REPORT #879

TAX SECTION

New York State Bar Association

June 3, 1996

Report with Respect to Proposed Regulations
Relating to Reas. S 1.882-5 and Section 884

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TAX SECTION
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The Honorable Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120 Main Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

The Honorable Margaret M. Richardson*
Commissioner, Internal Revenue Service
Room 3000
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: Proposed Regulations relating to Regs. § 1.882-5, the branch profits tax, and the branch level withholding tax

Dear Secretary Samuels and Commissioner Richardson:

The enclosed report, prepared by an ad hoc committee of the Tax Section, comments on regulations proposed on March 8 with respect to Regs. § 1.882-5, the branch profits tax and the branch level withholding tax.

The report generally supports the positions taken by the Proposed Regulations, including the proposed rules with respect to hedging, mark-to-market gains and losses, split assets and obligations to make guaranteed payments to partners. It includes, however, a number of specific comments on the hedging rules (see pages 8-18), the treatment of mark-to-market gains and losses (see the summary on pages 27-29) and also suggests (see pages 27 and 30-31) that consideration should be given to the netting of non-interest bearing liabilities, including net mark-to-market positions with negative value, against

other assets. The report recognizes, however, that there are arguments against the netting of non-interest bearing liabilities and assets.

Very truly, yours,

Richard L. Reiphold
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June 3, 1996

Report with Respect to Proposed Regulations Relating to Regs. S 1.882-5 and Section 884

This report, prepared by an ad hoc committee of the Tax Section*, comments on proposed regulations issued on March 8, 1996 (the "Proposed Regulations") with respect to the determination of a foreign corporation's deductible interest expense under Regs. § 1.882-5 and its liability for the branch profits tax and branch level withholding tax imposed by Section 884.

The Proposed Regulations accompanied the adoption of final Regs. § 1.882-5 ("final Regs. § 1.882-5"), which for taxable years beginning after June 6, 1996 will replace present Regs. § 1.882-5 ("existing Regs. § 1.882-5"). We do not comment here on final Regs. § 1.882-5 except to the limited extent required by our comments on the Proposed Regulations.** In addition, our comments should not be read as suggestions as to what might be provided by any revisions to the Regulations relating to the allocation and apportionment of interest expense

* Chaired by Andrew P. Solomon and Willard Taylor and consisting of Samuel Dimon, Susan Grbic, Christopher Haunschild, Deborah Jacobs and Michael Mundaca. Helpful comments were received from Harold Handler, Richard Loengard, Jr., Yaron Reich and Richard Reinhold.

** The Tax Section submitted comments on these Regulations at the time that they were proposed. See New York State Bar Association, Tax Section, Report on Proposed Regulations Section 1.882-5 (August 26, 1992), 92 TNT 189-51 (Sept. 18, 1992) (LEXIS, Fedtax library, TNT file)

by domestic taxpayers.*

The Proposed Regulations deal with the effect on the calculation of a foreign corporation's branch profits tax liability under Section 884 and the three steps involved in the calculation of deductible interest expense of a foreign corporation of (1) hedging transactions, within the meaning of Regs. § 1.1221-2(b); (2) mark-to-market gains and losses under Sections 4 75 and 1256, including the netting of losses and gains and the treatment of losses in excess of gains; and (3) the extent to which contracts and securities that are marked to market will create a U.S. asset (so-called “split assets”) in cases where the income from those instruments is subject to an advance pricing agreement that uses a “profit split” methodology. The Proposed Regulations also deal with the treatment for purposes of final Regs. § 1.882-5 of an obligation of a partnership to make guaranteed payments to a partner.

Each of these is covered separately below.

In general, we believe that the Proposed Regulations are appropriate, but we have a number of comments on their substance and form.

1. Proposed Hedging Regulations

Background

* These Regulations involve different considerations -- for example, our recommendation with respect to the effect of marking-to-market positions with a positive value (see pages 15-17) is based in part on branch profits tax considerations that are not relevant in allocating and apportioning the interest expense of a U.S. corporation. In addition, the manner in which interest expense is allocated and apportioned under Section 861 will affect computations under a variety of Internal Revenue Code provisions (including, for instance, Section 904 and Subpart F), and should be considered in that light.

Under Regs. § 1.882-5, the interest expense of a foreign corporation is generally determined by a three step process. In the first step, the foreign corporation determines its U.S. assets, valuing such assets either on the basis of fair market value or adjusted basis; in the second, it determines U.S. liabilities by applying to its U.S. assets either a fixed ratio of assets to liabilities or its actual worldwide ratio of assets to liabilities; and in the third, it determines the interest associated with its U.S. liabilities, either on the basis of the adjusted U.S. book liabilities method or on the basis of the separate currencies pool method. As an exception, interest may be directly allocated to income from assets in the narrow circumstances set out in Regs. § 1. 861-10T.

Section 884 of the Internal Revenue Code imposes tax on the dividend equivalent amount of a foreign corporation that does business directly in the United States through a branch or otherwise. The dividend equivalent amount is defined, in general, as the foreign corporation's earnings and profits for the year that are effectively connected with its U.S. business, increased by any reduction in the net equity of its U.S. business and decreased by any increase in the net equity of its U.S. business.

A foreign corporation's net equity in its U.S. business is the excess of its U.S. assets over its U.S. liabilities. For this purpose, an election may be made to reduce U.S. liabilities, other than booked third party liabilities, but U.S. liabilities will then also be reduced for purposes of step two of Regs. § 1.882-5. It is thus necessary to determine a foreign corporation's U.S. assets and U.S. liabilities, and in some cases its U.S. booked third-party liabilities, in order to apply the branch profits tax. In accordance with Section 884(c)(2)(C), the

branch profits tax regulations and existing and final Regs. § 1.882-5 generally make the determinations on a consistent basis.[*]

Section 884 also treats interest paid by a U.S. business of a foreign corporation as paid by a U.S. corporation and the "excess interest" of such a business as paid to the foreign corporation. As a consequence, excess interest will not be "portfolio interest" and may be subject to U.S. withholding tax unless there is a tax treaty exemption. Excess interest is defined as the interest attributed to the U.S. business under Regs. § 1.882-5 in excess of the interest paid on its booked third party liabilities. The possible liability for U.S. withholding tax on excess interest thus also depends on the amount of interest determined under Regs. § 1.882-5.

Neither existing Regs. § 1.882-5 nor the Regulations under Section 884 takes hedges into account for any purpose. Apart from the effect of Section 988(d) and Regs. § 1.988-5, therefore, the amount, value and currency denomination of assets and liabilities, and interest rate associated with liabilities, is determined without regard to any asset or liability hedge.

The Proposed Regulations

Under the Proposed Regulations, hedging transactions, which are defined by Regs. § 1.1221-2 (b), will be taken into account, in somewhat different ways, in determining assets and liabilities for purposes of the branch profits tax and in each of the three steps involved in the determination of a foreign corporation's deductible interest expense. Specifically, hedges will be taken into account.

[*] See Regs. § 1. 882-5 (b)(1)(i) with respect to assets, and Regs. § 1.884-1 (e)(1) with respect to liabilities.

(1) for purposes of the branch profits tax and, apparently, step one of Regs. § 1.882-5 in determining the amount and currency denomination of U.S. assets;[*]

(2) for purposes of the branch profits tax, the branch level withholding tax and step two of Regs. § 1.882-5 in determining the amount and currency denomination of a liability and, if the actual ratio is used in step two, the amount, value and currency denomination of worldwide assets,[**] and

(3) for purposes of the branch profits tax, the branch level withholding tax and step three of Regs. § 1.882-5 in determining the currency denomination, amount of, and interest rate associated with, a booked liability; or, if the foreign corporation uses the separate currency pools method in step three, the amount of, and interest rate associated with, a liability.[***] As discussed hereafter, final Regs. § 1.882-5 also take hedges into account in determining the amount and currency denomination of assets for purposes of the separate currency pools method.[****]

Comments on the Proposed Regulations

Since the Proposed Regulations define hedging transactions by reference to Regs. § 1.1221-2(b), the hedging

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[*] Prop. Regs. § 1. 884-1(c)(2)(iii)

[**] Prop. Regs. § 1.882-5(c)(2)(v), which (in the case of liabilities) carries over to Section 884 by virtue of Regs. § 1.884-1(e)

[***] Prop. Regs. §§ 1.882-5(d)(2)(vi) and (e)(3) which, in the case of booked liabilities, carries over to Section 884 by virtue of Regs. § 1.884-1(e).

[****] Regs. § 1.882-5(e)(1)(i), last sentence.

rule is relatively narrow --it covers hedges of liabilities and hedges of ordinary income assets, such as securities subject to Section 475 and loans described in Section 582(c), but not hedges of other assets.[*] In addition, as set forth hereafter, its practical significance may be largely limited to the calculation of interest expense in step three of Regs. § 1.882-5. Nonetheless, the proposed hedging rule is likely to be important for foreign banks that do business in the United States, and these are the principal class of taxpayers subject to Regs. § 1.882-5.

Taking hedges into account in determining assets, liabilities and interest expense generally makes economic sense and is consistent with the treatment of hedges in other contexts[**]. We therefore think the hedging rule of the Proposed Regulations, although limited in scope, is appropriate. Since the rule seems to be relevant in step two only in the case of a foreign corporation that has elected to use fair market value in step one, it should not as a practical matter complicate the calculation by most foreign corporations of the actual ratio in

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[*] Compare Regs. § 1.954-2(a)(4)(ii), which more broadly defines hedges in the case of a controlled foreign corporation.

[**] See, e.g., Regs. §§ 1.446-4 and 1.1221-2; Section 988(d); and Prop. Regs. § 1.1275-6(g)(1).

step two.[*]

We have, however, the following comments on the Proposed Regulations.

(a) A broader hedging rule, not limited to the relatively narrow class of transactions described in Regs. § 1.1221-2(b), might be considered. The policy considerations that led the Service to limit the hedging rule in Regs. § 1.1221-2 (b) to "ordinary property" do not appear to be relevant to the issues involved in Regs. § 1.882-5, the branch profits tax or the branch level withholding tax on interest.

(b) There are existing and proposed regulations which under certain circumstances integrate hedges with assets or liabilities to create "synthetic" positions.[**] Where these apply, it should be the resulting synthetic position that is taken into account for purposes of Regs. § 1.882-5 and Section 884. This would be consistent with the regulations providing for

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[*] Since hedges are commonly taken into account for. financial statement purposes, it seems unlikely that the proposed hedging rule would have this effect even in the case of a foreign corporation that has made a fair market value election in step one and an actual ratio election in step two. It is in fact possible that a broader hedging rule (i.e., one that was not limited to transactions described in Regs. § 1.1221-2(b)) would be less complicated to apply.

[**] Regs. § 1.988-5 and Prop. Regs. §§ 1.988-5(d) and 1.1275-6.

integration*, but the point could usefully be clarified.

(c) The relationship between Prop. Regs. § 1.884-1(c) (2) (iii) and step one of Regs. § 1.882-5 needs to be clarified. Prop. Regs. § 1.884-1 (c) (2) (iii) takes hedges into account in determining the amount and currency denomination of U.S. assets for branch profits tax purposes. The apparent assumption was that this would carry over to step one of Regs. § 1.882-5, since no separate hedging rule is provided in that step. This will not technically be the case, however, since the reference to the branch profits tax regulations in step one is to Regs. § 1.884-1(d), not Regs. § 1.884-1 (c) (2) (iii); and there is a separate rule for valuing assets for step one purposes in Regs. § 1.882-5(b) (2). Thus, if hedges are to be taken into account in determining the amount and currency denomination of assets for step one purposes, there should be a separate rule in that step which so provides.

(d) The last sentence of Regs. § 1.882-5 (e) (1) (i) should be modified to conform to the Proposed Regulations. That sentence, which takes "hedges" into account in determining the amount and currency denomination of assets for purposes of the separate currency pools method, will be unnecessary if, as recommended in (c) above, hedges are taken into account in determining value and currency denomination of assets in step one. In addition, it includes no definition of a hedge -- no reference to the definition in, and identification requirements of, Regs. § 1.1221-2.

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* Regs. § 1.998-5 (a)(9) (positions are "integrated and treated as a single transaction") and Prop. Regs. § 1.1275-6(g)(1) (positions are "generally treated as a single transaction").

(e) The several references in the Proposed Regulations to the "requirements" of paragraph (a) of Regs. § 1.1221-2 are confusing since that part of the Proposed Regulations relates to the effect of hedging on the character of gain or loss as ordinary or capital. These references might therefore be eliminated.

(f) The circumstances in which hedging treatment requires the foreign corporation to satisfy the identification requirements of Regs. § 1.1221-2(e) are unclear and should be clarified.

Identification in accordance with Regs. § 1.1221-2(e) is required (i) in determining U.S. assets for purposes of Section 884, (ii) in step one of Regs. § 1.882-5 and (iii) in step three of Regs. § 1.882-5 if the foreign corporation has elected to determine interest expense by use of the branch book method.[*] It is not required in determining the amount of, or interest rate associated with, a liability for purposes of step three if the foreign corporation has elected to use the separate currency

[*] For each of these purposes, the Proposed Regulations state that there is a hedge only if the transaction "meets the requirements of § 1.1221-2 (a), (b), and (c), and is identified in accordance with the requirements of § 1.1221-2(e)."

pools method of determining interest expense.[*] Whether it is required in step two by a foreign corporation that elects to use the actual ratio is unclear, since the text of the Proposed Regulations simply states that "only if the transaction meets the requirements of [Regs.] § 1.1221-2" will the transaction be considered to hedge an asset or liability.[**]

The apparent intention is to require identification when the hedge relates to a U.S. asset or liability, but not where it relates to a non-U.S. asset or liability -- put differently, to require identification only insofar as it affects U.S. rather than foreign numbers. This is consistent with a statement in the preamble to the Proposed Regulations (the "Preamble").[***] If that is the principle, it should be clearly stated in the Regulations. In such a case, identification would be required in step two by a foreign corporation electing to use the actual ratio only in respect of U.S. liabilities and U.S. assets that were included in the actual ratio.

(g) The reference in the Proposed Regulations to identification under Regs. § 1.1221-2(e) does not incorporate the anti-abuse rule of Regs. § 1.1221-2 (f) (2) (iii) -- that is, the ability of the Internal Revenue Service "to treat hedging transactions as such, notwithstanding the failure to identify, if

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[*] For this purpose, a transaction will hedge a liability "only if the transaction meets the requirements of §§ 1.1221-2 (a), (b) and (c)."

[**] If the fixed ratio is elected, hedges of liabilities will be irrelevant.

[***] See the last sentence of the first paragraph under "B. Hedging transactions", stating that

> If, however, the hedging transaction is entered into by the U.S. branch, it will only affect the amount of U.S. assets if it is contemporaneously identified as a hedging transaction in accordance with the provisions of § 1.1221-2.

there are no reasonable grounds for not treating it as a hedging transaction. This omission seems unintended -- if, for example, fair market value is used in step one and an asset hedge has a negative value, the Internal Revenue Service would presumably want the ability to require that the value of U.S. assets be reduced by the hedge.

(h) The example in the Proposed Regulations that illustrates the application of the hedging rule to a liability hedge considers a hedge of the principal amount of the liability, but states that this may also affect the interest rate associated with the liability.* It is not clear how this is to be done -- is the excess of the forward over the spot price to be treated as interest? If so, in what period?

(i) It is unclear in the example in the Proposed Regulations that illustrates an asset hedge why the hedge is an

* Example (4)(ii) of Prop. Regs. § 1.882-5(d)(6), stating that "FC must treat" the hedged foreign currency liabilities "as U.S. dollar liabilities to determine ... the interest paid or accrued on U.S. booked liabilities."

asset hedge and not a liability hedge.* In the example, in order to eliminate the mismatch between a Japanese yen loan and a U.S. dollar borrowing, a foreign bank buys dollars forward for yen. The example treats this as a hedge (i.e., a conversion into dollars) of the yen asset, but it could just as well be viewed as a hedge (i.e., a conversion into yen) of the U.S. dollar borrowing.** The example implies that the hedge is an asset hedge because so identified by the foreign bank. If this is the rule, it might usefully be stated.

(j) The Regulations might usefully spell out, in additional examples, what it means to "take" a hedging transaction "into account". The examples of the hedging rule (as opposed to the mark-to-market rule discussed below) are limited to illustrations of its application in step three.

Set out below is our understanding of what it means to take a hedge into account, assuming that the clarification suggested in (c) above is accepted.

Step one. Unrealized gains or losses in respect of hedges or hedged assets do not affect adjusted or "e & p" basis. It is therefore unclear why taking a hedge into account in step one should have any effect in step one (other than with respect to currency denomination of assets) if adjusted basis is used to value U.S. assets in that step or why it should affect the "e &

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* See Prop. Regs. § 1.882-5(e)(5), Example (2).

** The same comment could be made with respect to the liability hedge example contained in Prop. Regs. § 1.882-5(d)(6), Example (4).

p" basis of U.S. assets for purposes of Section 884.[*] If a foreign corporation has elected to use fair market value in step one, the positive value of the hedge, if any, will be an asset, and it also seems to be unnecessary for the hedge to be "taken into account" in such a case as an increase in the value of the hedged asset -- the increase and decrease in values will in any event offset each other.[**] The relevance of the hedging rule in the Proposed Regulations to step one would thus seem to be largely limited to a case where the foreign corporation has elected to use fair market value in that step and the hedge has a negative value -- the adjustment resulting from taking a hedge into account would presumably be to reduce the value of the related asset by the unrealized loss on the hedge.

Thus, assume that the U.S. branch of a foreign bank makes a fixed rate loan, and hedges that asset with an interest rate swap in the same currency that is identified as a hedge under Regs. § 1.1221-2(e). If the bank elects adjusted basis in step one, any change in the value of either the loan or the swap would have no effect on its assets in step one. Similarly, it will have no effect on the "e & p" basis of its U.S. assets for purposes of the bank's branch profits tax liability. If the bank makes a fair market value election for purposes of step one, and interest rates go up, the positive value of the hedge and the decline in the value of the loan will be taken into account in step one without the proposed hedging rule (and without regard to qualification or identification under Regs. §§ 1.1221-2(b) and-2(e)). If interest rates decline, however, the negative value of

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[*] The currency denomination of an asset may affect its value for purposes of step one, as provided in Regs. § 1.882-5(a)(4).

[**] As noted, under Regs. § 1.882-5(a)(4), the currency denomination of an asset may affect its value.

the hedge will reduce the value of the debt, assuming that there has been identification under Regs. § 1.1221-2(e).

Step two. Taking hedges into account for purposes of determining liabilities in step two of the calculation required by Regs. § 1.882-5 would likewise seem to have only limited effect. It will, of course, have no impact on the calculation of U.S. liabilities if the foreign corporation has elected to use the fixed ratio in step two, since U.S. liabilities in such a case are simply the result of applying the fixed ratio to U.S. assets determined in step one. If the actual ratio is elected, an asset hedge will be taken into account only to the limited extent set forth above under Step one, and a liability hedge will likewise be taken into account in determining worldwide liabilities only if a fair market value election has been made and the hedge has a negative value.

Assume, for example, that the U.S. branch of a foreign bank borrows at a floating rate and enters into an interest rate swap. If the fixed ratio has been elected, the hedge will be irrelevant in the step two calculation (although the positive value of the hedge might be relevant to the step one calculation if the bank has made a fair market value election for purposes of that step). If the bank elects the actual ratio, unrealized gain or loss on the hedge will not affect adjusted basis and so the hedge will be taken into account in determining worldwide liabilities or assets only; if the bank has also elected to use fair market value in steps one and two and the hedge has a negative value.

Step three -- adjusted U.S. booked liabilities method. If a foreign corporation has elected in step three to use the adjusted U.S. booked liabilities method of determining interest

expense, taking hedges into account for the purposes of determining the amount of, and interest rate associated with, booked third party liabilities would mean adjusting booked liabilities to reflect hedges. The Proposed Regulations illustrate this with an example in which the principal amount of a booked third party liability, denominated in Yen, is hedged into U.S. dollars and treated for purposes of step three as a U.S. dollar booked liability.* Subject to the comment in (h) above, we think that this is an appropriate illustration of the rule; and this and the other step three example, described below, illustrate the principal significance of the hedging rule in the Proposed Regulations.

Step three -- Separate currency pools method. If a foreign corporation has elected in step three to use the separate currency pools method of determining interest expense, taking hedges into account for the purposes of determining interest expense presumably means that the currency denomination of its U.S. assets will reflect any hedge** and also that the amount of, and interest rate associated with, its worldwide liabilities in each of the currency pools will reflect any hedges. The first point (i.e., the effect of a hedge on the currency denomination of the foreign corporation's assets) is illustrated by an example

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* Prop. Regs. § 1.882-5(d)(6), Example (4).

** Prop. Regs. § 1.884-1(c)(2)(iii).

in the Proposed Regulations[*], and subject to the comment in (f) above we think that this is an appropriate illustration of the rule.

2. Mark-to-market

Section 475 requires dealers in securities to mark to market securities. Section 1256(a) generally provides the same rule for Section 1256 contracts, and under certain circumstances mark-to-market accounting has been recognized outside of Section 475 and Section 1256.[**]

The only statements in the text of the Proposed Regulations with respect to mark-to-market gains and losses are a statement to the effect that the basis of instruments that are marked to market under Section 475 and 1256 will be adjusted to take into account such gains or losses for branch profits tax purposes[***] and a statement that, for purposes of Regs. § 1.882¬5, a "financial instrument" with a fair market value of less than zero is a liability.[****] Examples in the Proposed Regulations elaborate, however, and indicate that (a) mark-to-market gains will be reduced by mark-to-market losses, (b) a net mark-to-market gain will create an asset that will be a U.S. asset for purposes of Regs. § 1.882-5, as well as Section 884, if the income from the positions is effectively connected income and (c) if mark-to-market losses exceed mark-to-market gains, the excess

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[*] Prop. Regs. § 1.882-5(e)(5), Example (2).

[**] E.g., Rev. Rul. 74-223, 1974-1 C.B. 23. See also Prop. Regs. § 1.988-5 (f).

[***] Prop. Regs. § 1.884-1(d)(6)(v).

[****] Prop. Regs. § 1.882-5(b)(2)(iv)

will be a non-interest bearing liability for purposes of steps two and three and Section 884.[*]

In dealing with the effect of marking to market, it seems to us to be useful to distinguish between the rul&s in the Proposed Regulations with respect to (1) the treatment of mark-to-market positions with a positive value (the "basis rule"), (2) the netting of mark-to-market positions in determining assets for purposes of step one, step two if the actual ratio has been elected and the branch profits tax (the "netting rule") and (3) the treatment of a net negative position as a liability (the "liability rule") for purposes of steps two and three and Section 884. We have done so below.

Positions with a positive value -- the basis rule.

If a foreign corporation makes a fair market value election in step one, the value of assets that are marked to market, like the value of any other asset, will be taken into account in that step and, if the actual ratio has been elected, in step two. This is so under final as well as existing Regs. § 1.882-5. The rule in the Proposed Regulations with respect to mark-to-market positions with a positive value is relevant, therefore, only to a foreign corporation that has elected to use adjusted basis to determine value in step one.

If a position with a positive value is marked to market under Section 475, Section 1256 or otherwise, it seems entirely logical to treat that position as having an adjusted (or "e & p") basis equal to the value used in marking the position to market

[*] Examples ((6) and (7) of Prop. Regs. § 1.882-5(c)(5) and Example (6) of Prop. Regs. § 1.884-1 (d)(2)(xi).

for the purposes of the branch profits tax and Regs. § 1.882-5. Subject to the netting rule discussed below, we interpret the examples in the Proposed Regulations to so provide.* That result is consistent with the general principle that basis is adjusted upward or downward for realized income or loss, whether or not cash is received. Analogies would include debt obligations issued at an original issue discount or receivables of an accrual basis taxpayer -- these have a tax basis that is based on the realization of income, not the receipt of cash.

To conclude otherwise, moreover, would produce peculiar results -- it would mean, for example, that a foreign corporation which had a mark-to-market gain under Section 475 in its U.S. securities business had no corresponding U.S. asset for purposes of Section 884. Since the gain would increase its effectively connected earnings and profits, but would not increase the corporation's net equity, the entire amount of the gain would be included in the corporation's dividend equivalent amount and would be subject to branch profits tax. This is an obviously inappropriate result. Likewise, a foreign corporation with a mark- to-market loss in its U.S. business would not reduce U.S. assets for branch profits tax purposes, although the loss would reduce effectively connected earnings and profits.

Nor is it relevant that (i) the mark-to-market income is not specifically “funded” or that (ii) Section 475 may be unclear as to whether, for purposes of that Section, mark-to-market gains and losses give rise to an adjustment to basis.** Both existing

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* Examples (6) and (7) of Prop. Regs. § 1.882-5(c)(5) and Example (6) of Prop. Regs. § 1.884-1(d)(2)(xi).

** While the basis of Section 475(a)(1) inventory would be so adjusted, there is no similar rule for positions that are marked-to-market under Section*475(a)(2).

and final Regs. § 1.882-5 are premised on the assumption that all U.S. assets are debt financed to the extent determined in step two and, with the narrow exception in Regs. § l. 882-5(a)(1)(ii), give no effect whatever to whether acquisition or ownership of an asset can be traced to any particular borrowing. Whatever the effect of marking to market may be for purposes of Section 475, there is plainly the authority to treat mark-to-market gains and losses as adjustments to tax basis for purposes of Regs. § 1.882-5 and the branch profits tax and no need in that connection to consider the broader question of whether there should be basis adjustments for other purposes.

Positions with a negative value -- the netting rule.

To the extent that mark-to-market positions hedge other mark-to-market positions, the value of the positive value positions would be reduced under the hedging rule of the Proposed Regulations. An example in the Proposed Regulations goes on to provide, however, that a position that is marked to market under Section 475 or Section 1256 and has a negative value will reduce positions with a positive value that are also marked to market under those Sections.* This rule operates independently of the hedging rule described above -- i.e., whether or not the positions with a negative value were hedges of, or were hedged by, the positions with a positive value.**

It is generally inconsistent with the three step process of Regs. § 1.882-5 to net assets and liabilities. The fixed and

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* Example (7) of Prop. Regs. § 1.882-5(c)(5).

** Thus, for example, it applies to contracts that are marked to market under Section 1256, although they cannot be hedges under Regs. § 1.1221-2 (b), and whether or not there is identification under Regs. § 1.1221-2(e).

actual ratios used in step two are designed to determine the leverage attributable to gross assets, and permitting a foreign corporation to reduce gross assets by liabilities, and to apply the step two ratio to the net amount, may significantly increase the liabilities attributed to its U.S. business.*

The exception made by the Proposed Regulations for positions that are marked to market is presumably justified by the distortion that would result from treating only mark-to-market positions that have value as U.S. assets, and thus as debt- financed, notwithstanding that the net value of the U.S. book is substantially less than the value of the positions with a positive value. The only reasonable alternative would be to treat mark-to- market positions that have a negative value as liabilities, which would generally reduce the interest determined in step three. Since that will not necessarily avoid the distortion -- principally because, as explained hereafter, its effect depends on the foreign - corporation's step three election -- we think that netting of mark- to-market losses against mark-to-market gains is the best answer. Treating mark-to-market positions with a negative value as liabilities, rather than netting, might otherwise provide a powerful incentive to elect separate currency pools method. We thus support the netting rule in the Proposed Regulations.

Net negative value positions as liabilities -- the liability rule. In addition to netting positive and negative value mark-to-market positions, the text of the Proposed Regulations indicates that, if mark-to-market losses exceed mark-to-market gains, the excess will be treated as a non-interest

* The narrow exception in Regs. § 1.882-5 (a)(1)(ii) is presumably justified in large part by the view that there should be consistency with the treatment of domestic taxpayers under Regs. § 1.861-1OT.

bearing liability for purposes of Regs. § 1.882-5, and one of the examples treats the excess as a non-interest bearing booked liability for purposes of step three (and the related branch profits tax rules) in the case of a foreign corporation that has elected to use the adjusted U.S. booked liabilities method in that step.[*]

If the adjusted U.S. booked liabilities method has been elected, treating the excess of mark-to-market losses over mark-to- market gains of the U.S. business as booked liabilities will significantly reduce the deduction for interest expense that is allowed because no interest expense is incurred on such liabilities.[**] If the separate currency pools method has been elected, however, this treatment may have little or no effect, since in such a case the U.S. interest deduction is derived from the interest expense on average worldwide liabilities and U.S. liabilities may have only a marginal effect on this calculation.

Assume, for example, that the net negative value of the mark-to-market positions of the U.S. branch is $100X, that it has no other booked third party liabilities and that it has assets of $100X. If it has elected to use the adjusted U.S. booked liabilities method in step three, it will have no U.S. interest expense since it paid no interest on its booked third party liabilities and these exceed its U.S. liabilities. If it has elected the separate currency pools method, however, its U.S. liabilities', will bear interest at the average rate paid on

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[*] Prop. Regs. § 1.882-5(b)(2)(iv), last sentence, which states that "A financial instrument with a fair market value of less than zero is a liability, not an asset, for purposes of this section." See also Example (7) of Prop. Regs. § 1.882- 5(c)(5).

[**] Thus, the additional booked liabilities will either reduce non-booked liabilities attributed to the U.S. business or, under the scaling ratio, average down the interest paid on booked liabilities.

worldwide liabilities in the particular currency pool and this will be affected by the net negative position only to the extent that position is a liability in that pool and influences the average.

Because of the effect of treating net negative positions as liabilities depends so heavily on the election made in step three, the Internal Revenue Service might want to consider simply reducing other U.S. assets by the amount of such liabilities. In evaluating that option, however, two points should be kept in mind. First, the difference in result is not aberrational but follows from the fact that the adjusted U.S. booked liabilities method and the separate currency pools method look at different interest rates.* Second, if the net negative position is a relatively small part of total U.S. liabilities, which is likely to be the usual case, reducing U.S., assets (i.e., netting) will result in a larger interest deduction to a foreign corporation which has elected the adjusted U.S. booked liabilities method than would be allowed if the net negative position were treated as a non-interest bearing liability. This will be the case whenever the ratio of non-interest bearing to total booked liabilities is less than the foreign corporation's step two ratio.**

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* Thus, a separate currency pools method could result in a lower U.S. interest deduction if the net negative position were outside of the United States in a pool that affected the U.S. branch.

** If assets are reduced (i.e., there is netting), the reduction in interest expense will ordinarily be the rate of interest paid on "excess" U.S. liabilities (i.e., liabilities in excess of booked liabilities), times the step two ratio applied to such liabilities; but if the net negative position is treated as a booked liability, the reduction will ordinarily be the rate of interest paid on excess liabilities times the amount of the non-interest bearing liability.

Other non-interest bearing liabilities. Final Regs.§ 1.882-5 take the view, which is consistent with the Proposed Regulations' treatment net mark-to-market losses of the U.S. business, that liabilities which do not bear interest or original issue discount, such as accrued liabilities for expenses, are liabilities for the purposes of steps two and three.* Because the effect of this rule depends largely on which method has been elected in step three, as explained above, consideration might be given to reducing assets by such liabilities. On the other hand, the different result is consistent with the differences between the adjusted U.S. booked liabilities method and separate currency pools methods. In addition, netting such liabilities against assets will result in a larger interest deduction in cases where the adjusted U.S. booked liabilities method has been elected and the amount of non-interest bearing liabilities is relatively small in relation to other liabilities. This is likely to be the typical case.

In summary, we have the following comments on the proposed treatment of mark-to-market gains and losses.

(a) There should be clear statements in the text of any final Regulations of the basis adjustment, netting and liability rules. These should not be left to examples. The liability rule should include a definition of liabilities which specifies the “adjusted basis” of non-interest bearing liabilities for purposes

* See also the Example, discussed below, with respect to the treatment of a partnership's obligation to make guaranteed payments.

of steps two and three.*

(b) The basis adjustment rule should be rephrased as a rule that includes in basis any gain or income taken into account for tax purposes in respect of a position or asset, whether or not matched by a receipt of cash, so that it is not limited to mark-to- market gains and losses under Section 475 and Section 1256 but applies to any mark-to-market gain or loss and any other income, gain or loss realized for tax purposes.

(c) In order to avoid the distortion that might otherwise result in U.S. assets, there should be a rule that nets mark-to-market gains and losses under Sections 475 and 1256 in step one and, if the actual ratio is elected, step two. Netting should be in respect of all mark-to-market positions, notwithstanding that the foreign corporation has different "books" of instruments subject to the mark-to-market rules.

(d) In place of the liability rule of the Proposed Regulations, the Internal Revenue Service might consider reducing assets by non-interest bearing liabilities, including any excess of mark-to-market losses over mark-to-market gains. There are, however, persuasive arguments against that approach, as indicated above.

3. Split Assets

The Proposed Regulations provide a "split asset" rule -- specifically, that a "financial instrument" will be treated as a

* There is, of course, a considerable body of authority with respect to what is a liability for different Federal income tax purposes. See, e.g., Rev. Rul. 95-74, 1995-46 I.R.B. 6; Rev. Rul. 95-45, 1995-26 I.R.B. 4; Rev. Rul. 95-26, 1995-1 C.B. 131; and Rev. Rul. 88-77, 1988-2 C.B. 128.

U.S. asset of a foreign corporation, both for purposes of step one of Regs. § 1.882-5 and Section 884, in the same proportion that it produces effectively connected income, gain or loss for the year. Under existing Regulations[*], income, gain or loss from most financial instruments is either effectively connected or not, in its entirety. The Preamble explains that the rule in the Proposed Regulations is included to accommodate advance pricing agreements which, under a profit split methodology, may determine that only a fraction of the income, gain or loss of a business is income effectively connected with a U.S. business.[**]

If the Internal Revenue Service intends to conform the Regulations to the terms of its advance pricing agreement policies, a number of the changes in Regulations will be required -- in particular, Regs. § 1.863-7, relating to the determination of effectively connected income, must be modified. Since it would be better to evaluate these changes as a whole, we recommend that this part of the Proposed Regulations be adopted in final form only at the time those other changes are made.

4. Guaranteed payments by a partnership

Final Regs. § 1.882-5 generally treat partnerships as entities for purposes of Section 884 and the calculations required by Regs. § 1.882-5. Consistent with that view, and the definition of liabilities implicitly taken in the Proposed Regulations, it is arguable that a partnership obligation to make guaranteed payments to a partner, if described in Section 707(c), is a liability of the partnership for purposes of steps two and three of Regs. § 1.882-5. An example in the Proposed Regulations,

[*] Regs. § 1.863-7.

[**] See Notice 94-40, 1994-1 C.B. 351.

however, concludes that an obligation to make guaranteed payments is not a liability for purposes of the determination of the actual ratio in step two.[*]

The example is a useful clarification but, consistent with our comment above about the need for a general definition of liabilities, it would be better for any final Regulations to provide, in that definition, that a partnership's obligation to make payments described in Section 707(c) is not a partnership obligation.

5. Effective Date

The Proposed Regulations will be effective for taxable years beginning on or after their adoption as final Regulations. Because of their relevance to the elections that foreign corporations may make under final Regs. § 1.882-5, we urge that, with the exception noted above (see 3. Split Assets), they be adopted this year.

[*] Example (4) of Prop. Regs. § 1.882-5(c)(5).