

TAX SECTION

New York State Bar Association

The Branch Profits Tax -  
Report on Issues to be Addressed  
in Regulations

January 2, 1987

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**U.S. Activities of Foreign Taxpayers**  
Leslie J. Schreyer, New York City  
John A. Corry, New York City

Copies of the attached letter dated January 2, 1987 enclosing the Branch Profits Tax -- Report on Issues to be Addressed in Regulations was sent to the following:\_\_\_\_\_

The Honorable David H. Brockway  
Chief of Staff  
Joint Committee on Taxation

O. Donaldson Chapoton, Esq.  
Deputy Assistant Secretary (Tax Policy)  
Department of the Treasury

Alan L. Fischl, Esq.  
Legislation Attorney  
Joint Committee on Taxation

The Honorable William F. Nelson  
Chief Counsel  
Internal Revenue Service

Donald E. Osteen, Esq.  
Division Director  
Legislation and Regulations Division  
Internal Revenue Service

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REPORT # 554

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The Honorable Lawrence B. Gibbs  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20224

Dear Commissioner Gibbs:

On behalf of the Tax Section of the New York State Bar Association, I enclose a report containing recommendations for regulations to be issued under new Section 884 of the Internal Revenue Code. Section 884, which was added by the Tax Reform Act of 1986, provides for the imposition of a so-called "branch tax" on the "dividend equivalent amount" of a foreign corporation that carries on a United States trade or business.

I hope the report proves useful to you.

Sincerely,

Richard G. Cohen  
Chairman

RGC:jl

Enclosure

cc: The Hon. J. Roger Mentz  
(w/enclosure)

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NEW YORK STATE BAR ASSOCIATION  
TAX SECTIONThe Branch Profits Tax --  
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Section 1241 of the Tax Reform Act of 1986 adds to the Internal Revenue Code a new Section 884, which imposes a 30% tax (subject to possible treaty reduction and exemption) on a foreign corporation's "dividend equivalent amount" for the taxable year. It also revises substantially the rules that apply to interest paid by a foreign corporation that conducts a trade or business in the United States.\*

In making the recommendations set forth below, we have been guided by what we believe to have been the primary Congressional purpose for enacting the branch tax, i.e., that existing law, by not imposing any tax on transfers from United States branches of foreign corporations to their head offices, favors doing business in the United States through branches rather than through United States subsidiaries.\*\* We do not believe that Congress intended to replace one form of tax discrimination with another, i.e., to favor foreign

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\* This report was prepared by John A. Corry, Richard L. Reinhold, Alan W. Granwell, William L. Burke, Harry E. White and David Sachs.

\*\* Ways and Means Committee Report, p. 432; Finance Committee Report; 400-401.

corporations doing business through United States subsidiaries over those that conduct a branch business. The recommendations contained in this report are based on the premise that the regulations should reflect an even handed approach between the two methods of doing business to the greatest possible extent.

#### I. The Branch Tax on Earnings

Section 884(b) defines the "dividend equivalent amount" on which the branch tax is imposed as the foreign corporation's effectively connected earnings and profits for the year, as adjusted as provided in Section 884(b). Under Section 884(d)(1), the term "effectively connected earnings and profits" means earnings and profits (determined without reduction by reason of any distributions made during the taxable year) which are attributable to income that is effectively connected (or treated as effectively connected) with the conduct of a trade or business within the United States. The adjustments provided in Section 884(b) are:

- (i) A reduction to the extent that the U.S. net equity of the foreign corporation at the close of the year exceeds its U.S. net equity at the close of the preceding year and
- (ii) an increase to the extent that its U.S. net equity at the close of the preceding year exceeds its U.S. net equity at the close of the taxable year.

Section 884(c) defines U.S. net equity as meaning the U.S. assets reduced (including below zero) by U.S. liabilities. U.S. assets are defined as the money and aggregate basis of property of the foreign corporation treated as connected with the conduct of its United States trade or business. U.S. liabilities means the corporation's liabilities treated as connected with the conduct of a United States trade or business.

1. Determination of Allocable Assets and Liabilities. Section 884(c)(2) provides that the extent to which assets and liabilities are to be treated as connected with a United States trade or business is to be determined under regulations, the provisions of which "shall be consistent with the allocation of deductions under section 882(c)(1)." That Section itself does not specify how assets and liabilities are to be allocated to United States trade or business. Treas. Reg. § 1.882-4 provides that all expenses other than interest are to be allocated as provided in Treas. Reg. § 1.861-8. It does not refer to the allocation of assets. On the other hand, in allocating deductions for interest under Treas. Reg. § 1.882-5, the average total value of all assets of a foreign corporation that generate, have generated or could reasonably expect to generate income effectively connected with the conduct of a corporation's

U.S. trade or business will be treated as allocable to that business. In order to allocate liabilities, the United States effectively connected assets are multiplied by either (i) a fixed ratio (95% in the case of banking, financing or similar businesses and 50% in the case of other businesses) or (ii) the actual ratio that the average total amount of worldwide liabilities for the year bears to the average total value of worldwide assets for the year.

Thus, the Section 882 interest allocation regulations allocate assets on the basis of whether they produce effectively connected income, as determined by Section 864 and the regulations thereunder, but allocate liabilities on the basis of either of the formulas contained in those regulations. The report of the Senate Finance Committee on the branch tax (p. 404) appears to indicate that the Section 864(c) regulations must be applied in allocating both assets and liabilities. It states that assets and liabilities must be "directly related" to the effectively connected income, and should "include cash necessary to meet day-to-day operating requirements, receivables from the sale of goods or services, inventories, property, plant, and equipment used in the business investments so long as the income therefrom is effectively connected income, and other assets necessary to operate the business." Since these

items are all assets, it may be that the Committee Report reference to liabilities was misplaced. In any event, and perhaps with this confusion in mind, the Conference Report states (p. II-647) that the conferees "wish to clarify" that the regulations are to provide "rules for determining assets and liabilities treated as connected with the conduct of a U.S. trade or business for branch tax purposes" that "are to be consistent with the rules used in allocating deductions for the purposes of computing taxable income." Unlike Treas. Reg. § 1.881-4, Treas. Reg. § 1.881-5 provides a single set of rules for allocating both assets and liabilities. For that reason, and because its provisions are reasonable, the branch tax regulations should follow this mandate by adopting rules that are similar to those in the Section 882-5 regulations.

2. Definition of Liabilities. Neither Section 884 nor the Committee Reports contain a definition of "liabilities". Since the Section 882 regulations deal with liabilities on which interest is deductible, the regulations should make it clear that, for Section 884 purposes, liabilities should be determined by applying tax, not financial reporting principles. Thus, the term should include only those obligations that are treated as indebtedness for tax purposes as well as obligations such as repos that constitute debt for tax purposes but

may not be treated as debt for financial reporting purposes. The term should not include securities denominated as debt that are treated as stock for tax purposes. Similarly, it should not include items, such as sale harbor leases or other specially expensed items that are capitalized for financial reporting but not tax purposes.

3. Artificial Increases in Branch Assets. The Senate Finance Committee Report states that the Committee "expects" the Treasury Department to promulgate regulations that, among other things, will address the problem of a branch that temporarily increases its assets at the end of the taxable year merely to reduce the branch profits tax. (p. 404). The report does not suggest what test is to be applied by the regulations, and the Conference Committee Report does not discuss the matter. An analogous situation arises under Section 956, where Treas. Reg. § 1.956-1(e)(3) considers the case of a liability that is charged against certain United States property "for the purpose of artificially increasing or decreasing the amount of a controlled foreign corporation's investment of earnings in United States property", which the regulations state will not be recognized. However, in applying a facts and circumstances test, that regulation specifies only one fact that will be considered, i.e., whether the loan is from a related person. This factor would appear difficult to apply in the case of a contribution to the branch from a foreign corporation's head office that is likely to obtain funds from a number of sources. The FIRPTA regulations also provide no helpful analogies.

We suggest that an appropriate test to be included in regulations is that where there is a "bulge" in the equity capital of a branch during a period that spans the end of one year and the beginning of the subsequent year, a rebuttable presumption will be created that the increase was primarily due to tax avoidance motives and that the excess of assets over liabilities at year-end should be disregarded to the extent that it exceeded the higher of the branch's net equity on specified dates before and after year-end and to the extent that it exceeds a de minimis amount. The period of time should be long enough so that a foreign taxpayer seeking to circumvent the requirement would have to retain the contributed assets in the branch for a reasonable period of time. Since one month on each side is probably too short a period and three months is probably too long, we suggest a period of two months on either side of year-end.\* Otherwise, a facts and circumstances test would apply.

4. Effect of Casualty Losses. The Senate Finance Committee Report (p. 404) states that the regulations should address the extent to which a decrease in assets may not indicate that the branch has remitted profits during the year. It is not clear why this item was singled out, since an unreimbursed casualty loss would normally also reduce earnings and profits. Thus, only if for some reason a casualty loss is not fully offset by an earnings and profits reduction should it be appropriate not to treat an asset decrease as having occurred.

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\* E.g., for a calendar year taxpayer the period would be from November 1 through February 28.

5. Corporate Stock Investments. The Senate and Conference Committee Reports also imply that an investment by the branch in corporate stock cannot constitute an increase in its assets and hence a decrease in the amount on which the branch tax is imposed. This is indicated by the statement in the Conference Committee Report (p. II-648) that the regulations should require that the tax base should be decreased in stock acquisition cases if the branch tax would not have been imposed had assets, rather than stock been acquired, using as an example the acquisition of control of a U.S. corporation with a branch's profits, where the report states that it may be inappropriate to impose the branch tax. In addition, the Finance Committee Report (p. 404) states that the Treasury Department may not consider it appropriate to impose a branch tax if the branch is incorporated and the earnings of the branch are contributed to a new corporation rather than remitted. In Notice 86-17 (December 12, 1986), to be published in IRB 1986-52, the Service has announced that the tax will not be imposed in a Section 351 transaction.

Nothing in the provisions of Section 884 itself indicate how investments in stock are to be treated. The regulations under Section 864 provide that income from stock is to be treated as effectively connected income of a branch, where the branch is not engaged in a banking, financing or similar business, only if the stock is held to meet the "present needs" of the United States business. Treas. Reg. § 1.864-4(c)(2)(iv), Examples (2), (3), (4) and (5). Where the branch is so engaged, Treas. Reg. § 1.864-4(c)(5)(ii) provides that the stock will not be treated as effectively connected unless it was

acquired by the branch in the course of making loans, distributing the stock or pursuant to reserve requirements. We suggest that these rules should be applied in determining whether corporate stock is to be treated as a branch asset for purposes of determining the size of the tax base. Thus, we question whether, as the Conference Committee suggests, stock should be treated as an eligible asset if assets rather than stock had been acquired. Apart from being unclear, this statement appears to be inconsistent with the Section 864 regulations.

We propose that there should be no difference between a Section 351 transaction of the sort described in Notice 86-17 and the other acquisition of corporate stock so long as the asset is held as part of the assets of the branch and its income is generally treated for financial reporting purposes as branch income. In both cases, the funds utilized to purchase the stock presumably could have been invested in other assets that would constitute branch assets for purposes of computing the tax base. We believe that there is no reason to draw a line between the two, particularly because it would be difficult to know where the line should be drawn.\*

#### 6. Branch Termination

We welcome the statement in Notice 86-17 that incorporation of all of the United States trade or business activities of a foreign corporation into a wholly owned subsidiary in a Section 351 transaction will not be treated as an increase in U.S. net equity and thus

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\* Thus if there is such a distinction, should it be at 10% (degree of ownership under Section 902); 50% (degree of control under Section 269) or 80% (degree of control under Section 1504)?

will not increase the dividend equivalent amount of the foreign corporation. Notice 86-17 states that the regulations will determine the extent to which subsequent events, such as distributions from the U.S. subsidiary to its foreign parent or sale of the stock of the subsidiary by the foreign parent, will trigger either a branch profits tax or withholding tax on the parent.

Although distributions from the subsidiary will be treated as dividends subject to withholding tax to the extent of the subsidiary's earnings and profits, these would ordinarily not include earnings and profits of the branch prior to the branch's incorporation. We do not believe that the regulatory authority granted to the Internal Revenue Service under Section 988 is sufficiently broad to attribute such amounts to the new subsidiary. Nor, do we believe, should the sale of the subsidiary's stock trigger a branch tax in a usual case since the foreign corporation is no longer engaged in a U.S. trade or business.\* However, we believe that the Internal Revenue Service can and should provide that in situations in which distributions are made by the subsidiary or in which its stock is sold within a short period of time after the transfer of the branch assets to it, the transfer should be disregarded on a step transaction basis. In order to provide some certainty in this respect, we suggest that the regulations should

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\* In this connection, it should be noted that Section 864(c)(7) provides that the determination of whether income or gain attributable to a sale or exchange of property that ceases to be used in connection with a United States trade or business that occurs within 10 years of the cessation of that business shall be made as if the sale or exchange had occurred immediately prior to such cessation. In the ordinary case, however, we do not believe that the stock of the subsidiary should be treated as a former business asset merely because its own assets may have fallen in that category.

contain a rule determined with reference to a period of time, e.g., distributions or sales after one or two years would not invoke the step transaction rule but distributions or sales prior thereto would create a step transaction presumption that the taxpayer would be able to overcome by proving a change of circumstances.

In this connection, it should be noted that when a United States subsidiary of a foreign corporation is liquidated, its accumulated earnings and profits are not taxed to its foreign stockholder. In our earlier reports we suggested that the same result should be reached if a branch is terminated and all its assets are transferred to the foreign corporation outside the United States.\* Although neither Section 884 nor the Committee Reports address this issue, Notice 86-17 so provides in the context of a Section 332 liquidation or in cases where the foreign corporation has first disposed of its United States business to third parties. We welcome this announcement. We believe that the regulations should adopt a similar rule where the foreign corporation is acquired in a merger or other reorganization by another corporation, whether foreign or domestic.

Notice 86-17 does not address liquidations under Section 331 in cases in which the foreign corporation's United States business assets are not previously sold but are distributed to its stockholders. Under these circumstances, Section 381 provides no earnings and profits carryover to the stockholders. However, based on our belief that the branch profits tax should be imposed

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\* May 23, 1986 Report (p. 29) and June 19, 1986 Report (pp. 6-7).

only under circumstances where it equalizes the tax treatment of United States branch operations with business conducted through a United States subsidiary, since there would be no withholding tax on a Section 331 liquidation of a United States corporation, no branch profits tax should be imposed by reason of a foreign corporation's Section 331 liquidation. We suggest that the regulations should so provide.

## II. Effect of Tax Treaties

In general, the applicability of the branch tax, the rate of tax, and the manner in which it is to be applied will be determined by income tax treaties between the United States and the country in which the foreign corporate taxpayer is a resident rather than by Section 884, if the foreign corporation is a "qualified resident" of that foreign country. Further, under Section 884(e)(1)(B), such a treaty will apply even if the foreign corporation is not a qualified resident of the foreign country if the treaty permits a second level withholding tax on dividends paid by the foreign corporation.\*

1. What Treaties Prohibit the Branch Tax? The Conference Committee Report only partially addresses the question whether income tax treaties between the United States and foreign countries prohibit the branch tax. The Conference Committee Report (p. II-650) states that the Treasury Department interprets Article 24(3) of the

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\* Section 861(a)(2)(B) provides a reduction of the effectively connected income threshold for subjecting to United States tax dividends paid by a foreign corporation to foreign stockholders from 50% to 25%.

United States 1981 Model Income Tax Treaty to preclude the imposition of the branch profits tax. The report does not specifically state that the conferees are in agreement with this provision, but particularly in view of the fact that the Senate Finance Committee Report (p. 404) specifically states that such language will prevent imposition of the tax, it seems reasonably clear that this is the case. Under Article 24(3) of the 1981 Model Treaty,

"(3) The taxation of a permanent establishment which an enterprise of a Contracting State has in the other Contrary State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities."

Because the branch tax is imposed on a corporation that is doing business in the United States rather than, as in the case of a withholding tax, the recipients of dividends paid by such a corporation, it results in a higher effective rate of tax on that corporation than imposed on a similarly situated United States subsidiary of a foreign corporation or United States branch of a United States corporation which do not pay branch taxes. Thus, the regulations should accept the Treasury Department interpretation and should specifically state that a qualified resident of a country which has such a treaty with the United States will not be subject to the branch tax.

The Committee Reports do not address other tax treaty nondiscrimination provisions which state that the citizens of one of the contracting states shall not, while "resident" in the other state, be subjected therein to other or more burdensome taxes than are the citizens

of the other state residing in its territory. Although by itself, the term "citizens" appears to apply only to individuals, these treaties provide that the term for this purpose includes all "juridical" or "legal" persons, partnerships or associations created or organized under the laws of the respective contracting states. It would therefore appear that qualified residents of countries that have treaties with the United States containing this language also should be exempted from the branch tax. In this connection, it should be noted that a foreign corporation that is engaged in a United States trade or business is "resident" in the United States under Treas. Reg. 301.7701-5 and that in LTR 7846060, the Internal Revenue Service found that such a provision of the United States-German tax treaty exempted a German corporation that was doing business in the United States from the Section 4371(3) excise tax on reinsurers. See also, Rhodes & Langer, *Income Taxation of Foreign Related Transactions*, § 1A.14 at 1A-39 (1986). In our previous reports, we suggested that the Committee Reports should state that the branch tax is prohibited under this type of treaty language.\* Since they do not do so, we suggest that the issue should be specifically addressed by regulation and that the regulation state that such nondiscrimination clauses prevent imposition of the branch tax.

## 2. Qualified Resident -- 50% Ownership Test.

Under Section 884(e)(4)(A), the term "qualified resident" is defined to mean any foreign corporation that is a resident of a given foreign country unless either more

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\* Report of May 3, 1986 (pp. 16-19 and 25-26) and Report of June 1, 1986 (pp. 3-4). The treaties that fall in this category are enumerated on page 17 of the May 3, 1986 report.

than 50% by value of its stock is owned (within the meaning of Section 883(c)(4)) by individuals who are neither United States citizens nor tax residents of either that country or United States or unless 50% or more of its income is used directly or indirectly to meet liabilities to persons who are not residents of that country or the United States. Neither the statute nor the Committee Reports indicate how the 50% ownership test is to be applied. On its face, the statute would appear to create a slight presumption in favor of qualified residence, i.e., any foreign corporation will qualify unless it is shown by the Internal Revenue Service that it does not qualify. Because of the difficulty of proving the negative in such a case and in view of the exception contained in Section 884(e)(4)(B) (discussed below) relating to publicly traded corporations, we doubt that this was the legislative intent. Thus, we believe that the regulations should indicate that the general rule applies that in any challenge by the Internal Revenue Service the burden of proof is on the taxpayer.

The more difficult question is how either the taxpayer or the Internal Revenue Service is to determine ultimate ownership. In the case of corporations with registered shares, the registered owner of course need not be the beneficial owner. However, the regulations could require the corporation to ask the registered owner whether it is the beneficial owner or, if not, to identify the beneficial owner. It may be doubtful whether as a practical matter many foreign corporations would comply with such a request, but it at least presents a way for a foreign corporation to establish proof as to

its local or United States ownership.\* With a corporation with bearer shares, however, this would be impossible. In the case of such a corporation that does not meet the publicly traded exemption discussed below, perhaps the only recourse would be to establish its eligibility for the special regulatory exemption provided under Section 884(e)(4)(C), which we discuss below.

Another question that the regulations should address is at what time or times during the taxable year the requisite resident ownership test must be met. The issue involves a potential conflict between simplicity and the possibility that the requirement can be evaded by purchases and sales immediately before and after the relevant date or dates. Using as an analogy the regulations under Section 897 (Treas. Reg. § 1.897-1(c)(2)(iii)) the regulations could provide that the ownership test will be satisfied if it is met at any time during the taxable year. Alternatively, the regulations could appropriately apply a 30 day or more United States ownership standard similar to that contained in Section 951(a)(1).

3. Qualified Resident -- Securities Market Safe Harbor. Section 884(e)(4)(B) provides a qualified resident "safe harbor" under which a foreign corporation that is a resident of a treaty country shall be treated as a qualified resident of that country if its stock is primarily and regularly traded on an established securities market in the foreign country or if it is wholly-owned either directly or indirectly by another

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\* Cf. the information reporting requirements imposed on real estate investment trusts by Treas. Reg. § 1.857-8.

foreign corporation which is organized in such foreign country and the stock of which is so traded. This provision raises two questions:

- (a) What is an established securities market?; and
- (b) What standards are to be applied in determining whether the stock is "primarily and regularly" traded on such a market?

The regulations under Section 897 provide a helpful analogy in answering the first question. Treas. Reg. § 1.897-1(m) provides that a foreign securities market will so qualify if it is either "officially recognized, sanctioned or supervised by governmental authority" or reflected by a "system of general circulation to brokers and dealers which regularly disseminates quotations of stock and securities by identified brokers and dealers" (other than by quotation sheets containing only quotations of a single broker or dealer). It should be recognized, however, that, as under these regulations, the governmental authority of a tax haven jurisdiction could establish a securities market that qualifies under the first of these alternatives on which there is little trading activity but in a sufficient amount to satisfy the "primarily and regularly traded" requirement. Thus, depending upon the manner in which the regulations define the "primarily and regularly traded" requirement, it is possible that the definition of an established securities market should contain some minimum requirement of overall trading activity, i.e., that during the taxable year some minimum number of shares of all corporations shall have been traded on that market.

With respect to the "primarily and regularly traded" requirement, it would appear that, read literally, "primarily" means that, even if the stock of a corporation is traded on more than one exchange, more than 1/2 of the trading activity in that stock must take place on an exchange that is located in the country of which the corporation is a resident. Under this definition, if a corporation's stock is listed on more than one exchange, it will not be possible for the corporation to control on which exchange its stock is traded, leading to the result that it will have no control over whether it will be able to satisfy this requirement for the exemption. Furthermore, a literal reading of the requirement would appear to indicate that it should be applied with respect to all trades in a corporation's stock, rather than being applied only in connection with the trades of its stock on an exchange. Thus, even if a significant portion of the trades in a corporation's stock take place on an exchange located in the country of its residence and if its shares are not listed on any other exchange, if more than 1/2 of the trades in its stock for any year are not effected on any exchange, it would be unable to qualify under this provision. Although at first blush this interpretation might appear harsh, given the anti-treaty shopping purpose behind all these provisions, it would be reasonable for the regulations to interpret the statutory language in this manner where, as here, the Committee Reports provide no guidance, perhaps coupled with authority for the Service to provide exceptions by ruling on a case-by-case basis for corporations that are clearly actively traded.

In the case of the alternative exception for a foreign corporation that is "wholly-owned" by another foreign corporation the stock of which is primarily and regularly traded on an established securities market in that corporation's country of residence, the question arises whether equity-flavored securities that do not constitute stock should be taken into account. Neither Section 884 itself nor the Committee Reports indicate that this is to be the case. Moreover, in most other areas of the Internal Revenue Code, such as the consolidated return provisions of Section 1504, Congress has treated such equity-flavored securities as convertible debentures as stock only when it specifically so provided. Therefore, we believe that the wholly-owned requirement should be applied only to actual ownership of a corporation's stock and that any instrument that is not treated as stock for Federal income tax purposes generally should be similarly treated in applying this requirement under Section 884. The regulations should further provide that directors' qualifying shares should not be counted in applying this wholly-owned requirement. Similarly, of course, the Service can characterize an interest as stock under the usual tests.

4. Qualified Resident - Time for Determination. Section 884(e) does not indicate at what time the ownership requirements of Section 884(f)(iv)(A) are to be satisfied. In the case of the withholding tax on interest imposed under Section 884(f), it seems clear that the requirement must be satisfied with reference to a year other than the year in which interest is paid; otherwise, the corporation will have no way of knowing whether or not the requirement has been satisfied. For this purpose,

therefore, the regulations should provide that whether or not this condition has been satisfied should be determined with reference to the preceding taxable year of the payor corporation. In the case of the branch tax, application of the stock ownership requirement during the current year would not involve the same practical difficulties. However, since the foreign corporation could be subject to both the branch tax and the withholding tax and because the same standards apply in both instances in determining whether it is a qualified resident, it would be appropriate that for branch tax purposes the regulations would also apply the ownership test with reference to the prior taxable year of the foreign corporation instead of its current taxable year.

5. Secretarial Authority Provision. Under Section 884(e)(4)(C), a foreign corporation may be treated as a qualified resident of a foreign country if it establishes "to the satisfaction of the Secretary" that it meets "such requirements as the Secretary may establish" to insure that individuals who are not residents of that foreign country do not use a treaty between that country and the United States "in a manner inconsistent with the purposes of this subsection." The Conference Committee Report does not suggest what guidelines are to be utilized in applying this exception, but the Senate Finance Committee Report (pp. 405-406) states that the regulations are to list "circumstances in which a foreign corporation is not considered to be treaty shopping" and cites as an example a foreign corporation that operates an active trade or business in the country in which it is organized so long as a substantial amount of its income is not reduced by

amounts payable outside its country of organization. This provision is similar to the exception to the anti-treaty shopping rules in Article 16 of the December 1981 U.S. Model Treaty which applies to a corporation that establishes that it did not have a "principal purpose" of obtaining treaty tax benefits. The December 1981 Model Treaty states that carrying on in the foreign country an active business from which the U.S. source income is derived will constitute a presumption that treaty shopping is not involved, and provides a similar presumption where the tax saved by the use of the treaty is at least offset by the tax imposed on such income by the foreign country. We suggest that a comparable tax rate exception as well as the doing business exception should be incorporated in the regulations, but as safe harbors rather than as presumptions.\* Finally, the Service should be empowered to create additional exceptions by private ruling in other clear non-avoidance cases and should be instructed to exercise this power in an even handed and objective manner.

6. Income Not Effectively Connected With A Permanent Establishment. The regulations should confirm, as is implied by Section 884(e)(2)(B) and specifically stated by the Conference Committee (p. 650), that income that is effectively connected with a qualified resident foreign corporation's United States trade or business but not effectively connected with its United States

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\* The Tax Section made a similar safe harbor recommendation with respect to the Model Treaty in our report on the Treaty. 23 Harv. Int'l L.J. 219, 294 (1983). The Senate Finance Committee Report may imply that the regulations should provide safe harbor treatment rather than create a presumption where the doing business rule is satisfied.

permanent establishment will not contribute to the base on which the branch tax is computed.

7. Treaties of Friendship, Commerce and Navigation. In both our earlier reports, we suggested that either the tax reform legislation itself or the relevant Committee Reports should make it clear that, to the extent that anti-discrimination provision in United States tax treaties of friendship, commerce and navigation ("FCN") would prohibit the imposition of a branch tax, those provisions should take priority over the branch tax provisions of Section 884 to the same extent as income tax treaties. Unfortunately, neither Section 884 nor the Committee Reports address this issue. Although an implication that such treaties do not override Section 884 may be drawn from the fact that, unlike income tax treaties, these treaties are not referred to in Section 884 or its legislative history, we continue to believe that the policies that justify income tax treaty overrides in non-treaty shopping situations apply equally to FCN treaties. In this connection, although the interpretation may appear somewhat strained, we believe that it is possible to interpret Section 884's reference to "income tax" treaties as applying to any treaty that has an income tax effect.\* We therefore suggest that the regulations provide that the anti-discrimination provision of any FCN treaty that, if it were incorporated in a pure income tax treaty, would be

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\* Indeed, since FCN treaties are broader in scope than income tax treaties in that they deal with the major part of commercial relations between the signatories, it could be argued that any policy leading to their override by domestic legislation should be even stronger than in the case of a tax treaty and that they should not be overridden in the absence of specific Congressional instructions.

treated as overriding Section 884 and prohibiting the imposition of the branch tax should do so where it is contained in an FCN treaty. In any event, we believe that the regulations should specifically resolve the issue one way or the other so that all doubts on the question are eliminated.

### III. Interest Paid By Foreign Corporations

I.R.C. § 864(a)(1)(C) and (D) treats as United States source income interest subject to tax under Sections 871 and 881 a portion of the interest paid by foreign corporations more than 50% of the gross income of which is effectively connected with a United States trade or business. The 1986 Act replaces this second level tax with a new directly targeted withholding tax. Section 884(f)(1)(A) provides that any interest actually paid by a United States trade or business carried on by a foreign corporation will be treated as if it were paid by a United States corporation, i.e., it will constitute U.S. source income subject to withholding unless a Code or treaty exemption applies. Section 884(f)(1)(B) provides that to the extent that the amount of interest allowable to the foreign corporation as a deduction under Section 882 in computing its effectively connected income exceeds the interest actually paid by its United States trade or business, the foreign corporation itself will be taxable under Section 881(a) on such excess amount "in the same manner as if such excess were interest paid to such foreign corporation by a wholly-owned domestic corporation on the last day of such foreign corporation's taxable year." Treaty override rules "similar" to those

contained in Section 884(e)(3)(B) are to apply in interpreting this provision.

1. Determination of Interest Paid By Branch.

The Conference Report does not indicate how interest paid by a United States branch is to be determined for purposes of the special withholding tax on interest. We suggest that the easiest measure of actual payment is the amount that the branch shows on its books and records as having been paid by it, but only if that amount is otherwise subject to withholding. Thus, to the extent that interest is accrued for book purposes but is not currently taxable under the original issue discount rules contained in Sections 871 and 881, the regulations should reflect the tax result rather than the financial accounting result.

2. Characterization of Interest Paid by Branch.

In characterizing interest actually paid by a United States trade business carried by a foreign corporation as if it were paid by a United States corporation, it does not necessarily follow that in all cases such interest would constitute U.S. source income subject to withholding. Relevant Code exemptions may operate to eliminate a withholding requirement. Such exemptions include, among others, interest paid on deposits with persons carrying on the banking business, interest paid on obligations effectively connected with a U.S. trade or business, and original issue discount on obligations maturing 183 days or less from the date of issue. We suggest that, in order to avoid any uncertainty on the subject, the regulations specifically contain references to the various Code exemptions which could apply.

3. Certain Income Not Effectively Connected With a Permanent Establishment. Section 884(f)(1)(A) applies to a foreign corporation engaged in a United States trade or business. It has been suggested that where a foreign corporation organized in a treaty country is engaged in a United States trade or business but does not have a United States permanent establishment, Section 884(f)(1)(A) should not apply. This suggestion is based upon the premise that the withholding tax on interest should be inapplicable in cases where the foreign corporation does not obtain a deduction for that interest in computing its United States taxable income.

The distinction between conducting a United States trade or business through a permanent establishment and conducting a United States business without having a United States permanent establishment is at best a very fine one which is often hard to determine. The question has been raised particularly in the context of Netherlands Antilles financing subsidiaries, where the dividing line may be even more difficult to ascertain.\* Rather than establish a broad rule that might be difficult to interpret, we suggest as an alternative that the regulations merely provide that those foreign corporations that are treated as "applicable CFCs" under the portfolio interest exemption provisions of Section 127 of the Tax Reform Act of 1984 (which "grandfather" the tax treatment of United States source interest received by Netherlands Antilles financing corporations in respect of their pre-June 22, 1984 debt) should be treated as not engaged in a United States trade or

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\* See Rev. Rul. 73-227, 1973-1 C.B. 338.

business if they do not have United States permanent establishments.

4. Characterization of Excess Interest. The Conference Committee Report states (pp. II-648 -- II-649) that regulations are to determine for purpose of any special Code provisions how the excess Section 882 interest not actually paid by the United States branch is to be determined. The Conference Committee suggests, but does not direct that the regulations provide that where indebtedness of the home office of the foreign corporation is attributed to the branch under Section 882, the excess interest is to be treated as incurred on each type of external borrowing by the foreign corporation, such as bank deposits, and, should be determined by reference to the relative principal amounts of and the average interest rate on each type of external borrowing. For example, in the case of a bank, the excess interest is not necessarily to be treated as bank deposit interest.

The suggestion of the conferees may result in significant complications, particularly relating to the resulting need for the Internal Revenue Service to monitor the worldwide liabilities of foreign corporations with United States branches in order to determine the U.S. tax liability of the branch. On the other hand, similar although not identical considerations govern the Section 882 regulations to the extent that interest not actually paid by the branch may be deductible under the formulas set forth in those regulations. Thus, if a foreign corporation in computing the taxable income of its United States branch interest in excess of the

interest actually paid by the branch, it should be prepared to justify that deduction on the basis of permitting the Internal Revenue Service to examine its worldwide financial accounts.\* If it does not wish to provide the Service with access to its records, it can avoid that problem merely by not deducting the excess interest. Therefore, the suggestion of the conferees is a reasonable one and should be followed in the regulations, i.e., the taxpayer can have the deduction and can also avoid the withholding by providing satisfactory proof.

5. Interbranch Loans. The Conference Report (pt. II-649) also addresses interbranch debtor-creditor relationships, questions "the legitimacy of such arrangements from a tax perspective since only one legal entity is involved", but states that if a corporation is able to legally establish such a relationship, the regulations should address it and "possibly" treat the excess interest as incurred on each type of interbranch loan. In this connection, the conferees express a concern that taxpayers may artificially structure interbranch loans in a manner different from their external liabilities so as to reduce or eliminate this tax and "expect the regulations to address this concern."

It is not clear why the conferees raised the issue of interbranch loans in the context of the special tax on allocated excess interest under Section 884(f)(1)(B). Treas. Reg. § 1.882-5(a)(5) specifically

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\* It should be noted in this context that the foreign corporation may not necessarily obtain a current tax benefit from claiming such a deduction, e.g., if the effect is only to create or increase a net operating loss attributable to the branch's operations.

provides that interest expense resulting from loan or credit transactions of any type between the separate offices or branches of the same foreign corporation is to be disregarded in determining the amount of interest deductions under Section 882(c). The regulations do not except from this rule cases where a corporation is able to legally establish that a true debtor-creditor relationship exists in the context of interbranch loans.

On the other hand, a question as to the tax treatment of interbranch interest does arise in the case of interest actually paid by a United States branch of a foreign corporation to one of its foreign offices. Since, under the Section 882 regulations, such payments would be nondeductible, there is no strong tax policy reason why they should be subject to withholding taxes. We therefore suggest that the regulations under Section 884, like the regulations under Section 882, should specifically provide that interbranch interest will not be taken into account for purposes of both Section 884(f)(1)(A) and Section 884(f)(1)(B).

6. Extent of Treaty Override. Perhaps the most important issue that arises in applying the tax on excess interest is to what extent it is prohibited or reduced by treaty provisions. According to the Conference Report (p. 649), for this purpose the applicable treaty is generally any treaty between the United States and the country of the corporation's home office. However, since those treaties that do not contain non-discrimination clauses that would prohibit a branch tax in general permit taxes only on "income" or "profits" (other than the treaties with Poland, Romania, South Africa (now repealed) and the

Soviet Union), the practical effect of this rule, except in treaty shopping situations, would be to make the excess interest tax largely ineffective where a treaty is involved. We believe that the regulations should address the issue and elaborate on and make more specific the conclusion reached by the conferees. This is especially important since Section 884(f)(1), which cross-references to the dividend provisions of Section 884(e)(3)(B), is not entirely clear and may be read as suggesting that as in the case of interest paid by the branch, the applicable treaty is that which applies to the recipient of the additional interest. Such an interpretation, however, would lead to complexities in determining exactly to what persons such excess interest has been paid and the determination of whether such recipients are entitled to treaty benefits between the United States and the country of their residence on interest which has not been paid directly by the U.S. branch. For that reason and in view of the clear language in the Conference Committee Report, we believe that the regulations should interpret the treaty override provisions in the same way as that report.

7. Back-to-Back Loans. The Conference Report (p. 650) states that the conferees "are concerned that the branch level tax may lead to increased use of back-to-back loans by non-treaty residents" and that such loans "as generally provided under present law" will be collapsed by the Internal Revenue Service. It is not clear from this language how far the conferees intend that the Internal Revenue Service should go in this respect. It would appear that a loan to a United States borrower from a qualified treaty country resident that is

pledged directly or indirectly as collateral for a matching loan to that resident by a non-treaty country resident should be disregarded for tax purposes and that the treaty benefit would not apply. Cf., Rev. Rul. 76-192, 1976-1 C.B. 205, under which an investment in U.S. property under Treas. Reg. § 1.956-1(b)(4) is deemed to arise under such circumstances.\* However, what result should be reached where the loan to the U.S. borrower is made by a large bank in a treaty country and the bank earns a spread on the difference between the interest it receives on such loan and the deposit that it receives from the non-treaty country foreign corporation which is equivalent to what it would earn on other transactions between non-related parties? It may be relatively easy to apply conduit rules under similar circumstances where the corporations in question are all related. See Aiken Industries Inc. v. Commissioner, 56 T.C. 925 (1971), acq. (on ancillary questions) 1972-1 C.B. 1; Rev. Rul. 84-152, 1984-2 C.B. 381 and Rev. Rul. 84-153, 1984-2 C.B. 383. The conduit argument becomes more difficult to make, however, where the obligation of the U.S. borrower does not secure the deposit made by the related foreign party and where the bank's profit on the transaction is no different than it would have been had the deposit been made by an unrelated party. To attack such transactions as conduits would go well beyond Rev. Rul. 76-192 as well as Rev. Ruls. 84-152 and 84-153 and Aiken Industries, where the corporations that served as conduits were related to the the U.S. borrowers. The regulations should therefore make it clear that this back-to-back loan

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\* In Rev. Rul. 76-192, no direct pledge was involved, but the Internal Revenue Service interpreted the fact that the bank earned only a slight difference in interest rates as evidence that it would not have made the loan without the deposit, hence leading to the conclusion that the bank was merely a conduit.

exception to treaty exemptions will not be applied where the treaty country lender makes loans to a U.S. borrower and borrows (whether through deposits or otherwise) from a foreign affiliate of the borrower under circumstances where the interest it charges the borrower and the interest it pays the foreign affiliate are at rates that are no different than the rates the lender would charge and pay completely unrelated parties.