

## Section 864.—Definitions and Special Rules

*26 CFR 1.864-4: U.S. source income effectively connected with U.S. business.*

**T.D. 8657**

**DEPARTMENT OF THE TREASURY  
Internal Revenue Service  
26 CFR Parts 1 and 602**

### **Regulations on Effectively Connected Income and the Branch Profits Tax**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final and temporary regulations.

**SUMMARY:** This document contains final Income Tax Regulations relating to the determination of effectively connected income under section 864 and final and temporary Income Tax Regulations relating to the branch profits tax and branch-level interest tax under section 884 of the Internal Revenue Code of 1986 (Code). Section 884 was added to the Code by section 1241 of the Tax Reform Act of 1986. This document also contains conforming changes to sections 861, 871 and 897.

EFFECTIVE DATE: June 6, 1996.

FOR FURTHER INFORMATION CONTACT: Gwendolyn A. Stanley, (202) 622-3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

#### *Paperwork Reduction Act*

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1070.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated annual burden per respondent is .25 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may be material in the administration of any internal revenue law. Generally, tax returns and tax information are confidential, as required by 26 U.S.C. 6103.

#### *Background*

On September 2, 1988, proposed and temporary regulations (TD 8223 and INTL-934-86 [1988-2 C.B. 825]) under section 884 were published in the Federal Register (53 FR 34045). Written comments were received on the proposed amendments. On September 11, 1992, temporary regulations under § 1.884-2T were amended and final regulations (1992 final regulations) (TD 8432 [1992-2 C.B. 157]) under section 884 of the Code were published in the Federal Register (57 FR 41644). Proposed amendments (1992 proposed regulations) (INTL-0003-92 [1992-2 C.B.

752]) to the Income Tax Regulations (26 CFR part 1) under sections 864 and 884 of the Internal Revenue Code were published in the Federal Register (57 FR 41707) on the same day. Written comments were received on the proposed amendments. After consideration of all the comments, § 1.884-2(a)(2)(ii) and § 1.884-2(c)(2)(iii) of the 1988 proposed regulations and the 1992 proposed regulations are adopted as final regulations as amended by this Treasury decision. The revisions and conforming changes are discussed below.

#### *Explanation of the Provisions*

##### *I. Section 864 stock rule.*

The proposed regulations under section 864 provided that stock of a corporation shall not be treated as an asset used in, or held for use in, the conduct of a U.S. trade or business. Accordingly, the regulations proposed to delete the example of stock acquired and held to assure a constant source of supply as an asset that satisfies the asset-use test under § 1.864-4(c)(2). Commenters criticized this rule and cited to the legislative history to the Foreign Investors Tax Act of 1966 as contemplating that stock may satisfy the asset-use test. The IRS and Treasury continue to believe, however, that stock does not satisfy the asset-use test. Therefore § 1.864-4(c)(2)(iii) adopts the rule contained in the proposed regulations.

In response to our request for comments on whether insurance companies require an exception to the stock rule for their portfolio stock, one commenter suggested that foreign life insurance companies be permitted to refer to the National Association of Insurance Commissioners (NAIC) Annual Statement to determine whether their assets are used in, or held for use in, the conduct of a U.S. trade or business. The IRS and Treasury will continue to consider whether modifications to the regulations under section 864 are appropriate for foreign insurance companies and reserve on the treatment of stock held by a foreign insurance company.

Conforming changes have been made to regulations under section 864, as well as regulations under sections 871 and 897 to reflect the clarification of § 1.864-4(c)(2). The effective date of

the changes to sections 871 and 897 corresponds to the effective date of the changes to section 864.

##### *II. Branch profits tax.*

*A. Interest in a partnership.* Currently, a foreign corporation engaged in a U.S. trade or business through a partnership applies different rules to determine its U.S. assets depending on whether the determination is for purposes of section 884 or § 1.882-5. For purposes of computing its interest expense under § 1.882-5, the rules of § 1.861-9T(e)(7) apply. Therefore a foreign corporation takes into account either its pro rata share of partnership assets and liabilities or applies the rules of § 1.882-5 as if the partnership were a foreign corporation, depending on the nature of its interest in the partnership. In contrast, for purposes of section 884, a foreign corporation generally takes into account its adjusted basis in its partnership interest as a starting point for determining its U.S. assets.

Final regulations under section 882 published elsewhere in this issue of the Federal Register remove the temporary regulations under § 1.861-9T(e)(7)(i). These final regulations provide a new U.S. asset rule for partnership interests for purposes of determining the U.S. assets of a foreign corporate partner under sections 882 and 884. The final regulations under § 1.882-5 contain a corresponding rule to determine the value of a partnership interest held by a foreign corporation for purposes of computing its worldwide assets.

In the event that a partnership derives any income that is not effectively connected with a U.S. trade or business, or otherwise holds non-U.S. assets, the rules in § 1.884-1(d)(3) continue to provide a rule that allocates the basis in the partnership interest between U.S. and non-U.S. assets. However, the allocation rule is more flexible than the rule contained in either the 1992 final regulations or the proposed regulations under section 884. The rule allows a foreign corporation to use either an income method or an asset method to determine the proportionate share of its partnership interest that is a U.S. asset, regardless of its ownership interest in the partnership. This is a change from the previous 1992 final regulations, which required all foreign corporate partners to use an income method, and from the 1992

proposed regulations, which required more than 10% partners to use the asset method.

Based on commenters' suggestions, other clarifying changes have been made to the asset method. For example, the final regulations clarify that the adjusted bases of partnership assets reflect any adjustment under section 754 with respect to a foreign corporate partner.

*B. Interest in a trust or estate.* The rules applicable to interests in a trust or estate in § 1.884-1(d)(4) are finalized as proposed.

*C. Nonrecourse indebtedness and integrated financial transactions.* Because the final regulations under § 1.882-5 incorporate the special allocation rules of § 1.861-10T, certain changes to the final regulations under § 1.884-1(e) are needed to maintain the proper U.S. net equity of a foreign corporation that elects to directly allocate any portion of its interest expense. These regulations include a conforming change that provides that liabilities giving rise to such interest will be considered U.S. liabilities for purposes of section 884, notwithstanding that such liabilities are not taken into account in Step 2 of § 1.882-5.

In addition, a new provision has been added in § 1.884-4(b) so that branch interest continues to include interest paid with respect to liabilities that are subject to the special allocation rules, notwithstanding that such liabilities are not considered U.S. booked liabilities for purposes of Step 3 of the § 1.882-5 calculation.

*D. Structural changes to conform branch interest rules to final regulations under § 1.882-5.* These regulations adopt the changes made by the 1992 proposed regulations under § 1.884-4(b), and thus incorporate the rules in § 1.882-5(d)(2) (relating to U.S. booked liabilities) in defining the term branch interest of a foreign corporation. Although certain changes were made to the definition of U.S. booked liabilities in the final regulations under § 1.882-5, the manner in which a foreign corporation computes its branch interest and excess interest remains substantially unchanged.

*E. Excess interest—definition of a foreign bank.* A foreign corporation

that is a foreign bank may treat a minimum of 85% of its excess interest as interest on deposits, regardless of its actual ratio of deposits to interest bearing liabilities. The IRS and Treasury believe this rule should be applicable only to a foreign bank engaging in substantial deposit-taking activities, taking into account its activities in the United States as well as other countries in which it operates. The definition used in the 1992 final regulations did not clearly convey this limitation. Thus, § 1.884-4(a)(2)(iii) now defines a foreign bank by reference to section 585(a)(2)(B) of the Code, but also requires that a substantial part of its business consists of receiving deposits and making loans and discounts.

### III. Complete termination rules.

The rules in § 1.884-2T(a)(5), applicable to a foreign corporation whose beneficial interest in a trust terminates, are finalized as proposed by the 1992 regulations. In addition the waiver provisions contained in § 1.884-2 of the 1988 proposed regulations are finalized as amended by this Treasury decision.

### Special Analyses

It has been determined that this Treasury decision 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 Procedure 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, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### Drafting Information

The principal author of these regulations is Gwendolyn A. Stanley, Office of Associate Chief Counsel (International), within the Office of Chief Counsel, IRS. However, other personnel from the IRS and Treasury Department participated in their development.

## Adoption of amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

### PART 1—INCOME TAXES.

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805.

Section 1.884-2 also issued under 26 U.S.C. 884(g)

Par. 2. Section 1.864-4 is amended as follows:

1. The third sentence in paragraph (c)(2)(i) is revised.

2. Paragraph (c)(2)(ii) is revised.

3. Paragraphs (c)(2)(iii) and (c)(2)(iv) are redesignated as (c)(2)(iv) and (c)(2)(v) respectively.

4. New paragraph (c)(2)(iii) is added.

5. Newly designated paragraph (c)(2)(v) is amended by:

a. Revising the introductory text.

b. Removing *Example (2)* through *Example (4)*.

c. Redesignating “*Example (5)*” as “*Example (2)*”.

d. Amending newly designated *Example (2)* by:

i. Revising the fifth and sixth sentences.

ii. Removing the date “1968” and adding the date “1997” where it appears in the second, third, and eighth sentences.

6. The last sentence of paragraph (c)(6)(i) is removed.

7. Paragraph (c)(7) is added.

The additions and revisions read as follows:

*§ 1.864-4 U.S. source income effectively connected with U.S. business.*

(c)

(2)

(i) The asset-use test is of primary significance where, for example, interest income is derived from sources within the United States by a nonresident alien individual or foreign corporation that is engaged in the

business of manufacturing or selling goods in the United States. \* \* \*

(ii) *Cases where applicable.* Ordinarily, an asset shall be treated as used in, or held for use in, the conduct of a trade or business in the United States if the asset is—

(a) Held for the principal purpose of promoting the present conduct of the trade or business in the United States; or

(b) Acquired and held in the ordinary course of the trade or business conducted in the United States, as, for example, in the case of an account or note receivable arising from that trade or business; or

(c) Otherwise held in a direct relationship to the trade or business conducted in the United States, as determined under paragraph (c)(2)(iv) of this section.

(iii) *Application of asset-use test to stock—(a) In general.* Except as provided in paragraph (c)(2)(iii)(b) of this section, stock of a corporation (whether domestic or foreign) shall not be treated as an asset used in, or held for use in, the conduct of a trade or business in the United States.

(b) *Stock held by foreign insurance companies.* [Reserved]

(v) *Illustration.* The application of paragraph (iv) may be illustrated by the following examples:

*Example (2).* \* \* \* During 1997, the branch office derives from sources within the United States interest on these securities, and gains and losses resulting from the sale or exchange of such securities. Since the securities were acquired with amounts generated by the business conducted in the United States, the interest is retained in that business, and the portfolio is managed by personnel actively involved in the conduct of that business, the securities are presumed under paragraph (c)(2)(iv)(b) of this section to be held in a direct relationship to that business.

(7) *Effective date.* Paragraphs (c)(2) and (c)(6)(i) of this section are effective for taxable years beginning on or after June 6, 1996.

Par. 3. In § 1.871–12, paragraph (d) is amended by:

1. Revising the paragraph heading and introductory text.

2. Removing *Example 1*.
3. Removing the designation “(2)” in *Example (2)*.

The revision reads as follows:

§ 1.871–12 *Determination of tax on treaty income.*

(d) *Illustration.* The application of this section may be illustrated by the following example:

Par. 4. Section 1.884–0(b) is amended by revising the entries for §§ 1.884–1(d)(4), 1.884–2T(a)(5), 1.884–4(b)(1), and 1.884–4(b)(2) and adding entries for §§ 1.884–1(i)(4), 1.884–2T(a)(6), 1.884–4(e)(1) and 1.884–4(e)(2) to read as follows:

§ 1.884–0 *Overview of regulation provisions for section 884.*

(b)

§ 1.884–1 *Branch profits tax.*

(d)

(4) Interest in a trust or estate.

(i)

(4) Special rule for certain U.S. assets and liabilities.

§ 1.884–2T *Special Rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary (temporary).*

(a)

(5) Special rule if a foreign corporation terminates an interest in a trust. [Reserved]

(6) Coordination with second-level withholding tax.

§ 1.884–4 *Branch-level interest tax.*

(b)

(1) Definition of branch interest.

(2) [Reserved]

(3)

(4) [Reserved]

(e)

(1) General rule.

(2) Special rule.

Par. 5. Section 1.884–1 is amended as follows:

1. Paragraph (c)(2) is amended as follows:

a. The text of paragraph (c)(2) is redesignated as paragraph (c)(2)(i) and a paragraph heading for (c)(2)(i) is added.

b. New paragraph (c)(2)(ii) is added.

2. In paragraph (d)(2)(xi), *Example 2* through *Example 4* are redesignated *Example 3* through *Example 5*, respectively, and new *Example 2* is added.

3. Paragraph (d)(3) is revised.

4. The text of paragraph (d)(4) is added.

5. Paragraph (d)(5)(iii) is revised.

6. In Paragraph (d)(6)(iii) the reference to “(d)(3)(iv)” is removed and “(d)(3)(vi)” is added in its place.

7. Paragraph (d)(6)(v) is redesignated as paragraph (d)(6)(vi).

8. New paragraph (d)(6)(v) is added and reserved.

9. Paragraph (e)(2) is amended as follows:

a. The paragraph heading and text of paragraph (e)(2) are redesignated as paragraph (e)(2)(i).

b. In newly designated paragraph (e)(2)(i) the language “(e)(2)” is removed and “(e)(2)(i)” is added in its place.

c. A new paragraph heading for paragraph (e)(2) is added.

d. Paragraph (e)(2)(ii) is added.

10. Paragraph (e)(3)(ii) is revised.

11. Paragraph (e)(5) is amended as follows:

a. The second sentence in *Example 1* is revised.

b. In the list below, for each sentence in *Example 1* indicated in the left column, remove the language in the middle column and add the language in the right column:

<i>sentence</i>	<i>Remove</i>	<i>Add</i>
first and third sentence	1993	1997
first sentence	§ 1.882-5(b)	§ 1.882-5(c)
fourth and fifth sentence	§ 1.882-5(b)(2)	§ 1.882-5(c)(2)
seventh sentence	amount	value
seventh sentence	§ 1.882-5(b)(1)	§ 1.882-5(b)(2)

c. The second sentence in paragraph (i) of *Example 2* is revised.

d. In the list below, for each paragraph in *Example 2* indicated in the left column, remove the language in the middle column and add the language in the right column:

<i>Paragraph</i>	<i>Remove</i>	<i>Add</i>
(i) first sentence	1993	1997
(i) third and fifth sentence	1994	1998
(ii) first, second, and third sentence	1995	1999
(ii) second sentence	1994	1998
(iii) first sentence	1995	1999
(iii) last sentence	1994	1998

12. Paragraph (i)(4) is added.

The additions and revisions read as follows:

§ 1.884-1 *Branch profits tax.*

(c)

(2)(i) *In general.*

(ii) *Bad debt reserves.* A bank described in section 585(a)(2)(B) (without regard to the second sentence thereof) that uses the reserve method of accounting for bad debts for U.S. federal income tax purposes shall decrease the amount of loans that qualify as U.S. assets by any reserve that is permitted under section 585.

(d)

(2)

(xi)

*Example 2. U.S. real property interest connected to a U.S. business.* FC is a foreign corporation that is a bank, within the meaning of section 585(a)(2)(B) (without regard to the second sentence thereof), and is engaged in the business of taking deposits and making loans through its branch in the United States. In 1996, FC makes a loan in the ordinary course of its lending business in the United States, securing the loan with a mortgage on the U.S. real property being financed by the borrower. In 1997, after the borrower has defaulted on the loan, FC takes title to the real property that secures the loan. On December 31, 1997, FC continues to hold the property, classifying it on its financial statement as *Other Real Estate Owned*. Because all income and gain from the property would be ECI to FC under the principles of section 864(c)(2), the U.S. real property constitutes a U.S. asset within the meaning of paragraph (d) of this section.

(3) *Interest in a partnership—(i) In general.* A foreign corporation that is a partner in a partnership must take into account its interest in the partnership (and not the partnership assets) in determining its U.S. assets. For purposes of determining the proportion of the partnership interest that is a U.S. asset, a foreign corporation may elect to use either the asset method described in paragraph (d)(3)(ii) of this section or the income method described in paragraph (d)(3)(iii) of this section.

(ii) *Asset method—(A) In general.* A partner's interest in a partnership shall be treated as a U.S. asset in the same proportion that the sum of the partner's proportionate share of the adjusted bases of all partnership assets as of the determination date, to the extent that the assets would be treated as U.S. assets if the partnership were a foreign corporation, bears to the sum of the partner's proportionate share of the adjusted bases of all partnership assets as of the determination date. Generally a partner's proportionate share of a partnership asset is the same as its proportionate share of all items of income, gain, loss, and deduction that may be generated by the asset.

(B) *Non-uniform proportionate shares.* If a partner's proportionate share of all items of income, gain, loss, and deduction that may be generated by a single asset of the partnership throughout the period that includes the taxable year of the partner is not uniform, then, for purposes of determining the partner's proportionate

share of the adjusted basis of that asset, a partner must take into account the portion of the adjusted basis of the asset that reflects the partner's economic interest in that asset. A partner's economic interest in an asset of the partnership must be determined by applying the following presumptions. These presumptions may, however, be rebutted if the partner or the Internal Revenue Service shows that the presumption is inconsistent with the partner's true economic interest in the asset during the corporation's taxable year.

(1) If a partnership asset ordinarily generates directly identifiable income, a partner's economic interest in the asset is determined by reference to its proportionate share of income that may be generated by the asset for the partnership's taxable year ending with or within the partner's taxable year.

(2) If a partnership asset ordinarily generates current deductions and ordinarily generates no directly identifiable income, for example because the asset contributes equally to the generation of all the income of the partnership (such as an asset used in general and administrative functions), a partner's economic interest in the asset is determined by reference to its proportionate share of the total deductions that may be generated by the asset for the partnership's taxable year ending with or within the partner's taxable year.

(3) For other partnership assets not described in paragraph (d)(3)(ii)(B)(1) or (2) of this section, a partner's economic interest in the asset is deter-

mined by reference to its proportionate share of the total gain or loss to which it would be entitled if the asset were sold at a gain or loss in the partnership's taxable year ending with or within the partner's taxable year.

(C) *Partnership election under section 754.* If a partnership files an election in accordance with section 754, then for purposes of this paragraph (d)(3)(ii), the basis of partnership property shall reflect adjustments made pursuant to sections 734 (relating to distributions of property to a partner) and 743 (relating to the transfer of an interest in a partnership). However, adjustments made pursuant to section 743 may be made with respect to a transferee partner only.

(iii) *Income method.* Under the income method, a partner's interest in a partnership shall be treated as a U.S. asset in the same proportion that its distributive share of partnership ECI for the partnership's taxable year that ends with or within the partner's taxable year bears to its distributive share of all partnership income for that taxable year.

(iv) *Manner of election—(A) In general.* In determining the proportion of a foreign corporation's interest in a partnership that is a U.S. asset, a foreign corporation must elect one of the methods described in paragraph (d)(3) of this section on a timely filed return for the first taxable year beginning on or after the effective date of this section. An amended return does not qualify for this purpose, nor shall the provisions of § 301.9100-1 of this chapter and any guidance promulgated thereunder apply. An election shall be made by the foreign corporation calculating its U.S. assets in accordance with the method elected. An elected method must be used for a minimum period of five years before the foreign corporation may elect a different method. To change an election before the end of the requisite five-year period, a foreign corporation must obtain the consent of the Commissioner or her delegate. The Commissioner or her delegate will generally consent to a foreign corporation's request to change its election only in rare and unusual circumstances. A foreign corporation that is a partner in more than one partnership is not required to elect to use the same method for each partnership interest.

(B) *Elections with tiered partnerships.* If a foreign corporation elects to

use the asset method with respect to an interest in a partnership, and that partnership is a partner in a lower-tier partnership, the foreign corporation may apply either the asset method or the income method to determine the proportion of the upper-tier partnership's interest in the lower-tier partnership that is a U.S. asset.

(v) *Failure to make proper election.* If a foreign corporation, for any reason, fails to make an election to use one of the methods required by paragraph (d)(3) of this section in a timely fashion, the district director or the Assistant Commissioner (International) may make the election on behalf of the foreign corporation and such election shall be binding as if made by that corporation.

(vi) *Special rule for determining a partner's adjusted basis in a partnership interest.* For purposes of paragraphs (d)(3) and (6) of this section, a partner's adjusted basis in a partnership interest shall be the partner's basis in such interest (determined under section 705) reduced by the partner's share of the liabilities of the partnership determined under section 752 and increased by a proportionate share of each liability of the partnership equal to the partner's proportionate share of the expense, for income tax purposes, attributable to such liability for the taxable year. A partner's adjusted basis in a partnership interest cannot be less than zero.

(vii) *E&P basis of a partnership interest.* See paragraph (d)(6)(iii) of this section for special rules governing the calculation of a foreign corporation's E&P basis in a partnership interest.

(viii) The application of this paragraph (d)(3) is illustrated by the following examples:

*Example 1. General rule—(i) Facts.* Foreign corporation, FC, is a partner in partnership ABC, which is engaged in a trade or business within the United States. FC and ABC are both calendar year taxpayers. ABC owns and manages two office buildings located in the United States, each with an adjusted basis of \$50. ABC also owns a non-U.S. asset with an adjusted basis of \$100. ABC has no liabilities. Under the partnership agreement, FC has a 50 percent interest in the capital of ABC and a 50 percent interest in all items of income, gain, loss, and deduction that may be generated by the partnership's assets. FC's adjusted basis in ABC is \$100. In determining the proportion of its interest in ABC that is a U.S. asset, FC elects to use the asset method described in paragraph (d)(3)(ii) of this section.

(ii) *Analysis.* FC's interest in ABC is treated as a U.S. asset in the same proportion that the

sum of FC's proportionate share of the adjusted bases of all ABC's U.S. assets (50% of \$100), bears to the sum of FC's proportionate share of the adjusted bases of all of ABC's assets (50% of \$200). Under the asset method, the amount of FC's interest in ABC that is a U.S. asset is \$50 ( $\$100 \times \$50/\$100$ ).

*Example 2. Special allocation of gain with respect to real property—(i) Facts.* The facts are the same as in *Example 1*, except that under the partnership agreement, FC is allocated 20 percent of the income from the partnership property but 80 percent of the gain on disposition of the partnership property.

(ii) *Analysis.* Assuming that the buildings ordinarily generate directly identifiable income, there is a rebuttable presumption under paragraph (d)(3)(ii)(B)(1) of this section that FC's proportionate share of the adjusted basis of the buildings is FC's proportionate share of the income generated by the buildings (20%) rather than the total gain that it would be entitled to under the partnership agreement (80%) if the buildings were sold at a gain on the determination date. Thus, the sum of FC's proportionate share of the adjusted bases in ABC's U.S. assets (the buildings) is presumed to be \$20 [(20% of \$50) + (20% of \$50)]. Assuming that the non-U.S. asset is not income-producing and does not generate current deductions, there is a rebuttable presumption under paragraph (d)(3)(ii)(B)(3) of this section that FC's proportionate share of the adjusted basis of that asset is FC's interest in the gain on the disposition of the asset (80%) rather than its proportionate share of the income that may be generated by the asset (20%). Thus, FC's proportionate share of the adjusted basis of ABC's non-U.S. asset is presumed to be \$80 (80% of \$100). FC's proportionate share of the adjusted bases of all of the assets of ABC is \$100 (\$20 + \$80). The amount of FC's interest in ABC that is a U.S. asset is \$20 ( $\$100 \times \$20/\$100$ ).

*Example 3. Tiered partnerships (asset method)—(i) Facts.* The facts are the same as in *Example 1*, except that FC's adjusted basis in ABC is \$175 and ABC also has a 50 percent interest in the capital of partnership DEF. DEF owns and operates a commercial shopping center in the United States with an adjusted basis of \$200 and also owns non-U.S. assets with an adjusted basis of \$100. DEF has no liabilities. ABC's adjusted basis in its interest in DEF is \$150 and ABC has a 50 percent interest in all the items of income, gain, loss and deduction that may be generated by the assets of DEF.

(ii) *Analysis.* Because FC has elected to use the asset method described in paragraph (d)(3)(ii) of this section, it must determine what proportion of ABC's partnership interest in DEF is a U.S. asset. As permitted by paragraph (d)(3)(iv)(B) of this section, FC also elects to use the asset method with respect to ABC's interest in DEF. ABC's interest in DEF is treated as a U.S. asset in the same proportion that the sum of ABC's proportionate share of the adjusted bases of all DEF's U.S. assets (50% of \$200), bears to the sum of ABC's proportionate share of the adjusted bases of all of DEF's assets (50% of \$300). Thus, the amount of ABC's interest in DEF that is a U.S. asset is \$100 ( $\$150 \times \$100/\$150$ ). FC must then apply the rules of paragraph (d)(3)(ii) of this section to all the assets of ABC, including ABC's interest in DEF that is treated in part as a U.S. asset (\$100) and in part as a non-U.S. asset (\$50). FC's interest in ABC is treated as a U.S. asset in the same

proportion that the sum of FC's proportionate share of the adjusted bases of the U.S. assets of ABC (including ABC's interest in DEF), bears to the sum of FC's proportionate share of the adjusted bases of all ABC's assets (including ABC's interest in DEF). Thus, the amount of FC's interest in ABC that is a U.S. asset is \$100 (FC's adjusted basis in ABC (\$175) multiplied by FC's proportionate share of the sum of the adjusted bases of ABC's U.S. assets (\$100)) over FC's proportionate share of the sum of the adjusted bases of ABC's assets (\$175).

*Example 4. Tiered partnerships (income method)*—(i) *Facts.* The facts are the same as in *Example 3*, except that FC has elected to use the income method described in paragraph (d)(3)(iii) of this section to determine the proportion of its interest in ABC that is a U.S. asset. The two office buildings located in the United States generate \$60 of income that is ECI for the taxable year. The non-U.S. asset is not-income producing. In addition ABC's distributive share of income from DEF consists of \$40 of income that is ECI and \$140 of income that is not ECI.

(ii) *Analysis.* Because FC has elected to use the income method it does need to determine what proportion of ABC's partnership interest in DEF is a U.S. asset. FC's interest in ABC is treated as a U.S. asset in the same proportion that its distributive share of ABC's income for the taxable year that is ECI (\$50) (\$30 earned directly by ABC + \$20 distributive share from DEF) bears to its distributive share of all ABC's income for the taxable year (\$55) (\$30 earned directly by ABC + \$25 distributive share from DEF). Thus, FC's interest in ABC that is a U.S. asset is \$159 (\$175 × \$50/\$55).

(4) *Interest in a trust or estate*—(i) *Estates and non-grantor trusts.* A foreign corporation that is a beneficiary of a trust or estate shall not be treated as having a U.S. asset by virtue of its interest in the trust or estate.

(ii) *Grantor trusts.* If, under sections 671 through 678, a foreign corporation is treated as owning a portion of a trust that includes all the income and gain that may be generated by a trust asset (or pro rata portion of a trust asset), the foreign corporation will be treated as owning the trust asset (or pro rata portion thereof) for purposes of determining its U.S. assets under this section.

(5) \* \* \*

(ii) *Interbranch transactions.* A transaction of any type between separate offices or branches of the same taxpayer does not create a U.S. asset.

(6) \* \* \*

(v) *Computation of E&P basis of financial instruments.* [Reserved]

\* \* \* \* \*

(e) \* \* \*

(2) *Additional liabilities*—(i) \* \* \*

(ii) *Liabilities described in § 1.882-5(a)(1)(ii).* The amount of liabilities

determined under this paragraph (e)(2)(ii) is the amount (as of the determination date) of liabilities described in § 1.882-5(a)(1)(ii) (relating to liabilities giving rise to interest expense that is directly allocated to income from a U.S. asset).

(3) \* \* \*

(ii) *Limitation.* For any taxable year, a foreign corporation may elect to reduce the amount of its liabilities determined under paragraph (e)(1) of this section by an amount that does not exceed the excess, if any, of the amount of liabilities in paragraph (e)(1) of this section over the amount, as of the determination date, of U.S. booked liabilities (determined under § 1.882-5(d)(2)) and liabilities described in paragraph (e)(2) of this section.

\* \* \* \* \*

(5) \* \* \*

*Example 1.* \* \* \* For purposes of computing its U.S.- connected liabilities under § 1.882-5(c), A must determine the average total value of its assets that are U.S. assets. \* \* \*

*Example 2.* \* \* \* A has \$800 of liabilities under paragraph (e)(1) of this section and \$300 of liabilities properly reflected on the books of its U.S. trade or business under § 1.882-5(d)(2). \* \* \*

\* \* \* \* \*

(i) \* \* \*

(4) *Special rules for certain U.S. assets and liabilities.* Paragraphs (c)(2)(i) and (ii), (d)(3), (d)(4), (d)(5)(iii), (d)(6)(iii), (d)(6)(vi), (e)(2), and (e)(3)(ii), of this section are effective for taxable years beginning on or after June 6, 1996.

Par. 6. § 1.884-2 is added to read as follows:

*§ 1.884-2 Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary.*

(a) through (a)(2)(i) [Reserved] For further information, see § 1.884-2T(a) through (a)(2)(ii).

(a)(2)(ii) *Waiver of period of limitations.* The waiver referred to in § 1.884-2T(a)(2)(i)(D) shall be executed on Form 8848, or substitute form, and shall extend the period for assessment of the branch profits tax for the year of complete termination to a date not earlier than the close of the sixth taxable year following that tax-

able year. This form shall include such information as is required by the form and accompanying instructions. The waiver must be signed by the person authorized to sign the income tax returns for the foreign corporation (including an agent authorized to do so under a general or specific power of attorney). The waiver must be filed on or before the date (including extensions) prescribed for filing the foreign corporation's income tax return for the year of complete termination. With respect to a complete termination occurring in a taxable year ending prior to June 6, 1996, a foreign corporation may also satisfy the requirements of this paragraph (a)(2)(ii) by applying § 1.884-2T(a)(2)(ii) of the temporary regulations (as contained in the CFR edition revised as of April 1, 1995). A properly executed Form 8848, substitute form, or other form of waiver authorized by this paragraph (a)(2)(ii) shall be deemed to be consented to and signed by a Service Center Director or the Assistant Commissioner (International) for purposes of § 301.6501(c)-1(d) of this chapter.

(a)(3) through (a)(4) [Reserved] For further information, see § 1.884-2T(a)(3) through (a)(4).

(a)(5) *Special rule if a foreign corporation terminates an interest in a trust.* A foreign corporation whose beneficial interest in a trust terminates (by disposition or otherwise) in any taxable year shall be subject to the branch profits tax on ECEP attributable to amounts (including distributions of accumulated income or gain) treated as ECI to such beneficiary in such taxable year notwithstanding any other provision of § 1.884-2T(a).

(b) through (c)(2)(ii) [Reserved] For further information, see § 1.884-2T(b) through (c)(2)(ii).

(c)(2)(iii) *Waiver of period of limitations and transferee agreement.* In the case of a transferee that is a domestic corporation, the provisions of § 1.884-2T(c)(2)(i) shall not apply unless, as part of the section 381(a) transaction, the transferee executes a Form 2045 (Transferee Agreement) and a waiver of period of limitations as described in this paragraph (c)(2)(iii), and files both documents with its timely filed (including extensions) income tax return for the taxable year in which the section 381(a) transaction occurs. The waiver shall be executed on Form 8848, or substitute form, and shall extend the

period for assessment of any additional branch profits tax for the taxable year in which the section 381(a) transaction occurs to a date not earlier than the close of the sixth taxable year following the taxable year in which such transaction occurs. This form shall include such information as is required by the form and accompanying instructions. The waiver must be signed by the person authorized to sign Form 2045. With respect to a complete termination occurring in a taxable year ending prior to June 6, 1996, a foreign corporation may also satisfy the requirements of this paragraph (c)(2)(iii) by applying § 1.884-2T(c)(2)(iii) of the temporary regulations (as contained in the CFR edition revised as of April 1, 1995). A properly executed Form 8848, substitute form, or other form of waiver authorized by this paragraph (c)(2)(iii) shall be deemed to be consented to and signed by a Service Center Director or the Assistant Commissioner (International) for purposes of § 301.6501(c)-1(d) of this chapter.

(c)(3) through (f) [Reserved] For further information, see § 1.884-2T(c)(3) through (f).

(g) *Effective dates.* Paragraphs (a)(2)(ii) and (c)(2)(iii) of this section are effective for taxable years begin-

ning after December 31, 1986. Paragraph (a)(5) of this section is effective for taxable years beginning on or after June 6, 1996.

Par. 7. Section 1.884-2T is amended as follows:

1. Paragraph (a)(2)(ii) is revised.
2. Paragraph (a)(5) is redesignated as (a)(6).
3. New paragraph (a)(5) is added.
4. Paragraph (c)(2)(iii) is revised.

The additions and revisions read as follows:

§ 1.884-2T *Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary (Temporary).*

(a) \* \* \*

(2) \* \* \*

(ii) *Waiver of period of limitations.* [Reserved] See § 1.884-2(a)(2)(ii) for rules relating to this paragraph.

\* \* \* \* \*

(5) *Special rule if a foreign corporation terminates an interest in a trust.* [Reserved] See § 1.884-2(a)(5) for

rules relating to this paragraph.

\* \* \* \* \*

(c) \* \* \*

(2) \* \* \*

(iii) *Waiver of period of limitations and transferee agreement.* [Reserved] See § 1.884-2(c)(2)(iii) for rules relating to this paragraph.

Par. 8. Section 1.884-4 is amended as follows:

1. In paragraph (a)(1), the fifth sentence is revised.

2. Paragraph (a)(2)(iii) is revised.

3. Paragraph (b)(1) is revised and paragraph (b)(2) is removed and reserved.

4. Paragraph (b)(3) is amended by:

a. Removing the reference “(b)(1)(v)” and adding the language “(b)(1)(ii)” in the following:

i. Paragraph (b)(3)(i), first sentence.

ii. Paragraph (b)(3)(ii), introductory text.

iii. Paragraph (b)(3)(iii), heading and introductory text.

b. Adding a sentence at the end of paragraph (b)(3)(i).

5. Paragraph (b)(4) is removed and reserved.

6. In the list below, for each paragraph indicated in the left column, remove the language in the middle column and add the language in the right column:

<i>Paragraph</i>	<i>Remove</i>	<i>Add</i>
(a)(2)(i)(A)	apportioned	allocated or apportioned
(a)(4) <i>Example 1</i> first sentence	(b)(2)	(a)(2)(iii)
(a)(4) <i>Example 1</i> first and seventh sentence	apportioned	allocated or apportioned
(a)(4) <i>Example 1</i> first, second, and eighth sentence	1993	1997
(a)(4) <i>Example 2</i> first sentence	(b)(2)	(a)(2)(iii)
(a)(4) <i>Example 2</i> second and third sentence	1993	1997
(b)(5)(i) last sentence	apportioned	allocated or apportioned
(b)(5)(ii) <i>Example</i> first, fifth, and last sentence	apportioned	allocated or apportioned
(b)(6) paragraph heading	apportioned	allocated or apportioned
(b)(6)(i) first and last sentence	apportioned	allocated or apportioned
(b)(6)(i) second sentence	(b)(1)(v)	(b)(1)(ii)
(b)(6)(ii) first and second sentence	(b)(1)(v)	(b)(1)(ii)
(b)(6)(ii) first and second sentence	paragraphs (b)(1)(i) through (b)(i)(iv)	paragraph (b)(1)(i)



<i>Paragraph</i>	<i>Remove</i>	<i>Add</i>
(b)(6)(iv) <i>Example 1</i> introductory text, paragraphs (i), (iii), and (iv), flush language first, fourth, and seventh sentence	1993	1997
(b)(6)(iv) <i>Example 1</i> paragraph (ii)	1992	1996
(b)(6)(iv) <i>Example 1</i> flush language second, and sixth sentence	(b)(1)(v)	(b)(1)(ii)
(c)(1)(iv) <i>Example 1</i> first sentence	apportioned	allocated or apportioned
(c)(1)(iv) <i>Example 1</i> first, second, third, fifth, sixth, and seventh sentence	1993	1997
(c)(1)(iv) <i>Example 1</i> third, fourth, and seventh sentence	1994	1998
(c)(1)(iv) <i>Example 2</i> second sentence	apportioned	allocated or apportioned
(c)(1)(iv) <i>Example 2</i> first, second, third, and last sentence	1993	1997
(c)(1)(iv) <i>Example 2</i> second and last sentence	1994	1998
(c)(2)(i) first sentence	apportioned	allocated or apportioned
(c)(4) <i>Example</i> third, fourth, fifth, sixth, and eighth sentence	1993	1997
(c)(4) <i>Example</i> fifth sentence	allocated	allocated or apportioned

7. Paragraph (e) is amended as follows:

a. The text of paragraph (e) is redesignated as paragraph (e)(1) and a paragraph heading for (e)(1) is added.

b. The first sentence of newly designated paragraph (e)(1) is revised.

8. Paragraph (e)(2) is added.

The revisions and additions read as follows:

§ 1.884-4 *Branch-level interest tax.*

(a) \* \* \* (1) \* \* \* For purposes of this section, a foreign corporation also shall be treated as engaged in trade or business in the United States if, at any time during the taxable year, it owns an asset taken into account under § 1.882-5(a)(1)(ii) or (b)(1) for purposes of determining the amount of the foreign corporation's interest expense allocated or apportioned to ECI. \* \* \*

(2) \* \* \*

(iii) *Treatment of a portion of the excess interest of banks as interest on deposits.* A portion of the excess interest of a foreign corporation that is a bank (as defined in section 585(a)(2)(B) 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 (as described in

section 871(i)(3)), and shall be exempt from the tax imposed by section 881(a) as provided in such section. The portion of the excess interest of the foreign corporation that is treated as interest on deposits shall equal the product of the foreign corporation's excess interest and the greater of—

(A) The ratio of the amount of interest bearing deposits, within the meaning of section 871(i)(3)(A), of the foreign corporation as of the close of the taxable year to the amount of all interest bearing liabilities of the foreign corporation on such date; or

(B) 85 percent.

\* \* \* \* \*

(b) *Branch interest—(1) Definition of branch interest.* For purposes of this section, the term “branch interest” means interest that is —

(i) Paid by a foreign corporation with respect to a liability that is—

(A) A U.S. booked liability within the meaning of § 1.882-5(d)(2) (other than a U.S. booked liability of a partner within the meaning of § 1.882-5(d)(2)(vii)); or

(B) Described in § 1.884-1(e)(2) (relating to insurance liabilities on U.S. business and liabilities giving rise to interest expense that is directly allocated to income from a U.S. asset); or

(ii) In the case of a foreign corporation other than a corporation described

in paragraph (a)(2)(iii) of this section, a liability specifically identified (as provided in paragraph (b)(3)(i) of this section) as a liability of a U.S. trade or business of the foreign corporation on or before the earlier of the date on which the first payment of interest is made with respect to the liability or the due date (including extensions) of the foreign corporation's income tax return for the taxable year, provided that—

(A) The amount of such interest does not exceed 85 percent of the amount of interest of the foreign corporation that would be excess interest before taking into account interest treated as branch interest by reason of this paragraph (b)(1)(ii);

(B) The requirements of paragraph (b)(3)(ii) of this section (relating to notification of recipient of interest) are satisfied; and

(C) The liability is not described in paragraph (b)(3)(iii) of this section (relating to liabilities incurred in the ordinary course of a foreign business or secured by foreign assets) or paragraph (b)(1)(i) of this section.

(2) [Reserved]

(3)(i) \* \* \* A foreign corporation that is subject to this section may identify a liability under paragraph (b)(1)(ii) of this section whether or not it is actually engaged in the conduct of a trade or business in the United States. \* \* \*

(4) [Reserved]

(f)

(2)

(i) Held for the principal purpose of promoting the present conduct of the trade or business,

(e) *Effective dates*—(1) *General rule.* Except as provided in paragraph (e)(2) of this section, this section is effective for taxable years beginning October 13, 1992, and for payments of interest described in section 884(f)(1)(A) made (or treated as made under paragraph (b)(7) of this section) during taxable years of the payor beginning after such date. \* \* \*

PART 602—OMB CONTROL  
NUMBERS UNDER THE  
PAPERWORK REDUCTION ACT

Par. 11. The authority for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

(2) *Special rule.* Paragraphs (a)(1), (a)(2)(i)(A), (a)(2)(iii), (b)(1), (b)(3), (b)(5)(i), (b)(6)(i), (b)(6)(ii), and (c)(2)(i) of this section are effective for taxable years beginning on or after June 6, 1996.

Par. 12. In § 602.101, the table in paragraph (c) is amended by adding in numerical order “§ 1.884-2 ... 1545-1070”.

Par. 9. In section 1.884-5, paragraphs (e)(4)(ii) and (g) are revised to read as follows:

Margaret Milner Richardson,  
*Commissioner of Internal Revenue.*

§ 1.884-5 *Qualified resident*

Approved February 28, 1996.

(e)

(4)

(ii) *Presumption for banks.* A U.S. trade or business of a foreign corporation that is described in § 1.884-4(a)(2)(iii) shall be presumed to be an integral part of an active banking business conducted by the foreign country in its country of residence provided that a substantial part of the business of the foreign corporation in both its country of residence and the United States consists of receiving deposits and making loans and discounts. This paragraph shall be effective for taxable years beginning on or after June 6, 1996.

Leslie Samuels,  
*Assistant Secretary of the Treasury.*

(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. 9336)

(g) Except as provided in paragraph (e)(4)(ii) of this section, this section is effective for taxable years beginning on or after October 13, 1992.

Par. 10. Section 1.897-1 is amended as follows:

1. In paragraph (f)(1)(iii) the language “stock,” is removed.

2. Paragraph (f)(2)(i) is revised to read as follows:

§ 1.897-1 *Taxation of foreign investments in United States real property interests, definition of terms.*