TAX SECTION

New York State Bar Association

1986 Tax Reform Act Seminars

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NEW YORK STATE BAR ASSOCIATION

TAX SECTION

1986 Tax Reform Act Seminars

SESSION SIX: EFFECT OF THE 1986 ACT ON FOREIGN ACTIVITIES OF U.S. TAXPAYERS AND FOREIGN TAXPAYERS

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THE TAX REFORM ACT OF 1986
OUTLINE OF SELECTED CHANGES
TO THE SOURCE RULES

By

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I. Sales Of Personal Property

A. Background

In May of 1985, the President proposed the elimination of the title passage test for the reason that the sources of income determined pursuant to such test were generally unrelated to the location of either the economic activity generating the income or the legal protections facilitating the earning of the income. The Senate Finance Committee was concerned that elimination of the title passage test for inventory property would increase the difficulties U.S. businesses were having competing in international commerce. The Tax Reform Act of 1986 (86 TRA) retains the title passage test for inventory property, but instructs the Treasury to conduct a study of the rules relating to sales of inventory property and to submit a report to Congress with recommendations by September of 1987. The 86TRA makes certain other changes to the source rules for sales of personal property that have the effect of making the determination as to source more dependent on the location of the under lying activity.

B. General Rule

1. Income from the sale of personal property by a U.S. resident will be sourced in the U.S. Income from the sale of personal property by a nonresident will be sourced outside the U.S.

2. The term U.S. resident means (1) any individual who has a tax home (as defined in Section 911(d)(3) in the U.S., and (2) any corporation, partnership trust or estate which is a U.S. person (as defined in

Section 7701(a)(30)). The term nonresident means any person other than a U.S. resident.

C. Exceptions

1. Inventory - the pre-86TRA rules apply

a. Income derived from the purchase and resale of inventory will continue to be sourced at the location where the sale occurs. The title passage test of the regulations (Section 1,861-7) will continue to apply.

b. Income derived from the sale of manufactured inventory will continue to be subject to the rules of Section 863(b) and the title passage test. Under these rules, half of the income is typically sourced in the U.S. (the country of manufacture) and half is sourced outside the U.S. (by application of the title passage test).

c. For purposes of this exception, inventory means stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year or property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer’s trade or business (Section 1221(1)).

2. Depreciable personal property

a. Gain (not in excess of the depreciation on the property) is sourced in the U.S. to the extent of the percentage represented by U.S. depreciation over total depreciation.

b. Depreciation deductions consist of any deductions which treat an otherwise capital expenditure as deductible expenses.

c. U.S. depreciation consists of depreciation deductions that were allowed in computing U.S. source taxable income.

d. Gain in excess of the depreciation on the property is sourced as if such property were inventory -- see I.C.1 above (page 2).

3. Sale of Intangibles

a. Where payments are not contingent on the productivity, use or disposition of the intangible, the general rule of I.B.1. above applies, except in the case of the sale of goodwill. Example - Payments derived by a U.S. person on the foreign sale of a foreign trademark for a fixed price will be sourced in the U.S.

b. payments derived from the sale of goodwill are treated as from sources in the country in which such goodwill was generated.

c. Where payments are contingent on the productivity, use or disposition of the intangible, the payments are sourced as if they were royalties - i.e., look to the location where the property is to be used. Example - Payments derived by a U.S. person on the foreign sale of a foreign trademark for a percentage of future sales will be sourced outside the U.S.

d. Intangible means any patent, copyright, secret process or formula, goodwill, trademark, trade brand, or other like property.

4. Stock of affiliates

a. Gain derived from the sale by a U.S. resident of stock in an affiliate foreign corporation will be sourced outside the U.S. if:

(i) Such affiliate corporation is engaged in the active conduct of a trade or business, and

(ii) the sale occurs in the country in which the affiliate corporation derived more than 50 percent of its gross income during a 3 year test period.

b. The term affiliate means a member of the same affiliated group (within the meaning of section. 1504(a) without regard to section 1504(b)).

5. Portfolio investments

In the case of property not described in 1 through 4 above (e.g., a portfolio stock investment):

a. If a U.S. resident maintains an office or other fixed place of business outside the U.S., income from sales attributable to such office will be sourced outside the U.S. if an income tax of at least 10% (effective rate) of the income is actually paid to a foreign country.

b. If a nonresident maintains an office or other fixed place of business inside the U.S., income from any sale of personal property (including inventory) attributable to such office will be sourced in the U.S.

This rule does not apply to (1) the sale of inventory for use outside the U.S. if an office of the taxpayer

outside the U.S. materially participated in the sale or (2) any amount included in gross income as subpart F income.

c. The existing principles of Section 864(c)(5) apply in determining whether a taxpayer has an office and whether a sale is attributable to such office.

D. Regulations

The Treasury has been directed to prescribe regulations:

a. relating to the treatment of losses from the sales of property, and

b. applying the source rules to income derived from trading in futures contracts, forward contacts, options contracts and other instruments.

E. Effective dates

1. U.S persons - the new rules described above will apply to taxable years beginning after December 31, 1986.

2. Foreign persons (other than controlled foreign corporations) - The new rules described above will apply to transactions entered into after March 18, 1986.

II. Limitations on Special Treatment of 80-20 Corporations

A. Background

Prior to the 86TRA, the source rules for interest and dividends paid by corporations generally looked to the place of incorporation of the paying corporation. However, dividends and interest paid by U.S. corporations which derived less than 20 percent of their gross income over a 3 year test period from U.S. sources so-called 80-20 corporations) were treated as from sources outside the U.S.

The president proposed the repeal of the special exceptions to the source rules for 80-20 corporations, arguing that such repeal would serve to limit the circumstances in which the U.S. cedes its primary tax jurisdiction (under a theory that the country in which an entity is incorporated possesses primary tax jurisdiction) on income that should be subject to U.S. tax, particularly in instances where the income otherwise treated as from foreign sources (e.g., the dividends and interest paid by 80-20 corporations would not ordinarily be taxed by foreign countries. There was also a concern that these special rules artificially inflated U.S. persons' foreign source income or otherwise enabled them to average down high foreign tax rate income.

The 86TRA repeals the existing special exceptions to the source rules for 80-20 corporations. However, it creates additional special exceptions to the source rules for what should be called "New and Improved 80-20s", reflecting a new regime of tax policies.

B. Interest

1. General Rule - Interest derived from a U.S. resident alien or a U.S. corporation is sourced in the U.S.

2. Exception for "New and Improved 80-20s"

a. All of the interest derived from a U.S. resident alien or a U.S. corporation will be sourced outside the U.S. if 80 percent or more of the U.S. resident alien's or the U.S. corporation's gross income from all sources is active foreign business income.

b. Active foreign business income is income derived from sources outside the U.S. and attributable to the active conduct of trade or business in a foreign country or possession by the U.S. resident alien individual or the U.S. corporation.

c. If the interest described in a. above is received by a related person, such interest will be sourced outside the U.S. only to the extent of the percentage represented by the gross income of the resident alien individual or U.S. corporation from sources outside the U.S. over total gross income during a 3 year test period.

d. A person is a related person if:

(i) such person is an individual, partnership, trust, or estate which controls the resident alien or U.S. corporation;

(ii) such person is a corporation which controls, or is controlled by, the resident alien or U.S. corporation; or

(iii) such person is a corporation which is controlled by the same person(s) which control the resident alien or the U.S. corporation.

Control means ownership, directly or indirectly, of stock possessing more than 10 percent of the total combined voting power of all classes of stock entitled to vote.

C. Dividends

1. General Rule - dividends received from a U.S. corporation, other than a corporation which has an election in effect under Section 936, will be treated as income from U.S. sources.

2. Exception for “New and Improved 80-20s”

A percentage of the dividends received by a nonresident alien or a foreign corporation from a U.S. corporation meeting the 80

percent active foreign business income test will be exempt from U.S. tax.

The percentage of the dividends that will be exempt from U.S. tax is equal to the percentage represented by the gross income of such corporation from sources outside the U.S. over the total gross income of such corporation for a 3 year test period.

D. Effective Dates

1. General rule - the amendments described above will apply to payments after December 31, 1986.

2. Exception - Interest

The amendments described above will not apply to any interest paid or accrued on any obligation outstanding on December 31, 1985. However, if the payee of such interest is related (within the meaning of section 904(d)(2)(G)) to the payor, such interest will be treated for purposes of Section 904 as if paid by a controlled foreign corporation. (The effect of this requirement is to make the interest, though exempt from the new and improved 80-20 rules, subject to the new look-through rules in computing the foreign tax credit limitations).

3. Transition rules

a. In determining the amount of dividends paid to foreign shareholders and interest paid to related persons in 1987 that will be treated as income from U.S. sources, a calendar year 80-20 corporation under the pre-86TRA law must use the base period 1984, 1985 and 1986. However, the active foreign business income test will not be applied in making this computation. Interest paid to unrelated persons in 1987 will be treated as income from

foreign sources if paid by a corporation that is an 80-20 corporation under the pre-86TRA law.

b. The three-year testing period will not include taxable years beginning before January 1, 1987 in applying the amendments described above to payments made by a corporation in a taxable year beginning after December 31, 1987.

III. Interest Earned on Bank Deposits

The 86TRA repeals the rule that treated interest earned on U.S. bank deposits as foreign source income. Under the 86TRA, although such income is treated as income from U.S. sources, it is specifically exempted from U.S. tax and reporting requirements in the hands of nonresident aliens or foreign corporations, if no effectively connected with the conduct of a U.S. trade or business.

This 86TRA provision does not produce a change in outcome, as compared to prior law, but rather alters the mechanism for achieving tax exemption: a specific exemption provision rather than a manipulation of the source rules.

IV. Allocation of Interest And Other Expenses

A. Background

The allocation and apportionment rules are relevant for many purposes, but the following discussion should be considered in the context of computing the foreign tax credit limitations. Prior to the 86TRA, the Code did not prescribe specific rules for the allocation and apportionment of expenses, including interest. Treasury regulations (Section 1.861-8), however, have prescribed specific rules and have permitted the allocation and apportionment of expenses on a separate company basis, even where companies are members of an affiliated group. In connection with the 86TRA, the President proposed and Congress agreed to replace the separate company basis for allocating and apportioning interest expense with a consolidated group basis. It was thought that consideration of the entire interest expense

of the consolidated group in a single computation would be more likely to result in an allocation and apportionment of interest expense that would be reflective of economic reality. The separate company basis of allocation has enabled taxpayers to rather easily limit the amount of interest expense allocated to foreign source income by selective location of the borrowings within the affiliated group. For similar reasons, the 86TRA also adopts the consolidated group basis for allocating and apportioning other items of expense, besides interest.

B. Interest Expense

1. General Rule - Within an affiliated group, the entire interest expense of the group is allocated as if all members of the group were a single corporation.

2. Interest expense must be allocated on the basis of assets (the gross income method is not available).

3. In determining the asset base for purposes of the allocation, tax exempt assets are ignored.

   Where members of the affiliated group own 10 percent or more of the total voting power of a corporation that is not in the affiliated group, the adjusted basis of the stock of such corporation is increased by the earnings and profits and decreased by the deficits in earnings and profits (but not below zero) of such corporation accumulated during the period the members held the stock.

   Affiliated group has the meaning given by Section 1504 without regard to Section 1504(b)(4) i.e., Section 936 companies are included for this purpose.

C. Research and Experimental Expenditures

1. Background

In general, existing Treasury regulations provide for the allocation of research and experimental expenditures by U.S. taxpayers on the basis of U.S. and foreign sales or gross income.

The application of the existing regulations has been suspended by Congress since 1981. In place of the rules set forth in the regulations, Congress has provided that all of a taxpayer's research and experimental expenditures attributable to research conducted in the U.S. will be allocated to U.S. source income.

The 86TRA does not resolve the uncertainty in this area. Rather, in adopting a one year rule that will apply to calendar year taxpayers in 1987, Congress has shifted to Treasury the task of pursuing a permanent solution to the allocation issue.

2. 86TRA Rule - For taxable years beginning after August 1, 1986 and on or before August 1, 1987:

1) 50 percent of U.S. research expenditures will be allocated to U.S. source income; and

2) the remaining 50 percent will be apportioned on the basis of gross sales or gross income.

This rule does not apply to expenditures described in Section 1.861-8(e)(3)(i)(B)(i.e. Government imposed r&d).

D. Other Expenses

General Rule - Expenses other than interest not directly allocable and apportioned to specific income producing activity will be allocated and apportioned as if all members of the affiliated group were a single corporation. This is a very significant provision of the new law.

E. Regulations

Extremely broad regulatory authority has been delegated to the Treasury to prescribe regulations providing:

1. for the resourcing of income of any member of the affiliated group or modification to the consolidated return regulations to the extent such resourcing is necessary to carry out the purposes of the above changes;

2. for the direct allocation of interest expenses incurred to carry out integrated financial transactions; and

3. for the apportionment of expenses allocated to foreign source income among members of the affiliated group and various categories of income described in Section 904(d).

F. Effective dates - Allocation of Interest Expense

1. General Rule - The above amendments apply to taxable years beginning after December 31, 1986.

2. Transition Rules - No one is authorized to read these rules unaccompanied by a physician.

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THE TAX REFORM ACT OF 1986

AMENDMENTS TO SUBPART F, PASSIVE FICs AND THE FOREIGN TAX CREDIT PROVISIONS*

by

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I. Amendments to Subpart F.

A. Definition of Controlled Foreign Corporation ("CFC"). Code § 957, TRA §§ 1222(a) and 1224.**

1. New Vote or Value Test: Under prior law a foreign corporation was generally characterized as a CFC if more than 50 percent of the corporation's total combined voting power was owned (directly, indirectly or constructively) by 10 percent or greater "United States share-holders". TRA § 1222(a) amends Code § 957(a) to also include foreign corporations if more than 50 percent of the total value of the corporation's stock is owned (directly, indirectly or constructively) by 10 percent or greater "United States shareholders". The more than 25-percent ownership test (in Code § 957(b)) for foreign insurance companies is similarly amended. (Cf. the special rules for captive insurance companies in I.B.)

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* This outline is not intended as a comprehensive guide to these provisions, but rather as a summary of certain significant aspects of the changes in this area of the law.

** All "TRA §" and "Code §" references herein are, respectively, to the Tax Reform Act of 1986 ("1986 TRA") and the Internal Revenue Code as amended by the 1986 TRA.

2. Effective dates: The change in the definition of control is effective for taxable years of a foreign corporation beginning after December 31, 1986, with one exception. The exception is limited to corporations that become CFCs because of the new definition. For such corporations, only for purposes of applying Code §§ 951(a)(1)(B) and 956 dealing with the taxation of an increase in investment in United States property, only property acquired on or after August 16, 1986 is taken into account. TRA §§ 1222(a) and 1224(b).

B. New Rules for Captive Insurance Companies. Code § 953(c), TRA § 1221(b)(2).

1. Purposes: To tax currently income earned by captive insurance companies, such as industry cooperatives, that have heretofore avoided CFC status by having such diffuse U.S. ownership that 10 percent "United States shareholders" did not own more than 25 percent of the company's stock.

2. Taxation.

a. The terms "United States shareholders" and "controlled foreign corporation" are differently defined in a special subpart F rule for purposes of so-called "captive insurance companies" in new Code § 953(c). U.S. shareholders (under the special definition of captive insurance companies) that are "controlled foreign corporations" (as specially defined) are taxed currently on their pro rata share of "related person insurance income."

(1) For this purpose United States shareholder is any United States person who owns, directly or indirectly (but not constructively), any stock in a foreign corporation. The normal 10

percent ownership threshold does not apply. While indirect ownership under Code § 958(a) is counted, constructive ownership under Code § 958(b) does not seem to apply to determine if a captive is a CFC for this purpose.

(2) Controlled foreign corporation is any foreign corporation if at least 25 percent of the corporation's stock (measured by vote or value) is owned (directly, indirectly or constructively) by United States shareholders as defined immediately above. This should be distinguished from the normal rule for CFCs, which is more than 50 percent.

(3) "Related person insurance income" is "insurance income" attributable to a policy of insurance or reinsurance with respect to which the primary insured is either a United States shareholder (under the special definition) of the foreign corporation or a related person to such a shareholder. Insurance income for this purpose includes both premium income and investment income. (See the definitions of "insurance income" and "related person" at I.C.2 and 1.C.3 below)

b. Exceptions: Current taxation is avoided under two de minimis rules. De minimis for this purpose means an insurance company with minimal related-party insurance.

(1) Ownership Exception: If at all times during the taxable year less than 20 percent of the vote and value of the foreign corporation's stock is owned directly (or

indirectly) under the principles of new Code § 883(c)(4) (see TRA § 1212(c)(5)) by persons who are the primary insureds or who are related persons to the primary insureds or

(2) Annual Income Exception: For a particular taxable year, if less than 20 percent of the foreign corporation's "insurance income" (determined by ignoring the country of incorporation exception) is related person insurance income, a special exception applies to except a 25 percent U.S.-owned company's U.S. shareholders from current taxation of that year's related person insurance income.

c. Effectively-Connected Election: A captive insurance company may also elect to treat its related person insurance income as effectively connected with a U.S. trade or business. To do so, the company must waive all treaty benefits with respect to that income (e.g., a treaty permanent establishment threshold) and meet any other requirements that the Secretary may impose by regulation. This election removes the income from current taxation at the shareholder level under subpart F while making the income taxable currently to the foreign corporation. It also allows the foreign corporation to offset that income with any net operating loss carryovers that it may have, and otherwise to put it in close parity with a U.S. insurance company.

d. Regulations: Broad regulatory authority is granted, including a directive to issue regulations to deal with mutual

insurance companies and cross-insurance arrangements.

3. Effective date: The new captive insurance company provisions are effective for taxable years of foreign corporations beginning after December 31, 1986. TRA § 1221(g).

4. Other changes involving insurance income are made within the general subpart F provisions. See I.C.3. below.

C. Definition of Subpart F Income.

1. FPHC Income. Code § 954(c) and TRA § 1221(a). The definition of subpart F FPHC income is very substantially broadened. These changes do not apply to the FPHC provisions (Code §§ 551 et seq.), but only for purposes of subpart F.

a. Dividends, interest, rents and royalties.

(1) Special exclusions from FPHC income for dividends and interest earned by banks and insurance companies are repealed.

(2) However, there is an exception for "export financing interest" as defined in Code § 904(d)(2)(G) (TRA § 1201(b)) derived in the active conduct of the banking business. See III.A.1.b.(3). This applies to interest of a bank from financing the sale of related-party U.S.-manufactured, etc. property for use or consumption outside the U.S.

(3) There continue to be exclusions for active unrelated rent and royalties and for certain same-country related rents and royalties, but the definition

of related party has been modified. (See I.C.2 below). The portion of the Conference Report dealing with the foreign tax credit amendments states that, to the extent possible, new regulations will replace the current facts and circumstances test for distinguishing active from passive rents and royalties with a more objective test.

(4) Income equivalent to interest, e.g., commitment fees, will be treated as interest.

b. The rule treating gain from securities transactions as subpart F FPHC income is expanded to include the excess of gains over losses from the sale or exchange of any property which does not give rise LO any income or which gives rise to dividend, interest, rents and royalties, unless the income from the asset that is sold would not be FPHC income, e.g., because it qualifies for the active-rent exception.

c. The rule treating gains on commodities futures transactions is expanded to include the excess of gains over losses from transactions in commodities other than bona fide hedging transactions by producers, processors, etc. “reasonably necessary to the conduct of business” in a manner “customarily and usually conducted by others”, active business transactions by certain producers, professors, etc., and “section 988 transactions” in foreign currency.

d. The excess of foreign currency gains over foreign currency losses attributable to any “section 988 transaction” not directly related to the business needs of the corporation is treated as subpart F FPHC income.

e. Allocation of certain interest paid to passive income: Interest paid or accrued by a CFC to a U.S. shareholder or to a related CFC is first allocated as a deduction against subpart F FPHC income that is also “passive income” for foreign tax credit purposes (See III.B.3.e). TRA **§** 1201(c), Code **§** 9542(b)(5).

2. Foreign Base Company Income -- Definition of “Related Person”: The definition of related person in Code § 954(d)(3) is expanded to include partnerships, trusts or estates controlled by the CFC or that are controlled by the same persons that control the CFC. Also, the definition of common control (in defining a related party) is changed from more than 50 percent of stock, measured by vote, in the case of corporations, to 50 percent or more of stock measured by either vote or value and, in the case of a partnership, trust or estate, 50 percent or more of the beneficial interests therein. TRA § 1221(e).

3. Insurance Income: Prior to the 1986 TRA, subpart F picked up income from insurance of U.S. risks and income from insuring related persons' third-country risks. The 1986 TRA introduces a new category of subpart F income called “insurance income”, which is defined co include income from the insuring or reinsuring of risks in any country other than the CFC's country of incorporation (and equivalent cross-insurance arrangements), provided the income would be taxed under the insurance company provisions of the Code if earned by a domestic corporation. As a result of the various changes, subpart F now picks up premiums for unrelated foreign risks and investment income, as well as the insurance income it already picked up. These rules apply to CFCs and U.S. shareholders under the normal subpart F definitions. Code § 953(a), TRA § 1221(b).

4. Foreign Base Company Shipping Income: The exclusion from the definition of foreign base company shipping income for increases in qualified investment in foreign base company shipping operation is repealed. Code §§ 954(b)(2) and (g), TRA § 1221(c). In addition, the definition of foreign base company shipping income is expanded to include "income derived from ocean or space activities", which is defined as income from any activity conducted in space or on or under water not within the jurisdiction of a foreign country, a U.S. possession or the United States other than income from any activity giving rise to (i) transportation income (ii) international communications income and income from any activity with respect to mines, oil and gas wells or other natural deposits to the extent within the United States, a U.S. possession, or any foreign country. Code §§ 954(f) and 863(d)(2), TRA §§ 1221(c) and 1213(a).

5. Effective Dates: In general, the changes in the definition of subpart F income are effective for taxable years of a foreign corporation that begin after December 31, 1986. TRA § 1221(g).

D. Other Subpart F Changes.

1. Changes in the E&P Limitation. Code § 952(c) and (d), TRA § 1221(f). Subpart F income has been limited to earnings and profits. The TRA cuts back very substantially on a corporation's ability to reduce earnings and profits so as to limit subpart F income.

a. Repeal of the "Chain Deficit" Rule: The "chain deficit" rule of Code § 952(d), which allowed a United States shareholder owning stock in a chain of CFCs to offset a portion of an E&P

deficit in one foreign corporation in a chain against the subpart F income of another corporation in the chain, is repealed.

b. Cutback on Use of Accumulated Deficits: The use of accumulated E&P deficits to offset current E&P for purposes of calculating the E&P limitation is tightened considerably.

(1) Pre-1987 deficits may not offset post-effective date current E&P at all.

(2) In a manner similar to the at-risk rules and the passive activity loss rules, current E&P and accumulated E&P deficits are identified with the activities that produce them and current E&P from certain subpart F categories (e.g., foreign personal holding company income) can be offset only by a post-1986 accumulated deficit from activities that give rise to that kind of income and incurred while the foreign corporation was a CFC.

(3) Moreover, only four types of subpart F income (foreign base company shipping income, foreign base company oil related income, insurance income and subpart F FPHC income) may be offset by their respective accumulated deficits. Other categories of subpart F income (e.g., foreign base company sales or service income) may not be offset by accumulated deficits at all. Special limitations apply to the use of accumulated deficits attributable to insurance and FPHC income.

(4) In applying this limitation at the shareholder level, a United States shareholder's pro rata share of an accumulated deficit is the lesser of his share of the deficit (calculated under Code § 951(a)(2) principles) at the close of the current year or the close of the taxable year in which the deficit arose. This is intended to prevent the subpart F equivalent of loss trafficking.

c. Recharacterization of Later Year Non-subpart F E&P: If a subpart F inclusion in a year is limited by the E&P limitation of Code § 952(c)(1)(A) (i.e., because there is a current deficit in non-subpart F E&P for the year), positive non-subpart F E&P in subsequent years is recharacterized as subpart F income to effectively recapture the prior year benefit, under rules similar to the foreign tax credit recharacterization rules for prior years' losses. Code § 952(c)(2). See III.D.1.b.

2. Modification of "No Tax Avoidance" Exception: The subjective tax-avoidance test of Code § 954(b)(4), which applied only to foreign base company income, and the objective 10 percent-5 percentage points test of the regulations are replaced by a much tougher objective rule covering both foreign base company income (other than foreign base company oil related income) and insurance income. Under the new rule, these types of income are excluded from subpart F income only if the income is taxed by a foreign country at a rate greater than 90 percent of the Code § 11 rate. TRA § 1221(d).

3. Modification of the 10-percent De Minimis Rule: The 10-percent de minimis rule of Code § 954(b)(3)(A) which excluded all foreign

base company income from subpart F income if less than 10 percent of a CFC's gross income was foreign base company income is replaced by a rule covering both foreign base company and insurance income. The new rule excludes all foreign base company and insurance income from subpart F income if the sum of the CFC's foreign base company income and gross insurance income is less than the lesser of $1 million or 5 percent of the CFC's gross income. Gross insurance income means all items of gross income taken into account in computing insurance income. TRA § 1223(a).

4. Modification of the 70-percent Rule: The 70-percent rule of Code § 954(b)(3)(B) now treats 100 percent of a CFC's gross income as foreign base company or insurance income (as appropriate) if the sum of foreign base company income and gross insurance income exceeds 70 percent of the CFC's gross income. Previously, the rule had applied only to foreign base company income. TRA § 1223(a).

5. Effective Dates: The subpart F changes described in this I.D. are, in general, effective for a controlled foreign corporation's taxable years beginning after December 31, 1986.

II. Passive Foreign Investment Company ("PFIC"). TRA § 1235, Code §§ 1291-1297.

A. Definitions

1. PFIC. Code **§** 1296(a).

a. Generally, a PFIC is any foreign corporation that meets either an income test an asset test.

(1) Income test: 75 percent or more of the corporation's gross income for a particular taxable year is "passive income".

(2) Asset test: The average percentage of assets, by value, held by the corporation during the taxable year which produce "passive income" or which are held for the production of passive income is at least 50 percent.

b. Exceptions from PFIC definition.

(1) Start-up year exception: A foreign corporation is not treated as a PFIC in the first taxable year it has gross income if no predecessor was a PFIC, it is established that the foreign corporation will not be a PFIC in its second and third taxable years, and this turns out to be true. Code § 1297(b)(2).

(2) Changing-business exception: A foreign corporation is not treated as a PFIC for a taxable year in which it changes business if it (or any predecessor) was not a PFIC in a prior year; it is established that all of the passive income for the taxable year is attributable to the proceeds from the disposition of one or more active businesses; and it is both established and it turns out that in the two taxable years immediately following the disposition, the corporation is not a PFIC. Code § 1297(b)(3).

(3) FICs electing under Code § 1247 to distribute annually 90 percent of their taxable income (computed as if a domestic corporation) are excluded from the PFIC definition. Code § 1296(d). Cf. Qualified Electing Funds (II.C.2.b).

(4) Underwriters exception: The Conference Report states that it is expected that foreign underwriters will not be PFICs because of the nature of their income and assets.

(5) Holding company exception: Holding companies that own active subsidiaries are not intended to be PFICs. Thus, if a foreign corporation owns at least 25 percent (by value) of the stock of another corporation, one looks through the holding company for purposes of applying the income and asset tests. Code § 1296(c).

2. Passive Income. Code §§ 1296(b), 904(d)(2)(A), 959(c).

a. "Passive income" is defined by cross reference to the new definition of passive income for foreign tax credit purposes which, in turn, cross references the expanded definition of FPHC income for subpart F purposes.

b. The elements of passive income. Code § 954(c), TRA § 1221(a).

(1) Dividends, interest, royalties, rents and annuities, but not rents and royalties derived in the active conduct of a trade or business from unrelated parties (as well as related party rents and royalties if paid for using property in the corporation's country of incorporation), and not dividends and interest paid by a related person organized in the same country as the corporation and having substantial assets in that country used to carry on a trade or business therein, and not

"export financing interest" (see III.A.1.b.(3)) derived in the active conduct of a banking business.

(2) The excess of gains over losses from the sale or exchange of property that either does not give rise to any income or that gives rise to dividends, interest, rents, royalties, etc. (except for the types excluded from FPHC income), provided the property is not, in the hands of the corporation, inventory or dealer property.

(3) The excess of gains over losses from transactions in commodities other than certain bona fide hedging transactions by producers, processors, etc., active business transactions by certain producers, processors, etc., and certain section 988 foreign currency transactions.

(4) The excess of foreign currency gains over foreign currency losses attributable to any section 988 transaction not directly related to the business needs of the corporation.

(5) Income equivalent to interest, e.g., commitment fees.

c. Exceptions to the passive income definition.

(1) Banking income exception: Unless regulations provide otherwise, income derived from the active conduct of a bona fide banking business, defined as a foreign bank that is licensed to do business as a bank in the U.S. (or

any other corporation to the extent provided in regulations). Code § 1296(b)(2)(A).

(2) Insurance income exception: Unless regulations provide otherwise, income derived from the active conduct of an insurance business if such income would be subject to tax under subchapter L if the corporation were domestic. Code § 1296(b)(2)(B).

B. Coordination rules.

1. Subpart F rules: If both a CFC and a PFIC that is a Qualified Electing Fund, then 10-percent "U.S. shareholders" are taxed under subpart F. TRA § 1235(c), Code § 951(f). Apparently the same is true for a non electing PFIC. Less than 10 percent U.S. shareholders of CFC-PFICs would be subject to the PFIC rules, only.

2. FPHC rules: If both a FPHC and an PFIC that is a Qualified Electing Fund, then taxed under FPHC rules. TRA **§** 1235(e), Code **§** 551(g). are apparently taxed annually under the FPHC rules on their share of undistributed FPHC income. Note that foreign corporations that heretofore have successfully avoided the FPHC ownership test may now be PFICs.

3. Personal holding company ("PHC") rules: A PFIC is not subject to the PHC tax. TRA § 1235(f), Code § 542(c)(10).

4. Accumulated Earnings Tax ("AET") rules: A PFIC is not subject to the AET. TRA § 1235(f), Code § 532(b)(4).

5. Foreign Investment Company ("FIC") rules: A shareholder of a PFIC that is also a FIC is not taxed under Code § 1246 on gain realized

on the sale of his stock with respect to post 1986 E&P. Code § 1297(b)(7).

C. Taxation

1. Who is taxed.

a. Direct Owners: U.S. persons owning stock in a foreign corporation that is a PFIC at any time during the shareholder's "holding period". Code § 1297(b)(1).

b. Indirect Owners: Certain U.S. indirect owners of stock in a PFIC are taxed. Code §§ 1297(a), 1291(a)(1), 1293(a)(1).

c. Regulations will provide for attribution to ultimate beneficial owners in case of sale by an intervening entity of PFIC stock. Code § 1297(b)(5).

2. Timing and Computation.

a. PFIC not a "Qualified Electing Fund." Code § 1291.

(1) Summary: No tax is paid until a distribution is received or stock is sold. (Stock is treated as sold if it is used as security for a loan. Code § 1297(b)(6).) At that time, PFIC shareholder pays tax roughly equal to tax shareholder would have paid if income had been distributed annually as received plus accumulated interest on unpaid tax. The statute achieves this result by breaking any distribution (or sales proceeds) into two parts: the "excess distribution" and the balance. The balance is subject to all Code provisions other than the PFIC rules. The excess distribution, in

turn, is allocated to each day in the taxpayer's Code § 1223 holding period ending on the date of the distribution. The portions allocated to the current year and to days in the taxpayer's holding period before the first day of the first taxable year that the foreign corporation was a PFIC are taxed as ordinary income. The balance of the allocated excess distribution is excluded from gross income; however, the current year’s tax is increased by the “tax deferred amount” attributable to the “excess distribution.” Code § 1291(a).

(2) Calculation of the “tax deferred amount.”

(a) Calculate the “total excess distribution”: this is the excess of the distributions that the PFIC stockholder received for the taxable year over 125.percent of the average amount received during the 3 prior taxable years. Code § 1291(b)(2).

(b) Calculate the “excess distribution” for the taxpayer: this is the lesser of the distributions actually made to the stockholder during the taxable year and the stockholder’s portion of the total excess distribution for the year. Code § 1291(b)(1).

(c) Allocate the “excess distribution” to each day in the taxpayer’s holding period for his PFIC stock. Code § 1291(a)(1)(A).

(d) Calculate the hypothetical tax on the amount allocated to a particular year in the holding period (other than the current year and years prior to the first year the corporation was a PFIC) by applying the highest Code § 1 or § 11 rate (as applicable) for the year of allocation. Code § 1291(c)(2).

(e) Calculate the hypothetical interest (at the Code § 6621 underpayment rate) on the hypothetical tax from the due date of the return for that taxable year until due date of the return for the year of distribution. (The "due date" is the last day for filing, without extensions.) Code § 1291(c)(3).

(f) The sum of the hypothetical interest plus the hypothetical tax is the "tax deferred amount." Code § 1291(c)(1).

(3) Basis adjustments: Generally, basis adjustment rules similar to those of Code § 1246 will apply with certain modifications for the basis of stock transferred at death. Code § 1291(e).

(4) The indirect foreign tax credit is not allowed with respect to dividends paid by a PFIC that is not a Qualified Electing Fund. Code § 1291(a)(5).

(5) Regulations: Regulations may be issued to override nonrecognition provisions. Code § 1291(f).

b. Qualified Electing Funds. Code §§ 1293-1295.

(1) General rule: A PFIC shareholder includes in income annually, as ordinary income, his daily pro rata share of “ordinary earnings” (earnings reduced by net capital gains) and, as long term capital gain, his daily pro rata share of net capital gains of the PFIC for the taxable year of the PFIC which ends with or within his taxable year. Code § 1293(a).

(2) Distributions attributable to previously taxed E&P are not taxed. Code § 1293 (b).

(3) A PFIC shareholder's basis is increased by the annual hypothetical distributions and reduced by the untaxed distributions. A similar rule will be provided for indirect PFIC shareholders. Code § 1293(c).

(4) Ten-percent corporate shareholders of PFIC-CFCs are allowed the Code § 960 indirect foreign tax credit. Code § 1293(f).

(5) The PFIC must elect flow-through status and agree to provide certain information on earnings and shareholders. Election may be made in any taxable year and once made may be revoked only with the consent of the Secretary. To be effective for a taxable year the election must be made before the 15th day of the third month following the close of the taxable year. Code § 1295.

(6) Election to extend time for payment: A PFIC shareholder can elect to extend time to pay tax on undistributed PFIC earnings that are not subpart F income or undistributed FPHC income. In this case he pays actual interest, and a bond may be required. The election is terminated if the stock is sold or a distribution is made With respect to previously taxed earnings. Code § 1294.

c. Other Provisions.

(1) A PFIC shareholder that holds stock in the PFIC on the first day of the taxable year that the PFIC elects to be taxed as a Qualified Electing Fund may, if he can establish the fair market value of his PFIC stock, elect to recognize gain, step up his basis and start a new holding period running, as though he sold such stock on the first day of the year. Code § 1291(d)(2).

(2) For purposes of computing the foreign tax credit with respect to a PFIC “excess distribution” the entire amount of the distribution is included in gross income, not the “tax deferred amount.” Code § 1291(a)(4).

(3) If a foreign corporation ceases to be a PFIC, a shareholder may elect to recognize all previously untaxed gain and thus purge the stock of its PFIC taint. Code § 1297(b)(1).

D. Effective Date: The PFIC provisions apply to taxable years of foreign corporations beginning after December 31, 1986.

III. Amendments to the Foreign Tax Credit.

A. New Separate Limitation Categories: Five new categories of income are now subject to separate limitations and the separate passive interest limitation is repealed. The new categories are: passive income, high withholding tax interest, financial services income, shipping income and dividends from each "noncontrolled section 902 corporation". The separate limitations for FSC distributions, foreign trade income and DISC dividends as well as, of course, the "residual" limitation are retained. TRA § 1201(b), Code § 904(d)(1)(A)-(E).

1. Passive Income Category. Code § 904 (d)(2)(A).

a. Items Generally Included: Passive income includes all subpart F FPHC income (see I.C.1 above) plus the deemed distributions made by a PFIC that is a Qualified Electing Fund (see II.C.2.b) and by an FPHC. Thus the active business portion, if any, of an FPHC's undistributed FPHC income is converted into passive income for tax credit purposes

b. Exclusions.

(1) If an item of income falls into both the passive income category and one or more of the other new categories, it is exclude4 from the passive income category.

(2) High-taxed Income (the "high-tax kick-out").

(a) Highly taxed items of passive income are excluded from the passive

income category if the foreign income taxes paid by the U.S. recipient on that income plus any foreign income taxes deemed paid exceeds the amount of such income (grossed up under Code § 78) multiplied by the highest Code § 1 or § 11 rate, as appropriate. The Conference Report clarifies that the amount of passive income taken into account in applying this test is reduced by any expenses allocated to it at the U.S.-recipient level. Code § 904(d)(2)(F).

(b) Regulations will be issued providing for the aggregation of various items of passive income in applying the high-tax kick-out e.g., aggregation of all passive income items of a foreign branch or of all passive items in a subpart F inclusion. Regulations will also be issued dealing with distributions previously taxed as subpart F income.

(3) Export Financing Interest: Interest derived from financing the sale for use or consumption outside the United States of property which is manufactured, produced, etc. in the United States by the taxpayer or a "related person" and not more than 50 percent

of the fair market value of which is attributable to products imported into the United States. Code § 904(d)(2)(G).

(4) Foreign oil and gas extraction income.

2. High Withholding Tax Interest Category. Code § 904(d)(2)(B).

a Definition: Interest, other than export financing interest (see III.A.1.b.(3)), which is subject to at least a 5 percent withholding tax (or other gross-basis tax) of a foreign country or of a U.S possession.

b. Regulations may be issued to prevent avoidance of this limitation.

c. Special transition relief is provided for interest received on loans to borrowers in 33 designated less developed countries. TRA § 1201(c)(7).

3. Financial Services Income Category. Code 904(d)(2)(C).

a. Items Generally Included: Income which is not passive income (defined without regard to the exclusion for passive income that also falls into one or more of the new categories) and which either is (i) derived in the active conduct of a banking, financing or similar business, or (ii) is income from the investment by an insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its business or (iii) is

subpart F insurance income (defined without the same-country exception) including related-party insurance income of CFC captives (see I.C.3 above). This definition is meant to include the types of banking income enumerated in Reg. § 1.954-2(d)(2)(ii)(A)-(G) as well as, inter alia, investment banking fee income, currency- and interest-rate swap income and credit card services income.

b. The "predominantly engaged in" rule: Passive income of an entity "predominantly engaged" (to be defined in regulations) in the active conduct of a banking, insurance, etc. business is considered financial services income. According to the Conference Report when applying the look thru rules (see III.B) to subpart F inclusions, passive income is so recharacterized if either the CFC or its U.S. shareholder satisifies the test.

c. Exclusions: Financial services income that is also either export financing income or high withholding tax interest is excluded from the financial services income category whether or not the "predominantly engaged in" test is satisfied.

4. Shipping Income Category: Foreign base company shipping income is now a separate category. It does not include any financial services income of an entity predominantly engaged in the active conduct of a banking, insurance, etc. business during the year. Code §§ 904(d)(2)(D) and 904(d)(2)(C)(ii).

5 Dividends from Each Noncontrolled Section 902 Corporation.

a. Rule: Dividends paid by each foreign corporation that is not a CFC (or paid by a CFC out of E&P from any pre-CFC period) are treated as a separate category of income for each U.S. shareholder who meets the stock ownership requirements for an indirect (Code § 902) credit. For example, if a U.S. C corporation owns 10 percent voting interests in 15 foreign corporations that are not CFCs and they all pay dividends in a particular year, the corporation has 15 separate limitation categories.

b. Rationale: The conferees did not want to allow cross-crediting of taxes paid by one noncontrolled foreign corporation against those paid by another. Also, application of the look thru rules (discussed below) would have been difficult because noncontrolling shareholders might not have ready access to the required financial data.

c. Exclusion: Withholding taxes (but only to the extent of the excess over a 5 percent rate) paid by a noncontrolled section 902 corporation on high withholding tax interest are not treated as taxes paid for purposes of calculating the indirect credit due on noncontrolled section 902 corporation dividends.

B. New look-thru rules for CFCs and other controlled entities. TRA § 1201(b), Code § 9O4(d)(3). These rules serve to

recharacterize certain amounts into one or more of the five new categories of income and to treat each category of income as though it were earned directly by its U.S. parent. The purpose of this rule is to promote parity between a subsidiary and a branch for limitation purposes. The effect is to prevent manipulation.

1. Taxpayers Affected: Any United States shareholder of a CFC, including a United States shareholder of a captive insurance company (see I.B.2.a.(1) and (2)). Owners of, and interests in, controlled entities that would be, respectively, United States shareholders and CFCs, if the entities were foreign corporations are to be covered by regulations, as is interest paid by 80/20 companies.

2. Income Covered.

   a. Dividends paid by a CFC, including the increase in earnings invested in United States property.

   b. Subpart F inclusions, including the portion of the Code § 78 gross up amount attributable to subpart F income.

   c. Interest, rents and royalties paid by a CFC and, as provided in regulations, those paid by controlled entities.

3. Operating Rules.

   a. CFC de minimis rule: The look-thru rules do not apply to a CFC that meets the Code § 954(b)(3)(A) de minimis rule. (See I.D.3)

   b. No Tax Avoidance Exception: Generally, if the (amended) no tax avoidance exception of Code ,§

954(b)(4) (see I.D.2) is satisfied, then dividends are looked through only to segregate their high withholding tax interest component and their noncontrolled section 902 corporation dividend component.

c. Look-thru of dividends: Dividends from a CFC are apportioned among the five new categories of income based on the ratio of the E&P of the CFC in that category to total E&P.

d. Look-thru rule for subpart F inclusions': Subpart F inclusions retain their character in the hands of the United States shareholder. For example, if a U.S. corporation, that owns 100 percent of a CFC has a $100 subpart F inclusion for the year because the CFC had $90 of subpart F FPHC income and $10 of nonsubpart F services income, then $90 would be allocated to the passive income category and $10 would be allocated to the residual category.

e. Look-thru rule for interest, rents and royalties: Recognizing that interest, rents and royalties can be alternatives to a dividend as a means for repatriating funds, Treasury is to issue regulations specifying how to apportion these types of payments from a CFC to its U.S. shareholder among the five limitation categories. Regulations are also to be issued to provide look-thru rules for income paid or loans made through entities. Under the "netting rule," contained in Code § 954(b)(5) an interest payment made

to a United States shareholder (and to the extent provided in regulations, other persons) will first be allocated to any gross subpart F income which is passive to the extent of that income. The effect of this allocation is to reduce the passive subpart F income available for inclusion, and its aim is to avoid creating an incentive to keep or move passive investments offshore. Regulations may be issued to prevent exploitation of this allocation rule.

4. Effective Date: The new separate limitations and look-thru rules apply to taxable years beginning after December 31, 1986, except for phase-in of the high withholding tax interest provisions for the 33 less developed countries.

C. The Indirect Credit. Code § 902, TRA § 1202(a).

1. E&P Pooling: For purposes of calculating the indirect foreign tax credit, a dividend paid out of "post-1986 undistributed earnings" is not traced to a particular annual layer of E&P. Rather, the dividend is treated as paid out of a pool of E&P for taxable years beginning after 1986. It will no longer be possible to time dividend payments in order to pull up credits from a particular year (the "rhythm method"). Instead, a dividend will carry with it the average taxes paid with respect to the entire pool.

a. Dividends are deemed paid first out of "post-1986 undistributed earnings" and then out of pre-1987 E&P. The annual E&P pools of prior

law continue to apply in the latter case.

b. Calculation of the “post-1986 undistributed earnings” begins on the day the foreign corporation has a direct or indirect shareholder who satisfies the ownership requirements for a Code § 902 credit for taxes paid by the foreign corporation.

c. No guidance is provided on the treatment of dividends paid by a second or third tier subsidiary after 1986 out of pre-1987 E&P. Is the dividend mixed into post-1986 pool or does it maintain its pre-1987 character?

d. Regulations will be issued clarifying the interaction with Code § 960.

2. Repeal of 60-day rule: Dividends paid in the first 60 days of a taxable year are no longer deemed paid out of the prior years' E&P.

3. Effective date: Taxable years beginning after December 31, 1986.

D. Losses. TRA § 1203, Code § 904(f)(5)

1. Separate limitation losses: The rule in Code § 904(f) requiring all or a portion of an “overall foreign loss” sustained in one year to be recharacterized as U.S.-source income in a later year is retained and extended to take into account “separate limitation losses”, i.e., a loss in a year within any of the nine categories of foreign tax credit income.

a. Year of loss.

(1) A separate limitation loss first reduces any foreign-source income in the year of the loss in each of the other eight categories of income proportionately, i.g., based on the ratio of total foreign income to total foreign loss. When there is more than one separate limitation loss in a year, the Conference Report clarifies that each loss is allocated proportionately to the other categories of income. Any remaining separate limitation loss then reduces U.S.-source income.

(2) If there is a U.S.-source loss for the year, and if after allocating separate limitation losses among the categories of foreign income, one or more of those categories still has income, then the U.S.-source loss is used to reduce those categories of income proportionately.

b. Subsequent years: Income in a category that sustained a separate limitation loss in a prior year that was used to reduce income in one or more other categories is first recharacterized as income in those other categories in proportion to the reductions made in earlier years, up to the amount of the prior year's reductions. The balance, if any, is recharacterized as U.S.-source income for that year, subject to the Code § 904(f)(1) 50-percent limitation. The Conference Report

clarifies that for purposes of computing the 50-percent limitation, the entire foreign source income is taken into account.

c. Affiliated Groups: The Conference Report clarifies that the new rules will apply on an affiliated-group basis.

d. NOLS: The Treasury will issue regulations applying these rules to NOLS.

E. Carryovers and Carrybacks.

1. Carrybacks. TRA § 1205.

a. Excess credits for taxes paid or accrued after 1986 that are attributable to the U.S. tax rate reduction in the 1986 TRA may not be carried back to taxable years beginning before 1987.

b. Excess credits that may be carried back are subject to the residual limitation of Code § 904(d)(1)(E) as in effect prior to enactment of the 1986 TRA.

d. Excess credits attributable to high withholding tax interest may not be carried back to taxable years beginning before 1987.

2. Carryovers. TRA § 1201(b), Code § 904(d)(2)(I).

a. Pre-1987 credit carryovers attributable to passive interest income (pre-1986 TRA) are subject to the passive income limitation if carried over to post-1986 years.

b. Pre-1987 credit carryovers attributable to residual limitation income (pre-1986 TRA) are subject to the residual limitation if carried over, with certain exceptions for shipping and financial services income.

F. Subsidies. TRA § 1204, Code § 901(i). The rule of Reg. § 1.901-2(e)(3) that treats a tax that is directly or indirectly used to subsidize the taxpayer or a related party as not being a tax for foreign tax credit purposes is codified.

G. Changes in the Sourcing Rules and Interest-Allocation Rules: The changes in these rules significantly affect the calculation of the foreign tax credit.

IV. Foreign Personal Holding Company ("FPHC") Tax: The stock-ownership requirement in Code § 952(a)(2) for characterization as an FPHC, which previously was based only on value, is modified to conform with the new CFC vote or value rule, i.e., the more-than-50-percent ownership requirement is satisfied if a United States group owns more than 50 percent of either the vote or value of a foreign corporation's stock. TRA § 1222(b). This provision is effective for taxable years of a foreign corporation beginning after December 31, 1986. TRA § 1222(c).

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TAX REFORM ACT OF 1986
FOREIGN CURRENCY TRANSACTIONS

By

Wm L. Burke

I. Overview

Under prior law,* the tax treatment of foreign currency exchange gain or loss derives for the most part from case law. Under the regulation authority granted by Section 964, earnings and profits of foreign corporations for purposes of Subpart F inclusions (and characterizing gain under Section 1246 or 1248) are determined using a form of "net worth" method that has prescribed exchange rates and takes into account currently some unrealized exchange gains and losses. In certain cases, foreign currency transactions can also fall under the rules of Section 1092 or 1256. Treatment in, other situations, however, is governed by case law. As a result, the question of foreign exchange gain or loss has been the subject of confusing and often conflicting rules.

The Tax Reform Act of 1986 contains the first effort to establish a comprehensive set of statutory rules for the federal income tax treatment of foreign exchange gain or loss. Except for personal transactions by individuals (which continue to be governed by prior law), the new rules apply to all transactions by all relevant tax units (including investment transactions by individuals). The rules determine amount, timing of recognition, character and source of foreign exchange gain or loss.

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* To avoid confusion, all references to the law in effect until the general effective date of the Tax Reform Act of 1986 provision will be referred to as "prior" law, and the law as changed by the Act will be referred to as the "new" law.

The new rules make a number of major changes in prior law. Under the new rules, whenever a qualified business unit (or an individual in an investment transaction) ceases to have an asset or liability denominated in or by reference to what is a non-functional currency for it, it generally will recognize ordinary income or expense (further characterized as interest income or expense to the extent prescribed by regulations) whose source will be the place of residence of the tax unit having the recognition. This general rule is subject to modification, however, if the transaction is 2ar: of a hedging of risk of foreign currency fluctuations. Each tax aspect to be determined is also subject to specific exceptions.

The new rules also require income or loss and earnings and profits of a branch or foreign subsidiary (including Subpart F determinations) to be determined on the basis of the "profit and loss" method rather than a "net worth" method. In addition, the amount of foreign taxes which may be claimed as a foreign tax credit is converted to dollars at the exchange rate on the date the foreign tax is paid rather than the "Bon Ami" rule of the exchange rate for the related income inclusion.

In the implementation of the new rules, the IRS is given broad authority to prescribe such regulations may be "necessary or appropriate."

II. Detailed Description

The new provisions contain rules for determining the relevant tax units and their functional currencies and the treatment of exchange gain or loss for transactions by the tax unit that are not in that functional currency. In addition, the new provisions contain rules for further converting the activities of non-dollar functional currency tax units into dollars where that is necessary to determine the taxpayer's U.S. tax liabilities.

A. Exchange Gain or Loss on Transactions in Non-Functional Currency.

1. Relevant Tax Unit. Foreign exchange gain or loss is determined by reference to the relevant tax unit and its functional currency. For this purpose, each "qualified business unit" ("QBU") is treated as a separate tax unit. A QBU generally exists if all three of the following requirements are met:

(1) it is a separately and clearly identified unit,

(2) it involves a trade or business of the taxpayer, and

(3) it maintains separate book and records. A single taxpayer may have more than one QBU.

The legislative history indicates that a QBU "must include every operation that forms a part of the process of earning income." * Both the Senate and House reports state that a vertical, functional or geographical division of a single trade or business which is capable of producing income independently could qualify even though it did not constitute a separate trade or business. Also, existence for only a specifically limited time (such as a construction project). will not necessarily preclude a QBU from arising, especially if the activity is subjected to foreign tax. On the other hand, the House Report indicates that an office for a single salesman to solicit orders with the remaining sales function located elswhere would not qualify.

A qualified business thus may require more than is necssary to be treated as engaged in business under United States internal tax law provisions, but need not rise to the level of a separate trade or business. If it does not, the QBU is taken into account only for purposes of foreign currency gain or loss purposes and not for any other purposes. For example, while the adoption of its functional Currency is a method of accounting determined

* For brevity, references to committee reports will be referred to as the "Conference Report," the "Senate Report and the "House Report," respectively.

QBU by QBU, the same accounting methods (e.g. cash versus accrual accounting) otherwise must be used for all of the QBU's constituting a trade or business.

Note that the three requirements for a qualified business unit are cumulative. Even if the activity is sufficient to qualify, no separate unit would appear to arise if the requisite "separate books and records" do not exist. In this respect, the taxpayer may have some discretion to tailor the scope and functional currency of a QBU.

Because a QBU also necessitates a trade or business, for foreign exchange gain or loss determinations, an individual will be treated as a single separate tax unit for exchange gain or loss with respect to any individual investment transactions (including expenses deductible under Section 212 with the 2% de minimus floor disregarded).

2. Functional Currency. "Foreign:" exchange gain or loss is measured by reference to a tax unit's functional currency. A functional currency must be adopted for each QBU. Each individual taxpayer must also adopt one functional currency for all of his investment transactions. Once adopted, any change in functional currency for a unit constitutes a change in method of accounting requiring the prior consent of the IRS.

Except where use of the dollar is required, the functional currency of a QBU will be that currency which is both (i) the currency of "the economic environment in which a significant part of such unit's activities are conducted" and (ii) the currency used by the unit for keeping its books and records. The Senate Report indicates that the factors to be taken into account in measuring the first requirement generally correspond to criteria set forth in Statement of Financial Accounting Standards No. 52. The use in the statute of the phrase "a significant part" and the reference to current financial accounting criteria suggest that in some cases more than one currency might statisfy the "economic environment" requirement. The Senate Report indicates that in such a case, the taxpayer may choose among the available currencies by keeping the unit's books and records in the desired currency.

In certain cases, the dollar is mandated or may be elected as the unit's functional currency. If the activities of any QBU are primarily conducted in dollars, then dollars must be adopted as the functional currency. Unless regulations provide otherwise, the dollar also will be the required functional currency for all investment transactions of all individuals. The Conference Report adds two further situations where it is expected that dollars will be required as the functional currency:

(1) a foreign operation that is an "integral extension" of a U.S. operation, citing, as one example, a foreign finance subsidiary whose sole function is to act as a financing vehicle for affiliated corporations that are U.S. corporations, and, as another example, a foreign corporation used to hold passive foreign portfolio investments that could readily be carried on the U.S. parent's books, and

(2) a foreign operation of limited duration, citing as an example an offshore construction project by a U.S. taxpayer.

In addition, the Conference Report states an expectation that when a QBU's functional currency is not the dollar, the IRS will have authority to require dollar transactions to be kept in dollars "where appropriate."

Although Section 985(b)(1) would appear to give a taxpayer the option to use dollars as the functional currency for a QBU by keeping the books of the QBU in dollars or a currency not meeting the "economic environment" requirement, Section 985(b)(3) and the legislature make clear that it is up to the discretion of the IRS to permit use of the dollar as a unit's functional currency if the unit keeps its books and records in dollars. Primarily for units operating in hyperinflationary economies, the IRS may also permit an election to use the dollar as the functional currency if the unit uses a method of accounting that approximates a separate transaction method (e.g., translating all balance sheet items at historical dollar cost). If it so desires, the IRS can condition either election on the election being adopted by all of the taxpayers QBU's worldwide.

3. Foreign Currency Transactions. A transaction is a "foreign" currency transaction (a "Section 988 Transaction") if the amount which the taxpayer is entitled to receive or is required to pay is denominated in terms of, or is determined by reference to, a nonfunctional currency for the tax unit involved and the transaction is one of the following:

(i) the acquisition of a debt instrument or becoming the obligor under a debt instrument,

(ii) accruing (or otherwise taking into account) for income tax purposes any item of expense or gross income or receipts which is to be paid or received after the date on which so accrued or taken in account, or

(iii) entering into or acquiring any forward contract, futures contract, option, or similar financial instrument if such instrument is not marked to market at the close of the taxable year under Section 1256.

To the extent provided in regulations, category (i) includes preferred stock. For purposes of the new Section 988 hedging transaction rules (discussed below), transactions described in category (iii) are treated as Section 988 Transactions without regard to whether they would otherwise be marked to market under Section 1256.

The IRS Is given discretion to exclude from category (ii) any classes of items not necessary to carry out the purposes of the foreign currency transaction provisions, including establishing de minimus exceptions for small amounts or short time periods or otherwise. As examples of the latter, the Senate Report cites trade receivables and payables having a maturity or 120 days or less and any other receivables or payables having a maturity of six months or less that would be eligible for an exclusion under Section 1274.

4. Timing, Amount, Character and Source of Gain.

(i) Timing

When a tax unit ceases to have a non-functional currency asset or liability described in a Section 988 Transaction, it has a recognition event for purposes of computing foreign currency exchange gain or loss unless the asset or liability is treated as part of a Section 988 hedging transaction (discussed below) or different treatment is prescribed under the broad 'regulation authority granted the IRS. These rules apply even though there is no realization or recognition for other federal income tax purposes and even though the tax unit may receive nothing with respect to the asset or pay nothing with respect to the liability. They apply even though the asset or liability is transferred from one QBU of a taxpayer to another QBU of the same taxpayer having a different functional currency.

The Committee Reports indicate that demand or time deposits (and presumably other such “cash equivalents”) are treated as the currency in which they are denominated, so that use of non-functional currency to establish a time deposit in the same non-functional currency is not a recognition event. The IRS would also appear to have regulation authority to treat as a non-

recognition event a transfer of assets between same functional currency QBU's of a single taxpayer.

To the extent provided in regulations, limited recognition of exchange gain or loss is also required annually on certain high interest loans by a U.S. person or related person (using Section 954(d)(3) principles) to a foreign corporation in which the United States person owns directly or indirectly 10% of the voting stock. The Senate Report indicates that this provision was added to prevent possible manipulation to artificially increase foreign tax credit limitations. A loan falls within this provision if it is denominated in a currency other than dollars and bears interest at a rate at least 10 percentage points higher than the Federal mid-term rate applicable when the loan was made. Solely for the purpose of computing foreign tax credit limitations under Section 904, such loans are marked to market on an annual basis. (The result will be domestic source gain or loss, typically a loss on the assumption that the interest rate is intended to compensate for an expected exchange loss on the principal. The IRS is then authorized to resource interest earned on the loan in a like amount to compensate.)

Exchange gain or loss is also to be recognized on accrual of original issue discount on non-functional currency obligations under regulations. Pending the regulations, the accrued amounts are to be translated into the functional currency at the average exchange rate for the accrual period.

(ii) Amount

The realized exchange gain or loss is computed by multiplying the difference in the appropriate exchange rate (generally, the free market rate) for the non-functional currency between the acquisition date and the disposition date by the number of units of non functional currency booked on the acquisition, However, the amount of foreign currency gain or loss recognized is limited to the total gain or loss, respectively, with respect to the total transaction, including the "separate" underlying transaction. Non-exchange loss or gain on the transaction (i.e. loss or gain as computed in the non-functional currency) thus will offset any exchange gain or loss.

Example: Suppose X whose functional currency is dollars, purchases a non-functional currency asset for L 100 and sells the assets for L 200. If the exchange rate were $1 = L 1 when the asset was purchased, the recognized exchange gain or loss and remaining (regular) gain or loss at different exchange rates on the sale would be as follows:

Exchange Rate on Sale $1 =	Realized Exchange Gain or Loss (100 Times Exchange Difference)	Total Gain or Loss (Proceeds Less $100 Cost)	Exchange Gain or Loss Recognized	Remaining (Regular) Gain or Loss
L 1	-0-	$100	-0-	$100
L 2	$100	$300	$100	$200
L 75	($25)	$50	-0-	$50
L 5	($50)	-0-	-0-	-0-
L 25	($75)	($50)	($50)	-0-

(iii) Character

The recognized exchange gain or loss attributable to a Section 988 Transaction is treated as ordinary income or loss subject to two exceptions. First, as discussed further below, if the transaction is part of a Section 988 Hedging transaction, the gain or loss may be characterized differently. Second, a taxpayer may elect to treat a foreign currency exchange gain or loss as giving rise to capital gain or loss if all of the following conditions are satisfied:

(1) the gain or loss is attributable to a forward contract, a futures contract or option described in Section 988(c)(1)(B)(iii) (a “category (iii)” item above),

(2) the asset involved is a capital asset in the hands of the taxpayer and is not part of a Section 1092(c) straddle (determined without regard to the exception for qualified cover calls in Section 1092(c)(4)),

(3) the taxpayer makes the election and identifies the transaction by the close of the business day on which such transaction was entered into (or such earlier time as the IRS requires), and

(4) the IRS does not issue regulations prohibiting such election for the transaction.

As between the hedging rule and the capital gain election, the hedging rule provides that the capital gain election takes precedence. Since Section 988 does not change the definition of capital assets (only the character of the income), the condition requiring the asset to be a capital asset in order to elect capital gain or loss treatment apparently will carry over vestiges and uncertainties of that aspect of prior law.

To the extent that the exchange gain or loss is ordinary, the IRS in regulations may further characterize it for some or all purposes as interest income or expense. Any such further characterization could have further collateral implications under provisions such as the rules for allocation of interest expense in Treasury Regulation § 861-8 and withholding on interest under the new branch-level withholding rules. It is also expected that the IRS will issue regulations addressing the appropriate withholding treatment for payments to a counterparty under a swap transaction.

(iv) Source

The source of any exchange gain or loss generally is the residence of the taxpayer or QBU on whose books the transaction is properly reflected. For this purpose, the residence of a corporation, partnership, trust or estate is the United States if it is a United States person; otherwise the residence is abroad. The residence of an individual is his tax home within the meaning of Section 911(d)(3). Overriding both the rules is an "exception" which makes the residence of a QBU the country in which the principal office of the QBU is located.

It is unclear why the overriding residence exception for QBU's does not subsume everything other than transactions involving investments by individuals not constituting a trade or business. Note also that use of the "United States person" concept in the residence definition for trusts and estates and the "tax home" concept in the residence definition for individuals pulls in the usual problems with applying those concepts.

The general source rule is subject to four exceptions. First, if the transaction is part of a Section 988 hedging transaction, the source may be changed in connection with the application of those provisions. Second, if the exchange gain or loss arises from the distribution of earnings previously taxed under Subpart F or Section 1293, the source will be the same as the previous income inclusion (with rules for distributions through tiers of foreign corporations to be prescribed by the IRS). Third, in the case of a high interest related party loan coming within the special provisions of Section 988(a)(3)(C), the IRS may provide by regulations that the interest income earned for the taxable year is treated as domestic source to the extent of any loss arising from marking the loan to market for the year. This exception is, in effect, a kind of micro foreign loss recovery rule since any loss on the mark to market would be a domestic loss under the general source rule for foreign exchange gain or loss. Fourth, the IRS is given general discretion to prescribed regulations varying the general source rule.

5. Hedges Against Foreign Currency Risks. In an effort to insure that taxpayers do not use the new

foreign currency transaction rules to accelerate foreign currency losses and defer foreign currency gains, Section 988 contains a very broadly drafted hedging rule. This hedging rule takes precedence over both Sections 1092 and 1256. For this purpose, a hedging transaction is defined as any transaction –-

> "(A) entered into by the taxpayer primarily -
>
> (i) to reduce risk of currency fluctuations with respect to property which is held or to be held by the taxpayer, or
>
> (ii) to reduce risk of currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred, by the taxpayer, and
>
> (B) identified by the [IRSI or the taxpayer as being a 988 hedging transaction.

The language in subclauses (i) and (ii) of clause (A) is notably similar to the language in subclauses (i) and (ii) of Section 1256(e), but clause (A) does not require that the transaction be entered into in the normal course of the trade or business (as Section 1256(e)(2) requires). Also, unlike Section 1256 hedges, clause (B) permits a Section 988 hedge to be identified by either the taxpayer or the IRS. The Conference Report indicates that taxpayers are to be required to clearly identify a hedge before the close of the day the transaction is entered into, whereas the IRS can identify the transaction as a hedge at a later date (for example, on audit). If the IRS identifies the transaction as a different hedge than the taxpayer, it is not clear whose identification has precedence.

If (1) a Section 988 Hedging Transaction exists, (2)it includes a Section 988 Transaction (determined without regard to whether the transaction would be marked-to-market under Section 1256), and (3) a valid election has not been made under Section 988(a)(1)(B) to treat the included Section 988 Transaction as giving rise to capital gain or loss, then, (4) to the extent provided in regulations, all transactions which are a part of the hedge "shall be integrated and treated as a single transaction or otherwise treated consistently" for

exchange gain and loss purposes. The integration/consistency may include changing the character, source or timing of some part of the hedge.

The Conference Report indicates that the regulations are to address two different categories of hedging transactions. It also recognizes a possible need for rules directed at partially hedged transactions. The first category of transactions to be covered by the regulations is a “narrow class” of fully hedged transactions where a taxpayer has assured itself of a cash flow that will not vary with movements in exchange rates. An example is a transaction where a borrowing is made in a non-functional currency and a series of forward contracts are also entered into by the taxpayer to purchase the non-functional currency as needed for each interest and repayment of principal. In these situations, the Conference Report states that the transactions are to be integrated and treated as a single transaction. For example, in the case of the fully hedged non-functional currency borrowing, the intention is that the transaction will be treated as a functional currency borrowing with functional currency interest payments, and no recognition of exchange gain or loss. One consequence of such treatment is that the original issue discount rules would also apply to determine the appropriate interest deductions.

The second category of transactions which the Committee Reports indicate that the regulations are to address is broader. It involves transactions that are not entered into as an integrated financial package but are designed to limit a taxpayers exposure in a non functional currency. The example given in the Conference Report is the acquisition of a nonfunctional currency denominated liability to offset exposure with respect to a non-functional currency denominated asset. For this second category of transactions, the regulations need not provide for complete integration, For example, in the above example, the form of a non-functional currency borrowing could be respected and the interest deduction determined by reference to the spot rate on the date of payment. However, “where appropriate,” it is intended that the regulations covering these types of transactions should provide for consistent treatment with respect to character, source and timing. If there is a conflict between the separate pieces of the various transactions

comprising the hedge -- for example, if there would be differences in timing of recognition of gain or loss if the pieces were treated separately -- neither the statute nor the Committee Reports offer any guidance as to how the conflict is to be resolved to achieve the consistency objective.

B. Translation of Non-Dollar Functional Currency Activities to Dollars.

The rules in Section 988 deal with the question of exchange gain or loss for transactions in non-functional currency. Additional rules are provided in Sections 986 and 987 for the further conversions needed when the functional currency of a tax unit is not the dollar.

Under prior law, myriad differences in timing and ocher consequences could arise depending upon whether a foreign operation was conducted as a branch or as a subsidiary and, In the latter case, upon whether the subsidiary's earnings and profits were determined under the subpart F rules or under the general rules for determination of earnings and profits. In the case of a branch, taxpayers were able to choose either the so-called “profit and loss” method, under which exchange gain or loss is recognized only on a transaction by transaction basis, or the so-called “net worth” method, under which unrealized exchange gain or loss is recognized to at least some extent. If the operations were conducted in a subsidiary and subpart F applied, the earnings of the subsidiary were computed under a “net worth” method; if subpart F did not apply, the earnings of the subsidiary could be (and perhaps had to be) computed using a “profit and loss” method,

Foreign income taxes available for credit were translated at the rate of exchange in effect on the date the tax is paid, in the case of branch taxes and direct tax credits, and, in the case of an indirect foreign tax credit under Section 902, were translated at the same exchange rate used to convert the distribution to dollars (the Bon Ami rule)

The new rules in Sections 986 and 987 eliminate use of the net worth method, even in the case of subpart F determinations, and continue use of only the profit and

loss method. In addition, the Bon Ami rule is repealed and the amount of foreign income tax paid for purposes of computing the amount of the available foreign tax credits is based in all cases on the rate of exchange on the date the tax is actually paid. As a result, the differences between a branch, a foreign corporation with respect to which there is a subpart F inclusion and other foreign corporations are significantly reduced.

In the case of a branch, the taxable income or loss first will be computed separately in its functional currency and the resulting income or loss then will be converted to United States dollars using the weighted average exchange rate for that unit's taxable year. Upon a subsequent remittance of such income from the branch (determined using the same pooling concept as for post-1986 earnings of foreign subsidiaries), proper adjustments will be made (to be prescribed by the IRS in regulations), and resulting gain or loss will be treated as ordinary income or loss with the same source as the previously taxed income inclusion.

In the case of a foreign subsidiary, the earnings and profits first will be determined in the subsidiary’s functional currency. The results then will be converted into United States dollars at the time the earnings and profits are taxed to the United States shareholder. Where the United States shareholder is taxed on the earnings and profits by reason of a deemed dividend under Sections 551(a), 951(a) or 1293(a), the conversion will be made to United States dollars at the weighted average exchange rate for the taxable year of the foreign subsidiary in which the distribution is deemed made. As a result, the amount of the current inclusion, its character and source all will be the same in such cases as in the case of a branch (disregarding the usual differences between taxable income and earnings and profits calculations). If there has been a change in the exchange rate when the previously taxed earnings are in fact distributed, the United States taxpayer will recognize additional ordinary income or loss from the same source as the associated income inclusion. As a result, an actual distribution of previously taxed earnings (apart from any foreign witholding taxes which may be incurred) will have the same results as in the case of a remittance to the United States of post-1986 accumulated earnings from a foreign currency branch.

Any remaining earnings of a foreign subsidiary are translated at the spot exchange rate on the date such earnings are included in income (whether by reason of an actual distribution or by reason of a deemed dividend from a disposition under Section 1248). Again disregarding usual differences between taxable income and earnings and profits, at that time the aggregate amount of income and source of the income reported should be the same as in the case of remitted earnings of the branch and distributed earnings of a foreign subsidiary, as to which there has been a subpart F inclusion with one possible exception. There is no separate event of exchange gain or ass in the case of the delayed actual or Section 1248 dividend as there is in the case of the delayed remittance from a branch c r delayed distribution of previously taxed earnings of a subsidiary; in the case of the regular dividend, the intervening exchange gain or loss has been netted out in the computation of the earnings available for distribution. However, unless the exchange gain or loss recognized on the actual withdrawal of investment from the branch or actual distribution of previously taxed earnings is further characterized as interest, which could have implications, for example, on the allocation rules of Treas. Reg. section 861-8, or is allocated to a separate foreign tax credit limitation "basket," the ultimate result should be the same in all three cases.

C. Related Amendments.

Section 1092(e) is amended to add a special rule which treats an obligor's interest in a non-functional currency denominated debt obligation as a "position" in the non-functional currency for purposes of the tax straddle rules. It is also amended to provide that foreign currency is presumed to be actively traded if there is an active interbank market in the foreign currency. As a result, there will be a presumption that obligations denominated in or determined by reference to the value of a foreign currency will now be included within the reach of the tax straddle rules if there is an active interbank market for such currency without regard to whether the currency is the subject of regulated futures contracts.

In addition, the Conference Report indicates that bank forward contracts with maturities longer than the maturities ordinarily available for futures contracts are to be treated as within the definition of a foreign currency contract in Section 1256(g), if the requirements of that subsection are satisfied otherwise.

The special rule in Section 1256(e)(4) which, permits banks to qualify for the Section 1256 hedging exception to the straddle provisions without establishing that other taxpayers must show, is repealed.

D. Regulations Authority.

As is the case with a number of other provisions in the Tax Reform Act of 1986, the foreign currency exchange gain or loss provisions grant broad authority to the IRS to issue regulations that implement or modify the operation of the various statutory provisions. Many of the specific statutory provisions expressly are subject to revision by regulations or are made applicable only to the extent provided in the regulations. In addition, Section 989(c) gives the IRS authority to prescribe such regulations "as may be necessary or appropriate" to carry out the purposes of the foreign exchange gain or loss rules, including in particular regulation

> "(1) setting forth procedures to be followed by taxpayers with qualified business units using a Ret worth method of accounting before the enactment of [Subpart J],
>
> (2) limiting the recognition of foreign currency loss on certain remittances from qualified business units,
>
> (3) providing for the recharacterization of interest and principal payments with respect to obligations denominated in certain hyperinflationary currencies,
>
> (4) providing for alternative adjustments to the application of Section 905(c), and
>
> (5) providing for the appropriate treatment of related party transactions (including

transactions between qualified business units of the same taxpayer).”

III. Effective Dates and Transition Provisions.

The foreign exchange gain or loss provisions are effective for taxable years beginning after December 31, 1986 with one exception: for purposes of the indirect foreign tax credit rules in Sections 902 and 960, the amendments do not apply to either the computation of earnings and profits of foreign corporations for taxable years beginning on or before December 31, 1986 or to the foreign taxes paid or accrued by the foreign corporation with respect to such earnings and profits, No other “fresh start” or grandfather relief is specifically provided. Unless exceptions of relief are prescribed by regulations, therefore, built in foreign exchange gain or loss existing at December 31, 1986 will be recognized and taxed in the future under the new rules.

November 13, 1986

TAX REFORM ACT OF 1986
BRANCH-LEVEL AND SECOND TIER WITHHOLDING

By

Wm. L. Burke

I. Overview

Under prior law,[*] dividends and interest paid by a United States corporation to a foreign person generally are subject to withholding if the payments are not effectively connected with the conduct of a trade or business in the United States by the foreign person and, in the case of interest do not constitute portfolio interest to the recipient. If made by a foreign corporation, however, the same payments are subject to withholding only if 50% or more of the foreign corporation's gross income for the three preceding tax years was effectively connected with the conduct of a trade or business in the United States; in that event, a proportionate part of the payment is subject to withholding. Moreover, where the withholding would apply, this so-called second tier withholding tax typically is given up in United States treaties even though the treaty does not reduce the withholding rate to zero for similar payments by a United States corporation. In addition, transfers by a foreign corporation of assets in a United States branch to the home office or another branch are not subject to withholding.

The new law introduces a branch-level withholding system and makes changes in the source rules that affect the existing second tier withholding system; The changes are intended to create greater parity in the United States tax treatment of remittances and distributions from United States branches and foreign-owned United States subsidiaries. The changes are also intended to reduce the disparity in United States corporate and shareholder level taxes between United

[*] To avoid confusion, all references to the law in effect until the general effective date of the Tax Reform Act of 1986 provision will be referred to as "prior" law, and the law as changed by the Act will be referred to as the "new" law.

States-owned domestic corporations and foreign-owned foreign corporations operating in the United States.

Under the new law, unless prohibited or reduced by treaty, a withholding tax will be imposed at a 30% rate on any actual or notional interest payments deducted by a foreign corporation in computing its united States effectively connected income and on the remaining amount of its United States effectively connected earnings and profits to the extent not reinvested in the United States effectively connected business. If a treaty prohibits the "branch-level" withholding on remitted earnings, the old second tier withholding tax system continues to apply (with source rule modifications) unless that is also prohibited by treaty.

Availability of treaty protection is made subject to an anti-treaty shopping restriction relating to both ownership of the stock of the foreign corporation and the foreign corporation's use of its income. The statutory restriction is intended to insure that one of the withholding systems will apply where treaty shopping exists while minimizing the extent to which the treaty is overridden. If the anti-treaty shopping restriction is violated, any reduced treaty rates are disallowed and the branch-level withholding rules will apply unless the treaty permits only a second tier withholding tax (in which case the second tier tax applies).

II. Detailed Description

A. Branch-Level Interest Withholding.

Under Section 884(f), any interest actually paid by a foreign corporation from its trade or business in the United States is subject to withholding to the same extent as if paid by a domestic corporation. In addition, if the amount of interest allowable as a deduction in computing the effectively connected taxable income of the foreign corporation under the interest allocation rules exceeds the interest that is actually paid from the United States effectively connected business, the notional excess is subject to withholding to the same extent as if paid by a wholly-owned domestic corporation on a borrowing from the foreign corporation on the last day of the foreign corporation's taxable year. Where the

amount of withholding on any such interest could be affected by the nature of the borrowings of the foreign corporation giving rise to the allocated excess interest (for example, in the case of a Sank where interest on deposits might not be treated as subject to withholding), the IRS is given authority to issue regulations dealing with how the notional excess interest is to be attributed to the various types of borrowings. The Conference Report* also admonishes the IRS to police closely inter branch transactions and also back-to-back loans that should be collapsed under present law to prevent evasion of the branch-level interest withholding rules.

B. Branch-Level Withholding on "Remittances" of Earnings.

Branch remittances also will be subject to withholding. For this purpose, the earnings and profits effectively connected with the conduct by a foreign corporation of a trade or business within the United States are treated as remitted to the extent not reinvested during the year in the United States effectively connected business. The unreinvested amount--the "dividend equivalent amount" -- will be treated as if paid out as a dividend to the foreign corporation by a domestic corporation (not meeting the 80/20 exception in the new Section 861(c)). Similar to the "current earnings" rule for determining dividends from corporations, withholding is to apply to the extent the current year's earnings are not reinvested, without regards to whether there is an aggregate deficit in prior year's earnings.

Effectively connected earnings and profits are those which are attributable to income which is effectively connected (or treated as effectively connected) with the conduct of a trade or business within the United States. The term does not include, however, any earnings and profits attributable to the following provisions which specially treat certain income and gains as effectively connected:

* For brevity, references to committee reports will be referred to as the "Conference Report," the "Senate Report" and the "House Report," respectively.

(1) certain earnings derived by foreign sales corporations (income described in Sections 921(d) and 926(b));

(2) earnings derived by foreign transportation carriers that are exempt from U.S. tax pursuant to treaty or reciprocal exemption;

(3) earnings derived from the sale of any interest in U,S. real property holding corporations;

(4) earnings derived by corporations satisfying certain ownership and income requirements that are organized in certain U.S. possessions (corporations described in Section 881(b)); and

(5) earnings derived by certain captive insurance companies that elect to treat their income as effectively connected with a U.S. trade or business.

Similar to the operation of Subpart F provisions, the earnings and profits remaining to be taxed are not reduced for actual remittances during the year. Instead, the effect of such remittances is taken into account in the adjustment for the amount of earnings reinvested.

The exclusion for earnings derived by certain possessions corporations is intended to protect United States corporations operating in possessions of the United States from a branch-level tax under “mirror” provisions in those jurisdictions. Since the relevant earnings include those “treated” as effectively connected unless specifically excepted, the relevant earnings should include any real estate operations for which an election is made to be taxed on a net basis under Section 871(d) or 882(d) or any applicable tax treaty even though any gain on the sale of the properties is one of the specifically excluded items. The Conference Report also makes clear that effectively connected tax-exempt income (and presumably related expenses) is to be taken into account in computing effectively connected earnings and profits (as would be the case in the computation of earnings and profits of a domestic corporation).

The extent to which the effectively connected earnings as thus computed are reinvested so as not to be subject to the withholding tax is determined by comparing the net equity of the effectively connected business at the end of the taxable year with the net equity at the end of the preceding taxable year. To the extent that this comparison shows an increase, the amount subject to withholding is reduced (but not below zero); to the extent the comparison show a decrease, the amount subject to withholding is increased up to the net aggregate amount treated as reinvested in the business in post-1986 tax years. The relevant net equity in each case is computed by subtracting the liabilities treated as effectively connected from the adjusted basis (for purposes of computing earnings and profits) of the property treated as effectively connected.

The rules for determining the property and liabilities treated as effectively connected for the net equity calculation are to be consistent with the rules used in allocating deductions for purposes of computing taxable income. The IRS is authorized to issue regulations dealing with what assets and liabilities are to be taken into account. The Committee Reports indicate that working capital necessary for day-to-day operation of the business is to be included, but the IRS is to have authority to prevent abuses such as temporary year-end increases in assets. Presumably the regulations will exclude property and liabilities related to the income or expense which generally is specially deemed “effectively connected” but which is expressly excluded by the statute from the computation of effectively connected earnings and profits, Similarly, the regulations presumably will address the question of the extent to which real estate and related liabilities are to be taken into account when an election is made under Section 871(d), Section 882(d) or a treaty to treat the rental income as effectively connected, and the real estate involved either is or is not disposed of during the year in a transaction in which gain is taxed by reason of Section 897. A similar issue may arise with respect to previously “effectively connected” property subject to the new rule in Section 864(c)(7) for recognition of effectively connected gain or loss on the subsequent disposition of such property within ten years.

The regulations authority of the IRS also extends to permitting decreases in assets to be disregarded in computing changes in net equity to the extent the decrease may not reflect a real remittance of earnings during the year. The Senate Report cites as examples a casualty loss in the effectively connected business and the use of earnings to purchase the stock of a corporation whose assets would constitute an increase in net equity if purchased directly.

Note that even if an asset remains a part of the United States branch, and is accounted for on the financial balance sheet of the United States branch, it is not taken into account for the net equity computation unless it continues to be treated as an “effectively connected” asset. Consequently, if funds of the branch are used to purchase an investment asset, the earnings from which would be subject to withholding rather than

taxation on a net income basis, there is a “remittance” subject to withholding. Moreover, when an effectively connected business ceases to be conducted in the United States, the application of this principle would result in a “remittance” subject to withholding in the amount of the entire reinvested post-1986 effectively connected earnings of the United States operation even though a similar “liquidating” distribution from a corporation still would not be treated as a dividend (and therefore would not be subject to withholding with respect to the accumulated earnings distributed). Both the timing and amount of such remittance will depend, however, upon the interplay of the branch level withholding rules and the 10-year “shadow” rule in Section 864(c)(7) for recognition of effectively connected gain or loss on any of the assets or liabilities involved.

C. Anti-Treaty Shopping Restrictions.

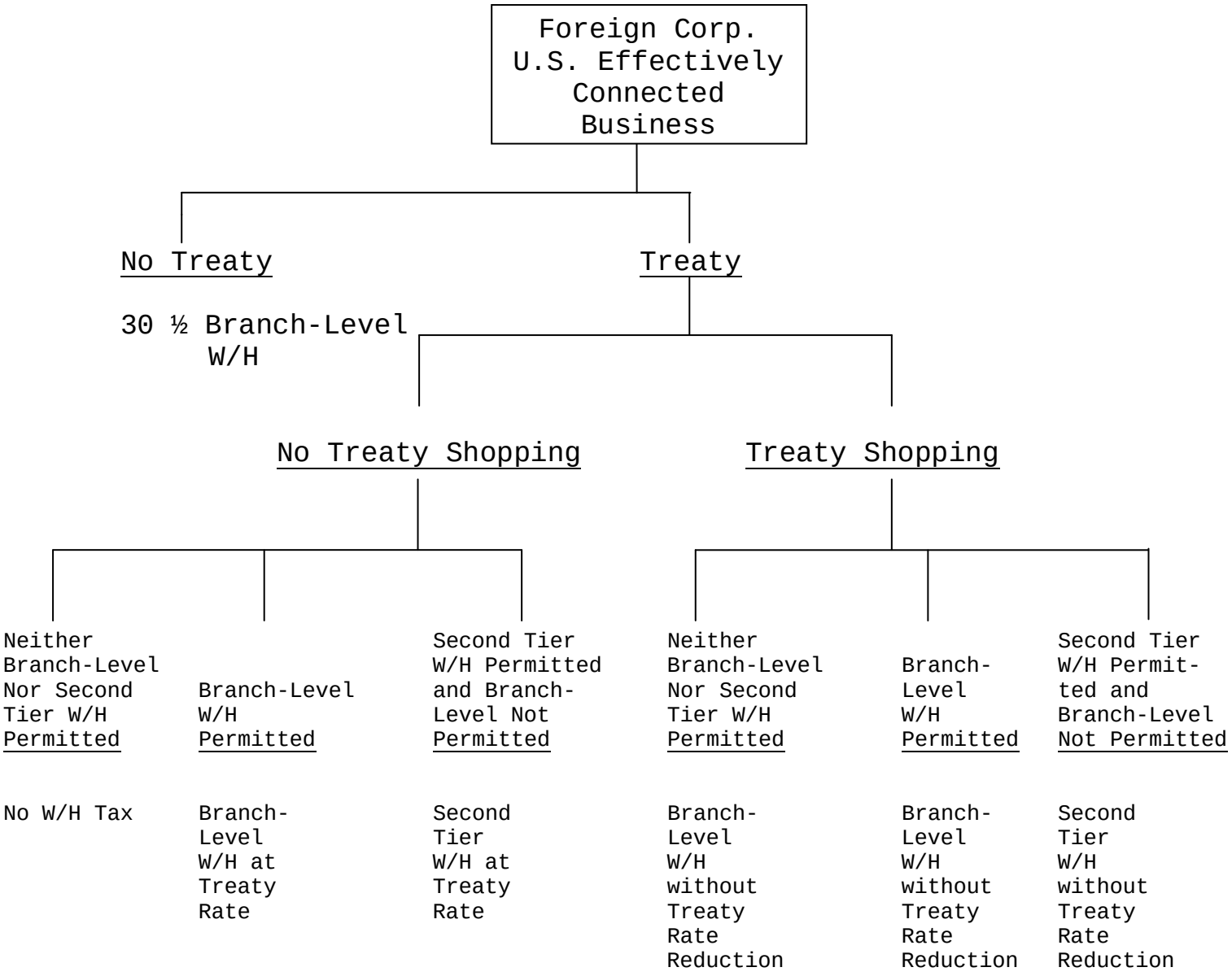
The new branch level withholding provisions and the revised second tier tax provisions are subject to treaty relief to the extent provided in any applicable United States treaty. An anti-treaty shopping rule restricts the applicability of income tax treaties unless two requirements are met. First, at least 50% (by value) of the stock of the foreign corporation must be owned directly or indirectly (applying the attribution rules used in Section 883(c)(4)) by individuals who are treaty residents of the same foreign country as the foreign corporation or who are United States citizens or tax residents. Second, 50% or more of the foreign corporation’s income cannot be used directly or indirectly to meet liabilities to persons (individuals and other juridical entities) who are not treaty residents of such foreign country or the United States.

If the stock of the foreign corporation, or that of another foreign corporation which wholly owns it directly or indirectly, is primarily and regularly traded on an established securities market in the foreign country whose treaty the foreign corporation is claiming, the anti treaty shopping rule will be considered satisfied. In addition, the IRS is granted authority to establish other exceptions consistent with the purposes of the rule and to decide “in its sole discretion” when the requirements for any such other exceptions are met. The Senate Report suggests as a possible example for such

regulations relief the case of a foreign corporation that operates an active trade or business in the country where it is organized and does not have a substantial amount of its income reduced by amounts payable outside that country.

If the anti-treaty shopping rule is not violated, the treaty benefits apply in full, including providing complete exemption from the branch-level tax where required by a nondiscrimination provision (as would usually be the case). Where the treaty permits a branch withholding tax, the computation of the “dividend equivalent amount” will be limited to only income “attributable to a permanent establishment” if the treaty has such a restriction for taxation of income on a net basis.

If the anti-treaty rule is violated, the extent to which the treaty is overridden depends upon further factors. of the treaty either permits a branch-level withholding or permits neither a branch-level withholding nor a second tier withholding, the branch-level withholding applies (without reduction in rate), If the treaty permits only a second tier tax, the second tier tax applies but again no treaty rate reduction is allowed. The range of alternatives is diagrammed in the following chart.


Foreign Corp. U.S. Effectively Connected Business
No Treaty
30 ½ Branch-Level W/H
Treaty
No Treaty Shopping
Treaty Shopping
Neither Branch-Level Nor Second Tier W/H Permitted
No W/H Tax
Branch-Level W/H Permitted
Branch-Level W/H at Treaty Rate
Second Tier W/H Permitted and Branch-Level Not Permitted
Second Tier W/H at Treaty Rate
Neither Branch-Level Nor Second Tier W/H Permitted
Branch-Level W/H without Treaty Rate Reduction
Branch-Level W/H Permitted
Branch-Level W/H without Treaty Rate Reduction
Second Tier W/H Permitted and Branch-Level Not Permitted
Second Tier W/H without Treaty Rate Reduction

III. Effective Dates and Transition Provisions.

The new law applies for taxable years beginning after December 31, 1986. There are no transitional provisions