[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9465]

RIN 1545-BF71

Determination of Interest Expense Deduction of Foreign Corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations under section 882(c) of the Internal Revenue Code (Code) concerning the determination of the interest expense deduction of foreign corporations engaged in a trade or business within the United States. These final regulations conform the interest expense rules to recent U.S. Income Tax Treaty agreements and adopt other changes to improve compliance.

DATES**:** These final regulations are effective **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

FOR FURTHER INFORMATION CONTACT: Anthony J. Marra, (202) 622-3870 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction

Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-2030. Responses to this collection of information are mandatory. The collection of information in these final regulations is in §1.884-1(e)(3)(iv). This information is required by the IRS to allow a taxpayer to reduce U.S. liabilities to the extent necessary to prevent the recognition of a dividend equivalent amount.

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.

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

Background

On August 17, 2006, the Treasury Department and the IRS published TD 9281 (71 FR 47443-01, 2006-2 CB 517) (the temporary regulations) under section 882(c) of the Internal Revenue Code regarding the determination of a foreign corporation's interest expense allocable to income effectively connected with the conduct of a trade or business within the United States. On the same day, a notice of proposed rulemaking (REG-120509-06, 71 FR 47459, 2006-2 CB 570) was published by cross-reference to the temporary regulations in the **Federal Register**. See §601.601(d)(2)(ii)(b).

Section 1.882-5 generally requires a foreign corporation to use a three-step calculation to determine the amount of interest expense that is allocable under section 882(c) to income effectively connected (or treated as effectively connected) with the foreign corporation's conduct of a trade or business within the United States. The notice of proposed rulemaking (the proposed regulations) provided for certain changes in the three-step calculation. First, the proposed regulations revised the election to use fair market value rather than adjusted basis in valuing U.S.

assets in Step 1. That revision required the taxpayer to use fair market valuations for both Step 1 purposes and the entire determination of the actual ratio in Step 2. The proposed regulations also revised the Step 2 elective fixed ratio for foreign banks, allowing a 95 percent fixed ratio to be used in lieu of the actual ratio. In Step 3, the proposed regulations allowed a foreign bank with excess U.S.-connected liabilities over U.S.-booked liabilities under the adjusted U.S. booked liabilities (AUSBL) method to elect to use the 30-day London Interbank Offering Rate (LIBOR) to calculate interest on the excess U.S.-connected liabilities.

In addition to the changes in the three-step calculation, the proposed regulations implemented guidance provided in Notice 2005-53 (2005-32 IRB 263, 2005-2 CB 263) regarding the interaction of §1.882-5 and U.S. income tax treaties in recognition that recent treaties expressly permit taxpayers to determine attribution of business profits to a permanent establishment by analogy to the 1995 Organisation for Economic Co-operation and Development Transfer Pricing Guidelines (Authorized OECD Approach). For purposes of applying the branch profits tax, the proposed regulations expanded the election under §1.884-1 to allow a taxpayer to reduce U.S. liabilities to the extent necessary to prevent the recognition of a dividend equivalent amount, but not below zero. Finally, the proposed regulations clarified the application of the 1996 final regulations under §1.882-5 with respect to certain direct interest allocations, the definition of U.S.-booked liabilities, and the treatment of certain currency gain and loss for purposes of §1.882-5. The preamble of TD 9281 includes background information with respect to the proposed regulations and a further explanation of these provisions. See §601.601(d)(2)(ii)(b).

The IRS received written comments in response to the proposed regulations. No requests to speak at a public hearing were received and no hearing was held. After consideration of the

comments received, the proposed regulations are adopted without substantive change by this Treasury decision, and the corresponding temporary regulations are removed. To relieve taxpayers of the burden of duplicative reporting, these final regulations coordinate the various elections provided in the three-step formula with the filing of taxpayer's Schedule I (Form 1120-F). Taxpayers filing protective tax returns under §1.882-4(a)(3)(vi) may make §1.882-5 protective elections by attaching Schedule I to a timely filed return (including extensions). Taxpayers must separately attach to the Form 1120-F, any election to reduce U.S. liabilities for branch profits tax purposes as permitted by §1.884-1(e)(3). A taxpayer's Schedule I must reflect the cumulative amount of all U.S. liability reductions.

Many of the comments received raised issues specific to certain financial transactions that require broader considerations than the interaction of §1.882-5 and those financial transactions. The Treasury Department and the IRS received a number of comments requesting that the 1996 proposed hedging regulations (INTL-0054-95, 1996-1 CB 844) be finalized and expanded, in certain cases, to cover interbranch activities (including currency gains and losses). Since those regulations were proposed, the increase in interdesk and interbranch hedging (in both dealer and nondealer operations) has given rise to special considerations other than the familiar limitations associated with capital and ordinary income distinctions. In this regard, the proposed 1998 global dealing regulations, for example, require special considerations as to the appropriate treatment of risk transfer agreements in similar circumstances. In light of the need for a broader consideration of these issues, the Treasury Department and the IRS are not adopting the suggestions outlined in the comments received at this time. See §601.601(d)(2)(ii)(b).

Commentators also suggested that the regulations adopt special rules that would govern the treatment of certain integrated financial transactions such as effectively connected sale-

repurchase agreements and securities lending transactions. The commentators suggested the adoption of a direct tracing rule that would, in effect, give zero risk weighting to such assets, especially in defined dealer books consisting of sale-repurchase transactions and securities loans involving U.S. Treasuries and other government securities. The suggested rule would scale back the amount of capital that is imputed to such portfolios under either the actual ratio or the fixed ratio to reflect the economic reality that such assets are entirely debt-financed. Commentators also suggested that "netting" rules apply for offsetting notional principal contracts within discrete portfolios. Finally, commentators suggested revisions to the definition of U.S.-booked liabilities that would exclude certain conduit interbranch lending arrangements. The Treasury Department and the IRS are not adopting these suggestions at this time but continue to consider the issues raised in this context and intend to coordinate these issues, where appropriate, with similar issues in analogous contexts, such as global dealing operations and section 864(e). See Notice 2001-59 (2001-41 IRB 315, 2001-2 CB 315). See §601.601(d)(2)(ii)(b).

Section 861(a)(1)(C), as amended by the American Jobs Creation Act of 2004 provides a special source rule for interest on obligations of certain foreign partnerships and may require coordinating changes to the branch-level interest tax rules under §1.884-4. Specifically, a foreign corporate partner is not treated as paying branch interest under §1.884-4(b)(1)(i)(A) and therefore may be liable for tax on excess interest even if that foreign partner has U.S. book interest paid with respect to its distributive share of U.S. booked liabilities under §1.882-5. Accordingly, the Treasury Department and the IRS are currently considering how best to coordinate the U.S. booked liability rules with the determination of partnership branch interest so that foreign corporate partners of partnerships described in section 861(a)(1)(C) are provided

similar treatment under §1.884-4 with respect to their distributive shares of interest expense as foreign corporations directly engaged in a trade or business within the United States.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 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) does not apply to these regulations. It is hereby certified that the collection of information contained in these regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. The collection of information requirement in these regulations generally only affects large foreign banks. Thus, the number of affected small entities will not be substantial and any economic impacts on those entities in complying with the collection of information would be minimal. Pursuant to section 7805(f) of the Code, these regulations have been 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 Anthony J. Marra of the Office of Associate Chief Counsel (International). However, other persons from the Office of Associate Chief Counsel (International) and the Treasury Department have participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

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 continues to read in part as follows:

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

Par. 2. Section 1.882-0 is amended by:

1. Revising the entries for §1.882-5(a)(1), (a)(1)(i), (a)(1)(ii), (a)(1)(ii)(A), (a)(1)(ii)(B), (a)(2), (a)(7), (a)(7)(i), (a)(7)(ii), (b)(2)(ii)(A), (b)(3), (c)(2)(iv), (c)(4), (d)(2)(iii)(A), and (d)(5)(ii).

2. Adding entries for §1.882-5(a)(7)(iii), (b)(3)(i), (b)(3)(ii), (d)(5)(ii)(A), and (d)(5)(ii)(B).

3. Removing the entries for §1.882-5T.

The revisions and additions read as follows:

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* * * * *

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* * * * *

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* * * * *

(5) * * *

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(A) General rule.

(B) Annual published rate election.

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Par. 3. Section 1.882-5 is amended by revising paragraphs (a)(1), (a)(2), (a)(7), (a)(7)(i), (a)(7)(ii), (a)(7)(iii), (b)(2)(ii)(A), (b)(3), (c)(2)(iv), (c)(4), (d)(2)(ii)(B)(2), (d)(2)(ii)(B)(3), (d)(2)(iii)(A), (d)(5)(ii), (d)(6) Example 5 and (f)(1) to read as follows:

§1.882-5 Determination of interest deduction.

(a)(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 allocable by the foreign corporation under the three-step process set forth in paragraphs (b), (c), and (d) of this section and the specially allocated interest expense determined under paragraph (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 section 882(c). 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 U.S.-booked liabilities, 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) or (c), as limited by §1.861-10T(d)(1), shall 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 paragraph (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) or (c) by the principal amount of the indebtedness that meets the requirements of §1.861- 10T (b) or (c). The foreign corporation shall also disregard any indebtedness that meets the requirements of §1.861-10T (b) or (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 paragraph (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) or (c), as limited by §1.861-10T(d)(1), shall 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) or (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. Except as expressly provided by or pursuant to a U.S. income tax treaty or accompanying documents (such as an exchange of notes), 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.

* * * * *

(7) Elections under §1.882-5--(i) In general. A corporation must make each election provided in this section on the corporation's original timely filed Federal income tax return for the first taxable year it is subject to the rules 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. Except as provided elsewhere in this section, each election under this section, whether an election for the first taxable year or a subsequent change of election, shall be made by indicating the method used on Schedule I (Form 1120-F) attached to the corporation's timely filed return. An elected method (other than the fair market value method under paragraph (b)(2)(ii) of this section, or the annual 30-day London Interbank Offered Rate (LIBOR) election in paragraph (d)(5)(ii) of this section) 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 his delegate. The Commissioner or his delegate will generally consent to a taxpayer's request to change its election only in rare and unusual circumstances. After the five-year minimum period, an elected method may be changed for any subsequent year on the foreign corporation's original timely filed tax return for the first year to which the changed election applies.

(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 Director of Field Operations 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.

(iii) Step 2 special election for banks. For the first taxable year for which an original income tax return is due (including extensions) after August 17, 2006, in which a taxpayer that is a bank as described in paragraph (c)(4) of this section is subject to the requirements of this section, a taxpayer may make a new election to use the fixed ratio on an original timely filed return. A new fixed ratio election may be made in any subsequent year subject to the timely filing and five-year minimum period requirements of paragraph (a)(7)(i) of this section. A new fixed ratio election under this paragraph (a)(7)(iii) is subject to the adjusted basis or fair market value conforming election requirements of paragraph (b)(2)(ii)(A)(2) of this section and may not be made if a taxpayer elects or maintains a fair market value election for purposes of paragraph (b) of this section. Taxpayers that already use the fixed ratio method under an existing election may continue to use the new fixed ratio at the higher percentage without having to make a new five-year election in the first year that the higher percentage is effective.

* * * * *

(b) * * *

(2) * * *

(ii) * * *

(A) In general--(1) Fair market value conformity requirement. 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 is eligible and uses the actual ratio method under

paragraph (c)(2) of this section and 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 his delegate consents to a change.

(2) Conforming election requirement. Taxpayers that as of the effective date of this paragraph (b)(2)(ii)(A)(2) have elected and currently use both the fair market value method for purposes of paragraph (b) of this section and a fixed ratio for purposes of paragraph (c)(4) of this section must conform either the adjusted basis or fair market value methods in Step 1 and Step 2 of the allocation formula by making an adjusted basis election for paragraph (b) of this section purposes while continuing the fixed ratio for Step 2, or by making an actual ratio election under paragraph (c)(2) of this section while remaining on the fair market value method under paragraph (b) of this section. Taxpayers who elect to conform Step 1 and Step 2 of the formula to the adjusted basis method must remain on both methods for the minimum five-year period in accordance with the provisions of paragraph (a)(7) of this section. Taxpayers that elect to conform Step 1 and Step 2 of the formula to the fair market value method must remain on the actual ratio method until the consent of the Commissioner or his delegate is obtained to switch to the adjusted basis method. If consent to use the adjusted basis method in Step 1 is granted in a later year, the taxpayer must remain on the actual ratio method for the minimum five-year period unless consent to use the fixed ratio is independently obtained under the requirements of paragraph (a)(7) of this section. For the first taxable year for which an original income tax return is due (including extensions) after August 17, 2006, taxpayers that are required to make a conforming election under this paragraph (b)(2)(ii)(A)(2), may do so on an original timely filed return. If a conforming election is not made within the timeframe provided in this paragraph,

the Director of Field Operations or his delegate may make the conforming elections in accordance with the provisions of paragraph (a)(7)(ii) of this section.

* * * * *

(3) Computation of total value of U.S. assets--(i) General rule. 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 (beginning of taxable year and monthly thereafter) by a large bank (as defined in section 585(c)(2)) or a dealer in securities (within the meaning of section 475) and semi-annually (beginning, middle and end of taxable year) by any other taxpayer.

(ii) Adjustment to basis of financial instruments. For purposes of determining the total average value of U.S. assets in this paragraph (b)(3), the value of a security or contract that is marked to market pursuant to section 475 or section 1256 shall be determined as if each determination date is the most frequent regular interval for which data are reasonably available that reflects the taxpayer's consistent business practices for reflecting mark-to-market valuations on its books and records.

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(c) * * *

(2) * * *

(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. The rules of paragraph (b)(3) of this section apply in determining the total value of applicable worldwide assets for the taxable year, except that the minimum number of determination dates are those stated in paragraph (c)(2)(i) of this section.

* * * * *

(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 or whether any such activities are effectively connected with a trade or business within the United States) may elect to use a fixed ratio of 95 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.

* * * * *

(d) * * *

(2) * * *

(ii) * * *

(B)* * *

(2) The foreign corporation enters the liability on a set of books reasonably contemporaneously with the time at which the liability is incurred and the liability relates to an activity that produces ECI.

(3) The foreign corporation maintains a set of books and records relating to an activity that produces ECI and the Director of Field Operations 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.

* * * * *

(iii) * * *

(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 before the close of the day on which the liability is incurred, and the liability relates to an activity that produces ECI; 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. For example, a liability that is used to fund an interbranch or other asset that produces non-ECI may have a direct connection to an ECI producing activity and may constitute a U.S.-booked liability if both the interbranch or non-ECI activity is the same type of activity in which ECI assets are also reflected on the set of books (for example, lending or money market interbank placements), and such ECI activities are not de minimis. Such U.S. booked liabilities may still be subject to paragraph (d)(2)(v) of this section.

* * * * *

(5) * * *

(ii) Interest rate on excess U.S.-connected liabilities--(A) General rule. 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 that are not U.S.-booked liabilities (as defined in paragraph (d)(2) of this section) and that are 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) that are not U.S.-booked liabilities and that are shown on the books of the offices or branches of the foreign corporation outside the United States for the taxable year.

(B) Annual published rate election. For each taxable year beginning with the first year end for which the original tax return due date (including extensions) is after August 17, 2006, in which a taxpayer is a bank within the meaning of section 585(a)(2)(B) (without regard to the second sentence thereof or whether any such activities are effectively connected with a trade or business within the United States), such taxpayer may elect to compute its excess interest by reference to a published average 30-day London Interbank Offering Rate (LIBOR) for the year. The election may be made for any eligible year by indicating the rate used on Schedule I (Form 1120-F) attached to the timely filed return. Once selected, the rate may not be changed by the taxpayer. If a taxpayer that is eligible to make the 30-day LIBOR election either does not file a timely return or files a calculation that allocates interest expense under the scaling ratio in paragraph (d)(4) of this section and it is determined by the Director of Field Operations that the taxpayer's U.S.-connected liabilities exceed its U.S.-booked liabilities, then the Director of Field Operations, and not the taxpayer, may choose whether to determine the taxpayer's excess interest rate under paragraph (d)(5)(ii)(A) or (B) of this section and may select the published 30-day LIBOR rate.

(6) * * *

Example 5. U.S. booked liabilities – direct relationship. (i) Facts. Bank A, a resident of Country X maintains a banking office in the U.S. that records transactions on three sets of books for State A, an International Banking Facility (IBF) for its bank regulatory approved international transactions, and a shell branch licensed operation in Country C. Bank A records substantial ECI assets from its bank lending and placement activities and a mix of interbranch and non-ECI producing assets from the same or similar activities on the books of State A branch and on its IBF. Bank A's Country C branch borrows substantially from third parties, as well as from its home office, and lends all of its funding to its State A branch and IBF to fund the mix of ECI, interbranch and non-ECI activities on those two books. The consolidated books of State A branch and IBF indicate that a substantial amount of the total book assets constitute U.S. assets under paragraph (b) of this section. Some of the third-party borrowings on the books of the State A branch are used to lend directly to Bank A's home office in Country X. These borrowings reflect the average borrowing rate of the State A branch, IBF and Country C branches as a whole. All third-party borrowings reflected on the books of State A branch, the IBF and Country C branch were recorded on such books before the close of business on the day the liabilities were acquired by Bank A.

(ii) U.S. booked liabilities. The facts demonstrate that the separate State A branch, IBF and Country C branch books taken together, constitute a set of books within the meaning of paragraph (d)(2)(iii)(A)(1) of this section. Such set of books as a whole has a direct relationship to an ECI activity under paragraph (d)(2)(iii)(A)(2) of this section even though the Country C branch books standing alone would not. The third-party liabilities recorded on the books of Country C constitute U.S. booked liabilities because they were timely recorded and the overall set of books on which they were reflected has a direct relationship to a bank lending and interbank placement ECI producing activity. The third-party liabilities that were recorded on the books of State A branch that were used to lend funds to Bank A's home office also constitute U.S. booked liabilities because the interbranch activity the funds were used for is a lending activity of a type that also gives rise to a substantial amount of ECI that is properly reflected on the same set of books as the interbranch loans. Accordingly, the liabilities are not traced to their specific interbranch use but to the overall activity of bank lending and interbank placements which gives rise to substantial ECI. The facts show that the liabilities were not acquired to increase artificially the interest expense of Bank A's U.S. booked liabilities as a whole under paragraph (d)(2)(v) of this section. The third-party liabilities also constitute U.S. booked liabilities for purposes of determining Bank A's branch interest under §1.884-4(b)(1)(i)(A) regardless of whether Bank A uses the Adjusted U.S. booked liability method, or the Separate Currency Pool method to allocate its interest expense under paragraph 5(e) of this section.

* * * * *

(f)(1) Effective/applicability date--(1) General rule. This section is applicable for taxable years ending on or after August 15, 2009. A taxpayer, however, may choose to apply §1.882-5T,

rather than applying the final regulations, for any taxable year beginning on or after August 16, 2008 but before August 15, 2009.

* * * * *

§1.882-5T [Removed]

Par. 4. Section 1.882-5T is removed.

Par. 5. Section 1.884-1 is amended by revising paragraphs (e)(3)(ii), (e)(3)(iv) and (e)(5) Example 2.

§1.884-1 Branch profits tax.

* * * * *

(e) * * *

(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 lesser of the amount of U.S. liabilities as of the determination date, or the amount of U.S. liability reduction needed to reduce a dividend equivalent amount as of the determination date to zero.

* * * * *

(iv) Method of election. A foreign corporation that elects the benefits of this paragraph (e)(3) for a taxable year shall attach a statement to its return for the taxable year that it has elected to reduce its liabilities for the taxable year under this paragraph (e)(3) and that it has reduced the amount of its U.S.-connected liabilities as provided in paragraph (e)(3)(iii) of this section and shall indicate the amount of such reductions on such attachment. The cumulative

amount of all U.S. liability reductions is shown on Schedule I (Form 1120-F) in addition to the separate elections attached to the timely filed return. An election under this paragraph (e)(3) must be made before the due date (including extensions) for the foreign corporation's income tax return for the taxable year.

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(5) * * *

Example 2. Election made to reduce liabilities. (i) As of the close of 2007, foreign corporation A, a real estate company, owns U.S. assets with an E&P basis of $1000. A has $800 of liabilities under paragraph (e)(1) of this section. A has accumulated ECEP of $500 and in 2008, A has $60 of ECEP that it intends to retain for future expansion of its U.S. trade or business. A elects under paragraph (e)(3) of this section to reduce its liabilities by $60 from $800 to $740. As a result of the election, assuming A's U.S. assets and U.S. liabilities would otherwise have remained constant, A's U.S. net equity as of the close of 1994 will increase by the amount of the decrease in liabilities ($60) from $200 to $260 and its ECEP will be reduced to zero. Under paragraph (e)(3)(iii) of this section, A's interest expense for the taxable year is reduced by the amount of interest attributable to $60 of liabilities and A's excess interest is reduced by the same amount. A's taxable income and ECEP are increased by the amount of the reduction in interest expense attributable to the liabilities, and A may make an election under paragraph (e)(3) of this section to further reduce its liabilities, thus increasing its U.S. net equity and reducing the amount of additional ECEP created for the election.

(ii) In 2009, assuming A again has $60 of ECEP, A may again make the election under paragraph (e)(3) to reduce its liabilities. However, assuming A's U.S. assets and liabilities under paragraph (e)(1) of this section remain constant, A will need to make an election to reduce its liabilities by $120 to reduce to zero its ECEP in 2009 and to continue to retain for expansion (without the payment of the branch profits tax) the $60 of ECEP earned in 2008. Without an election to reduce liabilities, A's dividend equivalent amount for 2009 would be $120 ($60 of ECEP plus the $60 reduction in U.S. net equity from $260 to $200). If A makes the election to reduce liabilities by $120 (from $800 to $680), A's U.S. net equity will increase by $60 (from $260 at the end of the previous year to $320), the amount necessary to reduce its ECEP to $0. However, the reduction of liabilities will itself create additional ECEP subject to section 884 because of the reduction in interest expense attributable to the $120 of liabilities. A can make the election to reduce liabilities by $120 without exceeding the limitation on the election provided in paragraph (e)(3)(ii) of this section because the $120 reduction does not exceed the amount needed to treat the 2009 and 2008 ECEP as reinvested in the net equity of the trade or business within the United States.

(iii) If A terminates its U.S. trade or business in 2009 in accordance with the rules in §1.884-2T(a), A would not be subject to the branch profits tax on the $60 of ECEP earned in that

year. Under paragraph (e)(3)(v) of this section, however, it would be subject to the branch profits tax on the portion of the $60 of ECEP that it earned in 2008 that became accumulated ECEP because of an election to reduce liabilities.

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§1.884-1T [Removed]

Par. 6. Section 1.884-1T is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 7. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 8. In §602.101, paragraph (b) is amended by removing the entry for "§1.882-5T" from the table.

Linda E. Stiff,
Deputy Commissioner for Services and Enforcement.

Approved: September 15, 2009.

Michael Mundaca,
(Acting) Assistant Secretary of the Treasury (Tax Policy).

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