REPORT # 529

New York State Bar Association

TAX SECTION

Report on the Proposed Foreign
Branch Level Tax

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TAX SECTION

New York State Bar Association

May 30, 1986

The Honorable Dan Rostenkowski
2232 Rayburn Building
Washington, DC 20515

Dear Representative Rostenkowski:

It is my pleasure to submit to you a report of the Tax Section of the New York State Bar Association on the branch level tax proposals of H.R. 3838.

Although the disparity in withholding tax consequences between a United States branch and a United States corporation may be an appropriate source of concern, the Tax Section believes that the pending proposal should not be adopted. In this important commercial area, when the complexity of the proposed branch level tax is compared with the limited amount of additional revenue it will produce, the new taxing scheme does not seem justified.

The branch tax proposal of H.R. 3838 introduces a high degree of complexity and multiple categories of taxpayers and transactions. If the disparity between the treatment of branches and subsidiaries under withholding tax provisions must be reduced, the Tax Section believes it can best be accomplished by shifting, more broadly than the bill contemplates, to a system of treating United States branches as separate corporations for all purposes.

The proposed legislation also raises broad issues over whether, and in what manner, existing United States treaty commitments should be overridden.

For these reasons, the Tax Section opposes the pending branch tax proposal. I hope the attached report will prove helpful to you.

Sincerely,

Richard G. Cohen

Enclosure

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

TAX SECTION

New York State Bar Association

May 30, 1986

The Honorable Bob Packwood
Chairman
Senate Finance Committee
Washington, DC 20510

Dear Senator Packwood:

It is my pleasure to submit to you a report of the Tax Section of the New York State Bar Association on the branch level tax proposals of H.R. 3838.

Although the disparity in withholding tax consequences between a United States branch and a United States corporation may be an appropriate source of concern, the Tax Section believes that the pending proposal should not be adopted. In this important commercial area, when the complexity of the proposed branch level tax is compared with the limited amount of additional revenue it will produce, the new taxing scheme does not seem justified.

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Sincerely,

Richard G. Cohen

Enclosure

cc: The Hon. Russell B. Long) with
John Colvin, Esq.) enclosure

TAX SECTION

New York State Bar Association

May 30, 1986

The Honorable J. Roger Mentz
Assistant Secretary (Tax Policy)
1500 Pennsylvania Ave., NW
Room 3108
Washington, DC 20220

Dear Roger:

It is my pleasure to submit to you a report of the Tax Section of the New York State Bar Association on the branch level tax proposals of H.R. 3838.

Although the disparity in withholding tax consequences between a United States branch and a United States corporation may be an appropriate source of concern, the Tax Section believes that the pending proposal should not be adopted. In this important commercial area, when the complexity of the proposed branch level tax is compared with the limited amount of additional revenue it will produce, the new taxing scheme does not seem justified.

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For these reasons, the Tax Section opposes the pending branch tax proposal. I hope the attached report will prove helpful to you.

Sincerely,

Richard G. Cohen

Enclosure

TAX SECTION

New York State Bar Association

May 30, 1986

The Honorable David H. Brockway
Chief of Staff
Joint Committee on Taxation
1015 Longworth Building
Washington, DC 20515

Dear Dave:

It is my pleasure to submit to you a report of the Tax Section of the New York State Bar Association on the branch level tax proposals of H.R. 3838.

Although the disparity in withholding tax consequences between a United States branch and a United States corporation may be an appropriate source of concern, the Tax Section believes that the pending proposal should not be adopted. In this important commercial area, when the complexity of the proposed branch level tax is compared with the limited amount of additional revenue it will produce, the new taxing scheme does not seem justified.

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The proposed legislation also raises broad issues over whether, and in what manner, existing United States treaty commitments should be overridden.

For these reasons, the Tax Section opposes the pending branch tax proposal. I hope the attached report will prove helpful to you.

Sincerely,

Richard G. Cohen

Enclosure

REPORT #529

New York State Bar Association Tax Section

Report on the Proposed Foreign
<u>Corporation Branch Level Tax</u>

May 23, 1986

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on the Proposed Foreign Corporation Branch Level Tax

This Report[*] considers the branch level tax that H.R. 3838 would impose on foreign corporations that carry on a United States trade or business.[**]

I. SUMMARY AND GENERAL RECOMMENDATIONS

The Committee believes that the branch level tax proposals in H.R. 3838 are ill-advised and should not be adopted. While the disparity in withholding tax consequences between a United States branch and a United States corporation may be an appropriate source of concern, H.R. 3838 incorrectly assumes that the disparity can only be reduced by the introduction of complexity and multiple categories of taxpayers and transactions. The Committee questions both the effectiveness of the proposed provisions and the need for the additional disparities and tax motives for manipulation that this aspect of H.R. 3838 will create.

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[*] This report was prepared by William L. Burke, Herbert L. Camp, Richard G. Cohen and John A. Corry. Helpful comments were received from Donald Schapiro, Arthur A. Feder, Richard L. Reinhold and Leslie J. Schreyer.

[**] The tax would be imposed by Section 651 of H.R. 3838 and would appear in a new Section 883 of the Internal Revenue Code (with present Sections 883 and 884 being redesignated as Sections 884 and 885, respectively). Section references herein are to sections of the Internal Revenue Code unless otherwise indicated.

The disparity that exists today between a United States corporation and a United States branch of a foreign corporation reflects fundamental differences in the approach to taxation of branches and separate corporations which pervade the Code, affecting such matters as source of income, deductions and various allowances. If the disparity between the withholding tax provisions must be reduced, the Committee believes such results are established by shifting, more broadly than the bill contemplates, to a system of treating United States branches as separate corporations for all purposes (including in particular computation of the amount of various deductions now subject to apportionment in the regulations under Section 861).

There is some very limited precedent for such an approach in the special election in Section 814 (formerly Section 819A) for contiguous country branches of domestic life insurance companies and the separate branch rules in Section 954(d) for determining foreign base company sales income. Nevertheless, such a change would be a major revision with potentially far-reaching effects. While it may or may not have merit when all of the many relevant factors and implications are assessed, the Committee questions whether a reduction in disparity in order to obtain additional tax revenues in the amounts suggested by the increase in tax revenues projected for H.R. 3838 justifies undertaking such a far-reaching change.*

The proposed legislation also raises broad issues over whether, and in what manner, existing United States treaty commitments should be overridden. Without effective treaty override provisions, it must be assumed that the

* From $16,000,000 in 1986 to $37,000,000 in 1990.

anticipated revenue gain from adopting the proposed branch tax is likely to be less than the small amounts projected by the Ways and Means Committee. On the other hand, any overriding of, treaty provision potentially carries implications extending well beyond the federal tax laws.

The Treasury Department has stated that the question of whether proposed amendments to the Internal Revenue Code, such as the branch profits tax, should override United States income tax treaties involves significant tax treaty and foreign policy considerations. In a letter dated April 7, 1986, Treasury Secretary Baker has advised Senate Finance Committee Chairman Packwood that the provisions of H.R. 3838 that would override treaties would diminish the value of future treaty commitments from the United States, would complicate the process of revising existing treaties or negotiating new treaties, and could offer foreign treaty partners an excuse to unilaterally abrogate the provisions of non-tax treaties (e.g., a treaty between the United States and The Netherlands regarding European missile testing). Therefore, according to Secretary Baker,

> "This Administration strongly opposes treaty overrides in tax reform legislation."*

The Committee is not in a position to question the treaty override views of the Administration insofar as foreign policy considerations are concerned. The potential conflicting considerations at least suggest, however, that a

* Secretary Baker's letter specifically addresses the question of treaty shopping and the current treaty negotiations between the United States and the Netherlands Antilles in which treaty shopping is a "central issue". His letter states that the United States is determined to resolve the problems that arise in connection with the Netherlands Antilles treaty "in the very near future."

provision should be likely to effectively accomplish its purposes before treaties are unilaterally overridden. From a more technical perspective, if the overriding of treaties meant that the proposed legislation would be significantly effective in dealing with the perceived problems, an outright treaty override after a suitable grace period of, say, three years should be considered, instead of the additional complexity introduced by the dual system potentially preserved in the proposed legislation.

Finally, there is the complexity of the proposed scheme. The Tax Section has consistently favored attempts to simplify the Internal Revenue Code. We believe that it is generally undesirable to introduce a new regime of taxation that would substantially complicate the tax rules that apply to a reasonably broad class of taxpayers unless the change is likely to produce substantial increases in tax revenues or to close an obvious tax loophole that is repugnant to an evenhanded system of taxation.

The proposed branch tax does not satisfy either of these requirements. It is not likely to produce substantial amounts of increased tax revenues,[*] would introduce a new and reasonably complex concept to U.S. taxation, and would significantly affect many foreign taxpayers that conduct

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[*] As we note above, the tax revenue increase that the Ways and Means Committee expects will result from adoption of the branch tax proposal contained in H.R. 3838 ranges from $16,000,000 in 1986 to $37,000,000 in 1990. These amounts are not large in the context of the revenue impact of other tax reform proposals contained in H.R. 3838. Presumably, they would be even smaller if, contrary to H.R. 3838; treaties were to override the branch tax even in treaty shopping cases. In its tax reform proposal of May, 1985, the Administration recommended that treaty provisions that prevent a branch tax should be renegotiated. If and when that is accomplished to a significant extent, the revenue that a branch tax would produce could increase but the aggregate revenues realized might not over balance concerns as to the

business in the United States in branch form for non-tax reasons.

II. CURRENT LAW

Foreign-controlled U.S. business activities presently are subject to different U.S. taxation regimes, depending upon whether such activities are carried out in U.S. subsidiary or branch form.

When a foreign corporation uses a U.S. incorporated subsidiary to conduct U.S. business activities, the taxable profits of the U.S. subsidiary are subject to normal corporate tax. Distributions of after-tax profits to foreign shareholders are subject to a gross 30% withholding tax at source; however many U.S. tax treaties reduce the withholding tax rate to a range of 5% to 15%. Interest paid to foreign creditors is generally tax deductible and also is subject to a gross 30% withholding tax at source. Here again, many U.S. tax treaties substantially reduce or completely eliminate this tax on interest payments.

When a foreign corporation conducts business activities in the United States through a branch, the taxable profits of the branch are determined using the "effectively connected" concepts of Sections 864 and 882 and are subject to normal corporate tax. Distributions of after-tax profits of the U.S. branch to its head office are free of U.S. taxation.

Dividend distributions by the foreign corporation to its shareholders are only subject to a 30% withholding

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effectiveness of the legislation to produce parity rather than opportunities for selective tax planning.

tax* (the so-called second-level tax) if more than 50% of its gross income (over a three-year period) is effectively connected with its U.S. trade or business. In that event, distributions are taxable in the proportion that the distributing corporation's effectively connected gross income bears to its total gross income. However, many U.S. income tax treaties with the countries in which foreign payor corporations are incorporated eliminate this second-level dividend tax.

Interest paid to foreign creditors by the foreign corporation is tax deductible in the United States under the formula approach of Reg. Sec. 1.882-5 and, like dividends, is only subject to a 30% U.S. withholding tax (or, depending on the creditor's nationality or residence, a lower tax treaty rate or exemption) if more than 50% of its gross income (over a three-year period) was derived from its U.S. trade or business. As with dividends, many U.S. income tax treaties with countries in which the payor corporations are incorporated eliminate this second-level interest tax.

In proposing a branch level tax, the Ways and Means Committee expressed concern that a foreign corporation that conducts its U.S. operations through a U.S. branch receives more favorable tax treatment than a foreign corporation that operates through a separately incorporated U.S. subsidiary:

(a) The second-level withholding tax applies only if a majority of the foreign corporation's income is derived from the U.S. branch. Therefore, a foreign corporation that derives a substantial amount of U.S. branch income may not be liable for the second level withholding tax.

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* In some cases a lower U.S. tax treaty rate would apply

(b) The second-level withholding tax is sometimes difficult to enforce both because it is often hard to know when the tax is due and since in any event it is difficult to enforce the collection of such a tax by a foreign corporation.*

The Committee also expressed concern that these differences between U.S. and foreign corporations operating in the United States, in addition to discriminating between different forms in which foreign corporations carry on their U.S. business, also favors foreign corporations doing business in the United States over non-foreign controlled U.S. corporations.

III. HOUSE PROPOSALS

The second-level dividend and interest tax would be repealed effective for taxable years beginning after December 31, 1985.

Where the proposed branch level tax is inconsistent with an existing U.S. tax treaty, and the treaty allows a second-level withholding tax, the existing second-level tax will continue to apply. However, these new rules will prevent "treaty shopping" by nonresidents of the treaty country (i.e., corporations that are not controlled by individual residents of the treaty country). Treaty shopping is deemed to exist if more than 50% of the stock of the foreign corporation is beneficially owned (or deemed owned

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depending on the residence of the shareholder.

* H. Rept. 99-426, 99th Cong., 1st Sess. (the "Committee Report") 432.

under the Section 958(b) attribution rules) by nonresidents of the foreign treaty party.[*]

In place of the second-level dividend-and interest tax, an additional 30% tax would be imposed on the after-tax profits of U.S. branches (“dividend equivalent amount”) and on certain interest payments by the foreign corporation (“allocable interest amount”). The dividend equivalent amount is defined as the foreign corporation's taxable income effectively connected with the conduct of a U.S. trade or business with the following adjustments:

(i.) It is reduced by the U.S. corporate income tax after any tax credits;

(ii.) It is reduced by any increase in “U.S. net equity”; and

(iii.) It is increased by any decrease in “U.S. net equity.”

The increase or decrease in U.S. net equity is determined by comparing the adjusted basis of its U.S. assets and its U.S. liabilities at the close of the preceding taxable year and at the end of the current taxable year.[*]

The allocable interest amount is defined as the interest paid or accrued by the foreign corporation during

[*] This rule will not apply to a foreign corporation the stock of which is “primarily and regularly traded” on an established securities market in the country of which it is a resident.

[*] The Committee Report (p. 434) indicates that Treasury Regulations are intended to address the potential abuse that may arise if a branch temporarily increases its assets at the end of its taxable year merely to reduce the branch level tax base. These regulations are also to address the extent to which a decrease in assets may not indicate that the branch has remitted profits during the year.

the taxable year to the extent that it is allowed as a deduction in arriving at U.S. effectively connected taxable income, and would be subject to U.S. withholding under Sections 1441 or 1442 if the foreign corporation was a U.S. corporation. This second requirement eliminates from the allocable interest amount:

(1) original issue discount on short-term obligations;
(2) interest effectively connected to the recipient's U.S. business;
(3) portfolio interest; and
(4) bank deposit interest.

The Committee Report states that if the foreign corporation is a resident of a country that has an income tax treaty with the United States and such treaty reduces U.S. tax on dividends, such reduced rate is to be applied (in lieu of 30%) to <u>both</u> the dividend equivalent amount and the allocable interest amount. This provision will not apply in “treaty shopping” situations.

If the branch level tax applies to the dividend equivalent amount, 10% or greater U.S. corporate shareholders of the foreign corporation will be entitled to a tax credit equal to their share of the branch tax. For example, a 100% U.S.-controlled foreign corporation earns $100 of income through a U.S. branch. It does not retain any after-tax income in such branch but distributes it to its sole U.S. corporate shareholder. The shareholder would be entitled to a tax credit of $19.20 ($100 less the normal U.S. tax of 36 (under H.R. 3838), or 64 x 30%).

IV. EFFECT OF U.S. INCOME TAX TREATIES

A. H.R. 3838 and the Committee Report

Most U.S. income tax treaties contain "nondiscrimination" clauses (discussed below) that are intended to prevent the United States from taxing certain foreign treaty country residents more heavily than a similarly situated U.S. person. From the text of proposed Section 883, it is not entirely clear how the branch tax would be affected by these non-discrimination provisions. Section 883(d)(2)(A) provides that if a treaty applicable to a foreign taxpayer "does not permit a branch tax on allocable interest", but does permit a withholding tax on interest described in Code Section 861(a)(l)(C), Section 861(a)(l)(C) will still apply to such amounts "paid to such taxpayer". A "similar" rule would apply to dividends described in Section 861(a)(2)(B).

Under Section 883(d)(2)(B), if a treaty prohibits both a branch tax and a Section 861(a)(l)(C) tax and more than 50% of the stock of the foreign corporation is beneficially owned (or deemed owned under the Section 958(b) attribution rules) by non-residents of the foreign country treaty party, "the amendments made by this section shall apply to allocable interest notwithstanding such treaty obligation to the contrary" and a "similar rule shall apply in the case of amounts described in section 86l(a)(2)(B). .."

The Committee Report is considerably more helpful than the statute. It states that "in general" the branch level tax is not to apply where it would be “inconsistent with an existing U.S. income tax treaty obligation”. After suggesting that a branch tax It does not unfairly discriminate against foreign corporations because it treats foreign corporations and their shareholders together no worse than U.S. corporations and their shareholders, it states that where third country investors are not using a treaty to avoid the branch tax, “the Committee is willing to allow the provisions of a treaty that prohibit imposition of a branch tax to take precedence over the tax, even though as later-enacted legislation the tax would normally override the treaty.”

The Committee Report provides that if a treaty does not allow the branch tax but does allow the existing second-level tax on either interest or dividends, the second-level tax is still to apply. In treaty shopping situations, the branch level tax will apply notwithstanding a treaty prohibition.[*]

B. Analysis of Tax Treaty Provisions

The Committee Report does not indicate what types of treaty provisions are “inconsistent” with a branch tax. Thus, an analysis of the treaties themselves is required. On this issue there are generally three categories of treaties:

(a) Those that permit such a tax specifically or by omission of a prohibition;

[*] The Administration's branch tax proposals would also permit existing treaties to override the legislation, but would instruct the

(b) Those that apparently prohibit the tax; and

(c) Those that may prevent imposition of the tax.

1 Treaties That Permit the Tax

The U.S. income tax treaties with Australia (Art. 10(6)), Barbados (Art. 24.2), Canada (Art. X.6), France (Arts. 13(2)(a) and 24(2)), New Zealand (Art. 23.2(b)), and Trinidad and Tobago (Arts. 6(2) and 12(5)) specifically permit the imposition of special branch profits taxes.*

2 Treaties That Apparently Prohibit the Tax

(a) A substantial number of treaties appear to prevent imposition of a branch level tax. They contain provisions similar to Article 24(3) of the Treasury's Proposed Model Income Tax Treaty, which reads as follows:

> "The taxation of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on

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Treasury Department to seek to amend those treaties that prevent the imposition of such taxes

* Several of these treaties limit the rate of tax: Australia (15% of the taxpayer's taxable income reduced by its regular income tax), Canada (10% of earnings not previously subjected to such tax), France (15% of 2/3 of the French tax base; a U.S. tax may be "comparable"), New Zealand (5%) and Trinidad and Tobago (10%). In the Polish (Art. 23(2)), Romanian (Art. 22(2)) and Russian (Art. X.2) treaties, the non-discrimination clauses compare the tax imposed on a treaty country taxpayer with that imposed on a taxpayer of a "third country". Since each of these countries and the United States is not barred from imposing a branch level tax on a resident of a non-treaty country, these treaties do not forbid the imposition of a branch tax. The non-discrimination provision in the treaty with South Africa (Art. III(2)) applies only to South African citizens residing in the United States.

enterprises of that other State carrying on the same activities."*

(b) Most other treaties that appear to prohibit a branch tax either permit or do not prevent the imposition of a second-level tax. Therefore, with respect to corporations that are residents of those countries, second-level dividend and interest taxes would continue to apply.**

3 Treaties that May Prevent Imposition of the Tax

The remaining treaties contain provisions that may prevent imposition of the branch tax. An example of such a provision is Article XVIII(3) of the Austrian treaty, which reads:

> "The citizens of one of the Contracting States shall not-, while resident in the other Contracting State, be subjected therein to other or more burdensome taxes than are the citizens of such other Contracting State residing in its territory."

(a) Except for the Irish treaty with respect to Irish nationals (Art. XXI), all these treaties provide that

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* Treaties that contain such provisions are those with Belgium (Art. 24(2)), Cyprus (Art. 7.2), Denmark (Art. 24.3), Egypt (Art. 26(2)), Finland (Art. 7.2), Hungary (Art. 21.2), Iceland (Art. 7(2)), Italy (Art. 24.2), Jamaica (Art. 25.2), Japan (Art. 7(2)), Korea (Art. 7(2)), Malta (Art. 25(2)), Morocco (Art. 22(2)), The Netherlands (Art. XXV(3)), Norway (Art. 25(2)), the Philippines (Art. 24(2)), and the United Kingdom (Art. 24(2)).

** These are the treaties with Denmark (Art. 10.6 (dividends in certain treaty shopping cases) and Art. 11.1 (interest paid to nonresidents of Denmark)), Egypt (Arts. 11(1), 12(1) and (4)), Finland (Art. 12.2 (dividends) and Art. 12.1 (interest paid to nonresidents of Finland)), Hungary (Art. 10.1 (interest paid to nonresidents of Hungary)), Italy (Art. 11.1 (interest)), Jamaica (Art. 11.1 (interest)), Japan (Arts. 12(1) and 13(1)), Korea (Arts. 12(1) and 13(1)), Malta (Art. 11(1) (interest)), Morocco (Art. 11 (interest)), Norway (Arts. 8(4) and 9 (7)) and the Philippines (Arts. 11(3) and 12(1)).

“citizens” include “all legal persons, partnerships and associations”.*

(b) For purposes of these provisions, to the extent that a foreign corporation has a U.S. permanent establishment or otherwise carries on a U.S. trade or business, it is arguably a United States “resident”.

(i) Treas. Reg. 301.7701-5 provides that a foreign corporation that is engaged in a U.S. trade or business is a “resident foreign corporation”.

(ii) In Ltr. Ruling 7846060, the Service held that a

> “foreign corporation having income that is effectively connected with the conduct of a trade or business in the United States is considered a resident of the United States to the extent of such effectively connected income”.

On that basis, the Service determined that the nondiscrimination provisions of the U.S.-German treaty prevented imposition on a German reinsurance corporation of the excise tax imposed by Code Section 4371(3) on reinsurance contracts or treaties.

(iii) The contrary interpretation would effectively negate the significance of including “legal persons, partnerships or associations” in the definition of “citizens” residing in the United States.

(c) On the other hand, at least two indications may point to a contrary conclusion.

(i) Under the usual treaty definition, a corporation is a “resident” of a treaty party only if it is incorporated therein. On this basis, a foreign corporation that does

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* These treaties are with Austria (Art. XVIII(3)), Germany (Art. XVIII(3)), Greece (Art. XVI(3)), Luxembourg (Art. XX(3))r Netherlands Antilles (Art. XXV(3) of previous Netherlands treaty), Pakistan (Art. XVII), Sweden (Protocol Para. 7) and Switzerland (Art. XVIII(3)). In a few of these treaties, “juridical persons is substituted for “legal Person”.

business in the United States is arguably not, for treaty purposes, a "resident" of the United States. On the other hand, the language being interpreted is "resident in" rather than "a resident of", which may be a significant distinction.

(ii) It has been suggested that the 1966 amendment to Article XXV(3) of the Netherlands treaty, which specifically makes U.S. permanent establishments of Netherlands corporations eligible for non-discrimination treatment, indicates that the contrary result should be reached under the earlier version of that provision (which still applies to the Netherlands Antilles and which contains the ambiguous reference to "resident"). However, the official explanation of the change merely states that the "original paragraph (3) contained a similar but less comprehensive prohibition against discriminatory tax treatment". The explanation does not state that the prior version did not apply to a United States branch of a Netherlands corporation; at most, it implies that the prior version may have been ambiguous.

(d) Under several of these treaties, the second-level tax would continue to be applicable.*

IV. SPECIFIC COMMENTS

We have the following comments on specific aspects of the branch tax proposal:

1. Base for Imposing Branch Tax

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* The treaties with Pakistan (interest (no provision)), Sweden (dividends (Art. VII(1)) and interest paid to Swedish nonresidents (Art. VIII)) and Switzerland (Art. XIV(1) payments to Swiss nonresidents) do not prevent the imposition of second-level taxes on dividends and interest.

The base on which the branch tax would be imposed is a foreign corporation's taxable income. On the other hand, dividends paid by a U.S. corporation to its foreign stockholders are limited by the corporation's earnings and profits. We understand that a major reason for proposing the branch tax was to restrict the tax benefits that are currently available through the utilization of foreign corporations, particularly those organized in the Netherlands Antilles, to make investments in U.S. real estate. Because of accelerated depreciation, a number of these corporations may have little or no taxable income and yet may have substantial earnings and profits. Thus, utilizing taxable income rather than annual earnings and profits as the tax base may vitiate a significant purpose behind the proposal.

The calculation of earnings and profits, however, is often a complex matter. Most corporations normally do not distribute all their earnings and profits, so that a precise calculation ordinarily is unnecessary. Thus, to require that the tax be based upon earnings and profits may involve complexities that conceivably might outweigh the possible advantages that would result from curtailing the benefits that some treaty shoppers might gain in the case of foreign incorporated real estate holding companies.*

A middle ground might satisfy both concerns. This would be to follow the approach embodied in Sections 705(a), 1366 and 1367 and provide that the branch tax will be based upon taxable income with increases or decreases for specific

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* The American Law Institute, which proposed the imposition of a branch tax, opposed an earnings and profits calculation for this reason. Federal Income Tax Project Draft No. 13 (March 28, 1984), pp. 90-92.

items. One example would be a capital loss that is not deductible in computing taxable income but probably should be for purposes of the branch tax. Another would be accelerated depreciation; it could be added back to taxable income as it now is under the earnings and profits adjustment in Section 312(k). Another item to be considered, although it may raise difficult policy questions, would be tax-exempt interest.

2. Treatment of Losses

The branch tax is to be imposed on the sum of the dividend equivalent amount and the allocable interest. As has just been discussed, the dividend equivalent amount is based on the foreign corporation's effectively connected taxable income. Neither the House Bill nor the Committee Report indicate how taxable income is to be computed if the branch is operating at a loss.

We believe that if the branch has a taxable loss after deducting its allocable interest but has a profit after adding back the interest, the tax should be imposed only to the extent that the add-back would produce taxable income. Otherwise, the tax could be imposed on a branch that pays substantial interest but also operates at a loss.[*] That result would be neither fair nor consistent with the treatment of United States subsidiaries of foreign

[*] For example, assume that the branch has allocable interest deductions of $10 million and has a net operating loss of $5 million. Apart from the interest deduction, its taxable income would be $5 million. However, since computation of the dividend equivalent amount apparently does not take into account negative taxable income, taxable income under H.R. 3838 would be zero so that the sum of that amount and the $10 million of allocable interest would be $10 million.

corporations. It should be made clear that, for purposes of the interest add-back, branch losses should be taken into account.

3. Interest Add-Back

A more basic issue involves the add-back itself. The Committee Report (p. 434) states that the add-back is intended to prevent foreign corporations from capitalizing their branches with debt and distributing branch earnings as interest payments. However, this issue is essentially no different from the debt-equity characterization questions that arise in the case of intercompany loans from foreign corporations to their U.S. subsidiaries. We believe that there is no reason to distinguish between the two Situations.*

There appears to be even less justification for the proposal to the extent that it applies to interest paid to unrelated persons, such as banks. In this connection, we note that in the absence of a treaty between the United States and a foreign lender there would be a U.S. withholding tax on interest paid by a U.S. subsidiary of a foreign corporation. However, the burden of that withholding tax would fall on the lender and not on the borrower.* This would not be true of the branch tax.

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* The American Law Institute proposal would not disallow interest deductions in computing the base on which the branch tax would be levied.

* Some loan agreements provide that the borrower will assume the economic cost of the tax, but this is not always true and in any event is the result of negotiations that may reflect other factors.

4. Rate of Tax

The branch tax would be imposed at the normal 30% rate applicable to dividends paid to foreign stockholders except that where an income tax treaty would reduce the withholding tax rate on dividends, that rate would generally apply to amounts representing both the dividend equivalent amount and the interest add-back.**

We suggest that the appropriate rate on the interest add-back should be the treaty rate applicable to interest rather than the rate applicable to dividends. When a U.S. corporation pays interest, either to its foreign shareholder or an unrelated foreign lender, the applicable withholding tax rate is the interest rate (including an exemption if the applicable treaty provides an exemption, as many treaties do for interest but not dividends). Therefore, applying treaty dividend rates causes the branch tax to discriminate against branches and in favor of subsidiaries. The primary justification for the proposal is that present law favors branch operations over subsidiary operations; in enacting the branch tax, Congress should not substitute one form of discrimination for another.

** The lower rate would not apply if the corporation is subject to the proposal's anti-treaty shopping rule.

5. Determining "Effectively Connected" Taxable Income

A few treaties limit United States tax on a foreign corporation's industrial or commercial profits (or business profits) to its U.S. source income.[*] However, under Section 864(c)(4), income "effectively connected" with a foreign corporation's U.S. trade or business may include certain categories of foreign source income. For purposes of computing the branch tax, if the measuring standard is to be taxable income (or modified taxable income), a foreign corporation's taxable income should be the same as that which is subject to the corporate income tax paid by the foreign corporation, i.e., its taxable income as limited by any applicable treaty provisions. We suggest that the Finance Committee Report make this clear.

6. Flawed Credit Mechanism

Under the House proposal, if the branch tax is imposed on a dividend equivalent amount, then a 10% or more U.S. corporate shareholder of the foreign corporation that receives a distribution of the foreign corporation's earnings may claim a credit for its allocable share of the branch level tax. The policy basis for this proposal is questionable.

If a U.S. subsidiary distributes earnings to its foreign parent and that distribution is subject to U.S. withholding tax, any 10% or greater U.S. shareholders of the foreign parent are not entitled to any credit for the withholding tax. Moreover, the withholding tax would be imposed whether or not the foreign parent had U.S. shareholders; indeed, it would be imposed if the foreign parent was 100% owned by 10% or more U.S. shareholders.

The proposed credit would thus produce an asymmetrical result and also would introduce additional complexity. We therefore question its desirability.

7. Clarification of Treaty Impact

As the discussion in Part IV.B.3 of this Report indicates, it is unclear whether the non-discrimination provisions of certain tax treaties between the United States and foreign corporations are to be viewed as inconsistent with the branch tax and hence prohibit the imposition of the tax. We suggest that this point be clarified by the Senate.

8. Clarification of Permanent Establishment as Basis for Tax

Most U.S. tax treaties provide that the "industrial or commercial profits" or "business profits" of a treaty resident may not be taxed by the other treaty party unless such profits are attributable to a permanent establishment In such treaty country. See, e.g., Canadian Treaty, Art. VII. Such provisions should prevent the imposition of a U.S. corporate income tax on U.S. business profits of a foreign corporation that may be engaged in a United States trade or business but does not have a United States permanent establishment. A similar result under the branch tax is indicated by proposed Section 883(a), which commences, "In

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[*] A few older treaties contain such provisions. See, e.g., the treaties with Ireland (Art. III(1)) and Switzerland (Art.III(1)).

addition to the tax imposed by Section 882 . . ." However, the Senate should make this result clear.

9. Treaty Shopping Rule Can Be Liberalized

In treaty shopping situations, the proposed new branch tax rules will not be overridden by treaties. As noted above, treaty shopping will generally be deemed to occur whenever less than 50% of the stock is owned by residents of the treaty country (with an exception for certain publicly-traded corporations). This definition may include in the treaty shopping category some corporations that would be excluded under current rules designed to prevent treaty shopping.

Recently negotiated United States tax treaties that contain anti-treaty shopping provisions do not treat as evidence of treaty shopping ownership by non-treaty country residents that have made their investment in the treaty country corporation for non-United States tax avoidance reasons. This could be evidenced, for example, by the fact that a shareholder of a foreign corporation who is not a resident of the same jurisdiction could have obtained similar tax treaty benefits directly.[*]

The anti-treaty shopping provisions that apply to the proposed branch tax should contain similar language.

10. Impact of Non-Discrimination Clauses

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[*] See treaties with Australia (Article 16) and France (Article 24 A) as well as Article 16 of the June 16, 1981 United States Model Income Tax Convention.

Non-discrimination provisions in U.S. income tax treaties probably had their genesis in similar rules in U.S. commerce and navigation treaties. Some of these treaties broadly prohibit the imposition of taxes (including income taxes) on corporations of either contracting party that are more burdensome than those borne by corporations of the other contracting party. See, e.g., Italian Treaty, Art. IX.1 and French Treaty, Art. IX.1(c).

The United States may have a commerce and navigation treaty with a foreign country with which it either does not have an income tax treaty, or, if it has an income tax treaty, that treaty does not contain a non-discrimination clause that clearly prohibits the operation of a branch tax. An example of this is Art. XI.1 of the Friendship, Commerce and Navigation Treaty with Israel (with which an income tax treaty has been signed but never ratified) under which the "companies" of either country "engaged in trade or other gainful pursuit" within the other country shall not be subject to income taxes that are more burdensome that those borne by companies of the other country.

It is not clear from the Bill and the Committee Report whether such non-discrimination clauses are intended to override the branch tax provisions of the Bill. This is another point that the Senate should clarify.

11. Effect of Subsequent Incorporation

The Senate should indicate what the tax result would be if a foreign corporation incorporates a U.S. branch that previously has incurred a branch tax. Earnings that had already been subjected to the branch tax should not be subject to withholding taxes if they are later distributed as dividends. For this purpose, as is the result with the foreign tax credit rule contained in Section 902(c)(l), such dividends should be treated as having been paid from the most recently accumulated earnings of the U.S. corporation. The Senate should clarify this point.

12. Liquidation Distributions

The proposed branch tax apparently would apply if a United States branch of a foreign corporation is terminated and all its assets are distributed to the foreign corporation in its home country. This is not the result upon liquidation of either a United States or foreign subsidiary of a foreign corporation. The United States subsidiary would be taxed on gain under Section 367, as interpreted by regulations that have not yet been issued. Under Treasury Regulations, a foreign corporation doing business in the United States would not be subject to any tax on liquidation.

Perhaps the branch tax proposals should be revised so that a liquidation of a foreign branch (other than a transfer to a corporation that satisfies the requirements of Section 351) would be treated similarly to the liquidation of a United States corporation, *i.e.*, the only tax imposed would be on the appreciation in property that it transfers to its home country.