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NEW REGIME OF BRANCH LEVEL TAXATION NOW IMPOSED ON CERTAIN FOREIGN CORPORATIONS

In some cases the 1986 Act provisions requiring branch level taxation will result in an increase in taxes and a limitation on the right to claim treaty benefits.

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Several provisions of the 1986 Act will have a significant impact on the choice between U.S. or foreign corporate investment vehicles. Among these are the new branch level rules. In some cases, these rules will tip the balance toward investment through U.S corporations, whereas in others investment through foreign corporations will prove more attractive.

New Section 884, added by the 1986 Act, imposes an additional tax at a 30% rate (or, in certain cases, a lower rate prescribed by tax treaty) on foreign corporations that have or had "earnings and profits" which are, or are considered to be, "effectively connected" with a U.S. trade or business. The new tax, called a "branch profits tax" (BPT) is effective for tax years beginning after 1986.

In general, the BPT is applied to a base intended to be equivalent to the amount which could have been distributed as a dividend by a hypothetical U.S. subsidiary of the foreign corporation whose only income, assets and liabilities are those of the U.S. business of the foreign corporation, with such amount referred to as the "dividend equivalent amount" (the DEA). Thus, the BPT is designed to replace secondary withholding on dividend distributions. Accordingly, a foreign corporation subject to the BPT is not required to withhold tax on actual dividend distributions. (However, in certain "treaty shopping" cases, a foreign corporation exempt from the BPT by virtue of a treaty provision may still be required to withhold tax on actual dividend distributions.)

The DEA is computed by reference to the U.S. "effectively connected earnings and profits" which are considered to be available for remittance. However, since amounts reinvested in U.S. business activities by the hypothetical U.S. subsidiary would not have been available for distribution as a dividend, the BPT is deferred to the extent of any such ***increased*** investment by the foreign corporation. However, any subsequent ***reduction in the amount*** invested in U.S. business activities is considered a remittance which ends the earlier deferral. The determination of the amount of investment in U.S. business activities at year-end, the benchmark for determining whether there has been an increase or decrease, is subject to calculations made according to Regulations to be written which are to be consistent with the rules for apportioning deductions.

In addition, Section 884 imposes a new branch level tax on the amount of the excess, if any, of the interest that a foreign corporation is entitled to deduct for U.S. income tax purposes over the amount of interest "paid" by its U.S. trade or business, with such excess referred to as "excess interest." Section 1241 of the 1986 Act also has modified the source rules with respect to interest and dividend payments made by a foreign corporation, making it more likely that such interest and dividend payments will be considered to be from U.S. sources.

In many cases, the new provisions are inconsistent with existing treaty provisions. However, inconsistent treaty provisions are specifically overridden in the case of so-called "treaty shopping," a term defined broadly enough to include not only treaty country corporations owned by third country resident shareholders, but also, under certain circumstances, treaty country corporations owned entirely by treaty country residents.

THE NEW RULES

The BPT is to be imposed, generally at a 30% rate, on a base designed to approximate the amount that could have been distributed as a dividend by a fictional U.S. subsidiary of the foreign corporation whose sole income, assets and liabilities are those of the foreign corporation considered to be effectively connected with its U.S. trade or business. The statute aptly refers to the amount described in the preceding sentence as the "dividend equivalent amount" (DEA) as indicated above and defines this term as the "effectively connected earnings and profits for the taxable year" with certain adjustments (described below).

Effectively Connected E&P

Section 884(d)(1) defines "effectively connected earnings and profits" as the "earnings and profits of [a U.S. branch (*i.e.*, the fictional U.S. subsidiary) of] a foreign corporation attributable to its income effectively connected . . . with a U.S. trade or business". While the use of the word "attributable" seems to indicate an allocation or apportionment is required, on further analysis this does not appear to be the case. Rather, it would

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seem that the statutory term "effectively connected earnings and profits" means the earnings and profits determined by reference to the items of income and expense of the fictional U.S. subsidiary; or stated differently, it is the items of income and expense of the fictional U.S. corporation adjusted in accordance with Section 312 with no further apportionment required. Thus, the starting point for computing the DEA of a foreign corporation is the determination of its effectively connected earnings and profits. To accomplish this, one must first determine the items of a foreign corporation's income and expense which are[1] or are considered to be[2] effectively connected with the conduct of a U.S. trade or business, and then adjust that amount to arrive at the attributable E & P.

E&P v. Taxable Income. The reason that the DEA is defined in terms of E & P and not in terms of taxable income (the two concepts are not identical) is that the BPT is a tax on a hypothetical dividend distribution. The concept of "earnings and profits" is generally relevant for the purposes of determining whether any corporate distribution is to be considered a dividend. The general rule under Section 316 is that a distribution will be considered a dividend to the extent of the corporation's historical earnings and profits, or the current year's earnings and profits (even if the corporation has a cumulative deficit, taking into account historical and current year's results). Thus, the DEA is not to be reduced by prior year's deficits,[3] so that while a net operating loss carryover would reduce taxable income, it would not reduce the DEA.

While the two terms are not identical, earnings and profits are usually defined by reference to taxable income, subject to adjustments under the principles of Section 312. Thus, certain items not included in the determination of taxable income are taken into account in the determination of earnings and profits, so that earnings and profits will be often greater than taxable income. For example, income exempt from tax under the Code or by treaty is nevertheless included for the purpose of determining earnings and profits,[4] and lower depreciation rates apply for earnings and profits purposes.[5] On the other hand, subject to certain limitations, an item of expense (such as U.S. income taxes) which can never be deducted for income tax purposes may reduce earnings andprofits.

Not every adjustment to taxable income required by Section 312 is applicable under Section 884. For example, in general, under Section 312(a), dividend distributions serve to reduce earnings and profits. However, actual dividends paid by a foreign corporation do not serve to reduce the DEA.[6] This is not surprising given the design to equate the DEA with what could have been distributed by the hypothetical U.S. subsidiary of the foreign corporation and not with what

The BPT is designed to replace secondary withholding on dividend distributions.

was, in fact, distributed by the foreign corporation. To equate what could have been distributed to what is considered to have been distributed, certain other adjustments are required. In addition, while income taxes which generally reduce earnings and profits are deductible for purposes of computing effectively connected earnings and profits, the authors assume that it is not intended that the BPT reduce effectively connected earnings and profits.

Exclusions from DEA. Special rules are also provided under which items of income which otherwise would be included in effectively connected earnings and profits are specifically excluded from the DEA. The items excluded by Section 884(d) consist of: (1) earnings and profits attributable to the operation of foreign registered ships or aircraft which are excluded from gross income under Section 883(a)(1) or (2);[7] and (2) earnings and profits attributable to income considered to be effectively connected under Section 921(d) (relating to foreign trade income of a foreign sales corporation), Section 926(b) (relating to distributions of a foreign sales corporations out of earnings and profits attributable to foreign trade income), Section 953(c)(3)(C) (relating to related person insurance income) and Section 897(c)(1)(A)(ii) (relating to gains from the sale of shares in domestic U.S. real property holding corporations). In the latter connection, note that any other gain from the disposition of a U.S. real property interest under Section 897(c) which is actually, or considered to be, effectively connected with a U.S. trade or business would not be excluded from effectively connected E & P. Thus, gain from the sale by a foreign corporation (including a foreign corporation treated as a domestic corporation under Section 897(i))[8] of an interest in real property is not excluded.

The following example illustrates some of the adjustments to taxable income required to arrive at DEA.

EXAMPLE 1: F, a foreign corporation resident in a country which does not have a treaty with the U.S., owns a building in the U.S. (but not the land upon which it is situated). The building was purchased in 1981 for $150,000 and is held for rental. F has been depreciating the building on a straight-line basis over 15 years, yielding a depreciation deduction of $10,000 per year. F's adjusted basis for the building is $90,000 at 12/31/86. F is a calendar year taxpayer, and has a net operating loss carryforward through 12/31/86 of $60,000. On 1/15/87, F sells the building for $150,000.

1. For income tax purposes, the sale for $150,000 will produce a $60,000 gain, which will be fully protected by the $60,000 NOL.

2. For BPT purposes, F's DEA will be $22,500, computed as follows:

Original cost	$150,000
Depreciation under Section 312(k) 2.5% × 6 years	(22,500)
Basis for E&P purposes	$127,500
Amount realized	150,000
E&P basis	(127,000)
DEA	$ 22,500

3. The DEA of $22,500 is not reduced by F's NOL, and will be subject to a BPT of 30% or $6,750.

4. The computation will be somewhat more complicated because of the alternative minimum tax.

The Required Adjustments

In order to arrive at the DEA, the amount assumed to have been available for payment as a dividend, ad-

justments are required to be made to effectively connected earnings and profits for increases and decreases in investments in the U.S. trade or business of the foreign corporation. If the "U.S. net equity" of a foreign corporation at the close of a taxable year exceeds the "U.S. net equity" at the close of the preceding taxable year, the increase is presumed to have been invested out of effectively connected earnings and profits that could otherwise have been available for a dividend payment. Since the amount of the increase was not available for dividend distribution, such amount *reduces* the DEA (but not below zero) pursuant to Section 884(b)(1).

However, the reduction is not permanent. Rather, to the extent of a decrease in U.S. net equity in any later year (for example, because of a withdrawal of investment) it is presumed that the effectively connected earnings and profits previously used for U.S. investment have been repatriated and the deferral occasioned by prior increases in investments terminates.[9]

U.S. Net Equity. According to Section 884(c), the term "U.S. net equity" means simply the difference between "U.S. assets" and "U.S. liabilities." The term "U.S. assets" is defined as the money and adjusted basis for earnings and profits purposes (*i.e.*, taking into account the depreciation allowed only for earnings and profits purposes) of property treated as effectively connected with a U.S. trade or business. The term "U.S. liabilities" is defined as the liabilities of the foreign corporation treated as connected with the conduct of a U.S. trade or business. Section 884(c)(2)(C) provides that the determination of the amount of U.S. assets and U.S. liabilities which is attributable to the U.S. trade or business is to be made pursuant to Regulations which are to be consistent with the rules for allocating deductions under Section 882(c)(1). Under those rules, U.S. assets would include those assets which generate, have generated or could reasonably have been expected to generate income, gain or loss effectively connected (or considered to be effectively connected) with a U.S. trade or business.

Under the predecessor versions of the 1986 Act, the determinations of U.S. assets and U.S. liabilities were to be made in accordance with rules which were to be consistent with the rules for allocating interest expenses as contained in Reg. 1.882-5. Those rules require an arbitrary determination of U.S. liabilities.[10] Despite the reference in the statute to Section 882(c)(1) rather than Reg. 1.882-5, the Regulations are likely to be consistent with the determination of U.S. liabilities under the interest expense allocation rules. Under those rules, the actual liabilities of the taxpayer on the U.S. books are not relevant to the determination of U.S. liabilities. Rather, U.S. liabilities are determined by multiplying U.S. assets by, at the election of the taxpayer, a fixed or actual ratio. The fixed ratio is 95% in the case of banks and other financial institutions and 50% in all other cases. The actual ratio is the ratio of worldwide liabilities to worldwide assets.

The election of the taxpayer to use a fixed or actual ratio may be revoked only with consent. If an election made under the interest allocation rules controls for BPT purposes, a dilemma may be created for taxpayers who may have different objectives under the interest expense allocation rules and under the BPT provisions.

The following examples illustrate the effect on DEA of an increase or decrease in U.S. net equity.

EXAMPLE 2: F, a foreign corporation resident in a country which does not have a treaty with the U.S., is formed in 1987. It invests $315,000 to purchase a nonresidential building in the U.S. (but not the land on which it is situated). F earns positive cash flow of $30,000 for 1987 and has $10,000 of depreciation for income tax purposes. F's taxable income is $20,000 and it pays a corporate income tax of $8,000 (*i.e.*, at a 40% rate). F distributes $22,000 of its cash flow on 12/31/87, leaving the balance for payment of its U.S. tax liability.

1. F's effectively connected earnings and profits must first be calculated:

Taxable income	$20,000
Section 312(k) adjustment	2,125
Less income tax	(8,000)
Total	$14,125

2. Adjustment for changes in U.S. net equity:

	Previous year-end	Close of current year
Building net of depreciation allowed under Section 312(k)	-0-	$307,125
Cash	-0-	8,000
Liabilities	(-0-)	(8,000)
U.S. net equity	-0-	$307,125

3. Adjustment for increase in U.S. net equity:

Effectively connected E&P	$14,125
Reduction for increase in U.S. net equity	(14,125)
DEA	-0-

First year earnings are deferred for BPT purposes.

EXAMPLE 3: In 1988, F's operating results are identical to its results in 1987. However, since the income tax rate is 34% rather than 40%, its income tax liability is $6,800 (34% × 20,000) rather than $8,000. As a result, its effectively connected E&P is $15,325. At the end of 1988, the basis for E&P purposes of its building has been reduced from $307,125 to $299,250 (by the $7,875 of depreciation allowed for E&P purposes).

Taking into account only its building and its income tax liability, there has been a net reduction of U.S. net equity of $6,675 ($7,875 reduction for depreciation, partially offset by a $1,200 reduced tax liability). If F were to distribute $15,400 of cash leaving $14,600 (or $1,200 more than necessary to meet its tax obligations), its DEA subject to BPT (assuming all of the cash were considered to be U.S. assets) would be $22,000—the sum of its effectively connected E&P of $15,325, and the reduction in U.S. net equity of $6,675. Thus, its BPT liability would be $6,600 (30% × $22,000). The balance sheet of F as of 12/31/87 and 12/31/88 is shown in Exhibit I in the box on page 7.

Another way to arrive at the BPT of $6,600 is to multiply the sum of the effectively connected earnings and profits ($15,325) and the reduction in U.S. net equity not attributable to BPT ($6,675 − $6,600) by

30% ($4,620) and then divide such product by 70%.

EXAMPLE 4: The facts are the same as in Example 3, except that F borrows $50,000 all of which it repatriates to its home office but does not distribute. It is assumed that F determines its U.S. liabilities consistent with Reg. 1.882-5 by using the "actual ratio." F multiplies its U.S. assets (or $313,850) by a fraction, the numerator of which is worldwide liabilities (in this case assumed to be $63,400) and the denominator of which is worldwide assets (in this case $363,850, *i.e.*, $313,850, plus $50,000 loan proceeds). In that case, F's U.S. liabilities would be approximately $54,700 rather than $13,400, or, approximately $41,300 more than in the prior example, decreasing its U.S. net equity to $259,150. If instead F were to distribute the $50,000 loan proceeds as a dividend (and assuming F had no other assets or liabilities), the entire $50,000 borrowing would be considered to be a U.S. liability. Thus, U.S. net equity at 12/31/88 would be $250,450, resulting in a reduction of U.S. net equity of $56,675 ($50,000 + $6,675). The DEA subject to BPT would be further increased as a result of such reduction, but only to the extent of effectively connected earnings and profits in prior years.

Reduction in U.S. net equity	$56,675
Prior increase in U.S. net equity giving rise to reduction in DEA	14,125
Increase in DEA as a result of reduction (lower of the two above amounts)	14,125
Effectively connected E&P	15,325
DEA	$29,450

New Branch Level Tax on Excess Interest

The new tax imposed on excess interest illustrates another interaction between the interest expense allocation provisions, the interest source rules and the branch level taxes. New Section 884(f) provides two new rules applicable to foreign corporations *actually* engaged in a U.S. trade or business. The rules literally do not apply to a foreign corporation that is not so engaged, whether or not its income is considered to be effectively connected income.

Section 884(f)(1)(A) provides that in the case of a foreign corporation engaged in a U.S. trade or business, any interest "paid by U.S. trade or business of such foreign corporation" is treated for the purpose of imposing a tax on the foreign recipient thereof and for withholding purposes as if such interest were paid by a domestic corporation. The effect of such treatment is that under Section 861(a)(1) (as modified by the Act) such interest is U.S. source income subject to withholding (except in the case of portfolio interest[11] or interest on bank deposits),[12] regardless of the proportion of income of the foreign corporation that was effectively connected with a U.S. trade or business and regardless of the portion of the interest paid which is deductible for U.S. tax purposes. This is a significant change from the prior law which imposed a 50% threshold before any interest paid by a foreign corporation could have been treated as from U.S. sources.[13]

The new branch level rules will force foreign corporations to reconsider how they conduct U.S. business activities.

U.S. branches of foreign banks rarely met the 50% threshold and as a result generally were not required to withhold the tax on interest paid to foreign lenders. Congress, apparently of the view that the 50% threshold provided an escape hatch for U.S. branches of large foreign corporations, considered reducing the threshold to as low as 10%. Banks lobbied for a 25% compromise but were successful in obtaining the 25% threshold only in the case of dividend payments; in the case of interest, a threshold no longer exists. Nor is there any requirement that interest be deductible for it to be considered from U.S. sources.

Interpreting the New Statute. For interest to be covered by Section 884(f)(1)(A), it must be paid by the foreign corporation's U.S. trade or business. Presumably it is intended that the "paid" requirement will be met where the U.S. trade or business actually bears the interest expense, whether or not the interest is paid currently. However, a specific statement to this effect in the Regulations that are to be issued would be most welcome.

The above assumes it can be determined that the foreign corporation's U.S. trade or business actually bears the interest expense. How will this be determined? To be sure, there will be clear cases where the U.S. trade or business actually maintains separate branch books and the rights of third parties are affected by whether an amount is reflected on such books. Suppose, however, separate branch books are not maintained or the rights of third parties are not affected by what is recorded on such books or the assets of the U.S. branch are not sufficient to support a borrowing of the branch, but the assets of the home office are sufficient?

Even where the interest paid by a foreign corporation is exempt from U.S. tax because of the portfolio interest rule, the bank deposit rule or by virtue of a tax treaty (described below), the interpretation of Section 884(f)(1)(A) is not academic. The reason is that the amount of excess interest subject to tax under new Section 884(f)(1)(B) is the excess of the amount of interest allowed as a deduction to the foreign corporation for U.S. income tax purposes,[14] over the amount of interest described in Section 884(f)(1)(A).

Excess interest is considered as having been received by the foreign corporation from its hypothetical wholly owned domestic subsidiary on the last day of such foreign corporation's taxable year and is considered to be from U.S. sources. The foreign corporation is subject to a tax of 30% (absent a specific exemption under the Code or a lower rate that may apply under a treaty) on the excess interest it is deemed to have received as if it were not effectively connected with the conduct of a U.S. trade or business by the foreign corporation.[15]

Thus, a foreign corporation may be subject to the tax on excess interest even though it is in an overall loss position; there is no requirement that the interest expense giving rise to excess interest give rise to a current income tax benefit. The Conference

Report clarifies that the tax due on excess interest is payable within the time prescribed for filing the foreign corporation's U.S. tax return (not including extensions),[16] implying that withholding is not required.

Source of Interest. Any interest of a foreign corporation that is neither paid by the trade or business in the U.S. of such foreign corporation nor is excess interest is to be considered foreign source income. Thus, consistent with the law prior to its amendment by the 1986 Act, all interest paid by a foreign corporation that is not actually engaged in a U.S. trade or business will be considered to be from foreign sources regardless of the portion thereof that may be deductible because of a net election.[17] However, any interest paid by the U.S. trade or business of the foreign corporation will be considered to be U.S. source interest income even if not deductible.

Issues Under Source Rules. In considering problems which may arise in the application of the above rules, it would be helpful to keep in mind that, for purposes of the imposition of second level taxes, the U.S. trade or business of the foreign corporation is to be treated as a domestic subsidiary.[18] As so regarded, interest expense of the U.S. trade or business should be treated in the same manner as interest expense of an actual U.S. corporation.[19] Consistent with this principle, only the portion of the interest paid by the fictional U.S. subsidiary which is deductible under the interest allocation rules should be treated as U.S. source income. Indeed, any interest paid in excess of the amount deductible is, in effect, treated as not having been incurred by a U.S. trade or business. However, all interest paid by the U.S. trade or business is to be treated for purposes of the U.S. source rules as interest paid by a U.S. corporation. So much for consistency.

It is equally difficult to determine the rationale for imposing a tax on excess interest. One possibility is that the draftsmen felt that the only way to be consistent with the treatment of the U.S. trade or business of the foreign corporation as a separate U.S. corporation would be to disallow any interest expense allocated under Reg. 1.882-5 which was not in fact incurred (paid?) by the U.S. trade or business, since an actual U.S. corporation could not obtain a deduction for interest that it did not incur. However, the tax on excess interest does not accomplish this result: absent an applicable exemption, it is imposed at a flat tax rate without regard to the income of the U.S. trade or business.

Unless it is clarified that the term "paid" as used in Section 884(f)(1)(A) means "paid or accrued," there will be another inconsistency between the interest source rules and the excess interest rules. Consider the simple case of a foreign corporation's U.S. trade or business issuing a zero coupon bond to U.S. persons, the proceeds of which are used in its U.S. trade or business. Assume that the foreign corporation has no activities, assets or income other than those of its U.S. trade or business and that it has no other liabilities. Further assume that at maturity (in say ten years) the face amount of the bond is paid in full by the U.S. trade or business of the foreign corporation.

Under Section 163(e)(1), the issuer of the bond will be entitled to deduct a portion of the original issue discount each year.[20] Because the issuer is a foreign corporation, it must determine the portion of the original issue discount otherwise deductible, which is allocable to effectively connected income. Assume in the simple case, all of the accrued original issue discount is allocable to effectively connected income and therefore is deductible. How much, if any, of the currently accrued original issue discount is excess interest?[21] It would seem that no portion of the original issue discount should be considered excess interest even though none has been paid currently. However, whether this common sense result will be obtained may depend on whether the term "paid" is to be construed as the equivalent of "economically borne by."[22]

Limitations of Tax Treaty Benefits

The imposition of the BPT and the branch level tax on excess interest will,

[1] Section 864(c).

[2] See, e.g., Sections 882(d) and 897(a).

[3] H. Rep't No. 99-841, 99th Cong., 2d Sess. II-647 (1986) (Conference Report).

[4] Reg. 1.312-6(b). The significance of this addition for earnings and profits purposes will become more apparent in the discussion below of tax treaty considerations relevant to the BPT. However, realized gain which is not recognized for income tax purposes because of a nonrecognition provision is not included in earnings and profits. Section 312(f)(1) and Rev. Rul. 76-239, 1976-1 CB 90.

[5] Section 312(k).

[6] Conference Report, *supra* note 3 at II-647.

[7] Were it not for the special exclusion afforded by Section 884(d)(2)(A), such income would be included in effectively connected earnings and profits. See Reg. 1.312-6(b) and note 4, *supra*.

[8] Conference Report, *supra* note 3 at II-647.

[9] Section 884(b)(2). New Section 864(c)(7) which treats gain on the disposition of former U.S. business property as effectively connected if the disposition occurs within ten years of the cessation, may provide a convenient further deferral.

[10] See Reg. 1.882-5(b)(2).

[11] Sections 871(h) and 881(c).

[12] Sections 871(i)(2)(A) and 871(i)(3).

[13] See Section 861(a)(1)(C) (prior to its amendment by the 1986 Act).

[14] Reg. 1.882-5.

[15] Section 881(a); Conference Report, *supra* note 3 at II-648. The Conference Report contemplates that Regulations will prescribe rules that may treat excess interest as having been incurred on each type of external borrowing by the foreign corporation. *Id.* at II-649. As so treated, all or a portion thereof may be exempt from the 30% tax pursuant to a specific Code provision. See Sections 871(h) and 871(i)(2)(A).

[16] Conference Report, *supra* note 3 at II-648.

[17] See Sections 861(a)(1) and 884(f)(1). *Cf.* Section 884(f)(2) (defining effectively connected income for purposes of Section 884(f) as including income considered to be effectively connected).

[18] Conference Report, *supra* note 3 at II-648.

[19] But, of course, the revised "80:20" rule of Section 861(a)(1)(B) is not to apply to the fictional U.S. corporation, whereas it could apply to an actual U.S. corporation.

[20] *Cf.* Section 163(e)(3).

[21] *Cf.* Section 163(e)(3).

[22] While the example illustrates the case of a zero coupon bond, the same result would appear to obtain to the extent of any interest not currently payable, regardless of whether such deferred obligation gives rise to OID.

[23] See, e.g., U.S. Model Income Tax Convention, Article 24(3); U.S.-Canada Income Tax Convention, Article XXV(6).

[24] See, e.g., U.S.-U.K. Income Tax Convention, Article 7(1); U.S.-Canada Income Tax Convention, Article VII(1).

[25] See Section 883(e)(4) and discussion, *infra*.

[26] Section 884(e)(1); Conference Report, *supra* note 3 at II-650.

[27] Conference Report, *supra* note 3 at II-650.

[28] Conference Report, *supra* note 3 at II-648-9. The reference in the Conference Report to a specific treaty exemption may imply that it is intended that a reduced rate under an interest provision is to apply to excess interest.

of course, conflict with existing treaties. For example, nondiscrimination provisions of treaties generally preclude the imposition of taxes on the business income of treaty residents which are more onerous than taxes imposed on similar activities of U.S. persons.[23] Similarly, tax treaties typically prohibit the U.S. from taxing business profits of a treaty resident unless the treaty resident has a permanent establishment in the U.S. to which such income is attributable.[24]

Qualified Residents. In general, the new provisions do not override conflicting treaty provisions in the case of "qualified residents."[25] Thus, a foreign corporation that maintains a permanent establishment in the U.S. and is a qualified resident of a country that has a treaty nondiscrimination provision similar to Article 24(3) of the U.S. Model Income Tax Convention will not be subject to the BPT with respect to its E & P which are attributable to its U.S. permanent establishment whether or not the treaty allows a secondary withholding tax on dividends; nor would such a foreign corporation appear to be subject to the branch level tax on excess interest.[26]

Where the taxation of a U.S. permanent establishment is not at issue, the entitlement to an exemption from the BPT and branch level taxes on excess interest under a treaty provision similar to Article 24(3) may be more problematic. However, it is intended that a foreign corporation that is engaged in a U.S. trade or business but is exempt from U.S. income tax on its business profits because it has no U.S. permanent establishment will not be subject to the BPT with respect to such income (even though such income would otherwise be included in effectively connected earnings and profits) if it is a qualified resident.[27] While, as a matter of policy, it would seem that the foregoing principle should carry over to the branch level tax on excess interest, it is unclear whether this is the intention.[28]

Nonqualified Residents. By contrast, a treaty resident that is not a qualified resident will be subject to BPT on its business profits even though exempt under a treaty business profits clause from income tax thereon,[29] and even though it would otherwise be entitled to nondiscriminatory treatment under the treaty. However, a treaty provision that bars the imposition of the BPT will not be overridden unless the treaty does not permit a secondary withholding tax.[30] If the treaty allowed a second level dividend withholding tax to be imposed on U.S. source dividends paid by such corporation, the foreign corporation would nevertheless be exempt from the BPT under Section 884(e)(1)(B).[31] This raises several issues.

Issues to Be Considered. In the event the treaty in question permits a secondary withholding tax on dividend payments only if an income threshold of greater than 25% is met,[32] the issue arises as to whether the treaty permits a withholding tax within the meaning of Section 884(e)(1)(B). While the Conference Report is silent on the issue, the Senate Report[33] indicates that conditions for the imposition of a secondary withholding tax such as the imposition of a 50% income threshold[34] would be construed as permitting a secondary withholding tax if the conditions were met, but presumably would not be so considered if the conditions were not met.

Even more difficult questions arise if the treaty provision permits a secondary withholding tax only with respect to distributions to third country residents.[35] Consider, for example, a Swiss corporation owned in part by Swiss residents and in part by third country residents. While the Swiss treaty would permit a secondary withholding tax on dividends paid to non-Swiss residents, it would preclude the secondary withholding tax on dividends paid to the Swiss resident shareholders. Thus, under a treaty containing a similar provision, it is not clear if the BPT would be imposed on the portion of the DEA equal to the percentage of treaty country ownership or on the entire DEA. Finally, a foreign corporation not exempt from the BPT under a treaty, would not be required to withhold any tax on dividend payments under Section 884(e)(3).[36]

A nondiscrimination provision of a treaty apparently will not prevent the application to a nonqualified resident of the branch level tax on excess interest. Nor will any other provision of a treaty reduce or eliminate the tax imposed under Section 881(a) with respect to U.S. source interest paid by a trade or business in the U.S. or with respect to excess interest and received or deemed to be received by a foreign corporation unless such foreign corporation were a qualified resident.[37]

Application of the Statute to Specific Treaty Provisions. Consider the case of a Netherlands Antilles corporation which is not a qualified resident of the Netherlands Antilles, the U.S. trade or business of which makes an interest payment to a non-U.S. person. Such interest payment would be considered to be U.S. source income. Article XII of the current Netherlands Antilles treaty precludes the imposition of any U.S. income tax or withholding on interest or dividend payments to a foreign person.

Apparently, Section 884(e)(3)(B)(i) was intended to prevent the Antilles corporation in the above illustration

Exhibit I:
Balance Sheet of F as of 12/31/87 and 12/31/88

	1987	1988	Increase/ decrease
U.S. assets			
Cash	$ 8,000	$ 14,600	$6,600
Building net of depreciation	307,125	299,250	(7,875)
Total assets	$315,125	$313,850	($1,275)
U.S. liabilities			
Income Tax	$ 8,000	$ 6,800	($1,200)
BPT	-0-	6,600	6,600
Total liabilities	8,000	13,400	5,400
U.S. net equity	$307,125	$300,450	($6,675)

from claiming the benefits of its own treaty. Significantly, the provision in the treaty which Section 884(e)(3)(B)(i) was designed to override confers a benefit on the third country resident that is the recipient of the interest payment — a person not covered by this provision. However, that person appears to be covered by Section 884(e)(3)(B)(ii). The latter provision, apparently, does not permit a treaty resident that is not a qualified resident to claim the benefits of its own treaty with respect to the receipt of United States source interest income actually paid by another foreign corporation whether or not for other purposes such income may be considered as having been paid by a domestic corporation.

Somewhat more obscure is the application of Section 884(e)(3)(B) to dividends. A foreign corporation not exempt from the BPT as a result of a treaty is not required to deduct or withhold a tax on its actual dividend payments. A nonqualified treaty resident either is subject to the BPT (because the treaty does not permit a secondary withholding tax) or is subject to the secondary withholding tax. In either case Section 884(e)(3)(B)(i) would not seem to have any application to the payment of dividends. Section 884(e)(B)(ii), however, does appear to apply to the recipient of a U.S. source dividend paid by another foreign corporation.

The following examples illustrate some of the results that follow under the Netherlands Treaty from classification of a foreign corporation as a treaty shopper.

EXAMPLE 5: N, a treaty shopper Dutch corporation is engaged in a U.S. trade or business but does not maintain a permanent establishment in the U.S. It realizes $1,000 of "effectively connected" gross income from U.S. sources in its first taxable year beginning after 1986. It has related expenses of $950 attributable to salaries payable to its principals (assumed to be reasonable in amount) for services performed by them outside the U.S. However, such salaries are deferred.

1. N is not subject to Federal income tax because of Article III(1) of the U.S.-Netherlands treaty.

2. However, since exempt business profits are includable as effectively connected earnings and profits in cases of treaty shopping, N is subject to BPT on $1,000. The $950 salary expense is deductible only when paid under Section 404.

EXAMPLE 6: N, a treaty shopper Dutch corporation, is engaged in a U.S. trade or business through a permanent establishment. A nondiscrimination provision of the treaty should ordinarily prevent the application of the BPT to a Dutch corporation. However, since Article XII of the treaty prevents the application of a U.S. withholding tax, the BPT will be imposed pursuant to Section 884(e)(1)(B).

In the case of a qualified resident of a treaty country that is subject to the BPT (for example, because the treaty does not have an appropriate nondiscrimination article), the 30% rate generally applicable will be replaced by the rate of tax specified in such treaty on branch profits,[38] or if no such rate is specified, the rate applicable will be the rate of tax which may be imposed on dividends paid by a wholly owned domestic subsidiary corporation according to Section 884(e)(2)(A). Furthermore, where a treaty provides for a branch profits tax, any limitation in such treaty with respect to the imposition of such tax applies to the BPT imposed on a qualified resident.

The U.S.-Canada Income Tax Convention (the "Convention") is one of the few treaties which has a specific provision dealing with branch profits. Article X(6) of the Convention specifically overrides Article XXV(6) (the nondiscrimination provision of the Convention) to the extent the latter provision would bar a tax permitted by the former. In this connection, Article X(6) specifically authorizes a branch profits tax imposed on the earnings of a Canadian corporation which are attributable to a U.S. permanent establishment, but apparently does not authorize a branch profits tax imposed on income which is not so attributable. In the case of earnings that are attributable to a U.S. permanent establishment, Article X(6) literally authorizes only a branch profits tax of 10% of the base set forth in that provision,[39] a limitation of the type to which the BPT will defer (except for treaty shopping cases). Thus, it appears fairly clear that with respect to earnings and profits attributable to a U.S. permanent establishment, Article X(6) of the Convention will permit the BPT but will limit the tax to 10% of the prescribed base. It also appears reasonably clear that Article X(6) does not authorize a branch level tax on excess interest as the latter term does not appear to come within the definition of "earnings;" nor would a branch level tax on excess interest appear to be permitted by Article XXV(6) of the Convention where the taxation of a United States permanent establishment is at issue.

This result should be contrasted with that of a non-treaty shopper foreign corporation resident in a country whose treaty with the U.S. does not have a branch profits provision, and has a nondiscriminatory provision barring such a tax. Thus, a qualified resident of the Netherlands with a U.S. permanent establishment would not be subject to the BPT *at all* because of the nondiscriminatory provision of Article XXV(3).

A more difficult issue arises in the case where a Canadian corporation engages in a U.S. trade or business, but does not maintain a permanent establishment. To the extent the income in question constitutes income exempt under Article VII(1), it is intended that such income would not be subject to the BPT, except in treaty shopping cases. The issue may arise, however, with respect to income that is not exempt under Article VII(1) such as, for example, interest, or real property income or gain. Literally, Article XXV(6) would have no application since the taxation of the income of a permanent establishment is not in issue, Article X(6) does not appear to authorize any branch profits tax applicable to earnings that are not attributable to a permanent establishment and, except to the extent authorized by Article X(6), Article X(5) appears to specifically preclude a second level tax, such as the BPT, imposed on undistributed earnings which are not attributable to a permanent establishment in the U.S.

However, there may well be a technical difficulty in concluding

that Article X(5) precludes branch level taxes on excess interest because such taxes are not imposed on undistributed profits, but rather are imposed on notional interest income, and as such may not be covered by the Convention[40] let alone Article X(5) thereof. Thus, while it may be difficult to conceive of the policy reason for permitting a branch level tax on excess interest where a tax on undistributed profits could not be imposed, it is unclear how the Regulations will deal with the issue, if at all. Indeed, the Regulations may take the position that a 15% rate (under Article XI(2)) is to apply to excess interest in these circumstances.[41]

Further, even if a branch profits provision of the type referred to above could be interpreted as prohibiting a branch level tax on excess interest, few treaties contain such a clause. In certain cases treaties exempt interest from U.S. taxation where there is no permanent establishment, *e.g.*, the Netherlands and the U.K. treaties, and it may well be that taxation of excess interest will similarly be exempt. However, many treaties do not eliminate U.S. taxation of interest, *e.g.*, the treaties with Canada, Japan, Switzerland, and Australia. The treatment of excess interest with respect to nontreaty shoppers must be clarified in these cases.

Qualified Residents and Treaty Shopping

Whether a foreign corporation is a qualified resident of a treaty country is of considerable significance. While a qualified resident is entitled to claim the benefits of a treaty provision which is inconsistent with the BPT, a treaty resident which is not a qualified resident is entitled only to the limited treaty relief afforded under Section 884(e)(1)(B).

A "qualified resident" must first be a resident of the foreign treaty country within the meaning of the treaty under which it is claiming treaty benefits. Qualifying as a resident within the meaning of the treaty is not enough, however: for a foreign corporation to be a qualified resident either it must meet both a stock ownership and an income test, or its shares must be primarily and regularly traded on an established securities market in the foreign country.

Tests to Be a Qualified Resident. According to Section 884(e)(4)(A)(i), a foreign corporation meets the stock ownership test if at least 50% of the value of its shares are beneficially owned directly or indirectly by individuals who are resident in such foreign country, or are citizens or residents of the U.S. In determining ownership for this purpose, stock owned directly or indirectly by or for a corporation, partnership, estate or trust will be considered as owned proportionately by their shareholders, partners or beneficiaries. Thus, for example, a Canadian corporation the shares of which are owned 40% by Canadian individual residents, and 60% by a U.S. corporation which is owned by Dutch citizens, will not meet the stock ownership test.

A foreign corporation that is a resident of a treaty country which meets the stock ownership test must still pass an income test. Under that test, if 50% or more of its income is used (directly or indirectly) to meet liabilities to persons who are not residents of the foreign country or the U.S., the foreign corporation is presumed to be a treaty shopper pursuant to Section 884(e)(4)(A)(ii) unless such foreign corporation can satisfy the Treasury that it should be entitled to treaty benefits.[42]

The income test may lead to odd results. Consider C, a large Canadian corporation owned 100% by one individual Canadian resident. C is engaged in business in ten jurisdictions, including the U.S. and Canada, in each case through a permanent establishment, C's operations in each of the ten jurisdictions are equal in size, C's profits are earned equally in the ten jurisdictions and C incurs expenses of equal amount in each of the jurisdictions. C's expenses are equal to 70% of its gross income. Since 80% of the expenses are incurred outside of the U.S. and Canada and since expenses equal 70% of income, expenses incurred outside of the U.S. and Canada equal 56% of its total income. In such case, C literally would be considered to be a treaty shopper since 50% or more of its income is used to meet liabilities to persons who are neither Canadian residents nor U.S. residents.[43] However, it is unclear that such a result is intended.

To meet the publicly traded exception, Section 884(e)(4)(B) requires that stock of the foreign corporation (or its parent organized in the same jurisdiction) must be primarily and regularly traded on an established securities market in the foreign country. Thus, returning to the previous example, if the shares of the Canadian corporation were primarily and regularly traded only on the New York Stock Exchange, the test would not be met, but if its shares were so traded on an established securities market in Canada, the test would be met. Moreover, public trading of the shares of the U.S. corporate stockholder would

[29] Conference Report, *supra* note 3 at II-650.

[30] See e.g., U.S.-Netherlands Income Tax Convention, Article XII; U.S.-Netherlands Antilles Income Tax Convention, Article XII; U.S.-Japan Income Tax Convention, Article 6(1); U.S.-Korea Income Tax Convention, Article 6(1); U.S.-Italy Income Tax Convention, Article 10(5).

[31] See, e.g., U.S. Model Income Tax Convention, Article 10(5).

[32] See, e.g., U.S.-France Income Tax Convention, Articles 13(1)(a), 9(4)(b)(80%).

[33] S. Rep't No. 99-313; 99th Cong., 2d Sess. 405 (1986).

[34] See, e.g., U.S.-Canada Income Tax Convention, Article 10(7); U.S. -Australia Income Tax Convention, Article 10(5)(c).

[35] See U.S.-Switzerland Income Tax Convention, Article XIV(1). The Swiss treaty does not contain a nondiscrimination provision that would prevent the application of the BPT.

[36] This rule seems to permit prior accumulations of earnings and profits to be paid out without withholding if in the year of payment the payor is subject to the BPT. But see S. Rep't No. 99-313, *supra* note 33 at 407.

[37] Sections 884(f)(1) (last sentence) and 884(e)(3)(B)(ii); Conference Report, *supra* note 3 at II-649.

[38] See U.S.-Canada Income Tax Convention, Article X(6).

[39] Article X(6) of the Convention permits a branch profits tax on business profits attributable to a U.S. permanent establishment which exceed prior years' losses and $500,000 (Canadian) and are not reinvested.

[40] See U.S.-Canada Income Tax Convention, Article II(2)(b); U.S. Treasury Department Technical Explanation of the Convention, 1 CCH-Tax Treaties, ¶13175 at 1249-126, 1249-127 (1984).

[41] However, were such a position to be maintained, it would appear to be by concession since excess interest is not interest within the meaning of that provision (Article XI(4)) nor any other type of income described in the Convention. *Cf.* Article XXII.

[42] Section 884(e)(4)(C).

[43] See Section 884(e)(4)(A)(ii).

not help even if those shares were regularly traded in Canada.

Conclusion

In light of the new branch level provisions, foreign corporations will have to reconsider the manner in which they conduct U.S. business activities. For example, in certain circumstances, it may be more beneficial to contribute the assets of a U.S. branch to a U.S. corporation prior to a sale of the U.S. branch's principal assets so as to avoid a significant additional tax under the BPT provisions.

On the other hand, it may still be advisable to carry on business operations through a foreign corporation. Foreign corporations may also have to consider repaying or otherwise refinancing debt, the interest on which would be subject to a withholding tax under the new rules or the payment provisions of which would cause the corporations to be treated as treaty shoppers. In cases where it is decided that doing business through a foreign rather than a domestic corporation is preferable, consideration must also be given to avoiding the new excess interest rules.

Moreover, consideration must be given to the new partnership withholding rules of Section 1446, and provisions of the 1986 Act other than the branch level tax which will affect the taxation of foreign corporations doing business in the U.S. ★

NEW DECISIONS

IRS announcd that it will grant relief with regard to the product grouping rules. (Notice)

The IRS has announced that it will grant relief under Section 7805(b) with regard to the product grouping rules of the final Regulations under Section 936(h), which were published in the Federal Register on 6/13/86. *Notice* 86-9, IRB 1986-35.

Form 5471 revised to reflect transactions between foreign corporations with common U.S. owner. (Ann.)

The Service has revised Form 5471, Information Return With Respect to a Foreign Corporation, to reflect a new regulatory requirement under Section 6038. U.S. taxpayers who control more than one foreign corporation must now report transactions between the corporations on Schedule M (Form 5471). *Ann.* 86-77, IRB 1986-24.

Form 926 revised. (Ann.)

Form 926, Return by a Transferor of Property to a Foreign Corporation, Foreign Estate or Trust, or Foreign Partnership, has been revised to reflect Temp. Reg. 1.6038B-1T. That Regulation provides that in cases of Section 367 transfers, information concerning the transfer must be made available to the Service. Information concerning the identity of the transferor and transferee, a description of the property transferred, the amount of consideration received, and use of the property must now be provided. This information must be attached to Form 926 and filed with the income tax return. *Ann.* 86-79, IRB 1986-26.

Computation of foreign tax credit determined. (TC)

Taxpayer, a U.S. citizen residing and working in Germany, received foreign source income and paid German income taxes. He also received incentive payments for working in Berlin, although this pay was not includable in income for purposes of German income tax. The taxpayer did not report the incentive payments on his U.S. income tax returns and claimed the foreign tax credit by taking into account all taxes he paid to Germany. The IRS determined the incentive payments were includable in gross income, and, alternatively, they reduced his allowable foreign tax credit.

Held: For Commissioner (in part). Since the incentive payments did not lead to any reduction or rebate in German taxes, the taxpayer was correct to take into account all taxes he paid to Germany in computing his foreign credit. However, the incentive payments are includable in the taxpayer's gross income and are not exempt from taxation under the U.S.-Germany tax treaty since the treaty is designed to prevent double taxation and these amounts were not taxed in Germany. Nor were the payments compensation for services exempt from U.S. tax under the terms of the treaty. *Foley, Jr.*, 87 TC No. 35.

U.S. citizen subject to self employmeny tax on Canadian earnings. (TC)

Taxpayer, a minister and citizen of the United States who resided in Canada, did not pay any U.S. self-employment tax on his U.S. or Canadian earnings. The Service determined that he was subject to the tax on the earnings from both jurisdictions. The taxpayer contended that he was entitled to relief under Section 7852(d) by which the Code is inapplicable where it conflicts with a treaty. The IRS said that the taxpayer was not exempt under the treaty.

Held: For the Commissioner. Unless a provision in a treaty specifically exempts a taxpayer from a savings clause in a treaty, a signatory reserves its right to tax its citizens as if the treaty did not exist. Since personal services are not specifically excepted under the treaty, the taxpayer's earnings are taxable in the U.S., and he is subject to self-employment tax. *Duncan*, 86 TC No. 58.

Publication concerning information on U.S.-Canada Tax Treaty available. (Ann.)

Publication 597, Information on the United States—Canada Income Tax Treaty, is now available. The document provides the text of the treaty and an explanation. The explanatory text is directed to U.S. citizens and residents who receive Canadian source income. *Ann.* 86-81, IRB 1986-26.

Form 8404 to determine interest charge on DISC-related deferred tax liability. (Ann.)

The Service has provided new Form 8404 for use by shareholders of interest charge domestic international sales corporations (IC-DISCs) to determine the interest charge on DISC-related deferred tax liability based on the deferred DISC income. *Ann.* 86-44, IRB 1986-14.