REPORT #567

TAX SECTION

New York State Bar Association

<u>Memorandum</u>

July 27, 1987

Table of Contents

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New York State Bar Association

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August 26, 1987

Hon. Laurence B. Gibbs
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, DC 20224

Dear Commissioner Gibbs:

I am enclosing a report relating to the Branch Profits Tax -- Additional Issues to be Addressed in Regulations. This report was pre-pared by the Committee on U.S. Activities of Foreign Taxpayers of the Tax Section of the New York State Bar Association. The report was written by John A. Corry, Co-Chairman of that Committee. Helpful comments were received from Juliet Cain, Richard O. Loengard, Jr., William L. Burke and James Ross Macdonald. The report was approved by the Executive Committee of the Tax Section.

The enclosed report supplements the report submitted by the Tax Section on January 2, 1987 dealing with the new branch profits tax imposed by Code Section 884. The enclosed report deals with the effect of treaties on second level withholding taxes on dividends, the effect of treaties on the tax on excess interest, the possible “double counting” of excess interest and the “primarily traded” requirement in the publicly traded securities safe harbor.

Sincerely,

Donald Schapiro

Copies of this letter and report
to persons on the attached list

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REPORT #567

Memorandum

July 27, 1987

Re: Branch Profits Tax -- Additional* Issues to be Addressed in Regulations

On January 2, 1987, the Tax Section of the New York State Bar Association submitted to the Treasury Department and Internal Revenue Service a report that considered a number of issues with respect to the new branch profits tax imposed by new I.R.C. § 884 (and related matters) that should be addressed in regulations to be issued by the Treasury Department and Internal Revenue Service. This report discusses two additional issues that should be considered in those regulations and also considers further an issue that was discussed in the prior report.

1. The Effect of Treaties on Second Level Withholding Taxes on Dividends

Under I.R.C. § 861(a)(2)(D), dividends paid by a foreign corporation are subject to U.S. withholding tax if 25% or more of its gross income from all sources for the three preceding years was effectively connected with the conduct of a U.S. trade or business. If 25% or more of the payor's gross income was thus

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* This report was written by John A. Corry, Co-Chairman of the Committee on U.S. Activities of Foreign Taxpayers. Helpful comments were received from Juliet Cain, Richard O. Loengard, Jr., William L. Burke, and James Ross Macdonald.

effectively connected, that portion of the dividends which equals the portion of the foreign corporation’s total gross income that was effectively connected with such trade or business will be treated as U.S. source income that is potentially subject to withholding taxes. However, under I.R.C. § 884(c)(3), such dividends will not be subject to the second level tax imposed by I.R.C. §§ 871(a), 881(a), 1441 or 1442 if the foreign corporation is not exempt, by reason of a treaty, from the imposition of the branch profits tax.

New I.R.C. § 884 (e)(3)(B)(i) provides that if the foreign corporation payor of dividends is not a “qualified resident” of a foreign country, it may not claim any income tax treaty benefits between the United States and such country with respect to dividends paid by it as to which the second level tax would otherwise be imposed. The purpose behind this provision is not clear since, if the payor is not a qualified resident of the foreign country in which it is a resident, it would not be able to obtain exemption from the branch profits tax and, because it would be subject to the branch profits tax, would not be subject to the second level tax in any event. Perhaps the language was intended to cover certain cases (described at page 221 of the description of the Technical Corrections Act of 1987) where branch profits tax is not imposed because the dividends are attributable either to pre-1987 earnings and profits or to earnings and profits arising in an earlier year in which the branch profits tax was prohibited by treaty. In any event, the implication of this provision is that the second level tax (like the branch profits tax) will not be imposed if it is prohibited by a treaty between the United States and a foreign country of which the payor is a qualified resident. Although the Conference Committee Report is silent on this matter, the Senate Finance Committee Report (p. 405) confirms that there will be no second level tax in a non-treaty shopping situation. The regulations should also confirm that this is the case.

The regulations should also address the specific types of treaty provisions which may be construed as preventing the imposition of the second tier tax. Some of these rather clearly should be applicable, where, as in the case of the treaty with the Netherlands, dividends paid by a Netherlands corporation will be exempt from U.S. tax except where the payment is to a United States citizen, resident or corporation.[*]

Other treaties raise more difficult issues. Thus

[*] Article XII.

Article 6(1) of the treaty with Japan provides that dividends will be treated as income from sources within a contracting state only if paid by a corporation of that contracting state. Although this provision, read literally, would apparently apply to dividends paid by a Japanese corporation to any non-United States holder, the Treasury Department's technical explanation of the treaty states that these source rules “do not serve to extend the benefit of the Convention to persons other than residents of the two States” and therefore that they “are not applicable in determining source of income of residents of other states, although the income of such other residents is of a type referred to in this article.” Thus, while this provision applies to dividends paid by a non-Japanese foreign corporation to a Japanese resident, it does not apply to dividends paid by a Japanese corporation to a non-Japanese resident. Accordingly, whether or not the payor of the dividends is a “qualified resident” of Japan under Section 884 is irrelevant. We therefore question whether the Japanese treaty exemption should apply to such dividends under section 884(e)(3)(B)(i), and we suggest that the regulations should provide that the exemption is inapplicable, where the dividends in question are paid by a Japanese corporation.[*]

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[*] In its discussion of the dividend provisions of Article 12 of the Japanese treaty, the Treasury Department's technical explanation specifically notes that the treaty does not contain a provision that limits the right of one treaty party country to tax dividends paid by a corporation of the other treaty party country to residents of that country. Thus, it is clear that the Treasury draws a distinction between such provisions, which would be similar to that discussed in the preceding paragraph, and the special source rule contained in Article 6(1) of the Japanese Treaty.

It should be noted, however, that another clause of section 884, i.e., section 884(e)(3)(B)(ii), by implication, would provide an exemption from the second level tax for dividends paid by a foreign corporation that would otherwise be subject to tax under I.R.C. § 861(a)(2)(B)if such dividends are received by a qualified treaty country resident from a foreign corporation that carries on business in the United States. Since the benefits of Article 6(1) of the Japanese treaty are intended to apply to Japanese residents that receive dividends from foreign corporations, under I.R.C. § 884(e)(3)(B)(ii) qualified Japanese residents should be entitled to avail themselves of the benefits of Article 6(1). The regulations should make clear that this will be the case. A like result should be reached in the case of the similar although more narrowly drawn exemption contained in Article XIV of the treaty with Switzerland, under which dividends paid by a corporation other than a United States domestic corporation will be exempt from United States tax where the recipient is a nonresident alien of the United States resident in Switzerland or a Swiss corporation not having a United States permanent establishment. A qualified Swiss resident should be able to benefit from this provision.

2. The Effect of Treaties on the Tax on Excess Interest

As we discuss in Part II.F of our earlier report, the 30% tax imposed under new § 884(f)(1)(B) on interest not paid by a U.S. branch of a foreign corporation but nonetheless deductible by it ("excess interest") is subject to treaty override under rules "similar to the rules of subsection (e)(3)(B)". As was noted in that report, this cross reference is not entirely clear and may be read as suggesting that, as in the case of interest actually paid by the branch, the applicable treaty is that which applies to the recipient of the excess interest rather than the foreign corporation paying such interest. However, the Conference Report (p.649) specifically states for this purpose the applicable treaty is any treaty between the United States and the country of the foreign corporation’s home office. The Joint Committee Explanation of the Tax Reform Act of 1986 confirms that this is to be the result and, unlike the case with interest actually paid by the branch, that any treaty between the United States and the payee's country of residence is not to be taken into account.*

As we pointed out in our earlier report, this interpretation would appear to provide treaty overrides, except in treaty shopping situations, in almost all cases, since even those treaties that do not contain nondiscrimination clauses that would prohibit a branch tax generally permit the United States to tax only “income” or “profits” that are effectively connected with a foreign corporation’s United States permanent establishment. Thus, in Article 7 of the June 16, 1981 model U.S. income tax treaty, it is stated that in determining the business profits of a permanent establishment that are subject to tax “there shall be allowed as deductions expenses which are incurred for the purpose of the permanent establishment, including . . . interest, . . . whether incurred in the State in which the permanent establishment is situated or elsewhere.” Imposition of the tax on excess interest would appear to take away from the permanent establishment a significant portion of the benefit of the indirect deduction for interest provided under the Internal Revenue Code and mandated by treaties such as the 1981 model. The regulations should confirm that where this is the result, the tax on excess interest will not be imposed in non-treaty shopping situations.

* This is also confirmed in the description of the Technical Corrections Act of 1987 (p. 221).

If the tax on excess interest is not prohibited under such treaty provisions, the further question arises whether it would be prohibited under a non-discrimination clause contained in a treaty between the United States and the country of the foreign corporation's home office. Considerations similar to those discussed in our earlier report with respect to the imposition of the branch tax itself would be equally applicable here. A further consideration, however, applies to the tax on excess interest. Excess interest by its very nature consists of payments made by the foreign corporation's offices other than its U.S. branch. A United States corporation situated similarly to the branch, e.g., as if the branch had been incorporated as a U.S. corporation, would not be a payor of such interest and thus would not be entitled to deduct it. Therefore, to the extent that the benefit of the deduction is offset by the tax on excess interest, that would not place the branch in a worse position than it would be in if it were a U.S. corporation. The fact that this may not be true in every case, e.g., a branch (and a comparable U.S. corporation) that has operating losses and hence cannot currently benefit from an interest deduction, should not alter that general principle. Therefore, we believe that in any case in which a treaty does not contain a definition of income or profits on which a permanent establishment can be taxed that prohibits the tax on excess interest, the treaty's non-discrimination provision also should not prohibit the imposition of that tax. The regulations should so provide.

3. The Possible "Double Counting" of Excess Interest

Because the treatment of interest under Section 884(f) combines the concept of interest payments and interest deductions (without regard to payment), it results in the possibility that deducted interest that has accrued but has not been paid during a taxable year will be subject to the tax on excess interest under Section 884(f)(1)(B) and will also be subject to withholding tax under Section 884(f)(1)(A) when it is paid in a subsequent year. This possibility can be illustrated by a simplified example. Assume that a U.S. branch foreign corporation incurs indebtedness on February 1, 1987 on which interest is payable annually each January 31. Assume further that the branch has incurred no other indebtedness, so that it pays no interest during calendar year 1987, which is its taxable year. Accordingly, the deductible Section 882 portion of interest paid or incurred by X during 1987, including the 11 months of interest payable by the branch on January 31, 1988, will be subject to the excess interest tax under Section 884(f)(1)(B). In 1988, the entire 12 months interest paid by the branch will be subject to withholding tax under Section 884(f)(1)(A)

In such a situation, interest will have been subjected to tax twice, which would not have been the case if X had been doing business in the United States through a U.S. subsidiary. There is no indication in the legislative history of Section 884 that Congress was aware of this problem and hence that it had any views on the subject. However, such a double tax effect is inconsistent with the expressed legislative purpose that the treatment of interest, like the branch tax, was intended to equalize generally the treatment of foreign corporations having U.S. branches with foreign corporations having U.S. subsidiaries.[*] Further, the Joint Committee Explanation (p. 1037) indicates that Congress enacted the tax on excess interest because items that were deducted “against U.S. effectively connected income generally should give rise to an inclusion subject to U.S. tax without regard to the level of business

[*] Conference Committee Report, p. 11-648.

conducted in the United States." This purpose would not be served by applying the tax on excess interest to interest that is payable by the branch in a later year and hence will be subject at that time to withholding taxes unless a treaty applies. We therefore doubt that Congress would have incorporated such a doubling up approach into the law had Congress been aware of the problem.

We therefore suggest that, in computing the tax on excess interest, a foreign corporation should be permitted a consistent basis to take into account interest payable by its U.S. branch on a cash payment basis even though the foreign corporation generally pays tax on an accrual basis. The effect of such a rule would be to impose the tax on excess interest only on interest not actually payable by the branch. Because this would be consistent with the statutory purpose for the excess interest tax, we believe that the broad regulatory authority grant of Section 884(g) to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section . . ." provides the Treasury Department and Internal Revenue Service the power to include such a provision in the regulations to be promulgated under Section 884(f).[*]

4. The "Primarily Traded" Requirement In the Publicly Traded Securities Safe Harbor

In our prior report, we discussed the provision in Section 884(e)(4)(B) that provides that a foreign corporation that is a resident of a treaty country will be treated as a qualified resident of that country eligible for treaty relief from the branch tax if its stock is "primarily and regularly traded on an established securities market" in that country. We suggested that the word "primarily", read literally, requires that more than one half of the trading activity in that stock must take place on such an exchange. It has been suggested that this interpretation is too restrictive and that, in view of such authorities as Malat v. Riddell, 383 U.S. 569 (1966), the word "primarily" should be interpreted as meaning "principally" or "of first importance".[*] Under that interpretation, the "primarily"

[*] An alternative suggestion would be to require that the taxpayer's excess interest tax liability, if any, be determined on an accrual basis but provide a credit for the excess tax against the tax that otherwise would be withheld when the interest is paid. This alternative, however, raises several significant problems. First, in the case of a foreign corporation that pays and accrues out of several offices a significant amount of interest to a number of borrowers, it would be difficult if not impossible to determine on what interest accruals the excess interest tax was paid and hence to determine on which interest payments by the U.S. branch credits would be available. Second, any credit procedure would have to take into account cases in which payments of interest would be exempt from withholding tax, thus raising the question whether the credit is to be refunded to the payor corporation or paid over to the payee. Finally, since this alternative would impose the excess tax on interest that is ultimately payable by the branch, it would appear to be inconsistent with the statutory policy basis for the excess tax that is discussed above; therefore, it may be difficult to argue convincingly that regulations that incorporated such a provision were carrying out "the purposes of this section. . ."

[*] See also Treas. Reg. § 1.269-3(a), which states that if a purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the "principal purpose" for purposes of Section 269.

test could be interpreted in the context of the qualified resident exception as being met by a foreign securities exchange that accounts for a higher volume than any other trading location even though trading on that exchange accounts for less than half of the total volume on all markets combined. Thus, in interpreting I.R.C. § 883(c)(3), which contains an exception to the treaty shopping ineligibility for the income exclusions provided in I.R.C. § 883(a), the Senate Finance Committee report (pp. 883-884) states that "primarily" in the phrase "the stock of which is primarily and regularly traded on an established securities market in the foreign country in which such person is organized" shall mean that "more shares trade in the country of organization than in any other country." We believe that this suggestion is well taken and amend our prior report accordingly.

Read literally, the "primarily traded" requirement seems to require a comparison of the volume of trading in a corporation's shares in a securities market in its country of residence with the volume of trading in other securities markets. This could vary from year to year and would be governed by factors which are unpredictable. Perhaps, therefore, the regulations should provide that if stock is traded on more than one securities market, it should be treated as primarily traded on the market on which securities brokers would normally treat as the primary market for the stock, i.e., on which they would normally execute retail sized orders to buy or sell the stock. If this test were satisfied by a securities market in the corporation's country of residence, the corporation would satisfy the "primarily traded" requirement even if that requirement were not satisfied on the basis of comparative trading volumes.

Finally, it has been suggested that where a multinational corporation is a resident of a fairly small country that has a stock exchange or other securities market on which its stock is regularly traded, but where the majority of trading in its stock occurs on some other exchange such as the International Stock Exchange in London, the fact that the local market was not the principal market for trading in such shares would be disregarded. Although this approach as a matter of first impression might be a reasonable one, it would appear to be fundamentally inconsistent with the "primarily" requirement. However, we suggest that it be included in the regulations under the broad regulatory authority contained in I.R.C. § 884(e)(4)(C), but only in the case of a large corporation that carries on an active business in its country of incorporation. e.g., its net asset value is at least §100 million, which is the volute test applied by the New York Stock Exchange under its special alternative listing requirement for foreign corporations.*

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* See NYSE Listed Company Manual, Section 103.