

International Banking & Capital Markets Conference*

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Federal Tax Hot Topics

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Agenda

New regulations for foreign bank interest allocation

Tax litigation: recent court decisions and docketed cases

Other tax developments, outlook

Financial accounting developments

Revisions to Treasury Regulations Sections 1.882-5 and 1.884-1

- Issued on August 17, 2006
- Implementation of changes described in Notice 2005-53
- Revisions to regulations issued in temporary form
- Effective for tax year end for which the original tax return due date (including extensions) is after August 17, 2006 (effective for calendar year 2005 tax returns)
- Taxpayers generally allowed or required a period of 180 days subsequent to the tax return extended due date to implement new provisions (until March 14, 2007 for calendar year 2005 taxpayers)
- Revisions made based on IRS analysis of how international banks capitalize their global operations

Treaty Based Tax Positions

- As stated in Notice 2005-53, the regulations note that they are no longer provide the exclusive method for the calculation of U.S. interest expense deduction of non-U.S. corporations
- In recognition of changes provided in the business profits articles of the UK and Japan Income Tax Treaties with the U.S. and accompanying notes which authorize separate entity treatment under OECD transfer pricing guidelines

Modifications to Three Step Calculation Under Treasury Regulations Section 1.882-5

Step I

- Conformity election requirement – Determination of U.S. assets on a fair market value basis in Step I can only be utilized if taxpayer applies the actual ratio in Step II
- Adoption of provisions requiring mark-to-market valuation under IRC Section 475 and IRC Section 1256 provisions of 1996 proposed regulations requiring valuations on each determination date (i.e., daily or monthly) within the taxable year

Modifications to Three Step Calculation Under Treasury Regulations Section 1.882-5

Step II

- Increase in fixed liabilities to assets ratio (“fixed ratio”) from 93% to 95%
- Preamble to the regulations notes that this change is in recognition of the revised ratio being more representative of international banks equity capital structure
- For taxpayer’s that continue to apply the fixed ratio, the impact of this change is that an additional 2% of their U.S. assets will be deemed to be funded with liabilities
- Will result in a significant increase in interest deductions on a permanent basis
- Taxpayers provided with a one time opportunity to change from actual liabilities to assets ratio (“actual ratio”) to the fixed ratio
- Continued use of the new fixed ratio will not constitute a new election

Modifications to Three Step Calculation Under Treasury Regulations Section 1.882-5

Step II, continued

- For taxpayer's currently using the actual ratio, the impact of this change should precipitate an analysis of:
 - Benefits of remaining on the actual ratio
 - Documentation requirements
 - Audit risk considerations
- Branch Profits Tax ("BPT") Impact – The increase in the fixed ratio over the prior year ratio can result in an increase in BPT liability (due to lower end of year U.S. net equity for the year in which the change is effective)

Modifications to Three Step Calculation Under Treasury Regulations Section 1.882-5

Step II, continued

- Potential BPT impact may be mitigated by the expanded availability of the liability reduction election under Section 884
 - However, no longer available beyond the amount required to eliminate BPT
 - This can limit the ability of taxpayers to reduce or eliminate Branch Level Interest Tax
- Preamble states intention to treat a taxpayer that is regulated as a bank in its home country, takes deposits, and makes loans as a substantial part of its business outside the United States as eligible to elect the 95% fixed ratio rather than the 50% fixed ratio applicable to non-banks

Modifications to Three Step Calculation Under Treasury Regulations Section 1.882-5

Step III

- Interest on excess of U.S. connected liabilities over U.S. book liabilities under the Adjusted U.S. Book Liabilities method can now be calculated by using the average 30 day LIBOR rate for the tax year
 - Taxpayer must note source of published rate applied in calculation
 - Taxpayer can continue to apply the average U.S. dollar borrowing rate of non-U.S. branches
 - This is an annual election

Clarifications of 1996 Final Treasury Regulations Section 1.882-5 Provisions

- Direct interest allocation – Financial institutions are not disqualified from direct allocation treatment by satisfying only the rules provided for non-recourse indebtedness
- A taxpayer which is eligible to change an election after the minimum five-year period can only do so on a timely filed return
- A taxpayer may change an election requiring a 5 year minimum period in any year subsequent to end of the 5th year
- U.S. booked liabilities do not require tracing to specific effectively connected uses
 - Whether there is a direct connection between the liability and activity that produces effectively connected income is determined under all the facts and circumstances

Clarifications of 1996 Final Treasury Regulations Section 1.882-5, continued

- Foreign currency gain/loss – Recognition of the fact that a currency position hedged with an interbranch transaction can be treated as an unhedged position for U.S. tax purposes; the preamble does solicit comments regarding the allocation, sourcing, and apportionment of currency gain or loss from unhedged third-party borrowings between effectively connected and non-effectively connected income

Recent Court Decisions

- Mark-to-market, accounting methods – *Bank One [JPMC]*
- Work product privilege – *Roxworthy [YUM! Brands]*
- Structured transactions
 - *Castle Harbour [GE Capital]*
 - *Coltec*
 - *Black & Decker*
 - *Klamath Strategic Fund*

Docketed Cases

- LILOs and SILOs
- Tax accrual workpapers – summons enforcement
- Treatment of credit card fees
- Interest expense allocable to tax-exempt obligations
- Dollar rolls – capital vs. ordinary

Financial Accounting Developments

- FIN 48, *Accounting for Uncertainty in Income Taxes*
- FSP FAS 13-2, *Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease*
- EITF 06-5, *Accounting for Purchases of Life Insurance*
- SOP 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*

Other Tax Developments, Outlook

- Proposed regulations target treatment of loans as ordinary assets by nonbanks
- New statutory provisions for employer-owned life insurance, e.g., BOLI
- Expectations for future published guidance
- Legislative outlook

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