Part III - Administrative, Procedural, and Miscellaneous

Foreign bank interest expense allocation to effectively connected income

Notice 2005-53

SECTION 1. OVERVIEW

On March 8, 1996, final regulations were published in the Federal Register (61 FR 9326; Treas. Dec. Int. Rev. 8658), under section 1.882-5 regarding the determination of the interest expense deduction of a foreign corporation engaged in a U.S. trade or business. The Treasury Department and the Internal Revenue Service have monitored these provisions to ensure that they continue to produce results that are consistent with the policies underlying the regulations, in light of current economic circumstances. The Treasury Department and the IRS believe that, in the context of the banking industry, certain changes to the regulations will facilitate compliance. This notice describes such changes, which will apply to determine the interest expense deduction of a foreign corporation that is a bank, within the meaning of section 585(a)(2)(B) without regard to the second sentence thereof (hereafter “foreign bank”). The Treasury Department and IRS intend to issue regulations consistent with this notice.

The remainder of this notice is divided into seven sections. Section 2 provides relevant legal background. Section 3 provides guidance on the coordination of section 1.882-5 with treaties. Section 4 invites the submission of data and other information relevant to the consideration of a revised fixed ratio available for purposes of determination of U.S.-connected liabilities in Step 2 of section 1.882-5. Section 5 provides guidance on the determination of the applicable rate for excess interest under the adjusted U.S.-booked liabilities method in Step 3 of section 1.882-5. Section 6 solicits comments on coordination of Step 1 determination of U.S. assets on the adjusted or fair market value basis with Step 2 determination of U.S.-connected liabilities using the fixed or actual ratio. Section 7 provides information on submitting comments. Finally, section 8 provides drafting information.

SECTION 2. LEGAL BACKGROUND

Section 1.882-5 generally requires a foreign corporation to determine the amount of interest expense that is allocable under section 882(c) to income effectively connected (or treated as effectively connected) with the conduct of the foreign corporation's trade or business in the United States by a three step calculation.

Step 1 determines the total value of the U.S. assets of the foreign corporation, generally the assets that produce (or would produce) income effectively connected with the conduct of the U.S. trade or business of the foreign corporation. The value of the U.S. assets is their adjusted basis, unless the taxpayer makes an election to value the assets on the basis of their fair market value.

Step 2 determines the U.S.-connected liabilities of the foreign corporation as the product of the U.S. assets multiplied either by the actual ratio of worldwide liabilities to worldwide assets or, if the taxpayer makes an election, by a fixed ratio, currently 93-percent. If the taxpayer has elected to value U.S. assets on the basis of fair market value for purposes of Step 1, then the taxpayer must value worldwide assets on a fair market value basis for purposes of Step 2.

Step 3 determines the allocable amount of interest expense under the adjusted U.S. booked liabilities ("AUSBL") method, or, if the taxpayer makes an election, under the separate currency pools method. Under the AUSBL method, the foreign corporation's interest expense is based on the interest expense on the foreign corporation's U.S. books. If the U.S. booked liabilities exceed the U.S.-connected liabilities, then the foreign bank's U.S. booked interest expense is scaled down. If the U.S.-connected liabilities exceed the U.S.-booked liabilities, interest expense in addition to the U.S. booked interest expense is allocated by reference to the foreign U.S. dollar borrowing rate multiplied by the excess U.S.-connected liabilities. Under the separate currency pools method, the worldwide interest expense is allocated to effectively connected income based on the U.S.-connected liabilities in each currency multiplied by the foreign bank's worldwide rate for liabilities in such currency.

Rules on the time and manner of making and changing the various elections are provided in sections 1.882-5(a)(7) and 1.882-5(b)(2).

SECTION 3. COORDINATION OF THE DETERMINATION OF THE INTEREST EXPENSE DEDUCTION FOR FOREIGN BANKS AND TREATIES

Section 1.882-5(a)(2) currently states that "[t]he provisions of this section provide the exclusive rules for determining the interest expense attributable to the business profits of a permanent establishment under a U.S. income tax treaty." This statement is no longer accurate in light of the income tax treaties entered into with the United Kingdom and Japan,[1] and, therefore, will be eliminated by the amendments to the regulations.

The Exchange of Notes to the current United States-United Kingdom and United States-Japan income tax treaties adopt the principles of Article 9(1) for determining the profits

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[1] See United States-United Kingdom Income Tax Treaty, Article 7 (July 24, 2001); United States-Japan Income Tax Treaty, Article 7 (November 6, 2003) and accompanying Exchange of Notes.

attributable to a permanent establishment.[2] Both Notes address the allocation of the capital of financial institutions to their permanent establishments, stating in pertinent part that the Contracting States may treat the permanent establishment

> as having the same amount of capital that it would need to support its activities if it were a distinct and separate enterprise engaged in the same or similar activities. With respect to financial institutions other than insurance companies, a Contracting State may determine the amount of capital to be attributed to a permanent establishment by allocating the institution's total equity between its various offices on the basis of the proportion of the financial institution's risk-weighted assets attributable to each of them.[3]

The Treasury Technical Explanations of the United Kingdom and Japan treaties acknowledge that the allocation method provided by section 1.882-5 does not take into account the relative riskiness of assets that are attributable to a permanent establishment and that equal weighting of risk, in some cases, "may require a taxpayer to allocate more capital to the United States (and therefore would reduce the taxpayer's interest expense deduction) than is appropriate."[4]

Accordingly, the two treaties permit United Kingdom and Japanese resident financial institutions the use of an alternative approach to the determination of their taxable income, without the section 1.882-5 determination of interest expense, for purposes of establishing the upper limit with respect to the amount of tax that may be imposed on a U.S. permanent establishment of a foreign bank. Such an alternative approach under the treaties would incorporate risk-weighting of the foreign bank's assets as well as other consequential deviations from the rules of section 1.882-5 in line with the arm's length principles of Articles 7 and 9(1) of those treaties.

As reflected in the Notes and Technical Explanations, the two treaties require an allocation of sufficient equity capital in determining the profits attributable to a permanent establishment. The amount of equity capital shown on a taxpayer's book's is not determinative. Therefore, it will be acceptable only to the extent such allotment is sufficient to support the assets and risks attributable to the permanent establishment.

The Treasury Department and IRS continue to believe that application of section 1.882-5 also results in a sufficient allocation of equity capital to a permanent establishment, and is simpler to apply than an alternative approach under the treaties. As stated in both Technical Explanations, taxpayers are not required to use the risk-weighted approach for allocating equity capital provided by the treaties. Rather, taxpayers may continue to use section 1.882-5 in lieu of an alternative approach under the treaties.

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[2] Exchange of Notes, United States-Japan Income Tax Treaty, para. 2 (July 24, 2001) and United States-United Kingdom Income Tax Treaty (July 24, 2001).
[3] Id.
[4] Technical Explanation of the United States-United Kingdom Income Tax Treaty, Art. 7, para. 3, CCH, p. 201,301; United States-Japan Income Tax Treaty, Art. 7, para. 3, CCH, p. 113,320.

SECTION 4. DETERMINATION OF U.S.-CONNECTED LIABILITIES UNDER THE FIXED RATIO FOR FOREIGN BANKS

As noted, Step 2 of the calculation is used to determine the amount of U.S.-connected liabilities. Section 1.882-5(c)(1) provides that "[t]he amount of U.S.-connected liabilities for the taxable year equals the total value of U.S. assets for the taxable year (as determined under paragraph (b)(3) of this section) multiplied by the actual ratio for the taxable year (as determined under paragraph (c)(2) of this section) or, if the taxpayer has made an election in accordance with paragraph (c)(4) of this section, by the fixed ratio." In 1996, the final regulations established the fixed ratio for foreign banks at 93 percent.

The Treasury Department and IRS have considered data from more recent years to determine whether the 93 percent fixed ratio continues to be appropriate. Based on that examination, it appears that a fixed ratio of between 94 and 96 percent may be more appropriate. The Treasury Department and IRS invite the submission of data and other information relevant to the consideration of a revised fixed ratio, including information about the nature of the assets and risks related to the U.S. trade or business as compared to the business conducted outside the United States.

It is expected that taxpayers will be permitted to make new elections with respect to section 1.882-5 to take into account these changes.

SECTION 5. DETERMINATION OF EXCESS INTEREST OF BANKS UNDER THE ADJUSTED U.S.-BOOK LIABILITY METHOD

Under the Adjusted U.S. Booked Liabilities ("AUSBL") method taxpayers may be required under certain facts and circumstances to calculate a portion of their interest expense allocation by reference to the average U.S. dollar borrowing rate incurred outside the United States. Section 1.882-5(d)(5) provides that where the U.S.-connected liabilities exceed the taxpayer's U.S. booked liabilities (as defined for banks in section 1.882-5(d)(2)(iii)), the excess U.S.-connected liabilities are multiplied by the taxpayer's average U.S. dollar borrowing rate with respect to interest expense and liabilities shown on the books of the taxpayer's offices or branches outside the United States. This portion of the Step 3 allocation is referred to as the "excess interest."

In prior regulations ("the 1980 regulations"), section 1.882-5 provided that where information necessary to compute the actual foreign U.S. dollar borrowing rate could not "be reasonably obtained," then "any method that reasonably approximates the actual rate" could be substituted so long as it was consistently applied from year to year.[5] The 1980 regulations provided that the 30-day LIBOR rate may constitute an appropriate proxy for an actual foreign borrowing rate but did not specify that the use of the published LIBOR rate could be used outright if the actual foreign borrowing rate was

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[5] §1.882-5(b)(2)(i)(B), T.D. 7749, 1981-1 C.B. 390, 394.

capable of being proved. Where the total foreign U.S. dollar borrowings were *de minimis*, the prior regulations substituted the actual average borrowing rate of the foreign corporation's trade or business within the United States.

Where a foreign corporation elects both the fixed ratio under Step 2 and the AUSBL method under Step 3, it is possible for the taxpayer's entire interest expense allocation to be determined by reference to the books and records of its trade or business within the United States. This may be true under the current regulations if the allocation for the taxpayer does not result in excess interest but, instead, is subject to the scale-down rule under section 1.882-5(d)(4). Otherwise, when these elections are made together, resort may still be necessary to information typically maintained outside the United States. In many cases, the information would be collected only for purposes of computing the taxpayer's excess interest.

To facilitate administrability both for foreign bank taxpayers and the IRS, the amendments to the regulations will provide that such taxpayers who are already eligible to use the AUSBL method for a particular year may make a binding annual election to calculate excess interest under the AUSBL method by reference to the published 30-day average LIBOR rate for such year, rather than the actual foreign U.S. dollar borrowing rate prescribed in §1.882-5(d)(5), by using such rate to calculate its interest expense deduction on a timely filed original Federal income tax return for such year. The election provisions of §1.882-5(a)(7) shall apply on an annual basis without regard to the binding 5-year minimum period. Such taxpayers may begin using such rate for tax years ending on or after the date on which this notice is published.

SECTION 6. COORDINATION OF DETERMINATION OF U.S. ASSETS ON AN ADJUSTED OR FAIR MARKET VALUE BASIS WITH DETERMINATION OF U.S.-CONNECTED LIABILITIES USING THE FIXED OR ACTUAL RATIO

The Treasury Department and the IRS recognize that an increase in the fixed ratio, as contemplated by section 3 of this notice, will render the fixed ratio relatively more attractive as compared to the actual ratio for purposes of the Step 2 determination of the U.S.-connected liabilities of foreign banks. Pursuant to the existing regulations, foreign banks may combine an election of the fixed ratio for the Step 2 determination of U.S.-connected liabilities with an election of the fair market value basis for the Step 1 determination of U.S. assets.

The Treasury Department and the IRS are reconsidering whether combining these elections is consistent with the policies underlying the regulations. In particular, it is unclear that such a combination of elections would produce an appropriate result in light of the prevalence and significance of intangibles in the banking industry. The Step 2 determination of U.S.-connected liabilities using an actual ratio determined on a fair market value basis reflects in a balanced manner the effect of intangibles because such intangibles would be taken into account at their fair market in both steps. The Step 2 determination of U.S.-connected liabilities using the fixed ratio in conjunction with a fair market value election in Step 1 may not similarly reflect in a balanced manner the effect of intangibles. The Treasury Department and the IRS are concerned, therefore, that the current ability to apply a fair market value election in conjunction with a fixed ratio election may distort the Step 2 determination of U.S.-connected liabilities. The Treasury Department and the IRS solicit comments to assist them in their review of this matter.

SECTION 7. SUBMISSION OF COMMENTS

Taxpayers may submit comments to: CC:ITA:RU (PGP-125111-02), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:ITA:RU (PGP-125111-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by submitting comments directly to the IRS Internet site at http://www.irs.gov/tax_regs/regslist.htm

SECTION 8. DRAFTING INFORMATION

The principal author of this notice is Paul S. Epstein of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in its development. For further information regarding this notice contact Paul S. Epstein and Gregory Spring at (202) 622-3870 (not a toll-free call).