the interest accrues, as in the case of an amount payable to a domestic corporation or even a foreign corporation that reports the interest as effectively connected with a trade or business in the United States. This is also a tax-relevant difference between a U.S. payee and a foreign payee. Thus, the disallowance of a deduction for interest expense accrued but not paid to a foreign lender is directly related to a tax-relevant difference and such difference in treatment is not discriminatory under Article of the Treaty.

In sum, Treas. Reg. §1.267-3(a) does not compel different tax treatment of corporations conditioned solely on the domestic or foreign status of the taxpayer corporation. As discussed above, is “comparably situated” to and is being treated similarly to a U.S. corporation that is on the cash method of accounting. in not is “comparably situated” to a U.S. corporation that is taxable on its world-wide income, nor is it is “comparably situated” to a U.S. or foreign corporation that is taxable on its U.S. source interest. Thus, Treas. Reg. §1.267-3(a) does not violate the nondiscrimination provision of the U.S.- Country A Tax Treaty.

II. Whether Treas. Reg. §1.267-3(a) is valid as a permissible construction of the relevant statutory provisions.

The taxpayer argues, in somewhat of a last ditch effort, that Treas. Reg. § 1.267-3(a) is “inconsistent with the plain meaning of section 267(a)(3) and does not represent a reasonable interpretation of section 267(a)(3).” Protest at 30. This argument has been addressed and dismissed by the Third Circuit in Tate & Lyle, Inc. v. Com’r, 87 F.3d 99 (1996), the Seventh Circuit in Square D Co. and Subs v. Com’r, 438 F.3d 739 (2006), and the Tax Court in Square D Co. and Subs v. Com’r,118 T.C. 299 (2002). Nonetheless, we will address the taxpayer’s argument below.

Authority Granted to the Secretary to Promulgate Regulations

The regulation at issue here, Treas. Reg. § 1.267(a)–3, was promulgated under the statutory directive that “[t]he Secretary shall by regulations apply the matching principle of paragraph (2) in cases in which the person to whom the payment is to be made is not a United States person.” I.R.C. § 267(a)(3). Such a regulation, adopted pursuant to a specific grant of statutory authority, is known as a “legislative” regulation. (e.g., Krukowski v. Commissioner, 279 F.3d 547, 551 (7th Cir 2002); Gehl Co. v. Commissioner, 795 F.2d 1324, 1328 (7th Cir. 1986)). It is well settled that a legislative regulation must be upheld unless it is “arbitrary, capricious, or manifestly contrary to [the] statute.” Krukowski, 279 F.3d at 551 (quoting Chevron U.S.A. Inc. v. Natural Res. Defense Council, Inc., 467 U.S. 837, 844 (1984)). Thus, “[w]here the Commissioner acts under specific authority, [the Court's] primary inquiry is whether the interpretation or method is within the delegation of authority." Rowan Cos. v. United States, 452 U.S. 247, 253 (1981).

Under authority expressly delegated to him, the Secretary of the Treasury adopted regulations providing that a taxpayer owing interest to a related foreign party is entitled to a deduction for that interest only at the time the interest is paid. The effect of the regulation is to place accrual basis taxpayers on the cash basis method of accounting with respect to such interest obligations. As stated above, the Tax Court in Square D Co. and Subs v. Com'r,118 T.C. 299 (2002), the Third Circuit in Tate & Lyle, Inc. v. Com'r, 87 F.3d 99 (1996) and the Seventh Circuit in Square D Co. and Subs v. Com'r, 438 F.3d 739 (2006) have all held the regulation valid under the authority delegated to the Secretary by I.R.C. § 267(a)(3), as a permissible interpretation of the statutory scheme.

The Supreme Court in Chevron laid out a two-step analysis to determine the validity of a regulation. See Chevron U.S.A. Inc. v. Natural Res. Defense Council, Inc., 467 U.S. 837, 844 (1984). First, does the plain meaning of the relevant Code provision support the regulation and second, if the plain meaning is either silent or unclear as to the regulations validity, then a court must evaluate the reasonableness of the Commissioner's determination. Square D & Subs. v. Com'r, 438 F.3d 739, 744 (2006).

Congress Remained Silent on How to Apply the Matching Principle of I.R.C. § 267(a)(2)

I.R.C. § 267(a)(3) directs the Secretary to adopt regulations applying "the matching principle" of I.R.C. § 267(a)(2) "in cases in which the person to whom the payment is to be made is not a United States person." I.R.C. § 267(a)(3). The Tax Court in Square D discussed above, like the Third Circuit in Tate & Lyle, 87 F.3d at 104–05, held that Congress had not "spoken to the precise question at issue," but rather had remained "silent or ambiguous" as to how the Secretary should apply that matching principle. Chevron, 467 U.S. at 842.

Thus, once it has been determined that "the statute is silent or ambiguous with respect to the specific issue," how to specifically apply the matching principle of I.R.C. § 267(a)(2), the second inquiry under the Supreme Court's Chevron doctrine is whether the regulation "is based on a permissible construction of the statute." Chevron, 467 U.S. at 843. The Third Circuit in Tate & Lyle held the regulation valid because it "is not manifestly contrary to section 267(a)(3)." 87 F.3d at 105. Similarly, the Tax Court in Square D concluded that "[r]egardless of whether petitioner or respondent (with whom we happen to agree) has the better interpretation" of the statute, the Secretary's "construction, as embodied in the challenged regulation, is a permissible one," and, "[u]nder the Chevron doctrine, that settles the matter." 118 T.C. 299 at *312.

Permissible Application of the Matching Principle

When trying to determine how the matching principle of I.R.C. § 267(a)(2) should be applied, one argument is that it only applies where there is a timing mismatch in items of income and deduction between related taxpayers due to differences in accounting methods, and that if the mismatch is not due to a difference in accounting method, the matching principle of I.R.C. § 267(a)(2) does not apply. This notion is incorrect. In the first place, I.R.C. § 267(a)(2) does not use the term "matching principle" that the Secretary is directed in I.R.C. § 267(a)(3) to apply by regulation, nor does any other section of the Internal Revenue Code use that exact term. Thus, nothing in the plain language of the statute requires that the matching principle be defined as only including a difference in accounting methods.

Further, when Congress enacted the present version of I.R.C. § 267(a)(2) in 1984, it was directed at mismatches in income and deduction that occurred as a result of differences in accounting methods, because it was that narrow situation that Congress viewed as giving rise to abuse, and thus a difference in accounting methods was made the "trigger." In I.R.C. § 267(a)(3), Congress directed the Secretary to issue regulations addressing other circumstances in which mismatches occur when foreign entities are involved, but it does not further specify what those circumstances are. Rather, the statute delegates broad authority to the Secretary to determine when, and under what circumstances, "the matching principle of" I.R.C. § 267(a)(2) should be applied. As Judge Swift reasoned in his Tax Court dissent in Tate & Lyle, 103 T.C. at 681:

> It is apparent that a treaty may represent the reason and cause for a mismatch in the tax reporting and treatment of items of income and expense as between domestic taxpayers and related foreign parties, and the conclusion is compelling that [the Secretary] has been delegated regulatory authority under section 267(a)(3) to provide that such a reason and cause for a mismatch will trigger the correction contemplated by section 267.

The bottom line is that what Congress did in I.R.C. § 267(a)(3) was instruct the Secretary to issue regulations defining other circumstances in which the matching principle of I.R.C. § 267(a)(2) should apply when foreign entities are involved. Congress did not instruct the Secretary to limit the triggering mechanism to the application of the regulation to differences engendered by a method of accounting. Thus, the application of the plain meaning rule here makes clear that Congress granted the Secretary broad authority to determine when, and under what circumstances, the matching principle of I.R.C. § 267(a)(2) should be applied.

This is even more apparent when the words of I.R.C. § 267(a)(3) are considered "in their context and with a view to their place in the overall statutory scheme." FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 133 (2000). I.R.C. § 267(a)(3) directs the Secretary to "apply the matching principle of paragraph (2) in cases in which the person to whom the payment is to be made is not a United States person." Nothing in I.R.C. § 267(a)(2) itself, however, says that that provision does not apply where "the person to whom the payment is to be made is not a United States person." On the contrary, taken alone, its terms establish that it does. I.R.C. § 267(a)(2) makes no distinction between transactions between two domestic taxpayers and those between a domestic taxpayer and a foreign entity. Thus, as the Third Circuit explained, if "the plain meaning of section 267(a)(3) requires the Secretary to apply exactly the same matching principle of section 267(a)(2) to foreign persons, then the language of section 267(a)(3) is redundant." Tate & Lyle, 87 F.3d at 104. To avoid redundancy, I.R.C. § 267(a)(3) must be understood as authorizing something broader.

Taxpayer Argues that the Regulation Violates the "Plain Meaning" of I.R.C. §267(a)(3)

The taxpayer argues that "because would not have included the interest income in income for U.S. tax purposes under Article of the U.S.- Country A Treaty, the matching concepts underlying sections 267(a)(2) and 267(a)(3) should not be applied. Section 267(a)(2) was designed to address timing issues only when income is included for U.S. tax purposes . . ." Protest at 29-30. In other words, taxpayer contends that the plain meaning of I.R.C. § 267(a)(3) requires regulations allowing companies in its situation to deduct interest when accrued, and that the Treas. Reg. 1.267(a)–3 violates this "plain meaning" by forcing it to use the cash accounting method.

The taxpayer is correct in pointing out that there is a "mismatch" between (non taxable) income and (deductible) interest expense, but the statute does not dictate exactly how this mismatch is to be resolved. The resolution of the problem is delegated to the Secretary to address by regulation. As the Third Circuit recognized, the literal terms of I.R.C. § 267(a)(2) would suggest that a taxpayer would not be entitled to any deduction: "if the matching principle of section 267(a)(2) was strictly applied here, the U.S. payor would never be entitled to an interest deduction because the related foreign payee would never have to include interest in taxable income under a tax treaty with the United States." Tate & Lyle, 87 F.3d at 104. It was to avoid this result, which Congress viewed as "unduly harsh," that the Secretary was authorized to address, by regulation, amounts owed to foreign payees. But the statute certainly does not specify whether the Secretary was to apply the matching principle by, as taxpayer suggests, allowing payees in its situation an immediate deduction when interest is accrued, or, as the Secretary determined in the Treasury Regulation, allowing a deduction only when the interest is paid.

Moreover, the assumption underlying taxpayer's argument, that because the interest income is exempt from tax by treaty, there is nothing to match against, is mistaken. As Judge Gerber explained in his Tax Court dissent in Tate & Lyle, 103 T.C.

at 683–684, “Congress did not relieve taxpayers from the requirements of section 267 where one of the related members is tax-exempt under section 501,” and it thus “does not follow that, if an entity is exempt from tax and the related entities are subject to section 267, an otherwise taxable entity that is exempt from some portion of its income, especially under a treaty, would result in the related entities’ not being subject to section 267.” As Judge Gerber further explained, “it does not follow that—because the income is tax-exempt, it is or becomes nonexistent for purposes of the accounting method requirements of sections 881(a)(1), 1442(a), and 267. The character of income is not changed simply because a treaty provides relief from part or all of the tax of one of the treaty countries. Rather, the [treaty] simply has the effect of eliminating the U.S. tax.” 103 T.C. at 684.

In sum, as the Third Circuit in Tate & Lyle observed, “[t]he legislative history of section 267(a)(3) reveals that Congress anticipated other reasons [than a difference in accounting methods] for the mismatch of interest expense and income between related persons, which would defer the deduction of interest expense until actually paid.” 87 F.3d at 105. Instead, as the Tax Court in Square D explained, “the scope of the regulations under Section 267(a)(3) is generally determined by the presence or absence of a U.S. method of accounting for the income in the hands of the foreign recipient, where the U.S. payor seeks to accrue a deduction with respect to that item.” Square D, 118 T.C. 299 at *312. Both the Senate and the House reports on I.R.C. § 267(a)(3) make clear, as the Third Circuit in Tate & Lyle observed, 87 F.3d at 105, that Congress contemplated that the Commissioner might combat such abuse by applying I.R.C. § 267(a)(3) to situations where the payee was not ultimately subject to tax on the amount received. In Treas. Reg. § 1.267(a)–3, the Secretary did no more than what the House and Senate reports said he could do. The Secretary adopted a rule providing that where an accrual basis United States taxpayer accrues interest payable to a related foreign payee, the United States taxpayer is allowed a deduction only when the interest is paid. Therefore, as found by the Seventh Circuit, the Third Circuit and the Tax Court, the regulation is based on a permissible construction of the statute and should be upheld.

III. Whether the fact that any interest due under the notes payable was not payable without the approval of the Superintendent of Insurance for the State of , and, as never received such approval, can the accrued interest even be considered a deductible expense at all because all events have not occurred which determine the fact of the liability.

Under the accrual method of accounting, expenses are deductible before they have become due and payable so long as “all events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy.” Treas. Reg. § 1.461–1(a)(2) (1992 ed.). See also, United States v. Gen. Dynamics Corp., 481 U.S. 239, 242–43 (1987); United States v. Hughes Props., Inc., 476 U.S. 593, 599–600 (1986). Under the accrual method, therefore, expenses are allowed as deductions before they are paid, but only on the assumption that they actually will be paid. An accrued expense is currently deductible only if it is “final and definite in amount,” “fixed and absolute,” and “unconditional.” Hughes Props., 476 U.S. at 600 (citations omitted).

In the taxpayer’s facts, because all of the notes payable required the Superintendent of Insurance for the State of to approve the payment of any interest due on the notes pursuant to State Insurance Law and the Superintendent never gave such approval, the interest expense is not currently deductible because it is not fixed, absolute or unconditional. In effect, all the events have not occurred which determine the fact of the liability under Treas. Reg. § 1.461–1(a)(2). Therefore, we believe that cannot currently deduct the accrued interest expense as it fails the tests enumerated in Treas. Reg. § 1.461–1(a)(2) and Hughes Props., 476 U.S. at 600.

Please call if you have any further questions.

Attorney