Internal Revenue Service

memorandum

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date: August 21, 1997

to: Charles Prince, Acting Case Manager CP:IN:D:C:EX:HQ1112
CC: Gi Gi Fenster

from: Paul Epstein, Senior Technician Reviewer, Branch 5
Associate Chief Counsel (International)

subject: **Field Service Advice**
[redacted]
Calculation of Interest Expense Under § 1.882-5

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ISSUES

Whether and to what extent insurance liabilities should be included for purposes of step 2 of the § 1.882-5 regulations for determining U.S. interest expense of the taxpayer.

CONCLUSION

Absent the promulgation of regulations, there is no authority for segregating out insurance liabilities from other liabilities in applying § 1.882-5

DISCUSSION

For the [redacted] tax year, [redacted] a Canadian Corporation a U.S. branch engaged in a U.S trade or business through two lines of business -- sale of insurance products and sale of financial products. The issue presented in this case is how to determine the U.S. interest deduction for computing the taxpayer's effectively connected income. In your request, you assume the U.S. interest expense for tax purposes for the taxpayer's insurance business is equal to the interest expense reflected on the books of the company as used for reserve computation. Accordingly, you suggest that § 1.882-5 is only necessary for determining the interest expense related to the financial products business. The discrete issue presented in your memorandum is whether the interest expense from the insurance business when calculating the interest expense for the financial products business under § 1.882-5 where the U.S. connected assets are shared by both business segments.[1]

You suggest two alternative ways of addressing the issue, both of which seem reasonable and logical. Moreover, we agree, that of the two methods presented, that the second method suggested is probably more reflective of the U.S. business. However, under current statutory and regulatory authority, there is no support for segregating the businesses for purposes of determining U.S. interest expense. Accordingly, we believe neither of the two alternative methods presented in your memorandum are supportable allocation methods under the relevant authority applicable to the facts.

Under § 1.882-5 as in effect for the years in question, there are no special provisions for insurance companies.[2] T.D. 7749, 1981-1 C.B. 390. Accordingly, in the absence of a special rule, the regulations, which adopt a fungibility approach for determining the imputation of U.S. liabilities and clearly provide that the total amount of worldwide liabilities and assets, must be used for determining the actual ratio. § 1.882-

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[1] We understand that the taxpayer has not taken a treaty based return position with respect to this issue. If this is not the case, other issues may be presented. See Northwest Corp. v. Commissioner, 108 T.C. No. 15 (1997).

[2] Under the current regulations special rules for insurance companies are reserved.

5(b)(2)(ii) (1981). The result under the current regulations would be the same. See § 1.882-5(c)(2)(i).

Further support for this result can be found by looking to the branch profit tax regulations under section 884 which address the issue of imputing assets and liabilities of insurance companies for purposes of applying section 884. These regulations are relevant to determining interest expense since the legislative history to the 1986 Tax Act required consistency among the branch profits tax and the determination of expenses as follows:

> The conferees wish to clarify that, under regulations, the rules for determining assets and liabilities treated as connected with the conduct of a U.S. trade or business for branch tax purposes are to be consistent with rules used in all allocating deductions for purposes of computing taxable income.

Conf. Rept. No. 99-841, 99th Cong., 2d Sess. II-647 (1986).

Under the regulations to section 884 special rules for determining the assets and liabilities of insurance companies were considered. A provision was included in the regulations that made clear that U.S. liabilities include the "amount of its total insurance liabilities . . . as well as any other U.S. connected liabilities determined under § 1.882-5. T.D. 8432, 1992-2 C.B. 159-60. Therefore, in determining the amount of liablilities for purposes of applying the branch profit rules, insurance companies must include all of their liabilities.

With respect to the determination of U.S. assets for branch profit tax purposes, the regulations considered applying special rules that would have imputed an amount of U.S. assets to correspond to the additional net investment income under section 842(b). However, due to the complexity, the provision was not included in the final regulation. Rather the final regulations provide that "foreign insurance companies will be subject to the same U.S. asset rules as all other foreign corporations." Id.

Accordingly, since the branch profits tax regulation applies the principle of fungibility in the absence of any language to the contrary, the same principle must be applied for purposes of § 1.882-5. Thus, for purposes of computing the actual ratio under § 1.882-5 worldwide assets and liabilities must be used.

Although the issue and the suggestions raised for determining interest expense by separating the two business may reach a interest expense which is reflective of the economics of the business, in the absence of regulations there is no authority for the approach suggested in you memorandum. [redacted]

[redacted]

If you have any questions regarding this matter, please contact Howard A. Wiener at (202) 622-3870.