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WHITHER THE BRANCHES?

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Whither The Branches?

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I. Introduction

A. *Tax Reform and Statutory Interpretation*

As commercial transactions become increasingly complex and the potential revenue loss to the U.S. government on sophisticated transactions becomes larger, Congress is increasingly active in the area of income tax legislation. In this decade alone, Congress (thus far) has enacted five comprehensive income tax acts,[1] three "technical corrections" acts,[2] four acts completely overhauling specific income tax provisions of the Internal Revenue Code,[3] and some 70 other major and minor statutes amending the Code.[4] In many cases, particularly in recent years, Congress has added provisions to the Code that describe the intended law in extremely general terms, expressly leaving it to the Secretary of the Treasury to interpret the provisions in regulations.[5] As a result, the Department of the Treasury has been increasingly active in drafting and promulgating proposed, temporary, and final regulations.[6] Since the enactment of the

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[1] Revenue Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330-382 [hereinafter 1987 Act]; Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 [hereinafter 1986 Act]; Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494; Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324; Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172.

[2] Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 [hereinafter 1988 Act]; Technical Corrections Act of 1982, Pub. L. No. 97-448, 96 Stat. 2365 (1983); Technical Corrections Act of 1979, Pub. L. No. 96-222, 94 Stat. 194 (1980). In addition, the 1986 Act contains technical corrections to the Deficit Reduction Act of 1984, which contains technical corrections to the Tax Equity and Fiscal Responsibility Act of 1982 and other tax legislation.

[3] Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669; Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389; Installment Sales Revision Act of 1980, Pub. L. No. 96-471, 94 Stat. 2247; Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, 94 Stat. 229.

[4] For example, Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, 100 Stat. 1874; Interest and Dividend Tax Compliance Act of 1983, Pub. L. No. 98-67, 97 Stat. 369.

[5] For example, IRC §§ 337(d), 338(i), 382(m), 469(k), 884(g), 904(d)(5). In addition, Congress throughout the Code has inserted phrases such as "as the Secretary shall by regulations prescribe" or "except as provided in regulations" in order to delegate legislative authority with respect to a specific matter, rather than an entire provision, to Treasury. For example, IRC §§ 67(c)(1), 367(e)(2), 465(b)(3)(A), 469(h)(2), 897(e)(2), 1446(a).

[6] As of May 31, 1989, Treasury had 507 open regulations projects. Office of Chief Counsel, Report on Regulations Projects Status and Disposition as of May 31, 1989, reprinted in Daily

Tax Reform Act of 1986, the Internal Revenue Service has been actively issuing expedited guidance in published form on newly enacted Code provisions, generally in the form of notices and announcements.

Anyone involved in structuring a transaction upon which recent legislation may have an effect—and it is difficult to imagine a transaction not falling into this category—is required to consult a myriad of primary sources in his or her search for the likely tax result. Potential pitfalls may be found in (1) Code provisions; (2) tax statutes not included in the Code; (3) temporary, proposed, and final regulations; (4) congressional committee reports; (5) Joint Committee "bluebooks"; (6) rulings, notices, announcements, news releases, forms, and publications of the Service; and (7) proposed, pending, and enacted "technical corrections" provisions. Increasingly often, the tax planner must act before final regulations have been promulgated, on the sole basis of a vague statute, ambiguous legislative history, and, perhaps, published guidance by the Service. The first question is which of the primary sources are relevant and authoritative.[7]

Generally, enacted statutes are the law; contemporary legislative history is relevant in discerning the meaning of an unclear statute;[8] subsequent legislative history (such as bluebooks and later statutes), while not unequivocal evidence of legislative intent,[9] is cited increasingly by courts and the Service as indicative of the earlier legislative intent;[10] and final regulations have the force of law.[11] Publications of the Service, however, carry less weight. While revenue rulings are official interpretations of the

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Tax Report (BNA) No. 124 (June 29, 1989). As of August 31, 1988, Treasury had issued some 60 sets of regulations on provisions of the 1986 Act and 1987 Act alone. Legislation and Regulations Division, Index to Legal Guidance Issued Under the Tax Reform Act of 1986 and the Revenue Act of 1987 as of August 31, 1988 (Sept. 14, 1988), reprinted in Daily Tax Report (BNA) No. 179, at L-2 (Sept. 15, 1988).

[7] For an excellent recent discussion of the relative weight of federal income tax authority, see Banoff, Dealing with the "Authorities": Determining Valid Authority in Advising Clients, Rendering Opinions, Preparing Tax Returns and Avoiding Penalties, 66 Taxes 1072 (1988).

[8] See 2A N. Singer, Sutherland Statutory Construction §§ 48.01-48.20 (1984 & Supp. 1988). While the Tax Court will seek out legislative history even in the case of a "clear" statute, "unequivocal evidence of legislative purpose" is required in order to construe a statute in a manner that is contrary to its "plain meaning." Compare U.S. Padding Corp. v. Commissioner, 88 T.C. 177, 184 (1987), aff'd, 865 F.2d 750 (6th Cir. 1989), with Woods v. Commissioner, 91 T.C. 88, 98 n.19 (1988), and Hirasuna v. Commissioner, 89 T.C. 1216, 1224 (1987); see generally Kozinski, Hunt for Laws 'True; Meaning Subverts Justice, Wall St. J., Jan. 31, 1989, at A18, col. 3.

[9] See, for example, Zinniel v. Commissioner, 89 T.C. 357, 365-67 (1987).

[10] For example, Federal Power Comm'n v. Memphis Light, Gas & Water Div., 411 U.S. 458 (1973); Merit Life Ins. Co. v. Commissioner, 853 F.2d 1435 (7th Cir. 1988); Holiday Village Shopping Center v. United States, 773 F.2d 276 (Fed. Cir. 1985); Butka v. Commissioner, 91 T.C. 110 (1988); Hirasuna v. Commissioner, 89 T.C. 1216, (1987), LTR 8829068 (Apr. 27, 1988).

[11] See Commissioner v. South Tex. Lumber Co., 333 U.S. 496 (1946).

Code and regulations on which taxpayers "generally may rely,"[12] the Service can usually revoke a revenue ruling retroactively without subjecting itself to an estoppel argument by a taxpayer who relied on the revoked ruling.[13] The Service has ruled that a published notice or announcement is the equivalent of a revenue ruling and, therefore, is an "administrative pronouncement" for purposes of § 6661.[14] Thus, a published notice or announcement can presumably be revoked or superseded by later published notices, announcements, rulings, or, particularly in the case of a notice that announces the content of regulations not yet promulgated, regulations.

B. The Section 884 Paradigm

Section 884, which imposes on certain foreign corporations the branch profits tax (BPT) and branch-level tax on excess interest (BIT), is a case in point. Prior to the enactment of the 1986 Act, a 30% (or lower treaty rate) withholding tax applied to a percentage of the dividends paid by a foreign corporation engaged in a U.S. trade or business to nonresident aliens or foreign corporations not so engaged, but only if 50% or more of the payor corporation's gross income for the three taxable years immediately preceding the close of the taxable year in which the dividend was declared was effectively connected with the conduct of the U.S. trade or business.[15] However, the United States imposed no comparable shareholder-level tax on distributions of profits of a U.S. branch of a foreign corporation.[16] On the other hand, a U.S. subsidiary that paid dividends to its foreign parent, which was not engaged in a U.S. trade or business,

[12] Rev. Proc. 86-15, 1986-1 C.B. 544; see also Reg. § 1.6661-3(b)(2) ("administrative pronouncements," such as revenue rulings, are "authority" for purposes of reducing or eliminating the addition to tax for substantial understatement). The Tax Court, however, treats revenue rulings as statements of the position of one of the litigants, not binding on the court. See, for example, Knowlton v. Commissioner, 84 T.C. 160, 165 (1985), aff'd, 791 F.2d 1506 (11th Cir. 1986).

[13] See IRC § 7805(b); Dixon v. United States, 381 U.S. 68 (1965); Manocchio v. Commissioner, 710 F.2d 1400 (9th Cir. 1983); Butka v. Commissioner, 91 T.C. 110 (1988); Rivers v. Commissioner, T.C. Memo. 1983-567, aff'd mem., 727 F.2d 1103 (4th Cir. 1984); compare Gehl Co. v. Commissioner, 795 F.2d 1324 (7th Cir. 1986), LeCroy Research Sys. Corp. v. Commissioner, 751 F.2d 123 (2d Cir. 1984), and Addison Int'l, Inc. v. Commissioner, 90 T.C. 1207 (1988), with CWT Farms, Inc. v. Commissioner, 755 F.2d 790 (11th Cir. 1985). But see Silco, Inc. v. United States, 779 F.2d 282 (5th Cir. 1986) (rulings the only available authority); Baker v. United States, 748 F.2d 1465 (11th Cir. 1984) (Service may not treat similarly situated taxpayers in a different manner).

[14] Rev. Rul. 87-138, 1987-2 C.B. 287. For an interesting use by the Service of a revenue procedure to prescribe rules the prescription of which is required by statute (§ 1446(a)) to be in regulations, see Rev. Proc. 89-31, 1989-20 I.R.B. 136.

[15] IRC §§ 861(a)(2)(B), 871(a)(1), 881(a), 1441, 1442 (1954).

[16] See S. Rep. No. 313, 99th Cong., 2d Sess. 401 (1986), reprinted in 1986-3 C.B. (vol. 3) 401.

was required to withhold 30% (or lower treaty rate) of the payment.[17]

Congress was concerned that the second-level withholding tax on dividends paid by a foreign corporation was difficult to enforce and was avoided by "nearly all foreign corporations with branches in the United States" by reason of the 50% threshold,[18] resulting in a "disparity in U.S. tax treatment of U.S. subsidiaries and U.S. branches of foreign corporations and . . . of U.S. corporations and foreign corporations that operate in the United States."[19] This disparity, in the eyes of Congress, created an "unintended advantage to foreign corporations" and an "undesirable incentive in many situations for foreign corporations to operate in the United States in branch form."[20] The BPT was enacted in order to "achieve greater parity between the remittance of branch profits and the distributions of subsidiary earnings,"[21] on the theory that a foreign corporation doing business in the United States "should be subject to the same substantive tax rules" that apply to a foreign corporation operating in the United States through a U.S. subsidiary.[22]

Congress enacted § 884 as part of the 1986 Act and amended it as part of the Technical and Miscellaneous Revenue Act of 1988. At the present time, the tax planner seeking official guidance under § 884 may consult eight committee reports,[23] a bluebook,[24] a technical corrections statute

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[17] IRC §§ 881(a), 1442 (1954).

[18] S. Rep. No. 313, 99th Cong., 2d Sess. 401 (1986), reprinted in 1986-3 C.B. (vol. 3) 401.

[19] H.R. Rep. No. 426, 99th Cong., 1st Sess. 432 (1985), reprinted in 1986-3 C.B. (vol. 2) 432.

[20] S. Rep. No. 313, 99th Cong., 2d Sess. 401 (1986), reprinted in 1986-3 C.B. (vol. 3) 401; H.R. Rep. No. 426, 99th Cong., 1st Sess. 432 (1985), reprinted in 1986-3 C.B. (vol. 2) 432.

[21] Conf. Rep. No. 841, 99th Cong., 2d Sess. II-647 (1986), reprinted in 1986-3 C.B. (vol. 4) 647.

[22] S. Rep. No. 313, 99th Cong., 2d Sess. 401 (1986), reprinted in 1986-3 C.B. (vol. 3) 401; see also Staff of the Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986, at 1036 (Comm. Print 1987) [hereinafter 1986 Bluebook]; Notice 86-17, 1986-2 C.B. 379 ("The principal purpose of § 884 is to equalize the tax treatment of U.S. branches and subsidiaries of foreign corporations.").

[23] The 1988 Act committee reports are Conf. Rep. No. 1104, 100th Cong., 2d Sess. (1988); S. Rep. No. 445, 100th Cong., 2d Sess. (1988); and H.R. Rep. No. 795, 100th Cong., 2d Sess. (1988). The committee reports with respect to an unenacted predecessor to the 1988 Act are S. Rep. No. 76, 100th Cong., 1st Sess. (1987); and H.R. Rep. No. 391, 100th Cong., 1st Sess. (1987). The 1986 Act committee reports are Conf. Rep. No. 841, 99th Cong., 2d Sess. (1986), reprinted in 1986-3 C.B. (vol. 4); S. Rep. No. 313, 99th Cong., 2d Sess. (1986), reprinted in 1986-3 C.B. (vol. 3); and H.R. Rep. No. 426, 99th Cong., 1st Sess. (1985), reprinted in 1986-3 C.B. (vol. 2).

[24] 1986 Bluebook, note 22. In addition, for explanations of the technical corrections provisions in the 1988 Act and its unenacted predecessors, see Staff of the Joint Comm. on Taxation, Description of the Technical Corrections Act of 1988 (H.R. 4333 and S. 2238) (Comm. Print 1988); and Staff of the Joint Comm. on Taxation, Description of the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350) (Comm. Print 1987). Apparently, the Joint Committee will not publish a bluebook for the 1988 Act.

(together with two predecessor bills),[25] six IRS notices,[26] one IRS announcement,[27] and temporary and proposed regulations issued under § 884 (the Regulations).[28] Notice 86-17 (the 1986 Notice),[29] which announced rules regarding termination and incorporation of a U.S. trade or business and liquidation and reorganization of a foreign corporation, states that its rules "will be effective until superseded by regulations. Taxpayers may rely on these rules with respect to the specific transactions described herein." As will be discussed below, the Regulations in some cases expand upon the rules announced in the 1986 Notice, in some cases follow those rules, and in some cases are more generous than those rules. Needless to say, the job of the tax planner is not made easy. This article will examine § 884, as amended by the 1988 Act, and the Regulations, attempting to explain and analyze the provisions in order to give the planner some idea of "what the law is."

II. The Mechanics of the BPT

Generally speaking, the BPT is a tax at a 30% rate (or, in certain limited circumstances, at such lower rate as may be prescribed by treaty) "on the after-tax earnings of a foreign corporation's U.S. trade or business that are not reinvested in a U.S. trade or business by the close of the taxable year, or are disinvested in a later taxable year."[30] The idea is to treat the foreign corporation's U.S. businesses as operated by a hypothetical U.S. subsidiary of the foreign corporation, and to apply the BPT to a base that is equivalent to the amount that could have been distributed as a dividend by that hypothetical subsidiary.[31] In the terminology of § 884, this base is the "dividend equivalent amount" (DEA), which, in general, is equal to the foreign corporation's "effectively connected earnings and profits" (ECE & P) for the taxable year, adjusted downward (but not below zero) for an increase in "U.S. net equity" (i.e., U.S. assets less U.S. liabilities) during the taxable year and upward (subject to a limi-

[25] 1988 Act, note 2; H.R. 2636, 100th Cong., 1st Sess. (1987); S. 1350, 100th Cong., 1st Sess. (1987).

[26] Notice 89-80, 1989-30 I.R.B. 10; Notice 89-73, 1989-26 I.R.B. 28; Notice 89-14, 1989-4 I.R.B. 12; Notice 88-133, 1988-52 I.R.B. 28; Notice 87-56, 1987-2 C.B. 367; Notice 86-17, 1986-2 C.B. 379.

[27] Announcement 87-76, 1987-35 I.R.B. 58 (announcing Rev. Rul. 87-80, 1987-2 C.B. 292).

[28] T.D. 8223, 53 Fed. Reg. 34045 (Sept. 2, 1988) (temporary regulations); INTL-934-86, 53 Fed. Reg. 34120 (Sept. 2, 1988) (proposed regulations). The first amendments to the Regulations already have been announced by the Service. Notice 89-80, 1989-30 I.R.B. 10; Notice 89-73, 1989-26 I.R.B. 28; Notice 89-14, 1989-4 I.R.B. 12; Notice 88-133, 1988-52 I.R.B. 28.

[29] 1986-2 C.B. 379.

[30] IRC § 884(a), (b); Temp. Reg. § 1.884-0T(a)(1).

[31] See Blessing, The Branch Tax, 40 Tax Law. 587, 590 (1987); Feingold & Rozen, New Regime of Branch Level Taxation Now Imposed on Certain Foreign Corporations, 66 J. Tax'n 2, 2 (1987).

tation) for a decrease in U.S. net equity during the taxable year.[32] Thus, computing the BPT requires a determination of the foreign corporation's (1) ECE & P, (2) U.S. net equity at the beginning of the taxable year, and (3) U.S. net equity at the end of the taxable year.

A. Effectively Connected Earnings and Profits

In general, ECE & P means the earnings and profits (E & P) or deficits therein, determined under § 312, that are attributable to income of the foreign corporation that is effectively connected with the conduct of a U.S. trade or business[33] (or income treated as effectively connected[34]), regardless of whether the E & P are taken into account in an earlier year (e.g., in the case of an installment sale[35]) or a later year than the corresponding items of taxable income.[36] Pursuant to § 312 principles, items excluded from gross income under § 103 or exempt from tax by reason of a treaty may be includable in ECE & P.[37] As a result, a BPT may be imposed on the U.S. business profits of an enterprise of a treaty country that is exempt from U.S. income tax thereon due to the absence of a permanent establishment, unless the enterprise is a "qualified resident" (discussed below) of a country whose treaty with the United States precludes the imposition of the BPT.

Consistent with the theory underlying the BPT, actual distributions made by the foreign corporation do not reduce the corporation's ECE & P.[38] Moreover, while income taxes serve to reduce E & P under generally applicable § 312 principles,[39] the Regulations provide that the amount of BPT and BIT paid by the foreign corporation does not serve to reduce ECE & P,[40] presumably because, at least in the case of the

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[32] IRC § 884(b); Temp. Reg. § 1.884-1T(b).

[33] See IRC § 864(c).

[34] See, for example, IRC §§ 882(d), 897(a).

[35] See IRC § 312(n)(5).

[36] IRC § 884(d)(1); Temp. Reg. § 1.884-1T(f)(1). ECE & P does not include E & P attributable to, inter alia, gain on the disposition of an interest in a U.S. real property holding corporation that is not otherwise effectively connected, income treated as effectively connected under § 882(e), and income of foreign governments and international organizations described in § 892. IRC § 884(d)(2); Temp. Reg. § 1.884-1T(f)(2). Property and liabilities treated as connected with such E & P are not taken into account in determining the U.S. assets and U.S. liabilities of the corporation. IRC § 884(d); see Temp. Reg. § 1.884-1T(f)(3). Moreover, while income treated as effectively connected solely by reason of § 864(c)(6) or (7) in connection with a complete termination of the U.S. trade or business gives rise to ECE & P, no BPT is imposed thereon. Temp. Reg. § 1.884-2T(a)(4); cf. Temp. Reg. § 1.884-1T(d)(13)(ii).

[37] Temp. Reg. § 1.884-1T(f)(4) Exs. 1 and 2; see Reg. § 1.312-6(b).

[38] IRC § 884(d)(1); Temp. Reg. § 1.884-1T(f)(1). The Regulations go beyond the statute in this respect, stating that distributions made "during any taxable year" will not reduce ECE & P.

[39] See B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 7.03, at 7-19 (5th ed. 1987).

[40] Temp. Reg. § 1.884-1T(f)(1).

BPT, the tax is imposed in lieu of a withholding tax on actual distributions, which would not reduce E & P. The reason for not reducing ECE & P by the BIT is less clear, perhaps because the conceptual basis for that tax is not all that clear. Of course, if the BPT or BIT were to reduce ECE & P, a difficult circular calculation would be required.

In any event, notwithstanding the inability to reduce ECE & P and thus DEA by the amount of BPT and BIT paid, it would appear that either the payment of such taxes or the accrual of a liability therefor will have an impact on the DEA by virtue of its impact on U.S. assets or U.S. liabilities and, accordingly, U.S. net equity. As discussed below, "U.S. liabilities," for this purpose, is defined as U.S. assets multiplied by either the actual ratio of the foreign corporation's worldwide liabilities to worldwide assets at the close of the taxable year or, in certain cases, a fixed ratio. An accrued liability for BPT or BIT presumably would be included within the definition of worldwide liabilities and, therefore, would affect the computation of U.S. liabilities, unless the foreign corporation computes its U.S. liabilities and its interest deduction using a fixed ratio of liabilities to assets.[41] For example, if on January 1, 1989 the U.S. assets of *F*, a foreign corporation that does not use the fixed ratio, totalled $100, its worldwide liabilities totalled $500, and its worldwide assets totalled $1,000, and *F* accrues a liability in 1989 for BPT of $50, its U.S. liabilities would increase by $5 from $50 (i.e., $100 × ($500/$1,000)) to $55 (i.e., $100 × ($550/$1,000)), and its U.S. net equity would decrease by $5 from $50 (i.e., $100 - $50) to $45 (i.e., $100 - $55). Accordingly, the accrual of a liability for BPT or BIT would increase U.S. liabilities and decrease U.S. net equity in an amount equal to the liability for the BPT or BIT multiplied by the ratio of U.S. assets to worldwide assets.

If, however, the foreign corporation pays its BPT or BIT before the end of its taxable year, rather than accruing the liability, and assuming the fixed ratio is not used, the result may depend upon which assets are used to make the payment. If the tax is paid out of non-U.S. assets, U.S. net equity will be reduced: The ratio of worldwide liabilities to worldwide assets will increase, and an increase in such ratio will increase U.S. liabilities and reduce U.S. net equity. In the above example, if the $50 BPT were paid out of *F*'s non-U.S. assets rather than accrued, *F*'s U.S. liabilities would increase by $2.63 from $50 to $52.63 (i.e., $100 × ($500/$950)), and *F*'s U.S. net equity would decrease by $2.63 from $50 to $47.37 (i.e., $100 − $52.63). If, however, the tax is paid out of U.S. assets, U.S. net equity will be reduced even further because there will be both an increase in the ratio of worldwide liabilities to worldwide assets

[41] See Temp. Reg. § 1.884-1T(e)(1); Reg. § 1.882-5(b)(2); notes 87-89 and accompanying text.

and a decrease in U.S. assets. The decrease in U.S. assets (1) reduces the amount of U.S. liabilities, but only in proportion to the ratio of worldwide liabilities to worldwide assets, and (2) directly reduces U.S. net equity dollar for dollar. Again using the above example, if the $50 BPT were paid out of *F*'s U.S. assets rather than accrued, *F*'s U.S. liabilities would *decrease* by $23.68 from $50 to $26.32 (i.e., $50 × ($500/$950)), and *F*'s U.S. net equity would decrease by $26.32 from $50 to $23.68 (i.e., $50 − $26.32).

As mentioned above, decreases in U.S. net equity cause upward adjustments to the ECE & P subject to an overall limitation. The limitation apparently was designed to limit the imposition of the BPT by reason of decreases in U.S. net equity to cases of disinvestment in the U.S. trade or business. As originally enacted, § 884(b)(2)(B) limited the amount of this positive adjustment to an amount not exceeding the aggregate reductions in the ECE & P for prior years caused by increases in U.S. net equity to the extent not previously taken into account by virtue of later decreases. Under the limitation as originally enacted, it appeared that a prior year's deficit in ECE & P could not affect the amount of the increase but that a current year's deficit could affect such increase.

For example, assume *F* has $150 of ECE & P for 1990, that its U.S. net equity at the end of 1989 was $1,000, and that its U.S. net equity at the end of 1990 is $1,150, so that the full $150 of ECE & P is deferred under § 884(b)(1) by reason of the $150 increase in U.S. net equity. Assume further that in 1991 *F* has a deficit in ECE & P of $100 and that its U.S. net equity at the end of 1991 is $1,000 (i.e., it has a reduction in U.S. net equity for 1991 of $150). The current year's deficit in ECE & P of $100 would be netted against the amount of the positive adjustment under § 884(b)(2)(A), resulting in a DEA for 1991 of $50. In this case, the positive adjustment has not been limited under former § 884(b)(2)(B), but rather the full positive adjustment has been made to the negative amount of ECE & P and, therefore, the full amount previously deferred under § 884(b)(1) has been taken into account. If, however, *F* instead has no decrease in U.S. net equity for 1991, no ECE & P for 1992, and a $150 decrease in U.S. net equity for 1992, a literal reading of former § 884(b)(2)(B) would have imposed a limitation of $150 (i.e., for the increase in U.S. net equity in 1990) and the $150 reduction in U.S. net equity for 1992 would have resulted in a DEA of $150.

The Regulations provide a somewhat more liberal rule, under which the positive adjustment to the ECE & P occasioned by a decrease in U.S. net equity will not exceed the "non-previously taxed accumulated effectively connected earnings and profits" at the close of the preceding year, which is defined as the excess of the aggregate amount of the ECE & P for taxable years beginning after December 31, 1986 over the aggregate

DEAs for those years.[42] Under the Regulations, each of the examples above would result in an overall DEA of $50.[43] Section 884(b)(2)(B), as amended by the 1988 Act, similarly limits the positive adjustment under § 884(b)(2)(A) to the "accumulated effectively connected earnings and profits" as of the close of the preceding year, which is defined as the excess of the aggregate ECE & P for preceding years beginning after 1986 over the aggregate DEAs for those years.[44] Thus, § 884 now requires a foreign corporation that has a U.S. trade or business to keep current and accumulated ECE & P accounts similar to the E & P accounts contemplated under § 316. Both nonpreviously taxed accumulated ECE & P and accumulated ECE & P will be referred to in this article as "deferred ECE & P."

As noted above, a prior year's deficit in ECE & P affects the computation of deferred ECE & P, which is relevant in determining the limitation, if any, on the amount of the positive adjustment required in the case of a decrease in U.S. net equity. A prior year's deficit in ECE & P does not, however, reduce the amount of the current year's ECE & P.[45] For example, suppose *F* has a deficit in ECE & P for 1989 of $100 and ECE & P for 1990 of $100. Assuming no change in U.S. net equity, the DEA for 1990 will be $100. Suppose, however, that *F* increased its U.S. net equity in 1990 by $100, thereby deferring the DEA, and then in 1991 its U.S. net equity is reduced by $100. In this case, the DEA for 1991 should be zero because, after taking into account the $100 deficit from 1989, deferred ECE & P is zero.[46]

B. U.S. Net Equity

As stated above, the DEA of a foreign corporation is the ECE & P adjusted for the difference, if any, between the U.S. net equity of the foreign corporation as of the close of the current year and the U.S. net equity as of the close of the preceding year.[47] The Code defines U.S. net equity as U.S. assets reduced by U.S. liabilities, and provides that U.S. net equity may be negative.[48]

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[42] Temp. Reg. § 1.884-1T(b)(3)(ii).

[43] See Temp. Reg. § 1.884-1T(b)(4) Ex. 5.

[44] 1988 Act, note 2, at § 1012(q)(1)(A).

[45] Temp. Reg. § 1.884-1T(b)(4) Ex. 6. This might be referred to as a "nimble dividend equivalent" rule. See IRC § 316(a)(2).

[46] This result is subject to an anti-abuse rule providing that U.S. assets do not include property acquired or used if "one of the principal purposes" of the acquisition or use "is to increase artifically the U.S. assets" of the foreign corporation on the determination date. Temp. Reg. § 1.884-1T(d)(B)(iii); see note 51 and accompanying text.

[47] IRC § 884(b).

[48] IRC § 884(c)(1); see Temp. Reg. § 1.884-1T(c). As a result, the reduction of a negative amount of U.S. net equity will constitute an increase in U.S. net equity.

1. U.S. Assets

U.S. assets generally means the amount of money and the aggregate adjusted bases for E & P purposes of the property of a foreign corporation that are treated under regulations as connected with the conduct of a U.S. trade or business.[49] Section 884(c)(2)(C) requires those regulations to be consistent with the allocation of deductions under § 882(c)(1), which, in general, allows deductions to the extent they are connected with effectively connected income.[50]

The Regulations provide that property is considered to be a U.S. asset if it (1) fits within certain enumerated categories of property (Included Categories) *and* (2) does not fit within certain other enumerated categories of property.[51] However, property not enumerated in an Included Category nevertheless will be a U.S. asset if all income from the use (and all gain on disposition) of that property is effectively connected income (or would be if the property were used or sold on the relevant date).[52] Presumably the term "use" is to be given a broad meaning.[53] Thus, for example, loans receivable of a U.S. branch of a foreign bank, all the interest on which is effectively connected income, should meet the use requirement. It would appear that the "all income" test would apply to characterize only a limited class of assets of a foreign corporation that are not in the Included Categories as U.S. assets.[54]

Apparently, the determination of whether the all income test is met for an item of property is made as of the "determination date," which is defined as the day on which a determination is made as to whether prop-

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[49] IRC § 884(c)(2)(A); cf. Reg. § 1.882-5(a)(2) (permitting valuation on the basis of either fair market value or adjusted basis for purposes of the interest deduction).

[50] Reg. § 1.882-4(c)(1). Expenses are allocated and apportioned to effectively connected income in accordance with § 1.861-8 (or, in the case of the interest deduction, § 1.882-5). Id.

[51] Temp. Reg. § 1.884-1T(d)(13). The excluded categories of property include (1) property the income, gain, or loss from which would not produce ECE & P; (2) property that would qualify as a U.S. asset solely by reason of § 864(c)(7) (relating to dispositions of property within 10 years after the property ceases to be used or held for use in a U.S. trade or business); and (3) property one of the principal purposes of the acquisition or use of which is to increase artificially the U.S. assets of the foreign corporation. Temp. Reg. § 1.884-1T(d)(13); see IRC § 884(d)(2); Temp. Reg. § 1.884-1T(f)(2); cf. S. Rep. No. 313, 99th Cong., 2d Sess. 404 (1986), reprinted in 1986-3 C.B. (vol. 3) 404 (regulations will address situations in which a branch temporarily increases its assets "merely to reduce its branch profits tax base").

[52] Temp. Reg. § 1.884-1T(d)(1)(ii).

[53] Cf. Temp. Reg. § 1.884-2T(a)(2)(v); note 112 and accompanying text.

[54] For example, because gain from the disposition of personal property by a foreign corporation generally will be foreign-source income (§ 865(a), (g); cf. § 865(e)(2)(A)), such dispositions will result in effectively connected income (and, accordingly, the property will be a U.S. asset) only if the property is inventory, the sale or exchange takes place through the corporation's U.S. office or other fixed place of business, and the property is not sold for use or resale outside the United States with a foreign office or other fixed place of business materially participating in such sale. IRC § 864(c)(4)(B)(iii). See also IRC § 864(c)(4)(B)(ii).

erty is a U.S. asset.[55] The only dates upon which such a determination must be made appear to be the last day of the current and preceding taxable years.[56] As a result, as of the last day of each taxable year, a determination must be made as to whether all income from the use of property not in an Included Category would be effectively connected income and if a sale on such day would give rise to effectively connected gain.

Section 1.884-1T(d)(2) through (12) of the Regulations enumerates the Included Categories.

a. *U.S. Real Property Interests*

A U.S. real property interest other than an interest in a domestic U.S. real property holding corporation is a U.S. asset whether or not current income derived therefrom is effectively connected.[57] An interest other than solely as a creditor in a domestic U.S. real property holding corporation or former domestic U.S. real property holding corporation is not a U.S. asset even if income from the disposition of such interest would give rise to effectively connected income.[58]

b. *Inventory*

Inventory is treated as a U.S. asset in the same proportion that the anticipated amount of gross sales from the sale or exchange of the property that is reasonably anticipated to be effectively connected bears to the anticipated total amount thereof.[59] U.S.-source inventory gain will automatically be effectively connected income.[60] Foreign-source inventory

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[55] Temp. Reg. § 1.884-1T(d)(1)(i).

[56] IRC § 884(b); Temp. Reg. § 1.884-1T(c).

[57] Temp. Reg. § 1.884-1T(d)(5)(i); see IRC § 897(c)(1)(A)(ii).

[58] See IRC §§ 884(d)(2)(C), 897(c)(1)(A)(ii); Temp. Reg. § 1.884-1T(d)(13)(i), (f)(2)(iii). The temporary regulations under § 897 provide that, pursuant to § 897(g), an interest in a partnership that meets both a 50% and 90% test shall, for purposes of determining the amount of gain that is considered to be derived from the disposition of a U.S. real property interest, be considered to be a U.S. real property interest to the extent gain on disposition of the interest is attributable to U.S. real property interests. Temp. Reg. § 1.897-7T(a). The aforesaid regulation applies to transfers occurring after June 6, 1988. Temp. Reg. § 1.897-7T(b). Notice 88-72, 1988-27 I.R.B. 26, suggests that in connection with the sale or exchange of a partnership interest, "attributable" gain may be treated as from the disposition of a U.S. real property interest whether or not the 50/90% test is met and whether or not the transfer occurs after June 6, 1988. Neither the regulation nor the notice appears to require that a partnership interest itself be treated as a U.S. real property interest (other than for § 1445 withholding purposes). Cf. IRC § 897(c)(4)(B); Temp. Reg. § 1.884-1T(d)(9), discussed below. For the rather broad definition for this purpose of interests other than solely as a creditor, see Reg. § 1.897-1(d)(3), (4).

[59] Temp. Reg. § 1.884-1T(d)(3).

[60] IRC § 864(c)(3). For inventory sourcing rules, see IRC §§ 861(a)(6), 862(a)(6), 863(b), 865(e)(2).

gain generally will be effectively connected only if the foreign corporation maintains a U.S. office to which the gain is attributable and through which the sale is made; however, the gain will not be effectively connected if the property is sold for use, consumption, or disposition outside the United States and a foreign office or other fixed place of business materially participates in the sale.[61] Inventory gain of a foreign corporation with respect to purchased property will generally be sourced at the place of sale,[62] and inventory gain of a foreign corporation with respect to manufactured property will generally be sourced in part at the place of manufacturing and in part at the place of sale.[63] However, income from sales attributable to a U.S. office or other fixed place of business, other than sales (1) for use, disposition, or consumption outside the United States, and (2) with respect to which a foreign office or other fixed place of business materially participates, is sourced in the United States.[64]

Thus, inventory on hand at the close of a taxable year will be a U.S. asset, regardless of whether or where that property is manufactured by the foreign corporation, if it is reasonable to anticipate that the inventory will be sold through a U.S. office, and either no foreign office will materially participate in the sale or the property will be sold for use in the United States. Inventory on hand at the close of a taxable year also will be a U.S. asset if it is reasonable to anticipate that the inventory on hand will not be sold through a U.S. office, but will be sold in the United States and has not been manufactured by the foreign corporation outside the United States. If the inventory will not be sold through a U.S. office but was manufactured or will be sold in the United States, a portion thereof will be a U.S. asset.

c. *Depreciable property*

Depreciable and amortizable property (other than a U.S. real property interest) is a U.S. asset in the proportion that the depreciation or amortization on that property is allowable (either as a deduction or as an inclusion in cost of goods sold) in computing effectively connected income.[65]

d. *Receivables*

A receivable with a maturity of six months or less arising from the sale of inventory, performance of services, or leasing of property in the ordi-

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[61] IRC § 864(c)(4)(A), (B)(iii); compare 1986 Act, note 1, at § 1211(b)(2) (repealing IRC § 864(c)(4)(B)(iii) (1954)), with 1988 Act, note 2, at § 1012(d)(7) (adding IRC § 864(c)(4)(B)(iii)).

[62] IRC §§ 861(a)(6), 862(a)(6).

[63] IRC § 863(b)(2); see IRC § 865(b).

[64] IRC § 865(e)(2).

[65] Temp. Reg. § 1.884-1T(d)(2); see Temp. Reg. § 1.884-1T(d)(14) Ex. 1.

nary course of the foreign corporation's trade or business is treated as a U.S. asset in the same proportion that the amount income represented by the receivable that would be effectively connected income bears to the total income represented by the receivable.[66]

e. Installment Obligations

An installment obligation received in connection with the sale of a U.S. asset is treated as a U.S. asset to the extent of the sum of (1) the effectively connected income that would be realized on the obligation if it were satisfied in full on the determination date and (2) the portion of the basis that would be attributable thereto.[67]

f. Money

Money is a U.S. asset if and to the extent it is needed in a U.S. trade or business in order to meet the present needs, rather than anticipated future needs, of the U.S. trade or business.[68] Thus, money held for working capital needs in order to meet operating expenses would be treated as a U.S. asset, but money held for the purpose of providing future diversification, expansion of non-U.S. business, or future plant replacement or contingencies would not. Under this rule, money held by a foreign corporation owning and operating a hotel to provide for replacement of furniture and fixtures would appear not to qualify as a U.S. asset, even though such a reserve is essential in that business, because it is held for "future plant replacement." This rule, however, is subject to an "expansion capital" exception, discussed below.

g. Marketable Securities

A marketable security is a U.S. asset if all income derived from that security during the taxable year is effectively connected income *and* either (1) any gain or loss on a hypothetical sale of the security on the last day of the year would give rise to effectively connected income or loss or (2) the security has a yield for the taxable year of at least 50% of the average monthly federal short-term rate during that year.[69] For this purpose, the term "marketable security" means a security (including

[66] Temp. Reg. § 1.884-1T(d)(4).

[67] Temp. Reg. § 1.884-1T(d)(7).

[68] Temp. Reg. § 1.884-1T(d)(6); see Reg. § 1.864-4(c)(2)(iii)(*a*); cf. Reg. § 1.897-1(f)(2) (similar standard for determining whether an asset is "held in a direct relationship to the trade or business," with the result that it is in the denominator for purposes of the 50% test for U.S. real property holding corporations).

[69] Temp. Reg. § 1.884-1T(d)(8); see IRC § 1274(d)(1)(C)(i). The reason for the yield maintenance test as an alternative to meeting the hypothetical sale test is unclear.

stock) that is part of an issue any portion of which is regularly traded on an established securities market, and a bank or savings and loan deposit.[70] Income derived from marketable securities may be effectively connected under either the asset-use test of § 1.864-4(c)(2)(iii)(A) or the business-activities test of § 1.864-4(c)(3)(i) of the regulations. Marketable securities that are used in a U.S. business for only part of the taxable year appear not to qualify as U.S. assets under the regulations as all income derived from the securities during the year will not be effectively connected.

h. Expansion Capital

Under the "expansion capital" rule, a foreign corporation can elect for *any* taxable year to treat as U.S. assets marketable securities (as defined above) that are not otherwise U.S. assets, provided that (1) the securities are identified within 30 days after the close of the taxable year and (2) the fair market value of the securities on the identification date is not less than their adjusted basis.[71] The adjusted basis of marketable securities that may be so treated cannot exceed 25% of the sum of the foreign corporation's ECE & P for the year and the deferred ECE & P attributable to the two preceding taxable years.[72] However, in the case of an involuntary conversion of a U.S. asset, the amount of marketable securities that may be treated as a U.S. asset can be increased by ruling.[73] Securities must be held for the entire taxable year after the year of the election (or, if disposed of, replaced with other securities on or before the date of disposition).[74] The reason for this requirement is not readily apparent. If the expansion capital becomes needed for the purpose for which it is being held and therefore is sold before the end of the following year, it is unclear why this should adversely affect the election. It is possible that the regulations are intended to imply that if the securities are disposed of to buy U.S. assets within the two-year period, they are U.S. assets.[75]

The effect of the election is that all income received with respect to such securities and all gain or loss on the sale of those securities in the year following the election (but presumably not in the year of the election) is treated as effectively connected income. Furthermore, any of those securities that are held on the last day of the year following the election are marked to market on that day with any gain and accrued

[70] Temp. Reg. § 1.884-1T(d)(8); see IRC § 871(i)(3)(A), (B); Temp. Reg. § 1.884-5T(d)(2), (4).

[71] Temp. Reg. § 1.884-1T(d)(11)(i), (iii).

[72] Temp. Reg. § 1.884-1T(d)(11)(i).

[73] Temp. Reg. § 1.884-1T(d)(11)(iv).

[74] Temp. Reg. § 1.884-1T(d)(11)(i).

[75] Cf. Reg. § 1.864-4(c)(2)(iii)(*a*).

income treated as effectively connected income; no loss is taken into account, however.[76] Thus, if marketable securities identified as expansion capital have depreciated before yearend, they must be sold to take the loss; however, the corporation must reinvest the proceeds in marketable securities.

It is interesting to compare this provision with the accumulated earnings credit under § 535. The accumulated earnings tax is imposed on the "accumulated taxable income" of a corporation, which is defined as taxable income adjusted pursuant to § 535(b), less the sum of dividends paid and the accumulated earnings credit.[77] Section 535(c)(2) allows a *minimum* accumulated earnings credit equal to the amount by which $250,000 ($150,000 for certain service companies) exceeds the accumulated E & P of the corporation at the end of the preceding year. However, in the case of a corporation other than a mere holding or investment company, the accumulated earnings credit, if greater, is equal to the excess of the amount of current E & P retained for the reasonable needs of the business over the net capital gains for the taxable year.[78] The regulations make it clear that E & P accumulated for, among other things, plant expansion or replacement or acquisition of a business enterprise will usually be considered to be accumulated for reasonable business needs.[79]

The effect of § 535, therefore, is to permit a U.S. corporation to accumulate up to $250,000 ($150,000 in certain cases) without showing any justification, and to permit further accumulation (other than in the case of a mere holding or investment company) if appropriate to meet present or future needs. By contrast, § 884, in effect, deems a distribution to occur to the extent of ECE & P regardless of whether the ECE & P are needed in the business, except to the extent there has been an actual increase in U.S. net equity. Furthermore, by narrowly defining U.S. assets so as to exclude, e.g., money held for plant expansion or replacement, the regulations appear to deem a distribution by the hypothetical subsidiary under § 884 before an actual corporation would be required to make an actual distribution in order to avoid the imposition of the accumulated earnings tax. A legitimate question can be raised as to whether such a result carries out the intention underlying § 884, which is to treat U.S.

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[76] Temp. Reg. § 1.884-1T(d)(11)(ii).

[77] IRC §§ 531, 535(a).

[78] IRC § 535(c)(1), (3), (b)(6). In the case of a foreign corporation, net capital gains reduce accumulated taxable income and the accumulated earnings credit only to the extent gains and losses are effectively connected and not exempt under treaty. IRC § 535(b)(9), (c)(1).

[79] Reg. §§ 1.537-1(b), -2(b)(1), (2); see also Reg. § 1.537-1(a) ("the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business").

business conducted through foreign and U.S. corporations in an equal manner.

It may be argued that this dichotomy in treatment is mandated by the construction of § 884, which imposes the BPT on the amount of the ECE & P less the amount of any increase in U.S. net equity plus the amount of any decrease in U.S. net equity (limited by the amount of deferred ECE & P). Strictly construed, the definition of U.S. net equity in § 884 arguably requires the above result. However, § 884(c) and (g) grants authority to Treasury to prescribe regulations as may be necessary or appropriate to carry out the purposes of § 884. The expansion capital rule in the regulations does not solve the problem of unequal treatment, but merely permits a limited amount of marketable securities to be considered U.S. assets without regard to whether those assets are needed for future anticipated needs of the business, and apparently without regard to whether the assets are in fact used for this purpose. Ironically, use of the "expansion capital" before the close of the next taxable year for the purpose for which it was intended, i.e., the acquisition of a U.S. asset, apparently retroactively disqualifies the marketable securities so used for the exception unless the use indicates that the securities were U.S. assets without regard to the expansion capital rule. Moreover, the regulations do not deal with the case in which a foreign corporation requires more than the limited amount allowed for future plant expansion.

A better solution might have been to permit expansion capital to be treated as a U.S. asset to the extent of the greater of (1) the limit currently contained in the expansion capital rule (or possibly an amount equivalent to the minimum accumulated earnings credit under § 535(c)) and (2) the amount of the reasonable future anticipated needs of the business. In addition, an interest charge could be imposed on the portion of the BPT that is deferred as a result of such treatment and is not due to increases in U.S. net equity over a three-year period (disregarding for this purpose increases in U.S. net equity resulting from ECE & P that are attributable to any income earned on the expansion capital).

i. Partnership Interests

A partnership interest is treated as a U.S. asset, but only to the extent of the foreign corporation's adjusted basis in the partnership interest multiplied by a fraction, the numerator of which is the foreign partner's distributive share of the partnership's gross income that is effectively connected income and the denominator of which is the foreign partner's distributive share of the partnership's total gross income.[80]

[80] Temp. Reg. § 1.884-1T(d)(9)(i).

For this purpose, the adjusted basis of a partnership interest is computed under § 705, but without regard to the foreign corporation's share of the partnership's liabilities as determined under § 752.[81] Instead, the basis is increased in the amount of the partnership's liabilities to the extent the partner "shares for income tax purposes" in the interest expenses attributable thereto.[82] Thus, it would appear that a foreign corporation that is a limited partner can take recourse liabilities of the partnership into account for purposes of determining the amount of its U.S. assets to the extent of its allocation under the partnership agreement of the interest expense thereon.[83] Moreover, the basis for this purpose will be affected by changes in partnership allocations of expenses.

Finally, the basis is adjusted to take into account any differences between the corporation's distributive share for taxable income and E & P purposes. Presumably, if the foreign corporation contributes property with an adjusted basis for tax purposes of $100 and an adjusted basis for E & P purposes of $150, the basis of the foreign corporation's partnership interest would be increased under § 722 by $100 and further increased under this rule by $50. Similarly, the distributive share of partnership income or loss would have to be recalculated under E & P principles to arrive at the adjustments to basis allowed under this provision. This would seem to require recalculating the worldwide income (including gain and loss) of a partnership on an E & P basis. As a result, partnerships that engage in U.S. business activities and that have foreign corporations as partners may be required (or at least pressed) to provide E & P information to those partners.

Under the partnership rule, the partnership interest itself is treated as a U.S. asset (to the extent provided above). Assume that *FC*, a foreign corporation, has no deferred ECE & P; U.S. net equity at the beginning of 1990 of $2,000; ECE & P for 1990 of $900; and noneffectively connected interest income in 1990 of $100, which was realized on $1,000 of cash generated by its U.S. business that *FC* needs to invest for future expansion but cannot invest in U.S. assets by yearend. Assuming no change in U.S. net equity during 1990, *FC* would have a DEA for 1990 of $900; however, it could elect expansion capital treatment with respect to $225 (25% of $900) of its marketable securities (including bank deposits), bringing its DEA down to $675. Assume instead that *FC* is a partnership and *FCP*, a foreign corporation, is a partner in *FC* whose sole activity relates to its investment in *FC*. Assume that *FCP*'s basis in its interest in *FC* at the beginning of 1990 is $2,000 and that *FCP*'s distribu-

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[81] Temp. Reg. § 1.884-1T(d)(9)(ii)(A).

[82] Temp. Reg. § 1.884-1T(d)(9)(ii)(B), (iii).

[83] Cf. IRC § 752; Temp. Reg. § 1.752-1T(d). The allocation presumably will be respected for this purpose only if it has substantial economic effect. See IRC § 704(b); Reg. § 1.704-1(b).

tive share of each item of partnership income is exactly equal to the amounts *FC* earned in the first example. At the beginning of 1990, *FCP* has U.S. assets of $2,000; at the end of the year, *FCP*'s investment in *FC* grows to $2,700, i.e., it was increased by the $1,000 of E & P and the total was multiplied by 90% (i.e., $900 of ECE & P divided by $1,000). Thus, *FCP*'s U.S. assets have increased, and its DEA has decreased, by $700. *FCP* presumably cannot further reduce its DEA by electing expansion capital treatment, as it has no marketable securities.

If "one of the principal purposes" of either the acquisition of a partnership interest or the acquisition of assets by a partnership is "to increase the U.S. assets of a foreign corporation artificially," the Service may recompute the amount of the corporation's U.S. assets with respect to the partnership to reflect more accurately the interest in the partnership's assets that would be U.S. assets if held directly by the corporation.[84] This test is broader than a primary purpose test; an "important" purpose is a principal purpose under this rule.[85] Factors to be considered include whether the partnership conducts unrelated businesses or accumulates liquid assets in excess of the *reasonable needs of the business*.[86]

2. *U.S. Liabilities*

As stated above, the amount of a foreign corporation's U.S. liabilities is the amount of its U.S. assets multiplied by either its actual ratio of worldwide liabilities to worldwide assets at the close of the taxable year or a fixed ratio (i.e., 50% or, in the case of a banking, financing, or similar business, 95%), depending upon the method of determining liabilities used by the corporation for purposes of determining its interest deduction.[87] Presumably, the amount of U.S. assets is determined as above; however, the asset valuation method used for this purpose must be the same as that used in apportioning the corporation's interest deduction to effectively connected income.[88] Worldwide liabilities for this purpose include the corporation's share of partnership liabilities as determined above.[89]

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[84] Temp. Reg. § 1.884-1T(d)(9)(iv).

[85] Id.

[86] Id.; cf. notes 70-71 and accompanying text.

[87] Temp. Reg. § 1.884-1T(e)(1); see Reg. § 1.882-5(b)(2). However, a repayment or other reduction of U.S. liabilities, one of the principal purposes of which is to decrease artificially the U.S. liabilities of the foreign corporation, is not taken into account. Temp. Reg. § 1.884-1T(e)(3).

[88] Temp. Reg. § 1.884-1T(e)(1); see Reg. § 1.882-5(a)(2).

[89] Temp. Reg. § 1.884-1T(e)(2); see notes 73-75 and accompanying text.

III. Termination, Liquidation, Reorganization, and Incorporation

A. Policy Considerations

As has been noted previously, a reduction in the U.S. net equity of a foreign corporation will have the effect of ending a prior deferral of BPT on deferred ECE & P. A foreign corporation that does not have any deferred ECE & P (because it has not previously deferred BPT or because subsequent deficits in ECE & P have reduced deferred ECE & P[90]) will not be adversely affected by a reduction in U.S. net equity. A foreign corporation with deferred ECE & P, however, will be affected adversely by such a reduction.

Subject to the special rules noted below, U.S. net equity will be reduced whenever a foreign corporation with U.S. assets (as defined above) transfers such assets in exchange for money or other property that does not qualify as a U.S. asset. For example, a foreign corporation may (1) sell its entire U.S. business for cash, (2) exchange its U.S. business assets for stock in a U.S. or foreign corporation in a transaction that qualifies for nonrecognition treatment under § 351 or 361, or (3) distribute its U.S. assets as an interim distribution in kind or a liquidating distribution that either does or does not qualify under § 332. These transactions raise the issues of whether the BPT should be imposed at all for the year of a termination of a U.S. trade or business,[91] and whether, and under what conditions, reductions in U.S. net equity arising from such transactions should require the end of any prior deferral of BPT.

In considering these issues, it should be remembered that Congress enacted the BPT in order to "achieve greater parity between the remittance of branch profits and the distribution of subsidiary earnings."[92] Accordingly, it would seem that the complete termination of all the U.S. trades or businesses of a foreign corporation should be viewed as essentially equivalent to the complete liquidation of the hypothetical U.S. corporation treated as operating the U.S. business under § 884.[93] Moreover, to continue the analogy, the deemed liquidation should be treated as a liquidation of a wholly-owned domestic subsidiary into its foreign parent.[94] In the case of a complete liquidation of a wholly-owned U.S. subsidiary into its foreign parent corporation, a distribution pursuant to that

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[90] See Temp. Reg. § 1.884-1T(b)(4) Ex. 5.

[91] For purposes of the regulations, the "U.S. trade or business" of a foreign corporation includes all the U.S. trades or businesses of the foreign corporation. Temp. Reg. § 1.884-0T(a); see 1986 Notice, note 29.

[92] Conf. Rep. No. 841, 99th Cong., 2d Sess. II-647 (1986), reprinted in 1986-3 C.B. (vol. 4) 647; see notes 15-22 and accompanying text.

[93] See 1986 Notice, note 29; see also Blessing, note 31, at 609-10.

[94] Cf. IRC § 884(f)(1)(B) ("excess" interest treated as if paid to the foreign corporation "by a wholly owned domestic corporation").

liquidation generally is not a dividend subject to withholding, irrespective of the amount of the subsidiary's current or accumulated E & P.[95] Therefore, symmetry between the treatment of foreign corporations operating in the United States through domestic subsidiaries and those doing business in the United States directly or through an unincorporated entity requires that no BPT be imposed on a complete termination of the U.S. trades or businesses of a foreign corporation.[96]

Not all terminations can be viewed as complete liquidations, however. The Service and the courts have held that a purported liquidation generally will not be treated for federal income tax purposes as a complete liquidation where more than a de minimis amount of the assets necessary to conduct the business of the former corporation are, as part of a plan, transferred to another corporation and there is substantial continuity of interest between the two corporations.[97] In such a case, any assets remaining with the shareholders will be considered to have been distributed as an interim (i.e., § 301 or 302) distribution, rather than a liquidating distribution, and any assets transferred to the reincorporated entity will ordinarily be treated as not having been distributed at all.[98] If all the assets of the liquidating corporation are distributed to shareholders that are corporations, the reincorporation doctrine will not usually be

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[95] See IRC §§ 331, 881(a), 1442(a); Reg. § 1.1441-3(b)(1)(ii). This is true even if the stock in the domestic corporation is a U.S. real property interest. IRC § 897(e)(1); Temp. Reg. § 1.897-5T(b)(3)(iv)(A). However, gain may be recognized by the distributing corporation on the distribution of property, other than U.S. real property interests, to the foreign parent corporation. IRC §§ 336, 367(e)(2), 897(e)(1); Temp. Reg. § 1.897-5T(b)(3)(iv)(A); see Notice 87-5, 1987-1 C.B. 416 (interaction of § 367(e)(2) with treaties). The legislative history of the 1986 Act indicates that regulations under § 367(e)(2) may permit nonrecognition upon the liquidation if the distributed property is not removed from the U.S. taxing jurisdiction prior to recognition of any appreciation thereon. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-202 (1986), reprinted in 1986-3 C.B. (vol. 4) 202.

[96] See 1986 Notice, note 29; Temp. Reg. § 1.884-2T(a). Legislation passed by the House of Representatives in 1987 would have repealed § 337 and amended § 332 to treat a distribution to a corporation in complete liquidation of another corporation as a dividend to the extent it would be so treated if it were a § 301 distribution. H.R. 3545, § 10139(a), 100th Cong., 1st Sess. (1987). While the October 1987 Senate Finance Committee bill picked up this provision, the "Leadership Deficit Reduction Amendment," approved by the Senate Finance Committee on December 3, 1987, did not. S. Doc. No. 63, 100th Cong., 1st Sess. (1987). As enacted, the legislation is more narrow than the House version, permitting distributor-level nonrecognition treatment only in the case of distributions to a direct (that is, without regard to Reg. § 1.1502-34) 80% distributee. 1987 Act, note 1, at § 10223(a) (amending § 337(c)).

[97] See, for example, Telephone Answering Serv. Co. v. Commissioner, 63 T.C. 423 (1974), aff'd mem., 546 F.2d 423 (4th Cir. 1976), cert. denied, 431 U.S. 914 (1977); Rev. Rul. 76-429, 1976-2 C.B. 97 (treated as partial liquidation); Reg. §§ 1.331-1(c), 1.301-1(l).

[98] See note 97. Where possible, the Service argues that the transaction is not a complete liquidation because it is properly analyzed under the reorganization provisions of the Code, particularly § 368(a)(1)(D) or (F). See, for example, Smothers Co. v. United States, 642 F.2d 894 (5th Cir. 1981); Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966), cert. denied, 386 U.S. 1018 (1967); Moffatt v. Commissioner, 363 F.2d 262 (9th Cir. 1966), cert. denied, 386 U.S. 1016 (1967).

invoked even if those corporations continue to conduct the same business, unless, as part of a plan, sufficient business assets of the former corporation are subsequently reincorporated.[99]

A discussion of the nature, quality, and amount of the business assets of a liquidating corporation that, if transferred to a related corporation before (or, if part of a plan, after) a liquidation, will invoke the reincorporation doctrine is beyond the scope of this article.[100] Suffice it to say that, for purposes of the BPT, it would seem that the transfer of anything greater than a de minimis amount[101] of U.S. business assets to a related foreign corporation in connection with a complete termination arguably should invoke the doctrine because U.S. assets held by a foreign corporation are deemed to be held by a U.S. subsidiary of that corporation for purposes of § 884. Moreover, any transfer of U.S. assets to a foreign corporation in connection with a complete termination could, under the fiction created by § 884, be treated as a distribution in liquidation followed immediately by a contribution to a newly formed U.S. corporation, i.e., a proscribed reincorporation. Presumably, however, § 884 was not intended to create a potentially fatal reincorporation problem for every termination of the U.S. business of a foreign corporation.[102]

In the case of a transfer of U.S. assets to a related corporation, the transferee may or may not succeed to the corporate tax attributes of the transferor, depending on the type of transfer. Where, as a result of a § 332 liquidation or a reorganization, the transferee succeeds to the tax attributes of the transferor pursuant to § 381, there does not appear to be any compelling reason to impose the BPT on the transferor, at least so long as the transferee would continue to be subject to that tax.[103] Special problems are presented, however, where the transferee would not succeed to the attributes of the transferor (e.g., in a § 351 exchange or a liquidation not described in § 332[104]), where the transferee is a foreign

[99] Cf. *Tasco*, 63 T.C. at 436 n.9.

[100] See generally B. Bittker & J. Eustice, note 39, at § 14.54; 335-2d Liquidation-Reincorporation, Tax Mgmt. (BNA); Note, New Answers to the Liquidation-Reincorporation Problem, 76 Colum. L. Rev. 268 (1976).

[101] See *Tasco*, 63 T.C. at 436 n.9; Mountain Water Co. v. Commissioner, 35 T.C. 418 (1960); TAM 8550001 (Aug. 29, 1985) ("only a very nominal amount of assets can be retained").

[102] See 1986 Notice, note 29.

[103] However, to the extent the transferor has a DEA for the short taxable year pursuant to § 381(b)(1) that is due to ECE & P, a decrease in U.S. net equity, or both prior to the § 381 transfer, it seems reasonable to impose the tax. See 1986 Notice, note 29.

[104] However, a § 351 transfer of all the U.S. assets of a foreign corporation could be seen as a hypothetical D or F reorganization (and, accordingly, a hypothetical § 381(a) transaction) involving a transfer from the hypothetical U.S. subsidiary to the newly created U.S. subsidiary. Cf. Rev. Rul. 88-25, 1988-1 C.B. 116 (domestication of foreign corporation is F reorganization).

corporation exempt from the BPT by virtue of a treaty, or where the transferee is not subject to the BPT because it is a domestic corporation.

B. Complete Termination of the U.S. Trade or Business

Drawing a comparison to the complete liquidation of a subsidiary, the Service, in the 1986 Notice,[105] advised that, subject to an anti-abuse rule, the regulations under § 884 would provide that the BPT would not be imposed for the year of a complete termination of all the U.S. trades or businesses of a foreign corporation, i.e., that the foreign corporation would be considered to have neither ECE & P nor a decrease in U.S. net equity. According to the 1986 Notice, the anti-abuse rule is intended to prevent a foreign corporation from terminating its U.S. business and reinvesting less than the full amount of its U.S. net equity in U.S. business assets. The regulations adopt this principle, providing that, subject to a detailed anti-abuse rule discussed below, (1) no BPT will be imposed for the year of a complete termination and (2) the foreign corporation's deferred ECE & P will be extinguished for purposes of § 884.[106] Moreover, § 1.884-2T(a)(5) of the regulations provides that ECE & P and deferred ECE & P that are exempt from the BPT as a result of a complete termination are not subject to a withholding tax under § 871(a), 881(a), 1441, or 1442 on a subsequent distribution thereof.

Under the principles discussed above, one might have assumed that a complete termination can occur only if at the end of the year the foreign corporation no longer owns U.S. assets and U.S. assets are not acquired by a related foreign corporation. The regulations depart somewhat from this standard. Under § 1.884-2T(a)(2)(A) of the regulations, a foreign corporation can be considered to have completely terminated its U.S. business if either (1) at the end of the year it has no U.S. assets, or (2) its shareholders have adopted an "irrevocable resolution" in that year to completely liquidate and dissolve, and all its U.S. assets either are distributed, are used to pay off liabilities, or cease to be U.S. assets before the close of the immediately succeeding year. Subject to the anti-abuse rule, a foreign corporation also will be considered to have completely terminated its U.S. trade or business if its stock is acquired by another corporation that makes or is deemed to make a § 338 election.[107]

These provisions are more strict than the requirements for tax-free treatment that would be imposed on a complete liquidation of the hypothetical U.S. subsidiary. First, while a liquidating subsidiary is given

[105] See note 29; cf. IRC § 884(g) (regulations will provide for "appropriate adjustments in the determination of the dividend equivalent amount in connection with the distribution to shareholders . . . of the taxpayer's U.S. assets").

[106] Temp. Reg. § 1.884-2T(a)(1).

[107] Temp. Reg. § 1.884-2T(a)(3).

three years from the close of the taxable year during which the first liquidating distribution is made to complete the liquidation,[108] the regulations require complete termination of the U.S. trades or businesses by the close of the taxable year (or, in the case of a liquidation of a foreign corporation not described in § 332, by the close of the next taxable year). Additionally, in the case of the liquidation of a foreign corporation not described in § 332, the regulations require an "irrevocable resolution" by the shareholders to completely liquidate and dissolve the corporation. Apart from the problem that a shareholders' resolution, even to liquidate the corporation, would appear in most cases to be revocable by a vote of the percentage of the shareholders required by law or the certificate of incorporation, an "irrevocable resolution" would not be required in the case of the complete liquidation of the hypothetical U.S. subsidiary. The reason for these strict requirements is unclear.

Expanding somewhat on the anti-abuse rule contained in the 1986 Notice, the regulations provide that a complete termination will not occur if either the foreign corporation or a related corporation

> uses, directly or indirectly, any of the U.S. assets of the terminated U.S. trade or business, or property attributable thereto or to effectively connected earnings and profits earned by the foreign corporation in the year of complete termination, in the conduct of a trade or business in the United States at any time during a period of three years from the close of the year of complete termination.[109]

Furthermore, the foreign corporation will not be considered to have completely terminated if it has any income that is or is considered to be (other than under § 864(c)(6) or (7)) effectively connected with the conduct of a U.S. trade or business during such three-year period.[110]

The term "property attributable" to U.S. assets is defined to include any asset (including cash) into which the U.S. assets or ECE & P are converted at any time before the end of the three-year period ending after the year of termination, and any money or other property attributable to a sale by a shareholder of the foreign corporation of its interest in the foreign corporation at any time after a date which is 12 months before the close of the year of the complete termination.[111] The direct or indirect use of property includes loans of the property to related corporations

[108] IRC § 332(b)(3). The regulations appear to allow the full three years in the case of an actual § 332 liquidation of the foreign corporation. Temp. Reg. § 1.884-2T(c); see IRC § 381(b)(2).

[109] Temp. Reg. § 1.884-2T(a)(2)(i)(B).

[110] Temp. Reg. § 1.884-2T(a)(2)(i)(C).

[111] Temp. Reg. § 1.884-2T(a)(2)(iii)(B).

or its use as security (as a pledge, mortgage, or otherwise).[112] For this purpose, a corporation is considered to be related if it is a 10% shareholder of another corporation (or would be so considered if a liquidating corporation had remained in existence). A 10% shareholder is one that owns 10% of the total combined voting power or 10% of the total value of the stock of the corporation.[113] To facilitate enforcement of the three-year rule, the regulations also require the foreign corporation to agree to extend the period of limitations to a date not earlier than the close of the sixth taxable year following the year of the termination.[114]

The anti-abuse rules in the regulations appear to be extremely harsh in light of the rules governing termination of a U.S. trade or business conducted by a U.S. subsidiary. For example, while use of the U.S. assets of the terminated branch (or the proceeds thereof) by a corporation 10% of the stock of which is owned by a foreign corporation would disqualify the termination and subject the foreign corporation to BPT, it is questionable whether the liquidation of a U.S. subsidiary followed by a reincorporation of its assets into a 10%-owned corporation could be challenged under the reincorporation doctrine.[115] Moreover, activities of a corporation holding 10% of the vote or value of a foreign corporation, as well as those of *any* shareholder of the foreign corporation within one year before the end of the year of the complete termination, can dramatically affect the BPT liability of a foreign corporation. Again, it is unclear why the regulations are or should be so harsh.

In light of the restrictive rules noted above, few foreign corporations that have disposed of all of their U.S. assets will be able to know whether they qualify under the complete termination rules. However, there likely will be instances in which a foreign corporation may be able to assume that it could not qualify. In order to allow a foreign corporation to avoid causing a sale of its U.S. assets to end a prior deferral of BPT, the regulations provide a one-time election to treat a limited amount of marketable securities (including bank deposits) as U.S. assets for the year of disposi-

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[112] Temp. Reg. § 1.884-2T(a)(2)(v). It is not clear whether a pledge of the stock of the corporation that owns the property is a "use" for this purpose. Cf. Reg. § 1.956-2(c)(1).

[113] Temp. Reg. § 1.884-2T(a)(2)(iv). Stock ownership for this purpose is determined using the attribution rules in § 871(b)(3)(C). Id.

[114] Temp. Reg. § 1.884-2T(a)(2)(i)(D), (ii); cf. Reg. § 1.332-4(a)(2).

[115] See Breech v. United States, 439 F.2d 409 (9th Cir. 1971); Gallagher v. Commissioner, 39 T.C. 144 (1962); Berghash v. Commissioner, 43 T.C. 743 (1965), aff'd, 361 F.2d 257 (2d Cir. 1966); see also *Tasco*, 63 T.C. at 435-36 (distinguishing *Breech*, *Berghash*, and *Gallagher* on the ground that shareholder continuity exceeded 84%); Rev. Proc. 72-9, 1972-1 C.B. 719 (no advance rulings if 20% overlapping ownership). It should be noted in this connection that § 368(a)(2)(H), added to the Code by the Tax Reform Act of 1984, reduces the control requirement for D reorganizations from 80% voting power to 50% of vote or value, and applies modified § 318 attribution rules in making the 50% determination.

tion and for one additional year.[116] The amount of marketable securities that may be used for this purpose is limited to the lesser of the adjusted bases of the securities at the close of the taxable year and the adjusted bases (presumably for E & P purposes) of the U.S. assets that ceased to be U.S. assets during the year of election (determined on the date or dates of such cessation). Furthermore, the marketable securities used for this purpose must be identified within 30 days of the date an equivalent amount of U.S. assets ceases to be U.S. assets and, on the date of the identification, the adjusted basis of the marketable securities must not exceed their fair market value.[117]

In general, the consequences of the election are similar to the consequences under the expansion capital rule, discussed above.[118] Thus, income or gain realized from the marketable securities so identified will be considered to be effectively connected income,[119] and the marketable securities so identified will be marked to market at the end of each year for which the election is in effect and immediately prior to such time as the foreign corporation substitutes U.S. assets for the marketable securities.[120] Apparently, the identified marketable securities will lose their status as U.S. assets at the end of the period for which the election is in effect unless the foreign corporation substitutes U.S. assets for such securities. Presumably, however, this will occur on the first day of the second year of the termination rather than on the last day of the first year after termination. In any event, it is assumed that at that time a complete termination may occur so long as the securities are not otherwise U.S. assets.[121]

C. *Section 381(a) Transactions*

In the 1986 Notice, the Service advised that the following special rules would apply in the case of a § 332 liquidation or nondivisive tax-free reorganization between two foreign corporations where the distributee or transferee corporation (the transferee) continues to conduct a U.S. trade or business previously conducted by the distributing or transferor corpo-

[116] Temp. Reg. § 1.884-2T(b). The preamble to the regulations explains that this provision "is a special relief measure designed for foreign corporations that may have liquidated all of their U.S. assets or retired them from use in a U.S. trade or business but continue to hold cash or property with the expectation of continuing a U.S. trade or business in the near future." T.D. 8223, Explanation of Provisions (Sept. 6, 1988).

[117] Temp. Reg. § 1.884-2T(b).

[118] Id.; see Temp. Reg. § 1.884-1T(d)(11), notes 71-79 and accompanying text.

[119] Temp. Reg. § 1.884-1T(d)(11)(ii).

[120] Temp. Reg. § 1.884-2T(b). The marking to market should have the effect of increasing the basis of the marketable securities for any appreciation. As noted earlier, a decline in value is not taken into account under § 1.884-1T(d)(11)(ii) of the regulations.

[121] See Temp. Reg. § 1.884-1T(d)(8).

ration (the transferor): (1) the distribution or transfer will not increase the DEA of the transferor for the short taxable year closed by the transaction and (2) to the extent the transferee's U.S. net equity is subsequently reduced, the transferee may be subject to BPT on an amount equal to the transferor's deferred ECE & P.[122] The regulations contain special rules for transactions in which the transferor is engaged (or deemed to be engaged) in the conduct of a U.S. trade or business immediately prior to the transaction and certain corporate attributes carry over to the transferee pursuant to § 381(a). These transactions are referred to in the regulations as § 381(a) transactions and include § 332 liquidations and certain reorganizations.[123]

Because a § 381(a) transaction is in essence a continuation of the business of the transferor corporation in modified form, it should come as no surprise that a § 381(a) transaction will not be viewed as a complete termination.[124] However, one effect of a § 381(a) transaction is that substantially all of the assets of the transferor are transferred to the transferee.[125] As a result, absent a special rule, the U.S. net equity of the transferor for its year ending on the date of the § 381(a) transaction would decline. Such a decline may end the deferral of BPT to the extent of the transferor's deferred ECE & P.

The regulations provide that as a general rule the transferor's U.S. net equity as of the close of its taxable year ending on the date of transfer[126] will be determined without regard to any transfers to or from the transferee in a § 381(a) transaction (and without regard to any liabilities assumed or taken subject to in any such transaction).[127] Accordingly, the

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[122] 1986 Notice, note 29. These rules do not apply where "the transferee would not be subject to the branch profits tax after the transaction," for example, because it is a U.S. corporation or entitled to a treaty exemption. Id.

[123] Temp. Reg. § 1.884-2T(c). Reorganizations to which § 381(a) applies include A, C, and F reorganizations and nondivisive D and G reorganizations. IRC §§ 381(a)(2), 354(b)(1).

[124] Temp. Reg. § 1.884-2T(c)(1); cf. FEC Liquidating Corp. v. United States, 548 F.2d 924 (Ct. Cl. 1977) (IRC § 337 (1954) does not apply to a sale and liquidation during the course of a C reorganization); General Housewares Corp. v. United States, 615 F.2d 1056 (5th Cir. 1980) (IRC § 337 (1954) applies to such a sale and liquidation where the ownership continuity is less than 1%). The 1988 Act amended § 361(b) to delete a provision added by the 1986 Act stating that §§ 336 and 337 do not apply to any liquidation pursuant to a plan of reorganization of a transferor corporation that is a party to a reorganization. 1988 Act, note 2, at § 1018(d)(5)(A). However, § 361, as amended, also provides that a corporation will recognize no gain (1) on the receipt in a reorganization of boot if the corporation distributes such boot pursuant to the plan of reorganization and (2) on the distribution pursuant to the plan of reorganization of stock (or stock rights) in another corporation a party to the reorganization that is received by the distributing corporation in the exchange. IRC § 361(b)(1)(A), (c).

[125] IRC §§ 381(a), 332, 346(a), 368(a)(1)(A), (C), (D), (F), (G), 354(b)(1).

[126] See IRC § 381(b)(1).

[127] Temp. Reg. § 1.884-2T(c)(2)(i). For purposes of computing the transferor's U.S. net equity, the transferor's adjusted basis for E & P purposes is increased in the amount of any gain taken into account for E & P purposes as a result of the § 381(a) transaction. Id. Appar-

transferor will have a DEA to the extent of its ECE & P, as adjusted for any increases and decreases in U.S. net equity unrelated to the § 381(a) transaction. However, the general rule does not apply if the transferee is a domestic corporation unless the transferee executes (1) a waiver of the period of limitation for the assessment of any additional BPT for the year of the § 381(a) transaction until the sixth taxable year after that year and (2) a transferee agreement (on Form 2045).[128] The transferor's ECE & P for the short taxable year in which the § 381(a) transaction occurs is determined without regard to the carryover of E & P under § 381 and the regulations, and is increased by the amount of gain taken into account for E & P purposes on the § 381(a) transaction.[129] Any decrease in the transferor's U.S. net equity for a taxable year after the year in which the § 381(a) transaction occurs will increase the DEA of the transferor for that year without regard to the amount of the transferor's deferred ECE & P as of the close of the prior year, but only to the extent the decrease in U.S. net equity does not exceed the balance of ECE & P and deferred ECE & P carried over to the transferee.[130]

The regulations provide detailed rules for the inheritance of ECE & P and deferred ECE & P by the transferee under § 381(c)(2) where the transferor is a foreign corporation. The transferee inherits the ECE & P and deferred ECE & P of the transferor, computed immediately before the close of the taxable year in which the § 381(a) transaction occurs.[131] For this purpose, the rules of § 1.381(c)(2)-1 of the regulations apply, with adjustments (1) to reflect the fact that DEAs, rather than actual distributions by the transferor to its shareholders, reduce ECE & P and deferred ECE & P and (2) subtracting the transferor's DEA for the year of the § 381(a) transaction and the transferor's DEA for any succeeding year due solely to a subsequent decrease in the transferor's U.S. net equity.[132] In addition, any ECE & P (or deficit therein) accumulated (or incurred) by the transferor and attributable to a period after the close of the year of the § 381(a) transaction and before the liquidation of the transferor will be deemed to have been incurred on or before the close of the year of the § 381(a) transaction and, accordingly, will increase (or reduce) the amounts inherited by the transferee.[133] The transferor's ECE & P and deferred ECE & P become deferred ECE & P (*and*, in the case

ently, BPT is imposed on the ECE & P of the transferor in the year of the § 381(a) transaction irrespective of any increase in the U.S. net equity of the transferee.

[128] Temp. Reg. § 1.884-2T(c)(2)(iii).

[129] Temp. Reg. § 1.884-2T(c)(2)(ii); see also IRC § 381(c)(2); Temp. Reg. § 1.884-2T(c)(4).

[130] Temp. Reg. § 1.884-2T(c)(3); see also IRC § 884(b)(2)(B); Temp. Reg. § 1.884-1T(b)(3)(ii).

[131] Temp. Reg. § 1.884-2T(c)(4)(i).

[132] Id.; see also Temp. Reg. § 1.884-2T(c)(3).

[133] Temp. Reg. § 1.884-2T(c)(4)(i).

of a domestic transferee, accumulated E & P for purposes of § 316(a)(1)) in the hands of the transferee.[134] In the event the § 381(a) transaction involves a transfer of assets by a domestic subsidiary of a foreign corporation to the foreign parent or an 80%-owned foreign subsidiary corporation of the foreign parent, the current and post-1986 accumulated E & P of the domestic subsidiary that carry over to the foreign transferee under § 381(c)(2) will carry over as deferred ECE & P.[135]

The regulations contain special rules for distributions by a U.S. transferee out of the deferred ECE & P inherited from the transferor. The distributions will qualify for benefits under an income tax treaty only if the distributee qualifies for those benefits and to the extent the § 381(a) transferor would have qualified if the distribution were instead a DEA for the taxable year of the § 381(a) transaction.[136] For this purpose, distributions retain their character as deferred ECE & P in the hands of any domestic distributee up the chain.[137] In addition, when a domestic transferee has both accumulated E & P under § 316(a)(1) and deferred ECE & P inherited from the transferor, the two categories of earnings and profits will be accounted for in separate pools, and any distribution of E & P will be treated as coming proportionately out of each pool.[138] Finally, § 871(i), which exempts from tax a percentage of dividends paid by a domestic corporation meeting the 80% foreign business requirements, will not apply to dividends paid by a domestic transferee out of its deferred ECE & P.[139]

Thus, the ECE & P accounts inherited by the transferee are (1) reduced by the transferor's DEA for the taxable year in which the § 381(a) transaction occurs and the transferor's later deficits in ECE & P, and (2) increased by the transferor's later decreases in U.S. net equity, but only to the extent of the balance of ECE & P and deferred ECE & P carried over to the transferee, and the transferor's later accumulations of deferred ECE & P. A foreign transferee's later deficits in ECE & P will reduce its deferred ECE & P,[140] presumably including those inherited from the transferor. However, the regulations at least imply that a domestic transferee's later deficits in E & P will not reduce its inherited deferred ECE & P. Particularly in light of the fact that the regulations provide that inherited ECE & P are both § 884 deferred ECE & P and § 316(a)(1) accumulated E & P in the hands of the domestic trans-

[134] Temp. Reg. § 1.884-2T(c)(4)(ii). This provision appears erroneously to refer to § 316(a)(2).

[135] Temp. Reg. § 1.884-2T(e). This provision appears erroneously to refer to § 381(c)(1).

[136] Temp. Reg. § 1.884-2T(c)(4)(iii).

[137] Id.

[138] Id.; cf. Reg. § 1.381(c)(2)-1(a)(5).

[139] Temp. Reg. § 1.884-2T(c)(4)(iii); see IRC § 861(c)(1).

[140] See Temp. Reg. § 1.884-1T(b)(4) Ex. 5(ii).

feree,[141] it is not clear why this should be the result, particularly where the transferee has reduced its § 316(a)(1) accumulated E & P to zero by reason of later deficits.

Additional BPT may be imposed on the transferor if the transferee is a domestic corporation and (1) either (a) there was a transfer of more than 25% of the value of the stock of the transferor within 12 months before the § 381(a) transaction, (b) there is a sale of shares of the transferee (or, if its parent stock was used in the § 381(a) transaction, its parent) at any time within three years after the close of the taxable year of the § 381(a) transaction by shareholders of the transferee that owned more than 25% of the value of the shares of the transferee (or, if applicable, its parent) within the 12-month period ending at the close of the taxable year of the § 381(a) transaction, or (c) where shares of the parent are used in a C reorganization, the transferee's parent disposes of its stock in the transferee within three years after the close of the taxable year of the § 381(a) transaction; *and* (2) the proceeds of any such sale are used in the conduct of a U.S. trade or business by a shareholder of the transferor that is a corporation or a corporation related to a shareholder of the transferor.[142] In that case, the transferor's BPT liability for the year of the § 381(a) transaction is determined taking into account the transfer of U.S. assets and liabilities pursuant to the § 381(a) transaction, and interest must be paid on any additional BPT that is required to be paid.[143] The additional tax and interest is also the liability of the transferee within the meaning of § 6901.[144] For purposes of these rules, the definitions of "property attributable," "related corporation," and "direct or indirect use" discussed above are applicable.[145]

These rules apparently are intended to prevent abuses by means of the equivalent of prearranged transfers of assets of the transferor to related corporations for use in a U.S. trade or business. The rules are so intricate as to be incomprehensible in some respects,[146] and appear to be extremely overbroad to meet the purpose, particularly since the corporate tax attributes remain with the transferee.

[141] Temp. Reg. § 1.884-2T(c)(4)(ii).

[142] Temp. Reg. § 1.884-2T(c)(6)(i).

[143] Id.

[144] Id.

[145] Temp. Reg. § 1.884-2T(c)(6)(ii); see Temp. Reg. § 1.884-2T(a)(2)(iii)(B), (iv), (v); notes 111-14 and accompanying text.

[146] For example, § 1.884-2T(c)(6)(i)(B) requires that shareholders of the transferee who owned more than 25% of the stock of the transferor within 12 months preceding the close of the year of the § 381(a) transaction "sell, exchange or otherwise dispose of their stock or securities" within three years. It is not at all clear from the language whether this is intended to require that such shareholders sell all their stock.

D. Incorporation Transactions

Section 884(g) authorizes regulations "providing for appropriate adjustments in the determination of the dividend equivalent amount in connection with the . . . transfer to a controlled corporation of the taxpayer's U.S. assets." The 1986 Notice advised that a § 351 incorporation of all the U.S. business of a foreign corporation into a wholly-owned U.S. subsidiary will not decrease the U.S. net equity of the foreign corporation. According to the 1986 Notice,

> the regulations will determine the extent to which events subsequent to the transfer, such as distributions from the U.S. subsidiary to the foreign parent or sale of the stock of the subsidiary by the foreign parent, will trigger either a branch profits or withholding tax on the parent.[147]

The regulations provide special rules for § 351 transactions in which part or all of the U.S. assets of the foreign corporation are transferred to a U.S. transferee and the foreign corporation is in control of the transferee immediately after the transaction without regard to any other transferors.[148] Pursuant to the regulations, a § 351 transaction does not qualify as a complete termination, and a complete termination cannot occur with respect to the transferee while the transferor (or its successor) owns stock or securities of the transferee.

The § 351 transferor will adjust its U.S. net equity for the amount of the assets and liabilities transferred unless the transferee elects on its tax return to be allocated a proportionate amount of the transferor's ECE & P and deferred ECE & P equal to the same proportion of such ECE & P and deferred ECE & P (determined immediately before the transfer and without regard to any DEA for the taxable year) that the adjusted basis for E & P purposes of the U.S. assets transferred bears to the adjusted basis for E & P purposes of all the U.S. assets of the transferor, determined immediately before the transfer;[149] in addition, the transferor must file an agreement with respect to a subsequent disposition of the transferee's stock.[150] The agreement must provide that the transferor will take into account as DEA the lesser of (1) the amount realized

[147] See note 29; S. Rep. No. 313, 99th Cong., 2d Sess. 404 (1986), reprinted in 1986-3 C.B. (vol. 3) 404 ("the Treasury Department may not consider it appropriate to impose a branch profits tax [on] the incorporation of a branch where the earnings of the branch are contributed to the new corporation rather than remitted").

[148] Temp. Reg. § 1.884-2T(d). Control for this purpose is defined in § 368(c) as at least 80% of the total combined voting power and at least 80% of the total number of shares of stock not entitled to vote. Thus, the regulations depart from the 1986 Notice's requirements that the subsidiary be "wholly owned" and that all of the U.S. assets be transferred.

[149] Temp. Reg. § 1.884-2T(d)(3), (4)(i), (ii).

[150] Temp. Reg. § 1.884-2T(d)(3), (5)(i).

(rather than the gain) on any disposition of the shares of the transferee, and (2) the amount of ECE & P and deferred ECE & P allocated to the transferee pursuant to the election described above, less any amount previously taken into account by the transferor as dividends or DEAs.[151] Dispositions for this purpose may occur *at any time* after the § 351 transaction and include any transfer of the shares of the transferee other than pursuant to a § 332 liquidation, an F reorganization, or any nonrecognition transaction so specified by the Service in a published or private ruling.[152]

If these conditions are complied with, the following will occur: The transferor's U.S. net equity is determined without regard to the U.S. assets or liabilities transferred in the exchange, except to the extent gain is taken into account for E & P purposes on the transfer.[153] The transferor will compute its DEA for the year of the transfer under the normal rules (except that reductions in U.S. net equity attributable to the transfer are not taken into account); however, the transferor's DEA will not exceed the sum of its ECE & P for the year and its deferred ECE & P, taking into account the amount allocated to the transferee.[154] For purposes of computing the transferor's DEA for the year after the transfer, the transferor's ECE & P and deferred ECE & P as of the close of the year of the § 351 transaction are reduced by the amount of ECE & P and deferred ECE & P allocated to the transferee.[155]

It is not clear why later dispositions of the stock of the transferee should be treated so differently from what would have been the treatment of dispositions of stock of the subsidiary had the U.S. business been incorporated from the beginning, i.e., no second-tier withholding. For example, it appears harsh to include in the DEA the amount realized, rather than the gain for E & P purposes, on such a sale and to require the transferor to obtain a ruling to assure tax-free treatment of a disposition of the stock of the transferee in a transaction otherwise protected by § 721, 351, 368(a)(1)(E), or 1036, to name but a few. In addition, it appears harsh to impose the BPT in the event of a disposition of the stock of the subsidiary occurring many years after the § 351 transaction and, in light of the allocation of ECE & P and deferred ECE & P to the subsidiary, to limit subsequent dispositions of stock at all.

[151] Temp. Reg. § 1.884-2T(d)(5)(i).
[152] Temp. Reg. § 1.884-2T(d)(5)(i), (ii).
[153] Temp. Reg. § 1.884-2T(d)(3)(i).
[154] Temp. Reg. § 1.884-2T(d)(3)(ii), (iii); see Temp. Reg. § 1.884-2T(d)(6).
[155] Temp. Reg. § 1.884-2T(d)(4)(iii).

IV. The BIT and Interest Sourcing Rules

Section 884(f) contains two basic substantive rules. Pursuant to § 884(f)(1)(A), interest paid by the U.S. trade or business of a foreign corporation is treated as if it were paid by a domestic corporation. Section 884(f)(1)(B) imposes the BIT on a foreign corporation to the extent of the excess of (1) the amount of interest allowed as a deduction under § 882 in computing the taxable income that is, or is treated as, effectively connected over (2) the interest paid by the U.S. trade or business; the tax is imposed under § 881(a) as if the excess were paid to the foreign corporation by a wholly-owned domestic corporation.

A. *Old Law Was Predictable if Not Symmetrical*

The source rule in § 884(f)(1)(A) for interest paid by a foreign corporation ignores the amount of the foreign corporation's U.S. contacts. Under prior law, and with certain exceptions, interest was considered to be sourced in the United States if the obligor was a U.S. resident.[156] For this purpose, the term "U.S. resident" included all U.S. corporations and any partnership or foreign corporation that engaged in a U.S. trade or business during the taxable year.[157] However, unlike the case of a resident partnership, not all interest paid by a so-called resident foreign corporation was considered to be from U.S. sources. Rather, before any such interest could be so treated, the foreign corporation had to meet a three-year 50% effectively connected income threshold;[158] if that test was met, only a pro rata portion of the interest would be from U.S. sources.[159]

Under prior law, the extent to which the interest paid by a resident foreign corporation or resident partnership was deductible for U.S. income tax purposes was irrelevant to the determination of whether the interest was U.S. sourced.[160] Thus, for example, if a resident foreign corporation did not meet the 50% income threshold for the applicable three-year measuring period, no portion of the interest it paid for the current year would be considered to be from U.S. sources even though all or a portion of the interest expense may have been deductible against the effectively connected income of the foreign corporation.[161] In addition, if 51% of the corporation's worldwide gross income consisted of effectively connected income for the applicable measuring period, 51% of the interest it paid for the year would be considered to be from U.S. sources,

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[156] IRC § 861(a)(1) (1954).
[157] Reg. § 1.861-2(a)(2).
[158] IRC § 861(a)(1)(C) (1954).
[159] IRC § 861(a)(1)(D) (1954).
[160] See Reg. § 1.882-5.
[161] IRC § 861(a)(1)(C) (1954).

regardless of the portion of the interest expense of the foreign corporation that was considered to be allocable to effectively connected income under the applicable regulations.[162]

A second illustration of the lack of symmetry between the amount of interest expense allowable as a deduction and the portion of an interest payment treated as U.S.-source income is that interest paid by a "nonresident partnership" would not be considered to be U.S.-source income even if all its partners were U.S. residents entitled to a deduction for their respective distributive shares of such interest.[163] Similarly, all interest paid by a partnership, all of the partners of which were foreign and which was engaged in a U.S. trade or business at some time during the year, would be U.S.-source income, regardless of the portion of the interest payments that was deductible in the United States.[164] Consider a foreign partnership, such as a foreign law firm, that performs services in the United States for one day. That partnership is considered under the regulations to be engaged in a U.S. trade or business during the taxable year and, therefore, is a resident of the United States.[165] The result is that all interest paid by that partnership is considered to be U.S.-source income. It is not difficult to see why in many cases this rule was too harsh to enforce. Nevertheless, it remains the law.[166] The 1986 Act adopts no less broad a source rule for interest paid by foreign corporations.

B. Section 884 Should Require Symmetry

Section 884(f)(1)(A), as originally enacted, provided that in the case of a foreign corporation engaged in a U.S. trade or business,[167] any interest "paid by the U.S. trade or business of such foreign corporation" is treated, for purposes of imposing a tax on the foreign recipient thereof and withholding, as if that interest were paid by a domestic corporation. The 1988 Act amended § 884(f)(1) to apply the provision to foreign corporations having gross income treated as effectively connected as well as those engaged in a U.S. trade or business, whether or not the corporation is a resident foreign corporation, and to apply § 884(f)(1) for all income tax purposes. The 1988 Act also added to § 884(f)(1) a provision that § 884(f)(1)(A) will not apply to interest in excess of "the amounts reasonably expected to be deductible under § 882," but only to the extent

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[162] IRC § 861(a)(1)(D) (1954); see Reg. § 1.882-5.

[163] IRC § 861(a)(1) (1954).

[164] Id.; Reg. § 1.861-2(a)(2).

[165] Reg. § 1.861-2(a)(2).

[166] IRC § 861(a)(1); cf. Temp. Reg. § 1.884-4T(b)(8)(v) Ex. 2.

[167] The Regulations provide that, for purposes of § 1.884-4T, a foreign corporation is treated as engaged in a U.S. business if it owns any U.S. assets or derives effectively connected income at any time during the taxable year. Temp. Reg. § 1.884-4T(a)(1).

provided in regulations.[168] The effect of § 884(f)(1)(A) is that this interest is considered under § 861(a)(1) (as modified by the 1986 Act) to be U.S.-source income regardless of the portion of the income of the foreign corporation that is effectively connected with a U.S. trade or business and (except as provided in regulations) regardless of the portion of the interest that is deductible for U.S. tax purposes.

This lack of symmetry between the deductibility of interest and its treatment as U.S.-source income appears to be inconsistent with the underlying premise of § 884. Under § 884, the U.S. trades or businesses of the foreign corporation generally are treated as one hypothetical wholly owned domestic subsidiary of the foreign corporation.[169] 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.[170] Consistent with this principle, only the portion of the interest paid by the foreign corporation that is deductible under the interest allocation rules should be treated as interest paid by a U.S. corporation and, hence, U.S.-source income.[171] Indeed, consistency would seem to require that any interest paid in excess of the amount deductible should be treated as not having been incurred by a U.S. trade or business. Consistency also would seem to require that the converse be true: Either the amount of interest considered to be paid by a U.S. trade or business for a taxable year should not be less than the amount of the interest deduction allowable under § 1.882-5 of the regulations or the amount of interest expense allowable under § 1.882-5 of the regulations should not exceed the amount of interest considered to be paid by the U.S. trade or business. But, if the converse were true, there would be no excess interest[172] problem to speak of.

C. *One Step Toward Symmetry and Away from Predictability—"Interest Shortfall"*

Except as may be provided in regulations, the statute does not expressly require consistent treatment.[173] The regulations do attempt to provide for consistent treatment in a number of, but not in all, circumstances. First, the regulations provide that where the amount of interest paid by the U.S. trade or business of a foreign corporation (defined be-

[168] 1988 Act, note 2, at § 1012(g)(3)(B) (adding language at the end of § 884(f)(1)).

[169] See notes 93-94 and accompanying text.

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

[171] See 1986 Bluebook, note 22, at 1037; cf. Convention for the Avoidance of Double Taxation: Taxes on Income, March 8, 1971, United States-Japan, art. 6(2), 23 U.S.T. 967, T.I.A.S. No. 7365, 2 P-H Tax Treaties ¶ 54,030 [hereinafter U.S.-Japan].

[172] See IRC § 884(f)(1)(B); Temp. Reg. § 1.884-4T(a)(2).

[173] Cf. IRC § 884(f)(1) (last sentence), (g).

low) exceeds the amount of the interest allowed as a deduction (including interest that would have been so allowed were it not required to be capitalized) that excess is to be eliminated.[174] As a result, the amount of the U.S.-source interest paid by a foreign corporation cannot exceed the amount of that foreign corporation's allowable interest expense, a rule that appears to make theoretical sense.

While theoretically sound, the rule does not take into account that the payor of interest must resolve the source issue at the time of payment, when withholding may be required. Providing that interest payments considered to be from sources within the United States cannot exceed the amount of the allowable interest expense is not helpful to the person attempting to determine how much of an interest payment falls within the category of U.S.-source interest subject to withholding, since the amount of interest that may be deducted can be determined only after the end of the year, well after the interest payment in question is made. The regulations have not gone as far as is authorized in § 884(f)(1), as amended by the 1988 Act. Rather, predictability is subordinated to symmetrical treatment, with the anticipation that where allowable interest expense falls short of the interest considered paid by a U.S. trade or business (that amount has been referred to as "interest shortfall"[175]), overwithholding will occur, and any overwithholding is to be corrected by a refund claim.[176] In this connection, it has been suggested that a better idea might be to preserve the U.S.-source character of the interest shortfall, but to permit the amount of the interest shortfall for one year to be carried back or forward to reduce any excess interest payment in another year so that an average symmetry could be achieved.[177]

D. *The 80% Solution*

The regulations require that the amount of interest considered as paid by a U.S. trade or business be increased by the amount of the excess of interest allowable under § 1.882-5 of the regulations and certain nondeductible interest over interest paid by a U.S. trade or business.[178] Significantly, however, this rule applies only for any year in which the U.S. assets of the foreign corporation at the close of the taxable year equal or

[174] Temp. Reg. § 1.884-4T(b)(6)(i).

[175] See N.Y. State Bar Ass'n Tax Section, Report on Temporary Branch Profits Tax Regulations 41-43 (Dec. 8, 1988) [hereinafter NYSBA Report].

[176] Temp. Reg. § 1.884-4T(b)(6)(iii) Exs. 1 and 2. To be sure, the regulations do provide for a limited election to designate the liabilities that do not give rise to interest paid by a U.S. trade or business. See Temp. Reg. § 1.884-4T(b)(6)(ii). In the absence of the election, other ordering rules apply. See Temp. Reg. § 1.884-4T(b)(6)(i). Neither of these rules appears to address the issues noted in the text.

[177] See NYSBA Report, note 175, at 42-43.

[178] Temp. Reg. § 1.884-4T(b)(5)(i).

exceed 80% of all money and the adjusted bases (for E & P purposes) of all property of the foreign corporation.[179]

When this 80% rule applies, the additional amount treated as having been paid by a U.S. trade or business is considered to be paid, first, pro rata in respect of all liabilities that are not included within the category of obligations that give rise to interest considered as not paid by a U.S. trade or business (under rules discussed below), and, second, pro rata with respect to liabilities that give rise to interest not considered to be paid by a U.S. trade or business. While not expressly authorized by the statute or its legislative history, the 80% rule is a commendable one: In one fell swoop it, in effect, eliminates the excess interest concern for any single-purpose foreign corporation that invests primarily in U.S. business activities without regard to whether such foreign corporation adheres to the requirements described below for payment of interest by a U.S. trade or business.

A legitimate question is whether the rule should be limited by the 80% requirement; absent that limitation, there could never be an excess interest problem. It is not readily apparent why that solution has not been adopted. Any additional interest treated as U.S.-source income because of a rule such as the 80% rule would or would not be subject to withholding depending on the status of the payee. Such a solution seems to be similar to that suggested by the conference report regarding the 1986 Act, which indicated that regulations may look to the external borrowings by the corporation.[180] One can only speculate that the time for repealing the excess interest rule (by regulation) is not yet ripe, so the commotion over the excess interest problem will continue at least for now. Of course, one need not repeal the excess interest rule to remedy the problem: It has been suggested that the requirement of symmetry, which appears to be the premise of § 884(b)(1)(B), could be achieved merely by enabling a foreign corporation to elect to forgo its allowable interest deduction to the extent it exceeds the amount of interest treated as having been paid by a U.S. trade or business.[181] It is unclear why such a solution has not yet found favor.

E. *Interest Paid by a U.S. Trade or Business*

Because of the excess interest rule, whether interest has been paid by a U.S. trade or business and, if so, when, become important issues. A fictional entity, however, cannot make an actual payment, and whether an obligation is recorded as a liability on a "branch's" books may not indi-

[179] Temp. Reg. § 1.884-4T(b)(5)(i)(A) [hereinafter sometimes referred to as the 80% rule].

[180] Conf. Rep. No. 841, 99th Cong., 2d Sess. II-649 (1986), reprinted in 1986-3 C.B. (vol. 4) 649.

[181] See NYSBA Report, note 175, at 55-57.

cate whether the U.S. branch or another branch will bear the liability. Notwithstanding these problems, the system can work only when identification is possible. One possibility might have been to permit an election to treat any interest in respect of any liability as having been paid by a U.S. trade or business. The regulations take several steps in this direction, but fall short. To be sure, the regulations, in effect, permit a foreign corporation to elect to treat a liability as giving rise to U.S.-source interest by identifying the liability as a liability of the U.S. trade or business on at least certain books and records.[182] However, for the election to be effective, *one* of the following three requirements must be met.

1. Timely Identification

Identification on books and records of the U.S. trade or business, on other records of the foreign corporation, or on a schedule established for the purpose of identifying the liabilities of the U.S. trade or business, which records or schedules are maintained in the United States by the foreign corporation or an agent of the foreign corporation, must be made on or before the earlier to occur of the date on which the first payment of interest on the liability is made or the sixtieth day after the liability was incurred.[183]

Each such liability must be identified with sufficient specificity that the amount of interest paid or accrued with respect to the liability and the name and address of the recipient can be readily identified from the records or schedule.[184] Effective for taxable years beginning after December 31, 1989 (and, if the foreign corporation so elects, for earlier years), the timely identification rule applicable to foreign corporations (other than those that maintain a federal or state banking branch or agency) will provide that (1) the liability must be identified as described above on or before the earlier of the date on which the first payment of interest is made thereon or the due date (including extensions) of the foreign corporation's income tax return for the taxable year, *and* (2) the foreign corporation must either make a return under § 6049 with respect to the interest payment or notify the recipient of the interest within two

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[182] Temp. Reg. § 1.884-4T(b)(1).

[183] Temp. Reg. § 1.884-4T(b)(1)(i)(B); Notice 89-80, 1989-30 I.R.B. 10; see note 187. The regulations originally provided that this requirement could be met by identifying liabilities on books and records on or before January 3, 1989. Temp. Reg. § 1.884-4T(b)(1). However, the Service recently extended this date to September 15, 1989, "in view of the rules announced in Notice 88-133." Notice 89-14, 1989-4 I.R.B. 12. Such records or schedules must be maintained for the entire period from the due date (including extentions) of the income tax return for the taxable year to which the records or schedules relate (or, if later, September 15, 1989) and ending with the expiration of the limitations period for assessment of tax for such year. Notice 89-80, 1989-30 I.R.B. 10.

[184] Notice 89-80, 1989-30 I.R.B. 10.

months of the end of the calendar year in which the interest was paid that the interest is U.S. sourced.[185] However, the amount of interest that is treated as paid by a U.S. trade or business by reason of this rule is not to exceed 85% of the amount of the excess interest of the foreign corporation, determined without taking into account § 1.884-4T(b)(1)(i)(B) of the Regulations.[186]

2. *Deductibility Under Branch Book/Dollar Pool Method*

Identification must be made on such books and records and the foreign corporation must use (for reasons that are not apparent) the branch book/dollar pool method (as opposed to the separate currency pools method) for determining its interest deduction under § 1.882-5(b)(3)(i) of the regulations.[187]

3. *Regulatory Books*

Identification must be made on either (1) financial statements that are required to be provided to a regulatory agency of the United States or a state or (2) books and records that are maintained in order to comply with regulatory requirements of such an agency and are used to prepare financial statements that are required to be provided to that agency.[188]

Of course, a foreign corporation engaged in a U.S. trade or business is required to maintain books and records from which its U.S. tax return is prepared.[189] Would such books qualify as books and records that are maintained in order to qualify with regulatory requirements? Is the Service a "regulatory agency?" Is the balance sheet statement on a tax return a "financial statement" that is required to be provided? The reference to "tax books" in the regulations[190] implies an affirmative answer to these questions, at least if the balance sheet statement required on Form 1120F is prepared from the "books." However, the Service recently announced that the regulations will be amended to provide that

[185] Id.; see 12 U.S.C.A. § 3101(1), (3), (5), (6), (11), (12) (1980 and Supp. 1989).

[186] Notice 89-80, 1989-30 I.R.B. 10. In addition, Notice 89-80 provides that § 1.884-4T(a)(2) of the regulations will be amended to provide that a portion of the excess interest of a foreign corporation that maintains a federal or state banking branch or agency will be treated as interest on deposits and, accordingly, exempt from tax under § 881(d). This portion is 85% of the excess interest or the ratio of deposits to all interest-bearing liabilities of the corporation as of the close of the taxable year, whichever is *greater*. Id.

[187] Temp. Reg. § 1.884-4T(b)(1)(i)(A). Effective for taxable years beginning after December 31, 1989 (and, if the foreign corporation so elects, for earlier years), the timely identification and branch book/dollar pool method rules will not apply to foreign corporations that maintain a federal or state banking branch or agency. Notice 89-80, 1989-30 I.R.B. 10.

[188] Temp. Reg. § 1.884-4T(b)(1)(ii).

[189] IRC § 6001.

[190] Temp. Reg. § 1.884-4T(b)(3) (describing Temp. Reg. § 1.884-4T(b)(1)(ii)).

liabilities identified on "regulatory books" include "only liabilities that must be taken into account in determining the required amount of reserves under Federal Reserve Regulation D, 12 CFR Part 204, and liabilities reported on NAIC annual statements to state insurance regulatory authorities."[191]

A liability that is not specifically identified nevertheless will give rise to interest paid by a U.S. trade or business if it is secured (during at least half the days during the portion of the year in which the interest accrues) predominantly by U.S. assets, but not if that liability is secured by substantially all the property of the foreign corporation.[192] Accordingly, general recourse liabilities of a foreign corporation would not appear to fall within this category, at least in a case in which the foreign corporation has significant assets other than U.S. assets. If the only asset of the foreign corporation is a U.S. asset that secures the liability, technically, there has not been compliance. However, the 80% rule may well make this issue moot. In addition, interest on a liability that is not specifically identified will be considered to be paid by a U.S. trade or business if the liability is incurred or continued to purchase a U.S. asset or if interest is required to be capitalized in respect of a U.S. asset.[193]

4. *Liabilities That Do Not Give Rise to Interest Paid by a U.S. Trade or Business*

In certain circumstances, interest paid on a liability that is not identified on "regulatory books," secured predominantly by U.S. assets, or subject to the capitalization rule may not be considered to be U.S.-source interest, even if the liability is timely identified on other books of the foreign corporation as a liability of a U.S. trade or business and even if the deduction is determined under the branch book/dollar pool method.[194] Those circumstances are described below.

Except in certain limited circumstances relating to liabilities that are deposits of foreign corporations engaged in the active conduct of a banking, financing, or similar trade or business in excess of $100,000, liabili-

[191] Notice 88-133, 1988-52 I.R.B. 28. This rule is effective for taxable years ended after December 31, 1986; any further changes to the treatment of liabilities reported to banking and insurance regulatory authorities, however, will be prospective only. Id. Effective for taxable years beginning after December 31, 1989 (and, if the foreign corporation so elects, for earlier years), a special regulatory books rule applies to foreign corporations that maintain a federal or state banking branch or agency. Notice 89-80, 1989-30 I.R.B. 10.

[192] Temp. Reg. § 1.884-4T(b)(1)(iii).

[193] Temp. Reg. § 1.884-4T(b)(1)(iv)(B).

[194] Temp. Reg. § 1.884-4T(b)(3). Effective for taxable years beginning after December 31, 1989 (and, if the foreign corporation so elects, for earlier years), these rules will not apply to foreign corporations that maintain a federal or state banking branch or agency. Notice 89-80, 1989-30 I.R.B. 10.

ties described above that are incurred in the ordinary course of a trade or business conducted outside the United States will not give rise to interest paid by a U.S. trade or business.[195] In addition, if a liability is secured predominantly by non-U.S. assets, interest thereon will not be considered to be paid by a U.S. trade or business unless the liability is secured by substantially all the assets of the foreign corporation.[196] A general recourse liability of a foreign corporation with significant U.S. assets and other assets appears to fall between the cracks.

5. *A Soak-Up Rule?*

Perhaps the rule that makes the least sense, at least prior to a recently announced amendment, is the one provided in § 1.884-4T(b)(3)(i) of the regulations. Under that rule as originally promulgated, if the income tax laws of a foreign country treat the interest expense on a liability described above either (1) inconsistently with the treatment by the foreign corporation as interest on the books of a U.S. trade or business or (2) as giving rise to a deduction for purposes of determining income from sources within such country under its foreign tax credit or exemption system, the interest expense will be treated as not having been paid by a U.S. trade or business. If this rule was intended to reduce the possibility of a double deduction, it did not do so, since deductibility in the United States depends on the rules in § 1.882-5 of the regulations. The rule did, however, increase the opportunity for the excess interest rules to apply. Moreover, it appeared to permit a foreign country to increase the amount of the foreign tax credit or exemption allowed in respect of the tax on excess interest. In other words, we can tax it so long as someone gives a credit for it—a kind of soak-up tax. The Service recently announced that, effective for taxable years beginning after December 31, 1989 (and, if the foreign corporation so elects, for earlier years), § 1.884-4T(b)(3)(i) of the regulations will not apply.[197]

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[195] Temp. Reg. § 1.884-4T(b)(3)(ii).

[196] Temp. Reg. § 1.884-4T(b)(3)(iii).

[197] Notice 89-80, 1989-30 I.R.B. 10. In the case of a corporation not making the election, the Regulations will be amended, effective for taxable years beginning before January 1, 1990, to provide that interest will not be treated as paid by a U.S. trade or business "only if the interest, or the liability that gives rise to the interest, is reflected on the books of a foreign branch of the foreign corporation and the income tax imposed in the country in which the branch is located is reduced, or an income tax benefit results, by reason of the fact that the interest or liability is reflected on such books." Id. Notice 89-80 gives the following example:

> [A]ssume that, under the laws of a foreign country, the amount of interest expense that reduces the income of a foreign corporation from sources within that country, for purposes of computing a foreign tax credit or for purposes of computing the income tax in a foreign country that provides relief from double taxation by way of an exemption system, is determined by apportioning the foreign corporation's worldwide interest expense to income from the foreign corporation's trade or business in such country based, for

F. *The Timing of Interest Payments and Interest Paid by Partnerships*

The regulations attempt to deal with two additional issues that arise under the excess interest provisions of § 884(f)(1)(B): (1) The time when interest will be considered to be paid and (2) the treatment of interest paid by a partnership in which a foreign corporation is a member. These issues arise because the BIT is imposed on the difference between the amount of the interest deduction for the year and the amount of interest "paid" by a U.S. trade or business. For example, interest accrued in year one and paid in year two or paid in year one and deductible in year two could easily give rise to an excess interest problem merely because of a timing difference, unless the 80 percent rule were to apply. Similarly, interest paid by a partnership in which a foreign corporation is a partner could give rise to an excess interest problem unless interest paid by the partnership were somehow taken into account.

1. *Interest Payments by Partnerships*

In the latter connection, it must be remembered that for interest to be treated as having been paid by a U.S. trade or business, it must arise in connection with a liability of the foreign corporation that either has been identified on certain books of the foreign corporation as being a liability of the U.S. trade or business, is secured primarily by U.S. assets, or was incurred in connection with the acquisition of U.S. assets. The draftsperson of the regulations must have assumed that a liability of a partnership in which a foreign corporation is a partner could not meet these requirements, perhaps because it is not a liability of the foreign corporation.[198] Accordingly, under § 1.884-4T(c)(2)(i) of the regulations, interest paid by a partnership is excluded from being characterized as interest paid by a U.S. trade or business of a foreign corporation for purposes of § 884(f)(1)(B). However, the foreign corporation's distributive share of interest paid by a partnership reduces, subject to a limitation discussed below, the amount of its excess interest, provided that interest is not paid in respect of a liability characterized, under the rules discussed above, as not giving rise to interest paid by a U.S. trade or business. The amount of the reduction is limited to the portion of the foreign corporation's dis-

example, on the ratio of the value of assets used in such trade or business to the value of all assets of the foreign corporation. In such case, the double tax benefit rule does not prohibit the identification of a liability as a liability that gives rise to interest paid by a U.S. trade or business, even though the liability is reflected on the foreign corporation's books as a liability of a trade or business in that country, because the amount of foreign income tax in that country is determined without regard to the branch to which a particular liability is booked.

[198] Cf. Temp. Reg. §§ 1.884-1T(e)(2) (providing that a portion of the liabilities of a partnership are taken into account for the purpose of determining U.S. net equity), 1.861-9T(e)(7).

tributive share of the interest paid by the partnership that is allowed as a deduction.[199]

The intent of this rule apparently is that the same interest not be treated both as excess interest and as U.S.-source interest. Whether this in fact will be the case in all circumstances is less than clear. In any event, when one considers that all interest paid by a resident partnership is U.S.-source income,[200] it is unclear why the foreign corporation's distributive share of interest paid by a U.S. trade or business is not treated as interest paid by a U.S. trade or business in its entirety. Indeed, such treatment would be consistent with the treatment for treaty purposes[201] of interest paid by a partnership in which there is a foreign corporate partner. However, by treating only a portion of the interest paid by a resident partnership as reducing excess interest, cases can arise in which the U.S.-source interest borne by a foreign corporation (through its participation in a resident partnership) will equal or exceed the interest deduction allowed under § 1.882-5 of the regulations and yet there will be excess interest, a result which appears to fly in the face of what one would suspect was the intent of § 884(f)(1)(B). If symmetry between the amount of interest that is deductible and that which is treated as U.S.-source income is the intent of § 884(f)(1)(B), a foreign corporation's distributive share of interest paid by a resident partnership should be considered interest paid by a U.S. trade or business.

2. *Timing*

The solution in the regulations to the problem caused whenever interest is deductible in a year other than the year of payment is also worth brief mention. The regulations provide for two elections. Under the first election, a foreign corporation can elect to reduce its excess interest by the amount of interest that accrues in a year earlier than payment, if the interest would be considered paid by a U.S. trade or business in the year of payment.[202] The second election allows a foreign corporation to reduce its excess interest for a later year if payment precedes the year of deduction.[203]

In the case of the first election, the accrued interest is treated as interest paid by a U.S. trade or business on the last day of the year in which it accrues.[204] That interest is not again to be treated as being paid by a U.S. trade or business in the year of payment. Presumably, this rule operates

[199] Temp. Reg. § 1.884-4T(c)(2)(i).
[200] See IRC § 861(a)(1); Reg. § 1.861-2(a)(2).
[201] See Temp. Reg. § 1.884-4T(b)(8)(iv).
[202] Temp. Reg. § 1.884-4T(b)(7)(i).
[203] Temp. Reg. § 1.884-4T(b)(7)(ii).
[204] Temp. Reg. § 1.884-4T(b)(7)(i).

only for purposes of mitigating the timing problem that might otherwise give rise to excess interest. It should not be extended to treat accrued interest that reduces excess interest under the rule as having been paid for the operative income and tax withholding provisions of the Code.[205] Indeed, were it extended to treat that interest as having been paid under the income and tax withholding provisions of the Code, the solution might well carry with it a number of problems. But, if the rule is limited as suggested in this article, why is the rule elective? If the rule were to be elective, it might be better to have the currently elective treatment be the general rule, with the possibility of an election out.

V. Treaty Considerations

A. *Overview*

The imposition of the BPT on the DEA of a foreign corporation and the BIT on its excess interest ordinarily could be seen as conflicting with nondiscrimination provisions of existing treaties.[206] In addition, tax treaties often preclude the imposition of a second-level tax on interest or dividend payments or impose conditions thereon.[207] Tax treaties generally also exempt from tax, or reduce the rates of tax on, business profits not attributable to a permanent establishment,[208] interest not attributable to

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[205] IRC §§ 871, 881, 1441, 1442; see NYSBA Report, note 175, at 43-44.

[206] See U.S. Draft Model Income Tax Convention, art. 24(3), June 16, 1981, 1 P-H Tax Treaties ¶ 1022; Convention with Respect to Taxes on Income and Capital, Sept. 26, 1980, United States-Canada, art. XXV(6), 1 P-H Tax Treaties ¶ 22,030 (entered into force Aug. 16, 1984) [hereinafter U.S.-Canada]; see also Notice 87-56, 1987-2 C.B. 367. But cf. U.S.-Canada, art. X(6); Convention for the Avoidance of Double Taxation: Taxes on Income, Aug. 6, 1982, United States-Australia, art. 10(6), T.I.A.S. No. 10773, 1 P-H Tax Treaties ¶ 15,030 [hereinafter U.S.-Australia]. Contra Notice 89-80, 1989-30 I.R.B. 10.

[207] Convention with Respect to Taxes on Income and Certain Other Taxes, Apr. 29, 1948, United States-Netherlands, art. XII, 62 Stat. 1757, T.I.A.S. No. 1855, supplemented by Supplementary Convention, Dec. 30, 1965, 17 U.S.T. 896, T.I.A.S. No. 6051, 3 P-H Tax Treaties ¶ 66,100 [hereinafter U.S.-Netherlands]; U.S.-Japan, note 171, art. 6(1); Convention for the Avoidance of Double Taxation: Taxes on Income, June 4, 1976, United States-Korea, art. 6(1), 30 U.S.T. 5253, T.I.A.S. No. 9506, 2 P-H Tax Treaties ¶ 56,100; Convention for the Avoidance of Double Taxation: Taxes on Income, Apr. 17, 1984, United States-Italy, art. 10(5), 2 P-H Tax Treaties ¶ 53,030 [hereinafter U.S.-Italy]; Convention for the Avoidance of Double Taxation: Taxes on Income, July 22, 1954, United States-West Germany, art. XIV(1), 5 U.S.T. 2768, T.I.A.S. No. 3133, modified by Protocol, Sept. 17, 1965, 16 U.S.T. 1875, T.I.A.S. No. 5920, 2 P-H Tax Treaties ¶ 39,100. Income Tax Treaty. In some cases, the benefit is available only to residents of the treaty country. See Convention for the Avoidance of Double Taxation: Taxes on Income, May 24, 1951, United States-Switzerland, art. XIV(1), 2 U.S.T. 1751, T.I.A.S. No. 2316, 3 P-H Tax Treaties ¶ 82,101 [hereinafter U.S.-Switzerland].

[208] Convention for the Avoidance of Double Taxation: Taxes on Income, Dec. 31, 1975, United States-United Kingdom, art. 7(1);' 31 U.S.T. 5668, T.I.A.S. No. 9682, 3 P-H Tax Treaties ¶ 89,030 (entered into force Apr. 25, 1980) [hereinafter U.S.-U.K.]; U.S.-Canada, note 206, art. VII(1).

a permanent establishment,[209] and dividends not attributable to a permanent establishment.[210] Certain treaties specifically allow a branch profits tax, but limit the rate of tax thereon and the computation of the amount subject to the tax.[211]

Section 884 takes a twofold approach. As a general rule, it does not purport to override any provision of a treaty that is inconsistent with the new provisions.[212] However, in the case of "treaty shopping," it may override conflicting treaty provisions.[213] In a nontreaty shopping case, (1) a treaty exempting a corporation from the BPT will control; (2) if a treaty allows a BPT but provides for a reduced rate of tax, the reduced rate will apply; and (3) if no specific treaty provision for BPT exists, a reduced nonportfolio dividend rate will apply rather than the 30% rate.[214] In addition, in a nontreaty shopping case, the rate of BIT will not exceed the rate provided under the treaty that would apply with respect to interest paid by a domestic corporation to a foreign corporate resident of the treaty country.[215] The related issue of whether a more general provision of an applicable treaty, such as an applicable nondiscrimination provision, may preclude the application of the tax on excess interest, originally was left for further consideration in connection with Treasury's study of the tax treaty program.[216] However, in a perplexing and somewhat remarkable statement, the Service recently announced that the Treasury Department "has concluded that the tax on excess interest is not prohibited by the nondiscrimination provision or any other provision in any income tax treaty to which the United States is a party." In the words of the Service, "[b]ecause the tax on excess interest is essentially a tax on interest paid by the foreign corporation that is apportioned to its United States permanent establishment, its imposition is no more a denial of a deduction than is the imposition of the tax on interest paid by the U.S. permanent establishment."[217] In addition, under the regulations, a conflicting treaty provision will control in a nontreaty shopping

[209] See, for example, U.S.-U.K., note 208, art. 11 (exemption); U.S.-Netherlands, note 207, art. VIII (exemption); U.S.-Canada, note 206, art. XI (15% rate); U.S.-Switzerland, note 207, art. VII(1) (5% rate).

[210] U.S.-Switzerland, note 207 art. VI (15 or 5%); U.S.-Netherlands, note 207, art. VII (15 or 5%); U.S.-Canada, note 206, art. X (15 or 10%).

[211] See U.S.-Canada, note 206, art. X(6); U.S.-Australia, note 206, art. X(6); see also Temp. Reg. § 1.884-1T(h)(4)(i)(B) (BPT rates for various treaty countries); Notice 89-73, 1989-26 I.R.B. 28 (BPT rate for France); Notice 87-56, 1987-2 C.B. 367.

[212] Cf. IRC §§ 894(a)(1), 7852(d)(1); 1988 Act, note 2, at § 1012(aa)(3)(E)-(G).

[213] IRC § 884(e)(1); Temp. Reg. § 1.884-1T(h)(1).

[214] IRC § 884(e)(2); Temp. Reg. § 1.884-1T(h)(1).

[215] Temp. Reg. § 1.884-4T(c)(3)(i); see IRC § 884(f)(3).

[216] See T.D. 8223, Explanation of Provisions (Sept. 6, 1988); see also Conf. Rep. No. 841, 99th Cong., 2d Sess. II-649 (1986), reprinted in 1986-3 C.B. (vol. 4) 649 (referring to a specific treaty exemption); cf. IRC § 7852(d)(1).

[217] Notice 89-80, 1989-30 I.R.B. 10.

case if the foreign corporation meets the requirements of any limitation of benefits provision of that treaty with respect to the DEA and the limitation of benefits provision entered into force after December 31, 1986.[218]

By comparison, a nonqualified resident of a tax treaty country (i.e., one who is treaty shopping and for whom a limitation of benefits provision described in § 1.884-1T(h)(1) of the regulations does not apply) may not:

(1) obtain the benefit of a nondiscrimination provision that would prevent the application of the BPT on the DEA;[219]
(2) claim the benefit of any treaty exemption for business profits not attributable to a permanent establishment in the United States with respect to the BPT;[220]
(3) claim the "benefit" of a provision of a treaty that precludes tax (or reduces the tax rate) on payments of dividends by such foreign corporation or interest by the U.S. trade or business of such foreign corporation;[221]
(4) claim the benefit of a tax treaty that permits an exemption from tax or reduced tax rate on dividends received from a foreign corporation;[222]
(5) claim the benefit of a tax treaty that permits an exemption from tax or reduced tax rate on interest paid to it by the U.S. trade or business of another foreign corporation or on excess interest deemed to be received by it from its U.S. branch;[223] or
(6) obtain the benefits of any reduction in rate or other modification under a treaty in the computation of the amount subject to the BPT.[224]

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[218] Temp. Reg. § 1.884-1T(h)(1).

[219] IRC § 884(e)(1). As originally enacted, § 884(e)(1)(B) provided that if the treaty permitted a secondary withholding tax on dividends paid by such a foreign corporation, the BPT could have been avoided to the extent it conflicted with a nondiscrimination provision. This provision has been repealed by the 1988 Act.

[220] See Temp. Reg. § 1.884-1T(f)(4) Ex. 2; Conf. Rep. No. 841, 99th Cong., 2d Sess. II-650 (1986), reprinted in 1986-3 C.B. (vol. 4) 650.

[221] IRC § 884(e)(3)(B), (f)(3)(A).

[222] IRC § 884(e)(3)(B); see IRC § 884(f)(3)(B).

[223] IRC § 884(f)(3)(B); Temp. Reg. § 1.884-4T(c)(3). This rule may be somewhat broader in its application than might otherwise appear. For example, under the regulations, a foreign corporation's distributive share of interest paid by a partnership falls under this rule. Accordingly, such interest will not obtain the benefit of a treaty exemption or reduced rate unless the foreign corporate partner or the recipient is a qualified resident. See Temp. Reg. § 1.884-4T(b)(8).

[224] IRC § 884(e)(1); Temp. Reg. § 1.884-1T(h)(4).

B. *Elimination of Withholding on Dividends Limited to Post-Effective Date E & P*

Because the BPT was enacted in order to replace the existing withholding rules applicable to remittance, it is not surprising that where a treaty does not preclude a BPT from being imposed on a foreign corporation for a taxable year, any dividends paid out of the E & P of the foreign corporation *for that taxable year* will not be subject to withholding under § 1441 or 1442 or tax under § 871(a) or 881(a).[225] Dividends paid after the effective date of § 884 (post-86 dividends) out of E & P accumulated in years prior to such effective date (pre-87 E & P), however, are not exempt from the withholding tax that otherwise might be applicable. Although the statute and the regulations are silent on this issue,[226] the 1986 Act bluebook and the description of "present law" in the legislative history of the 1988 Act modifications[227] suggest that, under the 1986 Act, (1) pre-1986 Act law regarding the withholding tax on dividends, rather than the BPT, applies to post-86 distributions of pre-87 accumulated E & P; (2) the withholding tax does not apply to post-86 dividends out of pre-87 E & P if the branch's income did not constitute at least 50% of the corporation's income "for the base period prescribed under prior law";[228] (3) pre-87 deficits in E & P do not reduce post-86 E & P in applying the BPT; and (4) post-86 deficits in E & P do not reduce pre-87 E & P in applying pre-1986 Act law regarding the withholding tax to post-86 distributions out of pre-87 E & P.

Thus, for purposes of this rule, the determination of whether a distribution is a dividend under § 316 will be made as if the foreign corporation's E & P account had been frozen on the day before the effective date of the BPT. A similar segregation may be required with respect to E & P accumulated for any year in which a treaty precludes the BPT, raising the issue of whether post-86 deficits in any year for which the BPT could not be imposed by reason of a treaty may be aggregated with positive post-86 E & P as well as with pre-87 accumulated E & P. Furthermore, while there is nothing in the regulations on the issue, it would seem that

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[225] IRC § 884(e)(3)(A). Section 884(e)(3)(A), prior to its amendment by the 1988 Act, literally precluded the imposition of the withholding tax in the case of a foreign corporation subject to BPT for a year on any dividends paid during the taxable year, without regard to whether the dividend was out of E & P accumulated during a year the foreign corporation was subject to the BPT. However, the 1986 Act Bluebook implied that the rule would be more limited. 1986 Bluebook, note 22, at 1047.

[226] The regulations reserve with respect to the issue of the interaction of the BPT and second-tier withholding pending the passage of the 1988 Act. Temp. Reg. § 1.884-3T; T.D. 8223, Explanation of Provisions (Sept. 6, 1988).

[227] See S. Rep. No. 445, 100th Cong., 2d Sess. 350 (1988) (discussion of "present law"); H.R. Rep. No. 795, 100th Cong., 2d Sess. 284 (1988); see also 1986 Bluebook, note 22, at 1047 ("effective date" discussion).

[228] See IRC § 861(a)(2)(B) (1954).

the most recently accumulated E & P should be considered distributed first in accordance with the general ordering rules.[229] Finally, it is not clear which three-year period is or ought to be used in applying the 50% income test to post-86 distributions of pre-87 E & P.

C. *The 36-Month Rule*

Additional problems may arise where the imposition of the BPT is deferred as a result of an increase in U.S. net equity, rather than barred by a treaty provision. If a subsequent reduction in U.S. net equity arises in a year for which the BPT is barred by a treaty provision, the BPT on the deferred ECE & P essentially will have been avoided. Similarly, if a reduction in U.S. net equity in a year for which the BPT may be imposed is followed by an increase in U.S. net equity in a year for which the BPT is barred by a treaty provision, the corporation may lose the benefit of the increase. The regulations address these issues to some extent.

Section 1.884-1T(h)(2)(i) of the regulations provides that a foreign corporation that is a "qualified resident" of the treaty country solely by virtue of the stock ownership and base erosion tests (described below) will obtain the benefit of a treaty bar to the imposition of the BPT (or reduced BPT rate) only for the portion of its DEA attributable to deferred ECE & P if the foreign corporation is a qualified resident for the taxable years included, in whole or in part, in a 36-month period that includes the taxable year of the DEA. Under this provision, if a foreign corporation is a qualified resident for the prescribed 36-month period,[230] even the portion of the DEA that is attributable to deferred ECE & P accumulated prior to the 36-month period would appear to be eligible for the treaty benefit. A foreign corporation that cannot meet the 36-month test by the end of the year in which the previously deferred amount is to be taken into account is not entitled to a treaty benefit for that year. However, the foreign corporation may obtain a refund if it has met the 36-month test by the end of the second taxable year succeeding the taxable year of the DEA.[231]

D. *Qualified Resident Rules*

Section 884(e)(4) provides that a foreign corporation that is a resident of a foreign country for treaty purposes will be a "qualified resident" if it

[229] Reg. § 1.316-2(a); cf. Temp. Reg. § 1.884-1T(h)(2)(i) (providing a last-in, first-out ordering rule); IRC § 1368(c) (S corporation having subchapter C E & P distributes earnings from subchapter S years prior to distributing such E & P, absent an election under § 1368(e)(3)).

[230] Presumably, the test must be met at all times during the 36-month period.

[231] Temp. Reg. § 1.884-1T(h)(2)(ii). However, interest will not begin to accrue on the refund until the filing date for the year in which the 36-month test has been met. Id.

meets either a stock ownership and base erosion test or a publicly traded test. The regulations provide that a resident meeting an active trade or business test also will be a qualified resident, and prescribes a ruling mechanism.

1. Stock Ownership Test

Under § 884(e)(4)(A)(i), the stock ownership test is met if 50% or more (by value) of the stock of the foreign corporation is not owned, directly or indirectly, by individuals who are neither residents of the treaty country nor citizens or residents of the United States (i.e., who are third-country residents). The regulations provide that a foreign corporation will meet the stock ownership test *only* if it can establish, using specified written documentation, that 50% or more of the value of its stock is in fact owned, directly or indirectly, by individuals who are not third-country residents during at least half the number of days in the taxable year.[232] While, in most cases, a corporation would have to establish the identity of its individual shareholders in order to meet the statutory test, the regulations provide that foreign governments and foreign corporations meeting the publicly traded test are considered to be shareholders that are individual residents of the treaty country, and that publicly traded corporations are considered to be owned by individual residents of the United States or the treaty country, as the case may be.[233]

Conspicuous by its absence in the regulations as initially promulgated is any mention of foreign pension funds and foreign charitable organizations, both of which may be viewed as foreign corporations. In either case, the statutory test should be met since there would be no third-country residents who are "shareholders." However, it will be impossible to prove that the statutory test is met by establishing, under the regulations, that 50% percent or more of the value of the shares is owned by individuals who are not third-country residents. In this connection, it is understood that the Service will take the position that a pensioner is the beneficial owner of the "stock" of a foreign pension fund to the extent of such pensioner's vested interest therein. In fact, the Service has recently announced rules under which shares of a corporation that are held by a pension trust will be treated as owned by the participants.[234]

Neither § 884(e)(4)(A)(i) nor the regulations promulgated thereunder indicates the date as of which the applicable determination of stock ownership is to be made. Given that the regulations provide that the value of stock of a corporation owned by another corporation is to be determined,

[232] Temp. Reg. § 1.884-5T(b)(1)(i).

[233] Temp. Reg. § 1.884-5T(b)(2)(ii), (iii).

[234] Notice 89-80, 1989-30 I.R.B. 10.

at least in part, by reference to the shareholder's percentage share of current E & P,[235] however, the last day of the foreign corporation's taxable year may well be the most appropriate applicable determination date.

In the latter connection, the regulations do not appear to alter traditional constructive ownership rules in the case of stock owned directly by an individual, a partnership, or a trust.[236] However, when stock in a foreign corporation is owned by another corporation, an individual shareholder of the corporate shareholder is considered to own stock in the foreign corporation in a proportion equal to the lesser of the shareholder's percentage share of the corporate shareholder's (1) current E & P, (2) accumulated E & P, and (3) assets upon liquidation.[237] Apparently, other factors, such as minority discounts, are not taken into account. It is unclear why such a test was devised. Equally unclear is whether such a test can withstand a challenge. Under the test, since each shareholder is tested separately, and assuming there are different classes of shares, the possibility that all the shareholders in the aggregate will be considered to own less than 100% of the value of a foreign corporation in the aggregate will be greatly increased.

In order to establish the required ownership under the regulations, certain documents must be obtained and kept available for inspection. Section 1.884-5T(b)(3) of the regulations provides that the required documentation must be obtained from a sufficient number of shareholders before the due date (including extensions) for filing of the foreign corporation's income tax returns for the year or, if a treaty benefit is claimed for interest, before the interest payment. Presumably, this requirement is procedural rather than substantive, with the result that documents obtained later will be sufficient to establish qualifications under the stock ownership test.[238]

In the case of individual shareholders, a written statement made under penalties of perjury that the individual is a direct or indirect beneficial owner is required. The statement must contain such information as the name and address of the shareholder, the number of shares beneficially owned, the period in the year during which the shares were owned, and information concerning any intermediaries and the country of resi-

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[235] Temp. Reg. § 1.884-5T(b)(2)(i)(D).

[236] Temp. Reg. § 1.884-5T(b)(2)(i)(A), (B), (C).

[237] Temp. Reg. § 1.884-5T(b)(2)(i)(D). E & P for this purpose is determined under the principles of § 1248. Id.

[238] Cf. Casanova Co. v. Commissioner, 87 T.C. 214 (1986) (late Form 1001 sufficient to establish exemption from withholding where regulations silent as to timing). The Service recently announced that the regulations will be amended to provide that, for its taxable year beginning in 1987, a foreign corporation has until the later of the due date (including extensions) for its tax return and September 15, 1989 to obtain the required documentation. Notice 88-133, 1988-52 I.R.B. 28. Query whether ownership may be established by means other than those prescribed in the regulations?

dence.[239] In addition, if an individual claims to be a resident of a treaty country, a certification of residency by the competent authority of that country must be obtained.[240] Statements from foreign governments and publicly traded corporations are to be signed by the competent authority and by a person authorized to sign tax returns on behalf of the corporporation, respectively.[241]

If there are "intermediaries" between the individual beneficial shareholders and the foreign corporation, intermediary statements also must be obtained.[242] In a case where an intermediary is a U.S. resident or a treaty resident foreign corporation, an "intermediary verification statement" may be obtained in lieu of the individual shareholder statements. However, in order for an intermediary to provide such a statement, it must (1) have obtained the appropriate individual documentation, (2) agree to retain and to make such information available to the Service, and (3) waive any right to bank or other secrecy.[243]

2. *Base Erosion Test*

In addition to meeting the stock ownership test, a foreign corporation cannot have "eroded its base." A foreign corporation is considered to have eroded its base if 50% or more of its income is used (directly or indirectly) to meet liabilities to third-country residents.[244] The regulations require that to meet this test, a foreign corporation must establish that amounts that in the aggregate are less than 50% of its income are used to meet liabilities to third-country residents, rather than requiring a showing that 50% or more of its gross income is used to meet liabilities to persons other than third-country residents.[245] Moreover, the use of funds to repay the principal amount of an obligation is not a proscribed use; rather, a proscribed use occurs if the payment gives rise to a tax benefit (including a deduction, an increase in basis, or tax credit) determined under U.S. tax principles.[246]

The base erosion test will be difficult to meet in many instances. Consider, for example, the case of a foreign corporation incorporated and resident in a treaty country that operates ten branches equal in size, including its home office and nine other branches, each in a different country. Assuming that the income and expense of each of the branches are

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[239] Temp. Reg. § 1.884-5T(b)(4)(i).

[240] Temp. Reg. § 1.884-5T(b)(4)(ii); cf. Prop. Reg. § 1.1441-6(c), 49 Fed. Reg. 3511 (Sept. 10, 1984).

[241] Temp. Reg. § 1.884-5T(b)(4)(i).

[242] See Temp. Reg. § 1.884-5T(b)(5), (6).

[243] Temp. Reg. § 1.884-5T(b)(6).

[244] IRC § 884(e)(4)(A)(ii).

[245] Temp. Reg. § 1.884-5T(c); cf. Temp. Reg. § 1.884-5T(b)(1).

[246] Temp. Reg. § 1.884-5T(c).

equal and assuming that expenses constitute a significant percentage of revenue, the amount paid to meet liabilities of third-country residents is likely to be more than 50% of the gross income of the foreign corporation. As a second illustration, consider the case of a third-country branch of a foreign corporation acquiring depreciable assets in an amount equal to more than 50% of its gross income. Such a corporation technically has eroded its base, apparently whether or not it financed the acquisition out of current earnings, out of borrowings, or out of existing or additional capital. The regulations do not appear to contemplate a tracing of funds.

3. *Active Trade or Business*

Recognizing that in many cases there will be problems meeting both the base erosion rule and the stock ownership rule, the regulations have provided for a separate basis for establishing a foreign corporation as a qualified resident.[247] To come within this special rule, the foreign corporation must be actively engaged in a trade or business in the treaty country,[248] and it must have a "substantial presence" within that country.[249] In addition, if qualification is sought in respect of the BPT, the foreign corporation must establish that the U.S. business activities are an integral part of the active trade or business conducted in the foreign country. Also, if qualification is sought in respect of interest paid by a U.S. trade or business, the foreign corporation must establish that the interest received is derived in connection with the active conduct of the trade or business in the foreign country.[250] None of these tests is easy to meet. To be sure, the active conduct test may present less of a problem for most foreign corporations.[251] However, the substantial presence and the integral relation tests are likely to be more problematic.

The substantial presence test is met for a taxable year if the average of three ratios exceeds 25% and each ratio is at least equal to 20%. The ratios are:

(1) The ratio of assets used in the trade or business in the foreign treaty country to worldwide assets;
(2) The ratio of gross income from the active conduct of the business in the foreign treaty country to worldwide gross income; and

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[247] Temp. Reg. § 1.884-5T(e).
[248] Temp. Reg. § 1.884-5T(e)(1)(i); see IRC § 367(a)(3); Temp. Reg. § 1.884-5T(e)(2).
[249] Temp. Reg. § 1.884-5T(e)(1)(ii).
[250] Temp. Reg. § 1.884-5T(e)(1)(iii).
[251] Indeed, a foreign corporation that qualifies as a banking, financing, or credit institution will be considered to meet this test. Temp. Reg. § 1.884-5T(e)(2)(ii).

(3) The ratio of payroll expenses in the foreign treaty country to worldwide payroll expenses.[252]

Any foreign corporation with more than four branches that are equal in size in different countries generally cannot meet this test.

The integral part test is met only if an active trade or business conducted in both the United States and the foreign country comprises "complementary and mutually interdependent steps" in the United States and the foreign country in the production and sale or lease of goods or in the provision of services.[253] Where goods are sold in the United States that have not been manufactured in the foreign country of residence, the integral part test will not usually be met. However, the integral part test will be presumed to have been met if at least 50% of the foreign corporation's worldwide gross income from the sale or lease of property of the type sold in the United States (or from the performance of services of the type performed in the United States) is derived from the sale or lease of that property for use, disposition, or consumption (or from the performance of such services) in the foreign country of residence.[254] In addition, a U.S. trade or business engaged in the banking business will be considered an integral part of the foreign corporation's banking business if at least 50% of the principal amount of the foreign corporation's loans are to residents of the foreign corporation's country of residence.[255] The 50% requirement is likely to make the presumption presumptively inapplicable to most multinational foreign corporations.

4. *Publicly Traded Exception*

Under the Code, a foreign corporation the shares of which are primarily and regularly traded on an established exchange in the country of residence or in the United States is considered to be a qualified resident.[256] So, too, is a foreign corporation that is a wholly-owned subsidiary, directly or indirectly, of a foreign corporation the shares of which are so traded.[257] In addition, a foreign corporation will be considered a qualified resident if it is a wholly-owned subsidiary, directly or indirectly, of a domestic corporation, the shares of which are primarily and regularly traded on an established securities market in the United States.[258] Thus, for example, a Dutch corporation does not qualify if its shares are primarily traded on an exchange in the United Kingdom even if its

[252] Temp. Reg. § 1.884-5T(e)(3).
[253] Temp. Reg. § 1.884-5T(e)(4)(i).
[254] Temp. Reg. § 1.884-5T(e)(4)(ii).
[255] Id.
[256] IRC § 884(e)(4)(B)(i); Temp. Reg. § 1.884-5T(d)(1).
[257] IRC § 884(e)(4)(B)(ii).
[258] IRC § 884(e)(4)(C); Temp. Reg. § 1.884-5T(d)(1)(ii).

shares are also regularly traded on an exchange in the Netherlands. The regulations provide that the primarily traded test is met if classes of stock representing 80% of the voting power and of the value of the corporation are listed on the exchange and the number of shares of each such class that are traded on the exchange exceeds the number of shares traded on any other exchange in a third country.[259] In addition, the regulations provide that a class of shares is not regularly traded if 100 or fewer persons own 50% or more of the outstanding shares of that class of stock, even if the shares held by the "public" are actively traded.[260] While it may be advisable to restrict the regularly traded concept in some manner, it may seem to some that the 50% threshold is too low.

5. *Ruling*

Finally, the regulations provide for a ruling procedure under which a foreign corporation may establish that it is a qualified resident by showing that (1) the establishment or maintenance of the corporation in the country of residence did not have as one of its principal purposes obtaining benefits under the treaty, and (2) the foreign corporation has substantial business reasons for residing in its country of residence.[261] Any ruling obtained under this provision is valid for the year for which it was requested and for two succeeding years.[262]

VI. Conclusion

The temporary regulations promulgated under § 884 provide a detailed set of rules for implementing the branch profits tax and branch-level interest tax. In some respects, the temporary regulations are consistent with the policy underlying § 884; in many respects, however, they are not. As a result, and because the temporary regulations are extremely lengthy and complex, it is likely that many foreign businesses will find that operating in the United States in branch form may be costly and difficult. It is hoped that the final regulations will better serve the legislative purpose—to treat foreign corporations operating in the United States in branch form in a manner that is similar to U.S. subsidiaries of foreign corporations.

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[259] Temp. Reg. § 1.884-5T(d)(3).
[260] Temp. Reg. § 1.884-5T(d)(4)(ii).
[261] Temp. Reg. § 1.884-5T(f).
[262] Id.; see also Notice 88-133, 1988-52 I.R.B 28.