REPORT #733

TAX SECTION

New York State Bar Association

REPORT ON PROPOSED REGULATIONS SECTION 1.882-5

Table of Contents

TAX SECTION
New York State Bar Association

August 26, 1992

The Honorable Shirley Peterson
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, DC 20224

Dear Commissioner Peterson:

Enclosed is a report with respect to Proposed Regulations § 1.882-5, relating to the determination of the U.S. interest expense of a foreign corporation. Our principal comments are summarized pages of 4 through 9 of the report.

Since it is important that these Regulations reflect experience in the 12 years since they were initially adopted and the enactment in 1986 of the branch profits and branch level withholding tax, we especially commend the Internal Revenue Service and the Treasury for undertaking to revise the existing Regulations.

We would be pleased to discuss our comments with you if you think that would be helpful.

Very truly yours,

John A. Corry
Chair

Identical Letter Sent to:

The Honorable Fred T. Goldberg, Jr.
Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

cc: Harry L. Gutman, Esq.
Chief of Staff
Joint Committee on Taxation
1015 Longsworth House Office Building
Washington, DC 20515

Abraham N.M. Shashy, Jr. Esq.
Chief Counsel
Internal Revenue Service
Room 3026
1111 Constitution Avenue, N.W.
Washington, DC 20224

Alan J. Wilensky, Esq.
Deputy Assistant Secretary
of the Treasury for Tax Policy
Room 3108 Main Treasury
15 & Pennsylvania Avenue, N.W.
Washington, DC 20220

James Mogle, Esq.
Acting International Tax Counsel
Department of the Treasury
Room 4222 Main Treasury
15 & Pennsylvania Avenue, N.W.
Washington, DC 20220

Robert E. Culbertson, Esq.
Associate Chief Counsel (International)
Internal Revenue Service Room
3052 CC: Int'l
1111 Constitution Avenue, N.W.
Washington, DC 20224

Charles T. Plambeck
Special Counsel to the Chief Counsel
Internal Revenue Service
Room 3034
1111 Constitution Avenue, N.W.
Washington, DC 20224

Karl T. Walli
Office of Associate Chief Counsel
International
Internal Revenue Service
Room 4562
1111 Constitution Avenue, N.W.
Washington, DC 20224

Emily McMahon
Associate International Tax Counsel
Department of the Treasury
Room 4222 Main Treasury
15th & Pennsylvania Avenue, N.W.
Washington, DC 20220

REPORT ON PROPOSED REGULATIONS SECTION 1.882-5

This report, prepared by an ad hoc committee of the Tax Section of the New York State Bar Association,[1] comments on Proposed Regulations Section 1.882-5, relating to the interest deduction allowable to foreign corporations that do business in the United States directly, through branches or otherwise.[2] While primarily of interest to foreign banks, which typically do business in the United States through branches, the Proposed Regulations (hereafter, the “Proposed Regulations”) apply to any foreign corporation, including a foreign government, that does business in the United States directly.

Introduction

Section 882(c)(1)(A) of the Internal Revenue Code provides that the proper apportionment and allocation of a foreign corporation's deductions for purposes of determining the income of the foreign corporation that is effectively connected with a United States business shall be determined under Regulations. Pursuant to this provision, Regulations (hereafter, the “existing Regulations”) relating to the determination of the deductible interest expense of a foreign corporation were first

---

1 Chaired by Willard B. Taylor and consisting of Laura Barzilai, Lior Evan, Andrew Feldstein, David Goldman, Susan Halpem, Richard Hiegel, Richard Loengard, David P. Mason, Dale Ponikvar, Chris Scobey, Kenneth Silbergleit and Robert J. Staffaroni. Helpful comments were received from Peter C. Canellos, John A. Corry, Carolyn Lee Ichel, Hugh T. McCormick, David Sachs, Michael L. Schler, Cynthia Shoss and Esta E. Stecher.

2 57 Fed. Reg. 15308 (April 24, 1992). Corrections were made on June 25, 1992, and on July 8, 1992 the time within which comments may be made was extended to October 9, 1992.

adopted in 1980.[3] These would be replaced by the Proposed Regulations, effective for taxable years beginning after the date of their adoption as final Regulations.

Like the existing Regulations, the Proposed Regulations provide that the determination of the deductible interest expense of a foreign corporation is made in three steps. In the first step, the foreign corporation determines its U.S. assets; in the second, it determines the liabilities attributable to such assets, either by the use of a fixed leverage ratio or on the basis of the ratio of its actual worldwide assets to worldwide liabilities; and, in the third, it determines the interest expense related to the liabilities attributed to its U.S. assets. The Proposed Regulations depart from the existing Regulations, however, in a number of respects, including the following:

(1) Coordination with other provisions. The Proposed Regulations coordinate the determination of allocable interest expense with rules that defer, disallow or capitalize interest and include certain separate rules for foreign governments and foreign insurance companies. There are no such rules in the existing Regulations.

(2) Determination of assets. The Proposed Regulations generally contemplate that U.S. assets and booked liabilities will be determined on a consistent basis for purposes of the Proposed Regulations and the branch profits tax imposed by Section 884 of the Internal Revenue Code. There is no such consistency in the existing Regulations.

---

[3] T.D. 7749 (December 30, 1980), amended as to the effective date by T.D. 7939 (February 2, 1984).

(3) Leverage ratios. The Proposed Regulations continue the rule that permits a foreign corporation to determine the liabilities of its U.S. business on the basis of the ratio of worldwide liabilities to assets (the so-called actual ratio method) or on the basis of a fixed leverage ratio but reduce the fixed ratio of foreign banks from 95% to 93% and, in the case of a foreign bank that determines its U.S. liabilities on the basis of the actual ratio, limits the actual ratio to 96%.[4] The Proposed Regulations do not change the 50% fixed ratio available to most other taxpayers[5] and put no "cap" on the actual ratio of such taxpayers.

(4) Determination of interest expense on U.S. liabilities. The Proposed Regulations determine the interest expense on the liabilities of the U.S. business by looking at the interest paid on so-called "booked liabilities" (that is, liabilities properly reflected on the books of the U.S. business), adjusted to reflect differences between booked liabilities and U.S. liabilities (and thus, in effect, continue the branch book/dollar pool method for determining interest expense). The rule in the existing Regulations that allows a foreign corporation to determine the amount of its interest deduction separately for each foreign currency in which the U.S. business has borrowed (the so-called "separate currency pools method") is eliminated and, in addition, the Proposed Regulations modify the branch book/dollar pool method of determining deductible interest by

[4] As noted below, the definitions of a foreign bank for purposes of the fixed 93% fixed ratio and the 96% "cap" differ.

[5] A special rule, described below, applies to foreign governments and the 50% fixed ratio is not available to foreign insurance companies.

(a) providing specific rules for determining when a liability will be regarded as a booked liability,

(b) providing specific rules for reducing the interest paid or accrued on booked liabilities in a case where booked liabilities exceed the liabilities attributed to the U.S. business, and

(c) if liabilities attributed to the U.S. business exceed booked liabilities, providing that the rate of interest on the excess will be 90% of the daily average LIBOR for demand deposits in U.S. dollars in the case of a foreign bank and 110% of such average in the case of any other foreign corporation.

Existing regulations simply define booked liabilities as those "shown on the books" of the U.S. business and, in a case where liabilities attributed to the U.S. business exceed booked liabilities, generally treat the excess as bearing interest at the actual average rate paid on U.S. dollar liabilities of the foreign corporation that are booked outside of the United States.

Summary of Comments

We believe that it is important to revise the existing Regulations to reflect experience in the 12 years since their adoption in 1980 and the enactment of the branch profits tax in 1986. We commend the Treasury and the Internal Revenue Service for undertaking such a revision and also for the decision to conform the definitions and concepts in the Proposed Regulations with those used for branch profits tax purposes. We have, however, a number of comments on the Proposed Regulations. In summary of our principal comments, which generally follow the order of the Proposed Regulations, and as more fully set out below:[6]

(1) Amendments to the branch profits tax Regulations that will affect the Proposed Regulations should be proposed promptly and the comment period for the Proposed Regulations should be kept open until there has been time to consider the proposed changes in the branch profits tax Regulations. The relationship between the Proposed Regulations and the Section 861 interest allocation and apportionment Regulations should also be clarified.

(2) It would be useful to clarify by example what is intended by the statement in Prop. Regs.§ 1.882-5(a)(1) that in no event may the interest expense of a foreign corporation determined under the Proposed Regulations exceed the interest paid or accrued by the foreign corporation during the year.

(3) More guidance is needed with respect to the integration of the Proposed Regulations and the rules that defer, capitalize or disallow interest expense or allocate interest expense for foreign tax credit limitation purposes. For these and other purposes, those rules should be applied to the interest on booked liabilities, determined under Prop. Regs. § 1.882-5(d)(2), with adjustments where the U.S. liabilities determined in step two differ from booked liabilities.

(4) Because Section 265 will have no, or only limited, application to income exempt from tax under Section 894, assets that generate such income should be excluded from U.S. assets in

[6] The numbered paragraphs of this summary correspond to the bracketed numbers in front of the headings in the part of the report that follows the summary.

step two (or alternatively, included and the step three interest expense then allocated and apportioned under the Section 861 regulations).

(5) While the rule in Prop. Regs. § 1.882-5(a)(3) that interprets all U.S. income tax treaties to be consistent with the Proposed Regulations is supported by legislative history and long-standing Internal Revenue Service rulings, it would be productive to give further consideration to possible treatment of the U.S. business of a foreign corporation as a separate entity (and thus to the recognition of interbranch transactions) for the purposes of determining the interest expense of a foreign corporation's U.S. business and for other purposes.

(6) Technical changes are needed to the rules for foreign governments in Prop. Regs. § 1.882-5(a)(4), including a definition of foreign government and a rule for a case where booked liabilities exceed 80% of U.S. assets. A different definition of booked liabilities for this limited purpose might be appropriate.

(7) Prop. Regs. § 1.882-5(b)(1) should be clarified to make it clear that U.S. assets (a) include obligations described in Section 103, and the full value of any obligations described in Section 133, assuming that they otherwise meet the definition of U.S. assets, (b) do not include assets producing income exempt from tax, or excluded from gross income, under Section 883, 892 or 894, include real property used in a U.S. business (such as property held for rent or used as the business premises) and (d) include real property subject to a net election under the Internal Revenue Code or an income tax treaty.

(8) Prop. Regs. § 1.882-5(b)(2)(ii) should be deleted and marketable securities treated as U.S. assets by reason of Regs. § 1.884-1T(d)(11) should be treated as U.S. assets.

(9) The final Regulations should clarify the relationship between the use of fair market value in the step one determination of U.S. assets and its use in step two.

(10) The rule in Prop. Regs. § 1.882-5(b)(2)(iii)(B) that includes the value of shares of stock in U.S. assets only to the extent of the percentage of dividends that is included in taxable income, taking into account the dividends received deduction, should be deleted.

(11) We think it unreasonable to require a foreign corporation that is not a bank to value non-marketable assets no less frequently than quarterly and suggest that this requirement be eliminated from Prop. Regs. Section 1.882-5(b)(3).

(12) Prop. Regs. § 1.882-5(c)(1) should be clarified to set out the time by which an election to use the fixed, rather than actual, ratio must be made.

(13) Serious consideration should be given to relaxing the requirements of Prop. Regs. §§ 1.882-5(c)(2)(ii) and (iii) that assets and liabilities for purposes of the actual ratio be calculated strictly in accordance with U.S. Federal income tax principles, and more guidance should be provided with respect to the U.S. tax principles used to determine liabilities for purposes of the fixed ratio.

(14) Foreign corporations electing the actual ratio should not be required to use the methodology of Regs. § 1.861-

9T(h) to determine fair market value. We recommend that the "any reasonable approach" method of the existing Regulations be retained.

(15) If the election provided to a bank by Prop. Regs. § 1.882-5(c)(2)(iv)(B) to compute the actual ratio on the basis of a hypothetical taxable year ending six months prior to the beginning of the actual year is retained, the text of the rule should be clarified so that it is clear that the effect of the election is to use the ratio for the seventh preceding month.

(16) The 96% "cap" on the actual ratio of a bank should be eliminated.

(17) The 50% fixed ratio available to foreign corporations that are not insurance companies or foreign governments and are not engaged in a banking, financing or similar business should be replaced by a rule, similar to that available to individuals and foreign governments, that treats booked liabilities of the U.S. business, up to 80% of the U.S. assets, as U.S. liabilities. It is not unreasonable to reduce to 93% the fixed ratio for foreign corporations engaged in a banking, financing or similar business, but the final Regulations should give the Internal Revenue Service the flexibility to adjust that percentage periodically to reflect changed capital requirements.

(18) We agree with the elimination of the separate currency pools method of determining interest expense in step three.

(19) In the case of the branch book/dollar pool method, more guidance is needed with respect to the circumstances in

which the Internal Revenue Service will invoke the exclusions from booked liabilities in Prop. Regs. § 1.882-5(c)(2)(iii).

(20) If a foreign corporation has a significant amount of foreign borrowings in U.S. dollars, the actual average worldwide U.S. dollar borrowing rate, rather than a percentage of LIBOR, should be used to determine the interest paid on U.S. liabilities in excess of booked liabilities.

(21) The matching rule in Prop. Regs. § 1.882-5(d)(2)(v) is flawed in several respects, including (a) in comparing liabilities to U.S. assets, (b) in the application of the 90% threshold to foreign corporations that are not banks, (c) in applying the rule in a case where there is greater matching in the U.S. business than there is worldwide and (d) in the absence of guidance on how to determine the currency denomination of assets that do not provide for payment in a particular currency.

(22) Guidance might be provided in step three on the meaning of “ordinarily”, “reasonably contemporaneous” and “attributable to a booked liability”.

(23) The application of the “scaling ratio” rule to income and expense of banks and other financial service entities from hedges should be clarified.

(24) It would generally be desirable to conform the definition of “interest paid” for branch profits tax and booked liability purposes. A reduction of interest expense under the Proposed Regulations' scaling ratio should reduce interest paid for branch profits tax purposes but should not be treated as a cessation of the use of, or a disposition of, property for

purposes of Section 864(c)(7) or, if the liability is denominated in a foreign currency, for purposes of Section 988.

(25) The examples illustrating the authority given to the Internal Revenue Service by Prop. Regs. § 1.882-5(e) to make adjustments to specific rules of the Proposed Regulations should be reconsidered.

(26) No inference should be drawn from the Proposed Regulations with respect to the proper interpretation of the existing Regulations. It should also be made clear that, when the Proposed Regulations are adopted as final Regulations, foreign corporations will not be bound by elections made under the existing Regulations (i.e., will be entitled to elect or not elect to use fair market value to value assets or to elect or not elect to determine U.S. liabilities by use of a fixed ratio)

(27) We agree that the treatment of investments in partnerships should be the same for purposes of the Proposed Regulations, the branch profits tax, branch level withholding tax and the Section 861 interest allocation and apportionment rules and that the branch profits tax and branch level withholding tax rules are generally appropriate for this purpose. It is unclear, however, to what extent the Proposed Regulations are intended to replace the existing Section 861 Regulations or to modify the branch profits tax and the branch level withholding tax Regulations.

(28) The three-step process of the Proposed Regulations should apply to foreign insurance companies, but for that purpose assets in both steps one and two should be reduced by insurance reserves, such reserves should not be treated as liabilities and the Internal Revenue Service should periodically prescribe

separate fixed ratios. The rules applicable to foreign insurance companies should, where appropriate, use the definitions and concepts in Section 842(b), and the branch profits tax rules applicable to foreign insurance companies should be conformed to the Proposed Regulations.

[1]. Coordination with Regulations under Sections 884 and 861

It is difficult to evaluate parts of the Proposed Regulations because they are tied to provisions of the branch profits tax Regulations which the Notice of Proposed Rulemaking says will be amended.[7] It would, of course, be desirable for any amendments to the branch profits tax Regulations that would affect the proposed Regulations to be proposed promptly and for the comment period on the Proposed Regulations to be kept open until those amendments are issued.

It would also be useful if the relationship between the Proposed Regulations and the Section 861 allocation and apportionment Regulations were clarified. Section 882 is given as one of the “operative” Sections for purposes of those Regulations,[8] but it is not clear whether (and if so, how) those

[7] Specifically, the Notice of Proposed Rulemaking says that(1)the definition of U.S. assets for purposes of Section 884 and the Proposed Regulations will be modified in some respects; and (2) the treatment of partnership assets and liabilities will be modified, apparently -- but this is not clear -- to conform the rules for purposes of Sections 884 and 861 interest allocation and apportionment to the rules in the Proposed Regulations. In addition, the Notice says that the definition of U.S. liabilities for purposes of Section 884 will be conformed to the definition of booked liabilities in the Proposed Regulations

[8] See Reas. § 1.861-8(a)(1).

Regulations apply to interest expense of a foreign corporation.[9] Our recommendation (set out below under Determination of U.S. assets -- Proposed Regulations § 1,882-5(b) -- General rule) that the amount of U.S. assets determined in step one not include assets which produce income exempt from tax under an income tax treaty or excluded from gross income by Section 883 or Section 892 assumes that the Proposed Regulations, rather than anything in the Section 861 allocation and apportionment Regulations, should determine the interest expense of a foreign corporation that is effectively connected with its U.S. business. The scope of the application of the Section 861 Regulations would under this approach be limited to expenses other than interest.[10] An alternative would be to include some or all of such assets in U.S. assets and then apply the Section 861 Regulations to disallow interest expense allocable to the assets that produce such income. This approach would be consistent with the notion that those assets do produce income which, although exempt from tax or excluded from income, is effectively connected with a U.S. business. Arguably, however, this would require foreign corporations to make in two steps a calculation that could be made in one, *i.e.*, first to include such assets in U.S. assets and then to disallow an interest deduction by allocating interest to such assets under the Section 861 allocation and apportionment Regulations. In addition, the Section 861 Regulations would for this purpose have to disregard Section 864(e)(3).

---

[9] The provisions of the Regulations relating to interest are now set out in Regs. § 1.861-8T(e)(2) but because of reservations in those Regulations it is impossible to say whether these rules, apart from the rule with respect to partnerships in Regs. § 1.861-9T(e), will apply to foreign corporations.

[10] We have suggested on page 13 below, however, that the Section 861 interest allocation and apportionment Regulations would apply, on the basis of booked liabilities, to the determination of the foreign tax credit allowed to foreign corporations.

In evaluating the alternatives, it should be borne in mind that they are likely to produce different results since they will produce different amounts of U.S. liabilities in step two and thus different amounts of interest expense in step three.

[2]. Limitation on Overall Allowance -- Prop. Regs. § 1.882-5(a)(1)

After referring to the three-step process for determining the interest expense of a foreign corporation that is connected with a U.S. business, Prop. Regs. § 1.882-5(a)(1) provides that "in no event" may the amount of a foreign corporation's interest expense exceed "the amount of interest on indebtedness paid or accrued by the taxpayer within the taxable year".

As we understand this rule, it would, for example, prevent a foreign corporation from using the fixed ratio to attribute liabilities to its U.S. business in step two, and thus to generate an interest deduction, in a case where the foreign corporation in fact had little or no debt and little or no interest expense. That seems entirely appropriate, but it might usefully be clarified, possibly by an example, that this is the kind of situation that is the focus of Prop. Regs. § 1.884-5(a)(1) and that it is not intended to authorize examining agents to override generally the specific rules of the three-step process.

[3]. Coordination With other provisions -- Prop. Regs. § 1.882-5(a)(2)

Prop. Regs. § 1.882-5(a)(2) provides that provisions of the Internal Revenue Code that disallow, defer or capitalize interest expense, such as Sections 163(j), 265 and 267(a)(3), apply after the determination of the U.S. business' interest expense under the Proposed Regulations. Thus, for example, the interest attributable to the U.S. business is determined under the Proposed Regulations before Section 265 is applied to determine whether any of that interest is attributable to purchasing or carrying tax exempt obligations. There is no such rule in the existing Regulations, although this general approach is consistent with the interpretation given to those Regulations in a private ruling[11] and with proposed Regulations issued under Section 163(j).

While we agree with this rule, as a starting point, it does not provide an answer as to how to apply the provisions of the Internal Revenue Code that limit the deduction for interest that is allocable to the U.S. business of a foreign corporation under the Proposed Regulations. Provisions that limit the deduction of interest generally determine the tax status of interest expense on the basis of either the identity of the payee of the interest or the purpose for which the particular funds were borrowed. What is needed, therefore, is a rule which for the purposes of these provisions explicitly relates the interest expense that is attributed to the U.S. business under the Proposed Regulations to specific liabilities. The three-step process of the Proposed Regulations does not clearly do this.

We suggest that the booked liabilities of the U.S. business, determined under Prop. Regs. § 1.882-5(d)(2), and the

[11] See PLR 8509059 (December 3, 1984) which included tax exempt obligations in U.S. assets for purposes of applying Regs. § 1.882-5 and then applied Section 265 to the interest expense determined under Regs. § 1.882-5. See also G.C.M. 39339 (February 21, 1985). The ruling and General Counsel's Memorandum were, however, premised in part on Regulations, since changed, that included tax exempt assets in assets for Section 861 interest allocation and apportionment purposes; in addition, the ruling is unclear on how Section 265 was applied, stating only that there would be no disallowance unless there was a connection “between a particular borrowing of the U.S. branches, or the Taxpayer's home office or foreign branches” and the acquisition of the obligation.

interest thereon should be treated as the liabilities and the interest expense of the U.S. business, not only for the purpose of determining the amount of interest paid or accrued by the U.S. business under the Proposed Regulations, but also for other purposes, such as the application of provisions of the Internal Revenue Code that defer, disallow or capitalize interest, the determination of foreign tax credit limitations under Section 904 of the Internal Revenue Code,[12] and, with the appropriate modifications, the application of the branch profits tax and the branch level withholding tax on interest.[13] Thus, for example, the interest disallowed under Section 265(a) of the Internal Revenue Code would be determined on the basis of whether booked liabilities were incurred or continued to purchase or carry tax-exempt obligations, Section 904 limitations would be calculated with respect to interest on such liabilities and Sections 163(e)(3) and 267(a)(3) would be applied to interest on obligations to related persons that were booked liabilities. As discussed below (see <u>Treatment of shares of stock -- Prop. Regs. § 1.882-5(b)(2)(iii)(B))</u>, the same rule would be used in applying Section 246A of the Internal Revenue Code, relating to the dividends received deduction allowed on debt financed portfolio stock.

This has the merit of simplicity. It is consistent with the proposal, set out in the Notice of Proposed Rulemaking, to conform the part of the branch profits tax Regulations relating to interest paid by a U.S. business to the Proposed Regulations (and thus with Prop. Regs. § 1.163(j)-8(c)) and also with the assumption of Prop. Regs. § 1.882-5(d)(3)(iv) that booked

---

12 Foreign corporations may be allowed a foreign tax credit under Section 906 of the Internal Revenue Code.

13 Another context might be the determination of cancellation of indebtedness income.

liabilities are the liabilities of the U.S. branch for purposes of determining foreign currency gain or loss under Section 988.[14]

Looking at booked liabilities will, of course, only deal completely with the rare case in which there is no difference between booked liabilities and the liabilities attributed to the U.S. business in step two. If booked liabilities are less than U.S. liabilities, the excess interest expense might, by analogy to Section 884(f)(1)(B) and Prop. Regs. § 1.163(j)-8(d), be treated as paid to a foreign parent corporation and, thus, to a related person for purposes of Sections 163(e)(3) and 267(a)(3). Since that could create related party interest where none in fact exists, however, we continue to think that it would be better to identify interest with specific unbooked liabilities.[15] If booked liabilities are greater, the scaling ratio of Prop. Regs. § 1.882-5(d)(3)(ii) could be applied and the interest expense attributed to any particular booked liability reduced accordingly.[16]

There are other approaches -- for example, if debt of a foreign corporation was held by a related party, Section 267(a)(3) might be applied by allocating to the U.S. business a portion of the accrued interest on that debt equal to the percentage of liabilities attributed to the U.S. business under

---

[14] See also Prop. Regs. § 1.882-5(d)(3)(iii) relating to notional principal contracts identified as hedges of booked liabilities. Cf. The reference in the Notice of Proposed Rulemaking to Regs. § 1.988-4.

[15] See New York State Bar Association Tax Section, Report on Temporary Branch Profits Tax Regulations (December 8, 1988), reprinted in Tax Notes Today (December 12, 1988) at 39-41 (the “Branch Profits Tax Regulations Report”); New York Bar Association Report on Section 163(j) of the Internal Revenue Code 47 Tax Notes 1495, 1507-1508 (June 18, 1990) (the “163(j) Report”)

[16] We reiterate the recommendations with respect to an “interest shortfall” in the Branch Profile Tax Regulations Report.

Prop. Regs. § 1.882-5(c)(1) and (2). There are, however, many difficulties with that approach -- principally, that it requires an inquiry into the worldwide liabilities of the foreign corporation.[17]

[4]. <u>Proposed Regulations Under Section 265 of the Internal Revenue Code</u>

The Notice of Proposed Rulemaking solicits comments on how Regulations to be proposed under Section 265 with respect to the disallowance of interest expense of a foreign corporation that is attributed in step three of the Proposed Regulations to its U.S. business should apply to income that is exempt under Section 894 of the Internal Revenue Code, relating to income exempt under an income tax treaty. Comments are specifically invited on whether the amount of the disallowed interest expense should always be at least equal to the amount of interest allocated under the Proposed Regulations to the assets that produce such income. A few older income tax treaties eliminate U.S. tax on foreign source income that is effectively connected with a U.S. business.[18]

If a foreign bank or other foreign corporation earns interest that is not taxable solely because the income, although effectively connected with its U.S. business, is exempt under an income tax treaty, the interest income would seem not to be on

---

[17] In addition, (1) it is not clear that this rule can be applied in a case where a fixed ratio is elected under Prop. Regs. § 1.882-5(c)(3), (2) such a rule must be integrated with the proposed Regulation under Section 163(j) discussed above,(3)it is not clear how Section 267(a)(3) itself can be applied if the interest payment is not U.S. source and not subject to U.S. tax in any event and (4) the rate of interest used to determine the interest deduction of a branch bears no relationship to the interest paid on any particular home office borrowing.

[18] For example, Article III(1)(a) of the U.S.-Swiss tax treaty. <u>See</u> Rev. Rul. 74-63, 1974-1 C.B. 374.

"obligations the interest on which is wholly exempt from the taxes imposed by" the Internal Revenue Code. If so, neither Section 265(a)(2) nor Section 265(b) would apply to interest income that was exempt under Section 894. The only disallowance under Section 265 would be under Section 265(a)(1), relating to interest and other expenses allocable to tax exempt "income other than interest" that is "wholly exempt" from tax under the Internal Revenue Code. It is unclear whether income that is exempt under a treaty is exempt income for this purpose and thus whether even Section 265(a)(1) would apply.[19] In any event, because Section 265 would at most apply to expenses allocable to non-interest income, we think a better approach would be to exclude assets that produce income exempt under Section 894 from the definition of U.S. assets for purposes of step one (or, alternatively, include such assets in U.S. assets, assuming that they otherwise meet the definition, and allocate and apportion the interest expense determined in step three under the Section 861 regulations, but without regard to Section 864(e)(3)). <u>See Coordination with Regulations under Sections 884 and 861 above.</u>

[5]. <u>Effect on income tax treaties and rejection of the "separate entity" approach -- Prop. Regs. § 1.882-1(a)(3)</u>

Prop. Regs. § 1.882-5(a)(3) provides that the Proposed Regulations "also apply for purposes of determining the interest expense attributable to [the] business profits of a permanent

[19] <u>See</u> Regs. § 1.265-1(b), which looks to the "class" of income, not the identity of the recipient, to determine whether Section 265 applies.

establishment under U.S. income tax treaties", citing two published rulings to the same effect.[20] In effect, the Proposed Regulations reject the so-called "separate entity" approach, which would treat the U.S. business as a separate U.S. corporation and give effect to interoffice and interbranch transactions, as a method for determining the U.S. interest expense of a foreign corporation that is covered by a tax treaty that includes the typical permanent establishment provisions.[21]

Although the two published rulings have been questioned by taxpayers and have never been reviewed by a court, the conclusion that the Internal Revenue Code, rather than any treaty provision, governs the deductibility of interest and other expenses of a foreign corporation is supported by the Conference Report to the Omnibus Budget Reconciliation Act of 1987, as one

---

[20] Rev. Rul. 85-7, 1985-1 C.B. 188, which held that the existing Regulations applied to determine deductible interest expense under Article 8(3) of the U.S.-Japanese treaty; and Rev. Rul. 89-115, 1989-2 C. B. 130, which held that the existing Regulations applied to determine deductible interest expense under Article 7(3) of the U.S.-U.K. treaty. Prior to the issuance of the existing Regulations, the Internal Revenue Service reached the same result under the U.S.-Japan treaty in Rev. Rul. 78-423, 1978-2 C.B. 194.

[21] The treaty language that forms the basis of the separate entity approach is the language which limits the tax on the profits of a permanent establishment to

> the profits which it might be expected to make if it were a distinct and separate enterprise . . . dealing wholly independently with the enterprise of which it is a permanent establishment.

E.g., Convention for the Avoidance of Double Taxation, Dec. 31, 1975, U.S.-U.K., Art. 7, ¶2.

of the rulings points out.[22]

Consistent with the rejection of the separate entity approach under income tax treaties," Prop. Regs. § 1.882-5(b)(1)(iii) provides that interbranch and interoffice transactions do not create assets, Prop. Regs. § 1.882-5(c)(2)(ii)(B) provides that interbranch or interoffice transactions do not create either assets or liabilities and Prop. Regs. § 1.882-5(d)(2)(iv) provides that interbranch and interoffice transactions do not create liabilities.[23]

Except as may be required by Section 884 of the Internal Revenue Code, it is unquestionably true that the Internal Revenue Service is not required to treat the U.S. business of a foreign corporation as a separate entity or to recognize interbranch and interoffice transactions, but we think it would be worthwhile to consider whether separate entity treatment is an appropriate way to determine the interest expense of the U.S. business, as well as for other purposes such as determination of the U.S. business' income from, notional principal contracts.[24] This may be particularly appropriate when the foreign corporation is a bank

---

[22] Rev. Rul. 89-115, which refers to H.R. Rep. 495, 100th Cong. 1st Sess., p. 984 (1987). In the course of discussing Section 842(b), relating to the taxation of the net investment income of foreign insurance companies, the Conference Report says in part that

> the conferees believe that the current regulatory provisions for determining liabilities allocable to a foreign corporation's U.S. business are fully consistent with the treaty obligations of the United States.

[23] See also Regs. § 1.884-4T(b)(4). We note that these three statements, if retained, could usefully be combined into a single statement.

[24] See Regs. Section 1.863-7T(a)(1) and Prop. Regs. Section 1.446-4(c)(1)(i) which provide that there can be no notional principal contract between a taxpayer and a qualified business unit or among qualified business units.

or insurance company and its U.S. branch is therefore subject to U.S. regulatory requirements.

As a matter of policy, why should there be an objection to treating the U.S. business of a foreign corporation as a separate entity for the purpose of determining interest expense so long as that entity is treated as having adequate equity, in relation to third-party liabilities, and interbranch loans and other transactions must be on arm's-length terms? The enactment of Section 884 in 1986 recognizes branches as separate entities for purposes of withholding on interest and taxing branch remittances;[25] in recognition of the virtual impossibility of not to some extent treating branches as separate entities, the Proposed Regulations permit the liabilities of a U.S. business to be determined by use of a fixed ratio and require the rate of interest on those liabilities to be determined by the booked liabilities of that business;[26] and Prop. Regs. § 1.163(j)-8(d) treats “excess interest”, as defined in Regs. § 1.884-4T(a), as interest paid to a related party for purposes of Section 163(j).[27] It is not clear to us why recognition of interbranch deposits is not to some degree consistent with the “general domestic law of the United States”, the phrase used in Rev. Rul. 85-7 to describe the relevant law, and hence might not be an

[25] The enactment in 1987 of Section 842(b), requiring the U.S. branches of foreign insurance companies to earn a minimum yield on its U.S. assets also in a sense treats U.S. branches as separate corporations.

[26] In the case of a foreign government, moreover, the determination of liabilities, as well as interest rate, is made on the basis of booked liabilities, limited to 80% of the value of the U.S. assets.

[27] As noted, the Tax Section has twice objected to this proposed § 163 interpretation and continues to favor the alternative approach it recommended. See its report on S 163(j), dated March 14, 1990, at pp. 44-52, and its report on the proposed § 163(j) regulations, dated October 23, 1991, at pp. 38-45.

appropriate method, if used on a consistent basis to calculate the income of a foreign corporation's U.S. business.

[6]. Foreign, governments -- Prop. Regs. § 1.882-5(a)(4)

Prop. Regs. § 1.882-5(a)(4) provides that the U.S. interest expense of a foreign government is the interest expense on booked liabilities, as defined in Prop. Regs. § 1.882-5(d)(2), but that booked liabilities may not exceed 80% of the value of the U.S. assets determined in step one and that interest on booked liabilities in excess of that amount is not deductible against effectively connected income. We have no comments on the substantive approach of this provision (which reflects the different circumstances of foreign governments) except to note that it is markedly different from that applicable to other foreign corporations since it assumes no debt financing except to the extent of booked liabilities of the U.S. business but on the other hand recognizes booked liabilities as U.S. liabilities without regard to the foreign government's worldwide liabilities.[28]

On a technical level, we recommend that (1) a “foreign government” for purposes of Prop. Regs. § 1.882-5(a)(4) be defined in any final Regulations by reference to Section 892 of the Internal Revenue Code (but that it exclude any “controlled commercial entity”);[29] (2) the Proposed Regulations deal with a case in which the U.S. business of the foreign government, as so defined, is a banking, financing or similar business for purposes

[28] Booked liabilities and liabilities secured by U.S. assets, up to 80% of U.S. business assets, are also used to determine the interest expense of the U.S. business of a nonresident alien individual or nonresident estate or trust. See Regs. § 1.861-9T(d)(2).

[29] “Controlled commercial entities” would be subject to the same rules as any foreign corporation.

of the fixed ratio available to such businesses under Prop. Regs. § 1.882-5(0)(3); and (3) the Proposed Regulations apply a scaling ratio similar to that in Prop. Regs. § 1.882-5(d)(3)(ii) to a case where booked liabilities exceed 80% in value of the foreign government's U.S. assets.

Since a determination that a liability is not a booked liability eliminates any deduction for interest on that liability for purposes of Prop. Regs. § 1.882-5(a)(4) (as opposed to simply affecting the rate of interest), we also question whether the authority given to the Internal Revenue Service to exclude liabilities from booked liabilities should be as broad for this purpose as for purposes of Prop. Regs. § 1.882-5(d)(2) -- for example, whether the presumptive exclusion of liabilities that bear interest at a rate more than 3 percentage points higher than the adjusted Federal rate should apply.

As noted below (see General rule under Determination of U.S. assets -- Proposed Regulations S 1.882-5 (b)), it could be usefully stated that the U.S. assets of a foreign government do not include assets that produce income that is excluded from gross income by Section 894 of the Internal Revenue Code.

[7]. Determination of U.S. assets -- Proposed Regulations § 1.8825(b)

Prop. Regs. § 1.882-5(b) sets out a methodology for determining U.S. assets and the value thereof – that is, the first step of the three-step process.

As a general rule, an item is classified as a U.S. asset only if that item is classified as a U.S. asset for purposes of the branch profits tax by Regs. § 1.884-1T(d). That Regulation sets forth, in subparagraphs (2)-(12), certain categories of assets that are considered to be U.S. assets and, in addition, includes as U.S. assets property if all income from the use, and all gain from the disposition, of the property is effectively connected income (or would be if sold). Prop. Regs. § 1.882-5(b)(1)(ii) then makes modifications to this general mile.

In general, the Committee favors conformity of the definition of U.S. assets for branch profits tax purposes and for purposes of the Proposed Regulations,[30] but we have a number of comments on the general rule and on the modifications.

General rule

With respect to the general rule, the treatment of assets that produce income that is excluded from gross income, such as obligations described in Section 103 of the Internal Revenue Code, could usefully be clarified.

Prop. Regs. § 1.882-5(a)(2), which applies the Proposed Regulations before Section 265, implies that obligations described in Section 103 of the Internal Revenue Code are included in U.S. assets. This was at one time the view of the Service under existing Regulations,[31] but the question is confused by Section 864(e)(3), which disregards tax-exempt assets for purposes of allocating interest expense under Section 861.[32]

---

[30] The existing Regulations treat as U.S. assets “assets of the corporation that generate, have generated, or could reasonably have been or be expected to generate” effectively connected income, and thus do not pick up any of the modifications of the branch profits tax Regulations.

[31] See PLR 8509059 (December 3, 1984) and G.C.M. 39339 (February 21, 1985). discussed above.

[32] See also Regs. § 1.861-8T(d).

If Section 265 is to be applied after the Proposed Regulations, which we believe is the only way that it can be applied properly, then obligations described in Section 103 should be included in U.S. assets if they otherwise meet the requirements of Prop. Regs. § 1.882-5(b).

Assets that produce income which is exempt from U.S. tax under an income tax treaty (and thus under Section 894) could, as previously noted (see Proposed Regulations under Section 265 of the Internal Revenue Code above), be treated in one of two ways. Final Regulations might exclude such assets from the definition of U.S. assets in step one. Alternatively, assets that produce income which is exempt from U.S. tax under Section 894 might be treated as U.S. assets in step one, assuming that they otherwise qualify, and the Section 861 interest allocation and apportionment Regulations then applied to the interest expense determined in step three in order to allocate (and disallow a deduction for) a part of the interest expense to those assets. The results may differ, since the amount of U.S. liabilities determined in step two will differ and this may affect the rate of interest in step three. While the alternative of including assets that produce income that is exempt from U.S. tax under Section. 894 may be conceptually better (since the income produced by such assets is effectively connected with a U.S. business), it would require separate Section 861 interest allocation and apportionment Regulations which in effect disregard Section 864(e)(3) in allocating and apportioning the interest expense of a foreign corporation.[33] Excluding such

[33] Since Section 265 will at most have only limited application to interest allocated to those assets (as discussed above under Proposed Regulations Under Section 265 of the Internal Revenue Code). including such assets in U.S. assets, and then applying Section 265 rather than the Section 861 interest allocation and apportionment Regulations, is not a realistic alternative.

assets from U.S. assets would, on the other hand, be consistent with the view of the Internal Revenue Service under the existing Regulations.[34]

In the case of assets that produce income which is excluded from gross income under Section 883(a), Prop. Regs. § 1.882-5(b)(1)(ii)(A)(2) excludes from U.S. assets any asset that produces income described in Sections 883(a)(3) and (b), relating respectively to income derived from railroad rolling stock and communications satellite systems, and the cross reference in Prop. Regs. § 1.882-5(b)(1)(i) to the branch profits tax Regulations excludes assets that produce income described in Sections 883(a)(1) and (2), relating to income derived from the international operation of ships and aircraft.[35] We believe that this is the right rule, and we think it should also apply to assets of a foreign government that produce income which is excluded from gross income under Section 892. While it might also be possible to include such assets, and then apply the Section 861 interest allocation and apportionment Regulations, that would require foreign corporations and governments to make seemingly unnecessary calculations. The full value of any obligations described in Section 133 of the Internal Revenue Code should be included in U.S. assets if they otherwise meet the. Requirements of Prop. Regs. § 1.882-5(b). While 50% of the interest on such loans is excluded from income, there is no disallowance under Section 265 of interest on debt incurred or continued to purchase or carry such obligations, since the interest is not wholly exempt from tax. Exclusion of the tax-exempt portion from U.S. assets would therefore put a foreign corporation in a worse position than a U.S. corporation that owned such an obligation.

---

[34] See PLR 8509059 (December 3, 1984) and 6.C.M. 39339 (February 21, 1985).

[35] See Regs. § 1.884-1T(f)(2).

Modifications

The first modification to the general rule in Prop. Regs. § 1.882-5(b)(1)(i) provides that an asset described in Section 897(c)(1)(A)(i) (i.e., Regs. § 1.884-1T(d)(5)) shall be excluded from U.S. assets except in the year that gain or loss is recognized from the asset under Section 897(a)(1). Section 897(c)(1)(A)(i) includes all United States real property interests other than stock of domestic corporations ("United States real property holding corporations") treated as United States real property interests tinder Section 897 (c)(1)(A)(ii).

The exclusion of Section 897(c)(1)(A)(i) assets should apply only to real property, such as undeveloped land, that is not otherwise used in a U.S. trade or business or generating effectively connected income.[36] A factory, or rental real property held in a rental business, should not be excluded from U.S. assets; likewise, the premises of the U.S. trade or business (e.g., the office building used by a foreign corporation) should be included in U.S. assets. In addition, U.S. assets should include real property with respect to which a net election has been made pursuant to Section 882(d) (or pursuant to an applicable income tax treaty provision) to treat income from the property as effectively connected income. This would be consistent with Prop. Regs. § 1.882-5(b)(1)(ii)(B), which classifies as U.S. assets other assets that produce income treated as effectively connected income (pursuant to Sections 921(d), 926(b), 897(c)(1)(A)(ii) in the year of sale,

[36] Dividends paid by a United States real property holding corporation ordinarily would not be effectively connected income, but in the event they, are effectively connected the stock of the distributing corporation should similarly be considered a U.S. asset, subject to Prop. Regs. S 1.882-5(b)(2)(iii)(B).

953(c)(3)(C) or 882(e)). The final Regulations should reflect these changes.

[8]. Value of U.S. assets -- Prop. Regs. § 1.882-5(b)(2)

The next paragraph of the Proposed Regulations, paragraph (b)(2), is entitled "Determination of value of a U.S. asset" and provides, as a general rule, that the relevant value of a U.S. asset is its adjusted basis for determining gain or loss but with a cross-reference to the election under Prop. Regs. § 1.882-5(c)(2)(iii)(A) to use fair market value in calculating the actual ratio in step two.

Prop. Regs. § 1.882-5(b)(2) sets forth in subparagraphs (11) and (iii) some "exceptions" to the general rule. We wonder why these exceptions are contained in paragraph (b)(2) relating to value, rather than in paragraph (b)(1).[37] In fact, the first of these exceptions, for marketable securities treated as U.S. assets solely by reason of Regs. § 1.884-1T(d)(11) (relating to expansion capital), does not speak in terms of value but states that such a marketable security is not treated as a U.S. asset. The next exception, for assets described in Regs. § 1.884-1T(d)(2)-(10) and (12), does speak in terms of value. Rather than treating such assets only partially as U.S. assets, these assets are treated as U.S. assets but at a reduced value.

Of more significance, we question the exclusion from U.S. assets of marketable securities treated as U.S. assets solely by reason of Regs. § 1.884-1T(d)(11). It is true that these assets may not actually be held in the U.S. trade or

[37] We applaud the clarity of the use of the common term "adjusted basis" as contrasted with the less common term "tax book value" used in the existing Regulations and in Regs. S 1.861-9T(g).

business and, as indicated in the Notice of Proposed Rulemaking, are funded by capital. Under Regs. § 1.884-1T(d)(11)(ii), however, the income from these securities is treated as effectively connected income for income and branch profits tax purposes. Consistent with Prop. Regs. § 1.882-5(b)(1)(ii)(B), these marketable securities should be treated as U.S. assets to the extent they are treated as generating effectively connected income. The same treatment should apply to marketable securities described in Regs. § 1.884-2T(b) (relating to the investment of the proceeds of a complete termination of the U.S. trade or business in marketable securities), since the same income tax rules apply to both classes of marketable securities.[38]

[9]. Election to use fair market value

If an election is made under Prop. Regs. § 1.882-5(c)(2)(iii)(A) to use fair market value for purposes of the actual ratio in step two, fair market value must be used for both U.S. and foreign assets. What is unclear, and might usefully be clarified, however, is whether an election to use fair market value to value U.S. assets may be made in step one without obligating the foreign corporation to use the actual ratio and fair market value in step two and, conversely, whether an election to use the actual ratio and fair market value in step two requires the foreign corporation to use fair market value to value U.S. assets in step one. We believe that the use of fair market value to value U.S. assets in step one should not commit a

[38] We note that Prop. Regs. § 1.882-5(b)(2)(iii)(B), which reduces the value of stock that is treated as a U.S. asset by the proportion of the dividends that qualify for the dividends received deduction, presumably applies only to nonmarketable stock, since marketable securities are treated as U.S. assets pursuant to Reg. § 1.884-1T(d) (8) only if all the dividends are effectively connected income.

foreign corporation to the use of the actual ratio and fair market value in step two (since the burdens of determining fair market value in the two steps are quite different), but that a foreign corporation which does elect to use fair market value in step one must use fair market value in step two if it elects to use the actual ratio (in order that assets be valued on a consistent basis) and that (for the same reason) a foreign corporation that elects to use the actual ratio and fair market value in step two should be required to use fair market value in step one.

[10]. Treatment of shares of stock -- Prop. Regs. § 1.882-5(b)(2)(iii)(B).

Prop. Regs. § 1.882-5(b)(2)(iii)(B) provides that the value of shares of stock that are treated as a U.S. asset is the percentage of the value equal to the result of dividing (i) the amount of the dividends, after reduction for any dividends received deduction, that are effectively connected income, by (ii) the total dividends paid on the shares during the year. For example, if all dividends paid on a share during the year were effectively connected income and eligible for the 70% dividends received deduction, only 30% of the value of the share would be treated as a U.S. asset. It seems to us that this is wrong for several reasons[39].

First, in the case of dividends paid on “portfolio stock”, the rule is inconsistent with Section 246A of the Internal Revenue Code since it in effect converts the reduction in the dividends received deduction provided for in that Section into a rule that treats all portfolio stock as debt-financed and

[39] For most foreign corporations, of course, dividends will not ordinarily be effectively connected income.

disallows the part of the interest expense attributable to the dividend eliminated by the dividends received deduction.[40] Section 246A requires that indebtedness be "directly attributable" to the ownership of shares of stock; it does not provide for an automatic reduction in the dividends received deduction whenever there is indebtedness, and we do not think that it is appropriate to reach that result only for foreign corporations through the partial exclusion of portfolio stock from the definition of U.S. assets.[41] As in the case of obligations described in Section 103 of the Internal Revenue Code, the full value of portfolio stock should be included in U.S. assets, assuming that it otherwise meets the definition in Prop. Regs. § 1.882-5(a), and Section 246A should then be applied, on the basis of booked liabilities, to determine whether there is a reduction in any dividends received deduction.

Apart from its inconsistency with Section 246A, we do not see why the value of shares of stock should be reduced by the dividends received deduction. If a U.S. corporation were to purchase shares of stock of another U.S. corporation with the proceeds of a loan, the interest on that loan would be deductible without regard to the fact that a dividends received deduction was available. Why should the rule be any different if a foreign corporation made the purchase?

In addition, as written, Prop. Regs. § 1.882-5(b)(2)(iii)(B) would completely exclude shares of stock from U.S. assets in a year in which no dividends were paid, regardless

[40] Indeed, it is possible that this rule applies <u>after</u> Section 246A and as a consequence applies only in a case in which the portfolio stock is <u>not</u> treated as debt-financed for purposes of that Section.

[41] In addition, the amount of the disallowance under the Proposed Regulations and under Section 246A may differ.

of whether any part of the dividends would, if paid, be eligible for the dividends received deduction. In such a case, both the numerator and the denominator of the ratio for determining the value of the shares would be zero. This seems to be a mistake.

[11]. Frequency of valuation -- Prop. Regs. § 1.882-5(b)(3)

Prop. Regs. § 1.882-5(b)(3) provides that the total value of U.S. assets is the average of the sums of the values computed at the most frequent, regular intervals for which data are reasonably available (and in no event less frequently than quarterly). This language differs slightly from existing Regs. § 1.882-5(a)(4), which requires computations at the most frequent, regular intervals for which data "for all assets" are reasonably available. In the case of a foreign corporation that is not a bank, we think it is unreasonable to require valuation of non-marketable assets no less frequently than quarterly. As Example 1 illustrates, this may impose on a foreign corporation the obligation to value real estate and other assets not easily susceptible to valuation.[42] The interest allocation and apportionment Regulations permit an average of beginning and end of year values unless that results in a "substantial distortion",[43] and we would favor the use of that rule in a case where more frequent valuations for all assets are not available.

The new language of Prop. Regs. Section 1.882-5(b)(3) also presumably permits (and, in fact, may require) taxpayers to value marketable assets more frequently than other assets, which does not appear to be permitted under the existing Regulations.

---

[42] Regs. § 1.882-5(f), Example 1.

[43] Regs. § 1.86l-9T(g)(2)(i).

[12]. Determination of U.S. liabilities -- Prop. Regs. § 1.882-5(c)

Prop. Regs. § 1.882-5 (c) sets out the rules for determining the U.S. liabilities of the U.S. business — that is, the second step.

In general, a foreign corporation may determine the liabilities of its U.S. business by multiplying U.S. assets times the ratio of its worldwide liabilities to assets (the so-called actual ratio method) or, at its election, by a fixed ratio. In the case of a corporation engaged in a banking, financing or similar business (as defined in Regs. § 1.864-5(c)(i)), the fixed ratio is 93%,[44] and the actual ratio of a bank (as defined in Section 585(a)(2)(B)) cannot exceed 96%;[45] in the case of other foreign corporations (except for foreign governments and foreign insurance companies), the fixed ratio is 50% but there is no limit on the actual ratio. Once elected, the fixed ratio must be used thereafter until the Internal Revenue Service consents to a change.

Prop. Regs. § 1.882-5(c)(1) requires a "valid and timely" election to use the fixed ratio. It is not clear what this means and, in view of the disputes under the existing Regulations as to whether banks filing returns on the basis of the separate entity approach could on audit assert the right to use the fixed ratio, the final Regulations should clarify by when the election must be made (and, possibly, whether "protective" elections will be given effect).

---

[44] In the Regulations originally proposed in 1980, the fixed ratio for foreign corporations engaged in a banking, financing or similar business was 90% but this was increased to 95% in response to comments.

[45] It is not clear why different definitions of a financial institution apply for purposes of the fixed ratio and the "cap" on the actual ratio -- both seem to be based on the same regulatory provisions.

Actual ratio -- Prop. Regs. § 1.882-5(c)(2).

A foreign corporation that determines U.S. liabilities in step two by use of the actual ratio must determine the total amount of its worldwide liabilities and of its worldwide assets. These must be determined Min conformity with U.S. tax principles”;[46] unless fair market value is elected, the assets must be valued at adjusted basis for U.S. income tax purposes; values (whether based on adjusted basis or fair market value) must be computed at the most frequent, regular intervals for which data is reasonably available but not less than quarterly (and not less than monthly in the case of a large bank, as defined in Section 585(c)(2)); the adjusted basis of shares of a 20% or greater owned foreign subsidiary must be adjusted to reflect its earnings and profits; and foreign currency amounts must be translated into U.S. dollars using the spot rate on the valuation date. If fair market value is elected, it must be established to the satisfaction of the Internal Revenue Service (or the corporation will be required to use adjusted basis) and must be determined in accordance with the rules set out in Regs. § 1.861-9T(g).

If a foreign corporation's U.S. operations represent only a fraction of its worldwide operations, the burden of these calculations is likely to make the use of the actual ratio impractical in almost every case -- it would, for example, require a foreign corporation that did not elect to use fair market values to restate according to U.S. tax principles the depreciation on all assets held on a valuation date and to conform its treatment for nondepreciable assets (such as

[46] See Prop. Regs. §§ 1.882-5(c)2(ii)(A) and -5(c)(2)(iii)(A).

goodwill) to U.S. tax rules. The Proposed Regulations are in this respect less flexible than the existing Regulations, which permit items to be classified “substantially” in accordance with U.S. tax principles. The only concession to complexity in the Proposed Regulations is the rule in Prop. Regs. § 1.882-5(c)(2)(iii)(C) which provides that the adjustment to the adjusted basis of the stock of any 20% or greater owned subsidiary may be made on the basis of financial statements distributed to shareholders if the foreign corporation would not otherwise calculate the U.S. earnings and profits of the subsidiary.[47]

[13]. Determination and valuation of assets and liabilities -- Prop. Regs. § 1.882-5(c)(2)(ii) and (iii).

Final Regulations should permit more flexibility in the calculation of the tax basis of the foreign assets of a foreign corporation that elects to use the actual ratio — for example, to account for selected items, such as depreciation, on the basis of financial statements. There would seem to be no objection to the use of different methods, on a consistent basis, so long as they do not understate, in comparison to U.S. tax rules, the amount of the foreign corporation's assets. Because of the wide variations in accounting practices, however, we do not think that the final Regulations should permit the actual ratio to be calculated

[47] This rule could be clarified in a number of respects. There is a reference to “financial statements provided to [the subsidiary's] shareholders” which leaves unclear what happens if the subsidiary is consolidated and prepares no such financials. Also, the reference should be to “shareholder”, not “shareholders”, so that it clearly covers a wholly owned subsidiary. Finally, we do not understand what is meant by the provision in Prop. Regs. § 1.882-5(c)(2)(iii)(C) that this adjustment is “noncumulative”.

entirely on the basis of financial or regulatory statements.

There should likewise be more flexibility in the direction in the Proposed Regulations to determine the amount of liabilities in accordance with U.S. tax principles -- for example, if debt is issued at a discount from, or a premium to, its face amount, must the discount or premium be amortized in accordance with U.S. tax rules or will another reasonable basis be accepted?[48] There would seem to be no objection to the use of different methods, on a consistent basis, so long as they do not overstate, in comparison to U.S. tax rules, the amount of liabilities.

Final regulations should also clarify whether the definition of liabilities refers only to liabilities in respect of which the foreign corporation may (subject to limitations such as Section 265 or 267) deduct interest or original issue discount or to all liabilities (including, for example, reserves or obligations under short sales, securities loan agreements and forward sale agreements). There is no single general definition of “liabilities” for Federal income tax purposes and the reference to “U.S. tax principles” is therefore not sufficient. Since booked liabilities logically include only liabilities that bear interest or original issue discount, it would seem consistent to include only such liabilities in the definition for purposes of step two.

[14]. Determination of Fair Market Value -- Prop. Regs. § 1.882-5(c)(2)(iii)(A)

[48] See. Regs. § 1.279-5(e)(1), which generally determines indebtedness in accordance with generally accepted accounting principles, and Regs. § 1.163(j)-3 which applies “generally applicable tax principles” to determine liabilities but includes specific rules for debt issued at a discount or a premium and includes anti-abuse rules.

As under the existing Regulations, a foreign corporation is permitted by Prop. Regs. § 1.882-5(c)(2)(iii)(A) to elect to use fair market value rather than adjusted basis to determine the value of its U.S. assets and worldwide assets. However, while the existing Regulations permit a taxpayer to use "[a]ny reasonable approach for determining fair market value" and, as appropriate, to use different approaches for different types of assets if consistently applied from year to year, the Proposed Regulations subject the valuation to Regs. § 1.861-9T(g)(1)(iii) and specifically incorporate the methodology of Regs. § 1.861-9T(h). While we do not object to imposing on foreign corporations the same burden of proof as to fair market value as applies to U.S. corporations under Regs. § 1.861-9T(g)(1)(iii),[49] we believe it is inappropriate to subject foreign corporations to the methodology prescribed by Regs. § 1.861-9T(h). This incorporates a large number of U.S. tax concepts and is geared to foreign tax credit calculations of U.S. corporations. The "any reasonable approach" formulation in the existing Regulations seems more appropriate.

Prop. Regs. § 1.882-5(c)(2)(iii)(A) also provides that, for purposes of computing the actual ratio, the value of a U.S. asset is not reduced or adjusted as provided in paragraphs (b)(2)(ii) and (iii), relating to expansion capital and assets that produce income that is only partially effectively connected with a U.S. business, although the value of these assets is reduced in determining U.S. assets in step one. Presumably this means that these assets are included at full value in determining the value of worldwide assets for purposes of step two. The

[49] As we noted, however, in Section III of our Report on Proposed Regulations Relating to the Allocation of Interest And Other Expenses for Foreign Tax Credit and Certain Other Purposes, dated December 18, 1987, we believe that guidance should be provided as to how a taxpayer may establish fair market value.

effect is that such assets are treated as non-U.S. assets rather than as assets totally excluded from the calculation (i.e., included in the denominator in full but only partially in the numerator rather than being excluded from both the denominator and the numerator). We assume this rule is necessary for these paragraph (b)(2) items but not for the items in paragraph (b)(1) because the former purport to be reductions in value of assets rather than exclusions from treatment as U.S. assets. Again, however, we wonder why it was necessary to phrase these paragraph (b)(2) items as reductions in value.

[15]. Elective six-month rule -- Prop. Regs, § 1.882-5(c)(2)(iv)(B)

Prop. Regs. § 1.882-5(c)(2)(iv)(B) permits a bank, as defined in Section 585(a)(2)(B), to determine its actual ratio on the basis of a hypothetical taxable year ending six months prior to the end of the taxpayer's actual taxable year.

Although the text of the Proposed Regulations implies the use of the actual ratio for a hypothetical taxable year, an example indicates that the actual ratio for any “large” bank making the election and making calculations on a monthly basis will in fact be calculated for any month by the actual ratio calculated for the seventh preceding month (for example, the actual ratio for January 1993 would be based on the calculation made for June 1992).[50] If this is intended, it could usefully be set out in the text of Prop. Regs. § 1.882-5(c)(2)(iv)(B), and the example could be expanded to show how the rule worked if a different valuation interval were used.[51]

---

50 Prop. Regs. § 1.882-5(f), Example 2.

51 In the example, the particular bank had also elected under Prop. Regs. § 1.882-5(d)(5) to compute U.S. assets on a daily basis. Since U.S. assets were assumed to remain constant, this had no consequences in the example – if they varied, however, we assume that the actual ratio would simply be applied separately to each day's amount.

According to the Notice of Proposed Rulemaking, the purpose of the election is to “aid banks in the pricing of their loans” -- presumably by giving them an elective means to determine the actual ratio that will apply at the time the loan is made. The elective six-month rule seems to us to be of limited utility, however, since it only affects the actual ratio for a particular monthly or shorter valuation interval -- it in effect permits a foreign bank to know, for one valuation period, one step in the three step process for determining the interest expense allocable to a loan. We question whether this is particularly useful.

[16]. “Cap” on Actual Ratio -- Prop. Regs. § 1.882-5(c)(2)(i)

The 96% limitation which Prop. Regs. § 1.882-5(c)(2)(i) puts on the actual ratio of a foreign bank should be eliminated. It undermines the premise of the Proposed Regulations that a foreign corporation's total liabilities and capital are properly allocable to the corporation's worldwide operations and has the potential to distort the true economic income of the U.S. business.

The Notice of Proposed Rulemaking suggests that the 96% cap is appropriate because United States banks are generally required to maintain equity at 4% of regulatory assets regardless of risk-adjusted asset levels.[52] We think that the fact that U.S.

[52] The requirement is actually 3% Tier I capital to regulatory assets. See 12 C.F.R. § 3.6 (national banks); 12 C.F.R. pt. 208, app. B (state chartered banks which are members of the Federal Reserve System); 12 C.F.R. § 325.3 (state chartered banks which are not members of the Federal Reserve System whose deposits are nonetheless FDZC insured); 12 C.F.R. pt. 225, app. D (bank holding companies). However, since these provisions provide that 3% is a minimum and that most U.S. banks must maintain a ratio 100 to 200 basis points above 3%, 4% probably is a proper figure.

banks are required to maintain certain capital standards is not a sufficient reason to allocate interest expense to the effectively connected income of the U.S. branch of a non-U.S. bank as if non-U.S. banks were subject to, and in fact met, the same standards.

First, non-U.S. banks whose U.S. presence is restricted to branch or agency operations do not need to meet capital maintenance standards for the bank as a whole or for the branch as a separate entity. For the protection of U.S. depositors, federal and state authorities do have the power to require that U.S. offices of non-U.S. banks enter into certain "asset maintenance agreements" or that they deposit assets, typically at a level of 5% of liabilities, with depositaries for the benefit of these authorities.[53] These provisions do not have the effect of allocating capital to U.S. operations, nor do they affect effectively connected income. Asset maintenance agreements typically require only that U.S. deposits booked by the branch be invested in assets within the branch's state of operation or within U.S. territory. However, assets subject to asset maintenance agreements are typically permitted at 100% of the level of such deposits. So-called "capital equivalency" deposit requirements as well do not have a capital maintenance effect. The assets deposited may be funded entirely from the branch's liabilities. The only income effect they may produce would result from the alteration of asset composition necessary to comply with provisions limiting assets eligible for deposit to certain high quality categories.[54]

---

[53] See, e.g., 12 C.F.R. §28.6; Cal. Fin. Code §§ 1761, 1762 and Cal. Code Regs. tit. 10, § 16101; N.Y. Banking Law § 202-b and N.Y. Comp. Codes R. & Regs. tit. 3, §§ 52.1 and 322.1.

[54] See, e.g., Cal. Fin. Code § 1761(a)(4).

Second, it might be argued that U.S. branches of non-U.S. banks should not be permitted to operate on an economic footing superior to that of their U.S. counterparts and should therefore be taxed as if they maintained the same capital as U.S. banks. This is a policy consideration, however, which should be addressed by Congress through legislation or a directive to those agencies charged with bank regulation to set appropriate capital adequacy requirements for non-U.S. banks operating in the U.S. through branches.[55] In the absence of specific capital regulation of the U.S. branches of non-U.S. banks, it is neither appropriate nor advisable for the Internal Revenue Service to attempt to influence the capital adequacy-of non-U.S. banks through interest allocation regulations, particularly when to do so undermines the goal that income attributable to the taxpayer's U.S. branch should reflect the branch's true economic income.

Last, we question the logic of the reason for the cap stated in the Notice of Proposed Rulemaking. Even if non-U.S. banks were required to maintain certain capital levels in order to operate a branch in the U.S., that fact is irrelevant to determining the economic income of the branch. Economic characteristics which the taxpayer does not possess should have no bearing on the accurate reflection of the income of the branch. In addition, since value for the purposes of the Proposed Regulations, which may be adjusted basis or fair market value, may differ from value for regulatory purposes, the 96% cap could operate to limit interest deductions even for a bank that was well within the regulatory requirements.

---

[55] We think it significant to note that Congress recently considered and rejected legislation which would have required non-U.S. banks operating in the U.S. solely through a branch or agency to comply with all regulatory requirements, including capital adequacy requirements, of the Bank Holding Company Act. See The Financial Institutions Safety and Consumer Choice Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (1991).

Aside from arguments based on the capital requirements of U.S. banks, we can imagine several other arguments which the Internal Revenue Service might put forth to support the cap. Conceivably, the Internal Revenue Service might argue that non-U.S. banks should report some minimum income for the privilege of operating through branches in the U.S., and that this minimum should be calculated by reference to U.S. capital levels. The decision to subject non-U.S. taxpayers to a minimum income requirement is, however, a policy matter which should be addressed, if at all, by Congress through appropriate legislation.[56]

The Internal Revenue Service might also believe that if the actual ratio as calculated under the Proposed Regulations is in excess of 96% that must be the result of some distortion of the economic position of the branch as a result of differences in the measurement of assets or liabilities under tax accounting versus bank regulatory methods. Effectively, the Service would be arguing that a liability level in excess of 96% somehow did not reflect the true economic liabilities of the U.S. branch. Although calculation differences do exist, we do not believe they justify the cap. To the extent that capital or assets may be measured differently for tax and regulatory purposes, unless those differences are identified and appropriate adjustments made, there is no particular reason to believe that the adjustments would have a greater effect on a U.S. branch than on the bank as a whole. To place an arbitrary cap on the U.S. branch's liabilities to account for some potential distortion ignores the fact that such distortion could exist equally in the calculation of the bank's worldwide assets.

---

[56] See Section 842(b), relating to foreign insurance companies.

[17]. Fixed ratios -- Prop. Regs. § 1.882-5(c)(3)

The elective fixed ratios are presumably provided in the existing and Proposed Regulations in recognition of the enormous difficulty of calculating actual ratios. Any taxpayer election is, from the Internal Revenue Service's point of view, a one-way street, but we think that under the circumstances it is particularly important that the fixed ratios reflect the liability levels of the group of taxpayers to which they apply.

Fixed ratio for nonbanks

Neither the Notice of Proposed Rulemaking for the existing Regulations nor that for the Proposed Regulations explain why the fixed ratio was fixed at 50% in the case of a foreign corporation that is not engaged in a banking, financing or similar business and is not a foreign government or a foreign insurance company and we are not aware of any studies that suggest 50% is right. It seems to us that a better rule would be to extend to those corporations the rule now available to nonresident alien individuals, foreign estates and trusts and foreign governments -- that is, to permit such a foreign corporation to elect, in lieu of an actual ratio, to treat booked liabilities as U.S. liabilities up to an amount equal to 80% of U.S. assets. The definition of booked liabilities and the 80% cap will put reasonable limits on the amount of U.S. leverage.

Reduction in fixed ratios of banks.

While we cannot say that it is unreasonable to reduce the fixed ratio for taxpayers engaged in a banking, financing or similar business from 95% to 93%, we think that in the final

Regulations the Internal Revenue Service should provide a mechanism for periodically reexamining that ratio.[57]

The Notice of Proposed Rulemaking explains that the reduction reflects developments in U.S. regulatory rules that implement the Basle Accord on bank capital standards (the “Basle Accord”). The Basle Accord is an agreement among bank regulatory and supervisory authorities of twelve leading nations, including the U.S., aimed at increasing and harmonizing the overall capital levels of banks worldwide. To this end, the Basle Accord requires that total equity, including, subject to certain limitations, subordinated debt, equal at least 8% of total risk-weighted assets,[58] and that at least one-half of total equity consist of so- called “core” capital elements such as common stock and non-cumulative perpetual preferred stock (Tier I capital). Other capital instruments having a lesser degree of permanence than Tier I capital (Tier II capital) may also be counted as equity subject to the foregoing limitation. For most of the Basle Accord's signatories, the requirements will be fully implemented by year-end 1992. Enforcement is the responsibility of each signatory's bank regulatory and supervisory authorities vis-a-vis the banks chartered within their jurisdictions.

We agree with the assumption of the Proposed Regulations that the fixed ratio for such taxpayers should reflect regulatory capital requirements in general and the Basle Accord in particular. Inasmuch as a significant number of non-U.S. banks operating in the U.S. through branches will be required to

---

[57] And, if it is retained, the 50% fixed rate.

[58] The agreement establishes risk-weight categories for all of a bank's assets and certain off-balance sheet items. Assets and on-balance sheet equivalents of off-balance sheet items are assigned risk-weight factors of 0%, 10%, 20%, 50% or 100% of face value depending primarily on the degree of credit risk associated therewith.

maintain worldwide capital to assets in conformity with the Basle Accord, we agree that it is an appropriate starting point for formulating the proper fixed ratio for taxpayers engaged in banking, financing or similar businesses. Several factors, however, should be considered in deriving an appropriate fixed ratio for this group of taxpayers from the basic Basle Accord capital requirements.

First, the Basle Accord capital requirements are calculated as a percentage of a bank's risk-adjusted assets. In deriving the proper capital levels, each bank must first determine its total risk-adjusted assets. Cash and certain direct government obligations deemed virtually free of credit risk do not require capital support under the Basle Accord. Other high quality assets are weighted at between 10 and 50 percent of face value, while all other assets, including commercial loans, are weighted at 100% of their full face value. Notably, off-balance sheet standby commitments are generally weighted at 100% of their face value. Thus, a taxpayer's capital requirements under the Basle Accord will differ from such levels calculated, as the Proposed Regulations require, under tax accounting principles depending upon the taxpayer's mix of cash, higher-quality assets and standby commitments to loans and other assets.

Second, the Basle Accord permits a bank to include subordinated debt having certain characteristics in Tier II capital. A bank may not, however, include in its Tier II capital that amount of subordinated debt which exceeds an amount equal to 50% of its aggregate Tier I capital. Thus, a bank with 4% Tier I capital can count toward Tier II capital subordinated debt with a face amount up to 2% of its risk-adjusted assets.

Third, the measurement of assets for tax and regulatory accounting purposes may differ. For example, a bank which chooses to finance assets through securitization may have such financings treated as sales for regulatory purposes while for tax purposes the assets remain on the bank's balance sheet.

Further, the Basle Accord is intended to set minimum capital levels for banks chartered in each signatory's country. Banks are expected to maintain, and presumably regulators will encourage maintenance of, higher capital levels consistent with a bank's asset mix.

The net effect of these factors on the liability-to-asset ratios as measured under tax principles of banks complying with the Basle Accord requirements is not clear. Starting, as the Notice of Proposed Rulemaking suggests that the Internal Revenue Service did, at 92% to reflect the basic Basle Accord total capital requirement, utilization of subordinated debt as part of total capital will increase the appropriate fixed ratio percentage, as will holdings of lower-risk assets which are weighted at 0% to 50% of face value. On the other hand, off-balance sheet commitments will reduce the appropriate figure, as will the fact that the Basle Accord requirements are absolute minimums and that banks will be encouraged to maintain capital levels higher than those requirements. Although we do not have any empirical data, we suspect that the most significant of these factors will be off- balance sheet commitments which non-U.S. banks have traditionally maintained at substantial levels compared to their U.S. counterparts.

Of the above factors, the Notice of Proposed Rulemaking suggests that the Internal Revenue Service has only attempted to account for the second, that is utilization of subordinated debt as part of a bank's Tier II capital, in arriving at the 93% figure. The Notice of Proposed Rulemaking explains that the 93% figure derives from a one percent adjustment as an allowance for subordinated debt levels which banks might maintain under the Basle Accord from the possible 2% of risk-adjusted assets permitted as subordinated debt for banks meeting the 4% Tier I requirement.

While we therefore cannot say that the 93% fixed ratio for taxpayers engaged in a banking, financing or similar business is unreasonable,[59] we suggest that the Internal Revenue Service revisit this question if, in time, empirical data suggest that the 93% figure materially differs from actual liability levels of banks meeting the Basle Accord targets calculated, as the Proposed Regulations require, as a percentage of assets determined on the basis of tax accounting principles. The authority to readjust the fixed ratio, upwards or downwards, should be retained in the final Regulations themselves so that it is not necessary to amend the Regulations in order to effect such a change.

Determination of interest expense attributable to U.S. liabilities -- Prop. Regs. §, 1.882-5 (d)

Prop. Regs. § 1.882-5(d) determines the interest expense that is paid on the liabilities of the U.S. business as determined in step two — that is, step three. Under the existing Regulations this may be done by either the separate currency pools or branch book/dollar pool method; the Proposed Regulations

[59] Although the Basle Accord capital requirements are not applicable to non-bank financing entities which are not regulated by a country's bank regulators, it is probably not feasible to attempt to distinguish such businesses from banks for purposes of determining the fixed ratio.

eliminate the separate currency pools method and make significant changes in the branch book/dollar pool method.

[18]. <u>Elimination of Separate currency. Pools Method</u>

The Committee agrees with the elimination of the separate currency pools method for the reasons set forth in the Notice of Proposed Rule Making -- principally, that: H[t]he availability of currency swaps permits fungibility among currencies to be achieved (thereby undermining the underlying assumption of the method), as is evident by the fact that a true interest rate can be ascertained only by determining the effect of all interest rate and currency swaps."

<u>Changes to the Branch Book/Dollar Pool Method</u>

Under step three, the interest expense allocable to effectively connected income is the interest actually paid or accrued on the "booked liabilities" of the U.S. business for the taxable year, increased by a deemed interest expense of 90% (for banks) or 110% (for nonbanks) of the daily average LIBOR for the taxable year on any excess of U.S. liabilities (as determined in step two) over booked liabilities, or reduced by the ratio (called the "scaling ratio") that any excess of booked liabilities over U.S. liabilities bears to the booked liabilities.[60] The scaling ratio is also applied to any income (or expense) that is effectively connected income (or allocable thereto) on notional principal contracts identified as hedges of booked liabilities in accordance with Temp. Reg. § 1.861-9T(b)(6) and to any exchange gain (or loss) under section 988 that is

---

[60] Prop. Regs. §§ 1.882-5(d)(1); 1.882-5(d)(3)(i) and (ii); 1.882-5(d)(4).

effectively connected income (or allocable thereto) and is "attributable to" booked liabilities.[61]

A liability is a booked liability only if it is "properly reflected" on the books of the U.S. trade or business and is not a transaction between offices or branches of the same taxpayer.[62] For a liability to be properly reflected, there must be a "direct relationship", as a factual matter, between the liability and the U.S. trade or business (such as an account or note payable arising from the purchase of goods or services by such trade or business).[63] A liability secured predominantly by a U.S. asset for at least half the days during the portion of the taxable year that interest accrues thereon is "ordinarily" considered to meet the properly reflected test (unless the liability is secured by substantially all the foreign corporation's property), as is a liability of a foreign insurance company that is taken into account on an annual statement furnished to a state regulatory authority.[64] In addition, a liability of a U.S. branch or agency of a foreign bank is "ordinarily" considered to be a booked liability if either: (i) it is treated as a liability of the U.S. branch or agency for purposes of federal or state regulatory requirements or (ii) personnel of the U.S. branch or agency perform all the material

---

61 Prop. Regs. §§ 1.882-5(d)(3)(iii) and (iv).

62 Prop. Regs. §§ 1.882-5(d)(2)(i) and (iv).

63 Prop. Regs. §§ 1.882-5(d)(2)(ii) and (iii)(C).

64 Prop. Regs. §§ 1.882-5(d)(2)(ii)(A) and (B). We noted in our report on the branch profits tax regulation, at 37-39, that the parenthetical exception for liabilities secured by substantially all of the foreign corporation's property is overbroad. It would appear to apply, for example, even where the corporation has only one substantial asset, such as a building. We reiterate our view that this exception should be more carefully drawn.

activities required to incur the liability, and it funds a U.S. asset or the interest thereon is payable in the United States.[65]

On the other hand, unless the Internal Revenue Service determines otherwise, a liability is not considered to meet the properly reflected test if: (i) it is not entered on the books of the U.S. trade or business at a time "reasonably contemporaneous" with its incurrence; (ii) in the case of a bank, it bears interest at a rate more than 3 percentage points higher than the AFR (or its equivalent, if the liability is in foreign currency); (iii) it is directly incurred in the ordinary course of the foreign corporation's trade or business conducted outside the United States; (iv) it is predominantly secured by a non-U.S. asset for more than half the days during the portion of the taxable year that interest accrues thereon (unless the liability is secured by substantially all the foreign corporation's property); or (v) it is a liability of a nonbank taxpayer that is identified as a U.S. liability for purposes of the branch-level interest tax but does not qualify as a properly reflected liability under the criteria described in the preceding paragraph.[66]

The contemporaneous booking mile is too restrictive, particularly if, as the Notice of Proposed Rulemaking indicates, the rules of the Proposed Regulations are incorporated in the branch level interest tax regulations. By failing to enter the liability on the U.S. books in a timely manner, a liability which may clearly be allocable to the U.S. business may result in an excess interest tax under Section 884(f). Timeliness of booking should be a factor in the determination of whether there is the

---

[65] Prop. Regs. § 1.882-5(d) (2) (ii) (C).

[66] 66 Prop. Regs. § 1.882-5(d) (2) (iii).

necessary "direct relationship between the liability and the U.S. trade or business", but it is not unusual, particularly in the case of real estate investors, for the separate "U.S. books" to be prepared at year-end (even where there may be no significant home office assets or liabilities). Such a foreign corporation should not be required to obtain a special determination from the Internal Revenue Service to treat such a liability as a booked liability if the necessary direct relationship exists.

If booked liabilities denominated in a foreign currency are more than 10% greater or less than the U.S. assets of the U.S. trade or business in that currency (taking into account the effect of any forward contracts, futures, options, currency swaps and similar financial instruments the income or expense from which is effectively connected income or allocable thereto), and if the taxpayer is unable to show that such mismatch is representative of its worldwide position in that currency, the Internal Revenue Service is given the authority to scale back the booked liabilities in that currency (where they are greater than the assets) or apply to a portion of the U.S. liabilities a rate "analogous" to the LIBOR percentages mentioned above (where the booked liabilities are less than the assets).[67]

Comments on Step Three

The definition of booked liabilities is of great importance, not only because it may fix the rate of interest on liabilities determined in step two of the Proposed Regulations[68] but also because deductible interest in excess of interest on

---

67 Prop. Regs. § 1.882-5(d)(2)(v).

68 And, in the case of a foreign government, determines whether there is any interest expense at all. See also Regs. § 1.861-9T(d)(2), which applies a simple "entered on the books and records" test to liabilities of nonresident aliens and foreign trusts and estates.

booked liabilities is treated under the present branch profits tax and earnings stripping Regulations as paid to a related foreign corporation. In addition, although the point is unclear (and could usefully be clarified), the definition of booked liabilities in the Proposed Regulations may also be relevant to the determination of a foreign corporation's foreign currency gain or loss[69] and the source of its income or loss[70] and to the determination of the interest expense of a nonresident alien individual or foreign trust or estate that is connected with a U.S. business.

[19]. Need for Guidance, on Presumptive Exclusion

Given the importance of the definition of booked liabilities, we are concerned about the lack of guidance on the circumstances in which it is intended that the Internal Revenue Service override the presumption in the Proposed Regulations that certain liabilities are not properly reflected on the books of a U.S. trade or business even though, as a factual matter, they are directly related to such business. For example, if the interest on a long-term bank liability exceeds AFR plus 3 percentage points, the liability is presumptively excluded from the U.S. branch's booked liabilities even though it may in fact have been incurred, say, to acquire the branch's furniture, fixtures and equipment in the United States. The Internal Revenue Service has

69 See the statement in the Notice of Proposed Rulemaking that Foreign currency gain or loss is computed in respect of booked liabilities, as defined in the Proposed Regulations.

70 See Regs. § 1.988-4T(b), which determines the source of foreign currency gain or loss by reference to qualified business unit on whose books the asset, liability or item of income or expense is “properly reflected”, and Regs. § 1.861-9(d)(2)(i), which generally determines whether interest expense of a nonresident alien individual or foreign trust or estate is connected with a U.S. business by looking at whether the liability is “entered on the books and records of” the business “when incurred” or is secured by assets that generate effectively connected income.

the authority to include such a liability in the branch's booked liabilities, but no guidance is given as to whether that authority should be exercised in such a case. Similarly, if a U.S. bank branch borrows foreign currency at a rate higher than 3 points over the AFR equivalent in order to make loans in that currency at a still higher rate, it is completely unclear whether it is intended that the Internal Revenue Service override the presumption and include such a liability in the branch's booked liabilities. If the presumptive exclusion provision of the Proposed Regulations is indeed intended to exclude liabilities in these kinds of circum-stances, we believe that there is an issue as to whether it exceeds the Treasury's authority under Section 882(c)(1) to apportion and allocate expenses actually incurred by a foreign taxpayer.[71]

[21]. Use of Percentages of LIBOR

The use of a rate equal to 110% of LIBOR to impute interest to nonbank U.S. offices, instead of the foreign taxpayer's actual U.S. dollar borrowing rate as under the existing regulations, seems arbitrary and unfair. Considering the fact that the particular LIBOR used is a rate for demand deposits of highly creditworthy banks, it is likely that virtually all nonbank taxpayers will in fact be required to pay much higher interest rates on fixed term liabilities. To the extent that this provision effectively disallows a deduction for an interest expense that is actually incurred by a foreign taxpayer and is

---

71 While our main objection to Prop. Regs. § 1.882-5(d) (2) (iii) (B) centers on the notion that there should be any ceiling on the rate of deductible interest other than as provided in generally applicable Code sections, we also note that the ceiling chosen -- 3 percentage points over AFR – is substantially more restrictive than the ceiling under Section 163(i), which only applies to debt instruments with a maturity of more than 5 years and requires both a 5 percentage point spread and significant original issue discount before it defers or disallows a deduction for interest.

appropriately allocable to its U.S. trade or business, we believe that it exceeds the Treasury's authority under Section 882(c)(1).

Similarly, the use of 90% of LIBOR to impute interest to U.S. branches of foreign banks is likely to understate those banks' average cost of U.S. dollar funds. Although a substantial portion of their liabilities consists of non-interest-bearing demand deposits, those deposits are in the bank's local currencies and do not fund U.S. operations. We therefore suggest that both banks and nonbanks be permitted to use the actual average worldwide U.S. dollar borrowing rate to determine interest expense in excess of booked liabilities if such rate can be established to the satisfaction of the Internal Revenue Service and the foreign corporation has a significant amount of U.S. dollar liabilities outside of the United States (e.g., equal to at least 25% of their "excess" liabilities).[72] Where that is not the case, consideration should be given to a known rate that is less likely than 90% or 110% of LIBOR to understate interest expense.

[20]. "Matching" rule

While we understand the need for the matching rule in Prop. Regs. § 1.882-5(d)(2)(v), it seems flawed in several respects:

1. First, the rule compares liabilities to U.S. assets, which presumably means those assets determined in

[72] We also note that the LIBOR for demand deposits in U.S. dollars is not published in the general financial press and therefore would not be readily available at the time the calculation of the average rate would normally be made. In addition, the requirement that a daily average be computed is unduly burdensome. We suggest that, if LIBOR is used at all, the calculation be based on a generally published rate such as one month LIBOR, and that foreign corporations be permitted to calculate the rate based on a monthly rather than a daily average.

step one of the Proposed Regulations. It is extremely unlikely, however, that a foreign corporation would take the provisions of step one into account in economically balancing its assets and liabilities in a particular currency. For example, the corporation would not exclude part of the value of a share of stock as an asset because of the dividends received deduction, but this is the rule under Prop. Regs. § 1.882-5(b)(2)(iii)(B). Thus, in many cases a foreign corporation that is in fact economically matched on a worldwide basis would not be able to satisfy the matching rule of the Proposed Regulations. We suggest, therefore, that for purposes of the matching rule, the special modification provisions of Prop. Regs. §§ 1.882-5(b)(1)(ii) and (b)(2), to the extent retained, be disregarded and that the foreign corporation's assets be valued using whatever method is actually used by the foreign corporation in managing its currency positions unless such method is designed to produce a mismatch in the foreign corporation's U.S. office.

2. Second, by requiring that liabilities in each foreign currency be at least 90% of assets in that currency, the rule will force many nonbank foreign taxpayers, whose aggregate liability/asset ratio in all currencies is generally lower than 90% (as evidenced by the Proposed Regulations' use of a fixed ratio of 50%), to establish that their U.S. offices' mismatch is representative of their worldwide position. It would be preferable to set a lower threshold ratio (say, 45%) for nonbanks. In addition, the Proposed Regulations should make it clear that the taxpayer's worldwide position in a particular currency, as well as the position of its U.S. business, should be

determined by taking into account forwards, futures, options, swaps and similar financial instruments.

3. Third, the Proposed Regulations would appear to apply even where a U.S. office's liabilities in a particular currency, while unrepresentative of the foreign taxpayer's worldwide position in that currency, are closer in amount to the U.S. office's assets in that currency than is the taxpayer's worldwide position (e.g., where the worldwide ratio is 50/100 and the U.S. ratio is 70/100). No adjustment should be made in that type of situation. In addition, the Proposed Regulations should expressly provide that currency swaps and similar financial instruments not giving rise to effectively connected income are to be taken into account in determining the foreign taxpayer's worldwide position in a particular currency.

4. Fourth, no guidance is given on how to determine the currency denomination of a physical asset, corporate stock or any other asset that does not call for payment in a particular currency. The most appropriate rule would seem to be that the denomination would be the functional currency of the U.S. trade or business, which presumably would be the U.S. dollar.

[22]. Need for guidance on definitions

Some guidance (perhaps by way of examples) on the intended meaning of the words “ordinarily” in Prop. Regs. § 1.882-5(d)(2)(ii), “reasonably contemporaneous” in Prop. Regs. § 1.882-5(d)(2)(iii)(A) and “attributable to a booked liability” in Prop. Regs. § 1.882-5(d)(3)(iv), quoted above, would be helpful. How the last-mentioned provision (which scales back exchange gain or loss when interest expense on booked liabilities is scaled back) is intended to be applied is particularly uncertain, since it is apparent that the income and expense from more than just Section 988(d) hedging transactions (i.e., those where a hedge of a specific liability is contemporaneously identified by the taxpayer) are intended to be scaled back.[73]

In addition, the rule in Prop. Regs. § 1.882-5(d)(2)(ii)(C)(2) that “ordinarily” treats a liability as a booked liability if, among other things, U.S. personnel perform substantially all of the material activities required to incur the liability should be extended to foreign corporations other than banks.

[23]. Identified hedges

Since Prop. Regs. § 1.861-9T(b)(6) recognizes the identification of financial products as hedges only by entities that are not financial service entities, it would appear that bank branches would not be governed by Prop. Regs. § 1.882-5(d)(3)(iii), which scales back income or expense from such identified hedges. This may not have been intended, and should be corrected for purposes of section 882(c)(1).

[24]. Comments an Coordinating the Proposed Regulations with sections 884(f) and 864(c) m and Regs. §§ 1.884-4T(b)(6) and 1.988-1(a)(10)

73 We note that Prop. Regs. §§ 1.882-5(d)(3)(iii) and (iv) may create a disparity in the treatment of U.S. offices of foreign taxpayers and domestic taxpayers in similar circumstances, since the latter's income and expense from interest rate and currency swaps and similar instruments will always be fully taken into account in computing their taxable income (although such income and expense may be treated as interest for foreign tax credit purposes), whereas the former's income and expense from such instruments may be scaled back in computing their taxable income. Arguably, such a disparity may, in particular cases, violate the nondiscrimination provisions of U.S. treaties.

In response to the Treasury's request for comments on conforming the definition of “interest paid” for purposes of the branch-level interest tax under section 884(f) of the Code to the definition of booked liabilities under Regs. § 1.882-5, and on coordinating the scaling ratio of the Proposed Regulations with Regs. § 1.884-4T(b)(6), section 864(c)(7) of the Code and Regs. § 1.988-1(a)(10), we offer the following:

(a) It would clearly be desirable, from both a conceptual and a simplification standpoint, to conform the interest paid and booked liability definitions for purposes of sections 884(f) and 882(c)(1), respectively. It should be noted, however, that (i) interest relating to U.S. assets that is not deductible by virtue of rules other than those in the regulations under section 882(c)(1) should continue to be included in the definition of “interest paid”, as is now provided in Regs. § 1.884-4T(b)(iv), and (ii) nonbank U.S. offices should continue to have the option of identifying liabilities under the rules of Notice 89-90, 1989-2 C.B. 394, so as to qualify the interest on such liabilities as “interest paid” and thereby reduce the branch-level tax on so-called “excess interest”--the excess of interest deductible under section 882(c)(1) over the interest paid as otherwise determined.

(b) It would appear that any reduction of allocable interest expense under the scaling-back rule of the Proposed Regulations would automatically result in a reduction of interest paid under the existing provisions of Regs. § 1.884-4T(b)(6), and this result is obviously correct.

(c) We believe that scaling back the booked liabilities of a U.S. trade or business under the Proposed Regulations should not be viewed as a cessation of the use of property and/or a disposition of property by such trade or business for purposes of Section 864(c)(7), which taxes gain on a disposition of property within 10 years after it ceases to be used in a U.S. trade or business. (The “property” here would arguably be the scaled-back liabilities, presumably having a value because of a “low” interest rate, like bank core deposits.) Congress obviously did not have such scaling-back in mind when it enacted Section 864(c)(7). Furthermore, since a booked liability, by definition, bears a direct factual relationship to the U.S. trade or business, it will generally be scaled back only in three cases: (i) when the actual leverage of a banking branch exceeds the 96% cap in the Proposed Regulations, (ii) when a liability/asset mismatch in a foreign currency is not representative of the foreign taxpayer's worldwide position in that currency or (iii) when the U.S. liabilities of a bank or nonbank U.S. office are reduced by operation of the rules in step one excluding certain assets from the category of U.S. assets. In these cases, it cannot be concluded that scaling back is equivalent, in any economic sense, to a transfer of the scaled-back liabilities to fund assets acquired or held by the foreign taxpayer's other offices; the liabilities still fund the assets of the U.S. office, even though not all of such liabilities, or not all of the assets, are recognized under the Proposed Regulations.

(d) For the same reasons as stated in paragraph (c) above, we do not believe that scaling back should be viewed as a transfer of scaled-back foreign currency liabilities to a foreign taxpayer's other offices for purposes of recognizing exchange gain or loss on such liabilities under the interbranch transfer rule of Regs. § 1.988-1(a)(10).

[25]. Authority to make adjustments -- Prop. Reas. § 1.882-5(e)

Prop. Regs. § 1.882-5(e) gives the Internal Revenue Service general authority to "make appropriate adjustments to the computation of allocable interest expense (and to amounts related to interest, such as income or expense attributable to notional principal contracts and section 988 gain or loss related to liabilities) ... when necessary to reflect a transaction in accordance with its substance, to prevent evasion of taxes, or to reflect clearly the income of the trade or business".[74]

The two examples in the Proposed Regulations that illustrate this provision are certain to create uncertainty.

Example 3[75] deals with a back-to-back loan made by a foreign parent corporation to a U.S. subsidiary through a deposit by the foreign parent with the home office of a foreign bank and a loan by the U.S. branch of the bank to the U.S. subsidiary. It concludes that "for purposes of Step 2", the only net liability of the bank is the excess of the deposit over the loan and that this is not a booked liability of the U.S. branch.[76]

---

[74] The existing Regulations, in Regs. § 1.882-5(a) (6), include an abbreviated version of the same rule and illustrate this with an example in which a loan by a foreign branch of a foreign corporation is treated in substance as an asset of a U.S. branch

[75] Prop. Regs. § 1.882-5(f), Example 3, which seems to parallel situation 1 of Rev. Rul. 87-89, 1987-2 C.B. 195.

[76] If the example is retained, it might usefully be stated that the loan made by the U.S. branch is not an asset in step one and that the interest received by the U.S. branch is not its income.

Since this treatment is likely to be beneficial to the bank (assuming, as we have, that the interest income would also be excluded from the effectively connected income of the U.S. branch), it is unclear whether the Internal Revenue Service would ever exercise its discretionary authority other than in a case where the loan resulted in a loss (that is, an excess of interest expense over interest income). More fundamentally, we wonder whether it necessarily follows that the loan should be offset by the deposit for purposes of applying the Proposed Regulations because it is treated as back-to-back for purposes of determining the treatment of the foreign parent and its U.S. subsidiary. Loans may be treated as back-to-back for that purpose even though there is no right to offset the liability against the asset -- the test is simply whether the loan would have been made on the same terms without the deposit.[77]

The second example, Example 4, involves a loan that is not a U.S. asset for purposes of step one, because the U.S. branch had no involvement in the loan, but which is funded and subsequently serviced by the U.S. branch, and it concludes that "income representing a service fee is allocable to" the U.S. branch. It seems to us to be inconsistent with the notion that a branch is not a separate entity, which is a major premise of the Proposed Regulations, to impute a "fee" from one office or branch to another, and there is nothing in the substantive rule (as opposed to the example) that supports the use of Section 482-like allocations. The appropriate solution would appear to be to disallow a portion of the expenses incurred by the U.S. branch

[77] See Rev. Rul. 87-89, supra. stating that the issue is whether the loan by the branch "would have been made or maintained on substantially the same terms irrespective of the deposit" with the home office/that the absence of a right to offset is not conclusive and that there was a back-to-back loan where the deposit resulted in a reduction by 1% in the rate of interest on the loan.

that are allocable to the income earned on the loan.

[26]. Effective Date -- Prop. Regs. § 1.882-5(f)

While the Proposed Regulations would be effective for taxable years beginning after their adoption as final Regulations, the Notice of Proposed Rulemaking indicates that, among other things, the Proposed Regulations “clarify certain issues raised in the implementation of” the existing Regulations. We do not think that the Proposed Regulations should be regarded as interpreting and resolving issues under the existing Regulations (such as the determination of booked liabilities under Regs. § 1.882-5(b)(3)(i)).

In addition, it should be made clear that:

(a) elections made under the existing Regulations to use fixed rather than actual ratios and to use fair market value rather than adjusted basis in valuing assets do not carry over, and that all foreign corporations will be free to make such elections or not for the first year to which the Proposed Regulations apply;[78] and

(b) liabilities that would have been booked liabilities but for the contemporaneous booking rule will not be excluded from booked liabilities if incurred before the adoption of the Proposed Regulations as final Regulations (and, if appropriate, promptly identified after such adoption).

---

78 Thus, as noted above, in the absence of a new election, the foreign corporation would use its actual ratio and value assets by reference to their adjusted basis.

Consideration should be given to continuing to apply the rules in Regs. § 1.861-9T(e) to partnership investments that are made prior to the date that the Proposed Regulations are adopted as final Regulations.

[27]. Prop Regs. §§ 1.882-5 (a)(2) and (3)-- Investments in Partnerships

The existing Regulations apply the Section 861 interest allocation rules to determine the effect of investments in partnerships on the interest expense of a foreign corporation.[79] The Proposed Regulations would replace these with rules that are generally similar to those in the branch profits tax regulations.[80]

(a) Adjusted basis of partnership interests

The approach of the branch profits tax Regulations to determining the adjusted basis of partnership interests seems appropriate. In particular, under those Regulations, a foreign corporation's basis in a partnership interest (as determined under Section 705) is reduced by the foreign corporation's share of the liabilities of the partnership (as determined under Section 752) and increased by the same portion of any partnership liability as the partner's share of the interest expense on that liability. In effect, for purposes of determining a partner's basis in a partnership, the Section 752 methodology is replaced with a methodology reflecting the allocation of interest from the particular liability. This seems appropriate. The Section 752 liability allocation methodology determines a partner's basis for purposes of Section 704(d) and, if applied here, where the

---

[79] Regs. § 1.861-9T(e)(7).

[80] <u>See</u> Reas. § 1.884-1T(d)(9).

inquiry is not who is at risk of loss but what amount of interest is appropriately attributable to the U.S., the Section 752 methodology could produce clearly incorrect results.[81]

In determining whether or not an asset is a U.S. asset, the Proposed Regulations refer to items classified as U.S. assets under Regs. § 1.884-1T(d).[82] Prop. Regs. § 1.882-5(b)(2) provides that the value of a U.S. asset is its adjusted basis under Section 1011, but has no special rule for partnership interests. In contrast, in computing the actual ratio, the value of a partnership interest and a partner's share of partnership liabilities are determined in the same manner as under the branch profits tax regulations.[83] Presumably, partnership interests should be valued in the same manner for purposes of determining treatment of U.S. assets as in computing the actual ratio and a statement to such extent should be added to Prop. Regs. § 1.882-5(b)(2).

---

81 For example, A and B form a limited partnership in which A, a foreign corporation, is general partner and B is a limited partner. A and B each contribute $100X to the partnership and the partnership purchases a building worth $1,000X, paying $200X and issuing a recourse note for $800X to the seller. Under the partnership agreement, A and B share in tax losses equally. Under Section 752, the $800X recourse obligation would be allocated to A, and A's Section 705 basis in the partnership would be $900X. Under the methodology of the branch profits tax regulations, the $800X recourse obligation would be allocated 50% to A, and A's basis in the partnership would be $500X.

82 Prop. Regs. § 1.882-5(b) (1) (i).

83 See Prop. Regs. §§ 1.882-5(c)(iii)(E) and 1.884-1T(d)(9).

(b) Fair market value of partnership interests

No special rules are provided to determine the fair market value of a partnership interest if the election to value U.S. assets on a fair market value basis is made. If this election is made, Prop. Regs. § 1.882-5(c)(2)(iii) states that the term "fair market value" should be substituted for the term "adjusted basis" in § 1.882-5(c)(2)(iii)(E) (treatment of partnership assets and liabilities for purposes of computing the actual ratios). This is incorrect since the adjusted basis of a partnership interest already reflects a gross-up for liabilities under Section 752, but the fair market value of a partnership is necessarily net of liabilities. Accordingly, the Proposed Regulations should be amended to provide that the partner's share of the liabilities of the partnership determined under Section 752 should not be subtracted from the fair market value of the partnership interest for this purpose, but that the fair market value of a partnership interest is increased by the partner's share of the partnership's liabilities determined under Prop. Regs. § 1.882-5(d)(2)(vi).

(c) Allocation of value of certain partnership interests

The principle behind Prop. Regs. § 1.882-5 is allocation on the basis of the value of assets, not gross income. If an investment in a partnership produces income only a portion of which is effectively connected with a U.S. business, therefore, we question whether the approach (based on a gross income allocation) of the branch profits tax Regulations[84] for

[84] Prop. Regs. § 1.884-1T(9) (i).

allocating the value of the partnership interest is appropriate for purposes of the Proposed Regulations. An allocation based on the relative adjusted basis (or fair market value, if elected) of the partnership's U.S. and non-U.S. assets (as adjusted under Section 754) would be more consistent with the general interest allocation scheme.

(d) Partner's Share of Partnership Liabilities

Under the Proposed Regulations, a partner's share of partnership liabilities is not determined under Section 752 but, consistent with the rule for determining adjusted basis, a partner shares in any liability of a partnership in the same proportion that it shares in the interest expense attributable to that liability. As stated above, this adoption of the branch profits tax methodology for determining a partner's proportion of partnership liabilities seems appropriate because a partner will be allocated a share of a liability only to the extent such partner actually bears the burden of the interest incurred on that liability.

(e) Booked Liabilities

Once determined, the partner's share of a liability will be considered a booked liability under the Proposed Regulations if it is properly reflected on the books of the U.S. business of the partnership. Although the Proposed Regulations focus on the determination of a particular partner's interest expense, it nonetheless seems appropriate to determine whether a liability may be considered booked by looking to partnership treatment of the liability. It might be helpful, however, to provide special rules for situations in which the partnership itself is not engaged in a U.S. business, but the partnership interest is effectively connected with the foreign partner's U.S. business. In such a case, the determination of whether liabilities are booked might more appropriately be made by focusing on the partner.

Finally, Prop. Regs. §§ 1.882-5(c)(2)(ii)(B) and -5(d)(2)(iv) provide that interbranch transactions are ignored for purposes of determining both U.S. liabilities and booked liabilities. It is unclear whether these principles will apply where a foreign corporation has made a loan to a partnership in which it is a partner, or vice versa.

(f) Conforming partnership rules

The Notice of Proposed Rulemaking says that the treatment of partnership assets and liabilities under Section 884 and Section 861 will be modified — we read this to mean that the rules in the Proposed Regulations will ultimately be adopted for purposes of Section 884 and, at least in the case of a foreign corporation, for purposes of Section 861 as well. This makes sense. All of the Regulations addressing the interest deductions of foreign corporations should be consistent and in one place.

What is unclear is whether different rules will apply to the allocation and apportionment of partnership interest expense in the case of U.S. partners. In particular, the focus of the Proposed Regulations on the basis of a partner's partnership interest differs from the approach of the Section 861 Regulations, which looks to a partner's share of the partnership's basis in the assets, and the Proposed Regulations also apparently abandon the special allocation rules found in the Section 861 Regulations for certain less than 10% partnership interests.[85] Whatever the merit of these changes[86], it seems to us that the rules for foreign partners should be the same as for U.S. partners. Accordingly, if any part of the special allocation rules in Temp. Treas. Reg. § 1.861-9T(e)(4) is retained for U.S. partners, consideration should be given to including a similar rule in the Proposed Regulations.[87]

It is also unclear whether the special anti-abuse rule in Regs. § 1.884-1T(d)(9)(iv) will be retained.

[28]. Foreign insurance companies

The Notice of Proposed Rulemaking requests comments on their application to foreign insurance companies. No fixed ratio election is provided to foreign insurance companies in the Proposed Regulations, and the treatment of reserves as liabilities for the purposes of the actual ratio is reserved.

(a) Existing-Regulations

Under the existing Regulations, a foreign insurance company is treated in the same manner as any other corporation that is not engaged in a banking, financing or similar business.

---

85 Regs. § 1.861-9T(e) (7).

86 The first change seems sensible. A partner's basis in its partnership interest (particularly an interest purchased from another partner where a section 754 election was not made) will more closely reflect the value of its interest in the partnership than the partnership's bases in its assets.

87 If a special allocation rule of this type is included in the Proposed Regulations, the adjusted basis of a partner's interest in this type of partnership should be reduced by such partner's share of the partnership's liabilities. This would be consistent with the tax treatment of U.S. persons. Regs. § 1.861-9T(e)(4)(ii). The concept set forth in the last sentence of Regs. § 1.861-9T(e)(7)(i) seems incorrect and should be deleted if the special allocation rule is retained.

It would thus use the three step process and may elect to use a 50% fixed ratio. The benefit of the resulting interest deduction, however, may be limited by Section 842(b) of the Internal Revenue Code, which generally provides that a foreign life or property and casualty company must report net investment income that is effectively connected with its U.S. business in an amount at least equal to the product of its "required U.S. assets"[88] and a yield based on yields earned by domestic companies, as determined by the Internal Revenue Service, or the company's worldwide investment yield. In addition, if the liabilities were not booked, interest might be subject to withholding tax, because it is treated as paid to a related foreign person (and thus not eligible for the exemption for "portfolio interest"); and interest might also be subject to the limitations of Section 163(j).

For branch profits tax purposes, U.S. assets are determined by multiplying worldwide assets by the ratio of the (i) sum of current effectively connected earnings and profits and non-taxed accumulated effectively connected earnings and profits to (ii) worldwide earnings and profits.[89]

(b) Comments on the treatment of insurance companies

While we think that the rules with respect to foreign insurance companies may need to be developed further than we have in this report (and we would be pleased to do that, if it would be helpful), as an initial matter we suggest the following:

---

[88] Required U.S. assets are the product of the company's liabilities in respect of its U.S. business and the percentage, determined by the Internal Revenue Service, that results from dividing the assets of similar domestic insurance companies by the insurance liabilities of those companies.

[89] Regs. § 1.884-1T(g).

The U.S. interest expense of a foreign insurance company would be determined in the same three step process that applies to other foreign corporations, except that the fixed ratio would differ, liabilities would exclude insurance reserves and assets would be reduced by an amount equal to insurance company reserves. In addition, to the extent feasible, the definitions would be the same as in Section 842(b) of the Internal Revenue Code, and the concepts and definitions used for the purposes of the Proposed Regulations would also be used for purposes of applying the branch profits tax to foreign insurance companies.

Under this approach, the U.S. assets of a foreign insurance company, both for branch profits tax purposes and for purposes of the Proposed Regulations, would first be determined by the rules that applied to any other foreign corporation. U.S. assets would then be reduced by an amount equal to the foreign insurance company's reserves in respect of insurance liabilities on U.S. business (as defined in Section 842(b)(2)(A(i) on the theory that the reserves in effect finance those assets. U.S. assets should not be increased by the excess of "required U.S. assets" over the investment assets that would be includible as U.S. assets under Prop. Regs. Section 1.882-5(b) since the incremental tax resulting from Section 842(b) assumes, in the calculation of domestic yield, that expenses (including interest) have been deducted from the income earned from those assets.

Consistent with the approach of Section 842(b), the Internal Revenue Service should periodically prescribe fixed ratios for foreign property and casualty and foreign life insurance companies. These would be based on the data with respect to domestic insurance companies used to make the other calculations required by Section 842(b). Alternatively, the Regulations might use the booked liability approach that we have suggested (see above Fixed Ratios -- Prop. Regs, § 1.882-5(c)(3) -- Fixed Ratio for nonbanks) for other foreign corporations that are not banks. In the case of an insurance company electing to use the actual ratio, worldwide assets would be determined on the same basis as in Section 842(b)(4)(B)(ii) and would be reduced by insurance liabilities (as defined in Section 842(b)(2)(B)), and worldwide liabilities would include liabilities other than insurance liabilities (as so defined).

Interest expense attributable to the liabilities determined in step two would be determined by the same rules that apply to foreign corporations that are not insurance companies.[90] In a case where step two liabilities exceed booked liabilities, we have recommended that the rate of interest be the actual average worldwide U.S. dollar interest rate, assuming that there are significant foreign U.S. dollar borrowings and that the insurance company can establish that rate, and under this approach to excess liabilities it would be unnecessary to distinguish between foreign insurance companies, banks and other foreign corporations.

---

[90] As the Proposed Regulations imply, insurance reserves would not be booked liabilities, since they are not interest bearing, see Prop. Regs. § 1.882-5(d)(ii)(B).