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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
April 6, 2000

Bank =

Country A =
State =
Date a =
Date b =
x% =

Dear :

This is in reply to a letter dated September 8, 1999, requesting rulings under section 882 of the Internal Revenue Code of 1986 ("the Code") and the interest article of the income tax treaty between the United States and Country A ("Treaty"). The information submitted for consideration is substantially as set forth below.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Bank is an international banking institution that is incorporated under the laws of Country A and that maintains offices in various countries. Bank represents that it is not a trust company. Bank previously operated a U.S. branch office under a State banking license ("Full License") through which Bank engaged in the active conduct of a banking, financing or similar business in the United States within the meaning of section 1.864-4(c)(5)(i) of the Income Tax Regulations ("Regulations"). Pursuant to an order by its Federal banking regulator, Bank was required to relinquish its Full License on Date a

during Bank's tax year ending Date b. Contemporaneously with the surrender of its Full License, Bank was able to continue many of its existing banking activities in the United States by restructuring the ownership of its U.S. based activities. Bank represents that as of Date b, it transferred its U.S. assets (within the meaning of section 1.884-1(d) of the Regulations) to a wholly-owned U.S. based limited liability company ("LLC") that will be treated as a disregarded entity within the meaning of section 301.7701-2(c)(2). The employees and income-producing activities of Bank's trade or business that operated under its Full License will continue to operate and record its activities in the name of the U.S. based LLC. Through the activities conducted by LLC, Bank's active conduct of a banking, financing or similar business in the United States within the meaning of section 1.864-4(c)(5)(i) will continue in the year ending on Date b and future years without interruption. LLC, however, will not have a banking license and will not be eligible to fund its activities by taking deposits.

In addition to its active conduct of a banking, financing or similar business through LLC's activities, Bank represents that it is also planning to establish an office in the United States pursuant to a license to establish a representative office in State ("Restricted License"). Under a Restricted License, the representative office will be permitted to act on behalf of Bank in certain capacities, such as soliciting and negotiating loans on behalf of Bank so long as Bank's personnel located outside the United States make the ultimate credit decisions. The representative office, however, cannot take deposits in the United States under a Restricted License. The representative office will be subject to supervision and examination by state and federal banking authorities.

Bank is a calendar year, accrual basis taxpayer and has filed a U.S. Income Tax Return for a Foreign Corporation (Form 1120F) with the Internal Revenue Service Center in Philadelphia to report income effectively connected with its U.S. banking trade or business for tax years prior to the tax years ending on date b.

Requested Ruling 1

For tax years beginning with Bank's tax year ending Date b, Bank has requested that it continue to be treated as a "bank" for purposes of section 1.882-5(c)(4) of the Regulations and that the election previously made by Bank to use the 93 percent fixed ratio continue to apply for determining its U.S. liabilities.

Section 1.882-5 of the Regulations provides rules for determining the amount of interest expense of a foreign corporation that is allocable under section 882(c) of the Code to income that is (or is treated as) effectively connected with the conduct of a trade or business within the United States. Under these rules, a taxpayer must determine its worldwide liability-to-asset ratio. Section 1.882-5(c)(4) provides:

> a taxpayer that is a bank as defined in section 585(a)(2)(B) (without

> regard to the second sentence thereof) may elect to use a fixed ratio of 93 percent in lieu of its actual ratio. A taxpayer that is neither a bank nor an insurance company may elect to use a fixed ratio of 50 percent in lieu of the actual ratio.

Bank represents that it timely elected, and is currently subject to, the fixed ratio method.

A bank as defined in section 585(a)(2)(B) in relevant part is a corporation that would otherwise meet the definition of a bank within section 581 except for the fact that it is a foreign corporation. Section 581 provides in relevant part:

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

Since Bank is a not a trust company and a substantial part of its business in the United States does not consist of exercising fiduciary powers similar to those permitted to national banks under authority of the Comptroller of the Currency, it will only qualify as a bank within the meaning of section 581 if it engages in the other activities prescribed by the statute. Thus, as applied to Bank’s facts, Code section 585(a)(2)(B), by reference to section 581, requires Bank to be substantially engaged in receiving deposits and making loans and discounts, and be subject to supervision and examination by a State or Federal regulatory agency.

As of Date a, when Bank relinquished its Full License, Bank was no longer able to take deposits in the United States. Because a substantial part of Bank’s U.S. trade or business does not consist of receiving deposits, Bank does not meet the definition of a bank for purposes of Code sections 581 and 585(a)(2)(B). Further, the scope of Bank’s regulatory supervision under a Restricted License would only extend to the scope of activities conducted pursuant to the license by the representative office and not the activities conducted by LLC. Bank’s banking, financing or similar business under section 1.864-4(c)(5)(i) of the Regulations which will be actively conducted through the activities of LLC is not subject to the supervision and examination by a State or Federal regulatory agency. Accordingly, based on the facts and representations submitted, Bank is not considered a bank for purposes of section 1.882-5(c)(4) of the Regulations beginning the day after Date a.

Since Bank timely elected under section 1.882-5(a)(7) of the Regulations to use the fixed ratio method in determining its Step-Two U.S. Connected Liabilities, Bank must

switch to the actual ratio method (as determined under section 1.882-5(c)(2)) in order to allocate an appropriate amount of interest expense associated with the funding of its effectively connected income. Section 1.882-5(a)(7) provides:

> an elected method must be used for a minimum of five years before the taxpayer may elect a different method. To change an election before the end of the requisite five-year period, a taxpayer must obtain the consent of the Commissioner.... The Commissioner ... will generally consent to a taxpayer's request to change its election only in rare and unusual circumstances.

Section 1.882-5(c)(1) provides the general rule for determining the total amount of U.S.-connected liabilities for the taxable year:

> The amount of U.S.-connected liabilities for the taxable year equals the total value of U.S. assets for the taxable year (as determined under paragraph (b)(3) of this section) multiplied by the actual ratio for the taxable year (as determined under paragraph (c)(2) of this section) or, if the taxpayer has made an election in accordance with paragraph (c)(4) of this section, by the fixed ratio.

To compute the total value of U.S. assets, section 1.882-5(b)(3) provides:

> The total value of U.S. assets for the taxable year is the average of the sums of the values (determined under paragraph (b)(2) of this section) of U.S. assets. For each U.S. asset, value shall be computed at the most frequent, regular intervals for which data are reasonably available. In no event shall the value of any U.S. asset be computed less frequently than monthly (beginning of taxable year and monthly thereafter) by a large bank (as defined in section 585(c)(2)) and semi-annually (beginning, middle and end of taxable year) by any other taxpayer.

Bank satisfied the definition of "bank" under section 585(a)(2)(B) and met the definition since the date of its election, through the beginning of its taxable year ending on Date b and up until it was required to surrender its Full License on Date a. On Date a, before the end of its tax year ending Date b, Bank ceased to meet the definition of a "bank" within the meaning of section 1.882-5(c)(4) and by reference section 585(a)(2)(B). Sections 1.882-5(b)(3) and (c)(1) do not provide for the determination of the total value of U.S. assets and U.S.-connected liabilities under split-year or pro-rata methods to arrive at combined total values for the full taxable year. Rather, a taxpayer's elected method must be applied to its total value of U.S. assets for the entire taxable year to determine its U.S.-connected liabilities. No pro-ration of assets is provided for in section 1.882-5(b)(3) to determine the U.S.-connected liabilities attributable to the period that Bank met the definition of Bank under section 585(a)(2)(B). Further, the

regulation requires that the actual ratio for the taxable year or the fixed ratio be applied. Accordingly, we conclude that the regulations contemplate that the method used by a taxpayer under a proper election for determining the total value of U.S.-connected liabilities must be applied for an entire taxable year.

Based on the facts and representations submitted, we conclude:

(1) Bank will be permitted to remain on the 93 percent fixed ratio method for the entire tax year ending on Date b since Bank satisfied the definition of bank under section 585(a)(2)(B) for a substantial part of the tax year.

(2) For tax years beginning after Bank's tax year ending Date b, Bank does not satisfy the definition of Bank under section 585(a)(2)(B). Accordingly, the fixed ratio applicable to Bank under section 1.882-5(c)(4) for tax years beginning after Date b is 50 percent.

(3) For tax years beginning after Bank's tax year ending Date b, Bank may elect to apply the actual ratio method prescribed in section 1.882-5(c)(2). If Bank so elects, it is required under section 1.882-5(a)(7) to use the actual ratio for a minimum period of five years, beginning with the first year in which Bank elects the actual ratio, before Bank may elect a different method.

<u>Requested Ruling 2</u>

For tax years beginning with Bank's tax year ending Date b, Bank has requested that interest paid or deemed paid by its U.S. permanent establishment continue to be treated as interest paid to which the exemption under the interest article of the Treaty applies.

Generally, the interest article of Treaty exempts interest paid between banks from tax in the source country. Bank seeks to apply this article with regard to branch-level interest allocated to and borne by its U.S. permanent establishment.

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

Code section 884(f)(1)(B) provides that to the extent the interest that is allocable to income that is effectively connected (or treated as effectively connected) with the conduct of a trade or business within the United States exceeds the interest described in section 884(f)(1)(A), a foreign corporation shall be liable for tax under section 881(a) in the same manner as if such excess were interest paid to such foreign corporation by a wholly owned domestic corporation on the last day of such foreign corporation's taxable year.

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

Code section 884(f)(3) and section 1.884-4(c)(3)(i) of the Regulations provide that in the case of any interest described in section 884(f)(1)(B) treaty benefits shall apply if such treaty is an income tax treaty and the foreign corporation receiving the interest is a qualified resident of such foreign country. The treaty between the United States and Country A is an income tax treaty. Bank represents that it is a qualified resident of Country A.

The interest article of the Treaty provides that the rate of tax imposed by one Contracting State on interest derived from sources in that Contracting State by a resident of the other Contracting State shall not exceed x%. This article of the Treaty provides, however, that such interest shall be exempt from tax by the other Contracting State if it is interest paid between banks, except on loans represented by bearer instruments. Therefore, interest paid by a bank in the United States to a bank in Country A is not subject to U.S. taxation under the interest article of the Treaty. For purposes of applying this article, both the payor and the payee must independently satisfy the definition of bank.

The Treaty does not provide a definition of bank. The Treaty provides that undefined terms shall have the meaning which it has under the laws of the country whose tax is being determined, unless the context requires otherwise. Because the context does not shed light on the meaning of the term in this situation, it is necessary to refer to domestic law. Section 1.884-4(a)(2)(iii) of the Regulations, which applies to foreign corporations that are treated as banks for purposes of the branch-level interest tax, specifically refers to section 585(a)(2)(B) for the definition of bank.

For reasons discussed above in Requested Ruling 1, Bank's representative office does not qualify as a bank within the definition of Code sections 581 and 585(a)(2)(B). In short, Bank's representative office is not permitted to take deposits without a Full License, and as a result, a substantial part of its business does not consist of receiving deposits. Accordingly, the U.S. Branch is not a bank within the definition of section 585(a)(2)(B) because it does not meet the criteria required by section 581.

Based on the facts and representations submitted, we conclude:

(1) Bank cannot avail itself of the interest article of the Treaty. Payments of branch-level interest, as defined in section 884(f), to Bank from its representative office are not

payments between banks as is required to receive benefits under the Treaty. Accordingly, any excess interest is subject to taxation in accordance with section 884(f)(1)(B).

(2) Based on Bank's representation that it is a qualified resident (as defined in section 1.884-5(a)) of Country A, its country of incorporation, Bank is entitled to the reduced withholding rate of x% under the interest article of the Treaty in accordance with section 1.884-4(f)(3) of the Regulations.

A copy of this letter must be attached to any income tax return to which it is relevant, including any previously filed return.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

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