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a separate set of books are maintained for the U.S. branch. In addition, both methods ignore intracompany branch loans.

Branch Book/Dollar Pool Method

Under the branch book/dollar pool method, the U.S.-connected liabilities (Step 2) are compared with the liabilities on the U.S. branch books. If the U.S.-connected liabilities are less than or equal to the average amount of U.S. branch book liabilities, the interest deduction allowed is computed by multiplying the average amount of U.S.-connected liabilities by the average U.S.-connected interest rate (that is, total interest expense shown on the books of the U.S. branch divided by the average amount of U.S. branch liabilities).

If the U.S.-connected liabilities exceed the average amount of the U.S. branch book liabilities, the interest deduction is equal to the sum of the total interest expense shown on the books of the U.S. branch plus a portion of the foreign dollar interest expense. This latter amount is the product of the excess of the amount of U.S.-connected liabilities over the average amount of U.S. book liabilities multiplied by the average interest rate on the U.S. dollar obligations, if any, on the books of the non-U.S. branches or offices of the foreign corporation.

The branch book/dollar pool method allows the taxpayer to allocate its interest expense on U.S. branch borrowing to its U.S. activities to the extent the funds have been used in the United States. If foreign loans have also been used for the U.S. business, the portion of the interest incurred on U.S. dollar loans by the foreign offices is also allocable to and therefore deductible by the U.S. branch.

Separate Currency Pools Method

Under the separate currency pools method, a separate interest deduction computation is made with respect to each currency in which the U.S. branch has borrowed. The interest deduction allowed for each currency is computed by first determining the ratio of the amount of U.S.-connected liabilities to the average amount of U.S. branch book liabilities. This ratio is then multiplied by the average amount of U.S. branch book liabilities denominated in the particular currency and by the average world-wide interest rate for that currency (that is, the ratio of the amount of interest expense incurred by the corporation with respect to the liabilities denominated in the particular currency to the average amount of liabilities denominated in that currency). The sum of the separate interest deductions allowed for each currency is the total interest expense deduction allowed the foreign corporation. In contrast to the branch book/dollar pool method, this method treats all assets and loans in a similar manner.

EFFECT OF REGULATIONS ON CANADIAN CORPORATION DOING BUSINESS IN THE UNITED STATES

The Canadian corporation doing business in the United States will want to plan its asset holdings and capital structure to maximize the benefit from the new interest deduction rules. First, the greater the proportion of the Canadian corporation's assets connected with its U.S. branch, the larger will be the U.S.-connected liabilities and the larger the interest deduction allowed. In addition, choosing the most favourable method of asset valuation will also increase the allowable interest deduction. The regulations permit the assets to be valued at either U.S. tax book value (that is, adjusted basis for determining gain or loss) or fair market value. The valuation method that produces the larger ratio of assets connected with the U.S. branch to the average world-wide assets will produce the largest interest deduction. Finally, in lieu of applying the ratio of average world-wide liabilities to average world-wide assets, a Canadian corporation may elect to apply the 95 per cent or 50 per cent ratio to its U.S. branch assets.

The election should generally be made if the fixed ratio exceeds the average world-wide liability/average world-wide asset ratio.

Once the maximum amount of liabilities connected with the U.S. branch is determined, the Canadian corporation will want to choose the method of computation that maximizes its deduction. As a general rule, if the corporation is incurring higher interest rates outside the United States in currencies in which the U.S. branch has borrowings, use of the separate currency pools method should maximize the interest deduction. Alternatively, if the borrowings of the Canadian corporation are concentrated in currencies with relatively low interest rates compared with the U.S. rate, use of the branch book/dollar pool method should be beneficial.

As previously stated, the effective date provision of the regulations provides the Canadian corporation with an option to apply these rules to taxable years beginning after 1976 or, alternatively, to taxable years beginning after February 6, 1980. The corporation should determine whether the use of the regulations in prior years would result in tax savings since there is a potential for refunds for tax years as early as 1977. The refund claim should, of course, be filed before the expiration of the statute of limitations set forth in section 6511 of the Internal Revenue Code.

The foreign corporation doing business in the United States must be advised to keep a separate set of books for that business. Failure to do so may preclude the corporation from taking any interest deduction because both the branch book/dollar pool method and the separate currency pools method require a determination of the U.S. trade or business book liabilities to compute the deduction.

Finally, since the allocation relates to the assets, liabilities, and interest expense of each corporation, the taxpayer must consider the effect of combining or separating U.S. operations into one or more corporations. Contributing additional assets used in a Canadian business to an existing Canadian corporation doing business in the United States will change the proportion of assets to liabilities and hence the interest allocable to the U.S. operation. Separating businesses into multiple corporations will also change the above proportion and consequently the amount of allocable interest deduction.

THE SOURCE OF A GUARANTOR'S INCOME

Fred Feingold

A recent decision of a trial judge of the U.S. Court of Claims confronts the issue of the characterization of income from international guarantee transactions.

Despite the frequency of guarantee transactions, U.S. and Canadian courts have only recently begun to focus on the characterization of the income realized by the guarantor. Thus, in *Associates Corporation of North America v. The Queen*[6] the court held that guarantee fees paid by a Canadian subsidiary to its U.S. parent did not constitute "interest" for the purposes of the Canada-U.S. income tax treaty, which excluded interest from the definition of industrial and commercial profits. Consider the following typical case.

S, a wholly owned U.S. subsidiary of P, a Canadian corporation, requires seasonal

[6]Cited infra footnote 11.

financing of its operations. One method often used for such financing is the issuance of its notes. The ability of S to "sell" its notes at terms that are acceptable often depends on the rating that would be given to such paper by the rating services. Assume that S has the ability to repay a loan made to it, but that its notes, if issued solely on the basis of its credit, cannot obtain a rating that would justify the interest rate that S wishes to pay. Further, assume that were P to guarantee the repayment of S's commercial paper, a satisfactory rating could be obtained. Finally, assume P is willing to affix its guarantee to S's commercial paper for payment by S of an arm's-length guarantee fee.

An initial issue is whether S would be viewed for U.S. tax purposes as the obligor on commercial paper issued with P's guarantee.[7] For purposes of this discussion, it will be assumed that S will be so viewed. This brings us to the issue of characterization of the activity and the income, if any, derived from P's guarantee.

Characterization of the income is important for determining the source of the income and for determining the amount, if any, subject to reallocation under IRC section 482 because different rules apply to different classes of income. Moreover, different classes of income (from U.S. sources) may be taxed differently (or not at all) under the Internal Revenue Code and under treaties to which the United States is a party. Finally, if any activities are performed in the United States, different rules may apply regarding the status of a foreign corporation as engaged in a U.S. trade or business; if a foreign corporation is so engaged for a year, it is required to file a U.S. tax return for that year and may be subject to other consequences.

Until the recent decision in *Bank of America, an Edge Act Corporation, v. U.S.*,[8] there was little in the way of precedent that could be of guidance on the issue of characterization. In *Bank of America*, a U.S. bank engaged in the international commercial banking business participated in what is known as export credit transactions in which foreign purchasers of goods from domestic sellers obtained from their foreign banks sight or time letters of credit. By virtue of the issuance of the letters of credit, the foreign banks obligated themselves to pay drafts drawn in favour of the domestic sellers upon presentation by the sellers of the documentation specified in the letters of credit. To facilitate such transactions, foreign banks requested U.S. banks to "confirm" these letters of credit. By so doing, Bank of America added its own independent obligation to pay the drafts drawn by the sellers. For this "confirmation," Bank of America charged a fee measured in part by the size of the letters of credit it confirmed. All activities that were performed by the bank relating to the confirmation were performed in the United States.

The issue was the source of income to the bank of the confirmation fees it received.[9] The taxpayer argued that the fees it received for confirming letters of credit were so closely analagous to interest income (that is, a payment for extension of its credit), that it should be so treated for source of

[7]See Treas. Reg. §1.385-9, discussed at page 243 of this issue (under the discussion on Guaranteed Loans), and *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712, 29 AFTR 2d ¶72-1408 (5th Cir. 1972). The consequences of S not being viewed as the obligor includes S's loss of an interest deduction, and interest and principal payments being treated as distributions from S to P subject to any applicable withholding tax on such distributions.

[8]81-1 USTC ¶9161, 47 AFTR 2d 81-652 (Ct. Cl. 1981).

[9]Treating income as foreign source is critical to a domestic taxpayer in respect of the calculation of its foreign tax credit limitation. See IRC §904.

income purposes.[10] The United States, on the other hand, argued that the confirmation was in essence the performance of a service, the income from which is sourced where the service is performed; in the government's view, the service was performed where the confirmation was accepted—that is, in the United States. The court reached a conclusion favourable to the taxpayer on a rationale different from the ones advanced by either litigant. Before discussing the rationale used by the court, it may be helpful to put the issue somewhat in context.

At various times consideration has been given to characterization of the income derived by a guarantor as interest,[11] as compensation for services,[12] as a contribution or dividend in the case of related parties,[13] or as insurance.[14] Moreover, in certain cases, it appears that the IRS has characterized income derived from the guarantee activity differently for different purposes.[15] The confusion is not entirely unjustified. A guarantor does provide a service to the obligor (consistent with a service and compensation characterization); the guarantor also provides the creditor protection against default (analagous to insurance); and the guarantor does make use of its credit (analogous to an interest or insurance characterization).

Assuming the service nature of the transaction is the preponderant one, determining the place of performance of the relevant services becomes significant. First, compensation is sourced in the country where the relevant services for which the compensation has been paid are performed;[16] second, to the extent services are performed in the United States by a foreign guarantor, it will be engaged in a U.S. trade or business.[17]

Before the place of performance of the relevant services can be identified, a determination must first be made of what the relevant services are.[18] The argument may be made, for example, that the essential service in connection with a guarantee is the execution of the guarantee. To so characterize the service, however, would appear to limit the guarantor's obligation in respect of earning the guarantee fee to merely signing the guarantee.[19] It would appear that a

[10]Under the interest income source rules, it is likely that the bank's fees in the circumstances indicated would be foreign source. See IRC §861(a)(1).

[11]See *Bank of America*, supra footnote 8; LTR 7808038; *Melford Developments Inc. v. The Queen*, 80 DTC 6074 (FCTD), aff'd 81 DTC 5020 (FCA); *Associates Corporation of North America v. The Queen*, 80 DTC 6049 (FCTD), aff'd 80 DTC 6140 (FCA).

[12]See LTR 7822005; *cf.* LTR 7808038.

[13]*Tulia Feedlot Inc. v. U.S.*, 513 F.2d 800, 75-2 USTC ¶9522 (5th Cir. 1975), cert. denied 423 U.S. 947 (1976).

[14]LTR 7822005.

[15]LTR 7822005 is not a private ruling, but rather a technical advice memorandum. Technical advice may be obtained from the IRS national office usually, but not always, at the request of a taxpayer when, in the course of an audit, an issue of law arises that cannot easily be resolved by the audit branch. Similar to a private letter ruling, a technical advice memorandum theoretically affects only the specific case for which technical advice is sought. Both are ordinarily published for informational purposes. An unpublished technical advice memorandum issued to the Dallas District Director on December 28, 1977 considered a gratuitous guarantee by a domestic parent of a debt of its foreign subsidiary to be analagous to insurance for source of income purposes, but compensation for purposes of the provisions of IRC §482 relating to reallocation of income between related taxpayers.

[16]IRC §§861(a)(3) and 862(a)(3); *cf.* IRC §861(a)(7).

[17]IRC §864(b).

[18]See *William N. Dillin*, 56 TC 228 (1971).

[19]This was essentially the argument advanced by the government in *Bank of America*. See Rev. Rul. 72-125, 1972-1 CB 211.

guarantor's obligation does not end with its endorsement of the obligation. Rather, the real service provided by a guarantor is the protection afforded under the guarantee. Stated differently, in this context a guarantee is an agreement to provide protection services in the future on the happening of some contingency.

In other areas there have been occasions for the courts and the Internal Revenue Service to rule on the source of compensation for an agreement to provide services in the future. It has been held that a fee paid for a covenant not to compete has its source at the place where it is most likely that the payee must refrain from competition to fulfill his obligation.[20] Similarly, "sign-on" bonuses paid to athletes have been held to be sourced in the country where it is most likely that services will be performed under the contract.[21] Thus it appears that income to be derived from an agreement to provide services in the future (or an agreement to refrain from providing competing services) is sourced at the place where it is most likely that the actual services, if they are performed, will take place.[22] While this analogy might lead a court to conclude that income earned by a parent for guaranteeing the debt of its subsidiary is analagous to compensation for services to be performed, if at all, in the future at the place where it is most likely that the guarantor must make good on its guarantee, the *Bank of America* case does not discuss this line of authority.

In *Bank of America,* the trial judge assumes that, to the extent services were provided in connection with the confirmation of letters of credit, they were actually performed by the bank accepting the paper—that is, before making good on its guarantee. What, then, are these services?

Bank of America holds that it is the assumption of risk that marks the dominant economic characteristic of the bank's participation in the letter of credit transaction. Having reached this conclusion, *Bank of America* goes on to hold that the guarantor is not in effect providing services, but rather is extending its credit, and it is the extension of its credit that creates the income. Since the substance of the transaction was a risk undertaking, income derived therefrom was held to have an insurance source rule—that is, place of risk.[23]

Consistent with the approach that, at least for the purpose of determining the source, the services in question are more closely analagous to insurance than to any other type of income, it would appear that a foreign parent guaranteeing the debt of its subsidiary should be in no worse position on the issue of whether it is engaged in trade or business within the United States than a foreign insurer insuring a U.S. risk. In this regard, it has been noted that:

> A foreign insurance company insuring U.S. risks *ordinarily* will not be viewed as conducting a U.S. trade or business and thus will not be subject to U.S. income tax if it has no U.S. office or agent and operates in the United States solely through independent brokers.[24]

Thus it would appear that if a guarantee is considered insurance, then a Canadian guarantor such as P in the case posited will not be engaged in trade or business with the United States merely by virtue of the guarantee of a U.S. risk, even though its income from such insurance will, under an insurance source rule, be considered from U.S. sources.[25]

The *Bank of America* case deals only with the issue of the source of a guarantor's income. Were the reasoning in that case to be adopted by other courts, it may resolve other issues that may arise in the case of a foreign guarantor guaranteeing a U.S. risk. Of course, thus far the *Bank of America* case presents the view only of the trial judge in the Court of Claims, which is subject to review of the judges of that court. It is as yet unclear whether the United States will seek to relitigate the issue in another court.

[20] *The Korfund Company, Inc.,* 1 TC 1180 (1943).

[21] Rev. Rul. 76-66, 1976-1 CB 189; Rev. Rul. 74-108, 1974-1 CB 248, but *cf.* Rev. Rul. 72-125, supra footnote 19.

[22] *Stemkowsk et al.,* 76 TC 23 (1981).

[23] IRC §861(a)(7). It is interesting to note that the case involved years in issue before the adoption of the insurance source rule presently contained in section 861(a)(7). Before the adoption of that rule, as the court noted, the place of risk was not the critical factor.

[24] S. Exec. Rep. No. 95-18, 95th Cong., 2d Sess., (1978), at 16. (Emphasis added.)

[25] It has been held that insurance premiums are not subject to withholding at source. See Rev. Rul. 80-222, 1980-33, IRB 10.

[26] Rev. Rul. 80-362, 1980-52 IRB, at 14.

[27] IRC §861(a)(4).

[28] Convention for the Avoidance of Double Taxation, March 4, 1942, United States-Canada, 56 Stat. 1399, TS 983.

THE SOURCE OF ROYALTY INCOME AND WITHHOLDING OBLIGATIONS OF FOREIGN PAYERS

Sidney I. Roberts

The hungry hand reaches out: royalties paid by a foreign corporation not present in the United States may be subject to U.S. tax and withholding.

An individual, A, resident of a country with which the United States has no tax treaty, owns worldwide patents. It licenses its U.S. patent to B, a Netherlands corporation, for a period less than the useful life of the patent, say, five years, for a fixed sum. B sublicenses the patent to a U.S. corporation for royalties measured by the number of units produced under the patent in the United States. Neither A nor B is engaged in trade or business within the United States, has a permanent establishment in the United States, or has any agent or representative in the United States. The only U.S. contact is the receipt of royalty income from the United States. In such a case, under a recent ruling[26] A would be subject to U.S. tax and B, the payer of the fixed royalty to A, would be required to withhold tax on the royalty.

THE TAXABILITY OF 'A'

While A, so remote from U.S. contact, may be surprised to learn that he is subject to U.S. tax on the royalties paid by B, the U.S. internal law appears to so provide. Royalties for the use of a patent in the United States or for the privilege of using patents in the United States are income from U.S. sources[27] without regard to the residence of the payer. (The same rule applies under U.S. internal law to copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and similar property.) In the case of a taxpayer not engaged in trade or business within the United States, income from U.S. sources is subject to U.S. tax at 30 per cent of gross royalty unless a treaty provides otherwise. While the Netherlands-U.S. treaty exempts the royalty income *received* by B, it does not exempt the royalties *paid* by B.

The rationale of the ruling would be equally applicable were A and B corporations resident in Canada. While the Canada-U.S. treaty currently in effect[28] reduces the rate of tax on patent royalties to 15 per