

to grant the banking exception only to corporations that conform to a traditional U.S. banking model.

However, the proposed rules liberalize the approach taken in the Notice in several ways. Most significantly, the proposed rules adopt subjective tests to measure whether the corporation meets the deposit-taking and lending requirements. The IRS and Treasury rejected reliance on objective tests such as those in the Notice after learning, through several ruling requests pursuant to the Notice, that objective standards may cause legitimate banks to be treated as nonbanks.

Because of the rigidity of the objective tests, the Notice permitted the IRS to rule in rare and unusual circumstances that a foreign corporation was an active bank even though it failed to satisfy the requirements of the Notice. The proposed regulations do not adopt this procedure because the IRS and Treasury believe that the enhanced flexibility of the proposed rules should permit all foreign corporations actively conducting a licensed banking business (whether directly or through affiliates) to qualify for the bank exception.

B. Licensing Requirement

A foreign corporation that is not licensed in the United States satisfies the licensing requirements of § 1.1296-4(c) if it is licensed or authorized to accept deposits from residents of the country in which it is chartered or incorporated, and to conduct, in such country, any of the banking activities described in the proposed regulations. However, a corporation fails this licensing test if one of the principal purposes for its obtaining a license was compliance with the requirements of this section.

The IRS and Treasury believe that being licensed as a bank by a bank regulatory authority is strong evidence that a corporation is a bank. The proposed regulations therefore adopt a licensing test to distinguish banks from investment funds.

C. Deposit-Taking Test

A foreign corporation satisfies the deposit-taking test of § 1.1296-4(d) if it regularly accepts deposits in the ordinary course of its trade or business from customers who are residents of the country in which it is licensed or authorized. In addition, the amount of deposits shown on the corporation's balance sheet must be substantial. Section 1.1296-4(d)(3) provides that whether the amount of deposits on a corporation's balance sheet is substantial depends on all the facts and circumstances, including whether the

capital structure and funding of the bank as a whole are similar to that of comparable banking institutions engaged in the same types of activities and subject to regulation by the same banking authorities.

The proposed regulations adopt this deposit-taking test in part to distinguish banks from finance companies, which do not accept deposits. This distinction between finance companies and banks is required by Congress. H.R. Conf. Rep. No. 213, 103d Cong., 1st Sess. 641 (1993) (noting that the banking, insurance, and securities exemptions "do not apply to income derived in the conduct of financing and credit services businesses"). Although the IRS and Treasury believe that deposit-taking is a key attribute of all active banks, they also recognize that subjective tests will better accommodate the various types of banks that have developed as a result of different banking systems and regulatory frameworks.

The proposed regulations introduce flexibility to the deposit-taking requirements in several ways. First, the requirement that the amount of deposits be substantial is more flexible than the Notice requirement that deposits constitute at least 50 percent of the total liabilities of the bank. The IRS and Treasury recognize that a bank's funding preferences may be affected by market conditions and regulatory requirements and believes that an institution may be properly treated as an active bank even if deposits do not constitute the institution's primary source of funding.

Second, unlike the Notice, the proposed regulations do not include any special rules for interbank deposits but treat them like any other deposit, regardless of whether they are received from persons who are members of a related group as defined in § 1.1296-4(i)(4). The IRS and Treasury believe this change is appropriate because the acceptance of interbank deposits from related or unrelated persons on an arm's length basis is a banking activity normally engaged in by banks. In addition, the impact of a rule that distinguishes between interbank deposits received from related persons and those received from unrelated persons is diminished where deposit-taking activity is not measured with a bright-line test.

Finally, the proposed rules change the Notice requirement that a corporation must hold deposits from at least 1,000 persons who are bona fide residents of the country that issued the corporation's banking license because this requirement proved troublesome for certain private banks with clientele from several countries. The requirement was

intended to address cases where a bank is licensed by a country but not allowed to accept deposits from its residents. In the IRS and Treasury's view, such an entity should not be treated as an active bank for purposes of section 1296 because it is not accorded full bank status by the bank authorities that issued its banking license. However, the IRS and Treasury believe that a bright-line deposit standard is not necessary to address this concern. Instead, the proposed regulations require that a corporation regularly accept deposits from residents of the country in which it is licensed.

D. Lending Test

A foreign corporation satisfies the lending test of § 1.1296-4(e) if it regularly makes loans to customers in the ordinary course of its trade or business. This is a change from the Notice's requirement that loans to unrelated persons make up more than 50 percent of the corporation's loan portfolio. The lending test is necessary to distinguish banks, which extend credit to customers, from corporations that merely invest. However, such a distinction can be drawn without relying on a bright-line standard such as that contained in the Notice.

In order to distinguish loans from investments for purposes of these rules, the proposed regulations provide that a note, bond, debenture or other evidence of indebtedness is a loan only if it is received by the corporation on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of the corporation's banking business. Debt instruments treated as securities for purposes of the corporation's financial statements generally are not loans.

E. Banking Income and Activities

Section 1.1296-4(f)(1) provides that banking income is gross income derived from the active conduct of any banking activity as defined in § 1.1296-4(f)(2). These activities include all of the activities treated as banking activities in the Notice, with no material changes, except that finance leasing is included as a banking activity.

The proposed regulations do not adopt the Notice's rule that all of the U.S. effectively connected income earned by a foreign corporation in the active conduct of a trade or business pursuant to a U.S. bank license automatically is nonpassive. One effect of this rule was that effectively connected income earned by a U.S.-licensed bank from transactions with related parties would have been banking income, while income earned by non-