OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM:

SUBJECT:

This Field Service Advice responds to your memorandum dated April 6, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used cited as precedent.

LEGEND:

Bank =
Country A =
Fiscal Year a =
Initial Year =
Year a (exam cycle 5) =
Year b (exam cycle 5) =
Year c (exam cycle 5) =
Year d (exam cycle 1) =
Year e (exam cycle 2) =
Year f (exam cycle 3) =
Year g (exam cycle 4) =
Bank of Country A =

Schedule A =

Schedule B =

Schedule C =

Schedule D =
Schedule E =

Amount A =

ISSUE(S):

1. Whether the Service is estopped or bound by a duty of consistency to allow Bank to treat certain of its interbranch borrowings liabilities) as third-party liabilities in Step-Three of § 1.882-5(b)(3)(i).

2. Whether the Service is estopped or bound by a duty of consistency to allow Bank to determine its U.S.-connected interest rate under a self-initiated two-step methodology not authorized by § 1.882-5(b)(3)(i)(A) or whether Bank is required to treat such liabilities fungibly with all of its other third-party liabilities shown on the books of its U.S. branch.

CONCLUSIONS:

1. Classification of Liabilities in Step-Three of § 1.882-5(b)(3)(i).

The Service is not estopped from binding the taxpayer to the form of its transaction. While not binding on the Service, the classification of Bank's liabilities as third-party liabilities for purposes of § 1.882-5(b)(3)(i) in prior cycles is a factor to consider in determining whether the same treatment should apply in the current cycle, to the extent that taxpayer proved the substance of the transactions to the satisfaction of the examiners. We note, however, that the information available to us does not establish that the substance of the borrowings is in fact traceable, matched-book, conduit financings that were acquired by the from for the sole purpose of making effectively connected investments through Bank's U.S. branch. Accordingly, the Service has discretion to treat the liabilities as third-party liabilities under the principles of § 1.882-5(a)(6).

2. Calculation of Bank's U.S.-connected Interest Rate under § 1.882-5(b)(3)(i)(A).

The Service is also not estopped from refusing to take the liabilities into account in calculating its U.S.-connected interest rate, and may disregard all such amounts under § 1.882-5(a)(5). Even if the Service were to exercise its discretion to treat the liabilities as third-party liabilities, the Service need not allow Bank to bifurcate its computation of its U.S.-connected interest rate under § 1.882-5(b)(3)(i)(A). Further, the regulations do not provide discretion to the Commissioner or his delegates to compute the U.S.-connected rate under any method other than that provided by its terms. To the extent that Bank demonstrates that it was allowed different treatment on prior exam cycles, such treatment was a mistake of law that the Service is entitled to correct in the current exam cycle and to the extent available, retroactively to prior exam cycles.

FACTS:

A. General Background

This Field Service Advice covers Bank's fiscal year a for Year a, Year b and Year c. Bank is incorporated in Country A and has been engaged in the active conduct of a banking, financing or similar business through a branch office network in the United States ("the U.S. branch") within the meaning of § 1.864-4(c)(5)(i). In the course of that business, the Bank engaged in transactions with its . These transactions" are back-to-back transactions of third-party placements made by in Bank's , which the on-lends to the U.S. branch for the purpose of consummating prearranged purchases of debt securities. The U.S. branch borrowings are recorded as interbranch borrowings for accounting and regulatory purposes on the U.S. books and records. We understand the third-party securities purchases are acquired through the U.S. branch and are treated as securities attributable to Bank's U.S. office of a type which give rise to effectively connected income under § 1.864-4(c)(5)(ii). For each year, Bank deducted all of the accrued interest expense with respect to these interbranch amounts.

During those years, Treas. Reg. §1.882-5[1] provided a three-step process for the allocation of interest expense of a foreign corporation to its U.S. trade or business. Step-One sets forth the determination of average assets that give rise to effectively connected income, gain or loss. Step-Two provides alternative methods for the fungible imputation of liabilities called US -connected liabilities, that are deemed to support the effectively connected assets determined in Step-One. Step-Three determines the allowable interest expense allocation.

Under Step-Three, the taxpayer was required to elect either the Branch Book/Dollar Pool method (Section 1.882-5(b)(3)(i)) or the Separate Currency Pools method (Section 1.882-5(b)(3)(ii)). An election once made may not be changed, except with the consent of the Commissioner or his delegate. Bank elected the Branch Book/Dollar Pool method. Bank sought permission from Exam to switch to the Separate Currency Pools method during Exam cycles 1 and 2 but was denied permission in both cycles.

Under the Branch Book/Dollar Pool method, the determination of allocable interest expense differs, depending on whether US-connected liabilities exceed the average third-party liabilities. If they do, the taxpayer must determine the "excess interest" that is deductible in addition to book interest, under section 1.882-5(b)(3)(i)(B). If the US - connected liabilities do not exceed the average third-party liabilities, the interest expense allocable must be calculated under section 1.882-5(b)(3)(i)(A), by multiplying the average U.S.- connected interest rate, based on the total interest expense shown on the books of the U.S. trade or business and the average total liabilities of the same U.S. business times the U.S.-connected liabilities.

B. <u>Bank's Return Position</u>

For each year, Bank included the transactions" in Step-Three of the interest allocation formula. The average borrowing rate with respect to these transactions is significantly higher than the average borrowing rate on all other third-party liabilities taken together of Bank's U.S. branch included in Step-Three of § 1.882-5(b)(3)(i). See Schedule A in this section, below. Bank's

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[1] Treas. Reg. § 1.882-5 was revised in 1996 and entered into force for years later in time than the current exam cycle. For the years in question, the version of § 1.882-5 that applies was promulgated in 1981 as T.D. 7749, 1981-1 C.B. 390, which was made retroactive at the taxpayer's election to years beginning after 1976 or later to years before January 1, 1977 by T.D. 7939, 1984-1 C.B. 171. We understand the taxpayer has engaged in the same activity for the later period that would be covered by the 1996 regulations. We do not address the treatment of those transactions and recommend a separate advice at such time that the later transactions may be examined.

other interbranch borrowings recorded on its U.S. branch were excluded from the § 1.882-5 computation in accordance with § 1.882-5(a)(5). For all three years in the current exam cycle, Bank was required to allocate its interest expense under § 1.882-5(b)(3)(i)(A). Using a self-initiated adjustment which modifies the requirements of the Branch Book/Dollar Pool method under § 1.882-5, Bank has deducted 100% of its interest expense on the transactions on its original income tax returns for these years.

Bank consistently applied its self-initiated adjustment methodology for the three years based on the following attributes shown in Schedule A:

Schedule A: Self-Initiated adjustment Attributes	Year a	Year b	Year c
Step-One Effectively Connected Assets			
Step-Two Actual Ratio			
Step-Two U.S. Connected Liabilities			
Third Party Interest Expense on Liabilities Third Party Liabilities Shown on U.S. Books			
Borrowing Rate on 3rd Party Book Liabilities	7.8551%	5.7172%	3.7438%
Interest Expense on Liabilities			
Borrowing Rate on	8.5299%	8.4835%	7.9331%
Combined 3rd Party + Interest Combined 3rd Party + Liabilities			
Combined U.S. Connected Interest Rate	7.9219%	5.9867%	4.1903%

Bank's self-initiated adjustment comprised two components of deductible expense that was determined in the following four steps:

First, Bank reduced its U.S. connected liabilities by the amount of liabilities to arrive at an adjusted amount of U.S. connected liabilities.

Second, Bank multiplied the adjusted U.S. connected liabilities by the average borrowing rate on the actual third-party liabilities shown on the U.S. branch books (i.e., excluding the liabilities from the average base) to arrive at one component of allocable interest expense.

Third, Bank applied the actual borrowing rate incurred on the liabilities to arrive at a second component of allocable interest expense.

This component was equal to the full amount of interest accrued on the liabilities.

Fourth, Bank added the two separately computed components of interest expense together to arrive at its total allocated interest expense deduction.

Had Bank followed full fungibility in the formula for all attributes including the amounts, the results would have been determined as shown below in Schedule B:

Schedule B: §1.882-5 per Regulations	**Year a**	**Year b**	**Year c**
Step-One Effectively Connected Assets			
Step-Two Actual Ratio			
Step-Two U.S. Connected Liabilities (U.S.C.L.)			
Step-Three Combined Third-Party Liabilities			
U.S. Connected Interest Rate	7.9219%	5.9867%	4.1903%
Allowable Deduction: U.S. Connected Rate x U.S.C.L.			

Although Bank has purported to compute its interest allocation in two separate components, its result effectively provides a higher U.S.-connected rate than it would have had without the self-initiated adjustment. The incremental increase to the U.S.-connected rate and a reconciliation to the additional interest expense it produced (see Schedule E, Column C) is shown in Schedules C and D, below:

Schedule C: Bank's Interest Allocation as filed with Self-Initiated Adjustment	**Year a**	**Year b**	**Year c**
Step-Two U.S. Connected Liabilities			
Less:			
Adjusted Step-Two U.S. Connected Liabilities			

Average Borrowing Rate on 3rd Party Liabilities	7.8551%	5.7172%	3.7438%
Interest Expense on Third Party Book Liabilities			
Liabilities			
Average Borrowing Rate on	8.5299%	8.4835%	7.9331%
Interest Expense on			
Interest Expense on Third Party Book Liabilities			
Total Interest Expense Claimed on Tax Returns			
Total U.S. Connected Liabilities			
Average Rate Applied to U.S. Connected Liabilities	7.9352%	6.0326%	4.3107%
Average Rate on Combined Liabilities (Schedule B)	7.9219%	5.9867%	4.1903%
Additional Borrowing Rate Assumed by Bank	**0.0132%**	**0.0459%**	**0.1204%**

This additional borrowing rate would be fungibly applied against all Step-Two U.S. connected liabilities of Bank if it purports to apply the Branch Book/Dollar Pool method. Application of the additional borrowing rate reconciles to Bank's deduction as shown by the mathematical check in Schedule D below:

Schedule D: Check of Additional Interest Expense	**Year a**	**Year b**	**Year c**
Step-Two U.S. Connected Liabilities (U.S.C.L.)			
Additional Borrowing Rate Assumed by Bank	0.0132%	0.0459%	.1204%
Additional Interest Expense Allocated by Bank			
Allowable Deduction: U.S. Connected Rate x U.S.C.L.			
Amount Deducted by Bank on its Original Returns			

C. Examination History

Taxpayer elected the application of §1.882-5 in Initial Year which was examined by the Office of the Assistant Commissioner (International). Based on the documents you provided us, no issue concerning the treatment or even the existence of borrowings was presented or considered. The Manhattan District conducted exam cycles 1 through 4. The Manhattan District is currently conducting exam cycle 5.

Bank incorrectly asserts that the Service has allowed it to apply a two-step method for determining its U.S.-connected interest rate since 1979, claiming that in the first years it applied its self-initiated adjustment to the Branch Book/Dollar Pool method, the Service approved its approach in all respects. A review of the section 1.882-5 calculations provided to us which were agreed to by Exam in Exam cycle 1 indicates that this factual assertion is untrue. It is true that for all years, the Service did not explicitly disallow treatment of the borrowings as third-party liabilities in Step-Three of § 1.882-5(b)(3)(i), and that a number of years and issues were audited.

For exam cycle 1, beginning with year d, Bank's U.S.-connected interest rate for the year that it was required to be used was determined solely by fungible treatment of all third-party amounts combined with all amounts that were treated as third-party expense and liability in Step-Three of § 1.882-5(b)(3)(i)(A). The revenue agent treated the liabilities as back-to-back transactions that were traceable to specific investments in effectively connected assets. The agent's exercise of discretion to treat the liabilities as third-party liabilities in Step-Three was reviewed by the Joint Committee on Taxation as part of an overall refund for that year.

For two years covered by Exam cycle 1 beginning with Year d, Bank had excess U.S.-connected liabilities and was required to compute its interest allocation method under § 1.882-5(b)(3)(i)(B). For those two years, all interest was deductible under the requirements of the allocation formula. For one of the years in Exam cycle 1, however, Bank's third-party liabilities shown on the books of its U.S. branch were greater than its U.S.-connected liabilities and Bank was required to use § 1.882-5(b)(3)(i)(A) for that year. The examiner exercised his discretion under § 1.882-5(a)(6) and allowed the liabilities into Step-Three of the formula for all three years. In doing so, he calculated the U.S.-connected interest rate fungibly, in the same manner as illustrated by Schedule B, above. The resulting U.S.-connected rate was multiplied against all U.S.-connected liabilities in accordance with the requirements of § 1.882-5(b)(3)(i)(A). The documentation you submitted indicates that Bank sought and the international examiner did not permit Bank to switch to the Separate Currency Pools method for exam cycle 1 because Bank had already elected the Branch Book/Dollar Pool method in Initial Year.

For exam cycle 2 Bank's self-initiated adjustment was claimed pursuant to the Manhattan District requiring Bank to again continue using the Branch Book/Dollar Pool method. The revenue agent did not permit Bank to switch to the Separate Currency Pools method. The Branch Book/Dollar Pool computations submitted by Bank for exam cycle 2 were the first application of Bank's self-initiated adjustment to the §1.882-5 formula. Beginning with year e, the examiner did not change the self-initiated adjustment claimed for the transactions even though Bank's U.S. booked liabilities exceeded its U.S.-connected liabilities for all three years. Thus, exam year e is the first year in which Exam arguably accepted Bank's change to the interest allocation formula requirements. The revenue agent's report and other examination materials provided to us for the cycle provide no explanation for allowing Bank's self-initiated adjustment even though this approach was not adopted in the calculations agreed to by the Manhattan District in the prior exam cycle.

For the tax years in exam cycle 3, the international examiner allowed Bank's self-initiated adjustment for all three years. However, the materials provided to us indicate that exam's acceptance of the self-initiated adjustment was based on incorrect assumptions on which the international examiner's report relied. The international examiner's report for exam cycle 3 stated that "it was determined that no adjustment [was] necessary on this item due to the fact that it was consistently used since [year d beginning with exam cycle 1]." As indicated, Bank's self-initiated adjustment was not adopted in any form for exam cycle 1 and no explanation other than the computations themselves, is provided concerning its use in exam cycle 2.

In Exam cycle 4 beginning with year g, the Manhattan District consistently applied Bank's two-component method for determining its U.S.-connected rate. The examination cycle materials provided to us, however, do not specifically explain why Bank's self-initiated adjustment was an acceptable application of § 1.882-5(b)(3)(i)(A). Unlike exam cycle 3, which referred to prior exam cycle treatment, the international examiner's report states only that "the taxpayer has elected to use the Branch Book/Dollar Pool method in order to determine the amount of its allowed interest deduction...Reviewed information and determined that no adjustment is necessary." Therefore, for exam cycles 1 through 4, the only apparent explanation for allowing Bank's self-initiated adjustment is stated in the international agent's report for exam cycle 3, which as indicated, relied on a mistaken understanding of the treatment accorded by the Service in certain prior exam years.

D. <u>Tax Impact of the Modified Branch Book/Dollar Pool Method Used by Bank</u>

Based on the data provided, Bank's interest expense allocation will materially differ depending on how the transactions are treated. Bank represents that the securities purchases are attributable to its U.S. office and give rise to effectively connected interest income under § 1.864-4(c)(5)(ii). Accordingly, Bank agrees that the securities purchases funded by the borrowings should be treated as effectively connected assets and included in Step-One of § 1.882-5. It is not known whether any of the transactions include purchases of securities that are described in § 1.864-4(c)(5)(ii)*(b)(3)* or whether any income with respect to such securities has been treated as only partially effectively connected under the special allocation formula in that section. Except where noted in this advice, we assume that all of the income with respect to the securities purchases is treated as effectively connected with Bank's U.S. trade or business. The potential for material differences in the § 1.882-5 interest expense allocation arises solely from application of Step-Three of the Branch Book/Dollar Pool method under the following alternative scenarios:

1. <u>Bank's tax return filing position (no adjustment)</u>: The formula is applied by treating the borrowings recorded on the U.S. branch books as third-party borrowings and not treating these amounts fungibly in the formula. Under Bank's self-initiated adjustment, the borrowings and interest

expense are treated as directly traceable to the effectively connected securities purchases included in Step-One of the formula [Column A, below];

2. <u>Intermediate material difference</u>: The formula is applied by treating the borrowings recorded on the U.S. branch books as third-party borrowings and including these amounts fungibly in the allocation formula [Column C, below]; or

3. <u>Most material difference</u>: The formula is applied by characterizing the component attributes of § 1.882-5 in accordance with Bank's form of recording transactions on its U.S. branch and books and records. Accordingly, the liabilities and interest expense are treated as interbranch amounts and disregarded under section 1.882-5(a)(5) [Column E, below].

These potential differences are summarized in labeled columns [A], [C] and [E], in Schedule E below:

Schedule E Year	**[A]** Bank Tax Return	**[B]** If Borrowing is Third Party	**[C]** [(A) - (B)] Adjustment Disallowance	**[D]** Borrowing is Treated as Interbranch	**[E]** [(A) - (D)] Adjustment Disallowance
Year a					
Year b					
Year c					
Total for Cycle					
Tax Rate					
Income Tax					

E. <u>Bank's Modified Branch Book/Dollar Pool Method Position</u>

Bank asserts that it is entitled to the total interest allocation shown in Column A, above, because it has been accorded the same treatment on four previous exam cycles beginning with year d (exam cycle 1) and continuing with years e (exam cycle 2), f (exam cycle 3) and the last cycle which began with year g (exam cycle 4). Bank has stated that the very same types of transactions were specifically reviewed by the

Service in accordance with the interest allocation rules and that it has relied on Exam's representations over the years by continuing to report them for tax purposes in the same manner up through the current cycle.

During the current cycle, the Service discussed with Bank its discretion to bind Bank to its form and treat the borrowings as disregarded amounts under § 1.882-5(a)(5) and that the results would be an adjustment in excess of Amount A for the entire cycle. Bank has argued in response that the Service is bound by a duty of consistency to allow Bank to continue to determine its U.S.-connected interest rate on its modified method, based on Bank's reliance on past examination treatment. Apart from the treatment allowed the Bank on exam cycles 2 through 4, including the erroneous stated assumption in the examiner's report for exam cycle 3 that Bank had consistently applied its methodology since exam cycle 1, no additional facts support Bank's claim that it actually depended on the tax treatment allowed by Exam as a condition for entering into the transactions.

LAW AND ANALYSIS

A. Application of Treasury Regulations to Facts

With respect to interbranch loans, Treas. Reg. § 1.882-5(a)(5) provides that "[a]ssets, liabilities, and interest expense amounts resulting from loan or credit transactions of any type between the separate offices or branches of the same foreign corporation are disregarded." Treas. Reg. § 1.882-5(a)(6) provides, with respect to adjustments to reflect substance, "[i]f the substance of a loan or other transaction differs from its form, <u>the Commissioner or his delegate may make appropriate adjustments</u> to reflect the transaction in accordance with its substance." (Emphasis added). An example to the paragraph provides that a back-to-back borrowing transaction that originates in a bank's as a third-party borrowing which it on-lends to its U.S. branch and which is booked in the United States as an interbranch borrowing may be treated by the Service as if the third-party borrowing were acquired directly by the U.S. branch. The example treats the as an agent or broker for the acquisition of the liability for its U.S. branch.

Under the Branch Book/Dollar Pool method, interest expense is treated as fungible and allocable under one of two non-elective alternatives. The applicable alternative for a given year is determined by reference to whether the taxpayer's U.S.-connected liabilities exceed the average third-party liabilities "shown on the books of the U.S. trade or business for the year (or portion thereof)." Bank and the Service agree that Bank is subject to § 1.882-5(b)(3)(i)(A) for all three years in the current exam cycle without regard to whether the transactions are treated as third-party liabilities in Step 3.

Treas. Reg. § 1.882-5(b)(3)(i)(A) provides:

> (i) *Branch book/dollar pool method*. (A) If the amount of U.S.-connected liabilities, determined under Step 2, does not exceed the average total amount of liabilities (in all currencies) shown on the books of the U.S. trade or business (stated in U.S. dollars), the interest expense allowed to the foreign corporation as effectively connected with the conduct of a trade or business in the United States is determined by multiplying the average total amount of U.S.-connected liabilities for the year by the average U.S.-connected interest rate. The average U.S.-connected interest rate is equal to the ratio of the total amount of interest expense shown on the books of the U.S. trade or business for the year (or portion thereof) to the average total amount of liabilities shown on the books of the U.S. trade or business for the year (or portion thereof). Both the numerator and denominator of this ratio must be stated in U.S. dollars. [Emphasis added.]

Under the provisions cited above, the Service alone has discretion to treat an interbranch borrowing substantively as a third-party borrowing of the U.S. branch. The regulation does not provide discretion to taxpayers. In addition, § 1.882-5(b)(3)(i)(A) does not provide for a bifurcation of particular transactions into separate liability pools in determining the average U.S.-connected interest rate. All third-party liabilities and related interest expense shown on the books of the U.S. trade or business must be included in a single, fungible determination of the average interest rate. Further, for the years in the current cycle, no provision anywhere in § 1.882-5 permits the direct allocation of interest expense outside the formula.[2] The regulation's requirement that all liabilities and interest expense be fungibly allocated prevents cherry-picking the inclusion of high rate liabilities under a substance over form analysis and disregard of low interest rate interbranch liabilities under § 1.882-5(a)(5).

For example, if Bank's borrowing rates on the transactions were lower than its overall third-party borrowing rate in the U.S. branch, Bank would benefit by disregarding the interbranch amounts under § 1.882-5(a)(5). Absent a specific disclosure to the Service of its borrowings, such amounts might not be detected among a large volume of borrowing transactions. The provisions of § 1.882-5(a)(6), although available to the Service, would likely not be applied without the appropriate identified facts. For this reason, § 1.882-5(a)(6) provides the Service discretion to bind a taxpayer to its form with

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[2] In contrast, the regulation's revised provisions for years beginning after June 6, 1996, provide for limited direct allocation for amounts that qualify as nonrecourse financing transactions under the rules of §§ 1.861-10T(b) and (c). Section 1.882-5(a)(1)(ii), T.D. 8658, 1996-1 C.B. 161,166.

respect to all interbranch borrowings including back-to-back conduit financing transactions. See Rev. Rul. 87-89, 1987-2 C.B. 195, 196.

B. Estoppel under Service's Duty of Consistency

Bank argues that the Service is estopped and bound by a duty of consistency to allow Bank to treat the borrowings as third-party borrowings of the U.S. branch based on the treatment accorded to Bank in over four previous exam cycles. Bank also argues that the duty of consistency applies equally with respect to its self-initiated adjustment in calculating the U.S.-connected interest rate.

The courts apply the following three-prong test in evaluating whether the U.S. Government is bound by a duty of consistency towards taxpayers with respect to its characterization and tax treatment of the same or similar items in separate tax years:

1. The Service has made a representation of fact in a prior year (presumably with respect to an item reported on a tax return by Bank);

2. Bank has relied on the Service's representation for that year; and

3. The Service is seeking to change its representation made in the prior year on which Bank has relied.

Johnston v. United States, 605 F. Supp. 26 (D. Mt. 1984); Massaglia v. Commissioner, 312 F.2d 311 (9th Cir. 1962); Conway Import Co., Inc. v. United States, 311 F. Supp. 5 (E.D.N.Y. 1969), Schuster v. Commissioner, 312 F.2d 311 (9th Cir. 1962), 1962-2 USTC Para. 12,121. and Willamette Valley Lumber Co. v. United States, 252 F. Supp. 199 (D. Ore. 1966). While the three-prong test is not specifically referred to by the courts in all estoppel cases, its elements are generally applied to one degree or another. The three elements taken together, have the most relevance in cases where the Service has made administrative determinations in accordance with the scope of its fact gathering role in applying the law.

Where issues concern the Government's right to correct a prior mistake of law, however, the three-prong duty of consistency test is not a sufficient standard by itself to estop the government. In this regard, detrimental reliance by a taxpayer on the treatment accorded it by the Service in prior exams is, with very limited exceptions, an insufficient condition for estopping the U.S. Government from correcting in a current year, a mistaken application of law by its agents in prior years. Automobile Club of Michigan v. Commissioner, 353 U.S. 180, 183 (1957).

Although some courts recognize exceptions to this "mistake of law" rule, its application is reserved for rare circumstances which would result in unconscionable harm to the taxpayer. However, detrimental reliance on the Commissioner's prior representation is still a necessary condition for unconscionable harm to be applicable. See Schuster v. Commissioner, 1962-2 USTC at 86,585. The standard that taxpayer's must meet has not been elucidated precisely by the courts, but should be considered so high that as a general rule, the Service is not limited to correcting prior mistakes of law prospectively, but is often allowed to correct them retroactively. Automobile Club of Michigan v. Commissioner at 183-184.

In applying the duty of consistency doctrine, it is important to distinguish between those situations where the Service exercises its administrative discretion to find facts and characterize items in accordance with their substance or their form, and those in which the Service corrects a mistaken application of law made by its agents on prior year examinations. In this regard, the Service's characterization of the liabilities as third-party liabilities was an act within the scope of its administrative authority under § 1.882-5(a)(6). In contrast, Service's allowing of Bank's self-initiated adjustment in calculating its U.S.-connected interest rate, was a clear mistake of law that is not warranted by the language of § 1.882-5(b)(3)(i)(A), which imposes a strict fungibility requirement.

C. Application of Duty of Consistency to Bank's Classification of Borrowings as Third-Party Liabilities.

The Service is not bound by the duty of consistency in characterizing the U.S. branch treatment of the borrowings of Bank. Because the underlying question involves questions solely of an administrative nature, we analyze the case law relevant to reviewing the binding nature of an exercise of discretion by the Service. The cases on estoppel are either distinguishable or wholly inapplicable to the Bank's case.

The first prong of the duty of consistency test requires that the Government make a representation of fact to the taxpayer in a prior year. The Service did not determine the nature of, or impose the classification of the borrowings on Bank. Rather, it granted the beneficial treatment requested, apparently through tacit acceptance of the classifications included in the overall computations. However, the classification of all liabilities in the section 1.882-5 formula, including the borrowings applies item-by-item with respect to each borrowing. Specific interbranch borrowings treated as third-party liabilities in a prior cycle have not been identified in the current exam cycle. Further, Bank has not provided documentation to prove the matched book conduit nature of the liabilities in the current cycle.

Assuming that Bank did receive a representation from an agent that the liabilities were in substance third-party borrowings of the U.S. branch, the prior exam treatment is only one of several factors to consider in classifying the current exam cycle liabilities. See Hospital Corporation of America v.

Commissioner, T.C. Memo 1996-105 at 62, 65, 68-69; Cf. Schuster v. Commissioner, 312 F.2d 311 (9th Cir. 1962); Massaglia v. Commissioner, 286 F. 2d 258 (10th Cir. 1961).

The second prong of the duty of consistency test requires that the taxpayer rely on the Service's prior year representation of fact. Bank argues that the Service's failure to adjust the tax treatment of the borrowings over four exam cycles is tantamount to an acquiescence on which Bank may reasonably rely. Bank has not shown, however, that it in fact it relied on the Service's prior exam treatment in entering into the transactions. Further, Johnston, Massaglia, Conway Import Co., Schuster and Willamette Valley Lumber Co. were cases all of which involved situations where the Service imposed either a tax characterization, an accounting method, or an administrative requirement on the taxpayer, and each of which had tax consequences less favorable than the taxpayer's own choosing. Under those circumstances, the courts determined a taxpayer reliance on government imposed requirements could be inferred where the taxpayer would not have selected the treatment for itself.

In contrast, in the present case the Service did not impose the classification of the borrowings as third-party borrowings on Bank nor did it require Bank to enter into the transactions in the back-to-back form that it followed.[3] Cf. Conway Import Co., Inc. v. United States, 311 F. Supp. 5 (E.D.N.Y. 1969). Further, no corresponding detriment attached to the Bank when the Service accepted Bank's characterization of the liabilities. Cf. Johnston v. United States, 605 F. Supp. 26 (D. Mt. 1984).

Back-to-back lending transactions may affect a U.S. trade or business's overall borrowing rate favorably or unfavorably as the case may be. The general rule, as stated above, is to disregard interbranch transactions, thereby holding a taxpayer to its form, and leave the treatment of particular conduit transactions to the Commissioner's discretion as needed under § 1.882-5(a)(6). Other than Rev. Rul. 87-89, which specifically addresses the Service's unilateral right to apply substance over form in conduit financing transactions generally, the Service does not have a pronounced administrative practice on the application of § 1.882-5(a)(6). Therefore, an exercise of the Commissioner's discretion under § 1.882-5(a)(6) to treat the borrowings of Bank in accordance with their form as disregarded interbranch liabilities under § 1.882-5(a)(5) cannot be construed as a change in policy or a change in the regulatory rule applicable to the taxpayer. Nor would it disadvantage the taxpayer vis-a-vis other taxpayers that are required to

[3] No information was provided concerning whether Bank entered into the borrowings in a back-to-back form through its in Country A in order to avoid U.S. withholding taxes, to obtain bank regulatory advantages in the United States or for some other reason.

allocate interest expense to effectively connected income under § 1.882-5. Cf. Willamette Valley Lumber Co. v. United States, 252 F. Supp. 199 (D. Ore. 1966).

Bank's interpretation of estoppel against the government would prevent the Commissioner from ever exercising its discretion again over Bank under § 1.882-5(a)(6) with respect to similar conduit financing transactions. In effect, Bank demands continuing special treatment under § 1.882-5 that is not available to the community at large. Even if Bank were able to show a pattern of clear acquiescence over a number of years by the Service with respect to the characterization of the borrowings as third-party liabilities, Bank's argument for estoppel does not defeat the Service's right to (1) determine the factual similarity between the present and past transactions, Hospital Corporation of America v. Commissioner, T.C. Memo. 1996-105 at 62, 65; (2) require proof that Bank relied on the Service's prior determination as a precondition for entering into transactions for the current years, Johnston v. United States, 605 F. Supp. 26 (D. Mt. 1984); Schuster v. Commissioner, 312 F.2d 311 (9th Cir. 1962), 1962-2 USTC para. 12,121; or (3) serve notice on Bank that it will no longer administratively follow the selective treatment singularly accorded to Bank by the Service in prior exams, Willamette Valley Lumber Co. v. United States, 252 F. Supp. 199 (D. Ore. 1966); Conway Import Co., Inc. v. United States, 311 F. Supp. 5 (E.D.N.Y. 1969).

The third prong of the duty of consistency test requires that the Service change in a later year the representation it made to the taxpayer in an earlier year, after the taxpayer has already relied on the earlier representation. This prong requires that the taxpayer show some sort of harm for its reliance on the earlier representation. As discussed above, absent any showing that Bank actually relied on the Service's treatment in prior exam cycles as a precondition for entering into the transactions relevant to the current cycle, the duty of consistency doctrine does not estop the Service from exercising its discretion to characterize the transactions under § 1.882-5.

An additional factor to consider in whether the Service may exercise its discretion to treat the liabilities as third-party liabilities of the U.S. branch is whether this would result in inconsistent treatment of the same transaction. Bank asserts that all of its effectively connected assets associated with the transactions have been treated as giving rise to effectively connected income in their entirety. However, this is not entirely clear from the facts submitted. The information provided indicates that Bank invested some of the funds in collateralized mortgage obligations. Depending on the type of obligations purchased, Bank may have classified some of the investments as securities described in § 1.864-4(c)(5)(ii)(b)(3). If this is the case and such classification is proper and gives rise to an allocation under the regulation between effectively connected and noneffectively connected income, then allowing taxpayer its proposed treatment would provide it with interest income that Bank would likely treat as partially tax-exempt but which is funded by interest expense that it fully deducts without fungible apportionment.[4] Since Bank's proffered § 1.882-5 calculations do not purport to allocate any interest expense between taxable effectively connected income and income treated as noneffectively connected under § 1.864-4(c)(5)(ii)*(b)(3)*, the potential for distortion of income and allocable expense under Bank's approach is a factor to consider in evaluating whether to continue the exercise of the Commissioner's discretion under § 1.882-5(a)(6) to treat the liabilities as third-party liabilities of the U.S. branch. Stated differently, if Exam determines that Bank's direct allocation of interest expense with respect to the borrowings does not clearly reflect the net income of the transactions as a whole, such results would differ materially from the treatment accorded to Bank on prior exam cycles. Under such circumstances, no factual precedent would arguably even exist for the treatment of the liabilities in the § 1.882-5 formula.

D. <u>Application of Duty of Consistency to Correct Prior Mistakes of Law: Calculation of Bank's U.S.-Connected Interest Rate under § 1.882-5(b)(3)(i)(A)</u>.

Bank's calculation of its U.S.-connected interest rate under § 1.882-5(b)(3)(i)(A) and the Service's acceptance of the treatment allowed to Bank in prior exam cycles involves the application of the duty of consistency doctrine when the Service and the Bank have made a mistake of law. The Service's pronounced policy on § 1.882-5 requires that all third-party liabilities "shown on the books of the U.S. trade or business" be included in step-3 of the Branch Book/Dollar Pool formula and that the amounts be fungibly allocated. Section 1.882-5(b)(3)(i)(A) is the sole method for allocation of Bank's third-party interest expense when Bank's third-party liabilities shown on the books of its U.S. trade or business exceed its U.S.-connected liabilities.

We unequivocally conclude that the Service is not estopped from correcting its prior mistake of law under <u>Automobile Club of Michigan v. Commissioner</u>. 353 U.S. 180, 186 (1957). Further, as stated in section C above, the Service did not impose the methodology on Bank in the prior exam cycles. Bank's argument that it relied on a self-initiated departure from the requirements of a final regulation is not supported by the case law. <u>Cf</u>. <u>Massaglia v. Commissioner</u>, 286 F.2d 258 (10th Cir. 1961); <u>Commissioner v. Schuster</u>, 312, F.2d 311 (9th Cir. 1962) Although the Ninth

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[4] No opinion is expressed as to whether any allocation of interest income to noneffectively connected income under § 1.864-4(c)(5)(ii)*(b)(3)* would be interest that is treated as portfolio indebtedness under section 881(c). No inference should be drawn that any collateralized mortgage obligations attributable to Bank's U.S. office within the meaning of §1.864-4(c)(5)(iii) should be classified as § 1.864-4(c)(5)(ii)*(b)(3)* securities.

Circuit in Schuster recognized that departures from the principle allowing the Commissioner to correct prior mistakes of law may be necessary to prevent "profound and unconscionable injury from [taxpayer] reliance on Commissioner's action[s]," it also acknowledged that "such situations must necessarily be rare" because "the policy in favor of an efficient collection of the public revenue outweighs the policy of the estoppel doctrine in its usual and customary context." Schuster v. Commissioner, 312 F.2d 311 (9th Cir. 1962), 1962-2 USTC at 86,585. Bank has not demonstrated that irreparable harm would result from applying §1.882-5 as promulgated. Further no information has been provided which shows that an assessment of U.S. tax on this issue would result in an increased tax liability to Bank on a worldwide basis.

Dickman v. Commissioner lends further support for the Commissioner's right to correct a mistake of law. 465 U.S. 330 (1984) (well established rule that the Commissioner may change an earlier interpretation of the law, even if such a change is made retroactive in effect), citing Dixon v. United States, 381 U.S. 68 72-75 (1965) and Automobile Club of Michigan v. Commissioner, 353 U.S. 180, 183-184. This rule applies even though a taxpayer may have relied to his detriment upon the Commissioner's prior position. Dixon, 381 U.S. at 73, 85; Knights of Columbus Council No. 3360 v. United States, 783 F.2d 69 (7th Cir. 1986). In the latter case, the Service was not estopped from correcting mistake of law made twelve years earlier, even where the mistaken application may have caused taxpayer to rely detrimentally and in good faith on the correctness of treating proceeds as non-taxable income. Further, the Court found no detrimental reliance on a governmental acquiescence if there was no judicial ruling or official agency action favoring taxpayer's construction of the law that Service misapplied. *See also* , Pekar v. Commissioner, 113 T.C. No. 15289-97 (Sept. 1, 1999).

Based on the foregoing, we conclude that neither estoppel nor quasi-estoppel are applicable here. The Service is not precluded from denying inclusion of the borrowings in Step-Three of § 1.882-5(b)(3)(i). Moreover, the Service has adequate discretion under section 1.882-5(a)(6) to determine the substance of a particular transaction without regard to the treatment accorded to Bank in prior exam cycles.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

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