Internal Revenue Service

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Department of the Treasury

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199917081

Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
February 2, 1999

Bank =

Country A =

Country B =

City A =

City B =

City C =

City D =

Date a =

Dear

This is in reply to a letter dated September 15, 1998, requesting rulings under section 882 of the Internal Revenue Code of 1986 (the "Code"). Additional information was submitted in a letter dated October 16, 1998. 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. This office has not verified any of the material submitted in support of the request for rulings. Verification of the factual information, representations, and other data may be required as part of the audit process.

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Bank is an international banking institution incorporated under the laws of Country A. Bank files a Form 112OF to report the income earned by its U.S. operations. Bank is an accrual basis taxpayer with a Date a, tax and financial year-end.

Through its branches and agencies located in City A, City B, City C, City D and Country B (the U.S. branches), Bank is engaged in the U.S. in a commercial wholesale banking business which includes but is not limited to lending activity, issuance of lines of credit, deposit taking activity, and dealing in derivatives.

The Country B branch of Bank was created in order to facilitate deposit-taking activity from the Eurodollar market. The Country B branch is an offshore shell branch having no employees and managed by personnel of the City A branch of Bank. Specifically, the employees of the City A branch identify the prospective depositors and negotiate the terms of the deposit. The Country A branch's sole activity is to raise third party funds from the Euro deposit market in order to make the funds available to the U.S. operations of Bank for their general banking operations. The City A branch personnel who perform the deposit taking categories for the Country B branch also place the funds acquired with the City A branch.

The City A and Country B branches of Bank each maintain a separate set of books in order to meet U.S. and foreign regulatory requirements. Because the Country B branch is licensed by a foreign jurisdiction, any transactions entered into under such foreign banking license must be booked in Country B and may not be booked by a branch licensed to do business in the U.S. However, since the Country B branch's deposit transactions are entered into by the City A personnel for use in the U.S. operations, City A personnel maintain the books and records of the Country B branch.

This activity is recorded on the respective Country B branch and City A branch books correlatively as interbranch loans and borrowings that accrue offsetting interbranch interest income and expense. The interbranch book assets, liabilities, income and expenses are disregarded by Bank in computing its U.S. taxable income. Although the U.S. operations extend loans to more than 50%-owned foreign affiliates, thereby generating interest income that is non-effectively connected to Bank's U.S. trade or business pursuant to Section 864(c)(4)(D)(i), the income with respect to the loans extended by the U.S. operations is predominantly effectively connected with Bank's U.S. trade or business.

Section 882(a) of the Code imposes U.S. tax on income of a foreign corporation that is effectively connected with the U.S. trade or business. Section 882(c)(1) allows foreign

116

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

Section 1.882-5 provides that the amount of deductible interest expense allocable to ECI is determined under a three step process provided in section 1.882-5(b), (c), and (d) or (e). Under step 1, a foreign corporation first determines the total value of its U.S. assets under section 1.882-5(b). Under step 2, the foreign corporation determines the amount of U.S. liabilities under Regulation Section 1.882-5(c). Under step 3, interest expense is computed either under the adjusted U.S. booked liabilities method provided in section 1.882-5(d) or the separate currency pool method provided in section 1.882-5(e).

Under the adjusted U.S. booked liabilities method, the adjustment to the amount of interest expense paid or accrued by the U.S. trade or business is determined by comparing the amount of U.S.-connected liabilities for the taxable year with the average total amount of U.S. booked liabilities properly reflected on the books of the U.S. trade or business. If U.S. liabilities exceed U.S. booked liabilities, interest expense is determined under section 1.882-5(d)(5) as the amount of interest accrued or paid by the U.S. trade or business during the taxable year plus the excess of U.S. liabilities over U.S. booked liabilities multiplied by the rate of U.S. dollar borrowing of the taxpayer's branches outside the U.S. If U.S. liabilities are equal or less than U.S. booked liabilities, interest expense is determined under section 1.882-5(d)(4) as the product of the total amount of interest accrued or paid by the U.S. trade or business during the taxable year times a fraction, referred to as the scaling ratio, the numerator of which is the amount of U.S. liabilities and the denominator of which is the average total amount of booked liabilities.

Section 1.882-5(d)(2)(iii) provides special rules for determining when U.S. booked liabilities are properly reflected on the book of a U.S. trade or business of a foreign corporation that is a bank as follows:

> "A liability, whether interest bearing or non-interest bearing, is properly reflected on the books of the U.S. trade or business of a foreign corporation that is a bank as described in section 585(a)(2)(B) (without regard to the second sentence thereof) if -
>
> (1) the bank enters the liability on a set of books relating to an activity that produces ECI before the close of the day on which the liability is incurred, and

(2) there is a direct connection or relationship between the liability and that activity. Whether there is a direct connection between the liability and an activity that produces ECI depends on the facts and circumstances of each case.

Accordingly, based solely on the facts and representations submitted it is held that for purposes of section 1.882-5(d)(2)(iii):

(1) The Country B books and the U.S. branch and agency books, collectively, are considered a single set of books for purposes of section 1.882-5(d)(2)(iii)(A)(1).

(2) The single set of books relates to an activity that produces ECI under section 1.882-5(d)(2)(iii)(A)(1) on the basis that the U.S. bank operations produce effectively connected income and the liabilities of the Country B branch are used to fund the general business of the U.S. branches and agencies.

(3) The liabilities of the Country B branch book will qualify as booked liabilities under Section 1.882-5(d)(2)(iii)(A)(1) if such liabilities are entered onto the Country B branch book before the close of the day on which they are incurred.

(4) The Country B branch book liabilities have a "direct connection or relationship to an activity that produces ECI" within the meaning of section 1.882-5(d)(2)(iii)(A)(2) without requiring that Country B's liabilities be individually traced to specific effectively connected loans or other assets.

Consequently, under the facts and representations submitted, it is held that the Country B branch book third-party liabilities are properly reflected on the books of Bank's U.S. trade or business within the meaning of section 1.882-5(d)(2)(iii)(A).

No opinion is expressed with respect to section 1.882-5(d)(2)(v), concerning whether any Country B liabilities treated as properly reflected under the requirements of section 1.882-5(d)(2)(iii) were incurred or held for the principal purpose of artificially increasing the interest expense of the U.S. booked liabilities within the meaning of section 1.882-5(d)(2)(v).

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

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

Sincerely yours, 199917081

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

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