

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

Number: **201614031**

Release Date: 4/1/2016

CC:INTL:B03:JPCowan

POSTU-132168-14

UILC: 861.08-02

date: February 11, 2016

to: Vincent J. Guiliano, Senior Counsel
(Large & Mid-Size Business)

from: Richard L. Chewning, Senior Counsel
(International)

subject: Use of Relative Risk Weighted Asset Value as Apportionment Key

You have requested that the National Office issue Chief Counsel Advice addressing whether the relative value of risk weighted assets is a reasonable key for apportioning deductions for supportive expenses under Treas. Reg. § 1.861-8. This memorandum should not be used or cited as precedent.

FACTS

Numerous foreign persons are engaged in a banking, financing, or similar business in the United States through a branch which earns effectively connected income (ECI). The local banking regulator in many of those foreign persons' home countries require the foreign person to hold capital equal to a certain percentage of its risk-weighted assets ("RWAs"), as determined under local banking regulations that implement regulations issued by the Basel Committee on Banking Supervision (Basel Accord). Several of those foreign persons are asserting that they are permitted to use the relative value of risk weighted assets as a reasonable key for apportioning deductions for supportive expenses under Treas. Reg. § 1.861-8. This advice is not specific to any one of those foreign persons.

LAW AND ANALYSIS

For purposes of determining ECI under section 882(c) and Treas. Reg. § 1.861-8(f)(1)(iv), a taxpayer takes into account its deductions for overhead, general, and

administrative expenses (hereafter “supportive expenses”) by first allocating such deductions to all gross income, then apportioning to its statutory grouping (or groupings) of effectively connected gross income based upon the relative value of the RWAs used in its U.S. trade or business to the value of the RWAs used in its worldwide trade or business. You have asked whether the relative value of RWAs is a reasonable key for apportioning the taxpayer’s deductions for supportive expenses under Treas. Reg. § 1.861-8.

A foreign person with a U.S. trade or business is generally required under Treas. Reg. § 1.861-8 to perform a two-step analysis whereby deductions are first allocated based on the factual relationship of the deduction to a class of gross income which ordinarily consists of items (or subdivisions of such items) of income enumerated under section 61. See Treas. Reg. § 1.861-8(a)(2) and (3). Next, the deductions within the class of gross income must be apportioned, again based on factual relationships, between the statutory grouping (or groupings) and the residual grouping. Id. Special rules exist for certain expenses such as interest and research and experimental expenditures.

With respect to the allocation step, a deduction is considered definitely related to a class of gross income and therefore allocable to that class if it is incurred as a result of, or incident to, an activity, or in connection with property, from which that class of gross income is derived. Treas. Reg. § 1.861-8(b)(2). In many cases, supportive expenses are factually related to all the taxpayer’s gross income and therefore, are allocated to all such gross income. Because the issue you present is not related to the proper allocation of supportive expenses we are assuming that the supportive expenses are allocated to all of the gross income of the foreign persons.

Step two of the rules require that the supportive expenses be apportioned between the statutory grouping of ECI and the residual grouping of non-ECI within the class of income to which the expenses have been allocated (in this case all gross income). See Temp. Treas. Reg. 1.861-8T(c)(1). The apportionment must reflect to a reasonably close extent the factual relationship between the deduction and the grouping of gross income. Id. Because apportionment is made on the basis of the factual relationship between a deduction and the statutory grouping of gross income, a taxpayer is required to furnish information which will establish that factual relationship. Treas. Reg. § 1.861-8(f)(5). As an example of the type of information required to be furnished, the regulations provide that in reviewing a taxpayer’s overall foreign tax credit limitation, the District Director should consider, and request if need be, “information which would enable him to determine the extent to which deductions attributable to functions performed in the United States are related to earning foreign source income, United States source income, or income from both sources.” Id.

Typically, supportive expense deductions include costs associated with numerous disparate activities. Representative activities in a banking, financing, or similar business include risk control, credit management, audit/tax, treasury, group strategy, IT, and human resources. It will be difficult for a foreign person engaged in a banking,

financing, or similar business to establish that the costs associated with most of those activities may be reasonably apportioned to the statutory grouping of ECI based upon relative RWA values. For example, the costs associated with activities such as human resources and IT expense have no clear relationship to the relative values of RWAs and therefore using RWAs for those costs would be unreasonable. Other back office support functions, such as risk control, credit management, tax/audit, and treasury, relate more generally to the banking operation as a whole, or a particular business line, rather than to a particular asset class, making the use of RWAs as an apportionment key for such expenses unreasonable. RWA-based apportionment likely will result in relative values being attributed to assets that bear no factual relationship to the amount of time or other resources expended in issuing, acquiring, or managing those assets and performing the supportive activities. The most drastic illustration of this is that under the Basel II regulations, certain assets may be determined under an RWA approach to have a value of zero (or close to zero) and thus not support the apportionment of any supportive expense. This result is unreasonable because all assets inherently entail some cost to manage.

Nonetheless, it is theoretically possible that it could be established that using RWA relative values is a reasonable method for apportioning the costs of certain specific activities to the statutory grouping of ECI. This would only be the case, however, where a clear factual relationship is established between the specific category of expense and the relative risk weighting of assets as determined under local banking regulations. To do so, a taxpayer would need to provide information demonstrating that the cost of engaging in the particular activity or incurring the particular expense bore a clear proportionate relationship to the risk weighting with respect to each particular asset class. That information might include, for example, time records indicating that employees engaged in an activity that was supportive of ownership and management of assets used in the business and that the time devoted to each asset category—both in the U.S. and in the home office—was proportionate to the asset category's risk weighting. If so, then apportionment of those costs based on RWAs might be deemed reasonable. You must consider whether adequate information has been supplied to enable you to make that determination.

Please call Jeffrey Cowan at (202) 317-4924 if you have any further questions.