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IRS Examinations of In-Bound Bank Interest Expense Deductions

Mark Leeds
Mayer Brown
(212) 506-2499
mleeds@mayerbrown.com

Foreign Banks Have Up to 3 Options to Determine Their US Interest Expense Deduction

- AUSBL – Adjusted US Booked Liability Method
  - Interest deduction begins with determining the amount of US assets
  - US assets are then multiplied by a fixed ratio or an actual ratio of liabilities-to-assets
- SCP – Separate Currency Pool Method
  - Separate US assets into currency pools
  - Determine US-connected liabilities by currency pool
- Treaty – If the taxpayer is resident in a Treaty jurisdiction, it can elect to use its actual US-booked interest expense (Belgium, Canada, Germany, Japan, United Kingdom)

Branch Interest Deductions Begin by Determining US Assets

- Swap books contain tens of thousands of positions
- Most dealers net positions by counterparty
  - Global netting agreements use net exposure in determining counterparty limits
  - General ledger is maintained on a net basis
- Sale-Repurchase Transactions can also be disaggregated
  - Right to receive back repo-ed securities is an asset
  - Liability to return cash is a liability

Not Netting Can Have Both Beneficial & Deleterious Effects on the Interest Deduction

- Grossing out positions can increase US assets (helpful)
- When US-connected liabilities exceed US-booked assets, the bank is entitled to an interest deduction on such excess (“Excess Interest”)
- The interest rate on excess liabilities is determined by dividing interest paid on US$ liabilities (*whether interest bearing or not*)
  - US-booked liabilities are excluded because the interest expense on US-booked liabilities has already been added to deductible interest expense
- Thus, grossing out the denominator substantially reduces the effective interest rate considered paid on excess liabilities

Netting Swap Books & Repos Appeared Uncontroversial, but the IRS Now Challenges Netting

- Swap books have become so large that grossing out positions results in an interest rate that is substantially below actual cost of funds.
  - Purpose of Treas. Reg. § 1.882-5 is derive a bank's actual cost of funds
- Swaps and other derivatives have substantial embedded interest expense that grossing out ignores.
- Example 7 of Treasury Regulation § 1.882-5(c) can only be read in a way that makes sense if mark-to-market positions are netted.
- Taxpayers can elect to use 30-day LIBOR in lieu of performing calculation.

IBOR Replacement

- Banks may desire to use SOFR in lieu of 30-day LIBOR in determining interest expense on excess liabilities
- SOFR requires a spread to determine the actual cost of funds
- Uncharted waters as 882-5 regulations have not been updated to reflect market turn from IBOR to SOFR or other indices.

Speakers

Mark H. Leeds

Partner – New York

mleeds@mayerbrown.com

T +1 212 506 2499

Mark H. Leeds is a Tax Transactions & Consulting partner in Mayer Brown's New York office. His practice is focused on the tax consequences of a variety of capital markets products and strategies, including over-the-counter derivative transactions, swaps, tax-exempt derivatives and strategies for efficient utilization of tax attributes—such as net operating losses.

Mark advises on the tax aspects of capital markets, structured finance, derivatives, financial products and insurance transactions and has extensive experience working with both buyers and sellers to develop and structure complex derivatives. A significant portion of his work involves the taxation of financial products and trading strategies engaged in by banks and other financial market participants. He also advises on hedge fund and other investment vehicle formation matters.