

## LB&I International Practice Service Process Unit – Audit

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Chapter	6.1.2	Determination of Proper Expense Allocation	<b>Level 3 UIL</b>	9422.01-02
Sub-Chapter	6.1.2.3	Interest Expense of U.S. Branch	–	–

<b>Unit Name</b>	Interest Expense of US Branch of a Foreign Bank Non-Treaty
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# Process Overview

## Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

### Process Description

Foreign Banks (FB) often operate in the U.S. in the form of a branch for regulatory and accounting reasons.

Generally, the branch will calculate its taxable income in accordance with the IRC 882(a)(2). With respect to the deductions being claimed this unit covers interest expense and specifically the application of the interest expense allocation formula under Treas. Reg. 1.882-5 to U.S. branches of foreign banks in a non-treaty context.

This process unit explores the key components of the interest expense allocation formula under Treas. Reg. 1.882-5 as well as certain elections that are available to taxpayers to maximize the interest expense. This unit also is designed to assist in determining circumstances where a large amount of interest expense may be claimed.

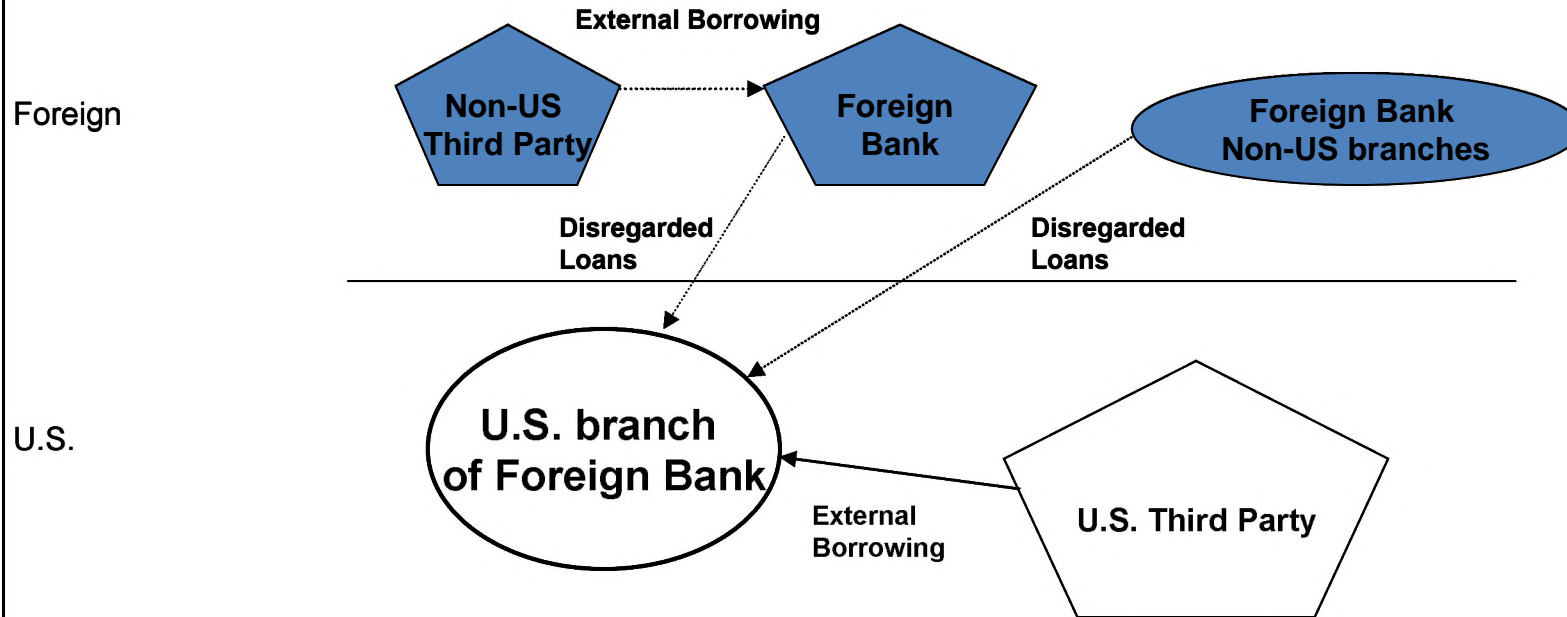
### Example Circumstances Under Which Process Applies

- These regulations generally apply whenever a foreign bank is filing a Form 1120-F and claims interest deductions.
- However, these regulations may not apply if the foreign bank is resident in certain treaty jurisdictions and allocates interest expense under such treaty.

# Process Overview

## Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

### Example Circumstances Under Which Process Applies



# Determination of Process Applicability

## Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

The following criteria should be present before the taxpayer can apply Treas. Reg. 1.882-5.

Criteria	Resources	6103 Protected Resources
<ul style="list-style-type: none"><li>▪ Taxpayer is claiming an interest expense deduction on its books and/or Form 1120-F</li></ul>	<ul style="list-style-type: none"><li>▪ Form 1120-F</li><li>▪ Form 1120-F Schedule I</li><li>▪ Form 1120-F Section 2 Line 19</li><li>▪ Form 1120-F Schedule M-3, Part III, Line 26</li></ul>	

# Summary of Process Steps

## Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

<a href="#">Step 1</a>	Determine the amount of U.S. assets
<a href="#">Step 2</a>	Determine the amount of U.S. booked liabilities
<a href="#">Step 3</a>	Identify the elections the taxpayer has made to compute the interest expense deduction
<a href="#">Step 4</a>	Determine the amount of interest expense allocable to effectively connected income (ECI)

# Step 1

## Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

### Step 1: Determine the amount of U.S. assets

Determining the amount of US assets is a factual determination based on the rules discussed below

Considerations	Resources	6103 Protected Resources
<p>The allocation of interest expense requires classifying assets as U.S. assets.</p> <p>The determination of U.S. assets generally follows the rules for branch profits tax.</p> <p>“U.S. asset” generally means an asset held on the determination date if :</p> <ul style="list-style-type: none"> <li>▪ All income produced by the asset is (or would have been) Effectively Connected Income (ECI) and</li> <li>▪ All gain from the disposition of the asset would be ECI if disposed of on the determination date</li> </ul>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.882-5(b)(1)</li> <li>▪ Treas. Reg. 1.884-1(d)</li> <li>▪ Treas. Reg. 1.864-4(c)(5)</li> <li>▪ Treas. Reg. 1.864-5(b)(2)</li> </ul>	

# Step 1 (cont'd)

## Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

### Step 1: Determine the amount of U.S. assets

Determining the amount of US assets is a factual determination based on the rules discussed below

Considerations	Resources	6103 Protected Resources
<p>For example, U.S. assets include:</p> <ul style="list-style-type: none"> <li>▪ Typically, bank and other deposits that are interest bearing and deposits that are non interest bearing, if income earned is ECI.</li> <li>▪ Certain debt instruments that would not otherwise be U.S. assets. For an asset (including a debt instrument) to be a U.S. asset, all gain from the disposition of the asset typically must be ECI. However, under a special rule, a debt instrument is a U.S. asset if all income derived by the foreign corporation is ECI and the yield for the period the instrument was held equals or exceeds the Applicable Federal Rate (AFR) for instruments of similar type and maturity, notwithstanding the fact that gain from the sale of the instrument would not be ECI.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.884-1:</li> <li>▪ Treas. Reg. 1.884-1(d)(2)(v)</li> <li>▪ Treas. Reg. 1.884-1(d)(2)(vi)</li> <li>▪ Treas. Reg. 1.884-1(d)(2)(vii)</li>   <li>▪ Treas. Reg. 1.864-(c)(5)(ii)(b)(3)</li> </ul>	



# Step 1 (cont'd)

## Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

**Step 1:** Determine the amount of U.S. assets

Determining the amount of US assets is a factual determination based on the rules discussed below


Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"><li>Stocks and securities held by a foreign corporation engaged in a banking, financing, or similar business that are described in Treas. Reg. 1.864-4(c)(5)(ii)(b)(3) (“B3 securities”), are considered U.S. assets in the same proportion as the income gain/loss from B3 securities is considered ECI under the 10% rule formula in Treas. Reg. 1.864-4(c)(5)(ii).</li></ul>		

# Step 1 (cont'd)

## Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

### Step 1: Determine the amount of U.S. assets

Determining the amount of US assets is a factual determination based on the rules discussed below

Considerations	Resources	6103 Protected Resources
<p>Although the ECI rules applicable to banks ordinarily treat income arising from B3 securities partly as ECI and partly as non-ECI, the income and gain attributable to those securities may be entirely ECI if the bank conducts another U.S. trade or business (e.g. trading). In such case, the B3 securities may be treated as U.S. assets in their entirety.</p> <p> <b>CONSULTATION:</b> If B3 securities are significant, contact counsel to assist in the determination if the income derived from these securities is 100% ECI since it affects the amount of assets treated as includable as U.S. assets</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.884-1(d)(2)(vii)</li> <li>▪ Treas. Reg. 1.864-4(c)(5)(vi)</li> </ul>	

# Step 1 (cont'd)

## Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

**Step 1:** Determine the amount of U.S. assets

Determining the amount of US assets is a factual determination based on the rules discussed below

Considerations	Resources	6103 Protected Resources
<p><b>Audit Tips:</b></p> <p>Did the taxpayer elect U.S. basis or worldwide basis reporting for the balance sheet on Schedule L?</p> <p>If the worldwide basis is elected, the profit and loss results from the same set(s) of books must be used to report the adjusted worldwide net income (loss) results on Schedule M-3 of Form 1120-F. Also, the US assets will be a subset of the worldwide assets.</p> <p>Certain interest expenses, including certain interest expenses incurred through partnerships, are directly allocable to ECI. The associated assets and liabilities are disregarded under the formula discussed later.</p>	<ul style="list-style-type: none"> <li>▪ Form 1120-F Instructions, Schedule L</li> <li>▪ Treas. Reg. 1.6012-2(g)(1)(iii)</li> <li>▪ Worldwide or separately prepared (audited, compiled or reviewed) financial statements</li> <li>▪ Schedule M-3, Part I, Line 11</li> <li>▪ Form 1120-F, Schedule P</li> <li>▪ Treas. Reg. 1.882-5(a)(1)(ii)</li> </ul>	

# Step 1 (cont'd)

## Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

**Step 1:** Determine the amount of U.S. assets

Determining the amount of US assets is a factual determination based on the rules discussed below

Considerations	Resources	6103 Protected Resources
<p><b>Audit Tips:</b></p> <p>Inquire about any assets arising from interbranch transactions. Eliminate such amounts from total U.S. assets</p> <p>Determine whether the interest or dividend income from, and gain (loss) from the sale or exchange of stocks or securities which are capital assets is ECI under the special rules applicable to banking, financing or similar activities.</p> <p>Determine whether other assets gives rise to income effectively connected with another USTB (U.S. Trade or Business) of the branch (e.g., a trading business) under the asset use or business activities test under section 864.</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.882-5(b)(1)(iv)</li> <li>▪ Treas. Reg. 1.864-4</li> <li>▪ Treas. Reg. 1.864-4(c)(5)(iii)</li> <li>▪ Treas. Reg. 1.864-5(b)(2)</li>   <li>▪ TAM 200811019- distributive share of income from securities held by Partnership are eligible for 10 Percent Rule formula</li> </ul>	

# Step 1 (cont'd)

## Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

### Step 1: Determine the amount of U.S. assets

Determining the amount of US assets is a factual determination based on the rules discussed below

Considerations	Resources	6103 Protected Resources
<p><b>Audit Tips:</b></p> <p>Confirm that if the taxpayer is making a fair market value election it is applying it consistently to all assets on the balance sheet</p> <p>Confirm the value of loans that qualify as U.S. assets are not reduced by the amount of any reserve for bad debts for large banks (defined as a bank with assets over \$500 million). Large banks must use a direct write-off method.</p> <p>If the taxpayer is a large bank or dealer in securities, the valuation of total U.S. assets needs to be computed at least on a monthly average basis per Treas. Reg. 1.882-5(b)(3); semi-annual (beginning, middle and end of the taxable year) for any other taxpayer.</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.882-5:</li> <li>▪ Treas. Reg. 1.882-5(b)(2)(ii)</li> <li>▪ Treas. Reg. 1.882-5(b)(2)(iii)</li> <li>▪ Treas. Reg. 1.882-5(b)(3)</li>   <li>▪ IRC 585(c)</li> </ul>	

# Step 1 (cont'd)

## Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

**Step 1:** Determine the amount of U.S. assets

Determining the amount of US assets is a factual determination based on the rules discussed below

Considerations	Resources	6103 Protected Resources
<p><b>Audit Tips:</b></p> <p>Confirm that U.S. assets were not acquired to increase U.S. assets artificially.</p> <p>Review assets recorded on the books of foreign parent and foreign branches to determine if they meet the standards previously discussed (slides 7 &amp; 8) and consider reclassifying them as U.S. assets. Also, assets on the U.S. books that don't meet the standards discussed must be eliminated from US assets.</p> <p>The potential adjustments to U.S. assets will likely effect the total amount of interest expense allocable to ECI under Treas. Reg. 1.882-5.</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.882-5</li> <li>▪ Treas. Reg. 1.882-5(b)(1)(v)</li> <li>▪ Treas. Reg. 1.882-5(b)(1)(ii) and (iii)</li> </ul>	

# Step 2

## Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

**Step 2:** Determine the amount of U.S. booked liabilities

Determining the amount of US booked liabilities is a factual determination based on the laws discussed below

Considerations	Resources	6103 Protected Resources
<p>Another step in computing the allocation of interest expense requires identifying U.S. booked liabilities (USBL)</p> <p>The liability must be properly reflected on the books of the U.S. trade or business</p> <p>The liability may be interest bearing or non-interest bearing</p> <p>For a bank, a liability, is properly reflected on the books of U.S. trade or business of a foreign corporation that is a bank if –</p> <p>(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</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.882–5:</li> <li>▪ Treas. Reg. 1.882-5(d)(2)(i)</li> <li>▪ Treas. Reg. 1.882-5(d)(2)(iii)</li> <li>▪ Treas. Reg. 1.882-5(d)(2)(iii)(A)</li> </ul>	

## Step 2 (cont'd)

### Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

**Step 2:** Determine the amount of U.S. booked liabilities

Determining the amount of US booked liabilities is a factual determination based on the laws discussed below

Considerations	Resources	6103 Protected Resources
<p>(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</p> <p>If the liability has not been recorded, the taxpayer still has the opportunity to add the liability if it can show a direct connection between the liability and the activity that produced the related ECI and the failure to enter the liability on its books was due to inadvertent error</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.882-5(d)(2)(iii)(A)</li>   <li>▪ Treas. Reg. 1.882-5(d)(2)(iii)(B)</li> </ul>	



## Step 2 (cont'd)

### Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

**Step 2:** Determine the amount of U.S. booked liabilities

Determining the amount of US booked liabilities is a factual determination based on the laws discussed below

Considerations	Resources	6103 Protected Resources
<p>Has the bank entered the liability on a set of books before the close of the day on which the liability is incurred?</p> <p>Request sample journal entries and/or general ledger account analysis to determine what ECI activity (expense) was recorded</p> <p>Is there a direct connection between the liability and an activity that produces ECI?</p> <p>Request explanation from the taxpayer why the liability relates to an activity that produces ECI</p> <p>Confirm that if the taxpayer is a large bank (defined in IRC 585(c)(2)), the average of the liabilities calculated is determined on a monthly average.</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.882-5(d)(3); semi-annual for taxpayers other than banks</li> </ul>	

## Step 2 (cont'd)

### Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

**Step 2:** Determine the amount of U.S. booked liabilities

Determining the amount of US booked liabilities is a factual determination based on the laws discussed below

Considerations	Resources	6103 Protected Resources
<p><b>Audit Tips:</b></p> <p>Consider whether a U.S. booked liability may be incurred or held to artificially increase interest expense.</p> <ul style="list-style-type: none"> <li>▪ Is the interest expense related to the liability large when compared to other liabilities denominated in the same currency? Test the interest rate on the specific liability and compare it to interest rate on non-related party liabilities to see if substantially greater.</li> <li>▪ Does the taxpayer have interbranch loans or other interbranch liabilities. Interbranch transactions should be disregarded.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.882-5:</li> <li>▪ Treas. Reg. 1.882-5(d)(2)(v)</li>   <li>▪ Treas. Reg. 1.882-5(d)(2)(viii)</li> </ul>	

## Step 2 (cont'd)

### Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

**Step 2:** Determine the amount of U.S. booked liabilities

Determining the amount of US booked liabilities is a factual determination based on the laws discussed below

Considerations	Resources	6103 Protected Resources
<p><b>Audit Tips:</b></p> <p>If a determination is made that a USBL has been incurred or held to artificially increase interest expense, consider disallowing the booked interest expense and USBL.</p> <p>If the interest rate on the specific booked liability is substantially greater than the interest rate on non-related party liabilities, consider disallowing the booked liability</p> <p>Interbranch loans, payables or other liabilities should be disregarded</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.882-5</li> <li>▪ Treas. Reg. 1.882-5(c)</li> <li>▪ Treas. Reg. 1.882-5(d)(2)(v)</li> <li>▪ Treas. Reg. 1.882-5(d)(2)(viii)</li> </ul>	

# Step 3

## Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

**Step 3:** Identify the elections the taxpayer has made to compute the interest expense deduction

Banks can make certain elections for administrative simplicity and for maximizing interest expense

Considerations	Resources	6103 Protected Resources
<p>A taxpayer has many elections it can make, which can make the interest expense calculations administratively simpler while maximizing the interest expense deduction at the same time.</p> <p>Banks may make a fixed ratio election of 95% for the total amount of USCL for the taxable year (50% for most other taxpayers) for Treas. Reg. Step 2 purposes; however once elected it is generally binding for 5 years.</p> <p>A taxpayer may make a fair market value election for all of its U.S. assets, but must use the actual ratio for Treas. Reg. Step 2 purposes. Once elected the fair market value method must be used for both Treas. Reg. Step 1 and 2 unless consent to change has been received.</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.882-5:</li> <li>▪ Treas. Reg. 1.882-5(a)(7)</li> <li>▪ Treas. Reg. 1.882-5(b)(2)(ii)(A)(1)</li> <li>▪ Treas. Reg. 1.882-5(b)(2)(ii)(A)(2)</li> <li>▪ Treas. Reg. 1.882-5(c)(4)</li> <li>▪ Treas. Reg. 1.882-5(d)(5)(ii)(B)</li> </ul>	

## Step 3 (cont'd)

### Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

**Step 3:** Identify the elections the taxpayer has made to compute the interest expense deduction

Banks can make certain elections for administrative simplicity and for maximizing interest expense

Considerations	Resources	6103 Protected Resources
Banks may make a current year election to use the average 30-day LIBOR rate to calculate the interest expense on excess USCL for Treas. Reg. Step 3 purposes		

## Step 3 (cont'd)

### Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

**Step 3:** Identify the elections the taxpayer has made to compute the interest expense deduction

Verify the disclosures made on the tax return

Considerations	Resources	6103 Protected Resources
<p>A taxpayer can also elect to use the 3-step separate currency pools method rather than the adjusted U.S. booked liability method to determine interest expense allocable to ECI under Treas. Reg. 1.882-5.</p> <p>Determine whether the taxpayer has elected to reduce its US connected liabilities under the branch profits tax regime (in order to increase net equity and potentially reduce the dividend equivalent amount)? If so, it must reduce its USCL under Treas. Reg. 1.882-5 by the same amount, typically reducing interest expense that is apportioned to ECI.</p> <p>Confirm that all elections have been properly made on Form 1120-F, Schedule I or supporting statements attached to Schedule I</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.882-5(e)</li> <li>▪ Treas. Reg.1.884-1(e)(3)(iii)</li>   <li>▪ Form 1120-F</li>   <li>▪ Form 1120-F Schedule I Question B</li> <li>▪ Form 1120-F Schedule I Step 1 Q1</li> <li>▪ Form 1120-F Schedule I Step 2 Q6, Q6d, Q7b</li> <li>▪ Form 1120-F Schedule I Step 3 Q10</li> <li>▪ Form 1120-F Schedule I Q16b</li> </ul>	

# Step 4

## Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

**Step 4:** Determine the amount of interest expense allocable to effectively connected income (ECI)

Follow the 3 step formula (Treas. Reg. Steps 1-3) indicated below

Considerations	Resources	6103 Protected Resources
<p>The regulations provide for a three step process adjusted U.S. booked liability (AUSBL) for calculating interest expense:</p> <p>Treas. Reg. Step 1</p> <ul style="list-style-type: none"> <li>▪ Determine the total value of the U.S. assets of the foreign corporation</li> </ul> <p>Treas. Reg. Step 2</p> <ul style="list-style-type: none"> <li>▪ Determine the U.S.-connected liabilities (USCL) of the foreign corporation</li> <li>▪ This is the product of the U.S. assets multiplied either by a) the actual ratio of worldwide liabilities (WWL) to worldwide assets (WWA) or b) an elective fixed ratio provided in the regulations.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.882-5:</li> <li>▪ Treas. Reg. 1.882-5(b)</li> <li>▪ Treas. Reg. 1.882-5(c)</li> </ul>	

# Step 4 (cont'd)

## Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

**Step 4:** Determine the amount of interest expense allocable to effectively connected income (ECI)

Follow the 3 step formula (Treas. Reg. Steps 1-3) indicated below

Considerations	Resources	6103 Protected Resources
<p>Actual Ratio: <math>USCL = \frac{\text{U.S. Assets} \times WWL}{WWA}</math></p> <p>Or</p> <p>Fixed Ratio: <math>USCL = \text{U.S. Assets} \times \text{fixed ratio}</math> (95% for banks; 50% for non-banks and non-insurance companies)</p>		



# Step 4 (cont'd)

## Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

**Step 4:** Determine the amount of interest expense allocable to effectively connected income (ECI)

Follow the 3 step formula (Treas. Reg. Steps 1-3) indicated below

Considerations	Resources	6103 Protected Resources
<p>Treas. Reg. Step 3</p> <ul style="list-style-type: none"> <li>▪ Determine the allocable amount of interest expense under the Adjusted U.S. Booked Liabilities (“AUSBL”) method,</li> <li>▪ Under the AUSBL method, the foreign corporation’s allocable interest expense is determined by comparing the U.S. booked liabilities (USBL) with the foreign corporation’s U.S.-Connected liabilities (USCL)               <ul style="list-style-type: none"> <li>- If the USBL exceed the USCL, then the U.S. branch’s allowable interest expense (USBI) is equal to the product of a) interest paid or accrued by the U.S. trade/business on booked liabilities and b) the scaling ratio (USCL / USBL)</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.882–5(d)</li> </ul>	

# Step 4 (cont'd)

## Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

**Step 4:** Determine the amount of interest expense allocable to effectively connected income (ECI)

Follow the 3 step formula (Treas. Reg. Steps 1-3) indicated below

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> <li>- If the USCL exceed the USBL, than the U.S. branch's interest expense is the sum of the U.S. booked interest expense plus the excess USCL multiplied by the foreign corporation's U.S. dollar borrowing rate on liabilities that are not booked liabilities or the 30-day average LIBOR rate for the year (if elected)</li> </ul> <p>If interest expense is allocated to the bank's U.S. trade or business (e.g., if USCL exceed USBL) consider the implications for the branch-level interest tax (BLIT)</p>	<ul style="list-style-type: none"> <li>▪ IRC 884</li> <li>▪ IRC 884(f)</li> </ul>	

## Step 4 (cont'd)

### Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

**Step 4:** Determine the amount of interest expense allocable to effectively connected income (ECI)

Special situations or other tax effects from performing the calculations

Considerations	Resources	6103 Protected Resources
<p>Under the separate currency pools method, the first two steps noted above are performed for each of the currencies in which the foreign corporation has U.S. assets. Under a special third step, the interest rate applicable to each currency is determined by multiplying USCL by a prescribed interest rate.</p> <p>The prescribed interest rate is determined by dividing the total interest expense incurred on each currency by the FB's average worldwide liabilities in such currency.</p> <p>Under the separate currency pools method, a foreign corporation may convert into U.S. dollars, any currency pool in which the foreign corporation holds less than 3 percent of its U.S. assets.</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.882-5(e)</li> </ul>	

# Step 4 (cont'd)

## Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

**Step 4:** Determine the amount of interest expense allocable to effectively connected income (ECI)

Special situations or other tax effects from performing the calculations


Considerations	Resources	6103 Protected Resources
<p>Any provision that disallows, defers, or capitalizes interest expense (e.g. IRC 265, 163(j), 163(e)(3), 267(a)(3) or 263A) applies after determining the amount of interest expense allocated to ECI</p> <p>Except as expressly provided by or pursuant to a U.S. income tax treaty or accompanying documents, Treas. Reg. 1.882-5 provides the exclusive rules for determining interest expense attributable to the business profits of a permanent establishment under a U.S. income tax treaty</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.882-5(a)(2)</li> <li>▪ Treas. Reg. 1.882-5(a)(5)</li> <li>▪ OECD 2010 Report on the Attribution of Profits to Permanent Establishments (July 22, 2010) Part II</li> </ul>	

# Step 4 (cont'd)

## Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

**Step 4:** Determine the amount of interest expense allocable to effectively connected income (ECI)

Special situations or other tax effects from performing the calculations

Considerations	Resources	6103 Protected Resources
 <b>CONSULTATION:</b> If the FB is organized in a country that has a treaty that permits another method be used to compute interest expense, then Treas. Reg. 1.882-5 may not be the exclusive method to calculate interest expense. In such cases, please contact counsel for further guidance and consultation on the application of the applicable treaty or Authorized OECD Approach (AOA) determination.		

# Other Considerations / Impact to Audit

## Interest Expense of a US Branch of a Foreign Bank (Non-Treaty)

Considerations	Resources
<p>Consider the effects on the Branch Level Interest Tax for any changes to allocated interest expense especially if USCL exceed USBL</p> <p>Consider the effects on the branch profits tax calculation, since liabilities effect the computation of U.S. net equity</p> <p>Limitation on interest expense- the amount of interest expense computed under Treas. Reg. 1.882-5 should not exceed the amount of interest on indebtedness paid or accrued by the taxpayer within the taxable year</p>	<ul style="list-style-type: none"><li>▪ IRC 884</li><li>▪ IRC 884(f)(1)(A)</li> <li>▪ IRC 884(c)(2)(B)</li> <li>▪ Treas. Reg. 1.882-5(a)(3)</li></ul>

# Training and Additional Resources

## Chapter 6.1.2 Determination of Proper Expense Allocation

Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions	<ul style="list-style-type: none"><li>▪ 2013 Centra- Form 1120-F Audit Tips Training Module 5 Interest Expense presented 2/14/13</li><li>▪ 2013 Centra- Branch Interest Expense/Branch Level Interest Tax presented 3/6/13</li></ul>	
Issue Toolkits	<ul style="list-style-type: none"><li>▪ Audit Tools - Proforma IDRs - Interest Expense Deduction - Pro-Forma IDRs 1 – 4</li></ul>	

# Glossary of Terms and Acronyms

Acronym	Definition
AFR	Applicable Federal Rate
AOA	Authorized OECD Approach
AUSBL	Adjusted U.S. Booked Liabilities Method
B3 securities	Securities described in Treas. Reg. 1.864-4(c)(5)(ii)(b)(3)
BLIT	Branch Level Interest Tax
ECI	Effectively Connected Income
FB	Foreign Bank
USBI	U.S. Branch Allowable Interest Expense
USBL	U.S. Booked Liabilities
USCL	U.S.-Connected Liabilities
USTB	U.S Trade or Business