

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:

Refer Reply To:

CC:INTL:B05

PLR-121637-18

Date:

November 26, 2018

Legend

Bank	=
State Branch	=
Parent	=
Country A	=
Country B	=
State	=
Date A	=
Date B	=
Year X	=

Dear :

We respond to your letter dated Date A, requesting rulings on behalf of Bank pursuant to section 864(c)(6) and section 1.864-4(c)(5) and 1.882-5(a)(7) regarding the proper U.S. federal income tax treatment of interest income and interest expense related to its U.S. banking business but which arises after Bank ceases to conduct a U.S. banking business.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Facts

Bank is wholly owned by Parent, a financial holding company organized under the laws of Country A. Bank is organized under the laws of, and regulated as a bank in, Country B. Bank operates in the United States through the activities of a branch licensed in State. The activities of State Branch include making loans to U.S. and foreign borrowers, acquiring bonds, and entering into swaps.

Bank has represented that State Branch and its predecessors have been engaged in the conduct of a banking, financing, or similar business in the United States, within the meaning of section 1.864-4(c)(5), for many years. It further represented that, with the exception of some loans and bonds acquired by non-U.S. operations of Bank and later transferred to State Branch, all of the loans and bonds held by State Branch were acquired with the material participation of employees of State Branch or its predecessors. All of the loans held by State Branch were acquired in the course of making loans to the public as described in section 1.864-4(c)(5)(ii)(a)(1). All of the bonds held by State Branch are securities described in section 1.864-4(c)(5)(ii)(b)(3), other than those acquired by non-U.S. operations of Bank and later transferred to State Branch.

State Branch uses an annual U.S. tax accounting period ending Date B. Bank currently uses the adjusted U.S. booked liabilities method to determine the amount of interest expense it can deduct under section 1.882-5 and has represented that it made an election to use the fixed ratio more than five years ago.

Bank has decided to wind down the U.S. banking business of State Branch and transfer most of the State Branch assets (the “Transferred Assets”) to Bank’s home office in Country B before the end of Year X. Bank has represented that after the close of Year X, Bank will not be engaged in the conduct of a trade or business in the United States. However, to the extent that interest earned on the Transferred Assets would have been effectively connected income if such interest had been earned in a year in which Bank was engaged in a trade or business within the United States, Bank will continue to treat such interest as effectively connected income after the closing of its State Branch pursuant to section 864(c)(6).

Law and Analysis

Ruling Request 1

Bank has requested a ruling that provides that the flush language of section 1.864-4(c)(5)(ii) describing the amount of interest from securities described in section 1.864-4(c)(5)(ii)(b)(3) that is effectively connected income (the “10% rule”) applies to determine the amount of interest on securities described in

section 1.864-4(c)(5)(ii)(b)(3) acquired by Bank in connection with its U.S. banking business and held by Bank after it ceases to be engaged in the active conduct of a trade or business in the United States that is treated as effectively connected income, so long as such interest is subject to section 864(c)(6).

Section 882(a)(1) provides-

A foreign corporation engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 11, or 59A, on its taxable income which is effectively connected with the conduct of a trade or business within the United States.

In determining the income effectively connected with the conduct of a trade or business within the United States, section 882(a)(2) provides-

In determining taxable income for purposes of paragraph (1), gross income includes only gross income which is effectively connected with the conduct of a trade or business within the United States.

Section 864(c)(1)(A) provides-

In the case of a nonresident alien individual or a foreign corporation engaged in trade or business within the United States during the taxable year, the rules set forth in paragraphs (2), (3), (4), (6), (7), and (8) shall apply in determining the income, gain, or loss which shall be treated as effectively connected with the conduct of a trade or business within the United States.

Section 864(c)(2) provides that the determination of whether fixed, determinable, annual or other periodic U.S. source income described in section 881(a) is treated as effectively connected with the conduct of a trade or business within the United States generally is made pursuant to an asset use or business activities test. However, section 1.864-4(c)(5)(ii) provides in relevant part that interest from securities or any gain or loss from the sale or exchange of securities which are capital assets, which is from sources within the United States and derived by a foreign corporation in the active conduct of a banking, financing or similar business in the United States shall be treated as effectively connected for such year with the conduct of that business only if the securities giving rise to such income, gain, or loss are attributable to the U.S. office through which such business is carried on and the securities were acquired in the manner provided in section 1.864-4(c)(5)(ii)(a) or the securities have the characteristics described in section 1.864-4(c)(5)(ii)(b).

Section 864(c)(4)(B)(ii) provides for the effectively connected treatment of foreign source interest income if it is derived in the active conduct of a banking, financing, or similar business within the United States. Section 1.864-6(b)(2)(ii)(b) applies the principles of section 1.864-4(c)(5)(ii) in determining whether foreign source interest income is attributable to a U.S. office of a banking, financing or similar business.

For purposes of determining effectively connected income with respect to U.S. source income relating to a banking, financing or similar business, section 1.864-4(c)(5)(v) defines a security as “any bill, note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to or purchase, any of the foregoing items.” Section 1.864-6(b)(2)(ii)(c) provides the same definition for securities that give rise to foreign source income.

In determining whether a security is attributable to a U.S. office or fixed place of business, section 1.864-4(c)(5)(iii)(a) provides in relevant part that a security “shall be deemed to be attributable to a U.S. office only if such office actively and materially participated in soliciting, negotiating, or performing other activities required to arrange the acquisition of the stock or security.” The U.S. office does not have to be the only participant involved in the acquisition of the stock or security.

Section 1.864-4(c)(5)(i) provides that the U.S. trade or business of a foreign corporation is considered a banking, financing, or similar business if the activities of the foreign corporation’s business consist of (a) receiving deposits of funds from the public, (b) making personal, mortgage, industrial, or other loans to the public, (c) purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness, (d) issuing letters of credit to the public and negotiating drafts drawn thereunder, (e) providing trust services to the public, or (f) financing foreign exchange transactions for the public.

For the effectively connected income rules of section 1.864-4(c)(5)(ii) to apply to securities, the securities must either be acquired in the manner provided in section 1.864-4(c)(5)(ii)(a) or have the characteristics described in section 1.864-4(c)(5)(ii)(b). Section 1.864-4(c)(5)(ii)(a) applies to securities that were acquired (1) as a result of, or in the course of making loans to the public, (2) in the course of distributing such stocks or securities to the public, or (3) for the purpose of being used to satisfy the reserve requirements, or other requirements similar to reserve requirements, established by a duly constituted banking authority in the United States. Section 1.864-4(c)(5)(ii)(b) applies to securities that are (1) payable on demand or at a fixed maturity date not exceeding one year from the date of acquisition, (2) issued by the United States, or any agency or instrumentality thereof, or (3) not otherwise described in section 1.864-

4(c)(5)(ii)(a) or (b)(1) or (b)(2). Securities in this residual category are commonly referred to as “(b)(3) securities.”

Pursuant to the 10% rule, the amount of interest from (b)(3) securities that is treated as effectively connected for the taxable year with the active conduct of a banking, financing, or similar business in the United States is determined by multiplying the entire amount of such interest for the taxable year from sources within the United States by a fraction. The numerator of this fraction is ten percent. The denominator is equal to the ratio of (1) the monthly average book value of the (b)(3) securities held by the U.S. office through which the banking, financing, or similar business is carried on over (2) the monthly average book value of the total assets of such U.S. office.

Section 864(c)(6) provides-

For purposes of this title, in the case of any income or gain of a nonresident alien individual or a foreign corporation which—

(A) is taken into account for any taxable year, but

(B) is attributable to a sale or exchange of property or the performance of services (or any other transaction) in any other taxable year,

the determination of whether such income or gain is taxable under section 871(b) or 882 (as the case may be) shall be made as if such income or gain were taken into account in such other taxable year and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the taxable year referred to in subparagraph (A).

Section 864(c)(7) provides-

For purposes of this title, if—

(A) any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, and

(B) such property is disposed of within 10 years after such cessation,

the determination of whether any income or gain attributable to such disposition is taxable under section 871(b) or 882 (as the case

may be) shall be made as if such sale or exchange occurred immediately before such cessation and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the taxable year for which such income or gain is taken into account.

Bank represents that State Branch and its predecessors have been engaged in the conduct of a banking, financing, or similar business in the United States, within the meaning of section 1.864-4(c)(5), for many years. Bank further represents all of the loans and bonds held by State Branch were acquired with the material participation of employees of State Branch or its predecessors, with the exception of some loans and bonds acquired by non-U.S. operations of Bank and later transferred to State Branch.

Bank represents that after the close of Year X, Bank will not be engaged in the conduct of a trade or business in the United States. However, to the extent that interest earned on the Transferred Assets would have been effectively connected income if such interest had been earned in a year in which Bank was engaged in a trade or business within the United States, Bank will continue to treat such interest as effectively connected income after the closing of its State Branch pursuant to section 864(c)(6).

Pursuant to section 864(c)(6), when income is taken into account in one taxable year but is attributable to a transaction that occurred in any other taxable year, the determination of whether income is taxable under section 882 is made as if the income were taken into account in the other taxable year.

Based solely on the submitted facts and representations, the 10% rule of section 1.864-4(c)(5)(ii) applies to determine the amount of interest on (b)(3) securities acquired by Bank in connection with its U.S. banking business and held by Bank after it ceases to be engaged in the conduct of a trade or business within the United States that is treated as effectively connected income, so long as such interest is subject to section 864(c)(6).

Ruling Request 2

Bank has requested that it be permitted to elect to apply the actual ratio method prescribed in section 1.882-5(c)(2) in the manner provided by section 1.882-5(a)(7) for taxable years in which it is no longer engaged in a trade or business within the United States but continues to have effectively connected income related to its U.S. banking business under section 864(c)(6) or 864(c)(7).

For purposes of determining the effectively connected income of a foreign corporation under section 882(a)(1), section 882(c)(1)(A) provides that in the

case of a foreign corporation, the deductions shall be allowed only for purposes of section 882(a) and (except for limited deductions for charitable contributions and gifts) only if and to the extent that they are connected with income which is effectively connected with the conduct of a trade or business within the United States. Section 882(c)(1)(A) further provides that the proper apportionment and allocation of the deductions for this purpose shall be determined in regulations prescribed by the Secretary.

Section 1.882-5 provides a three-step process for determining the amount of interest expense of a foreign corporation that is allocable under section 882(c) to income that is (or is treated as) effectively connected with the conduct of a trade or business within the United States. Under these rules, U.S.-connected liabilities must be determined by multiplying the U.S. assets determined under section 1.882-5(b) by the taxpayer's actual worldwide liability-to-asset ratio. Section 1.882-5(c)(4) provides that a taxpayer that is a bank as defined in section 585(a)(2)(B) (without regard to the second sentence thereof) may elect to use a fixed ratio of 95 percent in lieu of its actual ratio.

Section 1.882-5(a)(7) provides rules for making elections under section 1.882-5, such as the election to use the fixed ratio or actual ratio under section 1.882-5(c). It provides in relevant part that:

An elected method . . . 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 The Commissioner . . . 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.

Bank represents that it made an election to use the fixed ratio for purposes of section 1.882-5 more than five years ago. Based solely on the submitted facts and representations, Bank is permitted to elect to use the actual ratio for purposes of section 1.882-5 in the manner provided by section 1.882-5(a)(7) for taxable years in which it is no longer engaged in a trade or business within the United States but continues to have effectively connected income related to its U.S. banking business under section 864(c)(6) or 864(c)(7).

Rulings

Based on the information submitted and the representations made, we rule as follows:

- (1) The 10% rule of section 1.864-4(c)(5)(ii) applies to determine the amount of interest on (b)(3) securities acquired by Bank in connection with its U.S. banking business and held by Bank after it ceases to be engaged in the conduct of a trade or business within the United States that is treated as effectively connected income, so long as such interest is subject to section 864(c)(6).
- (2) Bank may elect to apply the actual ratio method prescribed in section 1.882-5(c)(2) in the manner provided by section 1.882-5(a)(7) for taxable years in which it is no longer engaged in a trade or business within the United States but continues to have effectively connected income related to its U.S. banking business under section 864(c)(6) or 864(c)(7).

Caveats

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

Procedural Statements

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

Sincerely,

Anthony J. Marra
Senior Counsel, Branch 5
Office of Associate Chief Counsel
(International)