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U.S. Federal Income Taxation of U.S. Branches of Foreign Banks: Selected Issues and Perspectives

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U.S. Federal Income Taxation of U.S. Branches of Foreign Banks: Selected Issues and Perspectives

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I. INTRODUCTION

The title of this article notwithstanding, the United States does not in fact tax the U.S. branches of foreign banks;¹ branches are not regarded as distinct entities for most federal income tax purposes. Rather, the United States taxes foreign corporations (including banks) that are engaged in a trade or business within the United States on taxable income that is effectively connected with the conduct of that U.S. trade or business.²

But the story is not so simple. Various provisions of the Code and Regulations—including especially Regulations section 1.882-5, providing for the determination of the deductible interest expense of a foreign bank attributable to its U.S. trade or business, the branch profits tax, and the branch level interest tax—treat U.S. branches of foreign banks as separate entities, to one degree or another. Also, most income tax treaties provide that there should be attributed to a U.S. branch (a permanent establishment) the business profits that it might be expected to earn if it were a distinct and separate entity.

Moreover, in recent years, the nature of international banking has evolved considerably. Many banks now actively trade and deal in foreign currencies; in interest rate and foreign currency forward and futures contracts, options, and swaps; and in various equity- and commodity-derivative products, as well as in securities. These activities have resulted in a tremendous expansion of the volume and type of transactions involving multiple branches of these banks, both in providing financial products to customers and in hedging the risks assumed by the banks. The involvement of multiple branches in these transactions takes a variety of forms, including transactions between branches (such as swaps, sales of property, loans, and forward contracts) and joint efforts to provide products to customers. These developments have placed considerable pressure on the concepts that traditionally have been applied in determining the amount of a foreign bank's taxable income for U.S. federal income tax purposes, including the extent to which a branch should be disregarded as a separate entity.

In addition to exploring the nature of a branch for federal income tax purposes, this article considers in some (but by no means comprehensive) detail certain selected aspects of the concept of "effectively connected income," the rules under Regulations section 1.882-5 for determining the deductible interest expense of a foreign bank, and the relationship between

1. The term "U.S. branch" is used in this article in a nontechnical sense to include any branch, agency, or other business office operated by a foreign bank in the United States under a banking license granted by a U.S. federal or state bank regulatory authority.

2. IRC § 882(a)(1).

the interest allocation rules and the branch profits tax and branch level interest tax.³

II. EFFECTIVELY CONNECTED INCOME

A. Overview

A foreign bank that operates a branch in the United States is almost certainly engaged in a U.S. trade or business and is therefore subject to federal income tax on its taxable income that is effectively connected with the conduct of the U.S. trade or business.⁴ If the foreign bank is eligible for the benefits of an income tax treaty, its ECI⁵ generally is subject to U.S. tax only if it is “attributable” to a “permanent establishment” maintained by the foreign bank in the United States. A U.S. branch of a bank is a permanent establishment for these purposes and, while the “effectively connected” and “attributable” concepts are not synonymous, they are sufficiently analogous to produce the same tax consequences in most (but not all) of the situations discussed in this article.⁶

A foreign banking corporation’s ECI is taxed in essentially the same manner as a U.S. domestic banking corporation’s income is taxed. Thus, such ECI is subject to a 35% net income tax.⁷ Special considerations relevant to the calculation of deductions allowed in arriving at the bank’s net taxable income (ECTI)—and particularly the special rules for determining deductible

3. Among the subjects relevant to the taxation of foreign banks that are not covered in this article are (1) issues facing foreign banks that are not materially different from those facing domestic banks, (2) the increasingly complicated and onerous record-keeping and reporting requirements (such as those found in §§ 6038A, 6038C, 6114, and 6662(e)), and (3) the very important subject of state and local income taxation.

4. IRC §§ 864(c), 882(a).

5. In this article, “ECI” refers to gross income effectively connected with a U.S. trade or business, while “ECTI” refers to effectively connected taxable income (ECI minus allocable deductions).

6. Accordingly, except as otherwise noted, the discussion below, which is phrased in terms of ECI, also should apply for purposes of determining profits attributable to a U.S. permanent establishment of a foreign bank.

On the relationship between the “effectively connected” and “attributable” concepts, see Rev. Rul. 81-78, 1981-1 C.B. 604 (interpreting the Polish-U.S. treaty). One important difference is that the residual force of attraction principle in § 864(c)(3)—treating all U.S. source, non-fixed or determinable annual or periodical income [hereinafter non-“FDAP” income] as effectively connected with the taxpayer’s U.S. trade or business—is inapplicable under most treaties. *Id.* at 605. See also Rev. Rul. 91-32, 1991-1 C.B. 107.

7. IRC §§ 11, 882(a). The bank also may be subject to the alternative minimum tax under §§ 53-59 and, pursuant to § 906, may be entitled to claim a credit for foreign income taxes on foreign source ECI.

interest expense—are discussed in Part III below. In addition, the bank may be subject to the branch profits tax and branch level interest tax under section 884, which are discussed in Part IV.

U.S. source income of the bank that is not ECI but is “fixed or determinable annual or periodical income” (FDAP), including dividend and interest income, is subject to a 30% gross withholding tax unless eligible for an exemption or a reduced rate of withholding under the Code or an applicable tax treaty.⁸ As discussed below, the interplay between the net income taxation of ECI and the treatment of U.S. source, non-ECI FDAP income has influenced both the regulations and the tax planning of foreign banks.

In general, in defining ECI, the Code and regulations provide separate rules for different categories of income, including (1) U.S. source FDAP and capital gains, (2) income from notional principal contracts, (3) income from foreign exchange transactions, (4) other U.S. source income, and (5) foreign source income. While these rules are relatively straightforward, some uncertainties exist as to their application in particular transactional settings, and the results mandated by some of these rules are not sensible or justifiable.

The rules for determining ECI of a foreign bank apply an “all or nothing” approach: particular income is either ECI in its entirety or not at all. The rules do not provide for an allocation of income among different branches of a bank based on, for example, each branch’s relative contribution towards the generation of that income.⁹ This approach may have the advantage of avoiding difficult allocation questions, but it can result in U.S. tax being imposed on more or less than the branch’s economic income. As

8. IRC § 881(a). Three important exemptions from withholding under the Code are: (1) interest on a bank deposit (which may include a deposit with an affiliate), IRC § 881(d); (2) interest or original issue discount on an obligation with an original maturity of 183 days or less, IRC §§ 871(g)(1)(B)(i), 881(a); Regs. § 1.1273-1(c)(5); and (3) “portfolio interest,” IRC § 881(c). See *infra* note 155 for a general discussion of what constitutes a “deposit.” Very generally, portfolio interest is non-ECI interest received by a foreign person on a registered obligation (provided the beneficial owner certifies its non-U.S. status) or on a foreign-targeted bearer obligation that satisfies certain requirements, provided in each case that the obligation is issued after July 18, 1984. However, portfolio interest does not include interest received by (1) a bank on an extension of credit under a loan agreement entered into in the ordinary course of its trade or business, (2) a “10 percent shareholder,” or (3) a controlled foreign corporation from a related person. IRC § 881(c).

9. In contrast, § 863(b) treats certain types of income (including income from personal property produced in a foreign country and sold in the United States or vice versa) as derived partly from U.S. sources (and consequently as ECI) and partly from foreign sources (and consequently exempt from U.S. tax). Section 863(a) authorizes the Internal Revenue Service (IRS) to issue regulations providing for the allocation and apportionment of items of gross income, expenses, losses, and deductions, other than those specified in §§ 861(a) and 862(a), to sources within or without the United States.

discussed below, more often than not the rules result in over-inclusion of income subject to U.S. taxation.

Moreover, consistent with the notion that the foreign bank is the taxpayer and is being taxed on its income that is effectively connected with its U.S. trade or business, transactions between the U.S. branch and another office of the bank generally are not given effect in determining ECI, on the theory that a branch is an integral part of the taxpayer corporation and a corporation cannot contract with itself. Accordingly, a loan or swap contract between the U.S. branch and the home office is ignored for U.S. tax purposes, regardless of whether the transaction is taken into account in determining the profits and losses of the U.S. branch for regulatory or financial reporting purposes or in determining the taxable income of the non-U.S. branch for foreign tax purposes.

In light of the foregoing, it is important for foreign banks to evaluate carefully whether they are likely to incur double taxation on income that is ECI but is also subject to tax in a foreign jurisdiction, and to consider ways to minimize such double taxation.

B. *Specific Categories of Income*

1. *Interest Income and Gains from Debt Securities.*—Typically, a substantial portion of the income of a U.S. branch of a foreign bank consists of interest on debt securities and gain from the sale, exchange, or redemption of those securities.¹⁰ Regulations section 1.864-4(c)(5) contains a special rule for determining whether such income is ECI in the case of a foreign corporation that is engaged in the “active conduct of a banking, financing or similar business in the United States.”¹¹ In general, a foreign bank with a U.S.

10. In this discussion, the term “securities” includes any type of debt instrument, including, for example, loans, loan participations, Treasury or other governmental securities, and notes or bonds issued by individuals, partnerships, corporations, or other persons. The term also includes any evidence of an interest in, or right to subscribe to or purchase, any of the foregoing items. See Regs. § 1.864-4(c)(5)(v).

11. A foreign corporation is engaged in the active conduct of a banking, financing, or similar business if it carries on a business in the United States the activities of which consist of any one or more of the following activities carried on, in whole or in part, in the United States:

- (a) Receiving deposits of funds from the public,
- (b) Making personal, mortgage, industrial, or other loans to the public,
- (c) Purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness,
- (d) Issuing letters of credit to the public and negotiating drafts drawn thereunder,
- (e) Providing trust services for the public, or
- (f) Financing foreign exchange transactions for the public.

branch that is licensed as a bank by a U.S. bank regulatory authority is subject to this special rule.

Under this special ECI rule for banks, interest income and gain or loss from a debt security are ECI if the security is "attributable" to the U.S. branch and the other requirements described below are satisfied. This special rule generally applies regardless of whether the income, gain, or loss is U.S. source or foreign source,¹² but it applies to gain or loss (as opposed to interest income) only if the gain or loss arises from the sale or exchange of a security that is a capital asset in the hands of the bank.¹³ However, U.S.

Regs. § 1.864-4(c)(5)(i). The fact that the taxpayer is subject to the banking and credit laws of a foreign country is taken into account, but it is the character of the business conducted in the United States that is determinative. *Id.*

12. For the application of this rule to foreign-source interest income, see IRC § 864(c)(4)(B)(ii); Regs. § 1.864-5(b)(2)(i), -6(b)(2)(ii)(b). However, interest income from a foreign corporation is never ECI if the bank owns stock of the corporation (directly or by attribution) carrying more than 50% of the voting power. IRC § 864(c)(4)(D).

In general, under § 865(e)(2) and (3), gain from the sale, exchange, or redemption of debt securities attributable to a U.S. branch (under the principles of § 864(c)(5), including Regs. § 1.864-4(c)(5)) is U.S. source gain, and therefore ECI, either under the special ECI rule for banks or under § 864(c)(3), discussed below. See *infra* note 89 and accompanying text regarding the treatment of losses. In general, under § 865, gain or loss from the sale or exchange of debt securities that are not attributable to a U.S. branch is foreign source and is exempt from U.S. tax, except as discussed *infra* note 14.

13. Regs. § 1.864-4(c)(5)(ii). Debt securities that are capital assets in the hands of the bank should be subject to this rule even if the gain or loss is ordinary by virtue of § 582(c). See Regs. § 1.582-1(d) (indicating that § 582(c) addresses the character of gain or loss, not whether the debt securities are capital assets); Harvey P. Dale, *Effectively Connected Income*, 42 Tax L. Rev. 689, 700 (1987) (reaching the conclusion stated in the preceding sentence, after expressing the view that the provision is ambiguous).

On the other hand, under § 1221(1), debt securities that are inventory of the U.S. branch or are held for sale to customers in the ordinary course of the U.S. branch's business are not capital assets, and gain or loss on their sale or exchange is therefore not subject to the special ECI rule for banks. Similarly, under *Burbank Liquidating Corp. v. Commissioner*, 39 T.C. 999 (1963), *aff'd in part, rev'd in part*, 335 F.2d 125 (9th Cir. 1964), mortgage loans (and perhaps other loans) made by a bank in the ordinary course of its business are "notes receivable acquired for services rendered" (the service of making loans) and therefore are not capital assets under § 1221(4). See *Federal Nat'l Mortgage Ass'n v. Commissioner*, 100 T.C. No. 36 (1993). As a result of the enlarged scope of § 1221(4), the special ECI rule for banks may apply to a significantly narrower category of gains from the disposition of debt securities than probably was envisioned when the regulations were promulgated.

The recent enactment of § 475, which requires dealers to mark-to-market securities (other than, in general, securities not held primarily for sale to customers in the ordinary course of the trade or business), has focused attention on the classification of debt securities held by banks. See, e.g., *Banks Concerned About Broad, Uncertain Scope of Mark-to-Market Rules*, 93 TNT 229-2 (Nov. 8, 1993) (LEXIS, Fedtax lib., TNT file); *Tax Bill Provision Could Cause Fundamental Change in Banking*, 93 TNT 165-3 (Aug. 9, 1993) (LEXIS, Fedtax lib., TNT file); see also Temp. Regs. § 1.475(b)-1.

source gain or loss from debt securities that do not qualify for the special ECI rule for banks is ECI under section 864(c)(3).¹⁴

In general, a security is considered attributable to a U.S. branch for purposes of the special ECI rule for banks if the branch *actively and materially participates* in soliciting, negotiating, or performing other activities required to arrange the *acquisition* of the security. The U.S. branch need not have been the only active participant in arranging the acquisition.¹⁵ Moreover, the focus is on the acquisition of the security, not on its subsequent use in a business. Thus, securities that are transferred by a foreign office of the bank to its U.S. branch, and in whose acquisition the branch did not participate, are not attributable to the U.S. branch and therefore do not generate ECI.¹⁶ On the other hand, with one exception discussed below, a security that is attributable to the branch, as a result of the branch's participation in its acquisition, always gives rise to ECI so long as the security continues to be held by the bank.¹⁷ The regulations do not define "active and material

14. Under § 864(c)(3), all U.S. source income, gain, or loss (other than FDAP income and capital gains or losses described in § 864(c)(2)) is ECI if the taxpayer has a U.S. trade or business. However, if a foreign bank is eligible for the benefits of an income tax treaty, such income, gain, or loss generally is not subject to U.S. taxation unless it is attributable to a U.S. permanent establishment.

In general, gain or loss from debt securities that are attributable to a U.S. branch (under the principles of § 864(c)(5), including Regs. § 1.864-4(c)(5)) is U.S. source and therefore is ECI. IRC §§ 865(e)(2), (3). See *supra* note 12 and *infra* note 89. This analysis should apply to gain or loss on all debt securities that would be subject to the special ECI rule for banks but for the fact that the debt securities are not capital assets (e.g., by virtue of § 1221(1) or (4)). Also, if debt securities are not attributable to the U.S. branch but are described in § 1221(1) (inventory and property held for sale to customers in the ordinary course of a trade or business), gain (and, in general, loss) on their disposition is U.S. source if title to the securities passes to the buyer in the United States. IRC §§ 861(a)(6), 865(b); Regs. § 1.861-7. However, if debt securities described in § 1221(1) are attributable to the U.S. branch, the gain or loss is foreign source (and therefore exempt from U.S. federal income taxation) if title to the securities passes to the buyer outside the United States, the securities are sold for use or disposition outside the United States, and a non-U.S. office of the bank materially participates in the sale. IRC §§ 864(c)(4)(B)(iii), 865(e)(2)(B).

15. Regs. § 1.864-4(c)(5)(iii).

16. As explained in Part III.B, a corollary effect of not attributing these assets to the branch is that they are not taken into account in allocating interest expense to the branch. As a result, the interest expense deduction of the branch is reduced proportionately.

17. In view of this "once attributable, always attributable" rule, § 864(c)(7) (which provides that gain on the disposition of an asset that ceases to be used in connection with a U.S. trade or business is ECI if the disposition occurs within 10 years after such cessation) generally does not apply to securities subject to the special banking rule. While § 864(c)(7) conceivably could apply to debt securities that are subject to the exception for "other securities" (discussed *infra* text accompanying note 20), such a result does not appear to make sense as a practical or a policy matter.

participation,” although they provide a list of activities that do not by themselves cause a security to be attributed to the United States.¹⁸

Once it is determined that a security is attributable to the U.S. branch, special rules determine the extent to which interest and gain thereon are ECI. In general, *all* interest and gain on a debt security that is subject to the special ECI rule for banks is ECI if the security *either*

- (a) was acquired (1) as a result of or in the course of making loans to the public, (2) in the course of distributing the securities to the public, or (3) for the purpose of satisfying the reserve or other similar requirements imposed by a banking authority, *or*
- (b) is payable on demand or at a fixed maturity date of not more than one year, or was issued by the United States or any agency or instrumentality thereof.¹⁹

If a debt security attributable to a U.S. branch is not described in (a) or (b) (e.g., a long-term corporate bond, foreign or municipal government bond, or mortgage pass-through security), interest income (and gain or loss) on the security may be ECI only in part under a formula prescribed by the Regulations. Under the formula, interest income (as well as gain or loss) from these “other securities” is ECI in its entirety if the securities represent 10% or less

18. The regulations provide that a security is not attributable to a U.S. branch merely because the branch (1) collects or accounts for the interest, gain, or loss from the security, (2) exercises general supervision over the activities of the persons directly responsible for carrying on the solicitation, negotiation, or performance of other activities required in the acquisition of the security, (3) performs merely clerical functions incident to the acquisition of the security, (4) exercises final approval over the execution of the acquisition of the security, or (5) holds the security in the United States or records the security on its books and records as having been acquired by the branch or for its account. Regs. § 1.864-4(c)(5)(iii)(b).

Foreign banks often maintain shell branches in the Bahamas or Cayman Islands that are operated by personnel of U.S. branches. Under the “active and material participation” test, the interest income and gain on securities booked in these shell branches are ECI.

19. Regs. § 1.864-4(c)(5)(ii) (paraphrased). For these purposes, securities issued by FNMA, Freddie Mac, or GNMA are treated as securities issued by an instrumentality of the United States government, but mortgage pass-through securities (which are guaranteed but not issued by such an instrumentality) are not so treated. See Rev. Rul. 84-10, 1984-1 C.B. 155 (holding that FNMA mortgage pass-through certificates are considered as representing “loans secured by an interest in real property” under § 7701(a)(19)(C)(v) to the extent the underlying real property is described in that provision). This ruling and other rulings cited therein do not treat such pass-through securities as obligations of the United States or an instrumentality thereof under § 7701(a)(19)(C)(ii). This difference in the treatment of mortgage pass-through securities may create planning opportunities since these securities may qualify for the special rule for “other securities” (described *infra* text accompanying note 20) and for the portfolio exemption from withholding tax.

of the U.S. branch's assets; the proportion of interest income (and gain or loss) from "other securities" that constitutes ECI declines to the extent such securities constitute more than 10% of the branch's assets.²⁰

The practical consequences of the special ECI rule for banks are simply stated: If the U.S. branch actively and materially participates in the acquisition of a security, then with limited exceptions all income and gain derived from the asset is taxable as ECI. This is so even if the branch is not the sole material participant in the acquisition of a security (for example, if the home office participates equally in the acquisition). Conversely, if the branch's participation in the acquisition is not "active and material," none of the income is ECI.

If a foreign bank is not eligible for the benefits of an income tax treaty that exempts U.S. source interest income from the 30% gross withholding tax, it usually wishes to ensure that loans to U.S. borrowers will give rise to ECI, so that only net interest income from the loans (after deducting the cost of funding) is subject to U.S. tax.²¹ Thus, it is necessary for the bank to ensure that its U.S. branch "actively and materially" participates in the acquisition of the security. This requires particular care where, as often is the case with foreign banks, the U.S. branch is not the only, or even the principal, participating office in arranging the loan.

For example, a foreign bank may have a longstanding relationship with a foreign-based multinational group. The multinational group negotiates a global line of credit with the bank's home office, a portion of which is made available to the group's U.S. subsidiary. Seeking to avoid U.S. withholding tax on interest paid by the U.S. subsidiary, the bank arranges to have its U.S. branch make all advances under the line of credit to the U.S. subsidiary. With proper care and sufficient planning, it should be possible to ensure that the U.S. tranche of the line of credit, but not other portions, will give rise to ECI.

20. Regs. § 1.864-4(c)(5)(ii). More specifically, the portion of the interest income from such "other securities" that is treated as ECI equals the U.S. source interest income on the securities, multiplied by a fraction the numerator of which is 10% and the denominator of which is the percentage of total U.S. assets that consist of "other securities" (in each case based on monthly average book values). *Id.* A similar fraction (with minor adjustments) applies to determine the percentage of gain (or loss) on such "other securities" that is treated as ECI. *Id.* For example, assume the U.S. branch of a foreign bank has total U.S. assets with an average book value for a particular year of \$25 million, the average book value of the branch's "other securities" is \$10 million, and the interest received on the "other securities" for the year is \$1 million. The denominator of the fraction is 40% (\$10 million/\$25 million), and the portion of the interest that is ECI is: $10\%/40\% \times \$1 \text{ million} = \$250,000$.

21. As discussed in Part III.B, the deduction for interest expense is computed under a special formula, and does not involve a direct tracing of interest expense against interest income.

In Revenue Ruling 86-154 (situation 3),²² the IRS held that a loan made by a U.S. branch of a foreign bank to a U.S. subsidiary of a multinational corporation was “attributable” to the U.S. branch even though the loan was pursuant to a global line of credit solicited, negotiated, and approved by the bank’s home office. Before the loan was made, officers of the U.S. branch negotiated the collateral for the loan and obtained from another U.S. branch of the bank an independent credit analysis of the U.S. subsidiary (but not of the parent company) and an evaluation of the collateral. Although the U.S. branch was instructed by the home office to fund the loan (subject to the U.S. branch’s normal credit analysis and loan review procedures), the ruling concludes that the U.S. branch’s participation in acquiring the loan was active and material. The ruling acknowledges that the home office’s active and material participation in the loan transaction did not preclude the U.S. branch from actively and materially participating in the acquisition of the loan.²³

The significance of this ruling is that U.S. branches that are strongly requested to participate in funding loan commitments negotiated by the home office can have the loans attributed to the U.S. branch, at least so long as each of the following conditions is satisfied:

- (1) The decision to participate in the loan transaction is made by the U.S. branch in accordance with its normal lending procedures;
- (2) Employees of the U.S. branch conduct direct negotiations with the borrower regarding certain aspects of the loan, such as collateral levels;
- (3) An independent credit analysis of the borrower is performed by either the lending U.S. branch or another U.S. branch;
- (4) The loan is funded directly to the borrower by the U.S. branch and recorded on the books of the U.S. branch; and
- (5) The borrower is an unrelated party.

Although not specifically required by the ruling, it is highly advisable for the U.S. branch to maintain in its files contemporaneous written documents evidencing the performance of these activities.

Where the foreign bank does not actively negotiate the loan (for example, where the bank participates in a syndicated loan that is negotiated and managed by another bank), the U.S. branch should be considered to “actively and materially participate” in the acquisition of the participation interest if it performs a significant portion of the activities that are typically performed by a loan participant and that were actually performed by the bank

22. 1986-2 C.B. 103.

23. *Id.*

in connection with the U.S. branch's participation in the particular loan. However, if the U.S. branch's participation interest is acquired after (and not as part of) the initial funding of the loan, the participation likely falls within the "other securities" basket described above, in which case, depending upon the facts, a portion of the resulting income might not be ECI.

If the borrower is related to the foreign bank, the bank should be particularly vigilant in adhering to the foregoing conditions and in contemporaneously documenting the active and material participation of the U.S. branch. In Revenue Ruling 86-154 (situation 2),²⁴ the IRS stated that it will closely scrutinize related party loans and, absent contemporaneous written documentation or other clear evidence of active and material participation by the U.S. branch, the branch will be presumed not to have actively and materially participated in acquiring the loans. In that situation, the IRS concluded that the branch did not actively and materially participate in the acquisition of a related party loan merely by funding the loan, booking it, and servicing it throughout its term where the home office performed all the essential functions in making the loan, including a review and evaluation of the borrower's capital needs and creditworthiness.²⁵

The special ECI rule for banks is relevant not only for foreign banks wishing to avoid withholding tax on U.S. source interest income, but it must also be carefully considered by foreign banks wishing to ensure that particular loans do *not* give rise to ECI.²⁶ For example, if situation 3 of Revenue Ruling 86-154, described above, had involved the U.S. branch of a Middle Eastern bank and a European-based multinational borrowing group, and the U.S. branch also performed a credit analysis of the Canadian subsidiary and evaluated the collateral provided by that subsidiary, it is quite likely that any advances to the Canadian subsidiary under the global line of credit, even if funded and booked by a foreign branch of the bank, would be attributable to the U.S. branch and therefore would give rise to ECI. Similarly, in what probably is a common fact pattern, a foreign bank enjoying the benefits of

24. *Id.*

25. *Id.* Depending on the circumstances, it is possible that even if a related party loan is attributable to the U.S. branch, it might be viewed as not arising "in the course of making loans to the public" and therefore as falling in the "other securities" basket, in which case a portion of the resulting income might not be ECI.

26. The concerns discussed in the text increased as a result of a 1984 amendment of the special ECI rule for banks, which eliminated a requirement that, in addition to "active and material participation" and satisfaction of the other conditions described above, the security had to be held by or for the U.S. branch and recorded on its books and records. This booking requirement was deleted because the IRS was concerned that it had the effect of making ECI treatment elective, thereby enabling foreign banks that were eligible for exemption from withholding tax under treaties to avoid paying U.S. tax on loans arranged by their U.S. branches but booked elsewhere. See LR-34-80, 1982-2 C.B. 877; T.D. 7958, 1984-1 C.B. 174.

a tax treaty exempting U.S. source interest from withholding tax runs the risk of having income and gains on various loans that are funded and booked by non-U.S. offices treated as ECI if a U.S. branch participates in essential functions necessary to the acquisition of the loan (such as performing the credit analysis of the U.S. or Latin American subsidiaries of a multinational borrowing group).

Two aspects of the foregoing situations are potentially troublesome for foreign banks seeking to avoid ECI. First, it is not clear what level of involvement is treated as "active and material participation." For example, is performing a credit analysis, without negotiating any terms (such as collateral) sufficient? What if the borrower (or its parent) is headquartered in the United States and employees of the U.S. branch assist in maintaining the client relationship but do not negotiate the terms of a particular loan? What if they act as an intermediary in forwarding terms between the borrower and the home office and discussing the parties' respective positions, but do not have independent negotiating authority?

Second, once the threshold of "active and material participation" is crossed, all income from the loan is ECI, regardless of the relative involvement of the U.S. branch and other offices of the bank. As a result, the bank may be exposed to double taxation, particularly if it (or another taxing authority) considers the loan to have been generated primarily by another office, which, for example, funds or books the loan.

One approach for dealing with these problems might be to replace the all or nothing approach of the existing rules with an allocation formula that takes into account the relative economic contributions of various offices of a bank. I do not favor that solution, for reasons discussed in Part II.C.3. Instead, further guidance should be provided regarding the application of the "active and material participation" standard to common situations that are not addressed in the regulations or in Revenue Ruling 86-154. In addition, a more appropriate balance between U.S. and foreign taxing jurisdictions should be struck by adding an exception to the special ECI rule for banks. Under this exception, interest income on a debt security issued by a foreign corporation (and gain or loss on the security) would not be attributable to the U.S. branch and therefore would not be ECI if a foreign office of the bank actively and materially participates in the acquisition of the loan, funds the loan, and records it on its books.²⁷ Under the proposed exception, if a non-U.S. office

27. More specifically, in addition to debt securities issued by foreign corporations, the exception should apply to any such debt security that gives rise to foreign source interest income, which also includes interest received from a foreign noncorporate resident or from a domestic corporation at least 80% of the gross income of which during a three-year testing period is active foreign business income. IRC §§ 861(a), (c); 862(a)(1). Also, under several income tax treaties, interest on a loan to a non-U.S. permanent establishment of a U.S.

of a foreign bank makes a loan to a non-U.S. subsidiary of a multinational group, interest on the loan would not be ECI even if the U.S. branch of the bank is involved in the acquisition of the loan (for example, by participating in negotiations with the U.S. parent or in performing a credit analysis). On the other hand, if the loan is made to a U.S. corporation, the interest would generally be ECI if the U.S. branch of the bank actively and materially participates, regardless of the level of involvement of a foreign office.

Regulations section 1.864-5(c)(5)(vi) provides that interest income and gains from debt securities that are not ECI under the special ECI rule for banks may be ECI under the “asset-use” and “business activities” tests (which generally apply in determining ECI in the case of FDAP income and capital gains arising from a nonbanking business),²⁸ if such interest income and gains are connected with a nonbanking U.S. trade or business of the foreign bank, such as trading in stocks or securities for the bank’s own account. Given that most banks trade in securities for their own account—usually as an integral part of their banking business and often in separate trading accounts as well²⁹—it is not entirely clear whether and under what circum-

corporation is foreign source if the loan was incurred in connection with the business of the permanent establishment and the interest was borne by it. See, e.g., Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Dec. 18, 1992, U.S.-Neth. art. 12, para. 4, K.A.V. 3507 [hereinafter “U.S.-Neth. Treaty”]; Convention Between the United States of America and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Mar. 8, 1971, U.S.-Jap. art. 6, para. 2, 23 U.S.T. 967 [hereinafter “U.S.-Jap. Treaty”]. It appears that policy arguments can be made on both sides of the issue of whether, in the absence of such a treaty provision, the United States should cede its taxing jurisdiction to a foreign country where a foreign bank’s non-U.S. branch makes a loan to a non-U.S. permanent establishment of a U.S. corporation under those circumstances.

The proposed exception is modeled on §§ 864(c)(4)(B)(iii) and 865(e)(2)(B), which provide that income from a foreign person’s sale of inventory property outside the United States that is attributable to a U.S. office of the taxpayer nonetheless is foreign source and is not ECI if the property is sold for use, consumption, or disposition outside the United States and a non-U.S. office of the taxpayer participates materially in the sale.

28. IRC § 864(c)(2); Regs. § 1.864-4(c)(2), (3). The cited provisions state that FDAP income or gain or loss from the sale or exchange of a capital asset is ECI if it is from U.S. sources and (1) it is derived from assets used or held for use in the conduct of the U.S. trade or business (the asset-use test) or (2) the activities of the U.S. trade or business were a material factor in the realization of the income, gain, or loss (the business activities test).

29. Because many foreign banks are dealers in stocks and securities outside the United States, they are not eligible for the safe harbor under § 864(b)(2), providing that trading in stocks and securities for the taxpayer’s own account is generally not a U.S. trade or business.

As discussed *supra* note 14, if the branch is itself engaged in dealer activities, income from U.S. sales of stocks, debt securities, and other financial instruments held in inventory by

stances this rule might permit a bank to avoid the 10% limitation for "other securities" giving rise to ECI, described above.

2. *Dividends and Gains on Stock.*—The special ECI rule for banks described above also applies to dividends (both U.S. source and foreign source) and gains from stock.³⁰ Stock is likely to be "attributable" to a U.S. banking branch—and therefore to give rise to ECI under the special ECI rule for banks—only if it (1) was acquired as additional consideration for making a loan,³¹ (2) was pledged by a borrower as collateral for a loan and was acquired by foreclosure upon a loan default,³² or (3) was acquired by the bank in the course of its distributing such stock to the public.³³ As in the case of debt securities, dividends and gain on stock may also be ECI under the asset-use or business activities test if the stock is held in the conduct in the United States of a business of trading in stocks and securities for the bank's own account or as a securities dealer.

Stock of a banking subsidiary cannot be attributable to the U.S. branch under the special banking rule,³⁴ and it is virtually never ECI under the asset-use or business activities tests.³⁵

3. *Fee Income.*—Banks earn various types of fee income for services they provide, either in connection with lending activities or in connection with other financial or advisory activities. These fees include commitment fees,³⁶ loan origination and servicing fees,³⁷ placement fees, and advisory fees. This income is U.S. source if the services are performed in the United

the branch or otherwise held for sale to customers in the ordinary course of the branch's business is ECI under § 864(c)(3).

30. Regs. § 1.864-4(c)(5)(ii).

31. See Regs. § 1.864-4(c)(5)(iv)(a).

32. See Regs. § 1.864-4(c)(5)(iv)(b).

33. See Regs. § 1.864-4(c)(5)(ii)(a)(2).

34. Regs. § 1.864-4(c)(5)(ii).

35. See I.R.S. T.A.M. 8940005 (May 15, 1989).

36. Loan commitment fees that represent charges for agreeing to make funds available rather than for the actual use or forbearance of money generally are treated as compensation for services rather than interest. See, e.g., Rev. Rul. 70-540, 1970-2 C.B. 101; cf. Rev. Rul. 74-395, 1974-1 C.B. 46 (commitment fee discounted from loan proceeds was interest).

37. See, e.g., *Metropolitan Mortgage Fund, Inc. v. Commissioner*, 62 T.C. 110 (1974); Rev. Rul. 70-540, 1970-2 C.B. 101; see also *Bank of America v. United States*, 680 F.2d 142, 150 (Ct. Cl. 1982) (holding negotiation fees received in connection with export letters of credit are for personal services). However, fees that are not earned for specific services, or which exceed reasonable compensation for services actually performed, may be interest (or original issue discount). See, e.g., Regs. § 1.1273-2(g)(2) (which, taken together with Regs. § 1.1275-2(a), provides that a bank lender should treat "points" as original issue discount rather than as fee income); *Wilkerson v. Commissioner*, 70 T.C. 240 (1978), rev'd on other grounds, 655 F.2d 980 (9th Cir. 1981); Rev. Rul. 69-188, 1969-1 C.B. 54, 55.

States,³⁸ in which case it is ECI.³⁹ As a practical matter, if a loan is attributable to a U.S. branch under the rules described above, fee income received in connection with the loan likely is also ECI.

4. *Letter of Credit and Guaranty Fees.*—Commissions earned on the issuance, confirmation, or acceptance of letters of credit (as well as similar fees earned in the course of providing other forms of guaranties or credit support in respect of the obligations of another person) are not interest and therefore are not covered by the rules described in paragraph 1 above. However, such commissions and fees have been analogized to interest for purposes of determining their source.⁴⁰ Under this analysis, if the person whose credit is being confirmed or otherwise guaranteed is a U.S. person, the commission income is U.S. source and is therefore ECI if the U.S. branch materially participates in the issuance of the letter of credit or other form of credit support.⁴¹ However, if the commission or fee is received for confirming or guaranteeing the credit of a foreign person, it is from foreign sources and not ECI, even if the U.S. branch issues the credit support.

5. *Income from Foreign Currency Transactions, Swaps, Options, Forward Contracts, and Other Financial Hedging Transactions.*—As mentioned in the Introduction, banks have expanded their activities in recent years beyond lending and other traditional banking activities. Many international banks now conduct active businesses in interest rate and currency swaps, forward contracts, options, and other instruments designed to hedge interest rate and currency risks, as an integral part both of servicing customers

38. IRC § 861(a)(3).

39. IRC § 864(c)(3). However, where the bank is eligible for the benefits of an income tax treaty, such income generally should be exempt as business profits not attributable to a U.S. permanent establishment if the services are performed by employees of a non-U.S. branch that are present in the United States on a temporary basis and the income is not attributable to the U.S. branch.

40. *Bank of America*, 680 F.2d at 149 (analogizing commissions earned on bankers acceptances to interest). See *Centel Communications Co. v. Commissioner*, 920 F.2d 1335 (7th Cir. 1990) (holding shareholder guaranties were not performance of personal services taxable under § 83 in exchange for stock, but were more closely analogous to loan transaction). But see *Priv. Let. Rul. 8508003* (Nov. 9, 1984) (treating loan guaranty fee as services income); *I.R.S. T.A.M. 7822005* (Feb. 22, 1978).

41. Regs. § 1.864-4(c)(3)(i) (business-activities test). If the branch does not materially participate in the issuance of the letter of credit or other form of credit support, the income is generally subject to a 30% U.S. withholding tax. However, if the bank is eligible for the benefits of an income tax treaty, the income is usually exempt from tax as business profits not attributable to a U.S. permanent establishment. See, e.g., *Priv. Let. Rul. 7306191420A* (June 19, 1973) (stating line of credit commitment fees paid to U.K. banks not engaged in a trade or business in the United States are "industrial or commercial profits" exempt from U.S. tax under the U.S.-U.K. income tax treaty).

and of managing their own interest rate and currency exposures. Most international banks provide foreign currency (forex) liquidity to the marketplace by entering into spot and longer-term forward forex contracts with their customers, who frequently take delivery of the physical currency under the contract. Some banks also act as dealers or traders with respect to equity- and commodity-derivative products.

To a significantly greater degree than traditional banking activities, the conduct of a swaps, forex, or derivatives business typically involves what has come to be referred to as global trading—the participation of several offices of the bank in a single transaction or a series of related transactions (e.g., hedges of customer transactions).⁴² The reasons for this global trading phenomenon—and the level, extent, and nature of the involvement of multiple offices of the bank—vary depending on how the bank has organized these

42. These activities and the tax issues raised by the involvement of multiple branches have been the subject of several recent excellent articles and other papers, and this article therefore provides only a cursory description of them. See generally Ernst & Young, *Tax Implications of Cross-Border Trading by International Banks*, 51 *Tax Notes* 765 (May 13, 1991); KPMG Peat Marwick, *Report on the Taxation of Global Trading of Certain Financial Instruments*, 21 *Highlights & Documents* 1983 (May 22, 1991); Charles Thelen Plambeck, *The Taxation Implications of Global Trading*, 48 *Tax Notes* 1143 (Aug. 27, 1990); Leslie B. Samuels & Patricia A. Brown, *Observations on the Taxation of Global Securities Trading*, 45 *Tax L. Rev.* 527 (1990); Letter from Lawrence R. Uhlick, Executive Director and General Counsel, Institute of International Bankers, to Charles Cope, Esq., Associate International Tax Counsel, Department of the Treasury (Sep. 17, 1993), 31 *Highlights & Documents* 51 (Oct. 1, 1993) [hereinafter the "IIB Cross-Border Paper"]; Letter from Edward I. O'Brien, President, Securities Industry Association, to The Honorable Fred T. Goldberg, Jr., Comm'r, Internal Revenue Service, and to The Honorable Kenneth W. Gideon, Assistant Secretary, Department of the Treasury (Dec. 28, 1990), 20 *Highlights & Documents* 293 (Jan. 9, 1991).

In contrast to some commentators, this article uses the term "global trading" to refer to the full gamut of issues raised by the involvement of multiple branches of a bank in these activities. Compare IIB Cross-Border Paper, *supra*, at 53:

As a threshold matter, it is important to recognize that the cross-border interbranch trading issue is separate from the tax issue raised by "global trading." The interbranch trading issue, which relates to the determination of which trading transactions are to be taken into account for tax purposes, generally arises when the various branches of a bank are independently trading in foreign exchange, swaps or other financial products. The global trading issue, which relates to the apportionment of the income from the bank's trading transactions, generally arises when various branches of the bank have cooperated in soliciting, negotiating or arranging particular transactions.

As a practical matter, it may be appropriate to develop different solutions for particular interbranch trading issues (such as interbranch transfers of foreign currency, discussed *infra* text accompanying notes 55-63). Nonetheless, I believe that as a conceptual and policy matter, the interbranch trading issue is more closely intertwined with the other global trading issues than the IIB Cross-Border Paper suggests.

activities, and also depending upon the particular product involved and the nature of the transaction. Thus, depending on the product, type of transaction, and bank, a transaction may involve marketing personnel, traders, risk managers, management, credit analysts, and other personnel from different offices.

In some cases, the activities associated with specific groups of transactions may be concentrated, or conducted exclusively, at individual branches, so that each branch develops and manages its own “book”⁴³ of, say, interest rate swaps and forward contracts with its customers (and related hedges). In other cases, there may be greater interaction among branches in trading and managing a book. The level of central management, coordination, and support may vary, as may the frequency and types of interbranch transactions. Thus, certain types of activity—for example, dealing in foreign currencies—typically involve numerous and frequent interbranch transactions even though customer transactions are concentrated at individual branches and each branch often maintains its own book of forex contracts.

Depending on the bank and the type of activity, branches might independently hedge, in the over-the-counter market or through instruments traded on stock or commodities exchanges, the risks of their customer transactions, or they might enter into interbranch swaps or other interbranch transactions with respect to all or a portion of such risks. The latter situation often occurs where the management of particular types of risks (and the books on which these risks are placed) are concentrated in a particular branch (or the home office) for reasons such as expertise, efficiency, and proximity to the principal trading market for instruments relating to the risk involved.

Global trading activities raise the most difficult contemporary issues regarding the taxation of U.S. branches of foreign banks.

Section 988(a)(3) and Regulations section 1.988-4 contain rules for determining when gain or loss from foreign currency swaps, options, spot and forward contracts, and similar financial instruments are ECI.⁴⁴ Regulations section 1.863-7 contains analogous rules for determining when income from

43. The term “book” refers informally to a taxpayer’s trading positions at any given time, either in the aggregate or in respect of certain categories of positions. A book will usually contain transactions with customers and related hedges, and may also contain proprietary trading positions.

44. In general, such contracts and instruments are subject to the § 988 ECI rules if any payment to be made or received thereunder is denominated in a nonfunctional currency of the U.S. branch or is determined by reference to the value of one or more nonfunctional currencies. The § 988 ECI rules also apply to a disposition of nonfunctional currency. Regs. § 1.988-1(a)(1). For these purposes, a spot contract to buy or sell nonfunctional currency within two business days is treated as a direct purchase or sale of the currency (rather than a forward contract) unless the contract is disposed of or otherwise terminated prior to making or taking delivery of the currency. Regs. § 1.988-2(d)(1)(ii). In general, any currency other than the U.S. dollar is a nonfunctional currency of the U.S. branch. Regs. § 1.985-1(b).

non-forex "notional principal contracts" (including interest rate swaps)⁴⁵ are ECI. In general, gain from non-forex forward contracts, futures contracts, and options, as well as from stocks, securities, and commodities used to hedge the bank's derivatives positions, are tested under the general rules under sections 865(e)(2) and (3) and 864(c)(2) and (3) (and Regulations section 1.864-4(c)) to determine whether the gain is ECI.⁴⁶ Therefore, as explained below, the same ECI analysis generally applies to all of these types of income and gains.

Regulations section 1.988-4(c) and 1.863-7(b)(3) provide, respectively, that forex gain or loss and non-forex notional principal contract income are U.S. source and ECI if, "under principles similar to those set forth in § 1.864-4(c) [they arise] from the conduct of a United States trade or business."⁴⁷ Regulations section 1.864-4(c) prescribes the rules for determin-

45. For purposes of Regs. § 1.863-7, a notional principal contract is "a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts." Regs. § 1.863-7(a)(1).

This definition also appears in Regs. § 1.446-3, although unlike Regs. § 1.863-7, that provision lists equity swaps as an example of a notional principal contract. The IRS is studying whether, for purposes of Regs. § 1.863-7, certain equity swaps should be subject to the same source rule as interest rate swaps. T.D. 8491, 1993-33 I.R.B. 6, 6-7 (Oct. 25) (Preamble to the § 446 swap regulations). The apparent concern is that absent a different rule, equity swaps may erode the U.S. withholding tax on dividend income. See generally Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System*, 69 *Tex. L. Rev.* 1319 (1991). However, given the identity of the definitions in Regs. §§ 1.863-7 and 1.446-3, unless and until the IRS issues special source rules, most practitioners are comfortable concluding that income on equity swaps should be sourced in the same manner as income on interest rate swaps, although the issue is not entirely free from doubt. See Richard L. Reinhold, *Tax Issues in Equity Swap Transactions*, 57 *Tax Notes* 1185, 1190-91 (Nov. 23, 1992); Lewis R. Steinberg, *Selected Issues in the Taxation of Swaps, Structured Finance and Other Financial Products*, 1 *Fla. Tax Rev.* 263, 288-89 (1993). However, regardless of the concern regarding the *source* of equity swap income, it appears likely that the rules for determining whether such income is ECI are unlikely to differ from the rules set forth in Regs. § 1.863-7.

A similar definition of notional principal contracts also is contained in Regs. § 1.988-1(a)(2)(iii)(B)(2), dealing with forex notional principal contracts, but it is limited to an instrument where the underlying property to which the instrument ultimately relates is currency or property the value of which is determined by reference to an interest rate (which includes a currency swap but not a commodity-index or equity-index swap).

46. For descriptions of § 864(c)(2), (3) and the regulations thereunder and of § 865(e)(2), (3), see *supra* notes 12, 14, and 28; see also § 865(j)(2) (granting regulatory authority to apply § 865 to "income derived from trading in futures contracts, forward contracts, options contracts, and other instruments").

47. This rule is an exception to the rules contained in Regs. §§ 1.988-4(a), (b); 1.863-7(b)(1), (2), under which such gain, loss, or income is sourced by reference to (1) the residence of the taxpayer or (2) the qualified business unit (QBU) of the taxpayer on whose

ing ECI from FDAP income and capital gains, including the asset-use test, the business activities test, and the special ECI rule for banks discussed above. While Regulations sections 1.988-4 and 1.863-7 do not provide explicit guidance as to which of these tests should apply,⁴⁸ where the U.S. branch actively and materially participates in arranging a notional principal contract, the income associated with that transaction is ECI under both the special ECI rule for banks and the general business activities test. Indeed, the business activities test (unlike the special ECI rule for banks) looks merely to “whether the activities of the trade or business conducted in the United States were a *material factor in the realization* of the income, gain or loss.”⁴⁹ Thus, it is quite possible that a lower threshold of involvement in a transaction by the U.S. branch than “active and material participation” suffices to generate ECI from financial instruments held by banks in connection with their global trading activities. In any event, under the business activities test, income or gain from positions in such financial instruments is likely to be ECI, even if the U.S. branch did not participate in the acquisition of a position but, for example, only in its disposition (or termination). Moreover, as noted above, these provisions apply an all or nothing approach: Once the threshold is crossed, all of the income from a particular transaction is ECI.

Application of the foregoing rules to the forex, swaps, and other derivatives activities of a foreign bank clearly results in a substantial over-inclusion of income for U.S. tax purposes because the rules fail to take into account the relative contributions of the U.S. branch and other offices of the bank. As a result, these rules can expose a foreign bank to a significant risk of double taxation as the United States taxes the entire amount of income generated by transactions that are viewed by the bank and other taxing authorities as attributable to a great extent to another jurisdiction.

For example, assume that a foreign bank with a worldwide interest-rate swaps business manages its book of dollar-denominated interest rate swaps in New York and manages its book of U.K. pound sterling swaps in London. The New York branch quotes the price for, and enters into, a dollar interest rate swap with a U.K. customer in a transaction in which marketing personnel in London conduct all discussions and negotiations with the

books the item is properly reflected (but, in the case of non-forex notional principal contract income, only if the QBU is outside the United States and the taxpayer's residence is the United States).

48. It has been suggested that the cross reference was left deliberately vague in order to incorporate all these tests. See Samuels & Brown, *supra* note 42, at 560 n.163. Regs. § 1.863-7(b)(3) was recently applied, in a nonbanking context, in Priv. Let. Rul. 9348015 (Aug. 31, 1993).

49. Regs. § 1.864-4(c)(1)(i) (emphasis added).

customer. Conversely, the London branch quotes the price for, and enters into, a sterling interest rate swap with a U.S. customer in a transaction in which marketing personnel in New York conduct all discussions and negotiations with the customer. Under the rules described above, the entire amount of gain on both swap transactions is ECI.⁵⁰

The U.S. rules are inconsistent with common business practices (and the rules of other taxing jurisdictions) in another significant respect. Interbranch transactions, including interbranch swaps and other hedges, generally are ignored for U.S. tax purposes, on the ground that a taxpayer cannot enter into a contract with itself.⁵¹ Thus, if the U.S. branch were to seek to hedge its net interest rate exposure under its interest rate swap book by entering into a swap with its home office, amounts paid or received by the U.S. branch under the interbranch swap would have no U.S. tax consequences.

A related feature of the U.S. tax rules is that there is no clear basis for integrating assets held by the U.S. branch with positions taken by the home office to hedge those assets. (This is referred to as the "split hedge" problem.) Thus, if the home office enters into a swap with a third party to hedge the net interest rate exposure of the U.S. branch (whether or not the U.S. branch enters into an interbranch swap with the home office), there is no assurance that the home office's third party swap can be integrated with the U.S. branch's net position for U.S. tax purposes. If the interbranch swap and the home office's swap with a third party are both disregarded in determining U.S. tax, the bank may incur U.S. tax liability on income or gains on the positions held by it (as a result of favorable movements in interest rates), even though the bank was hedged and therefore realized an offsetting loss on the third-party swap entered into by the home office.

A number of approaches have been suggested for dealing under existing law with the dual problems of the disregard of interbranch transac-

50. As discussed in Part III.A, expenses incurred by the London branch in connection with those transactions should be deductible in computing ECTI; however, none of the net profit from the transactions would be allocated to the London branch for U.S. tax purposes. It is possible that this result would be different for a bank entitled to the benefits of an income tax treaty, although IRS rulings suggest otherwise. See *supra* note 6, *infra* notes 52, 108-09 and accompanying text, and *infra* text accompanying note 116.

51. Regs. §§ 1.863-7(a)(1), 1.988-1(a)(10). However, interbranch transactions involving a transfer of nonfunctional currency or of contracts or instruments relating to nonfunctional currency are taken into account under § 988 if, as a result of the interbranch transfer, (1) the currency or other item ceases to be subject to § 988 (because the currency is the functional currency of the transferee branch) or (2) the source of forex gain or loss could be altered. Regs. § 1.988-1(a)(10)(ii). The treatment of interbranch transactions involving foreign currency is discussed *infra* notes 55-63 and the accompanying text.

tions and “split hedges,” none of which is completely satisfactory.⁵² One approach for dealing with the “split hedge” problem that may be defensible as a technical matter would be to apply the general rules for allocating and apportioning deductions so as to assign to a U.S. swaps or derivatives business the third-party hedging losses properly allocable thereto, even if they arise from positions entered into by a foreign branch under a “split hedge.”⁵³ It is unclear, however, how such allocation and apportionment would be determined, especially where the foreign branch does not hedge specific risks but, rather, hedges the overall net exposure of the bank’s activity. Also, this approach is unsatisfactory as a tax policy matter. By failing to fully integrate hedged activities, it allows the IRS to be whipsawed because it does not provide a rationale for attributing hedging gains realized by a foreign branch to the U.S. branch to offset losses on its positions.⁵⁴

If applied literally to foreign currency dealing activities of foreign banks, the rules described above for determining ECI from forex transactions and for the treatment of interbranch transfers of foreign currency can produce anomalous and inconsistent consequences. In connection with their forex dealing activities, which typically are conducted on a decentralized, local branch basis, foreign banks often engage in extensive interbranch transfers of foreign currency, often amounting to many thousands of individual transac-

52. See, e.g., Samuels & Brown, *supra* note 42, at 560-64, for a discussion of various approaches and the difficulties they raise.

In this regard, it has been argued that tax treaties may provide a basis for recognizing interbranch swaps and other interbranch hedging transactions, as well as for taking into account gain or loss on the non-U.S. legs of “split hedges,” because under tax treaties ECI must be “attributable” to the U.S. permanent establishment and the profits to be attributed to the U.S. permanent establishment are those that it might be expected to earn if it were a distinct and separate enterprise dealing on an independent basis with the enterprise of which it is a permanent establishment. *Id.* at 575-78. As discussed in Part III.B, the IRS has rejected a similar argument in the context of the allocation of interest expense to ECI, and, while not explicitly mentioning tax treaties, it has declined to recognize interbranch transactions in Regs. §§ 1.863-7(a)(1), 1.988-1(a)(10). However, although the interest expense regulations do not permit a direct deduction for the amount of interest paid or accrued by the branch, they do provide for a deduction for interest expense that can be viewed as resulting in a clear reflection of ECTI. In contrast, by failing to provide a mechanism for combining “split hedges” or, alternatively, for recognizing interbranch hedging transactions, the provisions dealing with income and deductions from hedging transactions do not result in a clear reflection of ECTI.

53. Regs. §§ 1.882-4(b)(1), 1.861-8.

54. In the context of the so-called *Arkansas Best* problem of whether the character of gain or loss on hedging transactions is ordinary or capital, the IRS recently dealt with a somewhat analogous whipsaw concern by requiring taxpayers to identify (and retain records regarding) hedging transactions excluded from capital asset treatment. Temp. Regs. § 1.1221-2(c). The accompanying notice solicits comments on how a taxpayer should identify a global or other aggregate hedge. T.D. 8493, 1993-35 I.R.B. 16, 18 (Nov. 8).

tions each year. For example, a branch may enter into a foreign currency forward contract with a customer and acquire the currency for delivery under the contract by entering into a spot contract with another branch.⁵⁵

As indicated above, an interbranch transfer of nonfunctional currency gives rise to taxable gain or loss (computed as if the nonfunctional currency had been sold at its fair market value) if the source of forex gain or loss could be altered as a result of the interbranch transfer.⁵⁶ Thus, a non-U.S. branch's transfer of foreign currency to a U.S. branch should generally be respected for U.S. federal income tax purposes because the source of forex gain or loss is altered from non-U.S. (and exempt from U.S. tax) to U.S. (and ECI).⁵⁷ In that event, the U.S. branch's basis in the foreign currency is the currency's fair market value at the time of the interbranch transaction.⁵⁸

On the other hand, where the U.S. branch transfers foreign currency to a non-U.S. branch (and the currency is not the functional currency of that branch), the interbranch transaction is likely to be ignored for U.S. federal income tax purposes because, "under principles similar to those set forth in § 1.864-4(c)," the U.S. branch is viewed as a material factor in the realization of the income, gain, or loss, which therefore continues to be U.S. source and ECI.⁵⁹ In that event, the bank is generally required to trace the foreign currency in some reasonable manner and to treat the sales proceeds therefrom

55. Spot contracts are treated as direct transfers of the nonfunctional currency (rather than as forward contracts) if the currency is delivered pursuant to the contract. See *supra* note 44.

56. Regs. § 1.988-1(a)(10)(ii), discussed *supra* note 51. An interbranch transfer of nonfunctional currency is also a taxable event if the currency is the functional currency of the transferee branch. These exceptions to the general rule that interbranch transactions are ignored also apply to interbranch transfers of forex forward, option, swap, and similar contracts (and debt instruments) that had been entered into with another taxpayer. However, it is relatively rare for such contracts themselves to be transferred between branches, as opposed to having the branch that entered into the customer transaction enter into a similar contract with another branch to hedge its exposure.

57. See *supra* notes 47-49 and accompanying text.

58. In general, this basis is thereafter accounted for by the U.S. branch in accordance with its method of accounting for inventory of foreign currency.

59. See *supra* notes 15-18 and 47-49 and accompanying text. It might be possible to argue, however, that the gain or loss should not continue to be U.S. source and ECI, and that therefore the interbranch transaction should be respected, because "principles similar to those set forth in § 1.864-4(c)" should be interpreted to include the principle of § 864(c)(4)(B)(iii), under which non-U.S. source gains from the sale of inventory that is attributable to a U.S. office nonetheless is not ECI if a non-U.S. office participates materially in such sale. While it is difficult to find persuasive technical support for this argument, it is not entirely unreasonable to interpret the principles of Regs. § 1.864-4(c) as being articulated in the context of, and subsuming, the overall statutory scheme, which includes § 864(c)(4)(B)(iii).

as ECI.⁶⁰ In contrast, where the U.S. branch transfers dollars to a non-U.S. branch, a subsequent disposition of those dollars by the non-U.S. branch should be exempt from U.S. federal income taxation.⁶¹

Apart from any administrative inconvenience of a rule that requires the foreign bank to trace foreign currency transferred from its U.S. branch to a foreign branch after it becomes part of the inventory of the foreign branch, treating *all* gain (or loss) from the disposition of such currency by the non-U.S. branch as ECI is inconsistent with the economics of the transaction and with the likely treatment of the transaction by the taxing jurisdiction in which the non-U.S. branch is resident. Moreover, while the rules relating to interbranch forex transactions⁶² may seem reasonable in the abstract, it is difficult as a practical or policy matter, in the case of a dealer in foreign currency, to justify a rule that distinguishes between interbranch transfers of nonfunctional currency *by* the U.S. branch and interbranch transfers of nonfunctional currency *to* the U.S. branch. Indeed, it is difficult to imagine that this distinction was carefully considered and intended by the drafters of these regulations.

Accordingly, particularly in view of the fact that the regulations already take into account interbranch transfers of foreign currency to the U.S. branch of a foreign currency dealer, the most sensible solution would be to extend such treatment to transfers by the U.S. branch. In this regard, the issues raised by interbranch transfers of nonfunctional currencies are similar to those raised by the other global trading activities of foreign banks, which were described in this Part II.B.5 and are explored further in Part II.C below. While a revision of the regulations to provide in all cases for the recognition

60. The tax accounting rules for inventory do not provide guidance as to how such tracing should be done where the item of foreign currency that is sold cannot specifically be identified. See generally Leslie I. Schneider, *Federal Income Taxation of Inventories* § 17.07 (1993) (suggesting reasonable approaches for dealing with analogous problems). In practice, it is usually the case that an interbranch transfer of foreign currency occurs when the transferee branch needs such foreign currency to cover a position with a customer, so that tracing should not be a problem in those situations.

61. Such a transfer of dollars by the U.S. branch to a non-U.S. branch should be viewed no differently than any other repatriation of money by the U.S. branch. Although the repatriation could give rise to branch profits tax implications (see Part IV.A), the U.S. branch should never recognize gain or loss as a result of the repatriation and should not be viewed as a “material factor in the realization” of subsequent gain or loss by the non-U.S. branch (in whose hands the dollars are likely to be nonfunctional currency) upon a disposition of the dollars by that branch. While the transfer of dollars by the U.S. branch to a non-U.S. branch does not involve a transfer of nonfunctional currency by the U.S. branch, and therefore is not covered by Regs. § 1.988-1(a)(10), if the non-U.S. branch acquires the dollars in exchange for other foreign currency, the transfer of such other currency to the U.S. branch is covered by that provision. *Id.*

62. See *supra* notes 47, 51 and accompanying text.

of interbranch transfers of foreign currency by forex dealers appears to be entirely consistent with the general approaches discussed in Part II.C, the details of these regulations should take into account the considerations discussed in Part II.C, including especially the need to ensure that these interbranch transactions are entered into at arm's length terms.⁶³

C. Practical Solutions; Future Prospects

1. *Advance Pricing Agreements.*—The rules for determining ECI from the forex, swaps, and other derivatives businesses of foreign banks are simply not workable, and banks that engage in these businesses with any material level of global trading activity, including interbranch transactions and split hedges, do so at their own peril as a U.S. tax matter. Fortunately, there is now a solution available for those banks that are willing to incur the expense—in terms of funds, time, and management resources—to obtain advance pricing agreements (APAs) from the IRS. Significantly, the APA process may be coordinated with agreements with other taxing authorities, either under tax treaty provisions for mutual agreements by competent authorities, or otherwise. Thus, if other taxing authorities are willing to enter into such agreements, a foreign bank may be able to obtain the agreement of the principal relevant taxing authorities as to the manner in which the business activities that are the subject of the APA will be taxed.

The APA is, as its name suggests, an agreement between the taxpayer and the IRS setting forth, prospectively, the transfer pricing methodologies (TPMs) for allocating income and deductions among the United States and other taxing jurisdictions.⁶⁴ Under the APA request procedure, the taxpayer

63. For example, the regulations might provide for strict scrutiny of the terms of interbranch transactions if there is a pattern of interbranch transfers of currency that are not made to satisfy the immediate needs of the transferee branch in respect of transactions with third parties, in order to determine whether appreciating currencies are being "parked" outside the United States while depreciating currencies are being "parked" in the United States.

The recognition of an interbranch transfer of foreign currency should not be affected by whether the foreign currency is transferred in connection with a larger interbranch transaction that is ignored for federal income tax purposes (or that is taken into account under other applicable rules). For example, the result recommended in the text should apply (and the foreign currency should be treated as sold for its fair market value) if the U.S. branch delivers nonfunctional currency to a non-U.S. branch pursuant to the terms (upon the maturity) of a long-term forward contract between those branches, even if the forward contract is ignored entirely. If the interbranch forward contract is taken into account, there may also be gain or loss in respect of the contract pursuant to § 988(c)(5) and Regs. § 1.988-2(d).

64. The procedures to be followed in requesting an APA and the scope and effect of an APA are set forth in Rev. Proc. 91-22, 1991-1 C.B. 526, as corrected by Rev. Proc. 91-22A, 1991-1 C.B. 534. The IRS also has been willing to have APAs apply retroactively to specified open tax years. For a description of the APA program, see generally Robert E.

proposes a TPM for specific categories of transactions, and provides data showing that the TPM produces results in those situations that are consistent with the arm's length standard of section 482. The IRS evaluates the request and, if it reaches an agreement with the taxpayer as to an acceptable TPM, the IRS and the taxpayer execute an APA. The APA is a binding contract, and it has a stated term, which can be renewed by agreement of the parties. If the taxpayer complies with the terms and conditions of the APA, the IRS will regard the results of applying the TPM as satisfying the arm's length standard of section 482 and will not contest the application of the TPM to the subject matter of the APA.⁶⁵

Although the APA process and any resulting agreement are confidential, it is generally understood that a number of foreign banks and other dealers in financial products have submitted requests for APAs, and that several such agreements have been finalized to date. Several of these agreements have involved tax authorities from other countries.

The IRS has announced its intention to publish generic guidance regarding approaches taken in APAs with respect to specific industries once a sufficient number of APAs in the industry have been issued to ensure that the identity of particular taxpayers cannot be determined.⁶⁶ Recently, in Notice 94-40, the IRS described its experience in concluding APAs with several taxpayers that have functionally fully integrated operations in the global trading of commodities and derivative financial products.⁶⁷

From reports regarding finalized and pending APAs and from Notice 94-40, it appears that taxpayers and the IRS have sought to devise TPMs that are appropriate to the economics of the particular business activities involved

Ackerman, et al., IRS, Office of Associate Chief Counsel (International), The Advance Pricing Agreement (APA) Program: A Model Alternative to the Dispute Resolution Process, 12 Daily Tax Report L-1 (Jan. 19, 1994). See also IRS, Advance Pricing Agreements (APAs), FS-94-5, 33 Highlights & Documents 487 (Apr. 12, 1994), providing an update of the APA program as of March 31, 1994.

65. Like other contracts, however, an APA may be canceled or renegotiated as a result of a mistake of fact or a change in underlying facts or assumptions, or revoked on account of misrepresentations or fraud. Rev. Proc. 91-22, *supra* note 64, § 10.05-07.

66. U.S. Dep't of the Treasury & IRS, Tax Compliance in a Global Economy: Statement of Policy and Action Plan, 93 TNT 257-16 (Dec. 20, 1993) (LEXIS, Fedtax lib., TNT file). See International Taxes: IRS Beginning Work on Advance Pricing Agreement Guidance, Culbertson Says, 61 Daily Rep. Executives, Mar. 4, 1992, at 6-7.

67. Notice 94-40, 1994-17 I.R.B. ____ (April 25), 33 Highlights & Documents 488 (Apr. 12, 1994). According to the Notice, global trading operations are functionally fully integrated if there is centralized management of risk and personnel, so that a single global book is maintained under the supervision of a head trader (rather than separate books for different trading locations), and the trading authority for that book is "passed" from trading location to trading location at the close of each trading day for that trading location.

but that, to the extent possible, are relatively simple to implement and monitor.

Where the business activities in different locations have a high degree of interrelationship and the business can be regarded as truly multijurisdictional in nature, the TPMs apparently have involved the computation of a single worldwide profit or loss from the activity⁶⁸ and its apportionment among taxing jurisdictions based on a multifactor apportionment formula, with different weighting accorded to the different factors. The factors selected have included, *inter alia*, (1) relative compensation in each jurisdiction of the principal producers of economic value in the transactions (e.g., traders), (2) relative compensation of management and other staff, and (3) level of business activity, or business assets, in each jurisdiction (determined on an appropriate basis for the business involved). For example, in Notice 94-40, the IRS indicated that in the APAs for functionally fully integrated global trading businesses, these factors have reflected (1) the relative value of the contribution of each location to the overall profit from the business activity (the "value factor"), which has typically been measured by the relative compensation in each location of the principal producers of economic value in the transactions (e.g., traders); (2) the relative potential risk to which a particular trading location exposes the worldwide capital of the taxpayer (the "risk factor"), measured based on the unique characteristics of the particular taxpayer;⁶⁹ and (3) the extent of the activity of each location (the "activity factor"), typically measured by the relative compensation of key support people at each location or by the relative net present value of the cash flows from the transactions executed at each location.

It is interesting that the IRS and other governments apparently have accepted such a formulary approach, which might be criticized as departing from the traditional approach in section 482 arm's length allocation inquiries and as adopting the formulary apportionment method employed by states and

68. Where appropriate, the worldwide profit from the activity has been computed after deduction of amounts paid (or deemed paid) to particular branches or affiliates as compensation for routine services or capital, when a judgment was made that an arm's length fee was more appropriate than a sharing in overall profits or losses. Also, where appropriate, the worldwide profit from the activity has been computed after deduction and allocation to particular locations of certain expenses incurred by those locations (such as office supplies, rent and communications). However, expenses that are required to be computed under specific provisions of the Code and Regulations, such as interest expense deductions discussed *infra* Part III.B, have been allocated under those provisions. See Notice 94-40.

69. According to Notice 94-40, the risk factor provides an important indication of the contribution of each trading location to the production of gross profits. This factor has been measured in several ways, such as the maturity weighted volume of swap transactions at the end of the year (determined by multiplying the notional amount of each swap transaction entered into by its maturity) entered into in each location.

rejected by the IRS and other foreign governments as inconsistent with internationally accepted standards.⁷⁰ In contrast to traditional statutory applications of the formulary apportionment method, however, each APA has been tailored to the specific economic conditions of the taxpayer involved, and the parties have selected, defined, and weighted the various formulary apportionment factors so as to take into account those specific economic conditions. Consequently, the formulary method TPM may fairly be viewed as an effort to reflect, through a simplified formula, the results of an arm's length allocation in a manner that is consistent with the principles underlying section 482. Indeed, Notice 94-40 indicates that the IRS considers the APAs utilizing such an approach to be applying a profit split method under section 482.⁷¹

Where business activities are concentrated at the local level in each jurisdiction, the IRS apparently has been inclined to adopt a natural home/separate entity approach, under which the profit for each local office that serves as a central location for particular financial products or types of transactions (natural home) is determined on a stand-alone basis and that office is treated as compensating other offices on an arm's length basis for their contributions of services or property. In such APAs, apparently the IRS is willing to take interbranch transactions into account in determining the profits and losses of each office, and is willing to limit the ECTI of the banks from the global trading activities covered by the APA to the separately determined taxable income of the U.S. branch.

Even at this relatively early stage in the evolution of APAs as a means of addressing the global trading problems of foreign banks, several important observations can be made.

Although an APA is supposed to be only an agreement between the IRS and a taxpayer on transfer pricing methodologies producing arm's length results under section 482, the IRS apparently has been willing to enter into APAs that, in effect, override the rules described above for determining a bank's ECI. Under the Code and Regulations, the principal issues confronted by foreign banks with respect to global trading activities are not arm's length

70. For a recent exchange of views on the relative merits and disadvantages of utilizing formulary apportionment to deal with transfer pricing issues in the international context, see generally Eric J. Coffill & Prentiss Willson, Jr., *Federal Formulary Apportionment As An Alternative to Arm's Length Pricing: From the Frying Pan to the Fire?*, 59 *Tax Notes* 1103 (May 24, 1993); Jerome R. Hellerstein, *Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment*, 60 *Tax Notes* 1131 (Aug. 23, 1993); Benjamin F. Miller, *A Reply to "From the Frying Pan to the Fire,"* 61 *Tax Notes* 241 (Oct. 11, 1993).

71. The profit split method is set forth in Prop. Temp. Regs. § 1.482-6. Although the formulary apportionment approach utilized in these APAs does not conform to any of the specific profit split methods described in Prop. Temp. Regs. § 1.482-6(c), it should qualify as an acceptable profit split method under Prop. Temp. Regs. § 1.482-6(c)(5).

pricing questions under section 482, particularly inasmuch as the banks are engaged in business in the United States directly through branches rather than through affiliates.⁷² Rather, the principal issues they confront relate to the amount of income that is treated as ECI under the all-or-nothing rules described above. That the IRS nonetheless is willing to deal with these issues in a constructive manner under the APA process is both remarkable and refreshing, although not at all surprising.

For several years, the IRS has been aware of the problems raised by global trading of financial instruments.⁷³ Indeed, it has been suggested that when the IRS was considering the issue of ECI from notional principal contracts and section 988 transactions, the drafters of the proposed regulations had difficulty formulating an appropriate rule and used the vague cross-reference, "under principles similar to those set forth in § 1.864-4(c),"⁷⁴ in the hope and expectation that commentators would provide assistance. Whether that story is apocryphal or true, it is clear that the IRS is now acutely aware that the rules are unsatisfactory. However, it has not yet been able to devise a replacement acceptable to it because of the complexities involved.

Under these circumstances, resort to the APA process by the IRS as an interim, stop-gap measure is appropriate and sensible. In addition to providing critically needed relief to taxpayers that would otherwise be adversely impacted by unworkable rules, the APA process is a real-life experiential and experimental laboratory for the IRS, providing it with valuable knowledge that can assist it in devising acceptable and workable rules and the experience of formulating those rules in conjunction with other countries that have a significant interest in global trading activities.

Viewed from this perspective, the APA process can be considered a step towards a more universal and permanent set of rules for determining a bank's ECI from global trading activities. While the IRS has not publicly articulated this view of the future, I believe that this evolution is inevitable,

72. Even where a foreign taxpayer conducts global trading activities in the United States through an affiliate rather than through a branch—as often is the case with securities firms and occasionally with banks—the affiliate may be treated as a "branch" of the taxpayer for U.S. tax purposes under the Code and applicable treaties, which would give rise to ECI and to income attributable to a permanent establishment. See generally Samuels & Brown, *supra* note 42, at 572-74.

73. See, e.g., T.D. 8258, 1989-2 C.B. 127 (soliciting comments regarding the application of Temp. Regs. § 1.863-7(b)(2)-(3) in circumstances involving global trading); Announcement 90-106, 1990-38 I.R.B. 29 (Sept. 17) (soliciting comments about issues raised by global trading of financial instruments that may be addressed by proposed regulations under §§ 482, 864, and other Code provisions).

74. Regs. §§ 1.863-7(b)(3), 1.988-4(c), discussed *supra* notes 47-49 and accompanying text.

if for no other reason than to preserve the legitimacy of the APA process. Unless the existing APA process in the global trading area is viewed as an interim step towards a revision of the applicable substantive rules, it will become increasingly vulnerable to criticism that it is “private law,” especially to the extent that it is perceived as overriding provisions of the Code and regulations and not merely as setting out factually based TPMs for section 482 allocation issues.

The foregoing is not intended to imply that the eventual, permanent solution necessarily will not involve an APA-type process. It may well be that, because of the highly varied global trading patterns of different taxpayers and categories of transactions, and because of the multijurisdictional nature of the issue, the IRS will require, or continue to make available, an APA process. However, I believe that eventually the rules for determining ECI will be revised to more closely comport with the results available under APAs.

2. Possible Revisions to the Rules for Determining ECI from Global Trading Activities.—It may be premature to suggest how the rules for determining ECI from financial instruments involved in global trading activities are likely to be revised. It seems to me, though, that revised rules—which should be reflected in amended regulations and in other forms of guidance—are likely to incorporate the following features:

- (a) Abandonment of the all or nothing approach of the existing regulations in favor of a section 482-type, arm’s length allocation analysis.⁷⁵ Conceptually, such an analysis, which takes into account the relative economic contributions of different offices, seems more appropriate than the existing rules,⁷⁶ and the IRS has implicitly recognized this point in the APAs in global trading situations.

75. The suggested revisions could be implemented as modifications of the source rules contained in Regs. §§ 1.863-7 and 1.988-4 (pursuant to regulatory authority under §§ 863(a) and 988(a)(3)(A)), and, in the case of gain or loss from the sale or exchange of stocks and securities (and of other financial instruments not covered by the foregoing provisions), through regulations under §§ 865(e)(2), (j), 864(c)(5).

In addition, discrete aspects of the global trading issue may appropriately be addressed through specific rules, such as the approach proposed above for recognizing interbranch transfers of nonfunctional currency by foreign currency dealers. See *supra* note 63 and accompanying text.

76. For a general discussion of reasons why a § 482-type analysis is appropriate for global trading activities and of the relative merits of various approaches based on such an analysis, see generally the articles and papers cited *supra* note 42.

- (b) Setting forth, perhaps in a revenue procedure, acceptable allocation methodologies and the general circumstances in which each methodology may be utilized.
- (c) Requiring taxpayers to establish an allocation methodology that is consistent with the approaches set forth in the revenue procedure and to establish the reasonableness of the method chosen, or to document and establish the reasonableness of an alternative methodology.⁷⁷
- (d) Requiring taxpayers to maintain records and to file relevant summary information with their tax returns regarding the methodologies they have selected.⁷⁸
- (e) Imposing accuracy-related penalties under section 6662 for failure to comply with the applicable allocation guidelines or the associated procedural requirements.

Careful consideration should be given to the appropriate scope of any revisions to the ECI rules. The revised rules should apply to all foreign persons that are dealers in stocks and securities, in notional principal contracts, or in forex or interest rate forward contracts, options, warrants, or similar financial instruments. Except as noted below, the revised rules should apply to all such financial instruments, stocks, and securities that are held in connection with the foreign person's dealer activity, including those held as hedges for inventory and similar property. Indeed, it appears appropriate for any such revised rules generally to apply to any "security" held by a "dealer" (as those terms are defined in section 475) to which the mark-to-market rules of section 475 apply. However, as noted in Part II.C.3 below, any revisions to the ECI rules probably should not apply to a debt instrument if interest on the instrument is covered by the special ECI rule for banks,⁷⁹ even if the instrument is held for sale to customers and is subject to section 475. Also, in general any such revisions to the ECI rules should not apply to interest rate or forex positions that are identified as hedges of such a debt instrument or as hedges of the bank's liabilities.⁸⁰ Finally, the revised rules generally

77. Use of an alternative methodology might be conditioned upon filing an APA request.

78. Cf. Temp. Regs. § 1.6662-6(d) (setting forth documentation requirements for avoiding accuracy-related penalties). Where appropriate, taxpayers might be required to make contemporaneous identifications of hedging and other transactions, or to record relevant market pricing information. Cf. § 1256(e)(2)(C); Regs. § 1.988-5(a)(8); Temp. Regs. § 1.1221-2(c).

79. Regs. § 1.864-4(c)(5), discussed in Part II.B.1.

80. See *infra* note 126 and accompanying text, where the recommendation is made that income and loss arising from such hedges should be treated as ECI to the extent that the debt securities or liabilities to which they relate give rise to ECI. As indicated below, consideration should also be given to the appropriate treatment of hedges conducted on a

should not apply to securities, notional principal contracts, or other financial instruments that are held for investment, arbitrage, or other trading purposes and are not subject to section 475, because these investments generally are made on a local, rather than global, level.

It has been suggested that the IRS might be reluctant to revise the ECI rules to adopt a section 482-type approach for global trading because it believes that any resolution of global trading issues requires the cooperation of other taxing jurisdictions, in order to prevent abuses and a one-sided loss of tax revenues by the United States as well as to minimize banks' exposures to double taxation. Consequently, it might be contended that revised ECI rules for global trading activities should permit a taxpayer to adopt a particular allocation method only if the method is also used for all relevant foreign income tax purposes. Such a requirement likely would significantly curtail potential abuses and minimize the risk of double taxation. However, such a requirement is not a condition to the adoption of an allocation method under section 482, and it is difficult to see why global trading should be treated differently in this regard. Moreover, it may be harsh to penalize taxpayers that are required for foreign tax purposes to adopt a method that is unacceptable for U.S. tax purposes.⁸¹ At a minimum, however, it would seem appropriate to require taxpayers to indicate on their tax returns if they utilize inconsistent methods for foreign tax purposes.

In addition to the question of consistency between the allocation methods selected for U.S. and foreign tax purposes, there is the question of consistency (or, quite frequently, the lack of consistency) in the rules for determining taxable income for U.S. and foreign income tax purposes. Even if similar allocation methods are utilized for U.S. and foreign tax purposes, a bank may suffer double taxation or may avoid full taxation of its income from global trading activities if the tax base is determined by different rules under U.S. and foreign law. In general, it is not appropriate or feasible to address this consistency problem in revised rules of general application for determining ECI from global trading activities.⁸² Instead, resolution of serious inconsistencies should continue to be handled on a case-by-case basis through APAs and agreements with competent authorities, subject to the constraints imposed by explicit provisions of the Code and Regulations.

global, or overall portfolio basis, without specific identification of offsetting positions.

81. In appropriate circumstances, the IRS may execute an APA without reaching agreement with the competent authority of a treaty partner, although the taxpayer must show good and sufficient reasons for such an APA. Rev. Proc. 91-22, *supra* note 64, § 7.08.

82. To the extent that one source of such inconsistencies is that interbranch transactions are not recognized for U.S. tax purposes, this problem presumably would be mitigated under certain allocation methodologies under generally applicable revised rules.

Among the more difficult issues that need to be addressed in formulating revised rules along the lines suggested above are the types of allocation methodologies that would be acceptable for U.S. tax purposes and the circumstances under which each methodology may be utilized. As mentioned above, the IRS apparently is exploring different basic typologies of TPMs, including in particular a worldwide formulary apportionment TPM and a natural home/separate entity method. Other typologies are also conceivable, including (1) hybrid methods that employ elements of both a natural home/separate entity method and a worldwide formulary apportionment method, and (2) methods that rely more directly on the arm's length allocation methods prescribed in the regulations under section 482.

Given the range of possible methodologies, the IRS will need to decide whether and under what circumstances taxpayers should have the freedom to choose a particular type of TPM.⁸³ Several considerations are relevant in this regard, including (1) the complexities involved in applying the methodologies, (2) the degree to which the methodologies produce results, in different types of circumstances, that are consistent with an arm's length analysis, (3) the extent to which the methodologies are consistent with general U.S. tax principles, (4) the ease and likelihood of coordinating those rules with applicable foreign tax rules, and (5) the potential that the IRS might be whipsawed if taxpayers are able to choose a method that is most favorable to them. While I do not propose to explore these issues in great detail in this article, I have the following general observations.

In the APA process the IRS, to its credit, appears to be favoring methods that are simpler to apply⁸⁴ over more complex methods that, at least in theory, might produce allocations that more closely reflect the application of an arm's length standard to specific factual situations. The decision to utilize, where appropriate, either a worldwide formulary apportionment method or a natural home/separate entity method may reflect the practical judgment that more complex methods—which for example might take into account more factors or dissect individual transactions into a greater number of components—are not likely to result in greater accuracy. Moreover, this decision may reflect the view that it is less important to have an economically accurate determination of the amount of income to be taxed by each jurisdiction than it is to have relatively simple rules that provide

83. In dealing with an analogous issue, the temporary regulations under § 482 apply a "best method" rule, under which the "method that provides the most accurate measure of an arm's length result under the facts and circumstances of the transaction under review" must be utilized. Temp. Regs. § 1.482-1(b)(2)(iii). Contrast to prior versions of the § 482 Regulations, which set out a hierarchy among methods. See, e.g., Regs. § 1.482-2(e)(1)(ii) (1989).

84. Even these simpler methods, however, involve complex analyses and detailed negotiations.

certainty and are generally fair. This decision may also reflect the view that these approaches are the easiest to apply in bilateral and multilateral agreements among tax authorities.

It is noteworthy that both the formulary apportionment method and the natural home/separate entity method depart to some extent from conventional U.S. tax principles. As indicated above, formulary apportionment has generally been considered incompatible with the arm's length standard under section 482, although in appropriate circumstances it may be an acceptable application of the profit split method.⁸⁵ And, to the extent that a natural home/separate entity method takes interbranch transactions into account for tax purposes, it might be considered inconsistent with the principle that a corporation is a single entity that cannot contract with itself, although (as discussed below) this approach should not be troublesome in the context of a section 482-type analysis.

Undoubtedly, there are situations in which the choice between a worldwide formulary apportionment method and a natural home/separate entity method is obvious, based on the manner in which the particular foreign bank conducts a particular type of global trading business. However, many businesses have some features that are more consistent with a worldwide allocation approach and other features that are more consistent with a natural home/separate entity approach. In these hybrid situations, each method by itself is likely to produce imperfect results, and the IRS should try to ensure that it will not be whipsawed as each taxpayer chooses the method that produces more favorable results for it.⁸⁶

In this regard, depending on the factors selected and their relative weighting, the results under a formulary apportionment method may not fully reflect the profitability or contributions of particular locations. Similarly, a natural home/separate entity method may not fully reflect the contributions of particular locations (including synergistic contributions to the business as a whole), especially if the profit or loss of offices other than the natural home for a product is fixed through the terms of an interbranch transaction and the

85. Also, as noted above, in contrast to traditional statutory applications of the formulary apportionment method, each APA has been tailored to the specific economic conditions of the taxpayer, so that the formulary method TPM may fairly be viewed as an effort to reflect, through a simplified formula, the results of an arm's length allocation. See *supra* note 71 and accompanying text.

86. Even apart from any whipsaw concerns, the results under a formulary apportionment method are likely to differ from the results under a natural home/separate entity method (as often is the case when the results of different allocation methods under § 482 are compared with one another). Indeed, in contrast to a formulary apportionment method, under a natural home/separate entity method, the U.S. branch could have a loss for income tax purposes in respect of particular transactions or the aggregate global trading activity even if the bank as a whole has a profit from those transactions or the aggregate global trading activity.

overall profit and loss on the product is concentrated in the product's natural home office. Therefore, in these hybrid situations, it may be appropriate to employ a formulary apportionment method for certain aspects of the business activity and a natural home/separate entity method for other aspects of that activity.

An important concern under any approach that permits interbranch transactions to be taken into account is whether taxpayers are setting the terms of the interbranch transactions in a manner that shifts profits to foreign offices. The extent to which this should be a serious concern in any given situation depends on a number of factors, including: the size and frequency of interbranch transactions; the frequency of comparable customer transactions and the extent of their comparability to the interbranch transactions; the availability of market pricing information; the proximity and pricing relationship between interbranch transactions and customer transactions; the extent to which other branches compete with third parties for the business of the U.S. branch; and, in some circumstances, the extent to which the interbranch transactions serve as a basis for compensation and performance evaluations.

In general, in those situations in which taxpayers are permitted to take interbranch transactions into account in determining ECI from global trading activities, they should be prepared to provide evidence enabling the IRS to verify that the terms of the interbranch transactions are at arm's length. In addition, in appropriate circumstances the IRS might require that the periodic (e.g., daily, weekly, or monthly) results of interbranch transactions fall within an acceptable range of comparable third party transactions during that period.

Subject to the foregoing caveats, I believe that interbranch transactions are an important and useful device for determining, within the context of a section 482-type analysis, what portion of a bank's profit or loss from global trading should be attributed to U.S. sources and taxed as ECI. In my view, this conclusion is not inconsistent with the principle that interbranch transactions have no effect for U.S. federal income tax purposes because a corporation cannot contract with itself, inasmuch as the interbranch transactions would not be given effect in themselves but simply would be evidence of the appropriate allocation that should be made under the arm's length principles of section 482. Surely, it should be permissible in the context of a section 482 analysis, subject to appropriate conditions and safeguards, to take into account a bona fide, contemporaneous effort by a taxpayer, duly recorded in the form of interbranch transactions, to achieve an allocation of income or loss from a transaction between the U.S. and foreign branches that participated in the transaction, by reference to what the terms of an unrelated third-party transaction would be.

3. *Implications for Other ECI Rules.*—The thrust of the preceding argument has been that the all-or-nothing approach of the existing rules for

determining ECI (and the source of income) do not produce proper results for global trading activities of foreign banks and that these rules should be replaced by a method that utilizes the principles of section 482.

If indeed such an approach is adopted, one question that might arise is whether the revised rules should be limited to global trading or whether they should instead have a more general application. In the context of foreign banks, for example, should such an approach replace the “active and material participation” rule under Regulations section 1.864-4(c)(5) for determining whether interest income and gain from debt securities is ECI?

As discussed in Part II.B.1 above, the “active and material participation” rule does have its shortcomings, attributable in some measure to the all-or-nothing nature of that test, and it may result in the overinclusion or underinclusion of income. Nevertheless, on this particular question, I subscribe to the notion that “if it ain’t broke too badly, don’t fix it.” Despite its shortcomings, the “active and material participation” rule is straightforward and reasonably simple to apply, particularly in comparison to a section 482-type analysis. A similar observation can be made about the other ECI rules discussed in Part II.B.1-4 above. While the existing rules for determining ECI in these situations may not give full effect to the economic contributions of different offices of a taxpayer, the results in most cases are generally acceptable. Moreover, these results generally are consistent with foreign tax laws, so that taxpayers do not face serious double taxation problems. Furthermore, as discussed in Part II.B.1 above, the principal problems with the “active and material participation” rule can be addressed through clarification and refinement. Because of its complexities, the section 482-type analysis should be reserved for a bank’s global trading activities (and other similar situations), where the existing rules produce results that are uneconomic and are inconsistent with foreign tax laws, thereby giving rise to severe double taxation problems that cannot be readily addressed through simple tinkering with the existing rules.

III. EXPENSES AND LOSSES OF THE BRANCH

A. *Expenses and Losses Other Than Interest*

In computing its taxable income that is effectively connected with a U.S. trade or business, a foreign bank is permitted to claim deductions to the extent they are connected with ECI.⁸⁷ The determination of whether deductions (other than interest expense, which is discussed in Part III.B below) are

87. IRC § 882(c)(1); Regs. § 1.882-4(b)(1). Deductions are allowed only if a tax return is filed within the time period prescribed by Regs. § 1.882-4(a).

connected with a bank's ECI is made in accordance with the rules, contained in Regulations section 1.861-8, for allocating and apportioning deductions between U.S. and foreign source income. Under these rules, expenses that are incurred by a foreign bank as a result of, or incident to, activities that generate ECI are deductible, as is a proportionate share of expenses that relate generally to all of the bank's income (based on the relative portion of the bank's total gross income that is ECI). As in other contexts, the amount of deductions is determined on the level of the bank as a whole, and interbranch transactions are ignored. However, as a result of the foregoing allocation rules, deductions of the U.S. branch (viewed as if it were a separate entity, except in respect of interbranch transactions), generally are allowed.⁸⁸

Thus, a foreign bank generally may deduct amounts payable to other persons by a U.S. branch in the conduct of its activities, including rent or depreciation on its office space, salaries of U.S. employees, other U.S. branch office expenses, and state taxes. To the extent that a non-U.S. office of the bank provides identifiable services to the U.S. branch (such as centralized data processing or clearing and custody functions for securities positions held by the U.S. branch), a portion of the expenses incurred in providing those services may be deducted in computing ECI. It is advisable for the bank to maintain documentation supporting the methodology for determining any deductions that are claimed. Finally, a portion of the general overhead of the bank, including salaries and other costs attributable to the bank's senior management, should be allocable to the U.S. branch, based upon the proportion of the bank's total gross income that constitutes ECI.

While not entirely clear, it is generally believed that under current law a loss on the sale of an asset (whether capital or ordinary) by a foreign bank is deductible (subject to applicable limitations) for U.S. tax purposes if the asset would have generated ECI if it were sold at a gain.⁸⁹ With respect

88. Limitations may apply to the extent expenses are attributable to assets or activities of the U.S. branch that do not generate ECI. Other rules of general application may limit the amount or timing of deductions, including provisions limiting the availability of deductions for expenses and losses incurred in transactions with related parties. See, e.g., § 267.

89. See Temp. Regs. § 1.861-8(c)(1) (suggesting that the general allocation rule applies to § 1221(1) assets); § 1.861-8(e)(7) (regarding capital assets and § 1231 assets); § 1.988-4(c) (regarding forex loss). Regs. § 1.863-7(b)(3), however, discusses notional principal contract income but not losses. Also, § 865(j)(1) grants the IRS authority to promulgate regulations dealing with the treatment of losses from the sale of personal property. In this regard, see Staff of Joint Comm. on Tax'n, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986 at 923 (1987) [hereinafter 1986 Bluebook] ("It is anticipated that regulations [under § 865(j)(1)] will provide that losses from sales of personal property generally will be allocated consistently with the source of income that gains would generate but that variations of this principle may be necessary"). Presumably the IRS would exercise

to the bad debt deduction for worthless loans, Regulations section 1.166-2(d)(4) provides that the special presumptions of worthlessness that apply to charge-offs of debt for regulatory purposes apply to a foreign bank only with respect to loans the interest on which is ECI.

B. Interest Expense

1. *Summary of the Interest Allocation Regulations.*—A foreign bank's deduction for interest expense (U.S., or deductible, interest expense) is not calculated simply as the interest paid or accrued by the branch on the liabilities reflected on its books. Rather, Regulations section 1.882-5 (the Interest Allocation Regulations) sets out a three-step formula for determining U.S. interest expense. These rules were promulgated in final form in 1981 (the 1981 regulations). In 1992, proposed regulations were issued that would replace the 1981 regulations, effective for taxable years beginning after the regulations are issued in final form. Although the two sets of regulations differ in certain significant respects, they share a common framework involving a three-step formula.

The first step in the formula is to determine the average total value of the "U.S. assets" of the bank during the taxable year. Under the 1981 regulations, the U.S. assets are those assets that "generate, have generated or could reasonably have been or be expected to generate income, gain, or loss" that is ECI.⁹⁰ The 1992 proposed regulations would, with certain exceptions, adopt the narrower, detailed definition of "U.S. assets" that is contained in the regulations under section 884, which implement the branch profits tax.⁹¹

such authority to preclude a deduction for losses on notional principal contracts or forex contracts that are booked in and managed by a non-U.S. office, even if the U.S. branch materially participates in the disposition of the contract.

90. Regs. § 1.882-5(b)(1).

91. Prop. Regs. § 1.882-5(b)(1). The relationship between the Interest Allocation regulations and the branch profits tax is explored in Part IV.B below. Although it is not entirely clear what practical effect the adoption of the § 884 definition would have, the § 884 definition is significantly narrower than the definition in the 1981 regulations because, subject to certain exceptions, it requires that *all* income and gain from an asset must be ECI in order for the asset to be a "U.S. asset." Regs. § 1.884-1(d)(1). Appropriately, however, Regs. § 1.884-1(d)(2)(vii) provides that "other securities" described in Regs. § 1.864-4(c)(5)(ii)(b)(3) (see *supra* note 20 and accompanying text) are U.S. assets in the same proportion that the income, gain, or loss from those securities is ECI. (A similar proportionate allocation rule should be adopted for purposes of the Interest Allocation Regulations and the branch profits tax in other contexts as well. See *infra* note 128.) Also, Regs. § 1.884-1(d)(2)(vi) provides that, in general, a debt instrument is a U.S. asset, notwithstanding that gain therefrom would not be ECI, if all income from the debt instrument during the taxable year is ECI and the yield on the debt instrument equals or exceeds the applicable federal rate.

With respect to inventory, Regs. § 1.884-1(d)(2)(ii) provides in general that inventory property is a U.S. asset in the same proportion as the amount of gross receipts from the sale

The second step in the formula is to determine the amount of "U.S. liabilities." In general, U.S. liabilities are computed by multiplying U.S. assets by either a "fixed ratio" or an "actual ratio."⁹² Under the 1981 regulations, the fixed ratio for foreign banks is 95%, whereas under the 1992 proposed regulations, the fixed ratio is 93%.⁹³ Instead of using the fixed ratio, a foreign bank can determine its U.S. liabilities based on the actual ratio of its average worldwide liabilities to its average worldwide assets.⁹⁴

of "such property" for the three preceding taxable years that is ECI bears to the total amount of gross receipt from the sale or exchange of "such property" during the three-year period. This provision appears to be unduly complicated (perhaps even to the point of being unadministrable) and may produce inappropriate results, if it is interpreted to require a foreign bank to determine its U.S. assets (for purposes of the Interest Allocation Regulations and the branch profits tax) by applying the foregoing three-year formula to all debt securities (or, possibly, to broad categories of debt securities) held by the bank anywhere in the world as inventory or primarily for sale to customers in the ordinary course of its trade or business.

The 1992 proposed regulations under § 882 would modify the § 884 definition to exclude real property from U.S. assets except in the year in which gain or loss is recognized under § 897(a)(1). See Prop. Regs. § 1.882-5(b)(1)(ii)(A)(1). In effect, under the 1992 proposed regulations, a branch would be denied an interest deduction for the portion of its debt that is allocable to its investment in real property, including real property acquired through foreclosure on mortgage loans as well as office buildings owned and occupied by the U.S. branch. This rule is both harsh and difficult to justify, and it has been criticized by commentators. See, e.g., New York State Bar Ass'n, Report on Proposed Regulations Section 1.882-5, 92 TNT 189-51 (Sept. 18, 1992) (LEXIS, Fedtax lib., TNT file) [hereinafter the NYSBA Report].

Another modification is that stock, the dividends on which are ECI, would not be a U.S. asset to the extent of the dividends received deduction. Prop. Regs. § 1.882-5(b)(2)(iii)(B). It is possible that this exclusion is viewed by the IRS as implementing § 864(e)(3), enacted in 1986, which provides that in allocating and apportioning interest expense, stock generally is not taken into account to the extent of the dividends received deduction allowable under § 243. However, there is some confusion regarding what was intended in this regard, and this rule has also been criticized by commentators. NYSBA Report, *supra*.

92. Once adopted, either method must usually be used for all subsequent years. Regs. § 1.882-5(b)(2); Prop. Regs. § 1.882-5(c)(3).

93. Regs. § 1.882-5(b)(2); Prop. Regs. § 1.882-5(c)(3). For a nonbanking business, the fixed ratio is 50% under both the 1981 regulations and the 1992 proposed regulations. A "banking business" for these purposes means a banking, financing, or similar business as defined in Reg. § 1.864-4(c)(5)(i). See *supra* note 11.

94. The 1992 proposed regulations would cap the actual ratio at 96%. Prop. Regs. § 1.882-5(c)(2)(i). The Preamble to the 1992 proposed regulations provides the following justification:

At present, U.S. banks generally are required to maintain a "leverage ratio" (i.e., equity to assets) of 4%. As a result of the passage of the Federal Deposit Insurance Corporation Improvement Act of 1991, the Federal Reserve Board and the Treasury Department are required to prepare, for submission to Congress, a report providing guidelines for

In the third and final step, the U.S. interest expense is calculated as the amount of U.S. liabilities, as determined under the second step, multiplied by an appropriate interest rate. Under the 1981 Regulations, taxpayers have the choice of using either the "branch book/dollar pool" method or the "separate currency pools" method to perform this calculation. The 1992 proposed regulations would permit use only of a modified form of the branch book/dollar pool method.

In general, under the branch book/dollar pool method, the amount of U.S. liabilities computed in step two is compared with the amount of actual liabilities shown (or, under the 1992 proposed regulations, properly reflected) on the books of the U.S. branch (booked liabilities).⁹⁵ Adjustments are then made based on whether the bank is considered to have borrowed in the United States to fund activities outside the United States (that is, the U.S. branch is overleveraged, as evidenced by the fact that booked liabilities exceed U.S. liabilities), or the U.S. branch is considered to be funded in part with borrowings by the bank outside the United States (because U.S. liabilities exceed booked liabilities, indicating that the branch is underleveraged). If booked liabilities equal or exceed U.S. liabilities (so that the branch is considered overleveraged), the interest expense allocable to the U.S. branch is based on the actual interest expense of the U.S. branch on booked liabilities, reduced to reflect any excess of booked liabilities over the U.S. liabilities computed in step two.⁹⁶ In contrast, if U.S. liabilities exceed booked liabilities, the interest expense allocable to the U.S. branch consists of two components: (1) the interest expense on booked liabilities, plus (2)

determining whether the capital of foreign banks conducting banking operations in the United States is equivalent to the capital standard for U.S. banks.

57 Fed. Reg. 15039-40 (1992). See NYSBA Report, *supra* note 91, for a critique of this cap.

95. The 1992 proposed regulations contain extensive rules for determining whether a liability is a booked liability. Prop. Regs. § 1.882-5(d)(2). These rules include special provisions relating to (1) liabilities of shell branches located in the Bahamas or Cayman Islands (see *supra* note 18), (2) high interest rate liabilities, and (3) situations where there is a significant discrepancy between the currency denomination of booked liabilities and the currency denomination of U.S. assets.

96. In this case, the U.S. interest expense under the 1981 regulations equals the product of the average U.S. liabilities for the year and the average interest rate for the year on the branch's booked liabilities. Regs. § 1.882-5(b)(3)(i)(A). The 1992 proposed regulations would modify this calculation by providing that U.S. interest expense equals the interest expense paid or accrued by the U.S. branch in respect of booked liabilities, multiplied by a "scaling ratio." The scaling ratio is a fraction, the numerator of which is booked liabilities less U.S. liabilities (as determined under step 2) and the denominator of which is booked liabilities. Prop. Regs. § 1.882-5(d)(3).

interest computed on the excess of U.S. liabilities over booked liabilities (excess liabilities).⁹⁷

As an alternative to the branch book/dollar pool method, the 1981 regulations permit taxpayers to elect a "separate currency pools method," under which interest expense is separately computed for each currency in which the branch has borrowed. In general, under the separate currency pools method, U.S. interest expense equals the product of booked liabilities in a particular currency, as adjusted,⁹⁸ and the foreign corporation's average worldwide interest rate for that particular currency. The 1992 proposed regulations would eliminate the separate currency pools method.⁹⁹

The Interest Allocation Regulations require all inter-branch transactions to be disregarded in applying the three-step formula. Thus, loans between the U.S. branch and the home office are ignored for purposes of determining the U.S. assets, U.S. liabilities, booked liabilities, and interest expense on booked liabilities.¹⁰⁰

2. *Policies Underlying the Interest Allocation Regulations.*—At first blush, the Interest Allocation Regulations appear to be complicated and unwieldy, both in concept and in practice. Closer examination of the regula-

97. Under the 1981 Regulations, component (2) generally is calculated using either the average interest rate on U.S. dollar liabilities shown on the books of the bank's non-U.S. offices or, if this rate is not reasonably determinable, using a method that reasonably approximates the actual rate (such as a LIBOR-based rate) that is consistently applied from year to year. Regs. § 1.882-5(b)(3)(i)(B). The 1992 proposed regulations are generally less favorable in that component (2) would be computed at a rate equal to 90% of the daily average for the taxable year of LIBOR for demand deposits. (In the case of taxpayers other than banks, under the 1992 proposed regulations, the interest rate used for component (2) would be 110% of LIBOR.) Prop. Regs. § 1.882-5(d)(4).

98. The adjustment consists of multiplying booked liabilities in a particular currency by a fraction the numerator of which is the branch's total U.S. liabilities (determined by the second step of the formula) and the denominator of which is the branch's total booked liabilities. Regs. § 1.882-5(b)(3)(ii)(A).

99. According to the Preamble to Prop. Regs. § 1.882-5, 57 Fed. Reg. 15038, 15040 (1992):

The separate currency pools method is eliminated because (1) it is difficult to reconcile this method with the interest paid and excess interest elements of the branch taxes of section 884, (2) it only reduces and does not eliminate the problems of weak and strong currencies which the regulation originally was intended to solve, (3) auditing overseas interest rates is extremely difficult, and (4) the 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.

100. Regs. § 1.882-5(a)(5); Prop. Regs. § 1.882-5(b)(1)(iii), (c)(2)(ii)(B), (d)(2)(iv).

tions and their evolution reveals that they reflect, to varying degrees, several competing and interrelated themes and concerns. Necessarily, the balance that has been struck between the competing policy considerations underlying the regulations is not perfect; indeed, the relative weights accorded to these considerations have shifted over time, and presumably will continue to change. Rather than discuss the technical aspects of the Interest Allocation Regulations, which have already been the subject of extensive commentary,¹⁰¹ this article focuses on some of the underlying policy considerations.

Among the competing and interrelated themes and concerns reflected in the Interest Allocation Regulations are the following:

- *Fungibility vs. separate entity.* The Regulations are influenced to a great extent by the principle that money is fungible and that liabilities (and related interest expense) are not specifically traceable to particular activities, assets, income, or geographic locations. The Regulations, however, also make important concessions to the view that a branch should be treated as a separate entity.
- *Administrability vs. accuracy.* The Regulations seek to reduce the administrative burdens of taxpayers and the IRS in determining the amount of deductible interest expense. However, the simplifying formulas and other rules contained in the Regulations make it somewhat difficult to maintain that they are an accurate measure of the amount of interest expense attributable to ECI.
- *Ensuring a minimum level of U.S. taxable income.* Some indications exist that one policy goal underlying the Regulations is to ensure that foreign banks with U.S. branches pay some minimum level of U.S. tax.
- *Coordination with other provisions and with hedging techniques.* An important factor in the formulation of the 1992 proposed regulations is the need to correlate the Interest Allocation Regulations with the branch profits tax and branch level interest tax. The 1992 proposed regulations also recog-

101. On the 1992 proposed regulations, see, e.g., Peter J. Connors, et al., New Interest Expense Allocation Rules Pose Practical Difficulties For Foreign Banks, 77 J. Tax'n 368 (1992); NYSBA Report, *supra* note 91; Letter from Lawrence R. Uhlick, Executive Director & General Counsel, Institute of International Bankers, to Shirley D. Peterson, Comm'r, Internal Revenue Service, 92 TNT 184-31 (Aug. 17, 1992) (LEXIS, Fedtax lib., TNT file) [hereinafter IIB Comment Letter]. On the 1981 Regulations, see, e.g., John O. Hatab, U.S. Taxation of Foreign Banking in the United States—An Overview, 41 Inst. on Fed. Tax'n § 27 (1983).

nize the need to coordinate the Interest Allocation Regulations with new financial developments, including currency and interest rate hedges, as well as with the rules under section 988 relating to forex gain or loss.

These themes are examined in detail below.

a. *Fungibility and its limits.*—Historically, one of the most important principles underlying the Interest Allocation Regulations has been the notion that because money is fungible, all borrowings equally support all activities of a bank (or other taxpayer), wherever they are undertaken.¹⁰² Under this fungibility principle, the amount of liabilities (and interest expense) attributable to a foreign bank's U.S. trade or business should bear the same ratio to its U.S. activities (however measured) as the ratio of the bank's worldwide liabilities (or interest expense, as the case may be) bears to the bank's worldwide activities. As explained below, however, this concept has been limited significantly in successive versions of the Interest Allocation Regulations.

Before 1977, both foreign corporations (in determining their ECTI) and U.S. corporations (e.g., in determining their foreign source income for purposes of applying the foreign tax credit limitation under section 904) generally allocated interest expense based on the factual connection between the item of interest expense and particular items of gross income. If a factual connection could not be established, the interest expense generally was apportioned on the basis of the ratio of the taxpayer's gross income from U.S.

102. See 1986 Bluebook, *supra* note 89, at 947 ("The Act adds new Code section 864(e), which generally adopts a one-taxpayer rule and other rules for expense allocation for purposes of [the international rules] for income arising outside the United States and for foreign taxpayers Generally, money is to be treated as fungible, and interest expenses are to be prorated on the asset method.")

While the regulation in which the following statement appears no longer governs the allocation of interest expense for purposes of determining ECTI of a foreign taxpayer, the classic statement of fungibility is as follows:

The method of allocation and apportionment for interest set forth in this section is based on the approach that, in general, money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid The fungibility approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. When money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes, and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes.

Temp. Regs. § 1.861-9(a).

sources to its worldwide gross income.¹⁰³ In practice, most foreign banks apparently determined their U.S. interest expense based on the interest expense shown on the books of their U.S. branch (the so-called "separate entity method").¹⁰⁴

Eventually the IRS began to assert that, regardless of its factual connection with particular items of gross income, money in fact is fungible and interest expense therefore should always be treated as attributable to all gross income. However, the IRS was rebuffed in several cases involving U.S. taxpayers on the basis of the literal language of the statute and the then existing regulations.¹⁰⁵ In response, the IRS amended the regulations in 1977 (finalizing changes that were proposed in 1973) to adopt the fungibility principle for allocating and apportioning interest expense.¹⁰⁶ The 1977 regulations required, with limited exceptions, that interest be ratably apportioned based on relative U.S.-to-worldwide assets (or, subject to certain limitations, relative U.S.-to-worldwide gross income).

The 1977 regulations applied to both U.S. and foreign corporations. It was soon realized, however, that as applied to U.S. branches of foreign banks, a full-fledged fungibility approach produced harsh results in some cases and bizarre windfalls in others. In general, the 1977 regulations favored foreign banks whose overall cost of funds was higher than their cost of U.S. dollar funds (so-called "soft currency" borrowers), and treated harshly foreign banks whose cost of U.S. dollar funds exceeded their average borrowing cost (so-called "hard currency" borrowers). In particular, Japanese and German banks were severely disadvantaged under the 1977 regulations because their yen or deutschemark borrowing costs were significantly lower than their U.S. dollar borrowing costs. Instead of allowing a deduction for the full amount of interest expense on the U.S. dollar borrowings of their U.S. branches, the

103. Regs. § 1.861-8(a) (1966), adopted in 31 Fed. Reg. 11144 (1966). See *Commercial Union Assur. Co. Ltd. v. Commissioner*, 144 F.2d 994 (2d Cir. 1944); *Third Scottish Am. Trust Co., Ltd. v. United States*, 37 F. Supp. 279 (Ct. Cl. 1941); *Balfour, Williamson & Co., Ltd. v. Commissioner*, 1 T.C. Memo 852 (1943).

104. On the use of the separate entity method by foreign banks before the 1977 Regulations, see Charles T. Crawford, *Allocation of Interest Expense for Foreign Branch Banking Operations in the U.S.*, 10 Tax Adviser 236 (1979); see also Hatab, *supra* note 101, § 27.03[2].

105. See, e.g., *Chicago, Milwaukee, St. Paul & Pac. R.R. v. United States*, 404 F.2d 960, 974 (Ct. Cl. 1968); *Missouri Pac. R.R. v. United States*, 392 F.2d 592, 604-06 (Ct. Cl. 1968); *F.W. Woolworth v. Commissioner*, 54 T.C. 1233, 1271-73 (1970), nonacq., 1971-2 C.B. 4.

106. Regs. § 1.861-8(e)(2), T.D. 7456, 1977-1 C.B. 200 (1977), which modified and adopted Prop. Regs. § 1.861-8(e)(2), published in 38 Fed. Reg. 15840 (1973). The articulation of the fungibility principle in former Regs. § 1.861-8(e)(2) is substantially the same as that found in Temp. Regs. § 1.861-9(a), quoted *supra* note 102.

1977 regulations required these banks to compute U.S. interest expense based on their lower overall costs of funds.

Several Japanese, German, and U.K. banks (as well as others) that were confronted with this situation contended that the income tax treaties between those countries and the United States specifically permitted use of the separate entity approach to compute a U.S. branch's interest expense.¹⁰⁷ In Revenue Ruling 78-423,¹⁰⁸ however, the IRS rejected this argument, and held that the 1977 regulations were compatible with the Japanese-U.S. income tax treaty and had to be applied by Japanese banks to determine their interest deductions. The IRS has continued to adhere to its view that the fungibility principle of allocating interest expense is compatible with income tax treaties, and has issued similar rulings under the 1981 Interest Allocation Regulations in the context of the Japanese and U.K. income tax treaties.¹⁰⁹

Nonetheless, the IRS responded to the foregoing concerns by issuing the 1981 Interest Allocation Regulations, which significantly curtail the fungibility principle in this context and contain important accommodations to the separate entity approach. For example, under the separate currency pools method, the interest rate for a particular currency continues to be based on the bank's worldwide interest rate for that currency, but it is taken into account only to the relative extent of the actual liabilities of the U.S. branch (vs. worldwide liabilities) in that currency. The branch book/dollar pool method gives even greater weight to a separate entity concept. Essentially, notwith-

107. For example, U.S.-Jap. Treaty, *supra* note 27, art. 8(2) provides that: there shall in each Contracting State be attributed to the permanent establishment the industrial or commercial profits which would be attributable to such permanent establishment if such permanent establishment were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the resident of which it is a permanent establishment.

Similar language appears in most other U.S. income tax treaties.

108. 1978-2 C.B. 194. See *infra* note 116 and accompanying text for a discussion of Rev. Rul. 78-423.

109. Rev. Rul. 85-7, 1985-1 C.B. 188 (U.S.-Jap. Treaty); Rev. Rul. 89-115, 1989-2 C.B. 130 (U.S.-U.K. treaty). See Prop. Regs. § 1.882-5(a)(3) (stating that "[t]he rules of this section also apply for purposes of determining the interest expense attributable to business profits of a permanent establishment under U.S. income tax treaties.").

This position was recently reaffirmed in connection with a number of newly concluded income tax treaties, see Treasury Department Technical Explanations of the U.S.-Netherlands and U.S.-Mexican income tax treaties, 2 Tax Treaties (CCH) ¶ 6121, 36,447-125 and 2 Tax Treaties (CCH) ¶ 5943, 35,829-11, respectively, and was endorsed by the Senate Foreign Relations Committee in its reports on those treaties, 2 Tax Treaties (CCH) ¶ 6119, 36,447-45 and 2 Tax Treaties (CCH) ¶ 5945, 35,867 (interpreting the provisions of those treaties regarding the allowance of deductions for interest in determining the profits of a permanent establishment as incorporating, for U.S. tax purposes, the Interest Allocation Regulations).

standing the three-step formula described above, this method can best be viewed as a *modified separate entity method*. Although it is set forth in step three of the formula, the real starting point for determining the amount of deductible interest is the interest expense shown on the books of the U.S. branch, which is then adjusted to the extent the branch is underleveraged or overleveraged, compared with the bank as a whole.

The 1992 proposed regulations, by eliminating the separate currency pools method, further tilt the balance towards a modified separate entity approach. One important reason for dropping the separate currency pools method is the need to correlate the Interest Allocation Regulations with the branch profits tax and the branch level interest tax, which are rooted in a view of the U.S. branch as a separate entity. The Preamble to the 1992 proposed regulations notes that it would have been “difficult to reconcile [the separate currency pools] method with the interest paid and excess interest elements of the branch taxes of section 884.”¹¹⁰

In summary, in the context of the Interest Allocation Regulations, the fungibility principle has been interpreted by the IRS to mean only that the *level of leverage* of the branch must be comparable to that of the bank as a whole, not that the interest rate applied to the branch’s liabilities (or the amount of deductible interest expense) must be comparable to that of the bank as a whole. This more limited interpretation of the fungibility principle—which in my view is justified in light of the considerations discussed in this part of the article—stands in contrast to the application of the principle in the context of the interest allocation rules under Temporary Regulations section 1.861-9 (e.g., for purposes of the foreign tax credit limitation), which generally require that worldwide interest expense be apportioned on the basis of assets.

As applied in the Interest Allocation Regulations, the fungibility principle effectively requires the branch to have the same ratio of equity capital to assets, for tax purposes, as the bank as a whole, thereby imposing a uniform debt-to-equity ratio on the U.S. branch and the bank as a whole. As in the case of other efforts to deal with the debt-equity question,¹¹¹ this rule can be viewed in part as an attempt to require taxpayers to report a minimum level of taxable income, a theme that is developed further below.

110. 57 Fed. Reg. 15038 (1992), quoted *supra* note 99, at 15040. While the reasons advanced by the Preamble have merit, it also is generally believed that the IRS became concerned that the separate currency pools method permitted foreign banks to “overstate” U.S. interest deductions because their U.S. dollar borrowings outside their U.S. branches typically bear higher interest rates than their U.S. branch borrowings.

111. See, e.g., IRC § 163(j)(2)(ii) (providing that corporations with debt/equity ratios in excess of 1.5 to 1 may be subject to “earnings stripping” rules); § 385 (authorizing the IRS to prescribe regulations classifying interests in corporations as debt or as equity).

The imposition of a uniform level of leverage on all business activities and transactions entered into by a U.S. branch can result in disparities between the bank's economic profit and loss and its ECTI from certain activities, and can render ostensibly profitable activities or transactions uneconomic on an after-tax basis. This unfortunate result is most likely to arise where the branch engages in economically integrated financial transactions involving higher levels of leverage than the overall level of leverage of the bank as a whole.

For example, banks (including U.S. branches of foreign banks) often hold sizeable amounts of U.S. Treasury securities, and they often engage in "repo" transactions.¹¹² The function of the repo transactions depends on the bank and its reason for holding Treasury securities. Thus, a bank that holds Treasuries in its dealer inventory, or because of their liquidity or the low regulatory capital charges involved, may find that repo transactions are an effective technique for financing the U.S. Treasuries at attractive rates. Indeed, because a repo typically represents an overnight secured borrowing, with a loan principal amount generally equal to the fair market value of the repoed securities, the bank can earn a positive spread between its interest income on the Treasuries and its repo interest expense. Banks that act as securities dealers may use repos as part of a "matched book" business in which the bank "repos in" securities from borrowers and "repos out" securities to lenders, earning in effect a commission.

For tax purposes, repos traditionally have been viewed as secured money loans that give rise to interest expense (in the case of a repo) or

112. In a repo transaction, one party sells ("repos out") securities, typically U.S. Treasury obligations or obligations of U.S. government-sponsored agencies, to a second party, and simultaneously agrees to repurchase identical securities from the buyer on a specified date at a specified price. The repurchase price reflects a time value component that may be stated as a premium above the selling price or as a separate "repo rate" applied to the selling price. The economic effect of the sale and repurchase transaction is to provide the party that repos out the securities with the use of cash at an attractive interest rate. A "reverse repo" is simply the same transaction viewed from the perspective of the other party: the purchase ("reversing in") of securities with a simultaneous agreement to resell identical securities to the original seller at a later date.

In a typical repo transaction, the securities are marked-to-market daily, and the repo "seller" (i.e., the money borrower) is obligated to provide additional collateral (or refund cash) if the value of the securities falls. As a result, the degree of overcollateralization required of repo sellers is very small, ranging from perhaps one to two percent in the case of a nondealer participant down to zero in the case of inter-dealer repo transactions. In addition, securities reversed in by a dealer (when it lends money) may be "rehypothecated"—that is, used by the dealer (whether through sale or otherwise) in its trade or business until the original reverse repo transaction is unwound.

interest income (in the case of a reverse repo).¹¹³ As indicated above, in a typical repo of Treasury securities, the principal amount of the loan generally equals the fair market value of the repoed Treasury securities, so that the securities are fully leveraged, with virtually no equity. Therefore, unless the U.S. branch is sufficiently underleveraged (before taking into account the Treasury securities and the repo transactions) so that it can absorb the 100% leverage ratio attributable to the repoed Treasuries, the Interest Allocation Regulations result in effect in a disallowance of a portion of the interest expense on the repoed Treasury securities.¹¹⁴

On the other hand, the fungibility principle benefits banks where they engage in business activities that are typically less leveraged. For example, a U.S. branch should be able to apply the fixed ratio for banks or its actual ratio to compute its U.S. interest expense on a leveraged lease that is leveraged at only 80%. Similarly, the bank can apply those ratios to a securities trading division of its U.S. branch that is leveraged at a lower level, even though if the securities trading operation were conducted through a nonbank foreign corporation, it would be required to utilize its actual (presumably lower) ratio or the 50% fixed ratio.

b. *Separate entity approach and its limits.*—As described above, the Interest Allocation Regulations give a considerable measure of recognition to the branch as a separate entity, particularly insofar as they take into account the interest expense reflected on the books of the branch. However, the IRS has emphatically refused, both in published rulings and in the Interest Allocation Regulations, to permit a bank to determine its deductible interest expense solely on the basis of the branch's records, or to recognize interbranch loans or other interbranch transactions. In this regard, the IRS' position—and its interpretation of U.S. income tax treaty provisions—differs from that of most other countries and from the OECD's interpretation of the OECD Model Convention (upon which most of the relevant U.S. tax treaty provisions are based).¹¹⁵

The IRS's rationale is most clearly set forth in Revenue Ruling 78-423:

113. Rev. Rul. 79-134, 1979-1 C.B. 76; Rev. Rul. 77-59, 1977-1 C.B. 196; Rev. Rul. 74-27, 1974-1 C.B. 24.

114. In contrast, the interest allocation rules under Temp. Regs. § 1.861-10(c) provide an exception to the general fungibility principle for certain integrated financial transactions (although this exception is not available to securities dealers).

115. See Org. for Economic Co-operation and Dev., *The Taxation of Multinational Banking Enterprises*, in OECD, *Transfer Pricing and Multinational Enterprises: Three Taxation Issues* (1984) [hereinafter OECD Report]. The OECD report expresses the view that, under the OECD Model Convention, bank branches should be treated as separate entities and interbranch transactions should be recognized.

The reference in Article 8(2) of the [Japan-U.S.] Convention to attributing profits to the permanent establishment as if it were an independent entity relates only to the computation of the profits of the permanent establishment in the dealings of such permanent establishment with the home office and with any other branch of the foreign resident that may exist. *This reference does not mean that the United States branch must be taxed as though it were a separate entity.* The resident taxpayer is the foreign bank itself, consisting of the home office and the branch, *P* and *P-1*, respectively. Consistent with this analysis, Article 8(1) provides that the United States may tax a Japanese resident on the "industrial and commercial profits of such resident . . . [that] are attributable to" *P-1*.

In determining the amount of such profits, Article 8(3) of the Convention permits the deduction of expenses that are "reasonably connected" with such profits, regardless of where the expenses are incurred. *However, the independent entity concept of Article 8(2) does not determine what expenses are "reasonably connected" with such profits.* Further, Article 8(3) is not to be interpreted as allowing the permanent establishment of *P* to allocate the interest deduction in a manner different from other United States taxpayers.

The Convention does not provide a specific rule for the allocation of expenses. Thus, in the absence of such a rule, Article 2(2) of the Convention indicates that the general domestic law of the United States is to be applied for the purpose of determining the expenses "reasonably connected" with the profits of a United States permanent establishment. With respect to the allocation and apportionment of the foreign bank's worldwide interest expense, the general allocation rule for the taxpayer in the instant case is found in section 1.861-8 [now found in section 1.882-5] of the Regulations.¹¹⁶

Critics of the IRS' position have argued that it is inconsistent with U.S. income tax treaties, that it exposes foreign banks to double taxation as a result of the lack of conformity in the determination of their interest

116. 1978-2 C.B. 194, 195 (emphasis added).

expense for U.S. and foreign tax purposes, and that the Interest Allocation Regulations that are necessary to implement the IRS' position require foreign banks to engage in complex and costly computations and to incur administratively burdensome recordkeeping obligations.¹¹⁷

I do not wish to express a comprehensive view as to whether a challenge to the IRS' interpretation of the relevant treaty provisions might have merit as a technical legal matter. However, it seems to me that the IRS' position that a U.S. branch should not be treated *solely* as a separate entity for purposes of determining its deductible interest expense is more consistent with the general approach of the U.S. tax law to the taxation of branches of foreign corporations, as discussed in this article,¹¹⁸ and permits a better balance to be struck among the various policies that should underlie the determination of a branch's deductible interest expense. Moreover, Congress weighed in on the matter in 1987, stating in the legislative history of section 842 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."¹¹⁹

Particularly in view of the foregoing and as discussed below, whether interbranch loans can, within the framework of existing law, or should, as a policy matter, be taken into account in any way under the Interest Allocation Regulations is at best unclear.¹²⁰ The treatment of interbranch loans touches

117. E.g., Institute of International Bankers, Taxation of U.S. Activities of International Banks, 19 Highlights & Documents 45 (Oct. 1, 1990) (LEXIS, Fedtax lib., TNT file). See Crawford, *supra* note 104.

118. See, e.g., *infra* Part V. Indeed, since 1986, § 864(e)(2) generally requires (unless the IRS determines otherwise, pursuant to § 864(e)(7)(F)) that interest expense be allocated utilizing an asset-based fungibility concept, rather than by treating a branch as a separate entity. The Interest Allocation Regulations, in effect, reflect the IRS' judgment that neither a pure fungibility approach nor a pure separate entity approach is appropriate for determining the deductible interest expense of a foreign corporation.

119. H.R. Rep. No. 495, 100th Cong., 1st Sess. 985 (1987). Section 842(b) applies to foreign insurance companies and is somewhat analogous to the Interest Allocation Regulations, although § 842(b) imputes bottom-line net income, not simply expenses, to the U.S. insurance business of the foreign insurer. The § 842(b) formula begins with the "booked" insurance liabilities of the U.S. business. These liabilities are then used to derive a minimum amount of deemed U.S. assets and the imputed U.S. assets are, in turn, deemed to earn a certain minimum investment return. Unlike the 1981 regulations and the 1992 proposed regulations, however, the § 842(b) formula is based on data of comparable domestic insurers. The impetus for this income imputation scheme was the underlying policy goal of reducing "the potential competitive advantage the present-law rules create [for foreign insurers]." H.R. Rep. No. 391, 100th Cong., 1st Sess., pt. 2, at 1109 (1987).

120. While approving the IRS' position that interbranch loans generally should not be respected, Congress appears to have granted the IRS some latitude on the matter:

The conferees are aware that some corporations attempt to establish actual debtor-creditor relationships for funds between a branch and a home office

upon the various themes and concerns underlying the Interest Allocation Regulations, including, significantly, the fungibility principle (codified in section 864(e)(2)) and whether a U.S. branch can or should be treated solely as a separate entity for purposes of determining its deductible interest expense.¹²¹ Consequently, it is relevant to consider whether the balance that was struck in the Interest Allocation Regulations—appropriately, in my view—between the fungibility and separate entity concepts can effectively be preserved through an alternative approach (such as, for example, by imposing a minimum equity capital level on the U.S. branch while otherwise treating it as a separate entity for purposes of the Interest Allocation Regulations). In addition, it is relevant to evaluate the considerations discussed in paragraphs *c* and *d*, below, including whether and to what extent the perceived benefits in simplifying the administrability of the Interest Allocation Regulations are outweighed by complications arising from the need to ensure that the terms of the interbranch loans are at arm's length and do not reduce the branch's taxable income below an acceptable level.

or between one branch and another. The conferees question the legitimacy of such arrangements from a tax perspective since only one legal entity is involved. Nonetheless, if companies are able to legally establish such relationships, it is intended that the regulations address these relationships and possibly treat the excess interest as incurred on each type of interbranch "loan." The conferees are concerned that taxpayers may artificially structure interbranch loans in a manner different from their external liabilities in an attempt to reduce or eliminate the tax on excess interest. The conferees, therefore, expect the regulations to address this concern.

H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-649 (1986). While this statement was made in the context of § 884, it is equally relevant for purposes of the Interest Allocation Regulations by virtue of § 884(c)(2)(C), see *infra* Part IV.B.

121. In theory, interbranch loans could be taken into account in a manner consistent with the balance that has been struck between the fungibility and separate entity concepts in the Interest Allocation Regulations. Within the framework of the three-step formula of the Interest Allocation Regulations, interbranch loans simply could be treated as booked liabilities and assets of the U.S. branch, in which case any booked interest expense on the interbranch loans would be subject to scaleback under step three if the branch is overleveraged. Also, interbranch loans could continue to be disregarded for purposes of determining the U.S. assets and U.S. liabilities under steps one and two of the formula, so that whether (and if so the extent to which) a branch is overleveraged or underleveraged would be determined without regard to interbranch loans. In that event, however, the principal effect of recognizing interbranch loans would merely be to substitute the actual interest rate on the interbranch loans for the rate prescribed by the Interest Allocation Regulations (which is 90% of LIBOR under the 1992 proposed regulations) if and to the extent the U.S. branch is underleveraged. Such a limited recognition of interbranch loans would not really achieve the principal benefits sought by proponents of such recognition—simplifying the administrability of the Interest Allocation Regulations and enabling foreign banks to achieve greater conformity between their U.S. and foreign tax treatment of interest expense and thereby reducing the risk of double taxation.

In light of the foregoing considerations, it is not at all clear whether any material benefits would be derived from recognizing interbranch loans for purposes of determining a foreign bank's deductible interest expense.¹²²

c. Correlation with other provisions and with hedging techniques.—

As indicated above, an important factor in the formulation of the 1992 proposed regulations is the need to correlate the Interest Allocation Regulations with the branch profits tax and branch level interest tax. The interrelationship between these provisions is discussed further in Part IV.B below.

The 1992 proposed regulations also recognize that in determining interest expense attributable to ECI, it is necessary to take into account forex gain or loss on relevant liabilities, as well as income and loss in respect of currency and interest rate hedges of relevant liabilities, since these items affect the true borrowing cost of the bank. However, under the 1992 proposed regulations, these items are taken into account only if the branch is over-leveraged and the scaling ratio applies. Thus, under the 1992 proposed regulations, income or gain from a notional principal contract that is ECI (or loss or expense that is allocable to ECI) and that is identified as a hedge of a booked liability is reduced by the application of the scaling ratio.¹²³ A similar rule applies for forex gain or loss under section 988 that is ECI and is attributable to a booked liability.¹²⁴

These rules need to be further refined and coordinated with the rules for determining ECI in respect of notional principal contracts and forex gain or loss (discussed above in Parts II.B.5 and II.C) to develop a comprehensive approach to integrating hedges and forex gain or loss, on the one hand, with both the income (and income-producing assets) and interest expense (and liabilities) to which they relate, on the other hand, for purposes of determin-

122. In my view, however, the treatment of interbranch loans should not be determined by whether as a legal matter a taxpayer can contract with itself since, as discussed in Part II.C.2 above, interbranch transactions can legitimately be relied upon, subject to appropriate conditions and limitations, as an indicator of the amount of income or expense that should appropriately be taken into account in determining ECI.

123. Prop. Regs. § 1.882-5(d)(3)(iii). The proposed regulations refer to Temp. Regs. § 1.861-9(b)(6) for rules governing the identification of a notional principal contract as a liability hedge, but at present that provision does not provide rules for financial services entities. In any event, the proposed regulations do not adequately deal with situations in which a bank hedges its liabilities on a more general or global basis.

124. Prop. Regs. § 1.882-5(d)(3)(iv). It would be helpful if the IRS clarified when forex gain or loss on a *hedge* of a booked liability (whether directly traceable or as part of a general hedge) is "attributable" to the booked liability.

ing ECTI.¹²⁵ In this regard, expanding upon the “scaling ratio” rule of the 1992 proposed regulations, ECTI would generally be more accurately measured if income and loss from notional principal contracts and other financial instruments that (1) are identified by a foreign bank as constituting hedges of assets or liabilities of the bank and (2) are entered into and booked by the same branch as the assets or liabilities that they hedge, are treated as ECI if and only to the extent that the assets or liabilities to which they relate give rise to ECI.¹²⁶

Also, it would be desirable for the Interest Allocation Regulations to provide explicit guidance regarding the extent to which notional principal contracts, forward contracts, options, and similar financial instruments are to be treated as “liabilities” and “assets” for purposes of the Interest Allocation Regulations.

By providing only for a “scaling ratio” rule, the 1992 proposed regulations implicitly take the position that notional principal contracts are not liabilities for these purposes. This result is proper, because the purpose of the Interest Allocation Regulations is to determine the portion of the actual interest expense incurred on actual liabilities of the foreign bank that should be allocated to its U.S. branch and deducted in computing ECI. This portion is determined based on the relative amounts of liabilities and assets of the branch compared to those of the bank as a whole. In all material respects, conventional notional principal contracts are executory contracts, result in no

125. For example, it has been noted that in requiring an automatic scale-down in forex gain or loss on a booked liability whenever the U.S. branch is overleveraged, the proposed regulations fail to take into account the relationship between the booked liability and the asset that it funds, and can thereby “unhedge” for U.S. federal income tax purposes positions that are economically hedged. This might occur if, for example, the booked liability, denominated in a foreign currency, funds an interbranch loan that is denominated in the same foreign currency. See IIB Comment Letter, *supra* note 101.

126. The results under this approach generally would correspond to the results under a natural home/separate entity method for allocating income from notional principal contracts. Where, however, a formulary apportionment method is adopted for allocating the bank's income from its dealing activity in notional principal contracts, this approach would provide an appropriate exception for contracts and similar financial instruments that are identified as hedges of assets or liabilities of the bank. This approach also would complement the modification to the special ECI rule for foreign banks that is proposed *supra* text accompanying note 27. See also *supra* text accompanying note 80.

Additional complications are raised where the hedging transaction and the corresponding assets or liabilities are entered into and booked by different branches. In the case of assets, the existence of a “split hedge” might suggest that the ECI or non-ECI status of the asset should be reexamined. Cases involving portfolio-wide or global hedges also raise complications, and may not be easily susceptible to a hedging identification rule.

debt proceeds to the obligor, and do not bear interest.¹²⁷ Thus, they should be treated no differently for purposes of the Interest Allocation Regulations than, say, an executory contract of a construction company to build a house or of a tenant to pay rent in respect of future periods, which obviously are not regarded as liabilities for these purposes. If notional principal contracts were taken into account as liabilities for these purposes, severe distortions could result in the application of the allocation formula.

In view of the purpose and mechanics of the Interest Allocation Regulations, it seems clear that notional principal contracts (as well as forward contracts, options, and similar financial instruments) should be treated as assets for purposes of the Interest Allocation Regulations if and to the extent that the bank (or other non-U.S. taxpayer) has a tax basis in the contracts (or other instruments) that is attributable to the expenditure of cash or other property (for example, by reason of purchasing a contract from another dealer). It is less clear whether notional principal contracts should be treated as assets for these purposes in other circumstances. In this regard, the mark-to-market rules of section 475 will dramatically increase the number of circumstances in which notional principal contracts (and similar financial instruments) held by a bank will have a tax basis (and a fair market value that is determined annually for tax purposes).

127. A conventional notional principal contract (e.g., an interest rate swap that is priced "at market" and provides only for annual periodic payments, without any premium or nonperiodic payments) is a nonexecutory contract that gives rise to a corresponding liability and asset only to the extent of any accrued but unpaid amounts due thereunder. Under Regs. § 1.446-3(e), amounts under the contract accrue on a daily basis, but for practical administrative reasons (and because these accrued amounts do not require actual debt or equity funding), it would be sensible to ignore such amounts (as an asset or liability) for purposes of the Interest Allocation Regulations. Immediately after each periodic payment is made, the contract reverts to being entirely executory. Guidance should be provided as to the extent to which any premium, embedded loan, or other nonperiodic payments under a notional principal contract (within the meaning of Regs. § 1.446-3(e)(3)) should be treated as giving rise to liabilities (and assets) for purposes of the Interest Allocation Regulations.

Under general tax principles, an executory contract is ignored until performance occurs. E.g., *Lucas v. North Texas Lumber Co.*, 281 U.S. 11 (1930) (holding taxpayer does not realize gain upon entering into an executory contract to sell property); *Hallack & Howard Lumber Co. v. Commissioner*, 18 B.T.A. 954 (1930) (holding taxpayer does not incur a deductible expense upon entering into an executory contract calling for the other party to perform services); Rev. Rul. 57-29, 1957-1 C.B. 519 (holding taxpayer's obligations under an executory contract are ignored prior to performance for purposes of determining taxpayer's basis in the contract).

Notwithstanding that notional principal contracts are largely executory contracts and, it is submitted, should not be treated as liabilities or (subject to certain exceptions) as assets for purposes of the Interest Allocation Regulations, in other contexts, it may be appropriate to treat them as real positions. See, e.g., Regs. § 1.1092(d)-1(c) (treating such contracts as an interest in personal property for purposes of the straddle rules).

On one hand, taking the mark-to-market basis (or, if elected, fair market value) of such contracts and instruments into account would be consistent with the treatment of securities for these purposes.¹²⁸ The potential for distortion would be diminished if, for purposes of the Interest Allocation Regulations, banks are also permitted to mark-to-market their contracts, instruments, and securities that are not attributable to their U.S. branch. On the other hand, requiring non-U.S. positions to be marked-to-market would increase administrative complexities, especially if this must be performed at the most frequent regular intervals for which data are reasonably available.¹²⁹ Moreover, because the tax basis that results from the application of section 475 is not attributable to any actual equity or debt funding, it would not advance the objectives of the Interest Allocation Regulations to take such basis into account. Indeed, unnecessary distortions would be created if and to the extent that the ratio of U.S. to foreign assets is materially changed as a result of these contracts and instruments being taken into account.¹³⁰

The Preamble to the 1992 proposed regulations requests comments on the coordination of the Interest Allocation Regulations with section 864(c)(7) and Regulations section 1.988-1(a)(10), which "potentially apply to the interbranch transfer of third party liabilities and hedges (which in theory

128. If notional principal contracts and other financial instruments are taken into account as assets for purposes of the Interest Allocation Regulations, it would be necessary to provide appropriate rules for positions that have negative value to the bank, under which such negative value would presumably be netted against the basis (or value) of other positions. In addition, if such assets are taken into account for these purposes and if revised rules for determining ECI from global trading activities involving such assets are adopted as suggested supra Part II.C, then for purposes of the Interest Allocation Regulations, the assets associated with such global trading activities should be treated as U.S. assets to the extent of the proportion of the income from those assets that is treated as ECI. This approach, it is submitted, is consistent with the general approach of the Code and Regulations to interrelating income and balance sheet items for purposes of coordinating ECI, the Interest Allocation Regulations, the BPT, and the BLIT (discussed infra Parts IV.B and V), and should not be considered inconsistent with § 864(e)(2), which provides that interest expense must be allocated on the basis of assets rather than gross income. A similar approach should apply for purposes of the branch profits tax. See supra note 91.

129. See Regs. § 1.882-5(a)(4); Prop. Regs. §§ 1.882-5(b)(3), (c)(2)(iv).

130. Even though it is suggested that notional principal contracts and similar instruments should not be treated as liabilities or (subject to certain exceptions) as assets for purposes of the Interest Allocation Regulations, a foreign bank should treat as assets and liabilities any positions in physical securities (and related financings) entered into to hedge its exposure under these contracts and instruments, just as a construction company that entered into an executory contract to build a house should take into account the raw materials that it acquires to satisfy its obligations under the construction contract and debt that it incurs to finance the raw materials.

occurs when they are scaled back).”¹³¹ To my mind, it would be unfortunate and unwarranted to treat the adjustments in U.S. liabilities (and related hedges) that are made (and adjusted each year) for purposes of determining the amount of deductible interest expense under the Interest Allocation Regulations as representing actual transfers of property for purposes of applying section 864(c)(7) and Regulations section 1.988-1(a)(10).

d. *Administrability, ensuring a minimum level of taxable income, and arriving at an appropriate determination of taxable income.*—These three themes, which are both interrelated and, to a degree, inconsistent with each other, are all evident in the Interest Allocation Regulations.

A rigorous application of the basic three-step allocation formula of the regulations with a view to deriving, with a high level of accuracy, the appropriate amount of U.S. interest expense, would require a bank (and the IRS) to engage in complicated and costly calculations and would impose significant record-gathering, record-keeping, and audit burdens. For example, a bank that elects to determine the actual ratio of U.S.-to-worldwide liabilities under step two of the formula must convert all its assets and liabilities to a single currency (using applicable exchange rates for each determination date)¹³² and determine the average value of its assets and average total amount of its liabilities “at the most frequent regular intervals (such as daily, weekly, monthly, or quarterly) for which data for all assets, or liabilities are reasonably available.”¹³³ The Interest Allocation Regulations ease these substantial burdens by permitting or requiring taxpayers to utilize simplifying assumptions and formulas. The most significant departure from precision is the election to utilize a fixed ratio of liabilities to assets in step two, instead of computing the actual ratio.¹³⁴ The 1992 proposed regulations would further ease administrative burdens by eliminating the separate currency pools method and by requiring taxpayers to utilize readily ascertainable interest rates (90% of LIBOR in the case of banks) to compute U.S. interest expense on excess liabilities.¹³⁵

131. 57 Fed. Reg. 15040 (1992). See *supra* notes 17 and 51 for a discussion of these provisions.

132. Regs. § 1.882-5(a)(3); Prop. Regs. § 1.882-5(c)(2)(iii)(B).

133. Regs. § 1.882-5(a)(4); see also Prop. Regs. § 1.882-5(b)(3), (c)(2)(iv) (requiring the computations to be made no less frequently than quarterly).

134. See *supra* note 93 and accompanying text.

135. See *supra* note 97. As mentioned *supra* note 97, under the 1981 Regulations, interest expense on excess liabilities generally is calculated by using the average interest rate on U.S. dollar liabilities shown on the books of the bank’s non-U.S. offices or, if that rate is not reasonably determinable, by using a method that reasonably approximates the actual rate (such as a LIBOR-based rate) that is consistently applied from year to year. In practice, many banks have found it extremely difficult and impractical to determine the average interest rate

While these provisions undoubtedly simplify the application of the Interest Allocation Regulations, the regulations continue to impose substantial administrative burdens, particularly in the determination of U.S. assets under step one. For example, a foreign bank must compute its total U.S. assets for each taxable year based on the average of the sums of the adjusted tax bases (or, if elected, fair market values) of its U.S. assets on the most frequent, regular intervals for which data is reasonably available (and, under the 1992 proposed regulations, no less frequently than quarterly).¹³⁶

It is also clear, at least from the 1992 proposed regulations, that the IRS is seeking, through the same provisions that simplify the administrability of the Regulations, to ensure that U.S. branches of foreign banks pay a minimum level of U.S. tax. Thus, for example, the 1992 proposed regulations would reduce the fixed ratio for banks from 95% to 93%, would cap the actual ratio at 96%, and would require banks to utilize 90% of LIBOR as the interest rate on excess liabilities.¹³⁷ This may be in response to a perception that foreign banks are not bearing their "fair share" of the tax burden, or it may simply be the tradeoff that the IRS expects banks to accept in exchange for greater simplicity and an easing of administrative burdens.

IV. THE BRANCH PROFITS TAX AND BRANCH LEVEL INTEREST TAX

A. Overview

Enacted in 1986, the branch profits tax (BPT) and the branch level interest tax (BLIT) are intended to equalize the position of foreign corporations doing business in the United States through branches with that of foreign corporations doing business in the United States through subsidiaries.

on U.S. dollar liabilities booked in non-U.S. offices, and have therefore utilized a LIBOR-based rate that, in their view, reasonably approximates the actual rate. However, upon audit, a bank would be required to establish that the selected rate is a reasonable approximation of the actual rate (which itself may be difficult to ascertain).

136. Regs. § 1.882-5(a)(2), (4); Prop. Regs. § 1.882-5(b)(2)(i), (3). To further complicate matters, for purposes of the BPT, U.S. assets must be determined as of particular determination dates (generally the close of the taxable year), based on their adjusted tax bases for earnings and profits purposes. Regs. § 1.884-1(c)(2), (d)(6).

137. See *supra* notes 93, 94, 97 and accompanying text. The 1992 proposed regulations have also increased administrative burdens on taxpayers that elect to apply the actual ratio. For example, large banks would have to compute the sum of their worldwide assets and liabilities no less frequently than monthly. Prop. Regs. § 1.882-5(c)(2)(iv). In their comments on the proposed regulations, The Institute of International Bankers observed that "[we are] not aware of any international bank that would be able to comply." IIB Comment Letter, *supra* note 101. Thus the 1992 proposed regulations seem to be pushing banks to elect the greater simplicity of the fixed ratio, but at a higher tax cost. The rule excluding real estate from U.S. assets until the year of disposition (see *supra* note 91) might have been similarly motivated.

Both branches and subsidiaries are subject to U.S. federal income taxation on a net income basis. However, before the BPT, the after-tax profits of a U.S. branch could be remitted to the home office of the foreign corporation free of additional tax, whereas foreign corporations operating through U.S. subsidiaries were and continue to be subject to withholding tax on dividend distributions from subsidiary to foreign parent. Similarly, interest paid by a U.S. subsidiary generally is U.S. source and therefore subject to withholding tax (subject to applicable exceptions), whereas, before 1987, U.S. interest expense of a U.S. branch was not subject to withholding tax.¹³⁸

The BPT eliminates this disparity in the treatment of remitted earnings by imposing a tax on a foreign corporation that has a U.S. branch, in addition to the normal U.S. tax on ECI. Like the dividend withholding tax, the BPT is generally imposed at 30%, which rate may be reduced if a tax treaty applies (subject to rigorous antitreaty shopping rules requiring the foreign corporation to be a "qualified resident" of the treaty country).¹³⁹

In seeking to approximate the effects of the dividend withholding tax, the drafters of the BPT faced several practical difficulties. As noted above, branches of foreign corporations are not regarded as separate entities for U.S. tax purposes. Thus, before the BPT, they were not required to account separately for their earnings and profits (the basic measure of a dividend for U.S. tax purposes). Moreover, since a branch by its nature is not legally separate from its home office, and funds may flow freely between the U.S. branch and the home office, it was necessary to devise a surrogate for the cash payments that, if made out of earnings, would trigger the dividend withholding tax.

The BPT addresses these considerations by introducing the concept of "dividend equivalent amount" and by requiring foreign corporations with U.S. branches to keep account of their post-1986 "effectively connected earnings and profits" (ECEP) and of changes in their "U.S. net equity." Through these concepts, a balance sheet is constructed for the branch, which reflects the assets and liabilities associated with the U.S. branch and which permits the calculation of amounts that are deemed to be remitted to the home office (and therefore subject to the BPT).

The BPT is imposed on a foreign corporation's dividend equivalent amount. The dividend equivalent amount equals the corporation's earnings and profits for the taxable year that are attributable to ECI (ECEP), adjusted to take account of any change during the taxable year in the corporation's U.S. net equity (U.S. assets, less U.S. liabilities). The adjustment for changes

138. So-called secondary withholding taxes on dividends and interest paid by a foreign corporation were applicable only if, in general, 50% or more of the foreign corporation's gross income during a three-year testing period was ECI. IRC § 861(a)(1)(C), (2)(B) (before amendment in 1986).

139. See *infra* notes 145-50 and accompanying text.

in U.S. net equity, which may be either positive or negative, is designed to identify when earnings of the branch have been reinvested in the branch's U.S. trade or business and when they should be considered to have been repatriated. The corporation's dividend equivalent amount is reduced by any increase in U.S. net equity during the taxable year (reflecting a reinvestment of ECEP in the United States) and increased by any reduction in U.S. net equity during the taxable year (to the extent of ECEP for previous years that was deemed reinvested and therefore not taxed). Thus, decreases in U.S. net equity generally increase the BPT and vice versa.¹⁴⁰

The purpose of the BLIT is to ensure that interest expense incurred by a branch on liabilities associated with its U.S. trade or business is treated in a comparable manner to interest expense incurred by a U.S. subsidiary. In general, the BLIT consists of two separate, but related, rules.

First, the BLIT provides that interest actually paid by the branch to third parties (booked or branch interest) is treated as if paid by a domestic corporation.¹⁴¹ Thus, such interest is sourced in the United States and is subject to a 30% U.S. withholding tax unless it is eligible for an exemption or reduction under the Code (including the exemptions for portfolio interest and for interest on bank deposits) or, in the case of a "qualified resident" of a treaty country, under an income tax treaty. This first rule does not itself impose a tax; it simply re-sources interest paid (which in turn has implications for the imposition of tax under generally applicable rules).

The second aspect of the BLIT is the tax on "excess interest."¹⁴² In general terms, under this rule, where a branch is considered underleveraged and excess liabilities are imputed to it under the Interest Allocation Regulations, the excess of the interest deduction over the interest paid by the branch is deemed to be paid to the foreign corporation by a wholly-owned U.S. subsidiary. As a result, the excess interest is subject to U.S. tax at 30% unless an exemption or reduced rate is available under a tax treaty and the foreign corporation is a "qualified resident" of the treaty country.¹⁴³ In effect, the

140. IRC § 884(a)-(d).

141. IRC § 884(f)(1)(A). This rule does not apply to the extent the amount of branch interest exceeds the amount of deductible interest expense. IRC § 884(f)(1); Regs. § 1.884-4(b)(6).

142. IRC § 884(f)(1)(B).

143. Because the branch is treated as a wholly-owned U.S. subsidiary, the portfolio interest exemption does not apply. IRC § 881(c)(3)(B). However, as discussed *infra* note 156 and accompanying text, the regulations enable a foreign bank or other foreign corporation to reduce its excess interest by 85%.

The symmetry between a U.S. branch and a U.S. subsidiary that is created by the BLIT with respect to excess interest extends to the "earnings stripping" rules under § 163(j), so that, to the extent that excess interest is subject to a reduced rate of BLIT as a result of an income tax treaty, the U.S. branch could be denied an interest deduction under § 163(j). Prop.

underleveraged branch is treated as a separate entity that has borrowed from its parent to the extent it is underleveraged. Thus, although actual interbranch loan transactions are ignored for purposes of the BLIT,¹⁴⁴ the BLIT replaces such interbranch loans with deemed loan transactions.

Fortunately for them, many foreign banks are “qualified residents” of countries having favorable income tax treaties with the United States, and therefore are exempt entirely from the BPT and BLIT on excess interest, or are subject to substantially reduced rates.¹⁴⁵ For example, banks that are qualified residents of Germany, Italy, Japan, the Netherlands, Switzerland, and the United Kingdom are exempt from the BPT,¹⁴⁶ and banks that are qualified residents of France, Germany, the Netherlands, and the United Kingdom are exempt from the BLIT on excess interest (but, except for the

Regs. § 1.163(j)-8. Usually, the earnings stripping rules are not of concern to foreign banks because they generally do not have net interest expense. However, earnings stripping could become a problem for foreign banks that engage in extensive derivatives, securities dealing, or other activities in the United States and have a substantial amount of ECI other than interest.

144. Regs. § 1.884-4(b)(4).

145. See § 884(e), (f)(3). Very generally, a foreign bank is a “qualified resident” of a tax treaty jurisdiction if one of the following conditions is met:

- (a) The bank’s stock is “primarily and regularly traded on one or more established securities markets” in its country of residence or the United States or both, or over 90% of its stock (by vote and value) is owned, directly or indirectly, by a corporation that is a resident of the same foreign country as the bank or of the United States, and is publicly traded in its country of residence or the United States or both. Regs. § 1.884-5(d).
- (b) More than 50% (by value) of the bank’s stock is beneficially owned (directly or by attribution) by one or more qualifying stockholders that are treated as residents either of the foreign country of which the foreign bank is resident or the United States, documentation is maintained establishing that this ownership requirement is satisfied, and the foreign bank satisfies a “base erosion” test limiting deductible payments to persons that are not residents of such country or the United States. Regs. § 1.884-5(a)(1), (b), (c).
- (c) The bank is engaged in the active conduct of business in its country of residence and maintains a substantial presence in that country, and its U.S. trade or business is an integral part of such active business. Regs. § 1.884-5(e) (containing special, generally favorable rules and presumptions for applying this test to foreign banks).
- (d) The IRS determines, in its sole discretion, that the bank should be treated as a qualified resident because the use of the treaty by the bank’s shareholders is not inconsistent with the purposes of the BPT or the BLIT (as the case may be), including the prevention of treaty-shopping. Regs. § 1.884-5(f).

146. Regs. § 1.884-1(g)(3).

United Kingdom, not from the BLIT on branch interest).¹⁴⁷ Banks that are qualified residents of Australia, Canada, France, and various other countries are subject to the BPT at reduced rates,¹⁴⁸ and banks that are qualified residents of Australia, Canada, Italy, Japan, Switzerland, and various other countries are subject to the BLIT on excess interest at reduced rates.¹⁴⁹ On the other hand, many other banks, including banks in Hong Kong, most Latin American countries,¹⁵⁰ and the Middle East are subject to the BPT and BLIT at the statutory rates.

147. Regs. § 1.884-4(b)(8)(i) (branch interest), (c)(3) (excess interest); Convention Between the United States of America and the French Republic with Respect to Taxes on Income and Property, July 28, 1967, U.S.-Fr. art. 10, paras. 1, 7, 19 U.S.T. 5280, 5294; Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Income, Aug. 29, 1989, U.S.-Ger. art. 11, paras. 1, 5, K.A.V. 713; U.S.-Neth. Treaty, *supra* note 27, art. 12, paras. 1, 6, K.A.V. 3507; Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, Dec. 31, 1975, U.S.-U.K. art. 11, paras. 1, 6, 31 U.S.T. 5668, 5680. Branch interest that is not otherwise exempt from withholding tax (see *supra* text accompanying note 141) may be exempt from withholding tax under a tax treaty with the recipient's country, provided that in the case of a recipient that is a foreign corporation, it is a qualified resident of that country. Regs. § 1.884-4(b)(8)(ii).

148. Regs. § 1.884-1(g)(4)(B) (Australia (15%), Canada (10%), France (5%)).

149. The rates are 15% in the case of Canada and Italy, 10% in the case of Australia and Japan, and 5% in the case of Switzerland. Convention Between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Aug. 6, 1982, U.S.-Austl. art. 11, para. 2, T.I.A.S. 10773, 29; Convention Between the United States of America and Canada with Respect to Taxes on Income and Capital, Sep. 26, 1980, U.S.-Can. art. 11, para. 2, T.I.A.S. 11087, 12; Convention Between the Government of the United States of America and the Government of the Republic of Italy for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fraud or Fiscal Evasion, Apr. 17, 1984, U.S.-It. art. 11, para. 2, T.I.A.S. 11064, 16; U.S.-Jap. Treaty, *supra* note 27, art. 13, para. 4, 23 U.S.T. at 990; Convention Between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, May 24, 1951, U.S.-Switz. art. 7, para. 1, 2 U.S.T. 967, 990.

150. But see Convention Between the Government of the United States of America and the government of the Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sep. 18, 1992, U.S.-Mex., arts. 11, 11A, K.A.V. 3508 (providing that banks that are qualified residents of Mexico are subject to the BPT at a reduced rate of 5% and to the BLIT at a reduced rate of 10% (which rate will fall to 4.9% beginning January 1, 1999).)

B. Coordination Among the BPT, BLIT and Interest Allocation Regulations, and Their Application to Bank Branches

The concepts "U.S. assets" and "U.S. liabilities" play important roles in both the BPT and the Interest Allocation Regulations, and section 884(c)(2)(C) provides that regulations interpreting these concepts for purposes of the BPT and the Interest Allocation Regulations should be consistent with each other. Consequently, with certain exceptions, the 1992 proposed Interest Allocation Regulations adopt the detailed definition of "U.S. assets" that is contained in the BPT regulations, and the BPT regulations in turn define "U.S. liabilities" by reference to the Interest Allocation Regulations.¹⁵¹

However, as discussed in Part III.B above, under the Interest Allocation Regulations, in the case of an underleveraged U.S. branch, "U.S. liabilities" include not only booked liabilities of the branch, but also the excess of U.S. liabilities (as determined under step two of the Interest Allocation Regulations formula) over booked liabilities. If these excess liabilities are included in "U.S. liabilities" for purposes of determining "U.S. net equity" under the BPT, a bank with an underleveraged U.S. branch could incur a BPT liability even though the U.S. branch has not remitted any earnings to its home office but has merely had its U.S. net equity reduced as a result of the allocation of excess liabilities under the Interest Allocation Rules. Absent special relief, the benefit that such an "underleveraged branch" would obtain from increasing its U.S. interest expense as a result of the excess liabilities (generally, 35% of the interest expense) would be outweighed by a 30% BPT on the full amount of the excess liabilities (to the extent such amount results in an increase in the bank's dividend equivalent amount). Such relief is provided by the regulations under section 884, which permit a bank to elect to reduce its U.S. liabilities for any taxable year by an amount that does not exceed the excess of U.S. liabilities over booked liabilities.¹⁵² If a bank makes this election, U.S. liabilities are reduced for purposes of the BPT, the BLIT, *and* the Interest Allocation Regulations.¹⁵³ In short, if the branch is willing to forego the interest deduction, it can avoid

151. Prop. Regs. § 1.882-5(b)(1), Regs. § 1.884-1(e)(1). However, for purposes of the Interest Allocation Regulations, "U.S. assets" equal the average of the adjusted tax bases of those assets (or, if elected, their fair market values) during the taxable year, whereas for purposes of the BPT, "U.S. assets" equal their adjusted tax bases for earnings and profits purposes as of particular determination dates (generally, the close of the taxable year). See *supra* note 136 and accompanying text. See also *supra* note 91. Similarly, for purposes of the Interest Allocation Regulations, "U.S. liabilities" is based on an average for the taxable year, whereas for purposes of the BPT, "U.S. liabilities" is measured as of particular determination dates (generally, the close of the taxable year). Regs. § 1.884-1(e)(1).

152. Regs. § 1.884-1(e)(3).

153. Regs. § 1.884-1(e)(3)(iii).

any BPT (and BLIT) that otherwise may result from its U.S. liabilities being greater than its booked liabilities.

The BLIT is also closely related to the Interest Allocation Regulations. While some definitional disparities exist,¹⁵⁴ the amount of "branch interest" under the BLIT generally corresponds to the amount of interest on "booked liabilities" under the Interest Allocation Regulations. Since "excess interest" for purposes of the BLIT is defined as the excess of U.S. interest expense (determined under the Interest Allocation Regulations) over "branch interest," the amount of "excess interest" also generally corresponds to the amount of U.S. interest expense in excess of the branch's actual interest expense on booked liabilities under the branch book/dollar pool method.

As indicated above, the 30% BLIT generally applies to excess interest unless a reduction or exemption is available under an income tax treaty. However, the BLIT regulations provide that a bank may treat as interest paid on a deposit (and therefore exempt from tax under sections 881(d) and 871(i)(2) and (3)) an amount of excess interest equal to the greater of (1) the ratio of the amount of its interest-bearing deposits as of the close of the taxable year to the amount of all interest-bearing liabilities of the bank on that date,¹⁵⁵

154. For example, unlike the 1992 proposed regulations, the definition of branch interest for banks does not expressly contain a contemporaneous booking rule. Compare Prop. Regs. § 1.882-5(d)(2)(iii)(A) with Regs. § 1.884-4(b)(2). Also, branch interest includes so-called "high interest rate liabilities" of banks, which would not be recognized under the 1992 proposed regulations. Compare Prop. Regs. § 1.882-5(d)(2)(iii)(B) with Regs. § 1.884-4(b)(2). In addition, branch interest is not subject to the "matching rule" in the 1992 proposed regulations which, in general, requires that the amount of liabilities booked in a particular currency be within ten percentage points of the amount of U.S. assets denominated in that currency (unless the taxpayer establishes that the mismatch is representative of its worldwide position in that currency). Compare Prop. Regs. § 1.882-5(d)(2)(v) with Regs. § 1.884-4(b)(2).

155. Questions can arise as to the amount of a foreign bank's total *deposit* liabilities if the bank has significant liabilities that are not labeled "deposits" but do not have materially different characteristics from liabilities that clearly are deposits. Although there is no precise distinction between deposits and other liabilities for federal income tax purposes, and the authorities do not clearly articulate their reasoning, the most significant factors appear to be: (1) the regulatory treatment of the obligation; (2) the role of the obligation in the overall funding structure of the issuing institution; and (3) the characteristics of the obligation, including the depositor's intent in advancing funds to the bank.

Regulatory Treatment. In general, a liability that is treated as a deposit for regulatory purposes is treated as a deposit for federal income tax purposes. Rev. Rul. 81-30, 1981-1 C.B. 388 (negotiable and nonnegotiable long-term certificates of deposit issued by a U.S. thrift institution that were treated as "savings accounts" eligible for federal deposit insurance); Rev. Rul. 73-505, 1973-2 C.B. 224 (nonnegotiable time deposits with fixed terms up to 15 years); Rev. Rul. 70-436, 1970-2 C.B. 148 (5-year negotiable certificates of deposit).

Role of Liability in Overall Funding. In several cases under the predecessor to § 581 and the former Excess Profits Tax, courts established a principle that a liability is treated as a deposit, regardless of how it is labeled, if it has the characteristics of a bank deposit and

or (2) 85%.¹⁵⁶ Thus, the maximum BLIT on excess interest is 4.5% (30% of 15%).

A number of interrelated considerations need to be taken into account in planning with respect to the BPT, BLIT, and the Interest Allocation Regulations. These considerations include: (1) whether the BPT or the BLIT is eliminated or reduced under an income tax treaty; (2) the amount of the branch's expected dividend equivalent amount for the year (which in turn depends, *inter alia*, on its profits and on whether the amount of its assets is expanding or contracting); (3) whether the branch should incur additional booked liabilities and whether it is underleveraged or overleveraged; (4) the impact on the BPT, BLIT, and Interest Allocation Regulations of electing to reduce excess U.S. liabilities; and (5) whether the branch has available net operating losses or credits to reduce its tax liability.

If a bank is not eligible for any treaty protection from the BPT or the BLIT, it should ordinarily prefer to have its U.S. branch maintain leverage, based on booked liabilities, at least comparable to that of the bank as a whole (or, if elected, to the fixed ratio under the Interest Allocation Regulations). Virtually all interest on booked liabilities is likely to be exempt from withholding tax,¹⁵⁷ whereas if the branch is underleveraged, its excess interest is subject to the BLIT (albeit at a maximum rate of 4.5%). In addition, if the U.S. branch maintains such a comparable leverage based on booked liabilities, its deductible interest expense is likely to approximate

plays a similar role in funding the institution's lending business. E.g., *Morris Plan Bank v. Smith*, 125 F.2d 440 (2d Cir. 1942); *Staunton Indus. Loan Corp. v. Commissioner*, 120 F.2d 930 (4th Cir. 1941). See G.C.M. 39155 (Mar. 1, 1984) (distinguishing and disagreeing with contrary authorities).

Terms; Depositor's Intent. Courts have also distinguished deposits from other types of bank liabilities in that deposits are offered to the public at large using standardized documentation that is not separately negotiated with individual lenders. E.g., *Commissioner v. Valley Morris Plan*, 305 F.2d 610, 617-18 (9th Cir. 1962). This reflects the general intent of a depositor, who seeks merely to invest funds in relative safety at a competitive return, with that of a nondepositor lender, who generally requires a more significant yield and financial covenants to compensate for additional risk.

156. Regs. § 1.884-4(a)(2)(iii). An equivalent rule—effectively allowing the BLIT to be reduced by 85% by identifying liabilities as booked liabilities of a U.S. business—is also provided for foreign corporations other than banks. Regs. § 1.884-4(b)(1)(v), (3).

157. Interest paid to U.S. persons (and to foreign persons in whose hands the interest income is ECI) is not subject to withholding (unless the backup withholding provisions of § 3406 apply), while non-ECI interest paid to non-U.S. persons generally qualifies for exemption either as interest on a bank deposit (under §§ 871(i)(2)(A) and 881(d)) or as portfolio interest (under §§ 871(h) and 881(c)). If the branch is overleveraged, the amount of deductible interest expense will not be materially affected, see *supra* note 96 and accompanying text, and the amount of branch interest in excess of deductible interest expense will not be subject to the BLIT on branch interest, see *supra* note 141.

closely its actual interest expense on booked liabilities, thereby enabling the branch to avoid the less favorable rules that would otherwise determine its deduction in respect of excess interest.¹⁵⁸

In any event, if the branch is underleveraged to any extent, it can avoid BPT liability by electing to reduce its excess liabilities, but at the cost of forgoing an interest deduction on such excess liabilities. In the absence of treaty protection from the BPT, such an election usually makes sense.¹⁵⁹ In contrast, if the bank has treaty protection from the BPT but not from the BLIT, the election is frequently not advantageous.¹⁶⁰

If a bank is exempt from the BPT under an income tax treaty, it may prefer to underleverage its U.S. branch and overleverage other branches. In that event, although the amount of its interest expense deduction should not be materially affected under the Interest Allocation Regulations,¹⁶¹ the bank might also be eligible for an interest deduction, for foreign tax purposes, in its overleveraged branches in respect of the liabilities that in effect are being used to fund assets of the U.S. branch.¹⁶²

V. CONCLUSION

When banks, or other businesses, engage in cross-border activities, each of the foreign jurisdictions in which they conduct business must address

158. See *supra* notes 97 and 135. Also, by minimizing the amount of excess interest, a bank with a potential earnings stripping problem can avoid the adverse effect of § 163(j). See *supra* note 143.

159. For example, consider the case of a foreign bank that experiences a reduction in U.S. net equity for the year of \$100 because it has \$100 of excess U.S. liabilities, and has excess interest of \$10. As a result, the bank faces a potential BPT of \$30 (30% of \$100), as well as BLIT of \$.45 (30% of 15% of \$10). However, the bank may claim an interest deduction of \$10 on the excess liabilities, which results in \$3.50 in tax savings. Thus, the bank has a net additional tax liability of \$26.95 as a result of the \$100 of excess liabilities. If the bank makes the election to reduce excess U.S. liabilities, it avoids this \$26.95 of net additional tax liability.

160. For example, under the facts set out in the preceding note, the foreign bank is potentially subject to a BLIT of \$.45, but the interest deduction is worth \$3.50. Thus, the bank is better off incurring the BLIT tax if it can utilize the interest deduction.

161. However, the amount of deductible interest expense in excess of the interest expense properly shown on the books of the branch is determined under the special, less favorable, rules described *supra* notes 97 and 135.

162. The efficacy of this technique for claiming a duplicate deduction for interest expense depends on a number of U.S. and foreign tax (as well as other legal) considerations. For example, a bank may be constrained as to how much leverage it can place on a particular branch, for tax or regulatory purposes, or it may be required to offset the increased interest expense attributable to the overleveraging of a foreign branch with interest income on interbranch loans. The BLIT should also be taken into account in determining the net benefit from such a technique (although, as indicated above, the maximum BLIT should be only 4.5%), as should the earnings stripping rules. See *supra* note 143.

the questions of when, to what extent, and how to tax the profits attributable to the activities relating to the taxing jurisdiction. Different tax systems take different approaches to these questions.

Many tax systems subject a foreign bank to net income taxation only when the bank has a permanent establishment, or branch, in the taxing jurisdiction. Once this threshold is crossed, these tax systems generally treat the branch as a separate entity for purposes of determining tax liability. Under these tax systems, the taxable profit of a foreign bank's local branch generally is determined by taking into account the gross income and expenses properly shown on the books of the branch, including income and expenses (e.g., interest) arising from transactions with other branches of the bank (so long as those transactions are entered into on an arm's length basis). The OECD model tax treaty provisions dealing with permanent establishment and business profits reflect this approach.¹⁶³

The Code and Regulations take a different approach, both to the question of the threshold of taxation and the determination of taxable income. The threshold—"engaged in a trade or business within the United States"—clearly is lower than having a permanent establishment and does not require the existence of a formal branch or permanent establishment. The basis of taxation—income effectively connected with the conduct of a U.S. trade or business—logically follows from this threshold. As discussed in Part II above, ECI is determined under certain straightforward rules, based on the source and category of income. Similarly, as discussed in Part III above, expenses are taken into account to the extent they are connected with ECI. Simply stated, the U.S. tax rules relating to foreign banks are ECI-based, not branch-balance sheet based.

Significantly, although the permanent establishment and business profits provisions of U.S. income tax treaties raise the threshold of taxation of foreign businesses from "engaged in a U.S. trade or business" to having a permanent establishment, the IRS does not interpret these provisions as supplanting the ECI-based system with a branch-balance sheet/separate entity-based system. Tax treaties typically state that a U.S. permanent establishment should be attributed the business profits that it might be expected to make if it were a distinct and separate person. According to the IRS, this treaty rule merely imposes a requirement that arm's length standards be utilized to determine the profits attributable to a U.S. permanent establishment; it does not replace the basic ECI rules of the Code with a tax accounting system that treats a branch as a separate entity.¹⁶⁴

163. See OECD Report, *supra* note 115.

164. See *supra* note 109 and accompanying text.

The BPT and BLIT provisions are engrafted onto this ECI-based system. A “branch” under the Code is a construct, the balance sheet of which consists of the assets that give rise to ECI and the liabilities (and net equity capital) attributable to those assets. It therefore may be useful to consider a “branch” under the Code in dynamic, functional terms, as an ECI-based “branch without walls,” in contrast to the more static, actual-balance-sheet-based concept of a branch under a separate entity approach. It is also important to recognize that the concept of a “branch” has only limited relevance under the Code—principally in the context of the BPT, BLIT and Interest Allocation Regulations, but not for purposes of determining ECI.

As described above in Parts III and IV, the Code and Regulations reflect a sophisticated and intricate interplay between the balance sheet-based BPT and BLIT, on the one hand, and the taxable income-related provisions for determining ECI and deductible interest expense, on the other hand. The Interest Allocation Regulations are particularly interesting in this regard because, as a result of the fungibility and separate entity concepts that underlie those rules, they take into account balance sheet items—assets and liabilities—to arrive at the amount of interest expense that is deductible from ECI in determining ECTI. Notably, however, the Interest Allocation Regulations use the interest expense shown on the books of the branch as a reference point in arriving at deductible interest expense.

Despite efforts to correlate the BPT, BLIT, and Interest Allocation Regulations, these rules continue to be complex to administer in practice. Moreover, while (or, perhaps, because) the Interest Allocation Regulations reflect a delicate balance among several principles and concerns, it is unclear whether they yield an economically accurate measurement of the interest expense attributable to ECI.

The rules relating to the determination of ECI from global trading activities of foreign banks are severely flawed, and are in need of immediate repair. Although the APA program provides a valuable interim solution for banks confronted with global trading issues, the integrity of the system will be called into question if a “private law” track is permitted to develop. As discussed in Part II.B above, the rules relating to the determination of ECI from global trading activities should be revised to adopt a section 482-type analysis, consistent with the approaches taken in APAs. Consistent with those approaches, and notwithstanding that the Code and Regulations do not treat branches as separate entities, it is appropriate to permit foreign banks to adopt section 482 transfer pricing methodologies that rely on interbranch transactions to determine the arm’s length profit that should be treated as ECTI, provided certain conditions are satisfied.