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Internal Revenue Service (I.R.S.)

Private Letter Ruling

Issue: May 1, 1992
January 28, 1992

Section 884 -- Branch Tax

884.00-00 Branch Tax

884.06-00 Effect of Income Tax Treaties

INTL-0672-90

LEGEND:

Taxpayer = * * *

Country X = * * *

Year A = * * *

Dear * * *

This ruling is in response to a letter dated November 9, 1990, requesting a ruling that Article 11(3) of the U.S.-Country X Income Tax Treaty (the "Treaty") exempts the "excess interest", if any, of Taxpayer for the taxable years ending December 31, 1989, and December 31, 1990, from the tax imposed by section 884(f)(1)(B) of the Internal Revenue Code. The information submitted for consideration is set forth below.

The ruling contained in this letter is predicated upon facts and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for a ruling. Verification of the factual information, representations and other data may be required as part of the audit process.

Taxpayer was created through legislation enacted by the Country X Parliament in Year A. Taxpayer is engaged in domestic and international banking activities. In addition to maintaining over 1,200 Country X offices, Taxpayer has branch operations in a number of countries, including a full branch operation located in the United States. Taxpayer is an accrual basis taxpayer with a calendar year end.

In connection with its U.S. banking business and the filing of its annual corporate tax return, Taxpayer anticipates that, in some taxable years, it will have "excess interest" within the meaning of section 884(f)(1)(B) of the Code. "Excess interest" arises where the interest allowable as a deduction in computing a foreign corporation's effectively connected taxable income exceeds the amount of interest described in section 884(f)(1)(A). Section 884(f)(1)(B) provides that a foreign corporation is liable for tax under section 881(a) on such amount as if the interest were paid to the foreign corporation by a wholly owned domestic corporation. Thus, absent an applicable treaty exemption, Taxpayer would be subject to the tax imposed by section 884(f) with respect to its excess interest.

Section 881(a)(1) imposes a 30 percent tax on interest received from sources within the United States by a foreign corporation to the extent such interest is not effectively connected with the conduct of a trade or business in the United States.

Section 884(f)(1)(A) of the Code provides that, in the case of a foreign corporation engaged in a trade or business in the United States, any interest paid by such trade or business in the United States shall be treated as if it were paid by a domestic corporation.

Section 884(f)(1)(B) provides that, to the extent the amount of interest allowable as a deduction under section 882 in computing the effectively connected taxable income of such foreign corporation exceeds the interest described in section 884(f)(1)(A), such foreign corporation shall be liable for tax under section 881(a) in the same manner as if such interest were paid to such foreign corporation by a wholly owned domestic corporation on the last day of such foreign corporation's taxable year.

Section 884(f)(3) provides that in the case of any interest described in section 884(f)(1)(B), no treaty benefit shall apply unless such treaty is an income tax treaty and the foreign corporation receiving the interest is a qualified resident of the treaty country.

Section 1.884-4T(c)(3) of the Temporary Income Tax Regulations provides that the rate of tax imposed on the excess interest of a foreign corporation that is a qualified resident of a treaty country shall not exceed the rate provided under such treaty that would apply with respect to interest paid by a domestic corporation to that foreign corporation.

Under Article 11(2) of the Treaty, the rate of tax imposed by one of the contracting states on interest derived from sources within that contracting state by a resident of the other contracting state shall not exceed 15 percent.

However, Article 11(3) of the Treaty provides, in relevant part, that notwithstanding Article 11(2), interest derived by a resident of one of the contracting states from sources in the other contracting state shall be exempt from tax by the other contracting state if it is interest paid between banks, except on loans represented by bearer instruments.

Notice 89-80, 1989-2 C.B. 394, discusses the definition of interest paid by a U.S. trade or business of a foreign bank and the treatment of excess interest of a

foreign bank. In particular, the notice announces that section 1.884-4T(a)(2) of the regulations will be amended to provide that a portion of the excess interest of a foreign corporation that is subject to these rules shall be treated as interest on deposits (as described in section 871(i)(B)), and thus exempt from tax under section 881(d) (relating to the exemption from tax for certain interest and dividends). This portion shall equal the greater of: (1) the ratio of the amount of deposits of the foreign corporation as of the close of the taxable year to the amount of all interest-bearing liabilities of the foreign corporation on such date or (2) 85 percent of the foreign corporation's excess interest.

These rules will apply to all taxable years beginning after December 31, 1989. A foreign corporation may make an election to apply these rules to taxable years beginning before January 1, 1990.

Taxpayer has represented that it is a "qualified resident" of Country X within the meaning of section 884(e)(4) of the Code. Taxpayer also has represented that it is engaged in the active conduct of a banking, financing, or similar business in the United States within the meaning of section 1.864- 4(c)(5)(i).

Taxpayer maintains that Article 11(3) of the Treaty exempts Taxpayer's excess interest from the tax imposed by section 884(f)(1)(B). As noted, section 1.884-4T(c)(3) provides that the rate of tax imposed on the excess interest of a foreign corporation that is a qualified resident of the treaty country may not exceed the treaty rate applying to interest paid by a domestic corporation to the foreign corporation. Article 11(2) of the Treaty specifies a 15 percent rate. Thus, absent Article 11(3), the excess interest would be subject to a 15 percent tax rate.

As Notice 89-80 states, a portion of the excess interest of a foreign corporation that is subject to these rules will be treated as interest on deposits (as described in section 871(i)(B)), and therefore exempt from tax under section 881(d). Thus, with respect to Taxpayer's taxable year ending December 31, 1990, (and December 31, 1989, if Taxpayer has made an election under the notice to apply the rules to such year), a portion of Taxpayer's excess interest will be exempt from tax under section 881(d). Accordingly, the question for Taxpayer's taxable year ending in 1990 (and 1989, if applicable) is whether Article 11(3) of the Treaty exempts the remaining portion of excess interest from tax.

The first issue is whether Article 11(3) of the Treaty may be applied in the case of excess interest since excess interest involves a deemed payment of interest from a deemed U.S. subsidiary to its foreign parent and not an actual payment of interest. Because Article 11(2) ordinarily would apply to excess interest, there is no reason why Article 11(3) should not apply to excess interest as well.

The second issue is whether the interest treated as paid to Taxpayer fails within the scope of Article 11(3) of the Treaty Taxpayer is a bank within the meaning of the Treaty, and its U.S. branch, if it were a domestic subsidiary, also would be a bank within the meaning of the Treaty. Thus, the excess interest would be treated as paid between banks within the meaning of the Treaty. Since the deemed loan between Taxpayer and its domestic subsidiary is not evidenced by an instrument of any sort and is payable solely to Taxpayer, it would also meet the

Treaty requirement that the loan not be represented by a bearer instrument. Furthermore, there is no indication that Article 11(3) is limited by its terms to payments between unrelated banks.

Because excess interest not otherwise characterized as interest on deposits falls within the scope of Article 11(3) of the Treaty and the general language of section 1.884-4T(c)(3) does not preclude the application of Article 11(3), it is held, based solely on the information and representations set forth above, that Article 11(3) of the Treaty exempts Taxpayer's "excess interest" not otherwise characterized as interest on deposits, if any, for the taxable years ending December 31, 1989 and December 31, 1990, from the tax imposed by section 884(f)(1)(B) of the Internal Revenue Code.

This letter gives no opinion regarding any other Code section, including whether Taxpayer is a qualified resident of Country X within the meaning of section 884(e)(4) of the Code or the effect of the Treaty on any other aspect of Taxpayer's U.S. trade or business.

A copy of this letter is to be attached to any return to which it is relevant.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file in this office, the original of this letter is being sent to you.

Sincerely yours,

Elizabeth U. Karzon

Senior Attorney, Branch 4

Office of the Associate Chief Counsel (International)

Enclosure

This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code.

PLR 9218032, 1992 WL 801513 (IRS PLR)

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