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Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:INTL:Br5:PLR-121421-98

Date:

February 1, 2000

Bank =

Country A =

Date a =

Date b =

Date c =

Date d =

Date e =

Date f =

City a =

City b =

r percent =

Dear :

This is in reply to a letter dated Date a, requesting rulings under sections 864, 882, and 884 of the Internal Revenue Code of 1986 (the "Code"). Additional information was submitted in letters dated Date b and Date c. The information submitted for consideration is substantially as set forth below.

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 ruling, it is subject to verification upon examination.

Bank is a publicly-held, international banking institution incorporated under the laws of Country A. Bank maintains offices in various countries and is represented in the major financial centers around the world. Currently, Bank has a representative office in the United States. Bank previously had a U.S. branch office in City a and U.S. agency in

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City b through which Bank was engaged in the active conduct of a banking, financing or similar business within the meaning of section 1.864-4(c)(5)(i) of the Income Tax Regulations ("Regulations"). These operations were closed during Bank's tax year ending Date d. During the tax year ending on Date d, Bank converted its banking license in City a to a licensed representative office. Bank is an accrual basis taxpayer and has filed a U.S. Income Tax Return for a Foreign Corporation (Form 1120F) with the Internal Revenue Service Center in Philadelphia to report income effectively connected with its U.S. banking trade or business for tax years prior to Date d based on its fiscal year end of Date e.

Pursuant to its surrender of its U.S. branch and agency licenses during its year ending Date d, Bank voluntarily withdrew from its U.S. banking business and currently represents that it no longer conducts or participates in any income producing business activities in the United States. Prior to terminating its U.S. business, certain money market assets, securities and customer loans ("Transferred Assets") that were booked at Bank's U.S. branch were transferred to and booked at Bank's head office in Country A. Bank represents that either none or a de minimus amount of securities described in section 1.864-4(c)(5)(ii)(b)(3) of the Regulations comprise the portfolio of Transferred Assets and that if the Transferred Assets represented all of the assets of a continuing U.S. banking, financing or similar business, that all of the interest income, gain or loss with respect to such assets would be effectively connected under section 1.864-4(c)(5)(ii) or section 1.864-6(b)(2)(ii)(b). In addition, certain off-balance sheet items were also transferred to and recorded as off-balance sheet items of Bank's head office. Income, gains and losses on the Transferred Assets and transferred off-balance sheet items will continue to be recorded on the books of the Bank's head office until such assets either mature, are sold or the contracts are terminated as the case may be. Bank represents that U.S. personnel actively and materially participated in soliciting, negotiating, or performing activities related to the acquisition of the Transferred Assets and the transferred off-balance sheet items. Prior to the termination of Bank's U.S. operations and withdrawal from business in the United States, Bank continued to treat these Transferred Assets as attributable to Bank's U.S. office under section 1.864-4(c)(5)(iii) and thus treated all income from the loans as effectively connected to Bank's U.S. banking trade or business while they were booked and managed in Bank's home office.

Bank represents that for an initial period after the U.S. banking branch and agency licenses were surrendered, the newly established representative office actively and materially participated in the sale of transferred assets to willing buyers, but that as of Date d, all sales activities of the representative office have ceased. Bank represents that as of Date d, the representative office does not engage in any income producing activity and serves only as a liaison for all U.S. Federal and local regulatory examinations of Bank and only to administer the preparation and maintenance of any U.S. books and records, as well as the filing of all business reports and tax returns.

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Requested Ruling 1

For tax years beginning after Date d, Bank has requested that income with respect to the Transferred Assets and gains and losses realized with respect to the disposition of the Transferred Assets be treated as effectively connected with the conduct of a trade or business within the United States during such period that Bank is not actually engaged in the active conduct of a trade or business within the United States.

For years in which Bank does not engage in a U.S. trade or business, section 864(c)(1)(B) of the Code provides in relevant part that for purposes of the Code, no income, gain or loss shall be treated as effectively connected with the conduct of a trade or business within the United States, except as provided in sections 864(c)(6) or (c)(7), or in section 871(d) or sections 882(d) and (e) of the Code. Section 871(d) provides an election to nonresident individuals to treat income derived from real property located in the United States as effectively connected with the conduct of a U.S. trade or business within the United States. Section 882(d) provides a similar election to foreign corporations. Section 882(e) provides a special rule for banks created or organized in or under the law of a possession of the United States and which carries on a banking business in a possession of the United States to treat interest income that is not exempt portfolio interest as defined in section 881(c)(2) as effectively connected with a U.S. trade or business. Bank is a foreign corporation that is not organized in or under the laws of a possession of the United States and income with respect to the Transferred Assets will not be income from real property located in the United States. Therefore, during the period that Bank does not engage in a U.S. trade or business, income with respect to the Transferred Assets will only be treated as effectively connected to a U.S. trade or business if it is income described in section 864(c)(6) or (c)(7).

a. Interest on Transferred Assets

Section 864(c)(6) of the Code provides that income or gain which is taken into account for any taxable year by a foreign corporation, but is "attributable to a sale or exchange of property or the performance of services (or any other transaction) in any other taxable year" will be taxable 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 U.S. trade or business in the year in which the income or gain is taken into account.

Interest income on the Transferred Assets is attributable to the loan transactions ("any other transaction") that occurred while Bank was engaged in a U.S. trade or business. Accordingly, section 864(c)(6) will apply to interest on the Transferred Assets accounted for by Bank in years beginning after Date d so long as the interest would have been treated as effectively connected with the conduct of a U.S. trade or business prior to Date d.

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Interest from a security which is a capital asset and from sources within the United States is generally treated as effectively connected with the conduct of a banking, financing, or similar business if the underlying security is attributable to a U.S. office. Section 1.864-4(c)(5)(ii) of the Regulations. For purposes of section 1.864-4(c)(5), a security that may give rise to income from sources within the United States is defined 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 1.864-4(c)(5)(v) of the Regulations. Bank represents that all of the Transferred Assets that may give rise to income from sources within the United States are assets described in section 1.864-4(c)(5)(v).

A security is attributable to a U.S. office if the U.S. office actively and materially participates in soliciting, negotiating, or performing other activities required to arrange the acquisition of the security. Section 1.864-4(c)(5)(iii) of the Regulations. Bank represents that its former U.S. banking branch office actively and materially participated in soliciting, negotiating, or performing other activities required to acquire the Transferred Assets and that during the period that Bank was engaged in a banking, financing or similar business in the United States, it treated the U.S. source interest income with respect to the Transferred Assets as effectively connected to its U.S. trade or business under section 1.864-4(c)(5)(ii).

Income derived by a nonresident individual or foreign corporation from sources without the United States is treated as effectively connected with the conduct of a banking, financing, or similar business if the taxpayer has in the United States at some time during the taxable year an office or other fixed place of business, as defined in section 1.864-7 of the Regulations, to which such income, gain, or loss is attributable in accordance with section 1.864-6. Section 1.864-5(a) of the Regulations. Interest from securities that are capital assets and that are from sources without the United States and derived by a nonresident individual or foreign corporation in the active conduct during the year of a banking, financing or similar business in the United States is treated as effectively connected for such year with the active conduct of that business under the principles of section 1.864-4(c)(5)(ii) that apply to determine U.S. source effectively connected income of the same banking, financing or similar business in the United States. Section 1.864-6(b)(2)(ii)(b) of the Regulations. The definition of “security” that may give rise to foreign source income is the same definition of security that may give rise to U.S. source interest income. Section 1.864-6(b)(2)(ii)(c).

For taxable years beginning after Date d, based solely on the facts and representations submitted, we conclude that, under section 864(c)(6), U.S. and foreign source interest income in the hands of Bank with respect to the Transferred Assets will be treated as effectively connected with the conduct of a U.S. trade or business.

b. Gain on Disposition of Transferred Assets

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Section 864(c)(7) of the Code provides that if any property ceases to be used or held for use in connection with the conduct of a U.S. trade or business and is subsequently disposed of within 10 years after such cessation, the income or gain attributable to the disposition will be treated as income or gain effectively connected with the conduct of a U.S. trade or business if the income or gain would have been so treated if the property had been disposed of immediately before such cessation. This determination is made 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 the income is taken into account.

Gains from the disposition of securities are treated as effectively connected with the conduct of a banking, financing, or similar business if the security is attributable to a U.S. office. Section 1.864-4(c)(5)(ii) of the Regulations. Based on Bank's representation that the Transferred Assets were attributable to Bank's U.S. office prior to the time Bank closed its business operations and surrendered its banking license, gain from the disposition of the Transferred Assets would have been treated as effectively connected with the conduct of a U.S. trade or business if such gains had been recognized immediately before cessation.

Based solely on the facts and representations submitted, we conclude that, under section 864(c)(7) of the Code, gains realized by Bank upon dispositions of Transferred Assets during the 10 years following Date d will be treated as effectively connected with the conduct of a U.S. trade or business.

c. Loss on Disposition of Transferred Assets

For taxable years beginning after Date d, Bank represents that it has ceased all income producing activities formerly conducted through its U.S. banking office and for a brief time during the year ending on Date d, through its representative office.

Section 1.864-4(c)(5)(ii) of the Regulations provides in relevant part that "any gain or loss from the sale or exchange of stocks or securities which are capital assets, which is from sources within the United States and derived by a nonresident individual or foreign corporation in the active conduct during the taxable year 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 stocks or securities giving rise to such income, gain or loss are attributable to the U.S. Office through which such business is carried on."

Section 864(c)(7) of the Code provides for the recognition of only income or gain with respect to dispositions within 10 years of assets that cease to be held for use in connection with the conduct of a trade or business within the United States. Under section 1.864-4(c)(5)(iii) of the Regulations, a security may be attributable to a U.S.

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office engaged in the active conduct of a banking, financing or similar business regardless of whether the security is held by the U.S. office or recorded on its books and records as having been acquired by such office for its account. Section 1.864-4(c)(5)(iii)(b)(5) of the Regulations. Accordingly, securities that are attributable to a U.S. office of a foreign corporation's banking, financing or similar business under section 1.864-4(c)(5)(iii), do not cease to be held for use in connection with the conduct of a trade or business within the United States if the foreign corporation remains engaged in a U.S. banking, financing or similar business through a U.S. office to which the transferred securities may be attributed.

Based solely on the facts and representations submitted, for taxable years beginning after Date d, all dispositions of Transferred Assets occurring after Date d will be dispositions of assets that have ceased to be held in connection with the conduct of a banking, financing or similar business in the United States. In accordance with section 864(c)(1)(B) of the Code, these dispositions may give rise to effectively connected income or gain solely under section 864(c)(7) and may not give rise to effectively connected income, gain or loss under section 864(c)(2), (c)(3) or (c)(4). Accordingly, losses with respect to such dispositions of Transferred Assets after Date d shall not be treated as effectively connected with the conduct of a trade or business within the United States.

Requested Ruling 2

Bank has requested for tax years beginning after Date d that Transferred Assets that have been materially modified with the participation solely of foreign office personnel will give rise to effectively connected income, gain or loss after the modifications have occurred. Section 1.1001-1(a) of the Regulations provides that gain or loss realized from the exchange of property for other property differing materially either in kind or in extent is treated as income or as loss sustained. Section 1.1001-3(b) provides that a significant modification of a debt instrument results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent. Accordingly, a significant modification (within the meaning of section 1.1001-3) will result in the realization of gain or loss under section 1001 of the Code giving rise to the deemed sale or exchange of the original instrument for a new instrument.

Based solely on the facts and representations submitted, with respect to Transferred Assets that are subject to a significant modification (within the meaning of section 1.1001-3 of the Regulations) through activities conducted solely through a non-U.S. office or fixed place of business, interest income with respect to such securities following the significant modification and any income, gain or loss with respect to a later disposition following the significant modification will not be treated as effectively connected with the active conduct of a U.S. trade or business under sections 1.864-4(c)(5)(ii) and 1.864-6(b)(2)(ii)(b) of the Regulations.

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Requested Ruling 3

Bank has requested for purposes of the branch-level interest tax on excess interest under section 884(f)(1)(B) of the Code, that it be permitted to treat a portion of its “excess interest” as interest on deposits under section 1.884-4(a)(2)(iii) of the Regulations for taxable years beginning after Date d.

Section 881(a)(1) of the Code imposes a 30 percent tax on interest received from sources within the United States by a foreign corporation to the extent such interest is not effectively connected with the conduct of a trade or business in the United States.

Section 884(f)(1)(A) of the Code provides that, in the case of a foreign corporation engaged in a trade or business in the United States, any interest paid by such trade or business in the United States shall be treated as if it were paid by a domestic corporation.

Section 884(f)(1)(B) of the Code provides that, to the extent the interest that is allocable to income that is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States exceeds the interest described in section 884(f)(1)(A), a foreign corporation shall be liable for tax under section 881(a) in the same manner as if such interest were paid to such foreign corporation by a wholly owned domestic corporation on the last day of such foreign corporation's taxable year.

Section 1.884-4(c)(3)(i) of the Regulations provides that the rate of tax imposed on the excess interest of a foreign corporation that is a qualified resident (within the meaning of section 1.884-5(a) of the Regulations) of a country with which the United States has an income tax treaty shall not exceed the rate provided under such treaty that would apply with respect to interest paid by a domestic corporation to that foreign corporation. Accordingly, Bank's excess interest (other than that portion characterized as interest on deposits) is subject to tax under section 881(a). Provided that Bank is a qualified resident of Country A (within the meaning of section 1.884-5(a) of the Regulations), the rate of tax on such excess interest shall be r percent.

Section 1.884-4(a)(2)(iii) of the Regulations provides that a portion of the excess interest of a foreign corporation that is a bank (as defined in section 585(a)(2)(B) of the Code without regard to the second sentence thereof), provided that a substantial part of its business in the United States, as well as all other countries in which it operates, consists of receiving deposits and making loans and discounts, shall be treated as interest on deposits and thus exempt from tax under section 881(a).

Bank represents that it meets the requirements of section 1.884-4(a)(2)(iii) of the Regulations, except that it is not engaged in an actual trade or business in the United States for taxable years beginning after Date d, and therefore it will not receive deposits

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or make loans and discounts within the United States during those taxable years. Bank represents that, prior to the date it surrendered its banking branch and agency licenses during the year ending on date d, a substantial part of its U.S. activities consisted of receiving deposits and making loans and discounts.

Section 585(a)(2)(B) of the Code treats a foreign bank as a bank if it would meet the requirements of section 581 but for the fact it is a foreign bank. Section 581 defines a “bank” in relevant part to be:

a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia) or of any state, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under authority of the Comptroller of the Currency, and which is subject by law to supervision and examination by State, or Federal authority having supervision over banking institutions.

Subsequent to the date that Bank surrendered its U.S. branch banking and agency licenses Bank no longer meets the requirements of section 1.884-4(a)(2)(iii) of the Regulations because it no longer receives deposits in the United States. Bank is eligible for the benefits of section 1.884-4(a)(2)(iii), however, because under section 864(c)(6) of the Code, Bank would have been eligible for the benefits of section 1.884-4(a)(2)(iii) if the interest income were taken into account in the prior year in which the transactions giving rise to the effectively connected income were entered into, and because, necessarily, Bank represents that after Date d it is no longer engaged in a U.S. trade or business. A final condition to qualify for the benefits of section 1.884-4(a)(2)(iii) is that Bank represents that it will continue to meet the requirement that a substantial part of its worldwide business will consist of receiving deposits and making loans and discounts.

Accordingly, based solely on the facts and representations submitted, Bank may treat a portion of its excess interest as interest on deposits under section 1.884-4(a)(2)(iii) of the Regulations for taxable years beginning after Date d.

Requested Ruling 4

Bank has requested that to the extent it remains subject to tax under section 882(a) of the Code in years beginning after Date d, that it be treated as a “bank” within the meaning of section 1.882-5(c)(4) of the Regulations and be permitted to elect the 93 percent fixed ratio method for determining its U.S. liabilities.

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Section 1.882-5 of the Regulations provides rules for determining the amount of interest expense of a foreign corporation that is allocable under section 882(c) of the Code 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, a taxpayer must determine its 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 93 percent in lieu of its actual ratio.

Section 1.882-5(a)(7) of the Regulations provides that elections under section 1.882-5 must be made on a corporation's federal income tax return for the first taxable year beginning on or after the effective date of section 1.882-5. In the event a taxpayer fails to make an election in a timely manner, the district director or the Assistant Commissioner (International) may make such election on the taxpayer's behalf.

Bank will not meet the definition of a bank for taxable years beginning after Date d because it represents that after that date, it is no longer engaged in business under the laws of the United States or any state. However, Bank represents that, during the years in which it was engaged in a trade or business within the United States, it was a bank as defined in section 585(a)(2)(B) of the Code, and that a substantial part of its worldwide business during taxable years beginning after Date d will consist of receiving deposits and making loans and discounts. Bank was engaged in a trade or business within the United States during the first taxable year in which section 1.882-5 and its requirement to make timely elections was effective. Accordingly, in order for Bank to be eligible to use the 93 percent fixed ratio method under section 1.882-5(c)(4), Bank must have made a timely election pursuant to section 1.882-5(a)(7). Bank represents that it made a timely election to use the 93 percent fixed ratio for its taxable year ended Date f and filed tax returns to report its income subject to tax under section 882(a).

Based on the facts and representations submitted, Bank's prior election, if timely made, renders the need to make the same election unnecessary for a subsequent year in which Bank is subject to tax under section 882(a) of the Code solely by reason of income and gain being treated as effectively connected under sections 864(c)(6) and (c)(7). Because Bank was eligible to and represents that it did timely elect the 93 percent fixed ratio election under section 1.882-5(c)(4) for its taxable year ended Date f, and Bank represents that subsequent to Date d, Bank will not actually be engaged in a U.S. trade or business, Bank shall continue to apply the 93 percent fixed ratio method under section 1.882-5(c)(4) until the first taxable year, whichever occurs earliest, in which (1) Bank earns no additional effectively connected income or gain with respect to the Transferred Assets pursuant to ruling 1 under sections 864(c)(6) and (c)(7), except that Bank shall not be required to use the fixed ratio beyond the minimum five year period beginning with Bank's fixed ratio election in year f; or (2) beginning in the year after Date d, Bank becomes engaged in a U.S. trade or business that does not meet

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the requirements of section 585(a)(2)(B) (without regard to the second sentence thereof).

The opinions expressed in rulings 1, 3 and 4 are conditioned on Bank's representation that after Date d, it is no longer engaged in a trade or business within the United States. 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. In particular, no ruling is expressed concerning whether, at any time, Bank's U.S. representative office has been or will be engaged in a U.S. trade or business, whether the Transferred Assets are securities as defined in sections 1.864-4(c)(5)(v) and 1.864-6(b)(ii)(c) of the Regulations, or whether any modifications previously effected through the sole participation of Bank's non-U.S. offices were significant modifications within the meaning of section 1.1001-3 or whether any income, gain or loss with respect to any significant modifications which pursuant to ruling 2, cannot be effectively connected under sections 1.864-4(c)(5)(ii) and 1.864-6(b)(2)(ii)(b) of the Regulations, is or should be treated as effectively connected under sections 1.864-4(c)(5)(vi) or 1.864-6(b)(2)(ii)(d) of the Regulations. Further, Bank did not request and no opinion is expressed concerning the application of the United States-Country A income tax treaty with respect to the Transferred Assets or the U.S. tax treatment of the transferred off-balance sheet items.

A copy of this letter must be attached to any income tax return to which it is relevant, including any previously filed return.

This ruling is directed only to the taxpayer requesting it. Section 6110(j)(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 the taxpayer.

Paul Epstein
Senior Technical Reviewer
Branch 5
Office of Associate Chief
Counsel (International)