INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Index (UIL) No.: 864.01-04, 864.02-00, 864.02-01
CASE-MIS No.: TAM-105543-06

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer:
Country A:
Country B:
Management Desk:
City A:
City B:
Year 1:
Year 2:
Year 3:
Date A:
Date B:
Date C:
Date D:

Amount A:
Amount B:
Amount C:
Amount D:
Amount E:
Amount F:
Amount G:
Amount H:
Rate A
Percent A

ISSUE(S):

1. Whether Taxpayer's interest in Partnership (which itself is not engaged in trade or business within the United States) is effectively connected under section 864(c) and the regulations with Taxpayer's banking, financing or similar business within the United States for the taxable years Year 1, Year 2 and Year 3; and

2. Whether Taxpayer's distributive share of income, gains and losses from securities held by Partnership are eligible for allocation under the 10 Percent Rule formula under §1.864-4(c)(5)(ii).

CONCLUSION(S):

1. *General principles of application to determining ECI from Partnership*. Subchapter K of the Code is a blend of aggregate and entity treatment for partners and partnerships, and for purposes of applying provisions of the Code not included in Subchapter K, a partnership may be treated as an aggregate of its partners or as an entity distinct from its partners, depending on the purpose and scope of such provisions. Rev-Rul. 91-32, 1991-1 CB 107. Taxpayer's interest in Partnership is evaluated in accordance with the purpose and scope of section 864(c) and the regulations thereunder. The scope of income that may be treated as ECI is determined in accordance with an entity theory so that Taxpayer's ECI from Partnership will not exceed its distributive share. The ECI or non-ECI treatment of Taxpayer's distributive share of income from an investment partnership (that itself is not engaged in trade or business) is evaluated on an aggregate approach. Taxpayer's interest in Partnership is not tested as a separate entity-level asset under any of the asset use, business activities or material participation tests in §1.864-4(c). The aggregate approach for determining ECI of Taxpayer's distributive share applies the appropriate test under §1.864-4(c) directly to the Partnership assets. This approach achieves the purpose of the §1.864-4(c) regulations by applying the same ECI characterization rule Taxpayer would

have applied to each particular type of income had all of the assets been acquired and held directly in the same capacity that they were acquired and held by Partnership.

2. *Application of the aggregate approach to partnerships not engaged in trade or business*. Taxpayer is engaged in the active conduct of a banking, financing or similar business within the United States under §1.864-4(c)(5)(i). Accordingly, the ECI treatment of income, gain and loss from securities (as defined in §1.864-4(c)(5)(v)) acquired for investment is determined by reference to whether the securities are attributable to the U.S. office where Taxpayer's banking, financing or similar business is carried on. §1.864-4(c)(5)(ii). When a taxpayer is engaged in a banking, financing or similar business within the United States, in lieu of the asset use test in §1.864-4(c)(2) and the business activities test in §1.864-4(c)(3), §1.864-4(c)(5)(iii) provides a material participation test for attributing securities to a U.S. office for purposes of determining ECI treatment of investment securities. The material participation test determines attribution to a U.S. office without regard to whether the securities are booked or held for use in the conduct of the trade or business within the United States and without regard to whether the income from the securities is, collected or used in the further conduct of the trade or business. §1.864-4(c)(5)(iii)(b). For these reasons, Taxpayer's interest in Partnership is not evaluated under the asset use test of §1.864-4(c)(2) or the business activities test of §1.864-4(c)(3) to determine whether its distributive share of securities income may be ECI at the partner level.

3. *Application of aggregate theory to Taxpayer's interest in Partnership*. Because Taxpayer is engaged in the active conduct of a banking, financing or similar business within the United States and Partnership's assets for taxable years Year 1, Year 2 and Year 3 consist entirely of securities as defined under §1.864-4(c)(5)(v), all assets held by Partnership are evaluated for their ECI treatment in accordance with the banking, financing or similar business rules. The securities initially sold to partnership were originally acquired through the material participation of the U.S. office and all of Partnership's activities and asset acquisitions were conducted through the continued material participation of Taxpayer's U.S. office. All of Partnership's securities, including some new securities acquired on the open secondary market instead of from Taxpayer, would have been attributable to Taxpayer's U.S. office under the material participation test applied at the time they were acquired by Partnership, had the securities been acquired directly by Taxpayer at that time.

4. *Application of the aggregate approach to the 10% Rule under §1.864-4(c)(5)(ii) and to Taxpayer's distributive share of Partnership*. All of Partnership's securities were acquired and held by Partnership for

investment. As a result, Taxpayer's distributive share of the income, gains and losses from securities held by Partnership that are described in §1.864-4(c)(5)(ii)(b)(3) is allocable under the 10% rule allocation formula, notwithstanding that prior to acquisition by Partnership, the majority of the securities were held for trading by Taxpayer for its own account and treated as wholly ECI under the 10% rule override provision in §1.864-4(c)(5)(vi). Section 1.864-4(c) principles do not prohibit an asset originally held for a trading use from being converted to an investment status during its holding period. Such conversion may be effected under the facts and circumstances for section 864 purposes without regard to whether such conversion is prohibited for other purposes of the Code, such as under section 475. Taxpayer adequately demonstrated that such conversion to investment status was effected by Partnership's acquisition and use of the securities in accordance with Partnership's charter and offering memorandum. Notwithstanding Partnership's investment use of all of the securities in its portfolio, Treasury securities held by Partnership are described in §1.864-4(c)(5)(ii)(b)(2) rather than paragraph (b)(3), and are not eligilble for the 10% rule allocation. Since Taxpayer's distributive share of Treasury securities income is attributable to Taxpayer's U.S. office of its banking, financing or similar business under the material participation test, such Treasury income is therefore treated as wholly ECI.

Treatment of Partnership assets in the 10% rule formula. To determine Taxpayer's overall ECI percentage under the 10% rule formula, Taxpayer's distributive share of Partnership assets and Taxpayer's directly held assets of its U.S. office must be combined in the denominator of the fraction in the formula. Similarly in determining Taxpayer's numerator in the formula, Taxpayer's distributive share percentage of Partnership's total securities described in §1.864-4(c)(5)(ii)(b)(3), must also be included in both the total "(b)(3) securities" numerator and combined with other (b)(3) securities, if any, that Taxpayer may have had attributable to its U.S. office. No amount of Taxpayer's outside basis of its interest in Partnership is includible in either the numerator or the denominator of fraction in the 10% rule formula.

FACTS:

Taxpayer is a corporation resident in Country A that conducts retail banking activities in Country A, and corporate and private banking, as well as other financial services, in Country A and throughout the world. Taxpayer has many subsidiaries and branches throughout the world, including in the United States where it is engaged in the active conduct of a banking, financing, or similar business within the United States as defined in §1.864-4(c)(5)(i). Taxpayer is also a dealer in securities for purposes of both section 864 and section 475.

Funding of Taxpayer's worldwide operations is overseen by its Management Desk located at its head office in City A. The responsibility for managing the day-to-day funding of the Bank's U.S. branch operations is delegated to the Management Desk located in the City B branch under the direction of the Country A treasurer. Among the activities conducted in the United States for tax years Year 1, Year 2 and year 3, was a securities arbitrage activity. This activity consisted of the ownership and management of five types of securities portfolios: REMICs, US government obligations, equity derivatives, US equity baskets and interest rate swaps. A senior vice president employed by the City B branch managed the Bank's securities arbitrage desk and its Management Desk in the United States.

The income, gains and losses at issue in this memorandum primarily, are with respect to the debt securities (as defined in Treas. Reg. §1.864-4(c)(5)(v)) originally held in Securities Arbitrage accounts located in Taxpayer's branch offices in the United States in City A and in Country B and which were sold to Partnership during Date A. Prior to their sale to Partnership, all of these securities were held in accounts designated by Taxpayer as utilized for trading for their own account (Trading Accounts) and were marked to market on Taxpayer's books and records in accordance with Country A generally accepted accounting principles as well as for U.S. tax purposes. Partnership also acquired some additional securities on the secondary market to replace securities at maturity that were originally acquired from Taxpayer. Taxpayer and Exam agree that all of the debt securities originally acquired from Taxpayer were attributable to Taxpayer's U.S. office located in City A within the meaning of Treas. Reg. §1.864-4(c)(5)(iii) and that all of the securities in the Trading Accounts were subject to mark to market treatment under section 475(a).

Formation of Partnership by Taxpayer and Unrelated Third Parties

In order to increase Taxpayer's Tier 1 bank regulatory capital under the bank regulatory rules applicable to Taxpayer in Country A, Taxpayer and unrelated third-parties formed Partnership in the United States for the stated limited purpose of acquiring and holding identified "eligible securities" from the pool of securities held by Taxpayer in its Trading Accounts on its City A and Country B books. Partnership is a LLC formed under the laws of State A that is treated as a partnership for U.S. tax purposes and a corporation for Country A tax and bank regulatory purposes. The debt securities identified as eligible securities to be held by Partnership were disposed of by Taxpayer from its Trading Accounts in the following manner:

> During Date A, the Bank transferred approximately Amount A in cash to Partnership, a newly formed State A company which is treated as a partnership for U.S. tax purposes. Through an initial offering, additional interests in Partnership were issued to unrelated third parties of Taxpayer for an additional Amount B. The unrelated third-party investors in Partnership received Series A Preferred Securities while Taxpayer received Common Securities in Partnership.

> Partnership used the Amount A and Amount B cash contributions to purchase approximately Amount C worth of the Trading Securities held by Taxpayer on its City A and Country B branch books. Taxpayer marked to market all of the securities sold to Partnership incident to the sale and recorded the gains and losses on its City A and Country B branch books and records.

Partnership's by-laws state that "the sole purposes of the Partnership are to issue Preferred Securities and Common Securities and to use substantially all of the proceeds thereof to purchase and hold Eligible Securities…"

Taxpayer, in its protest to Appeals, described Partnership's activities as follows:

- Partnership does not act as a broker-dealer or market maker in Eligible Securities;
- Partnership purchased additional Eligible Securities only to replace matured assets in the portfolio and only in the secondary market using Taxpayer's U.S. branch as an agent for the purchases;
- Partnership engages only in specified hedging transactions (other than holding the purchased securities for investment);
- Partnership is prohibited from borrowing and from engaging in repurchase or reverse-repurchase transactions;
- Partnership is not permitted to originate loans, purchase revolving credit agreements or participate in transactions where the Partnership commits in advance to extend credit to a borrower;
- Partnership cannot receive origination fees or other fees typically earned by an entity engaged in a banking or financing business; and
- Partnership is not licensed as a bank, mortgage broker, insurance company, broker dealer or finance company.

The Offering Memorandum for Partnership sets forth a stated strategy to buy and hold liquid income producing securities. It states that Partnership does not intend to:

(i) invest in securities of other issuers for the purposes of exercising control over such users;

(ii) underwrite securities of other issuers;

(iii) actively trade in investments;

(iv) offer securities in exchange for property; or

(v) make loans to third parties.

Purpose for formation and transfer of securities to Partnership

The Country A bank regulatory authority requires its resident banks to maintain minimum levels of bank regulatory capital in accordance with Country A's implementation of its commitments under the 1988 Basle Accords, as amended. Under Country A's bank regulatory requirements, certain Preferred Equity Securities held by unrelated third parties may qualify as Tier I capital for country A bank regulatory purposes. Taxpayer indicated that treating preferred equity securities held by unrelated third parties in a partnership for U.S. tax purposes would provide Taxpayer with a cost effective means of obtaining regulatory capital. The eligible securities identified for this purpose were those that would generate net income for distribution to holders of the Preferred and Common shares in Partnership. Taxpayer and Exam agree that Partnership at all times was engaged in an investment management activity and at no time was Partnership engaged in a trade or business within the United States.

Partnership's Offering Memorandum includes the following statement:

> "[Taxpayer] intends to treat the Series A Preferred Securities as Tier 1 capital of [Taxpayer] under relevant [Country A] regulatory capital guidelines. It is also expected that the issuance of the Series A Preferred securities will reduce [Taxpayer's] foreign exchange exposure with respect to its Tier 1 risk-based capital ratio."

Partnership's Offering Memorandum also provides that the Series A Preferred Securities held by the unrelated third party investors would have dividend and other distribution priority over the Common Securities issued to and held by Taxpayer. The coupon rate on the Series A Preferred Shares was a fixed Rate A for years prior to Date B. After the transfer of the Trading Securities to Partnership, none of the shareholders in Partnership had a specific interest in the securities held by Partnership. Taxpayer agreed to maintain its interest in Partnership for as long as any Series A Preferred Securities remained outstanding. The proceeds received by Partnership from the issuance of the Preferred Securities were included in Taxpayer's worldwide financial statements as stockholders equity - "minority interests."

After the acquisition of the securities from Taxpayer, Partnership's initial portfolio totaled Amount D in unpaid debt principal and Amount E of estimated market value. The initial portfolio consisted of floating rate REMICs, fixed rate REMICs, adjustable rate mortgages, hybrid adjustable rate mortgages and Treasury securities. All but a de minimis Amount F of the total Amount D initial portfolio had a current coupon rate below the Rate A Series A Preferred Shares. The average current coupon rate of Partnership's initial portfolio was Rate B, which was less than Rate A guaranteed return to the Series A Preferred Shareholders.

Taxpayer's activities with respect to and on behalf of Partnership

Taxpayer's City A branch office exercised significant management activities over Partnership generally and over the eligible securities portfolio both incident to and after its sale to Partnership. Taxpayer and Partnership entered into a "services agreement" under which Taxpayer's U.S. branch office maintained Partnership's securities portfolio, corporate records, financial statements and provided accounting, legal, tax and other support services for an annual fee of Amount F which was observed for Year 1 and Year 2. The annual fee was increased to Amount G in Year 3. Except for one independent director, all officers and directors of Partnership were officers and employees of Taxpayer for Year 1, Year 2 and Year 3. Partnership paid the one independent director, fees for services of Amount H per year plus reimbursement of expenses for attendance at director's meetings, but did not pay compensation to officers and directors that were employees of Taxpayer.

Taxpayer represents that all cash distributed by Partnership to Taxpayer as a result of the interest income earned from the Partnership investments was retained or reinvested by Taxpayer's U.S. branch office and all such interest income generated by Partnership with respect to Taxpayer's distributive share is reflected on Taxpayer's U.S. branch office books and records for both book and U.S. tax purposes.

After the acquisition of the eligible securities from Taxpayer, Partnership accounted for the securities on the accrual basis of tax accounting. Accordingly, after Taxpayer recognized gain on the transfer of securities to Partnership, it subsequently ceased to take into account the mark to market values of the securities as of the subsequent taxable year ends with respect to its distributive share of income from the same or replacement securities held by Partnership. Taxpayer recognized it's distributive share of income in accordance with Taxpayer's method of accounting as an investor in the securities.

Taxpayer's tax treatment of Partnership income

Taxpayer claimed for the tax years Year 1, Year 2 and Year 3, that its investment in the Common Shares of Partnership was a partnership interest that constitutes property held in connection with Taxpayer's trade or business within the United States under the asset use test in I.R.C. section 864(c)(2)(A) and Treas. Reg. §1.864-4(c)(2). Alternatively, Taxpayer claims that its distributive share of its investment in Partnership is ECI under the business activities test in section 864(c)(2)(B) and Treas. Reg. §1.864-4(c)(3). However, in determining the effectively connected amount of its distributive share of Partnership income, Taxpayer argues that the banking, financing or similar business rules including the formula allocation rules of §1.864-4(c)(5)(ii) ("the 10% rule") apply in addition to the asset use and business activities tests and overrides the ECI results of those provisions. Under the banking, financing or similar business rules, Taxpayer treated its distributive share of income as attributable to Taxpayer's U.S. office under the same rule that would have applied to the securities held by Partnership if such securities were held directly by Bank. This treatment was applied notwithstanding that Taxpayer used an entity theory to first treat its interest in Partnership as an ECI asset under rules that don't apply to investment securities under the banking, financing or similar business rules. Accordingly, Taxpayer has applied the ECI rules to its distributive share on both an entity basis and then supplementally under an aggregate approach once ECI treatment is first established with respect to Taxpayer's interest in Partnership.

In applying the rules of §1.864-4(c)(5)(ii)(b)(3) to its distributive share, Taxpayer did not include its ratable portion of the book value of Partnership's eligible securities in the 10% rule allocation formula. Instead, Taxpayer estimated that its outside basis in Partnership was approximately the same as its inside basis of its distributive share of securities, and it included its outside basis in the portion of the allocation formula that requires eligible debt securities under §1.864-4(c)(5)(ii)(b)(3). However, Taxpayer stipulates that its 10% rule allocation computation should be adjusted to the extent that Partnership held securities that would not have been eligible for allocation under §1.864-4(c)(5)(ii)(b)(3) (e.g. the Treasury securities that constituted approximately Percent A of the initial portfolio acquired by Partnership would not be eligible for allocation under the 10% rule formula and would give rise to an adjustment to the amount Taxpayer included in the allocation). For Taxpayer's years Year 1 and Year 2, Taxpayer's total volume of securities eligible for allocation under the 10% rule formula (including the amount of its outside basis in Partnership that it treated as a surrogate for its share of Partnership's securities) exceeded 10% of its total assets of its U.S. office. Accordingly, the 10% rule formula resulted in an allocation of income, gains and losses from both its directly held allocable securities as well as from its distributive share of securities income from Partnership. For Year 3, Taxpayer's computation of the volume of securities eligible for allocation under the 10% rule (again including its outside basis in Partnership in the formula) were less than 10-percent of all of Taxpayer's total assets of its U.S. office and therefore no allocation was made between effectively and noneffectively connected income for that year.

For interest expense allocation purposes under Treas. Reg. §1.882-5, Taxpayer has treated its investment in Partnership as a U.S. asset (prior to application of the 10% rule allocation formula). Taxpayer did not make an election under §1.884-1(d)(3)(iv) to use either the income or asset method to allocate and apportion the outside basis of its interest in Partnership between effectively and noneffectively connected characterization and stated that it believed the result would be the same under either method.

Exam does not agree that the outside basis of Taxpayer's partnership interest is effectively connected with Taxpayer's trade or business within the United States under section 864(c), and in any event, does not agree that Taxpayer's distributive share of income, gains and losses from Partnership are eligible for allocation under the 10% rule of §1.864-4(c)(5)(ii)(b)(3) even if its distributive share of Partnership income is treated as effectively connected under the asset use test of section 864(c)(2)(A) and §1.864-4(c)(2) or the business activities test in section 864(c)(2)(B) and §1.864-4(c)(3). Accordingly, Exam has treated all distributive share of income, gains and losses from Partnership as noneffectively connected with Taxpayer's trade or business within the United States for tax years Year 1, Year 2 and Year 3 and has excluded all of Taxpayer's outside basis in Partnership from inclusion in Taxpayer's U.S. Assets for interest expense allocation purposes under §1.882-5(b) and §1.884-1(d)(3). Consequently, Exam did not make an asset or income method election for Taxpayer with respect to its outside basis in Partnership under §1.884-1(d)(3)(v).

LAW AND ANALYSIS

This memorandum addresses the relevant applications of both entity and aggregate theories of partnership taxation to determine the ECI treatment of a distributive share of income from a partnership that is not itself engaged in trade or business within the United States, to a foreign partner that is directly engaged in the active conduct of a banking, financing or similar business within the United States. Taxpayer and Exam agree that Partnership was engaged solely in an investing activity that did not constitute a trade or business. At issue is under what applicable test(s) in section 864(c) and the regulations thereunder may Taxpayer's distributive share of Partnership's investment income be effectively connected to Taxpayer's banking, financing or similar business within the United States and whether the conditions of such test(s) are met for the taxable years Year 1, Year 2 and Year 3.

Investing for a taxpayer's own account does not constitute a trade or business within the United States. Higgins v. Commissioner, 312 U.S. 212 (1941). Managerial attention to investments, including maintaining records and collecting the income is encompassed by the term investing and such activities do not convert investment ownership to a trade or business regardless of the volume of this type of activity. Id at 217-218. A trade or business within the United States does not result solely from investing activities, even if such investment activities are conducted within the United States through the exercise of sole discretion by an agent. Liang v. Commissioner 23 T.C. 1040 (1955). A partnership does not cause a foreign partner to be treated as engaged in trade or business within the United States as a result of the partnership's activities unless the partnership activities constitute a trade or business. Section 875(1) provides "For purposes of this subtitle-

> A nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged.

However, the income from an investment partnership that is not itself engaged in trade or business within the United States, may still be taxable in a trade or business within the United States under section 882(a) if such income is effectively connected with a trade or business of one or more of its partners under the conditions of section 864(c). Under section 864(c)(2), ECI treatment is authorized for U.S. source investment income of a type described in section 871(a)(1), 871(h), 881(a), 881(c) or from the sale or exchange of capital assets if either the income gain or loss is derived from assets used or held for use in the conduct of a trade or business within the United States ("Asset Use test"), or the activities of a trade or business within the United States were a material factor in the realization of the income, gain or loss ("Business Activities test"). The asset use test is further described in §1.864-4(c)(2) and the business activities test in §1.864-4(c)(3). A third test is provided by regulations to determine the ECI treatment of income, gains and losses from certain stocks and securities earned in connection with the active conduct of a banking, financing or similar business. §1.864-4(c)(5).

In determining whether an aggregate or an entity theory should apply in characterizing a distributive share of income from a partnership as ECI or non-ECI, Rev. Rul. 91-32, 1991-1 C.B. 107, 108-109, provides in relevant part:

> "Subchapter K of the Code is a blend of aggregate and entity treatment for partners and partnerships. Compare section 751 of the Code with section 741. For purposes of applying provisions of the Code not included in subchapter K, a partnership may be treated as an aggregate of its partners or as an entity distinct from its partners, depending on the purpose and scope of such provisions.

Rev. Rul. 91-32 addresses the ECI treatment of a disposition of a partnership interest in accordance with the purpose and scope of section 864(c). However, the ruling addresses the partner's ECI treatment only where the partnership caused the foreign taxpayer to be engaged in trade or business within the United States under section 875(1). The ruling provides that gain or loss is ECI by reference to whether property dispositions would be ECI if sold by the partnership (i.e. "to the extent such gain or loss is attributable to ECI (United States source) property of the partnership."). The ruling observes the entity characteristics of the partnership and property that it holds in determining the ECI nature of the outside gain from the disposition of the partnership interest. However, Rev. Rul. 91-32 does not address how to determine the ECI or non-ECI character of the distributive share of income at the partner level when the partnership is not itself engaged in trade or business within the United States. Even though Partnership provides no effectively connected income to Taxpayer through a trade or business under section 875(1), the ECI or non-ECI characterization of Taxpayer's distributive share solely at Taxpayer's level as a partner must still be resolved in accordance with the purpose and scope of section 864(c) and the regulations thereunder. Accordingly, the principles of section 864(c) must be adapted to a factual situation not present in Rev. Rul. 91-32. The relevant inquiry is to determine the purpose and scope of section 864(c) as applied to interest income from securities of a taxpayer engaged in the active conduct of a banking, financing or similar business within the United States.

Entity approach for recognition of Taxpayer's distributive share and management fees

Exam agrees that Taxpayer's formation of Partnership and acquisition of securities for investment had a valid business purpose of efficiently raising bank regulatory Tier I capital for Taxpayer under its home country regulatory rules. Taxpayer and Exam also agree that the securities purchased by Partnership from Taxpayer during Date A were acquired for their fair market value and that all gains were taken into account by Taxpayer's trade or business within the United States incident to the sales disposition. Taxpayer and Exam also stipulate that the stated purposes of Partnership to acquire and maintain securities investments were observed at all times during tax years Year 1, Year 2 and Year 3. Taxpayer's management of Partnership was compensated through service fees recognized by Taxpayer as effectively connected fee income in its banking, financing or similar business.

While Taxpayer continued to exercise operating control over all of the securities it originally owned and managed directly in its U.S. office, Taxpayer's economic ownership of the income from the assets was reduced to the residual amount of income earned by Partnership after the Series A Preferred shareholders were paid their Rate A amount. Accordingly, after Partnership acquired the securities, Taxpayer may no longer treat the securities as wholly owned and wholly attributable to its U.S. office. The entity approach is necessary to give effect to Taxpayer's distributive share of income and to Taxpayer's fees for its management services to Partnership which were taken into account in determining Partnership's income. While the entity approach provides recognition of the management fees for services performed by Taxpayer, the exercise of certain of those services through Taxpayer's U.S. office, such as the acquisition of securities for Partnership, is relevant for determining Taxpayer's ECI treatment of its distributive share of income under the aggregate approach, discussed below.

The entity approach is also necessary to establish Taxpayer's outside basis in Partnership for purposes of Taxpayer's interest expense allocation to its total effectively connected income under §1.882-5 and for its computation of its branch profits tax under §1.884-1. However, the entity approach is limited to determining only the amount of Taxpayer's distributive share and its outside basis in Partnership that is subject to apportionment between ECI and non-ECI. The apportionment of Taxpayer's distributive share of income and its outside basis between ECI and non-ECI is separately evaluated in accordance with the purpose and scope of section 864(c) to which the aggregate approach is applicable.

Aggregate approach to determining ECI under the Banking, Financing or Similar Business Rule - §1.864-4(c)(5)

Taxpayer is engaged in the active conduct of a banking, financing or similar business within the United States under §1.864-4(c)(5)(i). As a result, the manner in which Taxpayer determines the ECI treatment of investment securities is determined under a defined "material participation test" and a special allocation rule ("10% rule") in §1.864-4(c)(5)(ii), both of which take precedence over the asset use test in section 1.864-4(c)(2) and the business activities test in §1.864-4(c)(3). The rule provides that U.S. source income, gain or loss from securities that are capital assets, and that are attributable to a U.S. office where the active conduct of a banking, financing or similar business is carried on, is also generally treated as effectively connected income if the security is acquired in the manner or for the purposes provided in §1.864-4(c)(5)(ii)(*a*)(*1*)-(*3*)[1], or, the security is of a type described in §1.864-4(c)(5)(ii)(*b*). Attribution to a U.S. office is determined by whether the U.S. office materially participates in negotiating, soliciting or performing other material activities necessary to the acquisition of the stock or security. §1.864-4(c)(5)(iii). The U.S. office need not be the only location that materially participates in the acquisition of the security and attribution does not require that a security be booked in the U.S. office or even held for use in connection with the taxpayer's banking, financing or similar business within the United States. §1.864-4(c)(5)(ii)(*b*); See Rev.Rul. 86-154, 1986-2 CB 103. However, §1.864-4(c)(5)(ii) also provides that the income, gains and losses from securities described in §1.864-4(c)(5)(ii)(*b*)(*3*) that are attributable to the U.S. office may be subject to allocation between ECI and non-ECI if the securities exceed 10-percent of the total value of the securities held by such U.S. office. Accordingly, in lieu of the asset use and business activities tests, §1.864-4(c)(5) applies an overriding third test, but only to determine the ECI treatment of stocks and securities attributable to the U.S. office where the foreign taxpayer carries on a banking, financing or similar business.

The banking, financing or similar business provisions of §1.864-4(c)(5)(ii) apply only to stocks acquired in the manner set forth in §1.864-4(c)(5)(ii)(*a*), or to securities (as defined in §1.864-4(c)(5)(*v*)). The material participation test applies to the ECI determination of all investment securities acquired by a foreign person's U.S. office of a banking, financing or similar business whether they are banking-related assets of the type described in §1.864-4(c)(5)(ii)(*a*)(*1*)-(*3*) and (*b*)(*1*)-(*2*) or whether they are treated as non-banking related securities under §1.864-4(c)(5)(ii)(*b*)(*3*) and are allocable under the 10% rule. Further, the material participation test applies separately to each security to determine the attribution of each to the U.S. office. Taxpayer's interest in Partnership is not a security as defined in §1.864-4(c)(5)(*v*) to which the material participation test may apply. However, for the tax years, Year 1, Year 2 and Year 3, all of Taxpayer's distributive share from Partnership was income, gains and losses with respect to investment securities that are subject only to the material participation test and ECI rules of §1.864-4(c)(5) and are expressly not subject to the asset use and business

[1] Section 1.864-4(c)(5)(ii)(*a*)(*1*)-(*3*) also applies to determine whether stocks may be ECI to a banking, financing or similar business within the United States. Partnership held no stocks for any of the tax years at issue.

activities tests in the hands of a banking, financing or similar business within the United States.

If the entity theory were applied to the determination of ECI and subjected to the asset use and business activities tests as a first step as Taxpayer and Exam propose, then the purposes of the banking, financing or similar business rules with respect to the treatment of investment securities income might be avoided. Accordingly, securities income to which a U.S. office materially participates could be converted to non-ECI as a result of the asset use or business activities rules that would not otherwise apply to the same securities if they were acquired directly by Taxpayer. Similarly, securities income to which a U.S. office does not materially participate could be converted to ECI as a result of the asset use or business activities rules applied to the partnership interest. The aggregate approach also preserves the purposes of the section 1.864-4(c) rules with respect to stocks or other investments in which a U.S. office of the banking, financing or similar business does not materially participate. For instance, if Partnership acquired and held any stocks for investment, the distributive share of dividends and gains or losses from the disposition of stocks by Partnership would be non-ECI under the asset use test rule in §1.864-4(c)(2)(iii)(*a*), unless it could be shown that the stocks were acquired for the more limited purposes to which the material participation test applies to stock in the banking, financing or similar business rules under §1.864-4(c)(5)(ii)(a)(1)-(3). In this regard, a taxpayer's distributive share of dividend income that could not be ECI under the asset use test if stocks were held directly by Taxpayer cannot be converted to ECI by treating the Partnership interest as an independent asset held in connection with Taxpayer's trade or business. Further if Partnership were to increase its securities investment holdings through additional tiered investments in other investment partnerships whose activities did not constitute a trade or business within the United States and such investment activities of the lower-tier partnerships were also not conducted by Taxpayer through its U.S. office where its banking, financing or similar business is carried on, under the aggregate approach, Taxpayer's distributive share of income, gain or loss with respect to securities held by such tiered partnerships would be non-ECI under the material participation test.

Taxpayer sold the securities to Partnership during Date A, and performed all of the material participation functions through its U.S. office in causing Partnership to be formed and to purchase such securities. In addition, Taxpayer also managed Partnership on a day to day basis and materially participated through its U.S. office in acquiring new securities for Partnership as older ones matured. Taxpayer and Exam agree that all of Partnership's securities including the new securities acquired as replacement securities would have been attributable to Taxpayer's U.S. office had they been acquired directly by Taxpayer during Date A and subsequently, instead of by Partnership.

For these reasons, the ECI treatment of Taxpayer's distributive share is evaluated on an aggregate basis, consistent with the purposes of attributing securities income to a U.S.

office of a banking, financing or similar business within the United States. Taxpayer's interest in Partnership is not tested on an entity basis under any of the asset use, business activities or material participation tests. Under the aggregate approach, the material participation test of §1.864-4(c)(5)(iii) and the ECI rule in §1.864-4(c)(5)(ii) is applied to each security held by Partnership to determine whether Taxpayer's distributive share of income from each is attributable to Taxpayer's U.S. office and whether such attributable income is treated as ECI under the banking, financing or similar business rules. Taxpayer and Exam agree that approximately Percent A of Partnership's total securities portfolio were Treasury securities described in §1.864-4(c)(5)(ii)(b)(2). Since the Treasury securities are attributable to Taxpayer's U.S. office under the aggregate approach, all of Taxpayer's distributive share of income, gains and losses from the Treasury securities is treated as ECI under §1.864-4(c)(5)(ii).

Application of aggregate approach to the 10% Rule under §1.864-4(c)(5)(ii)

Taxpayer's distributive share of non-Treasury securities income from Partnership is income eligible for allocation under the 10% rule in section 1.864-4(c)(5)(ii) and is not subject to the override provision applicable to securities held for trading in paragraph (vi). Taxpayer and Exam agree that other than the Treasury securities, all of the remaining assets in Partnership's portfolio for the tax years Year 1, Year 2 and Year 3 are securities described in §1.864-4(c)(5)(ii)(*b)(3*). It is also agreed that once the securities were acquired by Partnership, they were held at all times for investment. Prior to their acquisition by Partnership, the securities acquired from Taxpayer were held in Taxpayer's trading accounts and treated by Exam as wholly ECI under the 10% rule override provision in §1.864-4(c)(5)(vi). However, once acquired by Partnership, the securities were converted to an investment status, including with respect to the ECI treatment of Taxpayer's distributive share.

Nothing in §1.864-4(c)(5)(ii) or (vi) prohibits a security that is held for trading from being converted to an investment use during its holding period, regardless of whether such conversion to investment status is prohibited for other purposes of the Code, such as for timing of recognition of income purposes under section 475. Under the aggregate approach to evaluating the ECI character to a banking, financing or similar business of Taxpayer's distributive share of securities income, the acquisition and use of the securities by Partnership from Taxpayer is viewed the same as if Taxpayer remained the direct holder of the securities and sought to convert their use from trading status which is treated as wholly ECI under §1.864-4(c)(5)(vi) to investment status which is eligible for the 10% rule allocation without the override provision of paragraph (vi). However, the investment or trading status of the securities is evaluated by reference to their use at the Partnership level and not by reference to whether Taxpayer's interest in Partnership is held in an investment or trading capacity. While factual proof of conversion from an original trading use to investment status may be difficult to substantiate absent clear and convincing evidence, such proof was met for the taxable years Year 1, Year 2 and Year 3. Partnership purchased the securities for an investment purpose that was clearly stated in its articles of incorporation and offering memorandum, and both Taxpayer and Exam agree that Partnership's activities were in fact limited to the stated investment purposes which did not constitute being engaged in trade or business. Exam also agreed that the investment use of the acquired securities was easily identifiable by the reduced turnover of the portfolio which was limited to dispositions of securities at maturity.

Aggregate approach to the Treatment of Partnership assets in the 10% rule formula:

The 10% rule allocation formula is an asset-based allocation ratio comprised of a fixed ratio of 10%, divided by a fraction, determined as the average book value of securities described in §1.864-4(c)(5)(ii)(b)(3) (numerator) divided by the total average book value of the total assets of the U.S. office (including the securities described in §1.864-4(c)(5)(ii)(b)(3)) (denominator).

The income, gains and losses from the (b)(3) securities are multiplied by the following formula:

$$\frac{10\%}{\text{average book value of (b)(3) securities} \div \text{book value of total asset of U.S. office}}$$

The resulting percentage from the formula is the percentage of income, gain and loss from the securities described in paragraph (b)(3) that is treated as ECI.

Taxpayer included its outside basis in Partnership in the 10% rule formula as a surrogate for its share of Partnership assets. However, Taxpayer did not apportion its outside basis in Partnership to take account of the Percent A portion attributable to Treasury assets. The 10% rule contemplates that only securities (as defined in §1.864-4(c)(5)(*v*)) that are described in paragraph (b)(3) may be included in the numerator of the formula. The rule also does not provide for separate allocations of securities attributable to the U.S. office that are directly held and indirectly held through a partnership. Accordingly, Taxpayer's distributive share of assets from Partnership must be combined with all of Taxpayer's U.S. office assets. Its distributive share of securities described in paragraph (b)(3) that are attributable to its U.S. office under the material participation test must also be combined with Taxpayer's directly held "(b)(3)" securities attributable to Taxpayer's U.S. office.

Under the aggregate approach, Taxpayer's portion of Partnership's total assets and its share of Partnership's "(b)(3)" securities attributable to Taxpayer's U.S. office must be derived by multiplying the average balance of each by the percentage of Taxpayer's distributive share of Partnership's total income. Taxpayer's percentage distributive share of Partnership's total income applies pro-rata to all of Partnership's assets for each tax year Year 1, Year 2 and Year 3. The percentage distributive share is derived for each year by dividing the amount of Taxpayer's distributive share of income by the total amount of Partnership income. Since the Preferred Equity shareholders receive a fixed amount of income each year and the Partnership assets produce variable rates of income, Taxpayer's percentage distributive share will also vary in accordance with the residual amount of income allocated to Taxpayer in each year. Such varied percentage increase or decrease is also applied to Partnership's assets to determine the amounts Taxpayer must include in the numerator and denominator of the 10% rule formula. Since all of Partnership's "(b)(3)" securities were attributable to Taxpayer's U.S. office for the tax years Year 1, Year 2 and Year 3, Taxpayer's percentage distributive share may be applied to all of Partnership's "(b)(3)" securities and included in the numerator of the formula for those years. This approach may require adjustment for any tax year in which Taxpayer's distributive share of income is not pro rata with respect to all of the income of Partnership.

SUMMARY

Taxpayer's ECI treatment of its distributive share of income from Partnership is tested under an aggregate approach. Because Taxpayer is engaged in the active conduct of a banking, financing or similar business within the United States and it operated and managed Partnership through Taxpayer's U.S. office, its distributive share of income, all of which is from investment securities, is subject to the material participation test in §1.864-4(c)(5)(iii) and not to the asset use or business activities tests. The material participation test is applied directly to Partnership's assets and not to Taxpayer's interest in Partnership. Because Taxpayer performed all of the material functions necessary to the acquisition of securities for Partnership, all of Partnership's securities are treated as attributable to Taxpayer's U.S. office with respect to Taxpayer's distributive share of securities income. Under the ECI rules in §1.864-4(c)(5)(ii), Taxpayer's distributive share of Treasury income is treated as wholly ECI in accordance with §1.864-4(c)(5)(ii)(b)(2). The remainder of Taxpayer's distributive share is income with respect to securities described in §1.864-4(c)(5)(ii)(b)(3) and is income with respect to an investment activity of Partnership that is eligible for allocation and apportionment under the 10% rule. Taxpayer must apply its distributive share percentage of Partnership's total income to the book value of the Partnership securities described in §1.864-4(c)(5)(ii)(b)(3) and to the book value of the total Partnership securities to determine the pro-rata portions it must include in the numerator and denominator of the 10% rule formula. Taxpayer may not include its ECI portion of its outside basis in Partnership in the 10% rule formula. The entity approach applies to provide recognition of the amount of Taxpayer's distributive share of income and the management service fees Taxpayer earned for managing Partnership, and to establish Taxpayer's outside basis in Partnership for interest expense allocation purposes under §1.882-5 and for branch profits tax purposes under §1.884-1(d)(3). The apportionment between ECI and non-ECI of Taxpayer's outside basis in Partnership is determined under the same results obtained from the aggregate approach in determining Taxpayer's ECI treatment of its distributive share of income.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.