

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:

Telephone Number:

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Date:
December 14, 2004

LEGEND

Date A	=
Date B	=
Date C	=
Date D	=
Taxpayer	=
Country A	=
Location A	=

Dear :

This private letter ruling responds to your letter dated Date A in which you requested the following two rulings under Treas. Reg. § 1.882-5 on behalf of Taxpayer:

1. In determining its interest expense deduction under I.R.C. section 882(c) and Steps 1 and 2 of the interest allocation formula in § 1.882-5, Taxpayer requests permission to elect to determine the value of its U.S. assets under § 1.882-5(b) under the fair market value method while continuing to use the 93 percent fixed ratio to determine the amount of its U.S.-connected liabilities under § 1.882-5(c). Taxpayer requests permission to make the fair market value election and continue its original fixed ratio election on an amended return for the taxable year ended Date B.
2. Under Step 3 of the § 1.882-5 interest allocation formula, Taxpayer requests permission to switch from the adjusted U.S. book liability method in § 1.882-5(d) to the separate currency pool method provided in § 1.882-5(e) on an amended return for the taxable year ended Date B.

The information submitted for consideration of this ruling is substantially as set forth below. This ruling is predicated upon facts and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for a ruling. Verification of the factual information, representations, and other data may be required as a part of the audit process.

Taxpayer is a corporation engaged in the active conduct of an international banking business incorporated in Country A with headquarters in Location A. Taxpayer is directly engaged in the active conduct in the United States of a banking, financing, or similar business (within the meaning of § 1.864-4(c)(5)(i)) through its U.S. branch operations. Taxpayer also carries on business within the United States through directly and indirectly owned subsidiaries, and through limited liability companies that are classified as partnerships for U.S. federal income tax purposes.

Taxpayer represents that since the taxable year ended Date C it has determined the value of its assets for purposes of § 1.882-5(b) on the basis of the adjusted basis of those assets, has determined its U.S.-connected liabilities by use of the fixed ratio for banks described in § 1.882-5(c)(4), and has determined the interest expense allocable to its effectively connected income by use of the Adjusted U.S. Booked Liability method described in § 1.882-5(d). Taxpayer represents that it has satisfied the minimum five year requirement described in § 1.882-5(a)(7) as of the end of the taxable year ending Date D.

Taxpayer initiated the private letter ruling process before the extended due date for filing its original return for the year ended Date B. This ruling was issued after the filing date.

LAW

Section 1.882-5 provides a three-step formula for determining the amount of a foreign corporation's interest expense that is allocable to income, gain or loss that is effectively connected with the conduct of a trade or business within the United States. Step 1 requires the determination of U.S. assets as defined in § 1.882-5(b). Step 2 requires the determination of U.S.-connected liabilities, which are deemed liabilities computed as a ratio of the U.S. assets. Step 3 determines the amount of interest that is allocable to effectively connected income based on the amount of U.S.-connected liabilities imputed in Step 2 of the formula. In addition, § 1.882-5(a)(7) provides general rules for the available elections under all three steps of the formula, and time, place and manner rules for making and changing any or all of the elections. A specific provision for making a fair market value election is provided in § 1.882-5(b)(2)(ii)(A).

For purposes of Step 1 of the three-step formula, § 1.882-5(b) provides two alternative elective methods for corporations to determine the total value of U.S. assets for the taxable year. Section 1.882-5(b)(2)(i) generally provides that the value of a U.S. asset is the adjusted basis of the asset for determining gain or loss from the sale or other disposition of that item, subject to a reduction provided in § 1.882-5(b)(2)(iii) for the total value of bad debt reserve additions allowed as a deduction under section 585. Taxpayer is a large bank as defined in section 585(c)(2), and accordingly, does not use

the reserve method for claiming losses against its effectively connected income. Accordingly, the reduction in U.S. assets provided by subparagraph (iii) does not apply to Taxpayer.

Section 1.882-5(b)(2)(ii) states that 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), provided the taxpayer uses the methodology prescribed in § 1.861-9T(h). Once the fair market value election is made, the fair market value must be used by the taxpayer for both Step 1 and Step 2 of the formula described in § 1.882-5(b) and § 1.882-5(c), and must be used in all subsequent taxable years unless the Commissioner or her delegate consents to a change. Once the fair market value election is made, the general rule in § 1.882-5(a)(7) that permits new elections after a minimum five-year period does not apply for purposes of the asset valuation method in Steps 1 and 2 of the formula.

Under Step 2 of the three-step formula, § 1.882-5(c) provides two alternative elective methods for corporations to determine the total amount of U.S.-connected liabilities for the taxable year. Section 1.882-5(c)(1) provides a general rule, that the amount of U.S.-connected liabilities for the taxable year equals the total value of U.S. assets for the taxable year multiplied by the actual ratio for the taxable year. The actual ratio is defined in § 1.882-5(c)(2) as the total amount of worldwide liabilities for the taxable year divided by the total value of its worldwide assets for the taxable year. Section 1.882-5(c)(4) provides that a taxpayer that is a bank as defined in section 585(a)(2)(B) may elect to use a fixed ratio of 93% in lieu of the actual ratio.

For purposes of Step 3 of the three-step formula, two alternative elective methods are provided in § 1.882-5(d) and (e), respectively. Section 1.882-5(d) provides the Adjusted U.S. Book Liability ("AUSBL") method. Section 1.882-5(e) provides the separate currency pools method ("SCP"). The AUSBL and SCP methods are alternative formulas for determining the amount of interest expense allocable to effectively connected income.

Section 1.882-5(a)(7) states that a corporation must make each election provided in this section on the corporation's federal income tax return for the first taxable year beginning on or after the effective date 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. Section 1.882-5(a)(7) also states that each election under this section must be used for a minimum period of five years before the taxpayer may elect a different method, and a taxpayer must obtain the consent of the Commissioner in order to change an election prior to the end of the five year period. The regulation contemplates that consent will be granted by the Commissioner only in "rare and unusual circumstances." Each election is made by the corporation calculating its interest expense deduction in accordance with the methods elected. Under these principles, the use of the adjusted tax basis method to determine the value of U.S. assets and the 93-percent fixed ratio to determine U.S.-connected liabilities on timely filed tax returns in the first effective year that § 1.882-5 applies to a taxpayer constitute elections that are subject to the minimum five-year period. Once five years has past, a taxpayer is not required to make new elections for the next five years and is not treated as having made new elections in the sixth year for methods originally elected that the taxpayer does not change.

As indicated above, Taxpayer represents that it timely elected on its tax return for the year ended Date C, to use the adjusted basis method to determine the value of its U.S. assets in Step 1, the 93-percent fixed ratio to determine its U.S.-connected liabilities in Step 2, and the AUSBL method in Step 3 of the interest allocation formula. Taxpayer was eligible to make new elections without consent from the Commissioner or his delegates for all three steps of the formula on its tax return for the year ended Date B, but indicated that it did not wish to change from the adjusted basis method to the fair market value method for valuing U.S. assets in Step 1 unless it could remain with certainty on the 93-percent fixed ratio method for determining U.S.-connected liabilities in Step 2. Taxpayer has requested permission to change to the fair market value method for Step 1 purposes only, on an amended return for the year ended Date B. Taxpayer was independently eligible to switch its Step 3 method from the AUSBL method to the SCP method on a timely filed tax return for the year ended Date B, without regard to its eligibility to make new elections under Steps 1 and 2 of the formula, but it did not do so. It also has requested permission to adopt the SCP method on an amended return for the year ended Date B.

Based on the information submitted and the statutes, rules and regulations cited, the following rulings apply to Taxpayer:

RULING REQUEST 1:

Taxpayer may elect to use the fair market value election to determine the value of its U.S. assets under § 1.882-5(b) for the year ending Date B provided such election is made on a filed amended return within 120 days after the date of this letter. If Taxpayer does not make an election on an amended return for the year ending Date B within the time specified in this letter, Taxpayer may make a fair market value election on a timely filed return (including extensions) for any subsequent year. Once Taxpayer makes a fair market value election to determine the value of its U.S. assets, in accordance with § 1.882-5(b)(2)(ii), Taxpayer may not automatically change to the adjusted basis method after five years, and must continue to use the fair market value method unless consent to change to the adjusted basis method is obtained from the Commissioner or his delegate.

Taxpayer may continue to use the 93-percent fixed ratio method to determine its U.S.-connected liabilities under § 1.882-5(c) regardless of whether Taxpayer elects to switch to the fair market value method to determine its U.S. asset values under § 1.882-5(b). In accordance with the requirements of § 1.882-5(a)(7), including the minimum five year period, Taxpayer is eligible to switch to the actual ratio method under Step 2 on a timely filed original return (including extensions) for any tax year ending after Date B.

RULING REQUEST 2

Taxpayer may not elect to switch to the Separate Currency Pools method described in § 1.882-5(e) on an amended return for the year ended Date B. Taxpayer was independently eligible to make an SCP election on a timely filed return without regard to the determinations of its asset values under § 1.882-5(b)

or its U.S.-connected liabilities under § 1.882-5(c). In accordance with the requirements of § 1.882-5(a)(7), including the minimum five year period, Taxpayer is eligible to switch from the AUSBL to the SCP method on a timely filed return (including extensions) for any year ending after Date B.

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

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

It is important that a copy of this letter be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transaction covered by this ruling letter is consummated.

Pursuant to a power of attorney on file in this office, copies of this letter ruling are being furnished to your authorized representatives.

Sincerely yours,

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

Enclosure:
Copy for § 6110 purposes