Section 882.—Tax on Income of Foreign Corporations Connected With United States Business

26 CFR 1.882–5: Determination of interest deduction.

T.D. 8658

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Determination of Interest Expense Deduction of Foreign Corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains Income Tax Regulations relating to the determination of the interest expense deduction of foreign corporations and applies to foreign corporations engaged in a trade or business within the United States. This action is necessary because of changes to the applicable tax law made by the Tax Reform Act of 1986, and because of changes in international financial markets.

EFFECTIVE DATE: June 6, 1996.

FOR FURTHER INFORMATION CONTACT: Ahmad Pirasteh or Richard Hoge, (202) 622-3870 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On April 24, 1992, the IRS published proposed amendments (INTL–309–88, 1992–1 C.B. 1157) to the Income Tax Regulations (26 CFR parts 1) under section 882 of the Internal Revenue Code in the Federal Register (57 FR 15308). A public hearing was held on October 30, 1992. Numerous written comments were received. After consideration of all of the comments, the regulations proposed by INTL–309–88 are adopted as amended by this Treasury decision, and the prior regulations are withdrawn. The revisions are discussed below.

Discussion of Major Comments and Changes to the Regulations.

1. *Introduction.*

Section 882(c) of the Internal Revenue Code provides that a foreign corporation is allowed a deduction only to the extent that the expense is connected with income that is effectively connected with the conduct of a U.S. trade or business within the United States (ECI), and that the proper allocation is to be determined as provided in regulations. The proposed § 1.882–5 regulations that were issued in 1992 generally followed the approach adopted in the 1981 final regulations, with various changes intended to clarify and update the regulations.

The proposed regulations attracted a substantial number of comments, addressing both general and specific aspects of the regulations. In response to these comments, the Treasury Department and the IRS simplified the regulations, coordinated them more closely with other regulations, and generally responded to the concerns of foreign corporations doing business in the United States. For example, U.S. assets are defined in the first step of the three-step formula to coincide closely with the definition of a U.S. asset used for purposes of section 884. The computation of the actual ratio in Step 2 has been simplified considerably, minimizing both the number and the frequency of required computations. In Step 3, consistent with the emphasis in the regulations on the use of actual ratios and rates rather than prescribed ones whenever possible, the final regulations allow taxpayers to use either their actual interest rate on U.S. dollar liabilities, or, if they elect, to use their actual rates on liabilities denominated in each of the currencies in which their U.S. assets are denominated. The Treasury and the IRS believe that the final regulations strike a reasonable balance between the concerns of foreign corporate taxpayers and the interests of the United States government.

2. *§ 1.882–5(a): Rules of general application.*

Section 1.882–5(a) provides general rules for determining a foreign corporation's interest expense allocable to ECI. The final regulations specify that the provisions of § 1.882–5 constitute the exclusive rules for allocating interest expense to the income from the U.S. trade or business of all foreign corporations, including foreign corporations that are residents of countries with which the United States has an income tax treaty. In general, this requires all foreign corporations to use the three-step methodology described in the final regulations. In response to commenters' questions, however, § 1.882–5(a)(1)(ii) now provides that a foreign corporation that is engaged in a U.S. trade or business, either directly or through a partnership, and that satisfies certain requirements may allocate interest expense directly to income generated by a particular asset to the same extent that a U.S. corporation is permitted to directly allocate interest expense under the rules of § 1.861–10T. When a foreign corporation directly allocates interest expense under this rule, the final regulations require adjustments to all three steps of the calculation to avoid double counting of assets and liabilities.

Numerous commenters questioned whether a taxpayer that is entitled to the benefits of a U.S. income tax treaty should be required to use the rules of § 1.882–5 for purposes of determining the amount of interest expense allocable to the foreign corporation's income attributable to its U.S. permanent establishment. The IRS and the Treasury Department believe that the methodology provided in these regulations is fully consistent with all of the United States's treaty obligations, including the Business Profits article of our tax treaties. Generally, the Business Profits article requires that, in determining the business profits of a permanent establishment, there shall be allowed as deductions expenses that are incurred for the purposes of the permanent establishment, including interest expense. Section 1.882–5(a)(2) of the final regulations is a reasonable method of implementing that general directive, as our treaties do not compel the use of any particular method.

Most of the other changes to the general rules of § 1.882–5(a) are clarifications in response to commenters' questions. For example, the final regulations clarify certain aspects of the rules that limit a foreign corporation's allocable interest expense to the amount actually paid or accrued by the corporation in a taxable year, and the rules that coordinate the provisions of § 1.882–5 with any other section that disallows, defers, or capitalizes interest expense, and include examples that illustrate how § 1.882–5 applies to an asset that produces income exempt from U.S. taxation.

Many commenters requested that the regulations clarify how and when to make the various elections allowed under § 1.882–5. The final regulations provide uniform rules for changing any election prescribed under § 1.882–5, and give all taxpayers an opportunity to make new elections, if desired, for the first taxable year beginning after the effective date of these regulations. The regulations provide that, once a method is elected, a taxpayer must use the method for five years, unless the Commissioner or her delegate consents to an earlier change based on extenuating circumstances. The final regulations reflect the current practice of the IRS by providing that if the taxpayer fails to make a timely election, the district director or the Assistant Commissioner (International) may make any and all elections on the taxpayer's behalf.

Several commenters asked that the final regulations allow taxpayers to make correlative adjustments to their § 1.882–5 calculations in cases where, under the authority of § 1.881–3, the district director has determined that a taxpayer has acted as a conduit entity in a conduit financing arrangement. The IRS and Treasury do not believe that it is appropriate in this regulation to alleviate the consequences of § 1.881–3 if a taxpayer has engaged in a transaction one of the principal purposes of which is to avoid U.S. withholding tax. Allowing such correlative adjustments in this regulation would prevent § 1.881–3 from serving its function as an anti-abuse rule.

3. *§ 1.882–5(b): Determination of total amount of U.S. assets for the taxable year (Step 1).*

As in the proposed regulations, the final regulations provide that the classification of an item as a U.S. asset under § 1.884–1(d) generally governs its classification as a U.S. asset for purposes of § 1.882–5. Under the rules of § 1.884–1(d), an item generally is treated as a U.S. asset if all of the income it generates (or would generate) and all of the gains that it would generate (if sold at a gain) are ECI. Since the proposed § 1.882–5 regulations were issued in 1992, the regulations under § 1.884–1 were amended and released in final form. In light of those new regulations, the inclusions and exclusions enumerated in the proposed regulations were largely eliminated, so that the final § 1.882–5 regulations now closely conform to the § 1.884–1(d) definition of a U.S. asset.

Section 1.882–5(b)(3) of the final regulations continues the requirement that a foreign corporation must value its U.S. assets at the most frequent, regular intervals for which data are reasonably available. However, the rule is applied separately with respect to each U.S. asset. Paragraph (b)(3) specifies that the value of a U.S. asset must be computed at least monthly by a large bank and at least semi-annually by other taxpayers.

Many questions have been raised about how § 1.882–5 applies to partnership interests held by foreign corporations. With the elimination of § 1.861–9T(e)(7)(i) by these regulations, § 1.884–1(d)(3) and § 1.882–5 now provide the exclusive rules for determining a foreign corporation's interest expense allocable to an interest in a partnership. The new regulations under § 1.884–1(d)(3) provide that a foreign corporation determines its U.S. assets by reference to its basis in the partnership, and expand the methods available for determining the portion of its partnership basis that is a U.S. asset.

Numerous commenters were concerned that the provisions of the proposed regulations relating to real estate would treat international banks unfairly, since banks frequently acquire real estate through foreclosure, or own the buildings in which their offices are located. Commenters stated that it is unclear whether such real estate would qualify as a U.S. asset. Commenters also objected to the rule in the proposed regulations that provides that an interest in a U.S. real property holding company, which is not treated as a U.S. asset under § 1.884–1(d), would be treated as a U.S. asset only in the year of disposition. Commenters argued that banks frequently hold property acquired by foreclosure in special purpose subsidiaries in order to limit their exposure to environmental or other liabilities. However, such banks must service the debt they incurred to acquire the real property throughout the period they hold the stock, not merely upon disposition.

In response to these comments, an example is added under § 1.884–1(d)(2) to clarify that U.S. real estate acquired as a result of foreclosure by a bank acting in the ordinary course of its business is generally a U.S. asset, because the property would produce ECI to the bank under section 864(c)(2). Similarly, the building in which a bank's offices are located generally qualifies as a U.S. asset, because gain from the sale of the building generally would constitute effectively connected income under the asset-use test of § 1.864–4(c)(2). In addition, the final regulations specify that a taxpayer may achieve the same result under § 1.882–5 whether it holds foreclosure property or the office building it occupies directly or indirectly through a corporation. Section 1.882–5(b)(1)(iii)(A) provides a look-through rule that treats such real property as a U.S. asset for purposes of § 1.882–5 to the extent that it would have qualified as a U.S. asset if held directly by the taxpayer.

Commenters noted that the rule in the proposed regulations that reduces the value of shares of stock claimed as a U.S. asset by a percentage of the dividends received deduction had the effect of treating all stock as debt-financed under the principles of section 246A. This stock cut-back rule is eliminated from the final § 1.882–5 regulations. The elimination of the rule, however, will affect only those taxpayers whose stock satisfies the business-activities test or the banking, financing or similar-business test of § 1.864–4(c). This is because the final regulations under § 1.864–4, which are being issued contemporaneously with these regulations elsewhere in this issue of the Bulletin, generally eliminate any inference that stock can produce effectively connected income under the asset-use test of § 1.864–4(c)(2).

The final regulations add an anti-abuse rule similar to the rule in § 1.884–1(d)(5)(ii) to prevent taxpayers from artificially increasing the amount of their U.S. assets.

4. *§ 1.882–5(c): Determination of total amount of U.S. liabilities for the taxable year (Step 2).*

Commenters objected to many of the requirements in Step 2 of the proposed regulations on the grounds that the rules effectively prevented foreign banks from using their actual ratio of liabilities to assets by imposing excessive administrative burdens and capping the actual ratio at 96%. Because the IRS and Treasury believe that a taxpayer's interest deduction should be based on the taxpayer's actual ratio of liabilities to assets whenever possible, the final regulations adopt rules that are intended to encourage taxpayers to use their actual ratio. Accordingly, the final regulations drop the 96% cap on the actual ratio that was in the proposed regulations. The final regulations also substantially ease the administrative burden associated with computing the actual ratio.

Many commenters objected to the requirement in the proposed regulations that a taxpayer's worldwide liabilities to assets ratio be computed strictly in accordance with U.S. tax principles, citing the substantial burden that such a calculation would entail. In light of these comments, the final regulations require that only the classification of assets and liabilities must be strictly in accordance with U.S. tax principles. The value of worldwide assets and the amount of worldwide liabilities need only be substantially in accordance with U.S. tax principles. Examples of how these requirements apply are provided. With regard to material items, however, the final regulations specify that a foreign corporation must compute the value of U.S. assets and the amount of worldwide liabilities in Steps 1 and 2 in a consistent manner.

The proposed regulations would have required that a foreign bank compute its actual ratio monthly. Commenters were concerned that the burden of this rule would be excessive. In response, the final regulations decrease the required frequency of the computations of the actual ratio to semi-annually for large banks, and to annually for other taxpayers.

Commenters also were concerned that the rules in the proposed regulation requiring basis adjustments for 20% owned subsidiaries would be too burdensome. These rules, which serve a somewhat different purpose in section 864(e)(4), have been removed from the final regulations.

Commenters pointed out that the election provided by the proposed regulations to compute the actual ratio of a bank on the basis of a hypothetical tax year ending six months prior to the beginning of the actual year does not serve its intended purpose. The six month lagging ratio election has therefore been eliminated.

Section 1.882–5(c)(3) of the final regulations provides that the district director or the Assistant Commissioner (International) may make appropriate adjustments to prevent the artificial increase of a corporation's actual ratio. This rule, in conjunction with more specific anti-abuse rules in Steps 1 and 3, replaces the general anti-abuse rule in § 1.882–5(e) of the proposed regulations.

Commenters criticized the 93% fixed ratio for banks as too low, and disagreed with the reasons provided in the preamble to the proposed regulations supporting the 93% ratio. The final regulations, however, retain the elective fixed ratio at 93%. In conjunction with the more relaxed rules regarding the computation of a foreign corporation's actual ratio, Treasury believes that a 93% fixed ratio, which remains purely elective, represents an appropriate safe harbor for banks.

Section 1.882–5(c)(4) also modifies the definition of a bank for these purposes to clarify the previous definition and to limit the 93% fixed ratio to the intended class of businesses.

5. *§ 1.882–5(d): Determination of amount of interest expense allocable to ECI (Step 3).*

Commenters were concerned that Step 3 of the proposed regulations failed to reflect business realities, increased administrative costs and created uncertainty. In particular, they objected to the rules that eliminated certain high interest rate liabilities and certain liabilities denominated in a non-functional currency from the definition of *booked liabilities*, and the rules that prescribed an interest rate applicable to the extent that a taxpayer's U.S.-connected liabilities exceed booked liabilities (*excess liabilities*).

As noted above, the IRS and Treasury believe that the calculation of a taxpayer's interest deduction should reflect, to the greatest extent possible, the taxpayer's economic interest expense. Accordingly, these comments have been largely accepted.

The final regulations eliminate the fixed interest rates assigned to excess liabilities, and instead require that taxpayers compute their actual interest rate outside the United States. The IRS anticipates issuing regulations under section 6038C describing the records needed to verify the taxpayer's actual interest rate, among other things.

The final regulations also respond to commenters' requests for simplification and clarification in the Step 3 calculation. Under § 1.882–5(d)(2), a liability is a U.S. booked liability if the liability is properly reflected on the books of the U.S. trade or business. The final regulations set out two standards, one for non-banks and another for banks, to determine whether a liability is properly reflected on the foreign corporation's U.S. books. In general, the final regulations use a facts and circumstances test to determine whether a liability is properly booked in the United States. In response to requests from commenters for additional guidance on the requirement that the booking of a liability be ''reasonably contemporaneous'' with the time that the liability is incurred, the regulations specify that a bank is generally required to book a liability before the end of the day in which the liability is incurred. Section 1.882–5(d)(2)(iii)(B) provides a relief rule, however, for a situation where, due to inadvertent error, a bank fails to book a liability that otherwise would meet the criteria for a booked liability. The special rules for banks in the proposed regulations have otherwise been eliminated.

In response to comments, the computation of the scaling ratio that applies to taxpayers with excess liabilities has also been simplified, and its application has been reduced in scope. Under the final regulations, the scaling ratio is computed by simply dividing U.S.-connected liabilities by U.S. booked liabilities, and multiplying that fraction by the interest paid or accrued by the foreign corporation. The final regulations also delete the provision in the proposed regulations that applied the scaling ratio to section 988 exchange gain or loss from an unhedged liability. The amount and source of exchange gain or loss from a section 988 transaction will therefore continue to be determined under section 988, without any reduction as a result of the scaling ratio in § 1.882–5.

The rules in the proposed regulations relating to high interest rate liabilities and nonfunctional currency liabilities have been replaced in the final regulations by a simpler anti-abuse rule that provides that U.S. booked liabilities will not include a liability if one of the principal purposes of incurring or holding the liability is to increase artificially the interest expense on U.S. booked liabilities. Factors relevant to that determination are whether the interest rate on a liability is excessive and whether, from an economic standpoint, the currency denomination of U.S. booked liabilities matches the currency denomination of U.S. assets.

6. *§ 1.882–5(e): Separate currency pools method.*

Most commenters argued for retaining the separate currency pools method, which was deleted from Step 3 in the proposed regulations. After considering the comments, the IRS and Treasury agree that taxpayers should be permitted to use a methodology that looks to worldwide interest rates in all relevant currencies. Because the separate currency pools rate in the 1981 regulations ignored the currency denomination of U.S. assets and was based instead on the currency denomination of U.S. booked liabilities, however, it was subject to manipulation. The new separate currency pools method in § 1.882–5(e) of the final regulations allows taxpayers to treat their U.S. assets in each currency as funded by the worldwide liabilities of the taxpayer in that same currency. This new separate currency pools method, which is elective, is an alternative to the Step 3 approach based on U.S. booked liabilities in § 1.882–5(d). To prevent distortions, taxpayers that have more than 10% of their U.S. assets denominated in a hyperinflationary currency are precluded from using the separate currency pools method.

The anti-abuse rule of proposed regulation § 1.882–5(e) has been replaced by three separate rules that appear under each of the three steps of this section.

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 also has 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 Small Business Administration for comment on its impact on small business.

Drafting Information

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

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is 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 1.882–5 also issued under 26 U.S.C. 882, 26 U.S.C. 864(e), 26

U.S.C. 988(d), and 26 U.S.C. 7701(l). * * *

§ 1.861–9T [Amended]

Par. 2. Section 1.861–9T, paragraph (e)(7) is amended as follows:

1. Paragraph (e)(7)(i) is removed.

2. The heading in paragraph (e)(7)(ii) is removed.

3. Paragraph (e)(7)(ii) is redesignated as the text of paragraph (e)(7).

Par. 3. Sections 1.882–0 is added to read as follows:

§ 1.882–0 Table of contents.

This section lists captions contained in §§ 1.882–1, 1.882–2, 1.882–3, 1.882–4 and 1.882–5.

§ 1.882–1 Taxation of foreign corporations engaged in U.S. business or of foreign corporations treated as having effectively connected income.

- (a) Segregation of income.
- (b) Imposition of tax.
  - (1) Income not effectively connected with the conduct of a trade or business in the United States.
  - (2) Income effectively connected with the conduct of a trade or business in the United States.
    - (i) In general.
    - (ii) Determination of taxable income.
    - (iii) Cross references.
- (c) Change in trade or business status.
- (d) Credits against tax.
- (e) Payment of estimated tax.
- (f) Effective date.

§ 1.882–2 Income of foreign corporation treated as effectively connected with U.S. business.

- (a) Election as to real property income.
- (b) Interest on U.S. obligations received by banks organized in possessions.
- (c) Treatment of income.
- (d) Effective date.

§ 1.882–3 Gross income of a foreign corporation.

- (a) In general.
  - (1) Inclusions.
  - (2) Exchange transactions.
  - (3) Exclusions.
- (b) Foreign corporations not engaged in U.S. business.
- (c) Foreign corporations engaged in U.S. business.
- (d) Effective date.

§ 1.882–4 Allowance of deductions and credits to foreign corporations.

- (a) Foreign corporations.
  - (1) In general.
  - (2) Return necessary.
  - (3) Filing deadline for return.
  - (4) Return by Internal Revenue Service.
- (b) Allowed deductions and credits.
  - (1) In general.
  - (2) Verification.

§ 1.882–5 Determination of interest deduction.

- (a) Rules of general application.
  - (1) Overview.
    - (i) In general.
    - (ii) Direct allocations.
      - (A) In general.
      - (B) Partnership interest.
  - (2) Coordination with tax treaties.
  - (3) Limitation on interest expense.
  - (4) Translation convention for foreign currency.
  - (5) Coordination with other sections.
  - (6) Special rule for foreign governments.
  - (7) Elections under § 1.882–5.
    - (i) In general.
    - (ii) Failure to make the proper election.
  - (8) Examples.
- (b) Step 1: Determination of total value of U.S. assets for the taxable year.
  - (1) Classification of an asset as a U.S. asset.
    - (i) General rule.
    - (ii) Items excluded from the definition of U.S. asset.
    - (iii) Items included in the definition of U.S. asset.
    - (iv) Interbranch transactions.
    - (v) Assets acquired to increase U.S. assets artificially.
  - (2) Determination of the value of a U.S. asset.
    - (i) General rule.
    - (ii) Fair-market value election.
      - (A) In general.
      - (B) Adjustment to partnership basis.
    - (iii) Reduction of total value of U.S. assets by amount of bad debt reserves under section 585.
      - (A) In general.
      - (B) Example.
    - (iv) Adjustment to basis of financial instruments.
  - (3) Computation of total value of U.S. assets.
- (c) Step 2: Determination of total amount of U.S.-connected liabilities for the taxable year.
  - (1) General rule.
  - (2) Computation of the actual ratio.
    - (i) In general.
    - (ii) Classification of items.
    - (iii) Determination of amount of worldwide liabilities.
    - (iv) Determination of value of worldwide assets.
    - (v) Hedging transactions.
    - (vi) Treatment of partnership interests and liabilities.
    - (vii) Computation of actual ratio of insurance companies.
    - (viii) Interbranch transactions.
    - (ix) Amounts must be expressed in a single currency.
  - (3) Adjustments.
  - (4) Elective fixed ratio method of determining U.S. liabilities.
  - (5) Examples.
- (d) Step 3: Determination of amount of interest expense allocable to ECI under the adjusted U.S. booked liabilities method.
  - (1) General rule.
  - (2) U.S. booked liabilities.
    - (i) In general.
    - (ii) Properly reflected on the books of the U.S. trade or business of a foreign corporation that is not a bank.

(A) In general.
(B) Identified liabilities not properly reflected.
(iii) Properly reflected on the books of the U.S. trade or business of a foreign corporation that is a bank.
(A) In general.
(B) Inadvertent error.
(iv) Liabilities of insurance companies.
(v) Liabilities used to increase artificially interest expense on U.S. booked liabilities.
(vi) Hedging transactions.
(vii) Amount of U.S. booked liabilities of a partner.
(viii) Interbranch transactions.
(3) Average total amount of U.S. booked liabilities.
(4) Interest expense where U.S. booked liabilities equal or exceed U.S. liabilities.
(i) In general.
(ii) Scaling ratio.
(iii) Special rules for insurance companies.
(5) U.S.-connected interest rate where U.S. booked liabilities are less than U.S.-connected liabilities.
(i) In general.
(ii) Interest rate on excess U.S.-connected liabilities.
(6) Examples.
(e) Separate currency pools method.
(1) General rule.
(i) Determine the value of U.S. assets in each currency pool.
(ii) Determine the U.S.-connected liabilities in each currency pool.
(iii) Determine the interest expense attributable to each currency pool.
(2) Prescribed interest rate.
(3) Hedging transactions.
(4) Election not available if excessive hyperinflationary assets.
(5) Examples.
(f) Effective date.
(1) General rule.
(2) Special rules for financial products.

Par. 4. Section 1.882–5 is revised to read as follows:

§ 1.882–5 Determination of interest deduction.

(a) *Rules of general application*—(1) *Overview*—(i) *In general*. The amount of interest expense of a foreign corporation that is allocable under section 882(c) to income which is (or is treated as) effectively connected with the conduct of a trade or business within the United States (ECI) is the sum of the interest paid or accrued by the foreign corporation on its liabilities booked in the United States, as adjusted under the three-step process set forth in paragraphs (b), (c) and (d) of this section and the specially allocated interest expense determined under section (a)(1)(ii) of this section. The provisions of this section provide the exclusive rules for allocating interest expense to the ECI of a foreign corporation. Under the three-step process, the total value of the U.S. assets of a foreign corporation is first determined under paragraph (b) of this section (Step 1). Next, the amount of U.S.-connected liabilities is determined under paragraph (c) of this section (Step 2). Finally, the amount of interest paid or accrued on liabilities booked in the United States, as determined under paragraph (d)(2) of this section, is adjusted for interest expense attributable to the difference between U.S.-connected liabilities and U.S. booked liabilities (Step 3). Alternatively, a foreign corporation may elect to determine its interest rate on U.S.-connected liabilities by reference to its U.S. assets, using the separate currency pools method described in paragraph (e) of this section.

(ii) *Direct allocations*—(A) *In general*. A foreign corporation that has a U.S. asset and indebtedness that meet the requirements of § 1.861–10T(b) and (c), as limited by § 1.861–10T(d)(1), may directly allocate interest expense from such indebtedness to income from such asset in the manner and to the extent provided in § 1.861–10T. For purposes of paragraphs (b)(1) or (c)(2) of this section, a foreign corporation that allocates its interest expense under the direct allocation rule of this paragraph (a)(1)(ii)(A) shall reduce the basis of the asset that meets the requirements of § 1.861–10T(b) and (c) by the principal amount of the indebtedness that meets the requirements of § 1.861–10T(b) and (c). The foreign corporation shall also disregard any indebtedness that meets the requirements of § 1.861–10T(b) and (c) in determining the amount of the foreign corporation's liabilities under paragraphs (c)(2) and (d)(2) of this section, and shall not take into account any interest expense paid or accrued with respect to such a liability for purposes of paragraphs (d) or (e) of this section.

(B) *Partnership interest*. A foreign corporation that is a partner in a partnership that has a U.S. asset and indebtedness that meet the requirements of § 1.861–10T(b) and (c), as limited by § 1.861–10T(d)(1), may directly allocate its distributive share of interest expense from that indebtedness to its distributive share of income from that asset in the manner and to the extent provided in § 1.861–10T. A foreign corporation that allocates its distributive share of interest expense under the direct allocation rule of this paragraph (a)(1)(ii)(B) shall disregard any partnership indebtedness that meets the requirements of § 1.861–10T(b) and (c) in determining the amount of its distributive share of partnership liabilities for purposes of paragraphs (b)(1), (c)(2)(vi), and (d)(2)(vii) or (e)(1)(ii) of this section, and shall not take into account any partnership interest expense paid or accrued with respect to such a liability for purposes of paragraph (d) or (e) of this section. For purposes of paragraph (b)(1) of this section, a foreign corporation that directly allocates its distributive share of interest expense under this paragraph (a)(1)(ii)(B) shall—

(*1*) Reduce the partnership's basis in such asset by the amount of such indebtedness in allocating its basis in the partnership under § 1.884–1(d)(3)(ii); or

(*2*) Reduce the partnership's income from such asset by the partnership's interest expense from such indebtedness under § 1.884–1(d)(3)(iii).

(2) *Coordination with tax treaties*. The provisions of this section provide the exclusive rules for determining the interest expense attributable to the business profits of a permanent establishment under a U.S. income tax treaty.

(3) *Limitation on interest expense*. In no event may the amount of interest expense computed under this section exceed the amount of interest on indebtedness paid or accrued by the taxpayer within the taxable year (translated into U.S. dollars at the weighted average exchange rate for each currency prescribed by § 1.989(b)–1 for the taxable year).

(4) *Translation convention for foreign currency*. For each computation required by this section, the taxpayer shall translate values and amounts into the relevant currency at a spot rate or a weighted average exchange rate consistent with the method such taxpayer uses for financial reporting purposes, provided such method is applied consistently from year to year. Interest expense paid or accrued, however, shall be translated under the rules of § 1.988–2. The district director or the Assistant Commissioner (International) may require that any or all computations required by this section be made in U.S. dollars if the functional currency of the taxpayer's home office is a hyperinflationary currency, as defined in § 1.985–1, and the computation in U.S. dollars is necessary to prevent distortions.

(5) *Coordination with other sections*. Any provision that disallows, defers, or capitalizes interest expense applies after determining the amount of interest expense allocated to ECI under this section. For example, in determining the amount of interest expense that is disallowed as a deduction under section 265 or 163(j), deferred under section 163(e)(3) or 267(a)(3), or capitalized under section 263A with respect to a United States trade or business, a taxpayer takes into account only the amount of interest expense allocable to ECI under this section.

(6) *Special rule for foreign governments*. The amount of interest expense of a foreign government, as defined in § 1.892–2T(a), that is allocable to ECI is the total amount of interest paid or accrued within the taxable year by the United States trade or business on U.S. booked liabilities (as defined in paragraph (d)(2) of this section). Interest expense of a foreign government, however, is not allocable to ECI to the extent that it is incurred with respect to U.S. booked liabilities that exceed 80 percent of the total value of U.S. assets for the taxable year (determined under paragraph (b) of this section). This paragraph (a)(6) does not apply to controlled commercial entities within the meaning of § 1.892–5T.

(7) *Elections under § 1.882–5*—(i) *In general*. A corporation must make each election provided in this section on the corporation's federal income tax 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. Each election under this section, whether an election for the first taxable year or a subsequent change of election, shall be made by the corporation calculating its interest expense deduction in accordance with the methods elected. An elected method must be used for a minimum period of five years before the taxpayer may elect a different method. To change an election before the end of the requisite five-year period, a taxpayer must obtain the consent of the Commissioner or her delegate. The Commissioner or her delegate will generally consent to a taxpayer's request to change its election only in rare and unusual circumstances.

(ii) *Failure to make the proper election*. If a taxpayer, for any reason, fails to make an election provided in this section in a timely fashion, the district director or the Assistant Commissioner (International) may make any or all of the elections provided in this section on behalf of the taxpayer, and such elections shall be binding as if made by the taxpayer.

(8) *Examples*. The following examples illustrate the application of paragraph (a) of this section:

Example 1. Direct allocations. (i) *Facts*: *FC* is a foreign corporation that conducts business through a branch, *B*, in the United States. Among *B*'s U.S. assets is an interest in a partnership, *P*, that is engaged in airplane leasing solely in the U.S. *FC* contributes 200× to *P* in exchange for its partnership interest. *P* incurs qualified nonrecourse indebtedness within the meaning of § 1.861–10T to purchase an airplane. *FC*'s share of the liability of *P*, as determined under section 752, is 800×.

(ii) *Analysis*: Pursuant to paragraph (a)(1)(ii)(B) of this section, *FC* is permitted to directly allocate its distributive share of the interest incurred with respect to the qualified nonrecourse indebtedness to *FC*'s distributive share of the rental income generated by the airplane. A liability the interest on which is allocated directly to the income from a particular asset under paragraph (a)(1)(ii)(B) of this section is disregarded for purposes of paragraphs (b)(1), (c)(2)(vi), and (d)(2)(vii) or (e)(1)(ii) this section. Consequently, for purposes of determining the value of *FC*'s assets under paragraphs (b)(1) and (c)(2)(vi) of this section, *FC*'s basis in *P* is reduced by the 800× liability as determined under section 752, but is not increased by the 800x liability that is directly allocated under paragraph (a)(1)(ii)(B) of this section. Similarly, pursuant to paragraph (a)(1)(ii)(B) of this section, the 800x liability is disregarded for purposes of determining *FC*'s liabilities under paragraphs (c)(2)(vi) and (d)(2)(vii) of this section.

Example 2. Limitation on interest expense—(i) *FC* is a foreign corporation that conducts a real estate business in the United States. In its 1997 tax year, *FC* has no outstanding indebtedness, and therefore incurs no interest expense. *FC* elects to use the 50% fixed ratio under paragraph (c)(4) of this section.

(ii) Under paragraph (a)(3) of this section, *FC* is not allowed to deduct any interest expense that exceeds the amount of interest on indebtedness paid or accrued in that taxable year. Since *FC* incurred no interest expense in taxable year 1997, *FC* will not be entitled to any interest deduction for that year under § 1.882–5, notwithstanding the fact that *FC* has elected to use the 50% fixed ratio.

Example 3. Coordination with other sections—(i) *FC* is a foreign corporation that is a bank under section 585(a)(2) and a financial institution under section 265(b)(5). *FC* is a calendar year taxpayer, and operates a U.S. branch, *B*. Throughout its taxable year 1997, *B* holds only two assets that are U.S. assets within the meaning of paragraph (b)(1) of this section. *FC* does not make a fair-market value election under paragraph (b)(2)(ii) of this section, and, therefore, values its U.S. assets according to their bases under paragraph (b)(2)(i) of this section. The first asset is a taxable security with an adjusted basis of $100. The second asset is an obligation the interest on which is exempt from federal taxation under section 103, with an adjusted basis of $50. The tax-exempt obligation is not a qualified tax-exempt obligation as defined by section 265(b)(3)(B).

(ii) *FC* calculates its interest expense under § 1.882–5 to be $12. Under paragraph (a)(5) of this section, however, a portion of the interest expense that is allocated to *FC*'s effectively connected income under § 1.882–5 is disallowed in accordance with the provisions of section 265(b). Using the methodology prescribed under section 265, the amount of disallowed interest expense is $4, calculated as follows:

$$\$12 \times \frac{\$50 \textit{ Tax-exempt U.S. assets}}{\$150 \text{ Total U.S. assets}} = \$4$$

(iii) Therefore, *FC* deducts a total of $8 ($12 — $4) of interest expense attributable to its effectively connected income in 1997.

Example 4. Treaty exempt asset—(i) *FC* is a foreign corporation, resident in Country X, that is actively engaged in the banking business in the United States through a permanent establishment, *B*. The income tax treaty in effect between Country X and the United States provides that *FC* is not taxable on foreign source income earned by its U.S. permanent establishment. In its 1997 tax year, *B* earns $90 of U.S. source income from U.S. assets with an adjusted tax basis of $900, and $12 of foreign source interest income from U.S. assets with an adjusted tax basis of $100. *FC*'s U.S. interest expense deduction, computed in accordance with § 1.882–5, is $500.

(ii) Under paragraph (a)(5) of this section, *FC* is required to apply any provision that disallows, defers, or capitalizes interest expense after determining the interest expense allocated to ECI under § 1.882–5. Section 265(a)(2) disallows interest expense that is allocable to one or more classes of income that are wholly exempt from taxation under subtitle A of the Internal Revenue Code. Section 1.265–1(b) provides that income wholly exempt from taxes includes both income excluded from tax under any provision of subtitle A and income wholly exempt from taxes under any other law. Section 894 specifies that the provisions of subtitle A are applied with due regard to any relevant treaty obligation of the United States. Because the treaty between the United States and Country X exempts foreign source income earned by *B* from U.S. tax, *FC* has assets that produce income wholly exempt from taxes under subtitle A, and must therefore allocate a portion of its § 1.882–5 interest expense to its exempt income. Using the methodology prescribed under section 265, the amount of disallowed interest expense is $50, calculated as follows:

$$\$500 \times \frac{\textit{\$100 Treaty-exempt U.S. assets}}{\$1000 \text{ Total U.S. assets}} = \$50$$

(iii) Therefore, *FC* deducts a total of $450 ($500 — $50) of interest expense attributable to its effectively connected income in 1997.

(b) *Step 1: Determination of total value of U.S. assets for the taxable year*—(1) *Classification of an asset as a U.S. asset*—(i) *General rule*. Except as otherwise provided in this paragraph (b)(1), an asset is a U.S. asset for purposes of this section to the extent that it is a U.S. asset under § 1.884–1(d). For purposes of this section, the term *determination date*, as used in § 1.884–1(d), means each day for which the total value of U.S. assets is computed under paragraph (b)(3) of this section.

(ii) *Items excluded from the definition of U.S. asset*. For purposes of this section, the term *U.S. asset* excludes an asset to the extent it produces income or gain described in sections 883(a)(3) and (b).

(iii) *Items included in the definition of U.S. asset*. For purposes of this section, the term *U.S. asset* includes—

(A) U.S. real property held in a wholly-owned domestic subsidiary of a foreign corporation that qualifies as a bank under section 585(a)(2)(B) (without regard to the second sentence thereof), provided that the real property would qualify as used in the foreign corporation's trade or business within the meaning of § 1.864–4(c)(2) or (3) if held directly by the foreign corporation and either was initially acquired through foreclosure or similar proceedings or is U.S. real property occupied by the foreign corporation (the value of which shall be adjusted by the amount of any indebtedness that is reflected in the value of the property);

(B) An asset that produces income treated as ECI under section 921(d) or 926(b) (relating to certain income of a FSC and certain dividends paid by a FSC to a foreign corporation);

(C) An asset that produces income treated as ECI under section 953(c)(3)(C) (relating to certain income of a captive insurance company that a corporation elects to treat as ECI) that is not otherwise ECI; and

(D) An asset that produces income treated as ECI under section 882(e) (relating to certain interest income of possessions banks).

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

(v) *Assets acquired to increase U.S. assets artificially*. An asset shall not be treated as a U.S. asset if one of the principal purposes for acquiring or using that asset is to increase artificially the U.S. assets of a foreign corporation on the determination date. Whether an asset is acquired or used for such purpose will depend upon all the facts and circumstances of each case. Factors to be considered in determining whether one of the principal purposes in acquiring or using an asset is to increase artificially the U.S. assets of a foreign corporation include the length of time during which the asset was used in a U.S. trade or business, whether the asset was acquired from a related person, and whether the aggregate value of the U.S. assets of the foreign corporation increased temporarily on or around the determination date. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(2) *Determination of the value of a U.S. asset*—(i) *General rule*. The value of a U.S. asset is the adjusted basis of the asset for determining gain or loss from the sale or other disposition of that item, further adjusted as provided in paragraph (b)(2)(iii) of this section.

(ii) *Fair-market value election*—(A) *In general*. A taxpayer may elect to value all of its U.S. assets on the basis of fair market value, subject to the requirements of § 1.861–9T(g)(1)(iii), and provided the taxpayer uses the methodology prescribed in § 1.861–9T(h). Once elected, the fair market value must be used by the taxpayer for both Step 1 and Step 2 described in paragraphs (b) and (c) of this section, and must be used in all subsequent taxable years unless the Commissioner or her delegate consents to a change.

(B) *Adjustment to partnership basis*. If a partner makes a fair market value election under paragraph (b)(2)(ii) of this section, the value of the partner's interest in a partnership that is treated as an asset shall be the fair market value of his partnership interest, increased by the fair market value of the partner's share of the liabilities determined under paragraph (c)(2)(vi) of this section. See § 1.884–1(d)(3).

(iii) *Reduction of total value of U.S. assets by amount of bad debt reserves under section 585*—(A) *In general*. The total value of loans that qualify as U.S. assets shall be reduced by the amount of any reserve for bad debts additions to which are allowed as deductions under section 585.

(B) *Example*. The following example illustrates the provisions of paragraph (b)(2)(iii)(A) of this section:

Example. *Foreign banks; bad debt reserves*. *FC* is a foreign corporation that qualifies as a bank under section 585(a)(2)(B) (without regard to the second sentence thereof), but is not a large bank as defined in section 585(c)(2). *FC* conducts business through a branch, *B*, in the United States. Among *B*'s U.S. assets are a portfolio of loans with an adjusted basis of $500. *FC* accounts for its bad debts for U.S. federal income tax purposes under the reserve method, and *B* maintains a deductible reserve for bad debts of $50. Under paragraph (b)(2)(iii) of this section, the total value of *FC*'s portfolio of loans is $450 ($500 — $50).

(iv) *Adjustment to basis of financial instruments*. [Reserved]

(3) *Computation of total value of U.S. assets*. The total value of U.S. assets for the taxable year is the average of the sums of the values (determined under paragraph (b)(2) of this section) of U.S. assets. For each U.S. asset, value shall be computed at the most frequent, regular intervals for which data are reasonably available. In no event shall the value of any U.S. asset be computed less frequently than monthly by a large bank (as defined in section 585(c)(2)) and semi-annually by any other taxpayer.

(c) *Step 2: Determination of total amount of U.S.-connected liabilities for the taxable year*—(1) *General rule*.

The amount of U.S.-connected liabilities for the taxable year equals the total value of U.S. assets for the taxable year (as determined under paragraph (b)(3) of this section) multiplied by the actual ratio for the taxable year (as determined under paragraph (c)(2) of this section) or, if the taxpayer has made an election in accordance with paragraph (c)(4) of this section, by the fixed ratio.

(2) *Computation of the actual ratio*—(i) *In general*. A taxpayer's actual ratio for the taxable year is the total amount of its worldwide liabilities for the taxable year divided by the total value of its worldwide assets for the taxable year. The total amount of worldwide liabilities and the total value of worldwide assets for the taxable year is the average of the sums of the amounts of the taxpayer's worldwide liabilities and the values of its worldwide assets (determined under paragraphs (c)(2)(iii) and (iv) of this section). In each case, the sums must be computed semi-annually by a large bank (as defined in section 585(c)(2)) and annually by any other taxpayer.

(ii) *Classification of items*. The classification of an item as a liability or an asset must be consistent from year to year and in accordance with U.S. tax principles.

(iii) *Determination of amount of worldwide liabilities*. The amount of a liability must be determined consistently from year to year and must be substantially in accordance with U.S. tax principles. To be substantially in accordance with U.S. tax principles, the principles used to determine the amount of a liability must not differ from U.S. tax principles to a degree that will materially affect the value of taxpayer's worldwide liabilities or the taxpayer's actual ratio.

(iv) *Determination of value of worldwide assets*. The value of an asset must be determined consistently from year to year and must be substantially in accordance with U.S. tax principles. To be substantially in accordance with U.S. tax principles, the principles used to determine the value of an asset must not differ from U.S. tax principles to a degree that will materially affect the value of the taxpayer's worldwide assets or the taxpayer's actual ratio. The value of an asset is the adjusted basis of that asset for determining the gain or loss from the sale or other disposition of that asset, adjusted in the same manner as the basis of U.S. assets are adjusted under paragraphs (b)(2)(ii) through (iv) of this section.

(v) *Hedging transactions*. [Reserved]

(vi) *Treatment of partnership interests and liabilities*. For purposes of computing the actual ratio, the value of a partner's interest in a partnership that will be treated as an asset is the partner's adjusted basis in its partnership interest, reduced by the partner's share of liabilities of the partnership as determined under section 752 and increased by the partner's share of liabilities determined under this paragraph (c)(2)(vi). If the partner has made a fair market value election under paragraph (b)(2)(ii) of this section, the value of its interest in the partnership shall be increased by the fair market value of the partner's share of the liabilities determined under this paragraph (c)(2)(vi). For purposes of this section a partner shares in any liability of a partnership in the same proportion that it shares, for income tax purposes, in the expense attributable to that liability for the taxable year. A partner's adjusted basis in a partnership interest cannot be less than zero.

(vii) *Computation of actual ratio of insurance companies*. [Reserved]

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

(ix) *Amounts must be expressed in a single currency*. The actual ratio must be computed in either U.S. dollars or the functional currency of the home office of the taxpayer, and that currency must be used consistently from year to year. For example, a taxpayer that determines the actual ratio annually using British pounds converted at the spot rate for financial reporting purposes must translate the U.S. dollar values of assets and amounts of liabilities of the U.S. trade or business into pounds using the spot rate on the last day of its taxable year. The district director or the Assistant Commissioner (International) may require that the actual ratio be computed in dollars if the functional currency of the taxpayer's home office is a hyperinflationary currency, as defined in § 1.985–1, that materially distorts the actual ratio.

(3) *Adjustments*. The District Director or the Assistant Commissioner (International) may make appropriate adjustments to prevent a foreign corporation from intentionally and artificially increasing its actual ratio. For example, the District Director or the Assistant Commissioner (International) may offset a loan made from or to one person with a loan made to or from another person if any of the parties to the loans are related persons, within the meaning of section 267(b) or 707(b)(1), and one of the principal purposes for entering into the loans was to increase artificially the actual ratio of a foreign corporation. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(4) *Elective fixed ratio method of determining U.S. liabilities*. A taxpayer that is a bank as defined in section 585(a)(2)(B)(without regard to the second sentence thereof) may elect to use a fixed ratio of 93 percent in lieu of the actual ratio. A taxpayer that is neither a bank nor an insurance company may elect to use a fixed ratio of 50 percent in lieu of the actual ratio.

(5) *Examples*. The following examples illustrate the application of paragraph (c) of this section:

Example 1. Classification of item not in accordance with U.S. tax principles. Bank *Z*, a resident of country *X*, has a branch in the United States through which it conducts its banking business. In preparing its financial statements in country *X*, *Z* treats an instrument documented as perpetual subordinated debt as a liability. Under U.S. tax principles, however, this instrument is treated as equity. Consequently, the classification of this instrument as a liability for purposes of paragraph (c)(2)(iii) of this section is not in accordance with U.S. tax principles.

Example 2. Valuation of item not substantially in accordance with U.S. tax principles. Bank *Z*, a resident of country *X*, has a branch in the United States through which it conducts its banking business. Bank *Z* is a large bank as defined in section 585(c)(2). The tax rules of country *X* allow Bank *Z* to take deductions for additions to certain reserves. Bank *Z* decreases the value of the assets on its financial statements by the amounts of the reserves. The additions to the reserves under country *X* tax rules cause the value of Bank *Z*'s assets to differ from the value of those assets determined under U.S. tax principles to a degree that materially affects the value of taxpayer's worldwide assets. Consequently, the valuation of Bank *Z*'s worldwide assets under country *X* tax principles is not substantially in accordance with U.S. tax principles. Bank *Z* must increase the value of its worldwide assets under paragraph (c)(2)(iii) of this section by the amount of its country *X* reserves.

Example 3. Valuation of item substantially in accordance with U.S. tax principles. Bank *Z*, a resident of country *X*, has a branch in the United States through which it conducts its banking business. In determining the value of its worldwide assets, Bank *Z* computes the adjusted basis of certain non-U.S. assets according to the depreciation methodology provided under country *X* tax laws, which is different than the depreciation methodology provided under U.S. tax law. If the depreciation methodology provided under country *X* tax laws does not differ from U.S. tax principles to a degree that materially affects the value of Bank Z's worldwide assets or Bank *Z*'s actual ratio as computed under paragraph (c)(2) of this section, then the valuation of Bank *Z*'s worldwide assets under paragraph (c)(2)(iv) of this section is substantially in accordance with U.S. tax principles.

Example 4. [Reserved]

Example 5. *Adjustments*. *FC* is a foreign corporation engaged in the active conduct of a banking business through a branch, *B*, in the United States. *P*, an unrelated foreign corporation, deposits $100,000 in the home office of *FC*. Shortly thereafter, in a transaction arranged by the home office of *FC*, *B* lends $80,000 bearing interest at an arm's length rate to *S*, a wholly owned U.S. subsidiary of *P*. The district director or the Assistant Commissioner (International) determines that one of the principal purposes for making and incurring such loans is to increase *FC*'s actual ratio. For purposes of this section, therefore, *P* is treated as having directly lent $80,000 to *S*. Thus, for purposes of paragraph (c) of this section (Step 2), the District Director or the Assistant Commissioner (International) may offset *FC*'s liability and asset arising from this transaction, resulting in a net liability of $20,000 that is not a booked liability of *B*. Because the loan to *S* from *B* was initiated and arranged by the home office of *FC*, with no material participation by *B*, the loan to *S* will not be treated as a U.S. asset.

(d) *Step 3: Determination of amount of interest expense allocable to ECI under the adjusted U.S. booked liabilities method*—(1) *General rule*. The adjustment to the amount of interest expense paid or accrued on U.S. booked liabilities is determined by comparing the amount of U.S.-connected liabilities for the taxable year, as determined under paragraph (c) of this section, with the average total amount of U.S. booked liabilities, as determined under paragraphs (d)(2) and (3) of this section. If the average total amount of U.S. booked liabilities equals or exceeds the amount of U.S.-connected liabilities, the adjustment to the interest expense on U.S. booked liabilities is determined under paragraph (d)(4) of this section. If the amount of U.S.-connected liabilities exceeds the average total amount of U.S. booked liabilities, the adjustment to the amount of interest expense paid or accrued on U.S. booked liabilities is determined under paragraph (d)(5) of this section.

(2) *U.S. booked liabilities*—(i) *In general*. A liability is a *U.S. booked liability* if it is properly reflected on the books of the U.S. trade or business, within the meaning of paragraph (d)(2)(ii) or (iii) of this section.

(ii) *Properly reflected on the books of the U.S. trade or business of a foreign corporation that is not a bank*—(A) *In general*. A liability, whether interest bearing or non-interest bearing, is properly reflected on the books of the U.S. trade or business of a foreign corporation that is not a bank as described in section 585(a)(2)(B) (without regard to the second sentence thereof) if—

(*1*) The liability is secured predominantly by a U.S. asset of the foreign corporation;

(*2*) The foreign corporation enters the liability on a set of books relating to an activity that produces ECI at a time reasonably contemporaneous with the time at which the liability is incurred; or

(*3*) The foreign corporation maintains a set of books and records relating to an activity that produces ECI and the District Director or Assistant Commissioner (International) determines that there is a direct connection or relationship between the liability and that activity. Whether there is a direct connection between the liability and an activity that produces ECI depends on the facts and circumstances of each case.

(B) *Identified liabilities not properly reflected*. A liability is not properly reflected on the books of the U.S. trade or business merely because a foreign corporation identifies the liability pursuant to § 1.884–4(b)(1)(ii) and (b)(3).

(iii) *Properly reflected on the books of the U.S. trade or business of a foreign corporation that is a bank*—(A) *In general*. A liability, whether interest bearing or non-interest bearing, is properly reflected on the books of the U.S. trade or business of a foreign corporation that is a bank as described in section 585(a)(2)(B) (without regard to the second sentence thereof) if—

(*1*) The bank enters the liability on a set of books relating to an activity that produces ECI before the close of the day on which the liability is incurred; and

(*2*) There is a direct connection or relationship between the liability and that activity. Whether there is a direct connection between the liability and an activity that produces ECI depends on the facts and circumstances of each case.

(B) *Inadvertent error*. If a bank fails to enter a liability in the books of the activity that produces ECI before the close of the day on which the liability was incurred, the liability may be treated as a U.S. booked liability only if, under the facts and circumstances, the taxpayer demonstrates a direct connection or relationship between the liability and the activity that produces ECI and the failure to enter the liability in those books was due to inadvertent error.

(iv) *Liabilities of insurance companies*. [Reserved]

(v) *Liabilities used to increase artificially interest expense on U.S. booked liabilities*. U.S. booked liabilities shall not include a liability if one of the principal purposes for incurring or holding the liability is to increase artificially the interest expense on the U.S. booked liabilities of a foreign corporation. Whether a liability is incurred or held for the purpose of artificially increasing interest expense will depend upon all the facts and circumstances of each case. Factors to be considered in determining whether one of the principal purposes for incurring or holding a liability is to increase artificially the interest expense on U.S. booked liabilities of a foreign corporation include whether the interest expense on the liability is excessive when compared to other liabilities of the foreign corporation denominated in the same currency and whether the currency denomination of the liabilities of the U.S. branch substantially matches the currency denomination of the U.S. branch's assets. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(vi) *Hedging transactions*. [Reserved]

(vii) *Amount of U.S. booked liabilities of a partner*. A partner's share of liabilities of a partnership is considered a booked liability of the partner provided that it is properly reflected on the books (within the meaning of paragraph (d)(2)(ii) of this section) of the U.S. trade or business of the partnership.

(viii) *Interbranch transactions*. A transaction of any type between separate offices or branches of the same taxpayer does not result in the creation of a liability.

(3) *Average total amount of U.S. booked liabilities*. The *average total*

amount of U.S. booked liabilities for the taxable year is the average of the sums of the amounts (determined under paragraph (d)(2) of this section) of U.S. booked liabilities. The amount of U.S. booked liabilities shall be computed at the most frequent, regular intervals for which data are reasonably available. In no event shall the amount of U.S. booked liabilities be computed less frequently than monthly by a large bank (as defined in section 585(c)(2)) and semi-annually by any other taxpayer.

(4) *Interest expense where U.S. booked liabilities equal or exceed U.S. liabilities*—(i) *In general*. If the average total amount of U.S. booked liabilities (as determined in paragraphs (d)(2) and (3) of this section) exceeds the amount of U.S.-connected liabilities (as determined under paragraph (c) of this section (Step 2)), the interest expense allocable to ECI is the product of the total amount of interest paid or accrued within the taxable year by the U.S. trade or business on U.S. booked liabilities and the scaling ratio set out in paragraph (d)(4)(ii) of this section. For purposes of this section, the reduction resulting from the application of the scaling ratio is applied pro-rata to all interest expense paid or accrued by the foreign corporation. A similar reduction in income, expense, gain, or loss from a hedging transaction (as described in paragraph (d)(2)(vi) of this section) must also be determined by multiplying such income, expense, gain, or loss by the scaling ratio. If the average total amount of U.S. booked liabilities (as determined in paragraph (d)(3) of this section) equals the amount of U.S.-connected liabilities (as determined under *Step 2*), the interest expense allocable to ECI is the total amount of interest paid or accrued within the taxable year by the U.S. trade or business on U.S. booked liabilities.

(ii) *Scaling ratio*. For purposes of this section, the scaling ratio is a fraction the numerator of which is the amount of U.S.-connected liabilities and the denominator of which is the average total amount of U.S. booked liabilities.

(iii) *Special rules for insurance companies*. [Reserved]

(5) *U.S.-connected interest rate where U.S. booked liabilities are less than U.S.-connected liabilities*—(i) *In general*. If the amount of U.S.-connected liabilities (as determined under paragraph (c) of this section (Step 2)) exceeds the average total amount of U.S. booked liabilities, the interest expense allocable to ECI is the total amount of interest paid or accrued within the taxable year by the U.S. trade or business on U.S. booked liabilities, plus the excess of the amount of U.S.-connected liabilities over the average total amount of U.S. booked liabilities multiplied by the interest rate determined under paragraph (d)(5)(ii) of this section.

(ii) *Interest rate on excess U.S.-connected liabilities*. The applicable interest rate on excess U.S.-connected liabilities is determined by dividing the total interest expense paid or accrued for the taxable year on U.S.-dollar liabilities shown on the books of the offices or branches of the foreign corporation outside the United States by the average U.S.-dollar denominated liabilities (whether interest-bearing or not) shown on the books of the offices or branches of the foreign corporation outside the United States for the taxable year.

(6) *Examples*. The following examples illustrate the rules of this section:

Example 1. Computation of interest expense; actual ratio—(i) *Facts*. (A) *FC* is a foreign corporation that is not a bank and that actively conducts a real estate business through a branch, *B*, in the United States. For the taxable year, *FC*'s balance sheet and income statement is as follows (assume amounts are in U.S. dollars and computed in accordance with paragraphs (b)(2) and (b)(3) of this section):

	Value
Asset 1	$2,000
Asset 2	$2,500
Asset 3	$5,500

	Amount	*Interest Expense*
Liability 1	$ 800	56
Liability 2	$3,200	256
Capital	$6,000	0

(B) Asset 1 is the stock of *FC*'s wholly-owned domestic subsidiary that is also actively engaged in the real estate business. Asset 2 is a building in the United States producing rental income that is entirely ECI to *FC*. Asset 3 is a building in the home country of *FC* that produces rental income. Liabilities 1 and 2 are loans that bear interest at the rates of 7% and 8%, respectively. Liability 1 is a booked liability of B, and Liability 2 is booked in *FC*'s home country. Assume that *FC* has not elected to use the fixed ratio in Step 2.

(ii) *Step 1*. Under paragraph (b)(1) of this section, Assets 1 and 3 are not U.S. assets, while Asset 2 qualifies as a U.S. asset. Thus, under paragraph (b)(3) of this section, the total value of U.S. assets for the taxable year is $2,500, the value of Asset 2.

(iii) *Step 2*. Under paragraph (c)(1) of this section, the amount of *FC*'s U.S.-connected liabilities for the taxable year is determined by multiplying $2,500 (the value of U.S. assets determined under Step 1) by the actual ratio for the taxable year. The actual ratio is the average amount of *FC*'s worldwide liabilities divided by the average value of *FC*'s worldwide assets. The amount of Liability 1 is $800, and the amount of Liability 2 is $3,200. Thus, the numerator of the actual ratio is $4,000. The average value of worldwide assets is $10,000 (Asset 1 + Asset 2 + Asset 3). The actual ratio, therefore, is 40% ($4,000/$10,000), and the amount of U.S.-connected liabilities for the taxable year is $1,000 ($2,500 U.S. assets × 40%).

(iv) *Step 3*. Because the amount of *FC*'s U.S.-connected liabilities ($1,000) exceeds the average total amount of U.S. booked liabilities of *B* ($800), *FC* determines its interest expense in accordance with paragraph (d)(5) of this section by adding the interest paid or accrued on U.S. booked liabilities, and the interest expense associated with the excess of its U.S.-connected liabilities over its average total amount of U.S. booked liabilities. Under paragraph (d)(5)(ii) of this section, *FC* determines the interest rate attributable to its excess U.S.-connected liabilities by dividing the interest expense paid or accrued by the average amount of U.S.-dollar denominated liabilities, which produces an interest rate of 8% ($256/$3200). Therefore, *FC*'s allocable interest expense is $72 ($56 of interest expense from U.S. booked liabilities plus $16 ($200 × 8%) of interest expense attributable to its excess U.S.-connected liabilities).

Example 2. Computation of interest expense; fixed ratio—(i) The facts are the same as in *Example 1*, except that *FC* makes a fixed ratio election under paragraph (c)(4) of this section. The conclusions under Step 1 are the same as in *Example 1*.

(ii) *Step 2*. Under paragraph (c)(1) of this section, the amount of U.S.-connected liabilities for the taxable year is determined by multiplying $2,500 (the value of U.S. assets determined under Step 1) by the fixed ratio for the taxable year, which, under paragraph (c)(4) of this section is 50 percent. Thus, the amount of U.S.-connected liabilities for the taxable year is $1,250 ($2,500 U.S. assets × 50%).

(iii) *Step 3*. As in *Example 1*, the amount of *FC*'s U.S.-connected liabilities exceed the average total amount of U.S. booked liabilities of *B*, requiring *FC* to determine its interest expense under paragraph (d)(5) of this section. In this case, however, *FC* has excess U.S.-connected liabilities of $450 ($1,250 of U.S.-connected liabilities — $800 U.S. booked liabilities). *FC* therefore has allocable interest expense of $92 ($56 of interest expense from U.S. booked liabilities plus $36 ($450 × 8%) of interest expense attributable to its excess U.S.-connected liabilities).

Example 3. Scaling ratio.—(i) *Facts*. Bank *Z*, a resident of country *X*, has a branch in the United States through which it conducts its banking business. For the taxable year, *Z* has U.S.-connected liabilities, determined under paragraph (c) of this section, equal to $300. *Z*, however, has U.S. booked liabilities of $300 and *U*500. Therefore, assuming an exchange rate of the *U* to the U.S. dollar of 5:1, *Z* has U.S. booked liabilities of $400 ($300 + (*U*500 ÷ 5)).

(ii) *U.S.-connected liabilities*. Because *Z*'s U.S. booked liabilities of $400 exceed its U.S.-

connected liabilities by $100, all of *Z*'s interest expense allocable to its U.S. trade or business must be scaled back pro-rata. To determine the scaling ratio, *Z* divides its U.S.-connected liabilities by its U.S. booked liabilities, as required by paragraph (d)(4) of this section. *Z*'s interest expense is scaled back pro rata by the resulting ratio of ¾ ($300 ÷ $400). *Z*'s income, expense, gain or loss from hedging transactions described in paragraph (d)(2)(vi) of this section must be similarly reduced.

Example 4. [Reserved]

(e) *Separate currency pools method*—(1) *General rule*. If a foreign corporation elects to use the method in this paragraph, its total interest expense allocable to ECI is the sum of the separate interest deductions for each of the currencies in which the foreign corporation has U.S. assets. The separate interest deductions are determined under the following three-step process.

(i) *Determine the value of U.S. assets in each currency pool*. First, the foreign corporation must determine the amount of its U.S. assets, using the methodology in paragraph (b) of this section, in each currency pool. The foreign corporation may convert into U.S. dollars any currency pool in which the foreign corporation holds less than 3% of its U.S. assets. A transaction (or transactions) that hedges a U.S. asset shall be taken into account for purposes of determining the currency denomination and the value of the U.S. asset.

(ii) *Determine the U.S.-connected liabilities in each currency pool*. Second, the foreign corporation must determine the amount of its U.S.-connected liabilities in each currency pool by multiplying the amount of U.S. assets (as determined under paragraph (b)(3) of this section) in the currency pool by the foreign corporation's actual ratio (as determined under paragraph (c)(2) of this section) for the taxable year or, if the taxpayer has made an election in accordance with paragraph (c)(4) of this section, by the fixed ratio.

(iii) *Determine the interest expense attributable to each currency pool*. Third, the foreign corporation must determine the interest expense attributable to each currency pool by multiplying the U.S.-connected liabilities in each currency pool by the prescribed interest rate as defined in paragraph (e)(2) of this section.

(2) *Prescribed interest rate*. For each currency pool, the prescribed interest rate is determined by dividing the total interest expense that is paid or accrued for the taxable year with respect to the foreign corporation's worldwide liabilities denominated in that currency, by the foreign corporation's average worldwide liabilities (whether interest bearing or not) denominated in that currency. The interest expense and liabilities are to be stated in that currency.

(3) *Hedging transactions*. [Reserved]

(4) *Election not available if excessive hyperinflationary assets*. The election to use the separate currency pools method of this paragraph (e) is not available if the value of the foreign corporation's U.S. assets denominated in a hyperinflationary currency, as defined in § 1.985–1, exceeds ten percent of the value of the foreign corporation's total U.S. assets. If a foreign corporation made a valid election to use the separate currency pools method in a prior year but no longer qualifies to use such method pursuant to this paragraph (e)(4), the taxpayer must use the method provided by paragraphs (b) through (d) of this section.

(5) *Examples*. The separate currency pools method of this paragraph (e) is illustrated by the following examples:

Example 1. Separate currency pools method—(i) *Facts*. (A) Bank *Z*, a resident of country *X*, has a branch in the United States through which it conducts its banking business. For its 1997 taxable year, *Z* has U.S. assets, as defined in paragraph (b) of this section, that are denominated in U.S. dollars and in *U*, the country *X* currency. Accordingly, *Z*'s U.S. assets are as follows:

	Average Value
U.S. Dollar Assets	$20,000
U Assets	*U* 5,000

(B) *Z*'s worldwide liabilities are also denominated in U.S. dollars and in *U*. The average interest rates on *Z*'s worldwide liabilities, including those in the United States, are 6% on its U.S. dollar liabilities, and 12% on its liabilities denominated in *U*. Assume that *Z* has properly elected to use its actual ratio of 95% to determine its U.S.-connected liabilities in Step 2, and has also properly elected to use the separate currency pools method provided in paragraph (e) of this section.

(ii) *Determination of interest expense*. *Z* determines the interest expense attributable to its U.S.-connected liabilities according to the steps described below.

(A) First, *Z* separates its U.S. assets into two currency pools, one denominated in U.S. dollars ($20,000) and the other denominated in *U* (*U*5,000).

(B) Second, *Z* multiplies each pool of assets by the applicable ratio of worldwide liabilities to assets, which in this case is 95%. Thus, Z has U.S.-connected liabilities of $19,000 ($20,000 × 95%), and *U*4750 (*U*5000 × 95%).

(C) Third, *Z* calculates its interest expense by multiplying each pool of its U.S.-connected liabilities by the relevant interest rates. Accordingly, *Z*'s allocable interest expense for the year is $1140 ($19,000 × 6%), the sum of the expense associated with its U.S. dollar liabilities, plus *U*570 (*U*4750 × 12%), the interest expense associated with its liabilities denominated in *U*. *Z* must translate its interest expense denominated in *U* in accordance with the rules provided in section 988, and then must determine whether it is subject to any other provision of the Code that would disallow or defer any portion of its interest expense so determined.

Example 2. [Reserved]

(f) *Effective date*—(1) *General rule*. This section is effective for taxable years beginning on or after June 6, 1996.

(2) *Special rules for financial products*. [Reserved]

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved February 28, 1996.

Leslie Samuels,
Assistant Secretary of the Treasury.

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