REPORT # 532

TAX SECTION

New York State Bar Association

Supplemental report on the proposed
Foreign Corporation Branch Level Tax

June 20, 1986

Table of Contents

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Attached letter dated 6/20/86 enclosing supplemental Miscellaneous report on the proposed foreign corporation branch level tax Sent to the following:

The Honorable Dan Rostenkowski
cc: The Honorable John J. Duncan
Robert J. Leonard, Esq.

The Honorable Bob Packwood
Chairman
Senate Finance Committee
cc: The Hon. Russell B. Long
John Colvin, Esq.

The Honorable J. Roger Mentz
Assistant Secretary (Tax Policy)
Department of the Treasury

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

TAX SECTION

New York State Bar Association

June 20, 1986

The Honorable Dan Rostenkowski
2232 Rayburn Building
Washington, DC 20515

Dear Representative Rostenkowski:

Last month I sent you a report on the proposed foreign corporation branch level tax contained in H.R. 3838. I am now sending you a supplemental report on that tax as contained in the Senate amendments to H.R. 3838.

The Tax Section would be pleased to be of assistance to you in connection with this matter.

Sincerely,

Richard G. Cohen
Chairman

Enclosure
cc: The Hon. John J. Duncan) with
Robert J. Leonard, Esq.) enclosure

REPORT #532

New York State Bar Association Tax Section

Supplemental Report on the Proposed Foreign
Corporation Branch Level Tax

June 19, 1986

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Supplemental Report on the
Proposed Foreign Corporation Branch Level Tax

In a report dated May 23, 1986 (“the Report”), the Tax Section concluded that the branch level tax that H.R. 3838, as passed by the House of Representatives, would impose on foreign corporations that carry on a United States trade or business was ill-advised and should not be adopted.

On May 29, 1986, the Senate Finance Committee reported to the Senate a substitute to H.R. 3838 (the “Senate Bill”). Section 951 of the Senate Bill imposes a branch level tax that in many respects is similar to the proposals in H.R. 3838. Thus, the reasons expressed in the Tax Section Report as to why a branch profits tax should not be adopted also apply to the similar provisions of the Senate Bill.

We address herein specific branch level tax provisions of the Senate Bill, especially in the context of our previous comments on H.R. 3838.*

* This supplemental report was prepared by Richard G. Cohen and John A. Corry.

1. Tax Base

Our prior report discussed the relative merits of basing the branch tax on a foreign corporation's effectively connected taxable income (the approach of H.R. 3838) or basing the tax on the corporation's effectively connected earnings and profits. The Report proposed a middle ground, which would base the branch tax upon taxable income, but would adjust for certain items, such as capital losses and accelerated depreciation, that also constitute adjustments to taxable income in computing earnings and profits.

The Senate Bill follows H.R. 3838 in basing the branch tax on effectively connected taxable income. However, it limits the tax base to current and accumulated earnings and profits that are attributable to the branch’s effectively connected income. This proposal has some merit, since the branch tax is intended to be a substitute for the dividend withholding tax that would be imposed if the branch were a separate U.S. corporation. However, it does not address the concern expressed in the Report that a branch might have substantial earnings and profits but little or no taxable income as the result of accelerated depreciation; hence, if it were a separate corporation, distributions that it would make to its stockholders would be subject to withholding tax. By imposing the tax upon the lesser of taxable income and earnings and profits, the Senate Bill does not respond to that concern.

2. Treatment of Interest Expense.

We questioned H.R. 3838's add-back of interest to taxable income in determining the base for imposing the branch level tax and discussed specific problems that would result from doing it. The Senate Bill does not require an interest add-back. We support this change.

3. Effect of Treaties on Tax Base.

The Report suggested clarifying that the effectively connected income on which the branch tax is based taxable income as limited by any applicable treaty provisions. The Finance Committee Report does not discuss this issue. We recommend that the Conference Committee should do so.

4. Hypothetical Foreign Tax Credit.

The Report questioned H.R. 3838's allowance of a foreign tax credit for the branch tax to any 10% or greater U.S. shareholder of the foreign corporation. We support the Finance Committee's decision not to provide any such credit.

5. Effect of Treaty Non-discrimination Provisions.

Neither H.R. 3838 nor the Ways and Means Committee Report indicates the type of non-discrimination provisions of tax treaties that are to be viewed as inconsistent with the branch tax and hence prohibit its imposition. The Finance Committee Report specifically states that nondiscrimination provisions similar to those contained in the United States 1981 Model Income Tax Treaty will prevent imposition of the branch tax. Thus, it is an improvement on the House action on this issue (p. 404).

However, the Finance Committee Report does not discuss other non-discrimination clauses relating to legal persons that are residents of the United States. By not referring to treaties containing those provisions, the Finance Committee may be read as implying that it does not believe that there is any inconsistency between those treaties and a branch profits tax. Since as the Report indicated, the better view is that they are inconsistent, we believe that the Conference Committee should clarify this point by reaching that conclusion.

6. Treaty Shopping.

The Report suggested liberalizing the anti-treaty shopping rule of H.R. 3838 to authorize regulations that treat as non-treaty shopping the ownership of a treaty country corporation by non-treaty country residents who invested in the treaty country corporation for non-U.S. tax avoidance reasons.

The Senate Bill authorizes regulations that will make the anti-treaty shopping provisions inapplicable to individual non-residents of a foreign treaty country whose use of the treaty is not “inconsistent with the purposes of this subsection”. Although this language is similar to the “principal purpose” provision in the June 16, 1981 United States Model Income Tax Convention, it is not identical. We suggest adoption of that provision here.

7. Commerce and Navigation Treaties.

The Report noted that in certain cases United States commerce and navigation treaties contain non-discrimination provisions that are similar to income tax treaty non-discrimination provisions. These commerce and navigation treaties may be with countries with which the United States does not have income tax treaties, or with which it has income tax treaties that do not contain non-discrimination clauses that would prohibit a branch profits tax.

Neither Committee Report discusses such non-discrimination clauses and their possible effect on the branch tax proposals. The Conference Committee should clarify this point.

8. Termination of Foreign Branch.

The proposed branch tax apparently would apply if a branch is terminated and all its assets are transferred to the foreign corporation outside the United States. The Report suggested that the branch tax proposals be revised so that a liquidation of a foreign branch (other than a Section 351 transfer) would be treated similarly to the liquidation of a United States corporation. Under this rule, the only tax imposed would be on any appreciation in the property that is distributed.

We recommend that the Conference Committee clarify this point.*

9. Expansion of Second Level Tax.

The Senate Bill reduces from 50 to 10 the percentage of a foreign corporation's gross income that must be effectively connected with its United States trade or business for the second level tax on dividends and interest to apply. We oppose this change.

This proposal would substantially expand the number of cases in which the second level tax would there may be a large number of cases where at least 10% of income falls into that category. The Finance Committee Report's only explanation of this change is that the tax should apply "when the foreign corporation has more than a de minimis amount of U.S. operations when compared with its worldwide operations" (p. 402).

Elsewhere it its report, the Finance Committee that the second level withholding tax can be difficult to enforce because it is often difficult to know when and if the tax is due and since it is difficult to enforce its collection by a foreign corporation (p. 401). These problems with a second level tax can only be exacerbated by reducing the tax threshold from 50% to 10%.

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* Section 953 of the Senate Bill amends I.R.C. 8 864 to provide that the removal from U.S. tax jurisdiction of the assets of a foreign person's U.S. trade or business will be treated as a taxable disposition of those assets on which any appreciation would be subject to U.S. tax notwithstanding the nonrecognition provisions of I.R.C. 8 336.

For this reason, we question the practical utility of the reduction and recommend that the existing 50% threshold be retained.

10. Interest Payments.

Under the Senate Bill, when the second level tax applies to interest payments by a foreign corporation, the portion of interest treated as U.S. source is to be the interest paid multiplied by the ratio for the base period of interest deductions claimed on the corporation's U.S. income tax return to the corporation’s total interest deductions. This replaces the existing rule that fixes the portion of interest treated as U.S. source as the percentage of a foreign corporation's gross income that is effectively connected with its U.S. trade or business, i.e., the same threshold that applies in determining whether any portion of the interest is U.S. source.

The Finance Committee recommends this change on the basis that whenever there is a deduction allowed against U.S. source income there should be an inclusion subject to U.S. tax (p. 402). This proposal and the reasons behind it have merit and we believe it should be adopted.