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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

TD 9281

RIN 1545-BF70

Determination of Interest Expense Deduction of Foreign Corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains revised Income Tax Regulations relating to the determination of the interest expense deduction of foreign corporations and applies to foreign corporations engaged in a trade or business within the United States. This action is necessary to conform the rules to subsequent U.S. Income Tax Treaty agreements and to adopt changes to facilitate improved administrability for taxpayers and the IRS.

DATES**:** Effective Date: These regulations are effective starting the tax year end for which the original tax return due date (including extensions) is after August 17, 2006.

Applicability Date: These regulations are applicable starting the tax year end for which the original tax return due date (including extensions) is after August 17, 2006.

FOR FURTHER INFORMATION CONTACT: Gregory Spring or Paul Epstein, (202) 622-3870 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These temporary regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in these regulations has been reviewed and pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545-2030. Responses to this collection of information are mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

For further information concerning these collections of information, and where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble of the cross-referencing notice of proposed rulemaking published in this issue of the **Federal Register**.

Books and records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On December 30, 1980, the Treasury Department and the IRS published final regulations TD 7749 [46 FR 16100 (1981-1 CB 390) (see §601.601(d)(2) of this chapter)] under section 882(c) of the Internal Revenue Code (Code) regarding the determination of a foreign corporation's interest expense allocable to income effectively connected with the conduct of a trade or business within the United States. On March 8, 1996, the Treasury Department and the IRS published final regulations TD 8658 [61 FR 15891 (1996-1 CB 161) (see §601.601(d)(2) of this chapter)], and new proposed amendments INTL-0054-95 [61 FR 28118 (1996-1 CB 844) (see §601.601(d)(2) of this chapter)]. The 1996 amendments implemented certain statutory changes enacted in the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2085), and took account of developments in international financial markets. Comments were received on both the final and proposed 1996 regulations. Since then, two new U.S. income tax treaties have entered into force that follow a different approach for determining the limit on profits attributable to a permanent establishment in a contracting state and for determining interest expense allowed in computing such profits. On July 14, 2005, the Treasury Department and the IRS published Notice 2005-53 (2005-32 IRB 32, see §601.601(d)(2)), which described those new treaties and announced the intention to update the final §1.882-5 regulations to take account of changes in the international banking sector and to promote both ease of administration and certainty of application.

These temporary regulations in this document implement Notice 2005-53, make effective one part of the 1996 proposed regulations, make miscellaneous clarifications to the 1996 final regulations, and modify the branch profits tax liability reduction regulations under §1.884-1(e)(3).

Explanation of Provisions

The following discussion is divided into several parts. Section 1 of the following discussion summarizes Notice 2005-53. Section 2 addresses the coordination of §1.882-5 with U.S. tax treaties and discusses other modifications made by these temporary regulations to the three-step calculation of interest expense under §1.882-5. Section 3 addresses changes made to the branch profits tax regulations under section 884. Section 4 then addresses miscellaneous technical modifications made by these temporary regulations that clarify application of the existing final regulations. Section 5 describes the effective date of these regulations.

1. <u>Notice 2005-53</u>

Notice 2005-53 provided guidance regarding the interaction of §1.882-5 and U.S. income tax treaties and explained that since the recent treaties with the United Kingdom and Japan entered into force, §1.882-5 no longer provides the exclusive rules for determining the interest expense attributable to the business profits of a U.S. permanent establishment. The Notice also provided guidance and requested comments regarding certain potential modifications to certain elements of the three-step calculation of interest expense under §1.882-5. More specifically, the Notice requested information regarding a possible increase to the existing 93-percent fixed ratio in Step 2 of the calculation and announced the intention to allow the use of a safe-harbor interest rate for determining excess interest under the "adjusted U.S.-booked liabilities" method in Step 3. The Notice also requested comments regarding the effect of intangibles on the Step-1 determination of U.S. assets under the elective fair market value method and the Step-2 determination of U.S. liabilities using the fixed or actual ratio.

2. Modifications to Three-Step Calculation Under §1.882-5

a. Introduction/background

Section 1.882-5 generally requires a foreign corporation to use a three-step calculation to determine the amount of interest expense that is allocable under section 882(c) to income effectively connected (or treated as effectively connected) with the foreign corporation's conduct of a trade or business within the United States.

Step 1 determines the total value of a foreign corporation's U.S. assets, which generally are the assets that produce (or would produce) income effectively connected with the foreign corporation's conduct of its U.S. trade or business. The value of the U.S. assets for this purpose is their adjusted basis, or, if the taxpayer makes an election, their fair market value.

Step 2 determines the “U.S.-connected liabilities” of a foreign corporation as the product of the foreign corporation’s U.S. assets multiplied either by the actual ratio of the foreign corporation’s worldwide liabilities to worldwide assets, or by a fixed ratio. In the case of a bank, the fixed ratio is 93 percent. If a taxpayer elects to value its assets at fair market value for purposes of Step 1, then the taxpayer must value worldwide assets at fair market value for purposes of Step 2, as well.

Step 3 determines the allocable amount of interest expense under either the adjusted U.S.-booked liabilities (AUSBL) method or the separate currency pools method. Under the AUSBL method, a foreign bank’s interest expense allocable to effectively connected income is determined by comparing “U.S.-booked liabilities” with U.S.-connected liabilities and making appropriate adjustments as necessary. For this purpose, U.S.-booked liabilities generally include liabilities that are both entered on books relating to an activity that produces effectively connected income before the close of the day on which the liability is incurred and are directly connected to that activity. In consequence, U.S.-booked liabilities are not limited to liabilities reflected on books within the United States. If a taxpayer’s U.S.-booked liabilities exceed its U.S.-connected liabilities, then its U.S-booked interest expense is proportionately disallowed under a “scale down” ratio. If a taxpayer’s U.S.-connected liabilities exceed its U.S.-booked liabilities, then interest expense in addition to the U.S.-booked interest expense is allocated in an amount equal to the product of the excess U.S.-connected liabilities multiplied by the borrowing rate on U.S.-dollar liabilities that are not U.S.-booked liabilities.

Under the separate currency pools method, a foreign corporation’s interest expense allocable to income effectively connected with the conduct of a trade or business within the United States is the sum of the separate interest deductions for each of the currencies in which the foreign corporation has U.S. assets. The separate interest deductions generally are determined using a three-step calculation that multiplies the worldwide borrowing rate by the U.S.-connected liabilities relevant to U.S. assets denominated in each foreign currency.

Elections under §1.882-5T, as under the 1996 final regulations, generally are binding for a minimum of five years unless specifically provided otherwise. For example, consistent with the binding nature of a domestic corporation's fair market value election under section 861, a fair market value election under §1.882-5T may be changed only with consent of the Commissioner.

b. Treaty coordination – modification of §1.882-5 exclusivity rule

The preamble to the 1996 final regulations states that §1.882-5 was fully consistent with all of the United States' then-existing treaty obligations, including Business Profits articles, and the 1996 final regulations state that §1.882-5 provides the exclusive rules for determining the interest expense attributable to the business profits of a U.S. permanent establishment under a U.S. income tax treaty. However, the Treasury Department Technical Explanation to Article 7 of the United States–United Kingdom income tax treaty which entered into force on March 31, 2003, and the Treasury Department Technical Explanation to Article 7 of the United States-Japan income tax treaty which entered into force on March 30, 2004, note that §1.882-5 may produce an inappropriate result in some cases. As a result, the implementing documentation of these treaties provides that the 1995 Organization for Economic Co-Operation and Development (OECD) Transfer Pricing Guidelines will apply by analogy for the purpose of determining the business profits attributable to a permanent establishment. Thus, as noted in Notice 2005-53, the exclusivity provision in the 1996 final regulations is no longer accurate.

These temporary regulations modify the exclusivity provision by recognizing that express provision may be made by or pursuant to an income tax treaty or accompanying documents (such as exchange of notes) that alternative principles will apply by analogy to determine the business profits attributable to a permanent establishment. Such treaty provisions may be used to determine the limit on the business profits attributable to a U.S. permanent establishment, but taxpayers remain eligible to use §1.882-5, as explained in the Treasury Department Technical Explanations to Article 7(3) of the United States-United Kingdom and United States-Japan income tax treaties. The Treasury Department and the IRS believe that these treaties and agreements provide that a taxpayer must apply either the domestic law or the alternative rules expressly provided in the treaty in their entirety, in accordance with the consistency principle articulated in Rev. Rul. 84-17 [(1984-1 CB 308) (see §601.601(d)(2) of this chapter)] and described in the Treasury Department Technical Explanation to Article 1(2) of the United States-United Kingdom and United States-Japan income tax treaties. The Treasury Department and the IRS are continuing to consider the specific application of this consistency principle including the application of §1.882-5, the interaction of §1.882-5 with other U.S. income tax treaties (particularly those being renegotiated in whole or in part), and the application of the branch profits tax under alternative rules for determining interest expense attributable to business profits.

c. <u>Modifications to step one</u>

Consistency Requirement for Fair Market Value Election

Under the 1996 final regulations, a taxpayer that uses the fair market value method for Step 1 must also use the fair market value method for Step 2. Notice 2005-53 clarified that this consistency rule applies only when the taxpayer has elected to use the actual ratio in Step 2, because assets are not valued when the fixed ratio is used. Accordingly, under the final regulations, electing the fair market value method under Step 1 does not obligate a taxpayer to elect the actual ratio under Step 2.

Notice 2005-53 also stated that the prevalence and significance of intangibles in the banking industry warrants reevaluating the right to elect both the fair market value method in Step 1 and the fixed ratio in Step 2. The Treasury Department and the IRS are concerned that applying the fixed ratio to intangibles when a Step 1 fair market value election is in place would have the effect of treating existing intangibles as highly leveraged assets when in fact such items often are more properly reflected in the taxpayer's equity accounts under U.S. tax principles. Comments were requested.

The single comment received in response to this request stated that distortions could result either by failing to take the value of intangibles into account when revising the fixed ratio for banks or by applying the fixed ratio to directly purchased intangibles that are valued at tax basis.

As further discussed in this section in connection with modifications to Step 2, these temporary regulations adopt a fixed ratio that is believed to represent an approximation of current average banking-industry balance-sheet ratios estimated under U.S. tax principles. Following due consideration of the comment, these temporary regulations require that the fair market value method may be elected in Step 1 only if a taxpayer is eligible to elect and in fact uses the actual ratio in Step 2. The consistency rule continues to require that the fair market value method, once elected, must be used in both Step 1 and Step 2. This consistency rule applies to all foreign corporations that are subject to §1.882-5.

Conforming-Election Requirement

A taxpayer that has both a valid fair market value method election for Step 1 and a valid fixed ratio method election for Step 2 in effect on the date these temporary regulations are effective must conform those elections to the new rules. Accordingly, such a taxpayer either may maintain the fixed ratio method for Step 2 and elect the adjusted basis method for Step 1, or may maintain the fair market value method for Step 1 and elect the actual ratio method for Step 2. Such conforming elections must be made for the first year these temporary regulations are effective, on either an original timely filed return (including extensions) or an amended return within 180 days after the extended due date. If a conforming election is not made by the extended due date for filing the amended return, the Director of Field Operations may make a binding conforming election on the taxpayer's behalf. Conforming elections are subject to the minimum five-year period applicable to the adjusted basis method, fixed ratio and actual ratio method elections. Elections with respect to Step 1 and Step 2, whether made by the taxpayer (either under the terms of the regulations or pursuant to the Commissioner's grant of consent within what would otherwise be a five-year minimum period) or imposed by the Commissioner, are separate. Thus, for example, the Commissioner may consent to a taxpayer's request to move from the fair market value method to the adjusted basis method for Step 1 without granting consent to move from the actual ratio method to the fixed ratio method for Step 2.

Average Value of Securities Subject to Section 475 or Section 1256

The 1996 proposed regulations provide that financial instruments that are subject to mark-to-market valuation under section 475 or section 1256 must be valued for purposes of §1.882-5 on each "determination date" (as defined) within the taxable year. Taxpayers generally assess funding needs throughout the year, and this rule is intended to reflect such assessments more accurately than a single year-end valuation would do.

These temporary regulations adopt this rule from the 1996 proposed regulations. The rule applies solely to determine the average values of relevant assets for purposes of computing the average valuation of U.S. assets in Step 1 of the formula. The rule does not determine the actual tax basis of an asset for any other purpose. "Determination dates" for purposes of the rule are defined as the most frequent regular intervals for which data are reasonably available. These temporary regulations provide that a taxpayer that has elected the actual ratio in Step 2 must also take interim mark-to-market values into account using the most frequently available data but in no event less frequently than actual-ratio taxpayers are required to do.

d. <u>Modifications to step two</u>

New Fixed Ratio

The 1996 final regulations revised the fixed ratio for banks downward to 93 percent. Since then, foreign bank taxpayers have commented that 93 percent is not representative of regulated banking industry capital structures. Foreign bank taxpayers also have commented that use of the actual ratio in Step 2 presents the potential for significant tax risk and uncertainty of results, particularly when adjusting their books to conform to U.S. tax principles. It appears that many foreign banks have adopted the 93-percent fixed ratio despite indications that many operate on a smaller equity capital structure.

Notice 2005-53 indicated that the Treasury Department and the IRS were considering increasing the fixed ratio. In order to improve administration by aligning the fixed ratio more closely with an approximation of current average banking industry balance sheet ratios estimated under U.S. tax principles, these temporary regulations revise the fixed ratio for foreign banks upward to 95 percent. The new fixed ratio may be adopted by foreign banks for the first year in which the original tax return due date (including extensions) is after August 17, 2006, or for any subsequent year. The ratio may be adopted, for example, for the 2005 calendar year even if the original return was filed before these regulations were published. Taxpayers that want to try to support any further revision to the fixed ratio would have to submit detailed, specific, compelling evidence to that effect.

Branch Profits Tax Consequences of Fixed-Ratio Election

Use of the new 95-percent fixed ratio in Step 2 conceivably could give rise to branch profits tax consequences. For example, a taxpayer that elects the new fixed ratio and that had been using either the 93-percent fixed ratio or an actual ratio that is less than 95 percent could be viewed under the branch profits tax rules as having experienced a decrease in net equity, thus giving rise to a dividend equivalent amount. One comment received in response to Notice 2005-53 requested that regulations implementing the notice provide special immunity from branch profits tax consequences except to the extent that a taxpayer benefited from the 1996 reduction of the fixed ratio from 95 percent to 93 percent.

Such consequences under the branch profits tax rules should arise only to the extent a taxpayer uses a 95-percent ratio that is substantially higher than the ratio used in the prior year, and the taxpayer's asset base has not increased sufficiently in the ordinary course of business to cause current and accumulated effectively connected earnings and profits to be treated as reinvested. The 1996 final regulations identify the actual ratio as the preferred method, and taxpayers have always been entitled to elect their actual ratio. Accordingly, the Treasury Department and the IRS believe that granting the commenter's request is unnecessary and in some cases could produce an inappropriate windfall. In addition, considerable administrative difficulties would complicate efforts to identify and recapture prior tax benefits that may have resulted from the increase in net equity when the fixed ratio was reduced in the 1996 final regulations and to track the deferred component of the computation through the intervening years up to and including the effective date of the new fixed ratio. Further, a special rule of the type requested is inconsistent with the expectation of reduced effectively connected income through increased interest expense allocations that result from the higher ratio. Finally, any branch profits tax consequences of a new fixed-ratio election may be mitigated by applicable tax treaties and by the expanded availability of the liability-reduction election under section 884, as further discussed in Section 3. Accordingly, the comment is not adopted.

Elections

Taxpayers that currently have elected the fixed ratio for Step 2 may use the revised 95-percent ratio for the first tax year for which the original tax return due date (including extensions) is after August 17, 2006. Remaining on the fixed ratio does not constitute the election of a new five-year minimum period. For example, a taxpayer that used the 93-percent fixed ratio for three years preceding the publication of these regulations and used the 95-percent fixed ratio for three more years would be entitled to elect the actual ratio method in the following year.

Foreign bank taxpayers that currently use the actual ratio for Step 2 may make a binding five-year election to use the new 95-percent fixed ratio for the first year this amendment is effective, on either an original return or on an amended return filed within 180 days of the extended due date. An amended return election may not be made for any year where the extended due date for a timely filing is after December 31, 2006. If a fixed-ratio election is not made for the first year these regulations are effective, a taxpayer using the actual ratio may make the fixed-ratio election in any subsequent year, but only on a timely filed return.

Eligibility

Under the 1996 final regulations, the 93-percent fixed ratio is available to foreign banks, which are defined for this purpose as banks within the meaning of section 585(a)(2)(B), without regard to the second sentence thereof. This definition excludes foreign banking corporations that are not engaged in a banking business within the United States. This has the effect of excluding a foreign corporation that is engaged in the banking business outside the United States but terminates its U.S. banking licenses and continues to engage in a nonregulated trade or business within the United States.

The Treasury Department and the IRS intend that a taxpayer that meets the requirements of section 581 when considered on a worldwide basis should be eligible to elect the fixed ratio applicable to banks under §1.882-5 without regard to whether it remains engaged in a banking business within the United States. Therefore, a taxpayer that is regulated as a bank in its home country, takes deposits, and makes loans as a substantial part of its business outside the United States will be eligible to elect the 95-percent fixed ratio.

e. <u>Modifications to step three</u>

Excess Interest

A foreign bank that uses the AUSBL method to determine its allocable interest expense may be required to allocate interest expense in addition to its U.S.-booked interest expense if U.S.-connected liabilities exceed U.S.-booked liabilities. The 1996 final regulations provide that the interest rate required to be applied to excess U.S.-connected liabilities is generally the foreign bank's average U.S.-dollar borrowing rate outside the United States. This rule was a change from the 1981 regulations, which had allowed taxpayers to use published rates under certain conditions. Taxpayers have commented informally that using actual non-U.S. dollar borrowing costs in all circumstances imposes significant administrative burdens.

The Treasury Department and the IRS agree that the use of published data rather than the actual borrowing rate requirement would simplify administration of the excess-interest computation both for taxpayers and for the IRS. Notice 2005-53 announced the intention to permit the use of the published 30-day average London Interbank Offering Rate (LIBOR) for tax years beginning after the date the Notice was published.

In response to Notice 2005-53, two comments were received. One comment stated that the proposal to use published 30-day LIBOR rates would make sense if it has been difficult for banks to calculate their actual rate of interest and that consideration might be given to making such a rule available for prior years. The other comment stated that a small sample of available information suggested that the 90-day LIBOR rate rather than the 30-day rate may be more representative of the sampled banks and suggested that the IRS review tax returns with excess interest.

IRS experience in actual cases involving excess interest supports the adoption of a 30-day LIBOR rate rather than a 90-day LIBOR rate. In view of IRS experience and the absence of contrary data, these temporary regulations allow an annual binding election to use a published 30-day average LIBOR rate beginning with the first tax year in which an original tax return is due (including extensions) after August 17, 2006. Taxpayers may continue to use their actual U.S.-dollar borrowing rate in lieu of the 30-day LIBOR rate.

Relevant excess U.S.-connected liabilities

These temporary and proposed regulations provide that the determination of the actual U.S.-dollar borrowing rate applicable to excess U.S.-connected liabilities is made with regard only to U.S.-dollar liabilities that are booked outside the United States and that do not constitute U.S.-booked liabilities as defined. The rate applicable to excess U.S.-connected liabilities is intended to reflect the rate applicable to relevant borrowings and book interest expense that has not otherwise been allocated. Because interest with respect to U.S.-booked liabilities is allocable under Step 3 of the AUSBL method, including such interest expense in the determination of the rate applicable to excess U.S.-connected liabilities could distort the calculation.

Elections

The 30-day LIBOR election may be adopted on a year-to-year basis. For the first tax year in which the original tax-return due date (including extensions) is after August 17, 2006 and not later than December 31, 2006, taxpayers may make the 30-day LIBOR election on an original return, or on an amended return within 180 days of the original extended due date. For subsequent years, the election must be made on an original tax return timely filed (including extensions). The election is made by attaching a statement to the return identifying the three-steps of the AUSBL calculation and the published rate used. An election to use a 30-day LIBOR rate is binding for such taxable year and may not be changed on an amended return for any year. Accordingly, a taxpayer is bound by the published rate used on its original return. If a taxpayer does not timely file an income tax return, then the opportunity to make a timely 30-day LIBOR election will be forfeited for the tax year. Consistent with the general rules for untimely elections, in such circumstances, the Director of Field Operations may require a taxpayer to use the actual U.S.-dollar borrowing rate or apply a published 30-day LIBOR rate for the year.

3. Liability Reduction Election Under Branch Profits Tax

In general, the branch profits tax is imposed under section 884(a) in addition to the corporate income tax under section 882 and applies only to amounts that are treated as repatriated from the branch. These amounts are determined by reference to a foreign corporation's effectively connected earnings and profits for a year and accumulated effectively connected earnings and profits, adjusted upward to reflect decreases in U.S. net equity and adjusted downward to reflect increases in U.S. net equity. Adjustments to net equity generally are made by comparing U.S. net equity at the end of a taxable year to U.S. net equity at the beginning of a taxable year.

The branch profits tax rules impute equity capital to a branch according to a formula that treats a portion of reinvested amounts as having been funded by indebtedness. This generally reduces U.S. net equity and so gives rise to a dividend equivalent amount. Regulations provide that a taxpayer may elect to treat reinvested earnings as equity capital (rather than as debt-funded capital) by reducing U.S. liabilities as of the determination date. The amount of liabilities eligible for reduction under this election is limited to the excess of U.S. liabilities (which is generally based on U.S.-connected liabilities, as defined under §1.882-5) over U.S.-booked liabilities (as defined under §1.882-5) as of the determination date. An election to reduce liabilities under §1.884-1 also reduces the interest deduction available under §1.882-5.

Taxpayers have expressed uncertainty regarding the policy served by setting U.S.-booked liabilities as a floor for liability reduction and have requested greater latitude to treat earnings as reinvested. For example, taxpayers have noted that the amount of U.S.-booked liabilities is not relevant to the §1.882-5 allocation under the separate currency pools method. They have noted also that the amount of U.S.-booked liabilities taken into account under the AUSBL method is an average balance for the year that may differ significantly from a year-end balance.

The Treasury Department and the IRS believe that it is desirable to more nearly align the branch profits tax treatment of distributed earnings with the tax treatment of a subsidiary's distributed earnings while retaining integration with the interest allocation rules provided in §1.882-5. In view of taxpayer comments, these temporary regulations permit a taxpayer to reduce U.S. liabilities to the extent necessary to prevent recognition of a dividend equivalent amount. However, this election may not reduce U.S. liabilities below zero. The other liability-reduction rules of §1.884-1(e)(3) continue to apply in their entirety. An example in the final regulations is amended in the temporary regulations to reflect the new limitation rule. The new liability reduction election is effective for the first year for which the original tax return due date (including extensions) is after August 17, 2006. For tax years for which the first original tax return due date (including extensions) is not later than December 31, 2006, a liability reduction election may be made on an amended return within 180 days after the original extended due date for filing the original return.

4. Clarifications of 1996 Final Regulations

Questions have arisen regarding the application of certain rules contained in the 1996 final regulations. These temporary regulations clarify the application of the 1996 final regulations with respect to certain direct interest allocations, certain requirements applicable to elections generally under §1.882-5, the definition of U.S.-booked liability, and the treatment of certain currency gain and loss for purposes of §1.882-5.

a. Direct interest allocations

The direct interest allocation rules under §1.882-5 provide generally that a foreign taxpayer with both a U.S. asset and indebtedness that meet the requirements of both §1.861-10T(b) and (c) may treat the asset and the indebtedness as an integrated financial transaction and so may allocate interest expense with respect to the indebtedness directly to income from the asset. In general, §1.861-10T(b) provides rules for certain nonrecourse indebtedness, and §1.861-10T(c) provides rules for certain integrated financial transactions. Financial institutions may allocate interest directly only to the extent provided by the nonrecourse indebtedness rules. These temporary regulations clarify that a financial institution is not disqualified from direct allocation treatment by satisfying only the rules provided in §1.861-10T(b) with respect to particular nonrecourse indebtedness transactions. These temporary regulations also clarify that direct allocation is mandatory for eligible taxpayers if the requirements of either §1.861-10T (b) or (c) are satisfied.

b. General election requirements

The 1996 final regulations specify the time, place, and manner for making elections under each step of the formula. These temporary regulations clarify that a taxpayer eligible to change an election as of right after the minimum five-year period may do so only on an original timely filed return. These temporary regulations also clarify that the election procedures prohibit relief under §301.9100 for future elections as well as the elections in the first year a taxpayer is subject to the rules. These temporary regulations also clarify that after the minimum five-year period, a taxpayer may change an election on a timely filed return for any subsequent year. For example, leaving an election in place in the sixth year after the election was made does not constitute a new election subject to a new 5-year minimum period. The general election provision is updated to provide expressly that the elections to use the fair market value method election and the 30-day LIBOR rate election are subject to their own specific period requirements instead of the five-year minimum period.

c. U.S.-booked liabilities

The definition of U.S.-booked liability has changed over time. The 1981 final regulations defined U.S.-booked liabilities to include only liabilities shown on the books and records of the U.S. trade or business. This definition excluded assets that produced effectively connected income but were booked and maintained in a foreign branch. The 1996 final regulations modified the definition to include generally, for non banks, liabilities that are recorded reasonably contemporaneously with their acquisition on a set of books that has a direct relationship to an activity that gives rise to effectively connected income. For banks, liabilities generally must be recorded contemporaneously with their acquisition. These rules do not require tracing of specific borrowings to specific effectively connected uses. Whether there is a direct connection between the liability and an activity that produces effectively connected income is determined under all the facts and circumstances.

These temporary regulations amend the definition of U.S.-booked liability and provide an example to clarify that in the case of a bank, the liability must be recorded on a set of books before the end of the day on which it is incurred, and the liability relates to an activity that produces effectively connected income. The reasonably contemporaneous booking rule is retained for non banks and the language clarified to reassert that the liability must relate to an activity that produces effectively connected income.

d. Currency gain and loss

A foreign bank's U.S. branch commonly books third-party liabilities denominated in non-dollar currencies and uses the proceeds to make interbranch loans. Because interbranch transactions generally are not recognized for U.S. tax purposes, the third-party liability is treated as unhedged. As noted in the preamble to the 1996 final regulations, foreign currency gain or loss from an unhedged liability remains subject to the rules of section 988. As a result, the U.S. branch may have currency gain or loss with respect to the third-party borrowing but may not be entitled to recognize currency gain or loss with respect to the offsetting interbranch transaction. In addition, any scaling down of interest expense that might otherwise be required under the AUSBL method does not apply to foreign currency gain or loss.

Some taxpayers have suggested informally that, despite the absence of a general tracing principle in the interest allocation rules, currency gain and loss from such third-party liabilities should be traceable to currency gains and losses with respect to specific interbranch and noneffectively connected assets. The Treasury Department and the IRS solicit comments regarding the allocation, sourcing, and apportionment of currency gain or loss from unhedged third-party borrowings between effectively connected and non-effectively connected income. Comments are specifically requested regarding the viability of a tracing principle for this purpose and the extent to which current booking practices may provide an administrable basis for such rules in accordance with existing authority.

5. Effective Date

The temporary regulations are applicable for the first tax year end for which the original tax return due date (including extensions) is after August 17, 2006. Accordingly, for calendar-year taxpayers, the applicability date is for the tax year ended December 31, 2005. The rules provide an additional 180 days to make certain one-time special elections on an amended return for tax years for which the original tax return due date is not later than December 31, 2006.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6) please refer to the cross reference notice of proposed rulemaking published elsewhere in this issue of the **Federal Register**. Pursuant to section 7805(f) of the Code, this regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Paul S. Epstein and Gregory A. Spring of the Office of Associate Chief Counsel (International).

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements

Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority**:** 26 U.S.C. 7805 * * *

Section 1.882-5 also issued under 26 U.S.C. 882, 26 U.S.C. 864(e), 26 U.S.C. 988(d), and 26 U.S.C. 7701(l). * * *

Section 1.884-1 is also issued under 26 U.S.C. 884. * * *

Par. 2. Section 1.882-0 is amended by:

1. Revising the entries for §1.882-5(a)(1), (a)(1)(i), (a)(1)(ii), (a)(1)(ii)(A), (a)(1)(ii)(B), (a)(2), (a)(7), (a)(7)(i), (a)(7)(ii), (b)(2)(ii)(A), (b)(3), (c)(2)(iv), (c)(4), (d)(2)(iii)(A), and (d)(5)(ii).

2. Removing the entry for §1.882-5(b)(2)(iv).

3. Adding entries for §1.882-5T. The revisions and additions read as follows:

§1.882-0 Table of contents.

* * * * *

§1.882-5 Determination of interest deduction.

* * * * *

(a)(1) through (a)(2) [Reserved].

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(a)(7) through (a)(7)(iii) [Reserved].

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(b)(2)(ii)(A) [Reserved].

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(b)(3) [Reserved].

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(c)(2)(iv) [Reserved].

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(c)(4) [Reserved].

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(d)(2)(iii)(A) [Reserved].

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(d)(5)(ii) [Reserved].

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§1.882-5T Determination of interest deduction (temporary).

(a) [Reserved].

(1) Overview.

(i) In general.

(ii) Direct allocations.

(A) In general.

(B) Partnership interests

(2) Coordination with tax treaties.

(3) through (6) [Reserved].

(7) Elections under §1.882-5.

(i) In general.

(ii) Failure to make the proper election.

(iii) Step 2 special election for banks.

(8) through (b)(2)(ii) [Reserved].

(A) In general.

(b)(2)(ii)(B) through (b)(2)(iii)(B) [Reserved].

(3) Computation of total value of U.S. assets.

(i) General rule.

(ii) Adjustment to basis of financial instruments.

(c) through (c)(2)(iii) [Reserved].

(iv) Determination of value of worldwide assets.

(c)(2)(v) through (c)(3) [Reserved].

(4) Elective fixed ratio method of determining U.S. liabilities.

(c)(5) through (d)(2)(iii) [Reserved].

(A) In general.

(B) through (d)(5)(i) [Reserved].

(ii) Interest rate on excess U.S.-connected liabilities.

(A) General rule.

(B) Annual published rate election.

(6) through (f)(2) [Reserved].

Par. 4. Section 1.882-5 is amended by:

1. Revising paragraphs (a)(1) through (a)(2), (a)(7) through (a)(7)(ii), (b)(2)(ii)(A), (b)(3), (c)(2)(iv), (c)(4), (d)(2)(ii)(A)(2), (d)(2)(ii)(A)(3), (d)(2)(iii)(A), and (d)(5)(ii).

2. Removing paragraph (b)(2)(iv).

3. Adding paragraph (d)(6) Example 5.

The revisions and additions read as follows:

§1.882-5 Determination of interest deduction.

(a)(1) through (a)(2) [Reserved]. For further guidance, see entry in §1.882-5T(a)(1) through (a)(2).

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(a)(7)(ii) [Reserved]. For further guidance, see §1.882-5T(a)(7) through (a)(7)(ii).

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(b)(2)(ii)(A) [Reserved]. For further guidance, see §1.882-5T(b)(2)(ii)(A).

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(b)(3) [Reserved]. For further guidance, see §1.882-5T(b)(3).

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(c)(2)(iv) [Reserved]. For further guidance, see §1.882-5T(c)(2)(iv).

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(c)(4) [Reserved]. For further guidance, see §1.882-5T(c)(4).

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(d)(2)(ii)(A)(2) through (3) [Reserved]. For further guidance, see §1.882-5T(d)(2)(ii)(A)(2) through (3).

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(d)(2)(iii)(A) [Reserved]. For further guidance, see §1.882-5T(d)(2)(iii)(A).

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(d)(5)(ii) [Reserved]. For further guidance, see §1.882-5T(d)(5)(ii).

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(d)(6) Example 5 [Reserved]. For further guidance, see §1.882-5T(d)(6) Example 5.

Par. 5. Section 1.882-5T is added to read as follows:

§1.882-5T Determination of interest deduction (temporary).

(a) [Reserved]. For further guidance, see §1.882-5(a).

(1) Overview--(i) In general. The amount of interest expense of a foreign corporation that is allocable under section 882(c) to income which is (or is treated as) effectively connected with the conduct of a trade or business within the United States (ECI) is the sum of the interest allocable by the foreign corporation under the three-step process set forth in paragraphs (b), (c), and (d) of this section and the specially allocated interest expense determined under paragraph (a)(1)(ii) of this section. The provisions of this section provide the exclusive rules for allocating interest expense to the ECI of a foreign corporation under section 882(c). Under the three-step process, the total value of the U.S. assets of a foreign corporation is first determined under paragraph (b) of this section (Step 1). Next, the amount of U.S.-connected liabilities is determined under paragraph (c) of this section (Step 2). Finally, the amount of interest paid or accrued on U.S.-booked liabilities, as determined under paragraph (d)(2) of this section, is adjusted for interest expense attributable to the difference between U.S.-connected liabilities and U.S.-booked liabilities (Step 3). Alternatively, a foreign corporation may elect to determine its interest rate on U.S.-connected liabilities by reference to its U.S. assets, using the separate currency pools method described in paragraph (e) of this section.

(ii) Direct allocations--(A) In general. A foreign corporation that has a U.S. asset and indebtedness that meet the requirements of §1.861-10T (b) or (c), as limited by §1.861-10T(d)(1), shall directly allocate interest expense from such indebtedness to income from such asset in the manner and to the extent provided in §1.861-10T. For purposes of paragraph (b)(1) or (c)(2) of this section, a foreign corporation that allocates its interest expense under the direct allocation rule of this paragraph (a)(1)(ii)(A) shall reduce the basis of the asset that meets the requirements of §1.861-10T (b) or (c) by the principal amount of the indebtedness that meets the requirements of §1.861- 10T (b) or (c). The foreign corporation shall also disregard any indebtedness that meets the requirements of §1.861-10T (b) or (c) in determining the amount of the foreign corporation's liabilities under paragraphs (c)(2) and (d)(2) of this section and shall not take into account any interest expense paid or accrued with respect to such a liability for purposes of paragraph (d) or (e) of this section.

(B) Partnership interest. A foreign corporation that is a partner in a partnership that has a U.S. asset and indebtedness that meet the requirements of §1.861-10T (b) or (c), as limited by §1.861-10T(d)(1), shall directly allocate its distributive share of interest expense from that indebtedness to its distributive share of income from that asset in the manner and to the extent provided in §1.861-10T. A foreign corporation that allocates its distributive share of interest expense under the direct allocation rule of this paragraph (a)(1)(ii)(B) shall disregard any partnership indebtedness that meets the requirements of §1.861-10T (b) or (c) in determining the amount of its distributive share of partnership liabilities for purposes of paragraphs (b)(1), (c)(2)(vi), and (d)(2)(vii) or (e)(1)(ii) of this section, and shall not take into account any partnership interest expense paid or accrued with respect to such a liability for purposes of paragraph (d) or (e) of this section. For purposes of paragraph (b)(1) of this section, a foreign corporation that directly allocates its distributive share of interest expense under this paragraph (a)(1)(ii)(B) shall--

(1) Reduce the partnership's basis in such asset by the amount of such indebtedness in allocating its basis in the partnership under §1.884-1(d)(3)(ii); or

(2) Reduce the partnership's income from such asset by the partnership's interest expense from such indebtedness under §1.884-1(d)(3)(iii).

(2) Coordination with tax treaties. Except as expressly provided by or pursuant to a U.S. income tax treaty or accompanying documents (such as an exchange of notes), the provisions of this section provide the exclusive rules for determining the interest expense attributable to the business profits of a permanent establishment under a U.S. income tax treaty.

(3) through (a)(6) [Reserved]. For further guidance, see §1.882-5(a)(3) through (a)(6).

(7) Elections under §1.882-5--(i) In general. A corporation must make each election provided in this section on the corporation's original timely filed Federal income tax return for the first taxable year it is subject to the rules of this section. An amended return does not qualify for this purpose, nor shall the provisions of §301.9100-1 of this chapter and any guidance promulgated thereunder apply. Except as provided elsewhere in this section, each election under this section, whether an election for the first taxable year or a subsequent change of election, shall be made by the corporation calculating its interest expense deduction in accordance with the methods elected. An elected method (other than the fair market value method under §1.882-5(b)(2)(ii), or the annual 30-day London Interbank Offered Rate (LIBOR) election in paragraph (d)(5)(ii) of this section) must be used for a minimum period of five years before the taxpayer may elect a different method. To change an election before the end of the requisite five-year period, a taxpayer must obtain the consent of the Commissioner or his delegate. The Commissioner or his delegate will generally consent to a taxpayer's request to change its election only in rare and unusual circumstances. After the five-year minimum period, an elected method may be changed for any subsequent year on the foreign corporation's original timely filed tax return for the first year to which the changed election applies.

(ii) Failure to make the proper election. If a taxpayer, for any reason, fails to make an election provided in this section in a timely fashion, the Director of Field Operations may make any or all of the elections provided in this section on behalf of the taxpayer, and such elections shall be binding as if made by the taxpayer.

(iii) Step 2 special election for banks. For the first tax year for which an original income tax return is due (including extensions) after August 17, 2006 and not later than December 31, 2006, in which a taxpayer that is a bank as described in §1.882-5(c)(4) is subject to the requirements of this section, a taxpayer may make a new election to use the fixed ratio on either an original timely filed return, or on an amended return filed within 180 days after the original due date (including extensions). A new fixed ratio election may be made in any subsequent year subject to the timely filing and five-year minimum period requirements of paragraph (a)(7)(i) of this section. A new fixed ratio election under this paragraph (a)(7)(iii) is subject to the adjusted basis or fair market value conforming election requirements of paragraph (b)(2)(ii)(A)(2) of this section and may not be made if a taxpayer elects or maintains a fair market value election for purposes of §1.882-5(b). Taxpayers that already use the fixed ratio method under an existing election may continue to use the new fixed ratio at the higher percentage without having to make a new five-year election in the first year that the higher percentage is effective.

(8) through (b)(2)(ii) [Reserved]. For further guidance, see §1.882-5(a)(8) through (b)(2)(ii) .

(A) In general--(1) Fair market value conformity requirement. A taxpayer may elect to value all of its U.S. assets on the basis of fair market value, subject to the requirements of §1.861-9T(g)(1)(iii), and provided the taxpayer is eligible and uses the actual ratio method under §1.882-5(c)(2) and the methodology prescribed in §1.861-9T(h). Once elected, the fair market value must be used by the taxpayer for both Step 1 and Step 2 described in §§1.882-5(b) and (c), and must be used in all subsequent taxable years unless the Commissioner or his delegate consents to a change.

(2) Conforming election requirement. Taxpayers that as of the effective date of this paragraph (b)(2)(ii)(A)(2) have elected and currently use both the fair market value method for purposes of §1.882-5(b) and a fixed ratio for purposes of paragraph (c)(4) of this section must conform either the adjusted basis or fair market value methods in Step 1 and Step 2 of the allocation formula by making an adjusted basis election for §1.882-5(b) purposes while continuing the fixed ratio for Step 2, or by making an actual ratio election under §1.882-5(c)(2) while remaining on the fair market value method under §1.882-5(b). Taxpayers who elect to conform Step 1 and Step 2 of the formula to the adjusted basis method must remain on both methods for the minimum five-year period in accordance with the provisions of paragraph (a)(7) of this section. Taxpayers that elect to conform Step 1 and Step 2 of the formula to the fair market value method must remain on the actual ratio method until the consent of the Commissioner or his delegate is obtained to switch to the adjusted basis method. If consent to use the adjusted basis method in Step 1 is granted in a later year, the taxpayer must remain on the actual ratio method for the minimum five-year period unless consent to use the fixed ratio is independently obtained under the requirements of paragraph (a)(7) of this section. For the first tax year for which an original income tax return is due (including extensions) after August 17, 2006 and not later than December 31, 2006, taxpayers that are required to make a conforming election under this paragraph (b)(2)(ii)(A)(2), may do so either on a timely filed original return or on an amended return within 180 days after the original due date (including extensions). If a conforming election is not made within the timeframe provided in this paragraph, the Director of Field Operations or his delegate may make the conforming elections in accordance with the provisions of paragraph (a)(7)(ii) of this section.

(B) through (b)(2)(iii)(B) [Reserved]. For further guidance, see §1.882-5(b)(2)(ii)(B) through (b)(2)(iii)(B).

(3) Computation of total value of U.S. assets--(i) General rule. The total value of U.S. assets for the taxable year is the average of the sums of the values (determined under paragraph (b)(2) of this section) of U.S. assets. For each U.S. asset, value shall be computed at the most frequent regular intervals for which data are reasonably available. In no event shall the value of any U.S. asset be computed less frequently than monthly (beginning of taxable year and monthly thereafter) by a large bank (as defined in section 585(c)(2)) or a dealer in securities (within the meaning of section 475) and semi-annually (beginning, middle and end of taxable year) by any other taxpayer.

(ii) Adjustment to basis of financial instruments. For purposes of determining the total average value of U.S. assets in this paragraph (b)(3), the value of a security or contract that is marked to market pursuant to section 475 or section 1256 will be determined as if each determination date is the most frequent regular interval for which data are reasonably available that reflects the taxpayer's consistent business practices for reflecting mark-to-market valuations on its books and records.

(c) through (c)(2)(iii) [Reserved]. For further guidance, see §1.882-5(c) through (c)(2)(iii).

(iv) Determination of value of worldwide assets. The value of an asset must be determined consistently from year to year and must be substantially in accordance with U.S. tax principles. To be substantially in accordance with U.S. tax principles, the principles used to determine the value of an asset must not differ from U.S. tax principles to a degree that will materially affect the value of the taxpayer's worldwide assets or the taxpayer's actual ratio. The value of an asset is the adjusted basis of that asset for determining the gain or loss from the sale or other disposition of that asset, adjusted in the same manner as the basis of U.S. assets are adjusted under paragraphs (b)(2) (ii) through (iv) of this section. The rules of §1.882-5(b)(3)(ii) apply in determining the total value of applicable worldwide assets for the taxable year, except that the minimum number of determination dates are those stated in §1.882-5(c)(2)(i).

(c)(2)(v) through (c)(3) [Reserved]. For further guidance, see §1.882-5(c)(2)(v) through (c)(3).

(4) Elective fixed ratio method of determining U.S. liabilities. A taxpayer that is a bank as defined in section 585(a)(2)(B)(without regard to the second sentence thereof or whether any such activities are effectively connected with a trade or business within the United States) may elect to use a fixed ratio of 95 percent in lieu of the actual ratio. A taxpayer that is neither a bank nor an insurance company may elect to use a fixed ratio of 50 percent in lieu of the actual ratio.

(5) through (d)(2)(ii)(A)(1) [Reserved]. For further guidance, see §1.882-5(c)(5) through (d)(2)(ii)(A)(1).

(2) The foreign corporation enters the liability on a set of books reasonably contemporaneous with the time at which the liability is incurred and the liability relates to an activity that produces ECI.

(3) The foreign corporation maintains a set of books and records relating to an activity that produces ECI and the Director of Field Operations determines that there is a direct connection or relationship between the liability and that activity. Whether there is a direct connection between the liability and an activity that produces ECI depends on the facts and circumstances of each case.

(d)(2)(ii)(B) through (d)(2)(iii) [Reserved]. For further guidance, see §1.882-5(d)(2)(ii)(B) through (d)(2)(iii).

(A) In general. A liability, whether interest bearing or non-interest bearing, is properly reflected on the books of the U.S. trade or business of a foreign corporation that is a bank as described in section 585(a)(2)(B) (without regard to the second sentence thereof) if--

(1) The bank enters the liability on a set of books before the close of the day on which the liability is incurred, and the liability relates to an activity that produces ECI; and

(2) There is a direct connection or relationship between the liability and that activity. Whether there is a direct connection between the liability and an activity that produces ECI depends on the facts and circumstances of each case. For example, a liability that is used to fund an interbranch or other asset that produces non-ECI may have a direct connection to an ECI producing activity and may constitute a U.S.-booked liability if both the interbranch or non-ECI activity is the same type of activity in which ECI assets are also reflected on the set of books (for example, lending or money market interbank placements), and such ECI activities are not de minimis. Such U.S. booked liabilities may still be subject to §1.882-5(d)(2)(v).

(B) through (d)(5)(i) [Reserved]. For further guidance, see §1.882-5(d)(2)(iii)(B) through (d)(5)(i).

(ii) Interest rate on excess U.S.-connected liabilities--(A) General rule. The applicable interest rate on excess U.S.-connected liabilities is determined by dividing the total interest expense paid or accrued for the taxable year on U.S.-dollar liabilities that are not U.S.-booked liabilities (as defined in §1.882-5(d)(2)) and that are shown on the books of the offices or branches of the foreign corporation outside the United States by the average U.S.-dollar denominated liabilities (whether interest-bearing or not) that are not U.S.-booked liabilities and that are shown on the books of the offices or branches of the foreign corporation outside the United States for the taxable year.

(B) Annual published rate election. For each taxable year beginning with the first year end for which the original tax return due date (including extensions) is after August 17, 2006, in which a taxpayer is a bank within the meaning of section 585(a)(2)(B) (without regard to the second sentence thereof or whether any such activities are effectively connected with a trade or business within the United States), such taxpayer may elect to compute its excess interest by reference to a published average 30-day London Interbank Offering Rate (LIBOR) for the year. The election may be made for any eligible year by attaching a statement to a timely filed tax return (including extensions) that shows the 3-step components of the taxpayer's interest expense allocation under the adjusted U.S.-booked liabilities method and identifies the provider (for example, International Monetary Fund statistics) of the 30-day LIBOR rate selected. Once selected, the provider and the rate may not be changed by the taxpayer. If a taxpayer that is eligible to make the 30-day LIBOR election either does not file a timely return or files a calculation that allocates interest expense under the scaling ratio in §1.882-5(d)(4) and it is determined by the Director of Field Operations that the taxpayer's U.S.-connected liabilities exceed its U.S.-booked liabilities, then the Director of Field Operations, and not the taxpayer, may choose whether to determine the taxpayer's excess interest rate under paragraph (d)(5)(ii)(A) or (B) of this section and may select the published 30-day LIBOR rate. For the first taxable year for which an original tax return due date (including extensions) is after August 17, 2006 and not later than December 31, 2006, an eligible taxpayer may make the 30-day LIBOR election one time for the taxable year on an amended return within 180 days after the original due date (including extensions).

(d)(6) through (d)(6) Example 4 [Reserved]. For further guidance, see §1.882-5(d)(6) through (d)(6) Example 4.

Example 5. U.S. booked liabilities – direct relationship. (i) Facts. Bank A, a resident of Country X maintains a banking office in the U.S. that records transactions on three sets of books for State A, an International Banking Facility (IBF) for its bank regulatory approved international transactions, and a shell branch licensed operation in Country C. Bank A records substantial ECI assets from its bank lending and placement activities and a mix of interbranch and non-ECI producing assets from the same or similar activities on the books of State A branch and on its IBF. Bank A's Country C branch borrows substantially from third parties, as well as from its home office, and lends all of its funding to its State A branch and IBF to fund the mix of ECI, interbranch and non-ECI activities on those two books. The consolidated books of State A branch and IBF indicate that a substantial amount of the total book assets constitute U.S. assets under §1.882-5(b). Some of the third-party borrowings on the books of the State A branch are used to lend directly to Bank A’s home office in Country X. These borrowings reflect the average borrowing rate of the State A branch, IBF and Country C branches as a whole. All third-party borrowings reflected on the books of State A branch, the IBF and Country C branch were recorded on such books before the close of business on the day the liabilities were acquired by Bank A.

(ii) U.S. booked liabilities. The facts demonstrate that the separate State A branch, IBF and Country C branch books taken together, constitute a set of books within the meaning of (d)(2)(iii)(A)(1) of this section. Such set of books as a whole has a direct relationship to an ECI activity under (d)(2)(iii)(A)(2) of this section even though the Country C branch books standing alone would not. The third-party liabilities recorded on the books of Country C constitute U.S. booked liabilities because they were timely recorded and the overall set of books on which they were reflected has a direct relationship to a bank lending and interbank placement ECI producing activity. The third-party liabilities that were recorded on the books of State A branch that were used to lend funds to Bank A’s home office also constitute U.S. booked liabilities because the interbranch activity the funds were used for is a lending activity of a type that also gives rise to a substantial amount of ECI that is properly reflected on the same set of books as the interbranch loans. Accordingly, the liabilities are not traced to their specific interbranch use but to the overall activity of bank lending and interbank placements which gives rise to substantial ECI. The facts show that the liabilities were not acquired to increase artificially the interest expense of Bank A’s U.S. booked liabilities as a whole under §1.882-5(d)(2)(v). The third-party liabilities also constitute U.S. booked liabilities for purposes of determining Bank A’s branch interest under §1.884-4(b)(1)(i)(A) regardless of whether Bank A uses the Adjusted U.S. booked liability method, or the Separate Currency Pool method to allocate its interest expense under §1.882-5(e).

(e) through (f)(2) [Reserved]. For further guidance, see §1.882-5(e) through (f)(2).

(g) Effective date. (1) This section is applicable for the first tax year in which an original tax return due date (including extensions) is after August 17, 2006.

(2) The applicability of this section expires on or before August 14, 2009.

Par. 6. Section 1.884-1 is amended by revising the entries for paragraphs (e)(3)(ii), (e)(3)(iv) and (e)(5) Example 2.

§1.884-1 Branch profits tax.

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(e)(3)(ii) [Reserved]. For further guidance, see entry in §1.884-1T(e)(3)(ii).

* * * * *

(e)(3)(iv) [Reserved]. For further guidance, see entry in §1.884-1T(e)(3)(iv).

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(e)(5) Example 2 [Reserved]. For further guidance, see entry in §1.884-1T(e)(5) Example 2.

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Par. 7. Section 1.884-1T is added to read as follows:

§1.884-1T Branch profits tax (temporary).

(a) through (e)(3)(i) [Reserved]. For further guidance, see §1.884-1(a) through (e)(3)(i).

(ii) Limitation. For any taxable year, a foreign corporation may elect to reduce the amount of its liabilities determined under paragraph §1.884-1(e)(1) of this section by an amount that does not exceed the lesser of the amount of U.S. liabilities as of the determination date, or the amount of U.S. liability reduction needed to reduce a dividend equivalent amount as of the determination date to zero.

(iii) [Reserved]. For further guidance, see §1.884-1(e)(3)(iii).

(iv) Method of election. A foreign corporation that elects the benefits of this paragraph (e)(3) for a taxable year shall state on its return for the taxable year (or on a statement attached to the return) that it has elected to reduce its liabilities for the taxable year under this paragraph (e)(3) and that it has reduced the amount of its U.S.-connected liabilities as provided in §1.884-1(e)(3)(iii), and shall indicate the amount of such reductions on the return or attachment. An election under this paragraph (e)(3) must be made before the due date (including extensions) for the foreign corporation's income tax return for the taxable year, except that for the first tax year for which the original tax return due date (including extensions) is after August 17, 2006 and not later than December 31, 2006, an election under this paragraph (e)(3) may be made on an amended return within 180 days after the original due date (including extensions).

(v) through (e)(5) Example 1 [Reserved]. For further guidance, see §1.884-1(e)(3)(v) through (e)(5) Example 1.

Example 2. Election made to reduce liabilities. (i) As of the close of 2007, foreign corporation A, a real estate company, owns U.S. assets with an E&P basis of $1000. A has $800 of liabilities under paragraph (e)(1) of this section. A has accumulated ECEP of $500 and in 2008, A has $60 of ECEP that it intends to retain for future expansion of its U.S. trade or business. A elects under paragraph (e)(3) of this section to reduce its liabilities by $60 from $800 to $740. As a result of the election, assuming A's U.S. assets and U.S. liabilities would otherwise have remained constant, A's U.S. net equity as of the close of 1994 will increase by the amount of the decrease in liabilities ($60) from $200 to $260 and its ECEP will be reduced to zero. Under §1.884-1(e)(3)(iii), A's interest expense for the taxable year is reduced by the amount of interest attributable to $60 of liabilities and A's excess interest is reduced by the same amount. A's taxable income and ECEP are increased by the amount of the reduction in interest expense attributable to the liabilities, and A may make an election under paragraph (e)(3) of this section to further reduce its liabilities, thus increasing its U.S. net equity and reducing the amount of additional ECEP created for the election.

(ii) In 2009, assuming A again has $60 of ECEP, A may again make the election under paragraph (e)(3) to reduce its liabilities. However, assuming A's U.S. assets and liabilities under paragraph (e)(1) of this section remain constant, A will need to make an election to reduce its liabilities by $120 to reduce to zero its ECEP in 2009 and to continue to retain for expansion (without the payment of the branch profits tax) the $60 of ECEP earned in 2008. Without an election to reduce liabilities, A's dividend equivalent amount for 2009 would be $120 ($60 of

ECEP plus the $60 reduction in U.S. net equity from $260 to $200). If A makes the election to reduce liabilities by $120 (from $800 to $680), A's U.S. net equity will increase by $60 (from $260 at the end of the previous year to $320), the amount necessary to reduce its ECEP to $0. However, the reduction of liabilities will itself create additional ECEP subject to section 884 because of the reduction in interest expense attributable to the $120 of liabilities. A can make the election to reduce liabilities by $120 without exceeding the limitation on the election provided in paragraph (e)(3)(ii) of this section because the $120 reduction does not exceed the amount needed to treat the 2009 and 2008 ECEP as reinvested in the net equity of the trade or business within the United States.

(iii) If A terminates its U.S. trade or business in 2009 in accordance with the rules in §1.884-2T(a), A would not be subject to the branch profits tax on the $60 of ECEP earned in that year. Under paragraph §1.884-1(e)(3)(v) of this section, however, it would be subject to the branch profits tax on the portion of the $60 of ECEP that it earned in 2008 that became accumulated ECEP because of an election to reduce liabilities.

(f) through (j)(2)(ii) [Reserved]. For further guidance, see §1.884-1(f) through (j)(2)(ii).

PART 602--OMB CONTROL NUMBER UNDER THE PAPERWORK REDUCTION ACT

Par. 8. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 9. In §602.101, paragraph (b) is amended by adding an entry for "§1.882-5T" to the table to read follows:

§601.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.882-5T………………………………………………………………	1545-2030
* * * * *	

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement

Approved: August 2, 2006,

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury (Tax Policy)