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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, MANHATTAN DISTRICT
CC:NER:MAN
Attn: Carmen Baerga

FROM: Paul Epstein
Senior Technical Reviewer CC:INTL:BR5

SUBJECT:

This Field Service Advice responds to your memorandum dated July 17, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

| | |
|--------------|---|
| Taxpayer | = |
| B | = |
| C | = |
| D | = |
| Date a | = |
| Date b | = |
| Date c | = |
| Date d | = |
| Date e | = |
| Audit Period | = |
| Country A | = |
| Country B | = |
| City A | = |
| City B | = |
| Year 1 | = |
| Year 2 | = |
| Year 3 | = |
| Year 4 | = |
| a% | = |
| b% | = |
| c% | = |
| d% | = |
| e% | = |
| Amount A | = |
| X System | = |

ISSUES

1. Whether income, gains, and losses with respect to certain notional principal contracts and other derivative products entered onto the books of B, a dealer in derivatives and a wholly-owned U.S. subsidiary of Taxpayer, are sourced under Treas. Reg. §1.988-4.
2. Whether B has a separate qualified business unit ("QBU") within the meaning of §1.989(a)-1 with respect to the derivative transactions that were entered on B's books and records through the regular and continuous exercise of contractual authority by C, a foreign subsidiary of Taxpayer located in Country A.
3. If B has a separate QBU with respect to the transactions entered into on its behalf by C, in what country is the QBU resident? If the separate QBU of B is

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resident in Country A, what is the source of income, gains, and losses with respect to such transactions booked in B?

4. How are such transactions required to be taken into account for purposes of determining Taxpayer's interest expense allocation for foreign tax credit purposes under section 864(e) and the regulations thereunder?

CONCLUSIONS

1. All of the transactions at issue constitute section 988 transactions because they are denominated in nonfunctional currencies of B's separate QBU. Accordingly, all income, gains, and losses with respect to such transactions are sourced under §1.988-4(b). Section 865 does not apply to income, gains, or losses with respect to foreign currency denominated instruments.

2. The derivatives dealing activities conducted by C as agent for B, which acted as counterparty to the derivative transactions, constitute a separate QBU of B within the meaning of §1.989(a)-1. First, C's regular and continuous conduct of a derivatives dealing activity and contracting in B's name as counterparty with respect to such activity constitutes a trade or business that satisfies the requirement of §1.989(a)-1(c). Second, Taxpayer's separate management accounting and separate profit and loss reporting practices with respect to the transactions at issue satisfy the "separate books and records" requirement of §1.989(a)-1(d).

3. B's separate QBU is resident in Country A within the meaning of §1.988-4(d)(2) because the predominant activities with respect to the transactions and activities that form the separate QBU were all conducted in Country A by employees of C. Accordingly, this QBU's principal place of business is located in Country A. Because income, gains, and losses with respect to the transactions at issue are sourced by reference to the residence of B's separate QBU resident in Country A, they are foreign source.

4. For interest allocation purposes, Taxpayer must characterize the assets with respect to its derivative contracts in accordance with the source and type of income that such assets generate, have generated, or may reasonably be expected to generate. §1.861-9T(g)(3). Accordingly, because the income is foreign source, the assets are also characterized as foreign source.¹

¹ For purposes of this Field Service Advice, we refer to the characterization of assets interchangeably with the "source of assets" under the interest allocation rules in section 864(e).

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FACTSA. Organizational structure and business of Taxpayer and subsidiaries

Taxpayer is a U.S. holding company that, through its subsidiaries, is engaged in the business of making a market in U.S. dollar and non-U.S. dollar interest rate notional principal contracts and other derivative products (collectively, “swaps”), as well as entering into related hedges. B is a wholly-owned U.S. subsidiary of Taxpayer. B acts as the counterparty to these swaps and performs back office functions such as accounting, reconciliation, and certain operational control work. B has trading operations in the United States and, through foreign affiliates, City A and City B. Although Taxpayer’s swap transactions are accounted for in the aggregate on B’s books and records, separate business groups employed by various affiliates of Taxpayer enter into and manage the individual transactions that form B’s swaps book.

Taxpayer’s separate business groups were located in Country A, Country B, and the United States, and each group’s transactions were separately identified and entered onto separate management books. These separate “Managed Book” accountings were used by each group to monitor its day-to-day profits and losses. This Field Service Advice addresses only the transactions that constitute the City A Managed Book and that were entered onto B’s books through the activities of Taxpayer’s affiliate resident in Country A.

C (formerly named D in the Audit Period²), a wholly-owned second-tier Country A subsidiary of Taxpayer, performs nearly all hedging, risk management, trading, marketing, and foreign customer credit analysis related to the derivatives booked in B. Traders employed by C have discretionary trading authority, and they execute nearly all derivative transactions booked in B and record the transactions in the book-entry system. On rare occasions, during off hours in Country A, a trader employed by B, whose primary responsibilities are unrelated to the City A Managed Book, will execute a swap transaction for the City A Managed Book under specific instructions prepared by C’s traders. Taxpayer also represents that certain unique customer swap transactions are booked in C with the hedges, but these transactions constitute only about c% to d% of the total Country A based swap dealing activities.

The derivative transactions executed by C’s traders are recorded in the City A Managed Book, and Taxpayer calculates net profit from its dealing activity based on the net profit of this book. The City A Managed Book constitutes swap

² Years 2 through 4 constitute the Audit Period.

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transactions executed by C to which B is the counterparty and physical hedges purchased by C. Taxpayer adopted this practice to avoid stricter regulatory requirements applicable to swaps in Country A and to take advantage of a favorable tax treaty network Country A has with respect to other countries that enables C to avoid withholding taxes on payments and receipts on its hedge transactions.

A separate profit and loss statement is maintained with respect to the swap transactions, which Taxpayer and C use on a daily basis for purposes of hedging and management funding needs. This separate profit and loss accounting is used to allocate the profits and losses between B and C and to determine the compensation of C's employees who engage in activities with respect to the City A Managed Book. Taxpayer represented in meetings with the Service, that the swap transactions were entered into a separate computer system that C's traders used to record, value, and monitor the swaps (the X System), and that the transactions were individually identified with the City A Managed Book, which in turn was used to form the basis for journal entries into Taxpayer's financial accounting system. The amounts shown on the profit and loss statement that relate to the swaps held on B's books were reconciled by Taxpayer for Exam to Taxpayer's financial statements and consolidated tax return for each year at issue.

For internal management purposes, Taxpayer charges each trading book, including the City A Managed Book, a "cost of carry" in order to determine the operating profit or loss of the book. This approach applies overnight borrowing rates, that are generally available to Taxpayer, to the daily market value of the swaps and hedges. A separate cost of carry is charged to the City A Managed Book for swaps on B's books and for the hedges on C's books.³ The cost of carry is taken into account for measuring economic profit or loss of the City A Managed Book for purposes of compensating the employees associated with the City A Managed Book activities and to determine the allocation of profits and losses between B and C. The profit and loss of the City A Managed Book is comprised of the revenue from (1) swap and hedge transactions that independently reconcile to Taxpayer's financial statement profit and loss and tax accounting and transfer pricing methodologies and (2) cost of carry, which is calculated by reference to the asset and liability balances of the separate swaps and hedges.

³ Taxpayer's profit and loss statements show that a series of periodic cost of carry charges was applied separately for the swaps and the hedges rather than one periodic charge for each. For purposes of this Field Service Advice, the cost of carry charge refers to groupings or multiple charges that appear to have been made periodically.

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Taxpayer uses a mark-to-market method of accounting for its financial statements, for the City A Managed Book profit and loss accounting, and for management purposes to determine the compensation of C's employees and to allocate profits and losses between B and C. For other tax purposes, however, Taxpayer did not use a mark-to-market method for any years except Year 4.⁴ Exam reconciled the City A Managed Book profit and loss to the amounts taken into account by Taxpayer for tax purposes separately from Taxpayer's other managed books.

For its original tax returns, Taxpayer represented that it transferred from B to C all of the profits of the City A Managed Book reflected on B's books.⁵ After each year's transfer, C recognized all of the profit and loss of the City A Managed Book on C's and Taxpayer's original returns for U.S. and Country A tax purposes.

B. Taxpayer's description of its activities

1. Separate asset accounting for the City A Managed Book swaps

The City A Managed Book comprises foreign currency denominated swaps and hedges. Taxpayer provided information showing the breakdown of the assets of the City A Managed Book to Exam on Date b. Exam reconciled these balances to B's books and records and verified that they were included in the balances reported on Taxpayer's Form 1118:

| | \$ Value | \$ Value | \$ Value |
|-----------|----------|----------|----------|
| B's Books | | | Year 3 |

City A Managed Swaps -

⁴ For Years 2 and 3, the Service granted Taxpayer a change in accounting method so Taxpayer could account for its dealer swaps on the accrual method.

⁵ In demonstrating the book-to-tax reconciliations with respect to the City A Managed Book, Taxpayer noted in a memorandum dated Date c a discrepancy of approximately Amount A related to the transfer from B to C over the Audit Period. Taxpayer agreed to recognize this amount as income on its U.S. returns.

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TOTAL CITY A MANAGED SWAPS ON B's BOOKS

*OTHER SWAPS ON B's BOOKS***TOTAL SWAPS RECONCILED TO
B's BOOKS:**OTHER ASSETS
LESS:**GROSS ASSETS RECONCILED TO
TAXPAYER's B SUBSIDIARY W/P**

For Years 1 through 3, the percentage of City A Managed Swaps to the total swaps on B's books was approximately e%. For Year 4, Taxpayer did not provide the swap asset balances broken down by separate Managed Book to Exam. Taxpayer used the average percentage of the first three years (approximately e%) of B's total swaps for the City A Managed Book at the end of Year 4, because Taxpayer represented that the City A Managed Book operations remained the same relative to Taxpayer's swap dealing operations in other locations. Taxpayer represented that it operated the City A Managed Book during Year 4 in the same manner as for Years 2 and 3 and that it determined its cost of carry to the Book

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based on the same approach it used in the prior years. Thus, minimal distortion would result by using the average of the three prior years. Exam accepted this approach as reasonable.

2. Taxpayer's description of City A Managed Book functions

Taxpayer represented that C performed all marketing and risk management (market risk as well as credit risk) functions during the holding period of the contracts. Other than acting as counterparty to the City A Managed Swaps, Taxpayer represented that B performed only certain administrative functions. In support of its transfer pricing analysis, Taxpayer provided the following information concerning execution of transactions and documentation procedures for the City A Managed Book:

I. Transaction process procedures

1. C's traders execute the swap transactions using swap tickets that are pre-numbered by B.
2. C's operations unit is notified of new trades daily, receives completed deal tickets and confirmations, and verifies that trade tickets and confirmations are in agreement.
3. C's operations unit assigns account numbers to customers.
4. C's operations unit prepares complete trade packages and processes the information into the separate swap computer system. An additional person in C's operations unit separately conducts a review.

II. Operational controls performed by B in the United States

1. B's operations staff inputs swap rates in the mainframe computer for use by the traders in Taxpayer's on-line system.
2. B's operations staff reviews and approves the swap rate information input into the mainframe, which is also used to update individual transactions and update transaction accruals.

III. Accounting controls - revenue reporting performed by C in Country A

1. C's controller staff obtains copies of broker price screens at the end of each trading day.
2. C's controller staff runs reconciliation reports comparing swap details between the mainframe computer and the separate swap reporting system.

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3. C's controller staff prepares the profit and loss statement for the City A Managed Book.
4. C's traders review the City A Managed Book profit and loss statement.
5. C's controller staff publish the daily revenues for management.

IV. Cash movement and balance sheet controls performed by C in Country A

1. C's controller staff monitor cash control and movements in the accounts on a daily basis.
2. On a daily basis, cash receipts and payments are automatically "journalized" to a cash control account and are allocated to profit and loss accounts.
3. Realization of transaction amounts separately identified in C's trader's models are compared to those in the swaps computer system.
4. C balances the intercompany and cash control accounts and agrees the amounts with balances in the accounts in New York.

V. Trade validation

1. C's traders write deal tickets for new trades, assignments, or transactions that are unwound.
2. C's trade confirmations are distributed by an internal application to the controllers, operations personnel, and customers.
3. C's operations unit prepares daily activity reports to controllers and operations.
4. C's operations unit inputs deal ticket information such as the transaction description, cash flows, and valuations into the swaps computer system.
5. C's controllers compare the swap transaction description data, trade compliance information, the authorized currencies, swap contractual information under the ISDA master contracts, cross-checking to see if transactions were booked consistently in different legal entities.

VI. Documentation procedures

1. C's traders write the deal tickets. C's assistant trader faxes (same day) copy of the trade confirmation to the counterparty

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expressing agreed-upon economic terms. The matching deal ticket is sent to C's operations unit.

2. C's documentation staff receives a hard copy of the confirmation fax and establishes a file. Confirmations of trades are also sent to C's controllers and C's operations unit. If no master agreement exists with the counterparty, C sends a master agreement to the counterparty.
3. C's staff verifies the economic terms in the confirmation and compares the information in the operation unit's computer system to cross-check for discrepancies.
4. C and the counterparty to a transaction acknowledge transaction terms via a written proof of the transaction agreement.
5. C's confirmation letter (in accordance with the ISDA Agreement) is signed and a hard copy is sent to the counterparty for countersignature. A bilateral signed document is preferred mode of operation as a supplement to the Master Agreement.
6. C's original documentation is archived off-site from the City A offices. One copy is kept on-site.
7. C's information on completed transactions is recorded in a documentation database accessible to other documentation and operations staff.

VII. Daily cash payment procedures performed by B and C

A. Functions performed by B in the United States

1. B reviews a netted payment report for all U.S. dollar denominated cash flows.
2. B receives payment instructions in writing and enters them into a multiple delivery instruction system for all currencies.
3. B prepares a report of payments to be transmitted or "loaded" into an agent bank's system, and the payments are loaded onto an agent bank system and authorized.
4. The agent bank provides verification of its receipt of the U.S. dollar payment.

B. Functions performed by C in Country A

1. C reviews a netted payment report for all foreign currency denominated cash flows.

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2. C prepares a report of payments to be transmitted or loaded into an agent bank's system, and the payments are loaded onto the agent bank's system and authorized.
3. The agent bank provides verification of its receipt of the foreign currency payments.

VIII. Yield curve input

A. Functions performed by B in the United States

1. B prints Telerate and Reuters screens at the close of business for U.S. dollar denominated transactions.
2. B updates rates in the mainframe swaps computer system with the spread to Treasury securities provided by the traders.
3. Traders or trade support approve the rates.

B. Functions performed by C in Country A

1. C prints Telerate and Reuters screens at the close of business for foreign currency denominated transactions.
2. C updates rates in the mainframe swaps computer system with foreign currency par swap rates provided by C's traders.
3. Traders or trade support approve the rates.

C. Interest allocation with respect to B's assets for foreign tax credit purposes

On Form 1118 filed for each audit year, Taxpayer treated 100% of the City A Managed Book profits with respect to the swaps as U.S. source income and treated the gross assets described above as U.S. source for interest expense allocation purposes under §1.861-9T(g). All profits from the City A Managed Book that were booked in B were paid to C as compensation for entering into and risk managing the transactions for B, which acted as counterparty. Taxpayer classified this transfer from B to C as an expense directly related to the income, expense, gains, and losses from City A Managed Swaps for expense allocation purposes under §1.861-8. Taxpayer's request to adjust the transfer from 100% to b% would result in a disallowance of a% of the original expense deduction claimed by Taxpayer.

Although Taxpayer stated that it could not provide the individual asset balances for the City A Managed Book for each swap transaction as it had for Years 1 through 3, it did provide all of the income and loss by currency and the cost of carry charges on a separate year-end profit and loss statement of the City A Managed Book for Year 4. Taxpayer stated that the profit and loss amounts with

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respect to the swaps were derived from the ledger accounts that reconciled to B's general ledger and to Taxpayer's financial statements.

Taxpayer's dispute with the Service rests on the source of the asset balances shown above. It is generally advantageous to maximize foreign source net income for foreign tax credit purposes. In the present situation, it is advantageous to Taxpayer if its gross swap assets booked in B are treated as U.S. source because such treatment gives rise to a large allocation of its U.S. consolidated group interest expense to U.S. source income. By treating B's gross derivative assets as U.S. source, Taxpayer increased its foreign tax credit limitation. It is against this backdrop that Taxpayer argues that the separately accounted for profit and loss from the City A Managed Swaps held on B's books did not constitute a separate QBU of B that was resident in Country A.

D. Taxpayer's assertions concerning B's avoidance of a separate QBU resident in Country A

In response to an Information Document Request⁶ for a statement of Taxpayer's technical position supporting U.S. source treatment of the City A Managed Book swaps, Taxpayer provided the following arguments in a memorandum dated Date d:

1. The City A Managed Book swap income is sourced under §1.863-7. The income is U.S. source under §1.863-7(b) because B does not have a separate foreign resident QBU. B does not meet either test necessary for a separate QBU to exist under §1.989(a)-1 because:
 - A. B's foreign-based activity is not evidenced by separate books and records; and
 - B. C's entering into swap contracts in B's name does not constitute a trade or business for B. (B also apparently argues that because B does not have a foreign QBU, the rule requiring a QBU to be engaged in a trade or business in the jurisdiction where it is resident under section 988(a)(3)(B) cannot be met.)
2. The rule requiring swaps to be properly reflected on the books of the QBU also is not met because no separate QBU exists.

⁶ Information Document Request IE # 122

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3. C's activities on behalf of B cannot be attributed to B for purposes of creating a QBU because C's activities can only be attributed to B if C is a dependent agent. Further, dependent agent status is only relevant for purposes of subjecting B to tax in Country A, and not relevant for creating a QBU. Finally, there is no policy reason for departing from residence-based sourcing in this case because the income was not subject to foreign taxation.⁷

LAW AND ANALYSIS

As discussed below, Exam properly rejected all of the factual and technical arguments set forth in Taxpayer's memorandum and properly found that B's City A Managed Book activities constitute a QBU that is resident in Country A.

- A. The City A Managed Swaps booked in B are foreign currency swaps that are sourced under §1.988-4.

To determine the source of income with respect to the City A Managed Swaps, it is necessary to determine whether the swaps were foreign currency transactions within the meaning of section 988.

1. The functional currency of B's separate QBU is the U.S. dollar.

Taxpayer's City A Managed Book comprised swap transactions, all of which were denominated in foreign currencies. Taxpayer indicated that both B and C use the U.S. dollar as their functional currency. Section 985(b) provides that "the functional currency of any qualified business unit shall be the dollar if activities of such unit are primarily conducted in dollars." Whether a taxpayer or a QBU has a U.S. dollar functional currency depends on the economic environment in which the QBU conducts its activities. This determination is based on a facts and circumstances test in §1.985-1(c)(2).

Based on the information available, the functional currency of B's separate QBU is the U.S. dollar under §1.985-1(b)(1)(ii) because most of the swap transactions were entered into by reference to the U.S. dollar. All of the City A Managed Swaps were recorded in U.S. dollars and combined into the City A Managed Book, which was also reported to management and valued in U.S. dollars. Absent information to the contrary, we presume for purposes of this Field Service

⁷ Taxpayer asserted in a meeting with Exam that income with respect to the swaps should be sourced under section 865, which requires a foreign tax of 10% or more to be paid in order for the swap income to be treated as foreign source.

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Advice that the functional currency of B's separate QBU as evidenced by the City A Managed Book was the U.S. dollar. Accordingly, for sourcing purposes, all of the swap transactions in the City A Managed Book were transactions in nonfunctional currencies. Even if the U.S. dollar was not the QBU's functional currency, all or most of the transactions would nevertheless be in nonfunctional currencies, as demonstrated by Taxpayer's asset schedule.

2. Foreign currency swaps are section 988 transactions.

Taxpayer seeks to treat all of the City A Managed Swaps as U.S. source by erroneously applying §1.863-7(b) and section 865. Section 1.863-7(a)(1) states that its provisions "[do] not apply to income from a section 988 transaction within the meaning of section 988 and the regulations thereunder, relating to certain nonfunctional currency transactions." Section 1.988-1(a)(1)(ii) defines a section 988 transaction as any transaction that is described in paragraph (a)(2). Section 1.988-1(a)(2)(iii) provides that a section 988 transaction includes entering into or acquiring any forward contract, futures contract, option, warrant or similar financial instrument if the underlying property to which the instrument ultimately relates is a nonfunctional currency or generally is a foreign currency denominated debt instrument, payable or receivable. A currency swap is a notional principal contract that is within the term "similar financial instrument" if the payments required to be made or received under the contract are determined with reference to a nonfunctional currency. §1.988-1(a)(2)(iii)(B)(1) and (2). Accordingly, §1.863-7 does not apply to the nonfunctional currency swaps because those transactions (which comprised the entire book for each year) constitute section 988 transactions.

Similarly, Taxpayer argues that all of the City A Managed Swaps are U.S. source because section 865 applies. Section 1.988-4(a), however, states that "[t]his section takes precedence over section 865." Accordingly, all exchange gains and losses from the swap transactions are foreign currency gains and losses that are sourced under §1.988-4.

B. The City A Managed Swaps booked in B constitute a separate QBU of B resident in Country A.

The source of income with respect to the City A Managed Swaps is based on whether B has a separate QBU resident in Country A with respect to such swap dealing activities. A QBU is defined as a "separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records." Section 989(a); see also §1.989(a)-1(b); H.R. Rep. No. 841, 99th Cong., 2d Sess. II-660.

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The definition of a QBU requires that a two-part activities test be met: the separate unit of Taxpayer's trade or business itself must constitute a trade or business (as defined for purposes of the regulation), and a separate set of books and records must be maintained with respect to such activities. See §1.989(a)-1(b)(2)(ii). If C's swap dealing activities on behalf of B are evidenced by separate books and records, B will have a separate QBU whose residence will be determined by reference to the country where the QBU's principal place of business is located. §1.988-4(d)(2).

For the reasons detailed below, we conclude that B has a QBU resident in Country A because (1) C's regular and continuous exercise of contractual authority in B's name constituted a trade or business of B; (2) the City A Managed Book and profit and loss statements maintained by C throughout each taxable year were evidenced by separate transactions traceable to Taxpayer's X System and its journal entry system and thus satisfied the separate books and records requirement; and (3) the QBU that resulted from satisfying the two-part activities test has its principal place of business in Country A.

1. C's City A Managed Swaps activities constitute a trade or business activity within the meaning of §1.989(a)-1(c).

To qualify under the QBU trade or business standard, §1.989(a)-1(c) provides in relevant part:

Generally, a trade or business for purposes of section 989(a) is a specific unified group of activities that constitutes (or could constitute) an independent economic enterprise carried on for profit, the expenses related to which are deductible under section 162 or 212 (other than that part of section 212 dealing with expenses incurred in connection with taxes). To constitute a trade or business, a group of activities must ordinarily include every operation which forms a part of, or step in, a process by which an enterprise may earn income or profit.... It is not necessary that the activities carried out by a QBU constitute a different trade or business from those carried out by other QBUs of the taxpayer.

Whether a corporation or an activity of a corporation constitutes a trade or business is a factual determination. Generally, a trade or business exists if there is a regular, continuous, and considerable business activity. Pinchot v. Commissioner, 113 F.2d 718 (2d Cir. 1940). This principle applies in determining that a trader or dealer in securities is engaged in a trade or business. See Marrin

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v. Commissioner, 147 F.3d 147, 152 (2d Cir. 1998), aff'd T.C. Memo. 1997-24; United States v. Wood, 943 F.2d 1048, 1051 (9th Cir. 1991).

2. C's exercise of contractual authority on behalf of B constitutes a trade or business of B.

B satisfies the "trade or business" requirement in §1.989(a)-1(c) by merely acting as principal with respect to activities performed on its behalf by C. The regulations illustrate that the activities of an independent agent may cause a U.S. resident principal to be engaged in a trade or business within the meaning of §1.989(a)-1(c). Section 1.989(a)-1(e), Example 6 illustrates that an individual need not have a foreign office of its own and need not perform any activities other than to maintain, as owner, the portfolio of foreign currency investments managed by the independent broker. The example treats the U.S. individual as having a foreign QBU that will give rise to foreign source currency gains and losses with respect to the investments.

In determining what constitutes a trade or business, the courts have long held that the activities of an agent who trades securities with discretionary authority on behalf of another entity constitutes engaging in a trade or business, regardless of whether the principal has an office or fixed place of business in the location where the trade or business activity is conducted. See Adda v. Commissioner, 10 T.C. 273, aff'd, 171 F.2d 457 (4th Cir. 1948), cert. denied, 336 U.S. 952 (1949); Nubar v. Commissioner, 185 F.2d 584 (4th Cir.), cert. denied, 341 U.S. 925 (1951) (discretionary trading by an agent for a principal's proprietary account constituted trade or business of the principal). Similarly, an agent's dealer activities for its principal causes the principal to be engaged in a trade or business as a dealer in securities. Inverworld v. Commissioner, T.C. Memo. 1996-301, supplemented by T.C. Memo. 1997-226. See also Handfield v. Commissioner, 23 T.C. 633 (1955) (U.S.-based consignment contractor acting as exclusive distributor for Canadian seller of postal cards constituted a trade or business); Lewenhaupt v. Commissioner, 20 T.C. 151 (1953), aff'd, 221 F.2d 227 (9th Cir. 1955) (discretion granted by foreign resident alien to a related individual to contract in real estate and that was exercised by such individual was a U.S. trade or business of a foreign alien).

Further, the courts have held that even an independent agent may constitute a trade or business of a principal without requiring the conduct of business through a principal's office in the same location as the agent. See deAmodio v. Commissioner, 34 T.C. 894, aff'd, 299 F.2d 623 (3d Cir. 1962) (independent real estate agent activities in the United States constituted a trade or business of foreign principal although such activities were not a permanent establishment under

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the United States-Switzerland tax treaty). See also Taisei Fire & Marine Insurance Co., Ltd. v. Commissioner, 104 T.C. 535 (1995), acq., 1995-2 C.B. 1. The case law concerning whether a foreign person is engaged in a trade or business within the United States through the activities of an agent is relevant to determining whether a domestic taxpayer has a trade or business because the inbound cases rely on general trade or business principles that also apply to domestic taxpayers. Adda, 10 T.C. at 277 (citing Fuld v. Commissioner, 139 F.2d 465 (2d Cir. 1943)) (domestic taxpayer's extensive trading in commodities through brokers for its own account constituted a trade or business). Accordingly, no provision in the Code requires that such trading occur through a foreign office of the principal, or that the income be subject to tax by a foreign country, for a trade or business to exist as a result of the foreign agent's activities.

Taxpayer represented that C acted with full discretionary authority as agent for B to execute swap contracts for customers, binding B as principal with respect to such contracts. B conducted these activities daily on a full-time basis as described above. Because C's activities constitute the activities of a dealer in swaps and because C conducts these activities as an agent of B, B has a trade or business with respect to the City A Managed Book swaps under U.S. tax principles. Accordingly, the City A Managed Swaps will constitute a separate QBU of B if they are evidenced by separate books and records as described in §1.989(a)-1(d).

C. The City A Managed Swaps are evidenced by separate books and records under §1.989(a)-1(d).

In addition to the requirement that a particular activity of a corporation constitute a trade or business, a separate set of books and records must be maintained with respect to such activity in order for a QBU to exist. §1.989(a)-1(b)(2)(ii)(B). Taxpayer argues that since the City A Managed Book does not satisfy the "books and records" requirement, B does not have a separate QBU other than the QBU that constitutes B itself as a corporation under §1.989(a)-1(a)(2)(i). We disagree. Taxpayer's conclusion is contrary to its own description of its accounting system, recordkeeping, and reporting practices for the City A Managed Book, as well as the profit and loss accountings provided to Exam in support of the profit allocations of the City A Managed Book. Taxpayer itself argued that these practices constituted a reliable basis for allocating profits between B and C.

The regulations state that a "separate set of books and records shall include books of original entry and ledger accounts, both general and subsidiary, or similar records." §1.989(a)-1(d)(1). The regulation provides, for accrual basis taxpayers, that books of original entry include a journal to record sales (accounts receivable) and a journal to record expenses (accounts payable). Id. A journal is a

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chronological account of all transactions that an entity enters into during an accounting period. Id. A ledger account chronicles the impact during an accounting period of specific transactions recorded in the journal for that period upon the various items shown on the entity's balance sheet (i.e., assets, liabilities, and capital accounts) and income statement (i.e., revenues and expenses). Id.

Taxpayer's separate system for recording swap transactions (the X System) and measuring the profit and loss from these transactions meet the books and records requirement of §1.989(a)-1(d). The X System constitutes books of original entry because it chronologically records daily all swap transactions that C enters into on B's behalf. The swap tickets are prenumbered from B's system and separately identified for the accounts of the City A Managed Swaps Book. Specifically, C's traders, who execute all City A Managed Swaps that are booked in B, record the transactions in this book entry system. The City A Managed Swaps are accounted for on a separate City A Managed Swap profit and loss statement.

Taxpayer's description of its own documentation procedures for both the City A Managed Swaps and the City A Managed Book shows that the City A swap transactions are segregated into separate profit and loss reports prepared by a control unit of C and monitored on a daily basis by C's back office and traders. All City A Managed Swaps transactions are separately accounted for and, according to Taxpayer's own description, "journalized" into the cash control account on a daily basis. The profit and loss of the City A Managed Book is derived by reference to the movement in the swap asset (and liability) values and cash flows that are monitored by C on a daily basis. See Parts III (Accounting controls: revenue reporting performed by C in Country A) and IV (Cash movement and balance sheet controls performed by C in Country A) of Taxpayer's description of its City A Managed Book activities. These values and amounts were reconciled to Taxpayer's financial statements and U.S. consolidated tax return, and formed the basis for Taxpayer's allocation of profits and losses between B and C.

At a Date e meeting to discuss documentation supporting Taxpayer's allocation of profits between B and C, Taxpayer informed the Service that the swap transactions entered into on a daily basis by C's traders are first entered onto the City A Managed Book through the X System. Taxpayer explained the City A Managed Book is not derived from the journal entries that form Taxpayer's financial statements. Rather, it is the City A Managed Book transaction entries that are the points of original entry into Taxpayer's worldwide accounting system. The aggregation of the swap entries into the system that accounts for the City A Managed Book forms the basis for the journal entries to the financial accounts of the company. Accordingly, Taxpayer's financial statement entries are derived from the profits and losses reported on the management books and represent a

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consolidation of management book activities. Segregated accounting for the City A Managed Swaps enables Taxpayer to track offsetting positions held as counterparty by different legal entities.

The fact that Taxpayer's journal entries derive from high volume transactions that are aggregated into lump sum entries on B's books does not change the fact that the separate, original entries with respect to only the City A Managed Swaps are prepared by C's employees in Country A on behalf of B.

Taxpayer and C's ability to track the day-to-day asset and liability values of the separate swap transactions in the City A Managed Book was a necessary condition for its operation. Accordingly, the swaps in the City A Managed Book were marked to market and taken into account by Taxpayer's management separately for purposes of determining the net profit of that book. To determine such net profit, the cost of carry related to the swaps on the City A Managed Book was calculated from B's treasury desk in the United States and charged to the City A Managed Book (i.e., the transactions are segregated for mark-to-market purposes and for calculating cost of carry charges used on a daily, going concern basis). Further, Taxpayer's City A based managers managed the overall portfolio of swaps and hedges on a daily basis and monitored these balances in order to make informed decisions regarding the appropriate level of hedging. Finally, the compensation of C's employees was based on the portion of the net profit of the City A Managed Book that was derived in part from the City A Managed Swaps booked in B.

Taxpayer represented that it did not produce management reports reflecting the profits and losses of the City A Managed Book as frequently during the Audit Period as is done currently, but the QBU regulations do not require particular reporting intervals for profits and losses. The regulations only require that the ledger account chronicle the impact of specific transactions recorded in the journal during an accounting period on the assets, liabilities, capital, profits and losses. §1.989(a)-1(d). The assets and liabilities of the City A Managed Swaps and hedges were also contemporaneously identifiable throughout each taxable year because these amounts were used daily to calculate the cost of carry to the swaps and hedges separately. Taxpayer argues that the City A Managed Book does not satisfy the "separate books and records" requirement because the City A Managed Swaps are aggregated with B's other swaps for financial accounting purposes.

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However, Taxpayer ultimately did provide year end separate breakdowns by currency denomination for the City A Managed Swaps for Years 1 through 3.⁸

Taxpayer's segregation of journal entry transactions by the different Managed Books is what enables the separate monitoring and accruals of profits and losses for each separate business unit. It is this separately measured contribution to the City A Managed Book that forms the basis of the separate cost of carry calculations and the overall net profit of the City A Managed Book. If a separate profit and loss statement for the City A Managed Swaps were not available, it would have been impossible for B to allocate to C the correct amount of profits from the City A Managed Book. Further, it is the accuracy of reporting of the profits with respect to the separate City A Managed Swaps that, according to Taxpayer, demonstrates the arm's length nature of this profit allocation. Finally, Taxpayer represents that management used the profits of the segregated City A Managed Swaps transactions to compensate C's traders and other personnel who work on the City A Managed Book.

Based on the facts presented, a set of books and records that allowed Taxpayer to make these determinations existed at the time Taxpayer calculated its profit and loss and for employee compensation purposes. Taxpayer cannot now claim that these books and records do not exist for purposes of avoiding the separate books and records requirement of §1.989(a)-1(d). If they do not exist now, it is because Taxpayer failed to maintain them. If the records existed at the time the business was conducted, Taxpayer cannot retroactively elect not to have a QBU by failing to maintain or produce those records.

In a meeting with Exam, Taxpayer also argued alternatively that it did not have a QBU in Country A because its swap books and records were not maintained in the same location where the transactions were entered into, *i.e.*, in Country A. The regulations, however, only require that the transactions be recorded in the journal, not that the books and records be maintained in a particular location. See §1.989(a)-1(d)(1) and -1(e), Example 1 (domestic corporation maintained the separate set of books and records in United States with respect to all transactions conducted by its U.K. resident QBU). The regulations also illustrate that the separate books and records may be maintained by a person other than the taxpayer, such as a broker who manages a portfolio for a U.S. resident investor. See §1.989(a)-1(e), Example 6.

⁸ For Year 4, Taxpayer maintains that a separate breakout for even the entire City A Managed Swap balance is not available.

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Based on the facts presented, the City A Managed Book constituted a separate set of books and records within the meaning of §1.989(a)-1(d). Since Taxpayer was engaged in a trade or business through C's agent activities in Country A, B had a separate QBU within the meaning of §1.989(a)-1(b) for each of the audit years. As discussed below, B's income with respect to the City A Managed Book is foreign source if B's separate QBU is resident in Country A.

D. B's separate QBU is resident in Country A.

Section 1.988-4(d)(2) provides that "in the case of a qualified business unit of any taxpayer, the residence of such unit shall be the country in which the principal place of business of such qualified business unit is located." Based on the activities performed by B and by C on B's behalf in Country A, the principal place of business of the City A Managed Swap activity and the City A Managed Book is in Country A. All marketing, trading, and risk management functions are performed in Country A, and the predominant operations and back office functions are also handled and reported by employees of C. This conclusion is supported by the allocation of profits between B and C, which reflects the fact that C performs from its offices in City A most of the functions that generate the income in the City A Managed Book.

E. Taxpayer's City A Managed Swap assets are characterized as foreign source under §1.861-9T(g).

For each audit year, Taxpayer characterized all of the swaps on the City A Managed Book as assets that gave rise solely to U.S. source income in its interest allocation because Taxpayer did not treat these swaps as part of a separate QBU of B. As a result, the gross asset amounts shown above materially affected Taxpayer's consolidated interest allocation under §1.861-9T by allocating all interest expense associated with the assets of the City A Managed Book to U.S. source income.

Section 1.861-9T(g)(3) provides that assets are characterized for purposes of this section according to the source and type of the income that they generate, have generated, or may reasonably be expected to generate. In applying this rule, Taxpayer took the position that the City A Managed Swaps were U.S. source assets because the City A Managed Book activity did not constitute a separate QBU of B. As discussed above, however, B had a separate QBU resident in Country A and all of the income was foreign source under §1.988-4. Consequently all of the swap

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assets shown on the schedule above must be treated as foreign source assets in Taxpayer's interest expense allocation.⁹

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

1. Additional considerations with respect to sourcing

Taxpayer has represented that no straight U.S. dollar interest rate swaps were recorded on the City A Managed Book, and it did not explain whether the swaps identified on the asset balances as U.S. dollar denominated swaps in Years 2 through 4 are cross-currency swaps. Thus, we assume, and recommend that you hold Taxpayer to its representation, that none of the City A Managed Swaps are straight U.S. dollar swaps. However, should Taxpayer present new information, contrary to all prior representations, proving that it has straight U.S. dollar swaps, income from only these transactions would be sourced under §1.863-7(b) (as opposed to section 988 and §1.988-4). Because these rules adopt QBU rules analogous to the section 988 rules, the income from periodic payments and amortizations will also be foreign source. Section 1.863-7 provides that the source of income from U.S. dollar swaps is determined by reference to the residence of a QBU if (1) the taxpayer's residence, as determined under section 988(a)(3)(B)(i), is the United States; (2) the QBU's residence, as determined under section 988(a)(3)(B)(ii), is outside the United States; (3) the QBU is engaged in a trade or business where it is a resident; and (4) the swap is properly reflected on the books of the QBU.

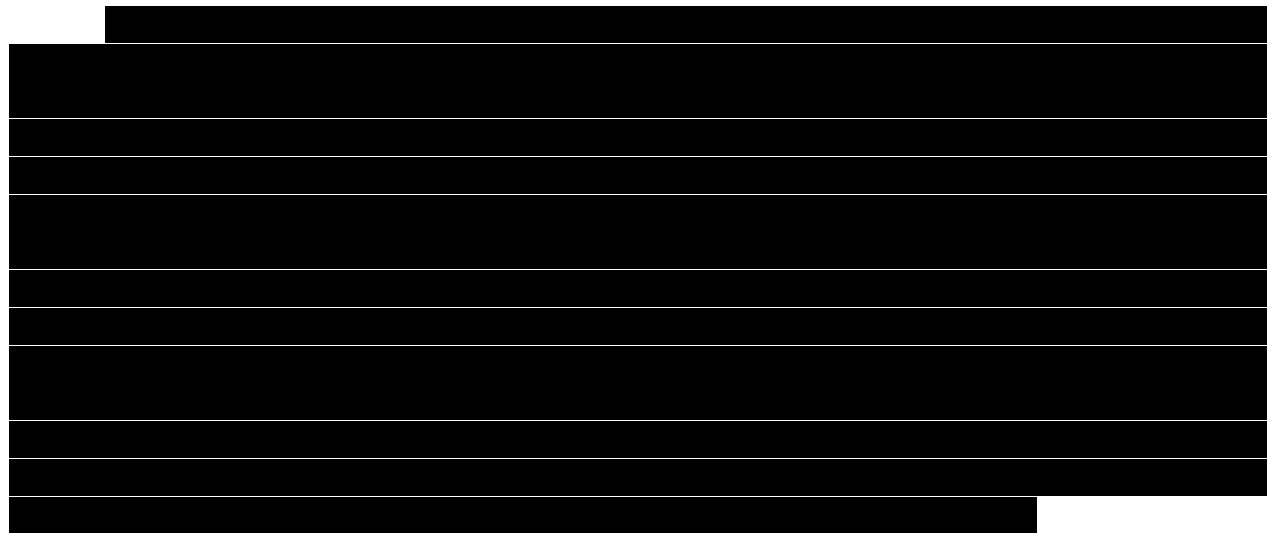
As discussed in Part B, Taxpayer has a QBU resident in Country A by virtue of C's dealing activities on behalf of B. In determining whether a swap is properly reflected on the books of the QBU, §1.863-7(b)((2)(iv) provides that the degree of participation in the negotiation and acquisition of a notional principal contract shall be taken into account. However, the rule provides that the Service may disregard a QBU's participation if it determines that a purpose for participating in an acquisition of the swap was to affect its source. For purposes of this case, we recommend that Exam treat all straight U.S. dollar swaps (if any exist), as properly reflected on the books of the foreign resident QBU. All periodic income will therefore be foreign source. Any periodic expense with respect to these swaps will be sourced reciprocally to the income and therefore will be allocable against foreign source income. See Notice 87-4, 1987-1 C.B. 416.

⁹ As also discussed above, this result is not affected by the fact that the aggregate swap book that comprises all the swaps from all of the Managed Books, may be held by B in the United States for financial accounting purposes. For purposes of characterizing the assets, §1.861-9T(g)(3) states that "the physical location of the assets is not relevant to this determination."

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Taxpayer further argued in its Date d memorandum that all gains and losses from the City A Managed Book Swaps should be sourced under section 865. As discussed above, section 988, not section 865, sources gains and losses from dispositions of nonfunctional currency swaps. Should Taxpayer prove that it has straight U.S. dollar swaps, resulting in a potential argument that section 865 applies to these swaps, we recommend that you contact the National Office for guidance concerning this limited group of transactions.

2. Additional considerations with respect to interest expense allocation



Further, under the facts described, no rule under §1.861-10T applies to allow Taxpayer to directly allocate interest expense to the swap income for foreign tax credit purposes. Lastly, if Taxpayer raises the netting rule in Prop. Reg. §1.884-1(d)(2)(xi) by analogy, its application should be rejected because the proposed rule is inapplicable to U.S. corporations and, in any event, is not currently effective.

Taxpayer acknowledged in its Date d memorandum that if its activities in Country A constituted a separate QBU of B, B would have a foreign resident QBU in Country B with respect to the City B Managed Book. You may wish to consider resourcing the City B Managed Book assets (denoted on Taxpayer's asset schedule as part of "other swaps on B's books") as well. If assets are not provided, you may try to allocate the remaining assets in B's Combined Book on the basis of relative gross income of the City B Managed Book to the U.S. Managed Book.

3. Foreign tax credit issue relating to Taxpayer's income from C

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Taxpayer acknowledged that C booked interest income as trading income (or loss) for the Audit Period but did not do so in later years. Exam stated that C also had hundreds of millions of dollars of interest income from related party transactions with Taxpayer's domestic affiliates. It appears that Taxpayer neglected to treat this income as giving rise to subpart F inclusions under section 951 to the extent of C's earnings and profits. Rather, we understand that Taxpayer reported dividend income on either the actual distributions C made or on a section 956 inclusion it reported in one of the years. (See section 4 below.) If the interest income earned by C was U.S. source income, then subpart F inclusions, or dividends subject to section 904(g)(5), would be treated as U.S. source income to Taxpayer under section 904(g). Such income might be eligible to be treated as foreign source income under the resourcing rule of Article 23 of the U.S.-Country A Treaty.



4. Coordination with other Field Service Advice

We understand that Exam made an accrual method of accounting adjustment for certain indexed options that were booked in C but that were unrelated to the City A Managed Book. The adjustment created a large increase in earnings and profits that will not be taxed in Country A and will likely absorb excess foreign tax credits for the Audit Period. Taxpayer may argue that the earnings and profits were distributed through a loan from B to a U.S. affiliate of Taxpayer that Taxpayer treated as a section 956 investment in U.S. property. A Field Service Advice issued by CC:INTL:Br2 concluded that certain back-to-back loans originating from another U.S. affiliate of Taxpayer to B might be collapsible and treated as a wholly domestic loan within the U.S. consolidated group. This would prevent the loan from C to the U.S. affiliate from being used as a vehicle to absorb the earnings and profits adjustment in C. In addition, we note that collapsing the loans into a domestic loan (the results of which would be eliminated on consolidation) would require a correlative adjustment to Taxpayer's related party loan from Taxpayer to C for §1.861-10T(e) purposes.

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