

Office of Chief Counsel
Internal Revenue Service
memorandum

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date: November 30, 2009

to:

from:

subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Country X =

Amount A =

Amount B =

ISSUES

1. Whether interest expense allocable to Taxpayer's U.S. branch is determined under section 1.882-5 when determining its U.S. income tax liability for its 2001-2002 taxable years?
2. If interest expense allocable to the branch is determined under section 1.882-5, are insurance reserves included in (i) "worldwide liabilities" under section 1.882-5(c) for purposes of determining the actual ratio used to determine its U.S. connected liabilities (Step 2), and (ii) "U.S. booked liabilities" under section 1.882-5(d) for purposes of determining the interest expense allocable to its income effectively connected with a U.S. trade or business (U.S. ECI) under the adjusted U.S. booked liabilities method (Step 3)?
3. Does the interest expense paid or accrued on U.S. booked liabilities under section 1.882-5 include interest in respect of items described in section 807(c)?
4. Is the deductible amount of Taxpayer's interest expense allocated to its U.S. ECI disallowed to any extent by section 805(b)(1)?

CONCLUSIONS

1. Taxpayer must use the allocation method set forth in section 1.882-5 to determine the interest expense allocable to its U.S. branch for purposes of determining its U.S. income tax liability for its 2001-2002 taxable years.
2. The amount of interest expense allocable to Taxpayer's U.S. ECI is computed by applying the three-step method set forth in section 1.882-5. In applying this method, Taxpayer's insurance reserves are included in "worldwide liabilities" under section 1.882-5(c) (Step 2) for purposes of calculating the actual ratio used to determine its U.S.-connected liabilities. Taxpayer's insurance reserves are also included in its "U.S. booked liabilities" under section 1.882-5(d)(2) (Step 3) for purposes of determining the amount of interest expense allocable to its U.S. ECI under the adjusted U.S. booked liabilities method.
3. The amount of interest paid or accrued on Taxpayer's U.S. booked liabilities includes interest in respect of items described in section 807(c).

4. Under the theory that money is fungible, a pro rata share of the total interest expense allocated to Taxpayer's U.S. ECI should be allocated to each U.S. asset, including the undivided part of Taxpayer's assets "reserved" to meet insurance obligations. Pursuant to the coordination with other Code section rule in section 1.882-5, section 801(b)(1) disallows any deduction (otherwise allowable under sections 805(a)(8) and 163) for the share of the interest expense in respect of the insurance reserves. In the absence of published guidance, a reasonable approach is to disallow a proportionate share of the interest expense under section 805(b)(1) by multiplying the total interest expense allocated to ECI under section 1.882-5 (that is, the interest expense paid or accrued within the taxable year on U.S. booked liabilities, which includes interest in respect of items described in section 807(c), plus the interest expense attributable the excess of Taxpayer's U.S. connected liabilities over the average U.S. booked liabilities) by a ratio, the numerator of which is the average adjusted basis of the assets represented by the branch's insurance reserves for the taxable year and the denominator of which is the average adjusted basis of the total U.S. booked assets for the taxable year. In no event, can the interest expense allocated to U.S. insurance reserves be less than the interest with respect to the section 807(c) items, as shown on Taxpayer's U.S. books.

FACTS

Taxpayer conducts a U.S. life insurance business through a branch that constitutes a U.S. permanent establishment, as that term is defined for purposes of Article V of the U.S.-Country X Income Tax Treaty (the "Treaty"). Taxpayer files a Form 1120L on a calendar year basis for its U.S. life insurance branch. In tax years 2001 and 2002, Taxpayer issued debt only in Country X.

In its timely filed income tax returns for 2001 and 2002, Taxpayer did not use the interest expense allocation rules in section 1.882-5 to determine its deductible interest allocable to its U.S. ECI when calculating its taxable income attributable to its U.S. operations. Taxpayer subsequently filed amended returns claiming branch interest expense deductions under section 1.882-5 of amount A for tax year 2001 and amount B for tax year 2002.

In computing its interest expense allocable to its U.S. ECI under section 1.882-5 on its amended returns, Taxpayer included the branch's insurance reserves in both U.S. booked and world-wide liabilities. However, in determining its deductible interest expense, Taxpayer did not reduce the amount allocated to its U.S. ECI by items of interest in respect of the reserves described in section 807(c).

LAW AND ANALYSIS

ISSUE 1

Application of section 1.882-5

A foreign company carrying on a life insurance business within the U.S. is taxable on its ECI under sections 842(a) and 801. Subject to a minimum effectively connected investment rule in section 842(b), an insurance company's ECI is determined under section 882.

Section 882(c)(1)(A) provides that in determining the taxable income of a foreign corporation engaged in a U.S. trade or business, deductions are allowed only if and to the extent that they are connected with the income that is effectively connected with the conduct of a U.S. trade or business, and that the proper apportionment and allocation of deductions for this purpose shall be determined as provided in regulations prescribed by the Secretary.

Section 1.882-5, as in effect for the years at issue (the 1996 Regulations) provides, in relevant part, as follows:

- (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 U.S. (ECI) is the sum of interest paid or accrued by the foreign corporation on its liabilities booked in the U.S., 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 expenses 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 pool method described in paragraph (e) of this section.
- (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.

Section 1.882-5, T.D. 8658, 61 FR 9329 (Mar. 8, 1996); 61 FR 15891 (Apr. 10, 1996) (emphasis added).

Taxpayer is a foreign corporation with a permanent establishment in the U.S. that is carrying on a life insurance business. A foreign corporation carrying on an insurance business is subject to U.S. tax on its ECI under sections 885(1), 842(a), and 801(a). Section 882(c) provides that Taxpayer may, in determining its taxable income, deduct from its gross income amounts effectively connected with its U.S. trade or business. Section 882(c)(1) also provides deductions with regard to Taxpayer's ECI shall be apportioned and allocated under regulations promulgated by the Secretary.

The 1996 Regulations prescribe the exclusive method (notwithstanding the provisions of any applicable income tax treaties) for determining the amount of interest expense Taxpayer may deduct from its gross income subject to tax under section 842(a). Thus, Taxpayer must apply section 1.882-5 to determine the allocations of its deductible interest expense.

ISSUE 2

Are insurance reserves included in "worldwide liabilities" under Step 2 and "U.S. booked liabilities" under Step 3?

The 1996 Regulations provide a formulary method for determining the amount of a foreign corporation's interest expense that is allocable to its U.S. trade or business. The method is based upon the worldwide assets and liabilities of the entire corporation.

The 1996 Regulations do not contain any special provisions for insurance companies. Instead, they reserve any special rules with respect to how insurance reserves are treated in Steps 2 and 3 of the methodology for promulgation at a later time, if appropriate. See section 1.882-5(c)(2)(ii) (reserved treatment of insurance reserves for purposes of determining the actual ratio); section 1.882-5(d)(2)(ii)(B)(2) (reserved treatment of insurance reserves for purposes of determining whether a booked liability was properly reflected on the books of the U.S. trade or business); section 1.882-5(d)(3)(i)(C) (reserved treatment of insurance reserves for purposes of determining the allocable amount of interest where booked liabilities equal or exceed U.S. liabilities). As the preamble to 1996 Regulations when proposed in 1992 states:

Section 1.882-5 applies to insurance companies, and a section is reserved to address specific concerns of these companies, particularly with respect to the treatment of insurance reserves. The Service is interested in receiving comments from the public regarding the classification of

insurance reserves as liabilities and other issues relevant to insurance companies.

57 Fed. Reg. 15038, 1992-1 C.B. 1157 (April 24, 1992).

Accordingly, in the absence of a special rule for insurance companies, the regulation's approach, which includes the total amount of worldwide liabilities and assets in the calculations under section 1.882-5, applies to insurance companies. Therefore, reserves of an insurance company are included in both "worldwide liabilities" for purposes of determining Taxpayer's "U.S.-connected liabilities" under section 1.882-5(c), and "U.S. booked liabilities" for purposes of determining Taxpayer's interest expense allocable to its U.S. ECI under the adjusted U.S. booked liabilities method under section 1.882-5(d).¹

ISSUE 3

Does the interest expense paid or accrued on U.S. booked liabilities under section 1.882-5 include items of interest in respect of items described in section 807(c)?

In describing the regulation's formulary method, 1.882-5(a)(1) provides that the amount of interest expense of a foreign corporation that is allocable under section 882(c) to income which is (or is treated as) ECI is the sum of—

- (1) interest paid or accrued by the foreign corporation on its liabilities booked in the U.S., as adjusted under the three-step process set forth in paragraphs (b), (c), and (d) of section 1.882-5, and
- (2) specially allocated interest expense determined under section (a)(1)(ii) of section 1.882-5.

Under the three-step process, Step 1 is the determination of the total value of the U.S. assets of a foreign corporation under section 1.882-5(b). Step 2 is the determination of the amount of U.S. connected liabilities under section 1.882-5(c). Finally, in Step 3 the amount of interest paid or accrued on liabilities booked in the U.S., as determined, is adjusted for interest expense attributable to the difference between U.S. connected liabilities and U.S. booked liabilities under section 1.882-5(d)(2). Alternatively, a foreign corporation may elect to determine its interest rate on U.S.

¹ This conclusion is consistent with the regulations under section 884, which include in U.S. liabilities the total insurance liabilities on U.S. business (within the meaning of section 842(b)(2)(B)) of a foreign corporation described in section 842 to the extent such liabilities are not otherwise treated as U.S. liabilities by reason of section 1.884-1(e)(1). Section 1.884-1(e)(2)(i). It also complies with the legislative history of the 1986 Tax Reform Act, which requires consistency among the branch profits tax and the determination of expenses. Conf. Rept. No. 99-841, 99th Cong., 2d Sess. II-647 (1986) ("The conferees wish to clarify that, under regulations, the rules for determining assets and liabilities treated as connected with the conduct of a U.S. trade or business for branch tax purposes are to be consistent with rules used in allocating deductions for purposes of computing taxable income.").

connected liabilities by reference to its U.S. assets, using the separate currency pools method described in section 1.882-5(e).

Section 1.882-5(d)(4) provides that when the U.S. booked liabilities exceeds U.S. connected liabilities, the interest expense allocable to ECI is the product of the total interest paid or accrued within the tax year by the U.S. trade or business on U.S. booked liabilities and the scaling ratio set forth in section 1.882-5(d)(4)(ii). The scaling ratio is the ratio of U.S. connected liabilities to the average total amount of U.S. booked liabilities.

Section 1.882-5(d)(4) also provides that if U.S. booked liabilities equal U.S. connected liabilities, the allocable interest expense is the total interest paid or accrued within the tax year by the U.S. trade or business on U.S. booked liabilities.

Section 1.882-5(d)(5)(i) provides that when the U.S. booked liabilities are less than U.S. connected liabilities, the interest expense allocable to ECI is the sum of (1) the total interest paid or accrued within the tax year by the U.S. trade or business on U.S. booked liabilities, and (2) 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 section 1.882-5(d)(5)(ii).

Section 1.882-5 does not define the “interest expense paid or accrued” within the taxable year on U.S. booked liabilities; that is, the amount of interest expense added to the additional amount allocated to Taxpayer’s U.S. ECI under Step 3 (because its U.S. connected liabilities exceed its U.S. booked liabilities) in order to determine the total amount allocated to Taxpayer’s U.S. ECI.

Sections 807(c)(1)-(6) describe the items that an insurance company takes into account as either a decrease in reserves included in income or an increase in reserves that may be deducted. Interest generally is taken into account in calculating amounts of reserves described in sections 807(c)(1)-(6) in that:

1. Section 807(c)(1) refers to “life insurance reserves” (as defined in section 816(b)). Section 816(b)(1)(A) defines “life insurance reserves” as those amounts that are (1) computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and (2) set aside to mature or liquidate, either by payment or reinsurance, future un-accrued claims arising from life insurance contracts involving (at the time with respect to which the reserve is computed) life, health, or accident contingencies. See also United States, v. Atlas Life Ins. Co., 381 U.S. 233 (1965) (“[T]he undivided part of a life insurance company’s assets represented by its reserves is considered as a fund held for the benefit of policyholders; Rev. Rul. 67-435, 1967-2 C.B. 232 (stating that life insurance reserves, broadly defined as the difference

between the present value of the benefits and the present value of the future premiums, are amounts theoretically necessary to be “reserved” out of premiums, which, at assumed rates of interest, will enable the company to pay all outstanding policies as they become claims, providing the facts are in accord with the assumptions made.)

For purposes of determining taxable income, the amount of life insurance reserves taken into account with respect to a contract is determined under section 807(d). If the amount taken into account is the amount determined under section 807(d)(2), then the interest rate used to determine the reserves is the greater of the “applicable Federal rate” (as defined in section 807(d)(4)(A)) or the “prevailing State assumed rate” (as defined in section 807(d)(4)(B)). If the amount of life insurance reserves for a contract is the net surrender value for the contract, then the interest rate used in determining the reserve is the interest rate used to calculate the contract’s net surrender value.

2. Section 807(c)(2) refers to “unpaid losses included in total reserves under section 816(c)(2).” The last sentence of the flush language of section 807(c), provides that “the amount of unpaid losses (other than losses on life insurance contracts) shall be the amount of discounted unpaid losses as defined in section 846.” The amount of discounted losses under section 846 is calculated using an “applicable rate of interest.” See sections 846(a)(2)(B) and 846(c).
3. Section 807(c)(3) refers to “amounts (discounted at the appropriate rate of interest) necessary to satisfy the obligations under insurance and annuity contracts . . . that do not involve life, accident, or health contingencies.” In addition, the first sentence of the flush language of section 807(c) provides that “the appropriate rate of interest for any obligations is whichever of the following rates is the highest as of the time such obligation did not involve life, accident, or health contingencies: the applicable Federal interest rate under . . . [section 807(d)(2)(B)(i)], the prevailing State assumed interest rate under . . . [section 807(d)(2)(B)(ii)], or the rate of interest assumed by the [insurance] company in determining the guaranteed benefit.”
4. Section 807(c)(4) refers to “[d]ividend accumulations and other amounts, held at interest in connection with insurance and annuity contracts.” The rate of interest for section 807(c)(4) reserves is the rate actually paid, credited, or accrued by the insurance company with respect to the reserves. See section 1.809-2(d)(1).

5. Sections 807(c)(5) and 807(c)(6) describe reserve items without mentioning “interest.” An insurance company may pay, credit, or accrue interest on these reserves. If so, then the rate of interest for these reserves also is the rate actually paid, credited, or accrued by the insurance company with respect to the reserves. See section 809-2(d)(1).

See also section 812(b)(2)(A) (relating to “required interest” on reserves under section 807(c).

As discussed above, under section 807(c) insurance reserves are determined based, in part, upon rates of interest. Therefore, because insurance reserves are included in U.S. booked liabilities under section 1.882-5, any interest paid or accrued on those liabilities should include any amounts considered “interest in respect of items described in section 807(c).”² Cf. sections 1.884-1(e)(2)(i) and 1.884-4(b)(1)(i)(B) (each of which include “total reserves” defined in section 816(c) and items referred to in section 807(c)(3)-(6) in additional liabilities for purposes of the branch profits tax and branch-level interest tax, respectively).³

ISSUE 4

The deductible amount of the interest expense allocated under section 1.882-5

Section 885(1) cross references section 842 for special provisions relating to foreign corporations carrying on an insurance business within the United States.

In relevant part, section 842(a) provides that if a foreign company carrying on an insurance business within the United States would qualify under part I or II of this subchapter for the taxable year if (without regard to income not effectively connected with the conduct of any trade or business within the United States) it were a domestic corporation, such company shall be taxable under the relevant part (I or II) of subchapter L on its income effectively connected with its conduct of any trade or business with the United States.

A “life insurance company” as defined in section 816(a) is subject to tax under part I of subchapter L (sections 801-818). Taxpayer’s U.S. trade or business would

² Section 818(f)(3) provides that for purposes of part I of subchapter N (sections 861 through 865), items described in any paragraph of section 807(c) shall be treated as amounts which are not interest. Section 818(f)(3) does not preclude the items described in section 807(c) from being considered an interest expense for purposes of determining the amount of the Taxpayer’s ECI under section 1.882-5.

³ Under section 1.884-4(b)(1)(i), branch interest includes interest paid with respect to total insurance liabilities on United States business (within the meaning of section 842(b)(2)(B)). Taxpayer may elect to treat its accrued interest on such liabilities as paid on the last day of the taxable year in which the interest accrues under section 1.884-4(c)(1), thus reducing the amount of its excess interest in the year of accrual.

qualify under part I of subchapter L if it were a domestic corporation. Accordingly, Taxpayer's U.S. ECI is taxable under part I of subchapter L.

Section 801(b) defines "life insurance taxable income" as "life insurance gross income" (as defined in section 803) reduced by "life insurance deductions" (as defined by section 804). Under section 804(a)(1), life insurance deductions include the "general deductions" provided in section 805. Among the general deductions described in section 805, section 805(a)(2) provides a deduction for the net increase in certain reserves required by section 807(b) based upon items of interest set forth in section 807(c).

Section 805(a)(8) provides that, subject to certain modifications described in section 805(b)(1), a life insurance company is allowed all of the deductions otherwise provided under Subtitle A for purposes of computing taxable income. A life insurance company thus is generally allowed to deduct interest expenses under sections 163 and 805(a)(8). Under section 805(b)(1), however, in applying section 163 (relating to the deduction for interest), no deduction is allowed for interest in respect of a reserve or similar item described in section 807(c).

Section 811(c) provides that "[n]othing in this part shall permit . . . (2) that same item to be counted more than once for reserves purposes, or (3) any item to be deducted (either directly or as an increase in reserves) more than once."

Section 1.882-5(a)(5) (titled "Coordination with other sections") provides that 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.

The method for allocating and apportioning interest expense under section 1.882-5 recognizes that money is a fungible asset. See, e.g., section 1.882-5(c) (providing an approach to determine U.S. liabilities by multiplying a foreign corporation's U.S. assets determined in Step 1 by the debt equity ratio of the entire corporation). Under a fungibility approach, interest expense is attributable to all activities and assets without regard to the specific reason for incurring the liability. See e.g., sections 864(e)(2) and 1.861-9T(a).⁴

⁴ Like section 861, exceptions to the fungibility principle exist under section 882 for assets and indebtedness that meet the requirements of section 1.861-10T(b) (qualified nonrecourse indebtedness) and (c) (assets acquired in integrated financial transactions), as limited by section 1.861-10T(d) (related person transactions), may directly allocate interest expense from such indebtedness to income from such asset in the manner and to the extent provided in section 1.861-10T. Section 1.882-5(a)(1)(ii).

The fungibility principle can be implemented with respect to the total interest expense allocable to Taxpayer's U.S. ECI (as determined under Step 3) by allocating a proportionate share to each U.S. asset. See, e.g., section 1.882-5(a)(8) (example 3).⁵ Under section 1.882-5(a)(5), however, the interest allocated on a pro rata basis to a particular asset might then be disallowed, deferred, or capitalized pursuant to another Code section.

Thus, under a fungibility approach, because assets represented by Taxpayer's insurance reserves are included in U.S. assets in the section 1.882-5 formula (Step 1), as well as "worldwide liabilities" in the actual ratio of Step 2 and "U.S. booked liabilities" under Step 3, a pro rata portion of the total interest expense allocable to Taxpayer's U.S. ECI should be attributable to the branch's insurance reserves. After the allocation, however, the interest deduction for the share of the interest expense in respect of the insurance reserves would be disallowed under section 805(b)(1) pursuant to section 1.882-5(a)(5)'s coordination rule.

In the absence of published guidance, a reasonable approach is to disallow a proportionate share of the interest expense under section 805(b)(1) by multiplying the total interest expense allocated to ECI under section 1.882-5 (that is, the interest expense paid or accrued within the taxable year on U.S. booked liabilities, which includes interest in respect of items described in section 807(c), plus the interest expense attributable to the excess of Taxpayer's U.S. connected liabilities over the average of U.S. booked liabilities) by a ratio, the numerator of which is the average adjusted basis of the assets represented by the branch's insurance reserves for the taxable year and the denominator of which is the average adjusted basis of the total U.S. booked assets for the taxable year. In no event, can the interest expense allocated to U.S. insurance reserves be less than the interest with respect to the section 807(c) items, as shown on Taxpayer's U.S. books.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Josephine Firehock at (202) 622-4233 if you have any further questions.

⁵ See also H.R. Rep. No. 841 (Conference), 99th Cong., 2d Sess. II-648-649 (1986) (suggesting a similar approach may be adopted by the Secretary in promulgating regulations with respect to excess interest allocable to ECI under section 1.882-5 for purposes of the branch profits interest tax; namely that, ". . . where indebtedness of the home office is attributed to the branch, the excess interest is to be treated as incurred on each type of external borrowing by the corporation and determined by reference to the relative principal amount of, and the average interest rate on, each type of external borrowing.")