

Notice of Proposed Rulemaking and Notice of Public Hearing

Proposed Amendments to the Regulations on the Determination of Interest Expense Deduction of Foreign Corporations and Branch Profits Tax

INTL-0054-95

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed Income Tax Regulations relating to the determination of the interest expense deduction of foreign corporations under section 882 and the branch profits tax under section 884 of the Internal Revenue Code of 1986. These proposed regulations are necessary to provide guidance that coordinates with guidance provided in final regulations under sections 882 and 884 published in * * * [T.D. 8657, page 4, and T.D. 8658, page 13, this Bulletin]. These regulations will affect foreign corporations engaged in a U.S. trade or business. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by June 6, 1996. Outlines of topics to be discussed at the public hearing scheduled for Thursday, June 6, 1996, at 10:00 a.m. must be received by May 23, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (INTL-0054-95), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (INTL-0054-95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington DC. The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW., Washington DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regula-

tions, Ahmad Pirasteh or Richard Hoge, (202) 622-3870; and the hearing, Michael Slaughter (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed regulations amending the Income Tax Regulations (26 CFR Part 1) under sections 882 and 884 of the Internal Revenue Code. In final regulations under sections 882 and 884, published elsewhere in this issue of the Federal Register, various sections were reserved. These proposed regulations would provide guidance under those reserved sections, as well as amend other sections, to coordinate with the final regulations.

Explanation of the Provisions

I. Financial products.

The proposed regulations include several provisions that take into account recent developments in the tax treatment of financial instruments, such as the enactment of section 475, the development of hedging rules and the introduction of profit split methodologies in global trading Advance Pricing Agreements. The IRS and Treasury intend to issue regulations under section 864 that will address these recent developments as they affect the determination of a foreign corporation's effectively connected income. Comments are solicited on these proposed regulations as they relate to financial products and on their interaction with the determination of effectively connected income.

A. "*Split asset*" rule for section 475 securities and section 1256 contracts. Currently § 1.884-1(d)(2)(vii) provides a "split asset" rule for certain securities described in § 1.864-4(c)(5)(ii)(b)(3) that produce income only a portion of which is treated as effectively connected with the conduct of a U.S. trade or business. Since other securities may also produce income split between effectively connected and non-effectively connected income, the rule has been broadened to cover all financial instruments that meet the

definition of a security under section 475(c)(2), as well as section 1256 contracts, that may produce such split income. Accordingly, a foreign corporation that, under an Advance Pricing Agreement, is permitted to apply a "profit split" methodology to determine the portion of its income from a portfolio of securities that is effectively connected with the conduct of a U.S. trade or business would apply this rule. This rule will also apply to determine the portion of a foreign corporation's portfolio of securities that is a U.S. asset for purposes of § 1.882-5.

B. *Hedging transactions.* Proposed § 1.884-1(c)(2)(ii) introduces a new rule for hedging transactions for purposes of section 884. The new rule requires that a taxpayer increase or decrease, as the case may be, the amount of their U.S. assets by the amount of any gain or loss on any transaction that hedges the U.S. assets. If the hedging transaction is undertaken outside the United States, perhaps as part of a global hedging strategy of the foreign corporation, then the hedging transaction is only taken into account to the extent that income from the transaction would be treated as income effectively connected with the U.S. trade or business of the taxpayer. If, however, the hedging transaction is entered into by the U.S. branch, it will only affect the amount of U.S. assets if it is contemporaneously identified as a hedging transaction in accordance with the provisions of § 1.1221-2.

In response to comments, hedging rules also have been added to the interest allocation rules of § 1.882-5. These rules provide that a transaction that hedges a U.S. booked liability will be taken into account in determining the amount, currency denomination, and interest rate associated with that liability for purposes of performing the second and third steps of the interest expense calculation.

C. *Securities marked-to-market.* Section 1.884-1(d)(6), which provides "E&P basis" rules for specific types of U.S. assets, has been clarified to provide rules for securities subject to mark-to-market accounting. The new provision in § 1.884-1(d)(6)(v) specifies that securities subject to section 475, as well as section 1256 contracts, have an E&P basis equal to their mark-to-market value as of the determination

date. Proposed § 1.882-5(b)(2)(iv) provides a basis adjustment rule under which such assets are treated as having been marked-to-market on each determination date. Examples are contained in the proposed regulations that illustrate the effect of these rules on the calculation of worldwide assets and liabilities.

II. Transactions between partners and partnerships.

Example 4 in proposed § 1.882-5(c)(5) would clarify that an obligation of a partnership to make payments to its partner for the use of capital, which gives rise to guaranteed payments under section 707(c), is not a liability for purposes of § 1.882-5. The Service and Treasury solicit comments on the treatment of loans between partners and partnerships as part of Treasury's review of the international tax aspects of pass-through entities.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Request for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (signed original and eight (8) copies) that are timely submitted to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Thursday, June 6, 1996, at 10:00 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW., Washington DC. Because of

access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons that wish to present oral comments at the hearing must submit written comments by June 6, 1996, and submit an outline of topics to be discussed and time to be devoted to each topic (signed original and eight (8) copies) by May 23, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

Several persons from the Office of Chief Counsel and the Treasury Department participated in drafting these regulations.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1

continues to read in part as follows:

Authority: 26 U.S.C. 7805. * * *

Par. 2. Section 1.882-5 is amended as follows:

- 1. The text of paragraph (b)(2)(iv) is added.
2. The text of paragraph (c)(2)(v) is added.
3. In paragraph (c)(5), Example 4, Example 6, and Example 7 are added.
4. The text of paragraph (d)(2)(vi) is added.
5. In paragraph (d)(6), Example 4 is added.
6. The text of paragraph (e)(3) is added.
7. In paragraph (e)(5), Example 2 is added.
8. The text of paragraph (f)(2) is added.

The added provisions read as follows:

§ 1.882-5 Determination of interest deduction.

* * * * *

(b) * * *

(2) * * *

(iv) Adjustment to basis of financial instruments. The basis of a security or contract that is marked to market pursuant to section 475 or section 1256 will be determined as if each determination date were the last business day of the taxpayer's taxable year. A financial instrument with a fair market value of less than zero is a liability, not an asset, for purposes of this section.

* * * * *

(c) * * *

(2) * * *

(v) Hedging transactions. A transaction (or transactions) that hedges an asset or liability, or a pool of assets or a pool of liabilities, will be taken into account in determining the value, amount and currency denomination of the asset or liability that it hedges. A transaction will be considered to hedge an asset or liability only if the transaction meets the requirements of § 1.1221-2.

* * * * *

(5) * * *

Example 4. Partnership liabilities. X and Y are each foreign corporations engaged in the active conduct of a trade or business within the United States through a partnership, P. Under the partnership agreement, X and Y each have a 50% interest in the capital and profits of P, and X is also entitled to a return of 6% per annum on its capital account that is a guaranteed payment under section 707(c). In addition, P has incurred a liability of \$100x to an unrelated bank, B. Under paragraph (c)(2)(vi) of this section, X and Y each share equally in P's liability to B. In accordance with U.S. tax principles, P's obligation to make guaranteed payments to X does not constitute a liability of P, and therefore neither X nor Y take into account that obligation of the partnership in computing their actual ratio.

* * * * *

Example 6. Securities in ratio as assets. FC is a foreign corporation engaged in a trade or business in the United States through a U.S. branch. FC is a dealer in securities within the meaning of section 475(c)(1)(B) because it regularly offers to enter into positions in currency spot and forward contracts with customers in the ordinary course of its trade or business. FC has not elected to use the fixed ratio. On December 31, 1996, the end of FC's taxable year, the mark-to-market value of the spot and forward contracts entered into by FC worldwide is 1000x, which includes a mark-to-

market gain of 500x with respect to the spot and forward contracts that are shown on the books of its U.S. branch and that produce effectively connected income. On its December 31, 1996, determination date, FC includes 500x in its U.S. assets, and 1000x in its worldwide assets.

Example 7. Securities in ratio as assets and liabilities. The facts are the same as in *Example 4*, except that on December 31, 1996, the mark-to-market value of the spot and forward contracts entered into by FC worldwide is 1000x, and FC has a mark-to-market loss of 500x with respect to the spot and forward contracts that are shown on the books of its U.S. branch and that would produce effectively connected income. On its December 31, 1996, determination date, FC includes the 1000x in its worldwide assets for purposes of determining its ratio of worldwide liabilities to worldwide assets. For purposes of Step 3, however, FC has U.S.-booked liabilities in the United States equal to the 500x U.S. loss position.

(d) * * *

(2) * * *

(vi) *Hedging transactions.* A transaction (or transactions) that hedges a U.S. booked liability, or a pool of U.S. booked liabilities, will be taken into account in determining the currency denomination, amount of, and interest rate associated with, that liability. A transaction will be considered to hedge a U.S. booked liability only if the transaction meets the requirements of § 1.1221-2(a), (b), and (c), and is identified in accordance with the requirements of § 1.1221-2(e).

* * * * *

(6) * * *

Example 4. Liability hedge—(i) Facts. FC is a foreign corporation that meets the definition of a bank, as defined in section 585(a)(2)(B) (without regard to the second sentence thereof), and that is engaged in a banking business in the United States through its branch, B. FC's corporate policy is to match the currency denomination of its assets and liabilities, thereby minimizing potential gains and losses from currency fluctuations. Thus, at the close of each business day, FC enters into one or more hedging transactions as needed to maintain a balanced currency position, and instructs each branch to do the same. At the close of business on December 31, 1998, B has 100x of U.S. dollar assets, and U.S. booked liabilities of 90x U.S. dollars and 1000x Japanese yen (exchange rate: \$1 = ¥100). To eliminate the currency mismatch in this situation, B enters into a forward contract with an unrelated third party that requires FC to pay 10x dollars in return for 1000x yen. Through this hedging transaction, FC has effectively converted its 1000x Japanese yen liability into a U.S. dollar liability. FC uses its actual ratio of 90% in 1998 for Step 2, the adjusted U.S. booked liabilities method for purposes of Step 3, and is a calendar year taxpayer.

(ii) *Analysis.* Under paragraph 1.882-5(d)(2)(vi), FC is required to take into account hedges of U.S. booked liabilities in determining

the currency denomination, amount, and interest rate associated with those liabilities. Accordingly, FC must treat the Japanese yen liabilities booked in the United States on December 31, 1998, as U.S. dollar liabilities to determine both the amount of the liabilities and the interest paid or accrued on U.S. booked liabilities for purposes of this section. Moreover, in applying the scaling ratio prescribed in paragraph (d)(4)(i) of this section, FC must scale back both the U.S. booked liabilities and the hedge(s) of those liabilities. Assuming that FC's average U.S. booked liabilities for the year ending December 31, 1998, exceed its U.S.-connected liabilities determined under paragraphs (a)(1) through (c)(5) of this section by 10%, FC must scale back by 10% both its interest expense associated with U.S. booked liabilities, and any income or loss from the forward contract to purchase Japanese yen that hedges its U.S. booked liabilities.

(e) * * *

(3) *Hedging transactions.* A transaction (or transactions) that hedges a liability, or a pool of liabilities, will be taken into account in determining the amount of, or interest rate associated with, that liability. A transaction will be considered to hedge a liability only if the transaction meets the requirements of § 1.1221-2(a), (b), and (c).

* * * * *

(5) * * *

Example 2. Asset hedge—(i) Facts. FC is a foreign corporation that meets the definition of a bank, as defined in section 585(a)(2)(B) (without regard to the second sentence thereof), and that is engaged in the banking business in the United States through its branch, B. FC's corporate policy is to match the currency denomination of its assets and liabilities, thereby minimizing potential gains and losses from currency fluctuations. Thus, at the close of each business day, FC enters into one or more hedging transactions as needed to maintain a balanced currency position, and instructs each branch to do the same. At the close of business on December 31, 1998, B has two U.S. assets, a loan of 90x U.S. dollars and a loan of 1000x Japanese yen (exchange rate: \$1 = ¥100). B has U.S. booked liabilities, however, of 100x U.S. dollars. To eliminate the currency mismatch, B enters into a forward contract with an unrelated third party that requires FC to pay 1000x yen in return for 10x dollars. Through this hedging transaction, FC has effectively converted its 1000x Japanese yen asset into a U.S. dollar asset. FC uses its actual ratio of 90% in 1998 for Step 2, has elected the separate currency pools method in paragraph (e) of this section, and is a calendar year taxpayer.

(ii) *Analysis.* Under paragraph (e)(1)(i) of this section, FC must take into account any transaction that hedges a U.S. asset in determining the currency denomination and value of that asset. FC's Japanese yen asset will therefore be treated as a U.S. dollar asset in determining its U.S. assets in each currency. Accordingly, FC will be treated as having only U.S. dollar assets in making its separate currency pools computation.

(f) * * *

(2) *Special rules for financial products.* Paragraphs (b)(2)(iv), (c)(2)(v), (d)(2)(vi), and (e)(3) of this section will be effective for taxable years beginning on or after the date these regulations are published as final regulations in the Federal Register.

Par. 3. Section 1.884-1 is amended as follows:

1. Paragraph (c)(2)(iii) is added.

2. Paragraph (d)(2) is amended as follows:

a. Paragraph (d)(2)(vii) is revised.

b. In paragraph (d)(2)(xi), *Example 6* through *Example 8* are added.

3. The text of paragraph (d)(6)(v) is added.

4. In paragraph (i)(4), a sentence is added at the end of the existing text.

The revised and added provisions read as follows:

§ 1.884-1 Branch profits tax.

* * * * *

(c) * * *

(2) * * *

(iii) *Hedging transactions.* A transaction that hedges a U.S. asset, or a pool of U.S. assets, will be taken into account in determining the amount of that asset (or pool of assets) to the extent that income or loss from the hedging transaction produces ECI or reduces ECI. A transaction that hedges a U.S. asset, or pool of U.S. assets, is also taken into account in determining the currency denomination of the U.S. asset (or pool of U.S. assets). A transaction will be considered to hedge a U.S. asset only if the transaction meets the requirements of § 1.1221-2(a), (b), and (c), and is identified in accordance with the requirements of § 1.1221-2(e).

(d) * * *

(2) * * *

(vii) *Financial instruments.* A financial instrument, including a security as defined in section 475 and a section 1256 contract, shall be treated as a U.S. asset of a foreign corporation in the same proportion that the income, gain, or loss from such security is ECI for the taxable year.

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(xi) * * *

Example 6. Hedging transactions—(i) Facts. FC is a foreign corporation engaged in a trade or

business in the United States through a U.S. branch. The functional currency of FC's U.S. branch is the U.S. dollar. On January 1, 1997, in the ordinary course of its business, the U.S. branch of FC enters into a forward contract with an unrelated party to purchase 100 German marks (DM) on March 31, 1997, for \$50. To hedge the risk of currency fluctuation on this transaction, the U.S. branch also enters into a forward contract with another unrelated party to sell 100 DM on March 31, 1997, for \$52, identifying this contract as a hedging transaction in accordance with the requirements of § 1.1221-2(e). FC marks its foreign currency transactions to market for U.S. tax purposes.

(ii) *Net assets.* At the end of FC's taxable year, the value of the forward contract to purchase 100 DM is marked to market, resulting in gain of \$10 being realized and recognized as U.S. source effectively connected income by FC. Similarly, FC marks to market the contract to sell 100 DM, resulting in \$8 of realized and recognized loss by FC. Pursuant to paragraph (c)(2)(iii) of this section, FC must increase or decrease the amount of its U.S. assets to take into account any transaction that hedges the contract to purchase 100 DM. Consequently, FC has a U.S. asset of \$2 (\$10 (the adjusted basis of the contract to purchase 100 DM) - \$8 (the loss on the contract to sell 100 DM)).

Example 7. Split hedge. The facts are the same as in *Example 5*, except that the contract to sell

100 DM is entered into with an unrelated third party by the home office of FC. FC includes the contract to sell 100 DM in a pool of assets treated as producing income effectively connected with the U.S. trade or business of FC. Therefore, under paragraph (c)(2)(iii) of this section, at its next determination date FC will report a U.S. asset of \$2, computed as in *Example 5*.

Example 8. Securities. FC is a foreign corporation engaged in a U.S. trade or business through a branch in the United States. During the taxable year 1997, FC derives \$100 of income from securities, of which \$60 is treated as U.S. source effectively connected income under the terms of an Advance Pricing Agreement that uses a profit split methodology. Accordingly, pursuant to paragraph (d)(2)(vii) of this section, FC has a U.S. asset equal to 60% (\$60 of ECI divided by \$100 of gross income from securities) of the value of the securities.

* * * * *

(6) * * *

(v) *Computation of E&P basis of financial instruments.* For purposes of this section, the E&P basis of a security that is marked to market under section 475 and a section 1256 contract shall be adjusted to take into

account gains and losses recognized by reason of section 475 or section 1256. The E&P basis must be further adjusted to take into account a transaction that hedges a U.S. asset, as provided in paragraph (c)(2)(ii) of this section.

* * * * *

(i) * * *

(4) * * * Paragraphs (c)(2)(iii), (d)(2)(vii), and (d)(6)(v) of this section will be effective for taxable years beginning on or after the date these regulations are published as final regulations in the Federal Register.

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Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on March 5, 1996, 8:45 a.m., and published in the issue of the Federal Register for March 8, 1996, 61 F.R. 9377)