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New York State Bar Association

One Elk Street, Albany, New York 12207 • 518/463-3200 • http://www.nysba.org

September 22, 2005

Mr. Eric Solomon
Acting Deputy Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3112 MT
1500 Pennsylvania Avenue, N.W.
Washington D.C. 20220

The Honorable Mark W. Everson
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington D.C. 20224

Re: Notice 2005-53 (U.S. Branch Allocation of Interest Expense)

Dear Acting Deputy Assistant Secretary Solomon and Commissioner Everson:

I am writing to provide you with comments of the New York State Bar Association Tax Section with respect to Notice 2005-53, which deals with the determination of the deductible interest expense of a U.S. branch of a foreign bank.[1] The Notice requests comments with respect to the items set out below.

[1] The principal author of this letter was Kimberly Blanchard. Helpful comments were received from David Hariton, David Miller, Yaron Reich and Willard Taylor.

Risk-Weighting. In light of the recent treaties with Japan and the United Kingdom, both of which contemplate that the deductible interest expense of a U.S. branch of a foreign bank may, at the bank's election, be determined by "risk-weighting" assets, the Notice acknowledges that it is no longer accurate for the Regulations to state that interest expense can only be determined by the methods now prescribed in Regs. §1.882-5.[2] The Notice says that the Regulations will be amended to eliminate that statement.

We agree with the proposed change, but think that two broader questions should also be addressed as part of the forthcoming regulations. First, consideration should be given to making the alternative of risk-weighting available, through a competent authority proceeding or otherwise, under any U.S. income tax treaty, regardless of when the treaty came into effect and whether or not that method is specifically contemplated by the treaty's terms. Second, the U.S. rules for risk-weighting assets, as well as the coordination of those rules with the rules of other countries, should be defined and developed in the forthcoming regulations.

Expanded Availability of Risk-Weighting. In principle, there seems to us to be no compelling policy reason to limit risk-weighting to situations specifically contemplated by a treaty. In the views of banking regulators, risk-weighting is, and for many years has been, the best way to determine the adequacy of bank capital. It seems logical, and consistent with our experience, that different assets require different levels of equity capital, with riskier assets requiring more capital than, say, a portfolio of Treasury securities. Accordingly, while administrability and other factors may justify the continued availability of the existing rules for determining the deductible interest of a U.S. branch of a foreign bank, we believe that risk-weighting should be made available on an elective basis to a broader range of banks than just U.K. and Japanese banks, subject to the considerations noted below.

We can imagine that one reason the IRS and Treasury might wish to limit risk-weighting to U.S. branches of U.K. and Japanese banks is that the treaties in question obligate the United Kingdom and Japan to extend reciprocal treatment to local branches of U.S. banks. If that is the concern, the IRS and Treasury could limit the use of risk-weighting to branches of banks resident in countries that extend the same benefit, by their domestic law or by competent authority proceedings, to local branches of U.S. banks. As they have done in other areas of the law, the IRS and Treasury could publish a list, to be updated from time to time, of those countries whose banks are eligible to determine their deductible interest expense using risk-weighting. Insofar as U.S. treaty policies may be implicated, we assume that risk-weighting is

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[2] *See* Regs. §1.882-5(a)(2).

generally an available option in the negotiation of any new treaty or protocol – it does not appear to us to be a U.S. concession that was "traded off" for a concession made by the United Kingdom or Japan.

All tax treaties, whether or not they address the allocation of branch interest expense of banks, are intended to prevent double taxation. If a given U.S. treaty partner uses risk-weighting to determine how to tax its own banks, while the United States persists in using the traditional formula approach, a bank resident in that country and having a U.S. branch may be subject to double taxation. Moreover, as indicated by the OECD Discussion Draft on the Attribution of Profits to a Permanent Establishment,[3] an international consensus is emerging that risk-weighting is an appropriate method for allocating liabilities among branches and other offices of a bank for purposes of determining the amount of deductible interest expense in each jurisdiction. Accepting risk-weighting only if it is specifically authorized by a treaty will for some foreign banks delay for decades a method of determining branch capital that is apparently acceptable today to the IRS and Treasury and that tends to eliminate double taxation.

The current Regulations are the only obstacle to making risk-weighting generally available, and we recommend that they be amended to make risk-weighting generally available. We are not necessarily recommending that risk-weighting be made available to all branches of foreign banks, or even to all branches of foreign banks covered by a tax treaty. The IRS and Treasury could determine the circumstances under which risk-weighting would be available. As suggested above, risk-weighting might be limited to foreign banks eligible for tax treaty benefits and that reside in countries that use risk-weighting, for example as a means to ensure that a foreign bank cannot achieve double non-taxation by using inconsistent methods.

Develop Risk-Weighting Rules. Risk-weighting needs to be defined for tax purposes even if it is limited to U.S. branches of U.K. and Japanese banks. This will require the development of rules to risk-weight assets for U.S. tax purposes and will also require the IRS and Treasury to consider how the U.S. rules should be coordinated, if at all, with the approach to risk-weighting adopted in the United Kingdom, in Japan or, if our suggestion above is adopted, in other countries. For example, the government might wish to address whether a treaty partner's risk-weighting rules will be

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[3] OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments (PEs): Part II (Banks) (March 2003). (OECD 2003 Permanent Establishment Banks Report).

acceptable for purposes Regs. §1.882-5, assuming that the treaty partner agrees to use the U.S. rules in determining the branch capital of U.S. banks.

Proposed change in fixed ratio. The Notice says that the IRS and Treasury are considering whether the fixed ratio of 93% (as opposed to 94-96%) continues to be appropriate. The fixed ratio raises factual issues that we are not competent to comment on, but we do think it would be useful for the IRS and Treasury to consider whether the amended Regulations should retain the flexibility to change the fixed ratio in the future, based on changes in the capital of international banks, without going through the process of amending the Regulations to do so. We made that recommendation in our comments on the 1992 proposed Regulations.[4]

Rate of interest on "excess liabilities". The Notice states that foreign banks will be allowed to determine the rate of interest on so-called "excess liabilities" (that is, liabilities in excess of booked liabilities) by the use of the published 30-day average LIBOR rate for the year. This would replace the rule that requires the use of the actual rate of interest on dollar borrowings by the foreign bank's non-U.S. branches and offices.

We think this change makes sense if the experience since the adoption of the Regulations in 1996 has been that it is difficult for banks and the IRS to calculate accurately the actual rate of interest. Depending on such experience, consideration might be given to making this portion of the forthcoming regulations available for prior years, rather than limiting it to taxable years ending on or after the date on which the Notice was published.

Whether 30-day LIBOR is the most representative rate of interest for dollar borrowings by non-U.S. offices of international banks is a factual question on which we have no comment.

Combining the fixed ratio with a fair market value determination of U.S. assets. The Notice questions whether foreign banks should be allowed to continue to combine an election to use the fixed ratio to determine U.S. liabilities with an election to use fair market value to determine U.S. assets.[5] The concern is that the fair market value election will include non-purchased intangibles in U.S. assets, but the fixed ratio may not take intangibles into account.

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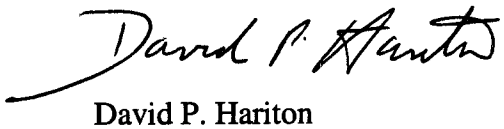
[4] *See* NYSBA Tax Section Report on Proposed Regulations Section 1.882-5 (August 26, 1992), 92 TNT 189-51.

[5] PLR 200513018 (December 14, 2004) allows such a combination under the present Regulations.

We think the resolution of this issue should depend on what is and is not taken into account in arriving at whatever fixed ratio (93% or 96%) is prescribed in the amended Regulations. It is unclear whether intangibles were taken into account in setting the 93% fixed ratio in 1996.[6] If intangibles are not taken into account as assets in setting the new fixed ratio, we agree that applying that ratio against the fair market value of U.S. assets could produce distortions. It should be borne in mind, of course, that directly-purchased intangibles would be taken into account if U.S. assets are valued at tax basis and, to that extent, there may also be a distortion in applying the fixed ratio to assets valued at tax basis.

We appreciate the opportunity to comment on the Notice. Please let us know if you have any questions.

Respectfully submitted,



David P. Hariton
Chair

cc: Michael J. Desmond, Acting Tax Legislative Counsel,
Department of the Treasury
Patricia A. Brown, Acting International Tax Counsel,
Department of the Treasury
Donald L. Korb, Chief Counsel,
Internal Revenue Service
Harry J. Hicks III, Associate Chief Counsel (International),
Internal Revenue Service
Steven A. Musher, Deputy Associate Chief Counsel (International),
Internal Revenue Service
John J. Merrick, Special Counsel (International),
Internal Revenue Service
Barbara A. Felker, Chief (International Branch 3),
Internal Revenue Service
Bethaney A. Ingwalson, Senior Counsel (International Branch 3),
Internal Revenue Service

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[6] The preamble to the 1992 Proposed Regulations, which introduced the 93% ratio, simply stated that it "was chosen with reference to U.S. regulatory requirements implementing the Basel Agreement on bank capital standards," and the preamble to the final regulations simply said that 93% "represents an appropriate safe harbor for banks".