

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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Date:

April 10, 2000

LEGEND:

- Bank =
- Date a =
- Date b =
- Date c =
- Date d =
- Country A =
- Country B =
- Country C =
- X Amount =
- U.S. City =
- Fiscal Year =
- Fiscal Year 1 =

Dear :

This is in reply to a letter dated Date a, requesting rulings under 884 of the Internal Revenue Code of 1986 (the "Code") and the Treasury regulations thereunder (the "Regulations"). Additional information was submitted in letters dated Date b, Date c and Date d. The information submitted for consideration is substantially as set forth below.

The rulings contained in this letter are based upon information and representations submitted by Bank and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for rulings. Verification of the factual information, representations, and other data may be required as part of the audit process.

FACTS:

Bank is a banking institution incorporated in Country A. Bank's Head Office is located in Country A and Bank has two foreign branch offices, one in Country B and the other in U.S. City, through which it conducts foreign branch banking activities. Bank also conducts a "shell branch" operation through its offices in U.S. City. Bank is a calendar year-end accrual basis taxpayer. Bank files a Form 1120F for its year end Fiscal Year

to report its effectively connected income (“ECI”) earned by its U.S. operations.

Through its U.S. City branch office, Bank is engaged in a commercial wholesale banking business in the United States, consisting of making loans, loan guarantees and providing letters of credit which earn ECI to Bank. Bank conducts its branch banking operations in the United States under a federal license issued by, and is subject to the supervision of, the Office of the Comptroller of the Currency (“OCC”).

Bank’s U.S. operations are accounted for on three separate sets of books: (1) U.S. City - Domestic; (2) U.S. City - International Banking Facility (“IBF”) and (3) Country C - Shell Branch (collectively, the “U.S. Books”). The U.S. Books are combined for purposes of financial and tax reporting in the United States. Currently, the bookkeeping, operations, lending and treasury functions relating to the U.S. operations (e.g., U.S. City, U.S. City-IBF and Country C Shell Branch) are performed by separate groups of employees working out of Bank’s U.S. City branch office.

The Country C Shell Branch has no employees of its own, but is organized as an offshore branch for purposes of reducing U.S. reserve requirements on deposit liabilities placed with banking institutions and to facilitate lower cost Eurodollar market deposit-taking. Because the Country C Shell Branch is licensed by a foreign jurisdiction, any transactions entered into under such foreign banking license must be booked in the Country C branch. Bank represents that all of the Country C Shell Branch’s deposit transactions are entered into by Bank’s U.S. City personnel for use in the U.S. operations and that U.S. City personnel maintain the books and records of the Country C Shell Branch at the U.S. offices. The Country C Shell Branch assets and liabilities are subject to federal bank regulatory supervision including examination by the OCC and are reported on Federal Financial Institutions Examination Council (“FFIEC”) Form 002S. Bank also represents that a substantial part of its business in its Country B branch consists of taking deposits and making loans.

For U.S. tax purposes, Bank elected in its first eligible year to allocate interest expense to its ECI using the separate currency pools method under section 1.882-5(d) of the Regulations. Although determining whether liabilities of Bank’s U.S. trade or business are properly reflected on Bank’s U.S. books and records is not a requirement for determining the allocable interest under the separate currency pools method, Bank represents that the liabilities recorded on its U.S. books are acquired and recorded in accordance with the requirements of the adjusted U.S. book liability method applicable to banks under section 1.882-5(d)(2)(iii).

As part of a restructuring plan for its U.S. operations, Bank plans during its tax year ending Fiscal Year 1 to transfer certain of its bookkeeping, operations such as transactions processing, collection and payments and treasury functions from the U.S. City branch to Head Office. However, loan production and management functions will be retained in U.S. City.

After the restructuring, the Bank's personnel in Country A will assume certain bookkeeping functions relating to transaction processing and payments and collections and the treasury functions on behalf of U.S. City and Country C Shell Branch. These transferred functions will include bookkeeping for both existing branch liabilities as well as any new branch liabilities. Other than the location of certain bookkeeping functions being moved to Country A, the U.S. Books will be maintained in the same manner as before the restructuring. Head Office personnel in Country A will make the appropriate entries to be reflected on the appropriate set of U.S. books. Any new funding relating to assets recorded on the U.S. City-IBF, U.S. City-Domestic or Country C Shell Branch books will be recorded on the corresponding U.S. book where the related asset is recorded. Through electronic communications links, accounting reports will be made available to the Bank's personnel in its U.S. City branch office, where the U.S. Books will continue to be maintained by U.S. City personnel.

After the restructuring, the treasury (deposit-taking) function formerly handled by the Bank's U.S. City branch personnel will be performed by the Bank's personnel located in Country A. Bank represents that in every case where deposits are to be acquired and contemporaneously booked to the U.S. books, the U.S. City branch employees will have some level of participation with respect to such deposit. This participation will be in the form of U.S. City branch employees initiating each deposit by notifying Head Office at the time a funding need arises. For example, the funding need will arise upon notification received from a borrower of a draw down on a line of credit, when a decision is made to purchase a security or an existing short-term liability requires renewal. For LIBOR loans, notification to Head Office will normally be two days in advance in order to synchronize the funding with the loan. Notification made by the U.S. City branch personnel will include the terms, principal amount and interest rate of the loan or security to be purchased for purposes of setting forth parameters required for funding.

These third party liabilities will be recorded on the U.S. books in the same manner as before the restructuring, except that Head Office personnel located in Country A will solicit and negotiate the acquisition of the deposit liabilities and perform the bookkeeping function with respect to these transactions. Most of these deposits will be booked in Country C Shell Branch.

After the treasury function is moved to the Head Office as described, the Bank will continue to be licensed in the U.S. as a bank and will remain subject to federal supervision in the same manner as before the restructuring. Bank represents that the remainder of its U.S. based banking activities will continue without interruption. Activities conducted by the Bank's employees in the U.S. will include soliciting, investigating, negotiating and arranging new loans, performing credit checks, monitoring the existing loan portfolio and coordinating deposit-taking activities with Head Office and general management and executive functions.

Bank represents that historically a very substantial portion of its U.S. assets (as defined

in section 1.884-1(d) of the Regulations) have been recorded on its Country C Shell Branch books and that such practice will continue after Bank's treasury function is moved to its Head Office in Country A. Bank also represents that both its U.S.-City Domestic and U.S. City-IBF have transactions and assets recorded from activities that produce ECI. In addition, after the treasury function is moved to Country A, the Country C Shell Branch shall continue to be subject to OCC supervision and all assets and liabilities constituting the Country C Shell Branch books will continue to be reported on FFIEC Form 002S.

RULING REQUESTS:

Based on the factual representations made above, Bank has requested the following rulings:

Ruling Request One

After Bank transfers part of its bookkeeping and treasury functions related to its U.S. City branch operations to its Head Office in Country A, Bank may treat its interest expense with respect to newly recorded liabilities on its U.S. City-Domestic, U.S. City-IBF and Country C Shell Branch books as branch interest under section 1.884-4(b)(1)(A) that is paid with respect to a U.S. booked liability within the meaning of section 1.882-5(d)(2).

Ruling Request Two

After Bank transfers certain of its bookkeeping and treasury functions to its Head Office in Country A, it will still continue to qualify under section 1.884-4(a)(2)(iii) of the Regulations as a bank that is entitled to treat a portion of its excess interest as interest on deposits.

DISCUSSION:

Ruling Request One

Section 882(a) of the Code imposes U.S. tax on income of a foreign corporation that is effectively connected with the U.S. trade or business. Section 882(c)(1) allows foreign corporations a deduction against ECI to the extent such deduction is connected with income which is effectively connected with a conduct of a trade or business within the U.S. Section 1.882-5 of the Regulations provides rules for determining a foreign corporation's interest expense allocable under section 882(c) to ECI.

Section 1.882-5 of the Regulations provides that the amount of deductible interest expense allocable to ECI is determined under a three step process provided in section 1.882-5(b), (c), and electively, (d) or (e). Under step 1, a foreign corporation first

determines the total value of its U.S. assets under section 1.882-5(b). Under step 2, the foreign corporation determines the amount of U.S. liabilities under section 1.882-5(c) deemed connected with the U.S. assets. Under step 3, interest expense of the foreign corporation is allocated either under the adjusted U.S.-booked liabilities method provided in section 1.882-5(d) or the separate currency pool method provided in section 1.882-5(e). Bank represents that it timely elected the separate currency pools method in its first eligible year under section 1.882-5(a)(7) of the Regulations.

Under the separate currency pools method, the amount of interest expense allocated to the U.S. trade or business of a foreign corporation is determined without reference to the separate amount of interest paid or accrued by the foreign corporation's U.S. trade or business. The amount of allocation is determined by the sum of separately computed interest deductions with respect to each currency in which the foreign corporation has U.S. assets (under section 1.882-5(b)). The three-step process for computing the separate interest deductions allocable to ECI under section 1.882-5(e) requires the determination of (1) the amount of U.S. assets in each currency pool; (2) the U.S.-connected liabilities in each pool by multiplying the taxpayer's actual or elective fixed ratio percentage by the respective U.S. assets in each pool; and (3) the prescribed interest rate in each pool by dividing the total interest expense paid or accrued in the denominated currency of the U.S. asset pool by the average worldwide liabilities in that same currency pool. The prescribed interest rate in a currency pool is multiplied by the U.S.-connected liabilities in the same currency pool to arrive at the calculated allocable deduction for the particular currency.

For purposes of the branch-level interest tax, section 884(f)(2) provides:

For purposes of this subsection, the term "allocable interest" means any interest which is allocable to income which is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States.

Section 884(f)(1) provides:

In the case of a foreign corporation engaged in a trade or business in the United States (or having gross income treated as effectively connected with the conduct of a trade or business in the United States), for purposes of [Subtitle A of the Internal Revenue Code]-

(A) any interest paid by such trade or business in the United States shall be treated as if it were paid by a domestic corporation, and

(B) to the extent that the allocable interest exceeds the interest described in subparagraph (A), such foreign corporation shall be liable for tax under section 881(a) in the same manner as if such excess were interest paid to

such foreign corporation by a wholly owned domestic corporation on the last day of such foreign corporation's taxable year.

To determine the amount of excess interest subject to tax under section 884(f)(1)(B), section 1.884-4(a)(2)(i) provides:

For purposes of this section, the term "excess interest" means-

- (A) The amount of interest allocated or apportioned to ECI of the foreign corporation under section 1.882-5 for the taxable year, after application of section 1.884-1(e)(3); minus
- (B) The foreign corporation's branch interest (as defined in paragraph (b) of this section) for the taxable year, but not including interest accruing in a taxable year beginning before January 1, 1987; minus
- (C) The amount of interest determined under paragraph (c)(2) of this section (relating to interest paid by a partnership).

Accordingly, for purposes of section 884(f)(1), the amount of "any interest paid" by a foreign corporation's U.S. trade or business in the United States that is treated as paid by a domestic corporation is defined under the Regulations as "branch interest". Section 1.884-4(b)(1) provides the definition of "branch interest" in relevant part as follows:

For purposes of this section, the term "branch interest" means interest that is -

- (i) Paid by a foreign corporation with respect to a liability that is -
 - (A) A U.S. booked liability within the meaning of section 1.882-5(d)(2) (other than a U.S. booked liability of a partner within the meaning of section 1.882-5(d)(2)(vii))

Section 1.882-5(d) qualifies a liability as a U.S. booked liability only if it is "properly reflected" on the books of the U.S. trade or business. In determining whether a liability is "properly reflected" the Regulations provide separate requirements for foreign corporations that are banks (as defined for purposes of the paragraph) and for nonbanks.

Whether a liability of a nonbank is "properly reflected" on the books of a U.S. trade or business is determined under section 1.882-5(d)(2)(ii) which provides in relevant part:

- (A) *In general.* A liability, whether interest bearing or non-interest bearing, is properly reflected on the books of the U.S. trade or business of a foreign

corporation that is not a bank as described in section 585(a)(2)(B) (without regard to the second sentence thereof) if-

- (1) The liability is secured predominantly by a U.S. asset of the foreign corporation;
- (2) The foreign corporation enters the liability on a set of books relating to an activity that produces ECI at a time reasonably contemporaneous with the time at which the liability was incurred; or
- (3) The foreign corporation maintains a set of books and records relating to an activity that produces ECI and the District Director or Assistant Commissioner (International) determines that there is a direct connection or relationship between the liability and that activity. Whether there is a direct connection between the liability and an activity that produces ECI depends on the facts and circumstances of each case.

To determine whether a liability may be taken into account as properly reflected on a book of a U.S. trade or business that is a bank, a more restrictive standard applies. In this regard, section 1.882-5(d)(2)(iii) prescribes a narrower time-frame for booking the liabilities to the U.S. trade or business:

(A) *In general.* A liability, whether interest bearing or non-interest bearing, is properly reflected on the books of the U.S. trade or business of a foreign corporation that is a bank as described in section 585(a)(2)(B) (without regard to the second sentence thereof) if --

- (1) the bank enters the liability on a set of books relating to an activity that produces ECI before the close of the day on which the liability is incurred, and
- (2) there is a direct connection or relationship between the liability and that activity. Whether there is a direct connection between the liability and an activity that produces ECI depends on the facts and circumstances of each case.

(B) *Inadvertent error.* If a bank fails to enter a liability in the books of the activity that produces ECI before the close of the day on which the liability was incurred, the liability may be treated as a U.S. booked liability only if, under the facts and circumstances, the taxpayer demonstrates a direct connection or relationship between the liability and the activity that produces ECI and the failure to enter the liability in those books was due to inadvertent error.

Section 585(a)(2)(B) provides in relevant part that "For purposes of this section-

(B) Banking business of United States branch of foreign corporation. The term “bank” also includes any corporation to which subparagraph (A) would apply except for the fact that it is a foreign corporation.

Section 585(a)(2)(A) provides:

(A) *In general.* The term “bank” means any bank (as defined in section 581).

Therefore, if Bank would meet the requirements of section 581 but for the fact it is a foreign corporation, then Bank may be considered a “bank” for purposes of section 585(a)(2)(B) and by reference, for purposes of section 1.882-5(d)(2)(iii)(A).

Section 581 provides in relevant part:

[t]he term “bank” means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia) or of any State, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under authority of the Comptroller of the Currency, and which is subject by law to supervision and examination by State, or Federal authority having supervision over banking institutions.

Because Bank represents that a substantial part of its business conducted through its U.S. City office consists of making loans and discounts and it is subject by law to the supervision and examination by the OCC with respect to its U.S. Books (including its Country C book), Bank will meet the definition of the term “bank” within the meaning of sections 581 and 585(a)(2)(B) if the deposit taking functions performed by the Head Office and recorded on the U.S. Books are treated as deposits taken in the United States. If such deposits are treated as deposits taken within the United States, Bank will be required to determine its branch interest for purposes of section 1.884-4(b)(1)(i) by reference to whether liabilities are properly reflected under the stricter requirements of section 1.882-5(d)(2)(iii).

Ruling Request Two

Code section 884(f)(1)(A) provides that, in the case of a foreign corporation engaged in a trade or business in the United States (or having gross income treated as effectively connected with the conduct of a trade or business in the United States), any interest paid by such trade or business in the United States shall be treated as if it were paid by a domestic corporation.

Code section 884(f)(1)(B) provides that, to the extent the allocable interest exceeds the

interest described in Code section 884(f)(1)(A), a foreign corporation shall be liable for tax under section 881(a) in the same manner as if such interest were paid to such foreign corporation by a wholly owned domestic corporation on the last day of such foreign corporation's taxable year.

Section 1.884-4(a)(2)(iii) of the Regulations provides that a portion of the excess interest of a foreign corporation that is a bank (as defined in section 585(a)(2)(B) without regard to the second sentence thereof) shall be treated as interest on bank deposits (within the meaning of section 871(i)(3)(A)) and shall be exempt from tax under section 881(a) provided that a substantial part of its business in the United States, as well as all other countries in which it operates, consists of receiving deposits and making loans and discounts. The portion of the excess interest that is treated as interest on deposits shall equal the product of the foreign corporation's excess interest and the greater of:

- (a) the ratio of the amount of interest-bearing deposits, within the meaning of section 871(i)(3)(A), of the foreign corporation as of the close of the taxable year to the amount of all interest bearing liabilities of the foreign corporation on such date; or
- (b) 85 percent.

Ruling Number One

Based solely on the facts and representations submitted, for purposes of section 1.884-4(b)(1)(i) of the Regulations and subject to the rules of section 1.884-4(b)(6):

- (1) For the period beginning after Bank's treasury function is moved to its Head Office in Country A, the recording and maintenance of Bank's Head Office acquired liabilities on the U.S. Book will constitute the taking of deposits in the United States within the meaning of section 585(a)(2)(B). Accordingly, Bank is required to determine whether its liabilities are properly reflected on the books of its U.S. trade or business under the requirements of section 1.882-5(d)(2)(iii). Bank may not use the rules of section 1.882-5(d)(2)(ii) to determine whether any liabilities of its U.S. trade or business are "properly reflected" for purposes of determining Bank's branch interest under section 1.884-4(b)(1)(i).
- (2) The liabilities acquired by Bank's Head Office and recorded on one of the books that constitute a part of the U.S. Books will qualify as booked liabilities that are properly reflected on the books of Bank's U.S. trade or business under section 1.882-5(d)(2)(iii)(A)(1) if such liabilities are entered onto one of the books which constitute a part of the U.S. Book before the close of business on the day they are incurred by Bank.

- (3) U.S. City-IBF and U.S. City-Domestic Book constitute a set of books that relate to an activity that produces ECI under section 1.882-5(d)(2)(iii)(A)(1).
- (4) Bank's Country C Shell Branch books do not collectively with U.S. City-IBF and U.S. City-Domestic constitute a single set of books that relate to an activity that produces ECI under section 1.882-5(d)(2)(iii)(A)(1). However, Bank's Country C Shell Branch books will constitute a separate set of books that meet the requirements of section 1.882-5(d)(2)(iii)(A)(1) under the representations made by Bank.
- (5) The liabilities recorded on the U.S. books have a "direct connection or relationship to an activity that produces ECI" within the meaning of Treasury Regulation section 1.882-5(d)(2)(iii)(A)(2), without requiring that the U.S. Book liabilities be individually traced to specific effectively connected loans or other U.S. assets on the U.S. Books.

No opinion is expressed whether Bank may treat liabilities recorded on its U.S. Books as properly reflected on such books under the requirements of section 1.882-5(d)(2)(iii)(B) of the Regulations if any liabilities fail to meet the requirements of section 1.882-5(d)(2)(iii)(A)(1) of the Regulations. In addition, no opinion is expressed with respect to section 1.882-5(d)(2)(v), concerning whether any U.S. Book liabilities treated as properly reflected under the requirements of section 1.882-5(d)(2)(iii) are incurred or held for the principal purpose of artificially increasing the interest expense of the U.S. booked liabilities within the meaning of section 1.882-5(d)(2)(v).

Ruling Number Two

Based solely on the facts and representations submitted, after Bank transfers its treasury operations to its Head Office in Country A, Bank will continue to qualify as a bank within the meaning of section 1.884-4(a)(2)(iii) and, accordingly, may treat a portion of its excess interest as interest on deposits to the extent provided by the regulation. For purposes of applying the requirements of section 1.884-4(a)(2)(iii)

- (1) The treatment of Bank's Head Office acquired liabilities recorded on the U.S Books as the taking of deposits in the United States for purposes of applying section 585(a)(2)(B) under section 1.882-5(d)(2)(iii) (as referenced by section 1.884-4(b)(1)(A)) also constitutes the taking of deposits in the United States for purposes of section 1.884-4(a)(2)(iii) of the Regulations.
- (2) Meeting the other requirements of section 585(a)(2)(B) (without regard to the second sentence thereof) for purposes of section 1.882-5(d)(2)(iii) also constitutes satisfaction of the section 585(a)(2)(B) requirement for

purposes of section 1.884-4(a)(2)(iii) of the Regulations.

* * *

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item not discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,
Paul S. Epstein
Senior Technical Reviewer, Branch 5
Office of Associate Chief Counsel
(International)