U.S. International Taxation – Interest Expense of Foreign Corporations

Treasury Department Issues Final Regulations on the Interest Expense of a U.S. Branch of a Foreign Bank or Other Foreign Corporation

SUMMARY
On September 24, 2009, the Treasury Department issued final regulations (the “Final Regulations”) with respect to the determination of the interest expense of a U.S. branch of a foreign bank or other foreign corporation. The Final Regulations adopt without substantive change temporary regulations that were issued on August 17, 2006 (the “Temporary Regulations”). For a description of the Temporary Regulations please see the August 29, 2006 S&C Publication, “IRS Issues New Rules for Determining Interest Expense of U.S. Branches of Foreign Banks,” a copy of which is attached to this memorandum. The Final Regulations did not accept a number of changes suggested by comments on the Temporary Regulations, but the preamble to the Final Regulations (the “Preamble”) states that some of the issues raised by comments will be considered in connection with the reissuance of regulations relating to global dealing operations. The Final Regulations are effective for taxable years ending on or after August 15, 2009.

ELECTIONS FOR CALCULATING DEDUCTIBLE INTEREST EXPENSE
Under Section 1.882-5 of the Treasury Regulations, the deductible interest expense of a foreign corporation that has a branch in the U.S. is determined under a three step process: in Step One, U.S. assets are determined, using either tax basis or fair market value; in Step Two, liabilities connected to those U.S. assets are determined by use of the actual ratio of the foreign corporation’s worldwide liabilities to worldwide assets or a fixed ratio set out in the Treasury Regulations; and, in Step Three, the
interest expense on the U.S.-connected liabilities is determined by use of the adjusted U.S.-booked liabilities method or by the separate currency pools method.

In connection with this three-step process, the Final Regulations make permanent the ability of a foreign bank to elect to use a 95% fixed ratio in Step Two to determine its U.S.-connected liabilities so long as the bank uses tax basis in Step One to determine the value of its U.S. assets for the taxable year.1 Prior to the Temporary Regulations, the fixed ratio had been 93%. There is no indication in the Preamble to the Final Regulations that any consideration is being given to further changes in the fixed ratio.

The Final Regulations also make permanent the ability of a foreign bank to elect, on an annual basis, to use 30-day average LIBOR to determine interest expense on “excess liabilities” if the adjusted U.S.-booked liabilities method is used to determine interest on U.S.-connected liabilities in Step Three.2

The Temporary Regulations reflected a concern that a foreign corporation which used fair market value to value its U.S. assets in Step One would be able to over-leverage some of its intangibles if it were also allowed to use the fixed ratio to determine its U.S. liabilities in Step Two. In response, the Temporary Regulations provided that a taxpayer may only elect to value its U.S. assets at fair market value in Step One if it also uses the actual (rather than fixed) ratio of liabilities to assets to determine U.S.-connected liabilities in Step Two.3 The Final Regulations make this rule permanent.4

The Final Regulations provide that, for taxable years ending on or after the effective date of the Final Regulations, each election made under Section 1.882-5 of the Treasury Regulations must be attached to the foreign corporation’s timely filed U.S. corporate tax return, including extensions (generally on

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1 Treas. Reg. § 1.882-5(c)(4).
4 Treas. Reg. § 1.882-5(b)(2)(ii)(A)(1). As a result, a foreign corporation that formerly used fair market value to determine its U.S. assets in Step One and the fixed ratio in Step Two was required to make an election consistent with the Temporary Regulations on its first tax return due after August 17, 2006, and if the foreign corporation failed to do so, the Temporary Regulations provided that a binding conforming election could be made by the IRS on behalf of such foreign corporation. Fmr. Temp. Treas. Regs. § 1.882-5T(a)(7) and (b)(2)(ii)(A)(2). The Final Regulations adopt this rule without change from the Temporary Regulations. Treas. Regs. § 1.882-5(a)(7) and (b)(2)(ii)(A)(2). Therefore, foreign corporations must continue to use the consistent method elected pursuant to the Temporary Regulations, subject to the rules governing changing such elections. Treas. Reg. § 1.882-5(a)(7) generally provides that elections under the Final Regulations cannot be changed for five years without the consent of the IRS; however, Treas. Reg. § 1.882-5(b)(2)(ii)(A)(2) generally provides that a foreign corporation which elects to use the fair market value method in Step One must use the actual ratio method in Step Two indefinitely absent the consent of the IRS to change the election and further provides that, when available, the election by a foreign bank to apply 30-day average LIBOR to exceed U.S.-connected liabilities may be made annually.
Schedule I of Form 1120-F); and not on a foreign corporation’s amended return. This also applies to the election prescribed under Section 1.884-1(e)(3) of the Treasury Regulations, further described below.

**BRANCH PROFITS TAX**

**A. DETERMINING U.S. LIABILITIES**

For purposes of the branch profits tax, a foreign corporation may elect to treat reinvested earnings solely as equity, rather than as part debt-funded, by correspondingly reducing its U.S. liabilities. Prior to the Temporary Regulations, a foreign corporation’s U.S. liabilities could only be reduced to the extent that they exceeded U.S.-booked liabilities as of the determination date. The Temporary Regulations removed that floor and permitted a foreign corporation to reduce its U.S. liabilities to the extent necessary to prevent recognition of a dividend equivalent amount, so long as U.S. liabilities are not reduced below zero. As a consequence of such an election, deductible interest expense is also reduced (because the amount of U.S. liabilities for branch profits tax purposes is the same as the amount of U.S.-connected liabilities for purposes of determining interest expense). The Final Regulations make this rule permanent.

In a case where a foreign bank is not covered by a tax treaty that eliminates the branch profits tax, the increase under the Temporary Regulations in the fixed ratio from 93% to 95% may result in a branch profits tax liability because it will reduce the net equity of the U.S. branch. This could in some cases be larger than any tax savings from the additional interest expense resulting from the increase in the fixed ratio. In such a case, a bank would presumably elect to treat the increased leverage as equity under the branch profits tax liability reduction election described above. Comments on the Temporary Regulations objected to this result, but the comments were not accepted and, consequently, a foreign bank subject to the branch profits tax may still need to estimate its overall U.S. tax liability both with and without the fixed ratio election in order to determine the overall effect of the election. This difficulty is compounded by the rule that a foreign bank may not change its Step Two election for five years without the consent of the Internal Revenue Service (“IRS”).

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7 Treas. Reg. § 1.884-1(e)(3).
9 See Treas. Reg. § 1.884-1(e)(5), example 2.
B. BRANCH-LEVEL INTEREST TAX ON CORPORATE PARTNERS IN FOREIGN PARTNERSHIPS

For withholding tax purposes, the branch-level interest tax rules treat "excess interest" of a foreign corporation (i.e., interest on liabilities attributed to a U.S. branch in excess of the interest paid on booked liabilities of the branch) as though it were paid to the foreign corporation by a wholly owned domestic corporate subsidiary.\(^{12}\) The Preamble notes that consideration is being given to the interaction between the 2004 statutory changes to the rules governing the source of interest paid by a foreign partnership that carries on a U.S. trade or business and the branch-level interest tax. Specifically, under the 2004 statutory change, interest that is (a) not paid by a U.S. trade or business of the partnership and (b) not allocable to income of the foreign partnership that is effectively connected with that business will not be treated as derived from U.S. sources if the foreign partnership is predominantly engaged in the active conduct of a trade or business outside of the United States.\(^{13}\) However, the Treasury Regulations implementing the branch-level interest tax do not reflect the 2004 amendment; i.e., such interest is still treated as paid by a domestic corporation and thus treated as U.S.-source for purposes of the branch-level interest tax rules.\(^{14}\) The Preamble states that the Treasury Department and the IRS are considering how to coordinate the "excess interest" rule with the 2004 amendment so that a corporate partner of a foreign partnership subject to the 2004 amendment is given the same treatment under the branch-level interest tax rules as a foreign corporation directly engaged in a trade or business within the United States, but no interim guidance is provided on how to mitigate the negative tax effect of the interaction of these rules.

OTHER NOTABLE PROVISIONS OF THE FINAL REGULATIONS

**Direct Interest Allocations.** The Final Regulations, like the Temporary Regulations, allow a foreign corporation or foreign partnership that has a U.S. asset subject to nonrecourse indebtedness to directly allocate interest expense pursuant to Section 1.861-10T of the Treasury Regulations.\(^{15}\) This rule also applies to assets that are part of certain integrated financial transactions.\(^{16}\)

**Definition of U.S.-Booked Liabilities.** The Final Regulations adopt without modification the Temporary Regulations’ definition of "U.S.-booked liabilities." The central changes made in the Temporary Regulations were (1) a requirement that a bank record a liability on the books before the end of the day on which it is incurred in order to treat such liability as a U.S.-booked liability\(^{17}\) and (2) the principle that

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\(^{12}\) I.R.C. § 884(f)(1)(B). The tax is imposed at the rate imposed in I.R.C. § 881(a), currently 30%.

\(^{13}\) I.R.C. § 861(a)(1)(C).

\(^{14}\) Treas. Reg. § 1.884-4(a)(1).


\(^{16}\) Treas. Reg. § 1.861-10T(c).

the specific borrowings need not be traced to specific effectively connected uses in order to be treated as U.S.-booked liabilities.\footnote{18} The Preamble states that the Treasury Department and the IRS considered and rejected a suggestion that the definition be revised to exclude certain conduit inter-branch lending arrangements, and that this issue will be coordinated with similar issues in analogous contexts (e.g., liabilities arising in global dealing operations and allocations of interest expense in affiliated groups pursuant to Section 864(e) of the Internal Revenue Code of 1986, as amended (the “Code”)).

**Computation of Total Value of U.S. Assets.** The Final Regulations adopt without change the rules in the Temporary Regulations with respect to the total value of a foreign corporation’s U.S. assets, including the rules with respect to mark-to-market valuation by foreign banks. Instead of using a single year-end valuation, any financial instruments subject to mark-to-market valuation under Sections 475 or 1256 of the Code must be valued on each “determination date” which is defined as the most frequent interval for which data is regularly available.\footnote{19} In contrast, non-banks are only required of “reasonably contemporaneous booking.”\footnote{20}

**Coordination with Tax Treaties.** The Temporary Regulations permit a foreign bank that is eligible under an income tax treaty that allows the risk weighting of assets to elect to use either the treaty provision or the method set out in Section 1.882-5 of the Treasury Regulations to determine the interest expense of a U.S. branch.\footnote{21} The Final Regulations adopt this provision without change.\footnote{22} The purpose is to allow foreign banks eligible for the benefits of certain recent tax treaties, including the U.S.-U.K. treaty, the U.S.-Japan treaty and the U.S.-German treaty, to calculate the capital of their U.S. branch using risk weighted assets.\footnote{23}

**Foreign Currency Gain or Loss.** In the preamble to the Temporary Regulations, the IRS requested comments on the use of tracing to allocate, source and apportion currency gain or loss from unhedged third-party borrowings between effectively connected and non-effectively connected income and also on the extent to which the current practice of foreign corporations in booking such foreign currency gains and losses may be used as a basis for tracing. The Temporary Regulations did not, however, resolve these issues, and the Final Regulations do not implement (nor does the Preamble discuss the consideration of) any new provisions with respect to foreign currency gain or loss.

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\footnote{18}{See Treas. Reg. § 1.882-5(d)(6), example 5 and Fmr. Temp. Treas. Reg. § 1.882-5T(d)(6), example 5.}

\footnote{19}{Treas. Reg. § 1.882-5(b)(3)(ii).}

\footnote{20}{Treas. Reg. § 1.882-5(b)(3)(i).}

\footnote{21}{Fmr. Temp. Treas. Reg. § 1.882-5T(a)(2).}

\footnote{22}{Treas. Reg. § 1.882-5(a)(2).}

TAXPAYER COMMENTS ON INTEGRATED AND INTERBRANCH TRANSACTIONS

The Final Regulations do not address integrated financial transactions, including the possibility of netting “repoed” or loaned securities against offsetting liabilities. This has been an open issue for many years.\textsuperscript{24} Comments on the Temporary Regulations included a suggestion that a direct tracing rule be adopted to effectively give zero risk weighting to such assets, and thus scale back the amount of capital that is imputed to such portfolios to reflect that the fact that such assets are entirely debt-financed. In a similar vein, the comments requested that the Treasury Department amend and finalize the 1996 hedging regulations\textsuperscript{25} to cover a foreign corporation’s interbranch activities in certain cases. Additionally, the comments included a suggestion to allow “netting” of offsetting notional principal contracts within discrete portfolios.

The Final Regulations made no changes or additions to the Temporary Regulations in response to any of these suggestions. However, the Preamble notes that the Treasury Department and the IRS are continuing to consider these issues further because they require “broader considerations” and states an intention to work on these questions in a coordinated manner with similar situations elsewhere in the Code.

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\textsuperscript{25} 1996-1 C.B. 844.
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