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The Branch Profits Tax: An Analysis of Its Impact on Stockholders of U.S.-Owned Foreign Corporations and Its Interrelationship with the U.S. Network of Tax Treaties

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The Branch Profits Tax: An Analysis of Its Impact on Stockholders of U.S.-Owned Foreign Corporations and Its Interrelationship with the U.S. Network of Tax Treaties

The U.S. Tax System was given a complete overhaul by the Tax Reform Act of 1986. The international aspects of the U.S. tax system were not exempt from this overhaul. The Act imposed a second layer of tax (the "branch profits tax") on the profits of a U.S. branch of a foreign corporation by imputing a dividend distributed from the domestic branch to the foreign corporation. The branch profits tax does not apply where its application would be inconsistent with an existing U.S. tax treaty obligation.[1] The "treaty shopping" rules of this provision, however, limit treaty exemption if the foreign corporation is not a qualified resident.[2]

This Note surveys the tax imposed on the income of a foreign corporation that is connected with a U.S. business prior to the Tax Reform Act. An examination of the branch profits tax provision which was created by the Act will be made. In particular, this Note analyzes the impact this provision will have on U.S.-owned foreign corporations and its interrelationship with the U.S. network of income tax treaties. Since the branch profits tax has been criticized for its impact in these areas, this Note highlights such criticisms and evaluates their validity.

I. Prior to The Tax Reform Act of 1986

Under the provisions for section 882, "[a] foreign corporation that is engaged in a trade or business within the United States . . . [is] taxable as provided in section 11, . . . or 1201(a) on its taxable income which is effectively connected with the conduct of a trade or business."[3]

Even though the term "trade or business" is defined in the Code,[4] it is difficult to grasp the scope of this elusive concept. The Supreme Court established the scope of this term by stating, "[t]o determine whether the activities of a taxpayer are 'carrying on a business' requires an examina-

[1] *See* I.R.C. § 884(e)(1)(A) (1986); *infra* note 41 and accompanying text.

[2] *Id.*

[3] I.R.C. § 882(a)(1) (1986).

[4] I.R.C. § 864(b) (1986). "[T]he term 'trade or business within the United States' includes the performance of personal sevices within the United States at any time within the taxable year, but does not include (1) performance of personal services for a foreign employer . . . [and] (2) trading in securities or commodities."

tion of the facts in each case."[5] Several court decisions, however, have provided additional insight to the scope of "trade or business" with regard to both nonresident alien individuals and foreign corporations. Such courts have held that an individual or corporation is engaged in a "trade or business" if its activities represent the active pursuit of profit[6] or if such activity is considerable, continuous and regular.[7]

The second conjunctive requirement of section 882 requires the taxable income of the foreign corporation to be "effectively connected" to its trade or business conducted in the United States.[8] In defining the term "effectively connected," section 864(c) has trifurcated taxable income into specific categories containing dispositive standards for each classification.[9] The three categories of income are: periodical income from sources within the United States;[10] other income from sources within the United States;[11] and income from sources without the United States.[12]

If a foreign corporation derives fixed or determinable income or capital gains, an "asset-use test" or a "business-activities test" is applied to determine if such income is "effectively connected."[13] The second category of income acts as a catch basin. If a foreign corporation derives

[5] Higgins v. Commissioner, 312 U.S. 212, 217 (1941). The taxpayer merely kept records of the dividends and interest he received from his securities. He then attempted to deduct the expenses associated with the management of his investment as expenses incurred in the carrying on of a trade or business. The court held that mere investing is not the carrying on of a business. *Id. see also* Continental Trading Inc. v. Commissioner, 265 F.2d 40 (9th Cir.), *cert. denied*, 362 U.S. 70 (1959). In a fact pattern analogous to that of *Higgins*, a foreign corporation whose activities in the United States predominantly consisted of managing investments and collecting dividends attempted to obtain a favorable tax treatment by qualifying for a dividends received credit. Based upon the holding in *Higgins*, the court held that the foreign corporation was not engaged in a trade or business and, therefore, did not qualify for the credit. *Id.*

[6] Continental Trading Inc. v. Commissioner, 16 T.C.M. (CCH) 724, 727. *See also supra* note 3.

[7] Lewenhaupt v. Commissioner, 20 T.C. 151 (1953), *aff'd per curiam*, 221 F.2d 227 (9th Cir. 1955); Herbert v. Commissioner, 30 T.C. 26 (1958), *acq.* 1958-2 C.B. 6; Amodio v. Commissioner, 34 T.C. 894 (1960), *aff'd on other grounds*, 299 F.2d 623 (3d Cir. 1962).

[8] I.R.C. § 882(a)(1) (1986).

[9] I.R.C. § 864(c) (1986).

[10] I.R.C. § 864(c)(2) (1986).

[11] I.R.C. § 864(c)(3) (1986).

[12] I.R.C. § 864(c)(4) (1986).

[13] Treas. Reg. § 1.864-4(c)(1)(i) (1986). "The asset-use test [is ordinarily applied] in making a determination with respect to income, gain or loss of a passive type where the trade or business activities as such do not give raise directly to the realization of the income, gain or loss." "The asset-use test is of primary significance where . . . interest or dividend income is derived from sources within the United States by a . . . foreign corporation that is engaged in the business of manufacturing or selling goods in the United States." Treas. Reg. § 1.864-4(c)(2)(i) (1986). "The business-activities test [on the other hand] is of primary significance, . . . where (a) dividends or interest are derived by a dealer in stocks or securities, (b) gain or loss is derived from the sale or exchange of capital assets in the active conduct of a trade or business of an investment company, (c) royalties are derived in the active conduct of a business consisting of the licensing of patents . . ., or (d) service fees are derived in the active conduct of a servicing business." Treas. Reg. § 1.864-4(c)(3)(I) (1986).

income from sources within the United States that is not fixed or determinable, the provisions under section 864(c)(3) are applied and the income is automatically considered "effectively connected."[14] Finally, under the third category, certain foreign source income is considered "effectively connected" to a "trade or business" if it is one of three types of income; (1) rents, royalties or gains on sales of intangible property; (2) dividends or interest, or gains or loss from sales of stocks or securities; and (3) income, gain or loss from the sale of goods or merchandise through a U.S. office. In addition, this income must be attributable to an office or other fixed place of business within the United States.[15]

If a foreign corporation conducts a "trade or business," the taxable income which is "effectively connected" to those activities will be taxed at graduated rates.[16] However, there is an exception, where the foreign corporation's income is constructively treated as being "effectively connected" to a "trade or business."[17] If a foreign corporation does not conduct a trade or business within the United States or has source income which is "effectively connected" to the domestic trade or business, all income which falls within the provision of 881(a) is taxed at a flat rate of 30 percent.[18]

The provision under section 1442 requires a withholding of tax on amounts paid to foreign corporations in the same manner and on the same items of income as provided in section 1441(a).[19] Under section

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[14] I.R.C. § 864(c)(3) (1986). "All income, gain or loss derived by a foreign corporation engaged in a trade or business in the United States from sources within the United States which does not consist of income, gain or loss from the sale of a capital asset is treated as effectively connected with the trade or business in the United States." The application of this provision is illustrated in Treas. Reg. § 1.864-4(b) examples (1)-(3) (1986).

[15] I.R.C. § 864(c)(4) (1986). *See* P. POSTLEWAITE AND M. COLLINS, INTERNATIONAL INDIVIDUAL TAXATION 70 (1982).

[16] I.R.C. § 882(a)(1) (1986).

[17] I.R.C. § 897(a) (1986). If a gain or loss arises from a foreign corporation's disposition of a U.S. real property interest, the foreign corporation will be treated as if it was "engaged in a trade or business within the United States . . . and as if such gain or loss [was] effectively connected with such trade or business." *Id.*

[18] I.R.C. § 881(a) (1986). To a foreign corporation with a small amount of U.S. income, the flat rate may not be preferable to the graduated rates of section 11. In such instances, the roles one might expect the taxpayer (the foreign corporation) and the Service to play are reversed. The foreign corporation may argue that they are engaged in a domestic business, while the Service contends that they are sporadic and insubstantial, thereby not constituting a trade or business. *See also* P. POSTLEWAITE & M. COLLINS, *supra* note 14, at 65 (for an analogous proposition based upon section 871).

"The United States imposes the tax at a flat 30 percent rate because generally it is not feasible to determine and collect a tax on net income from foreign persons who have limited tax contacts with the United States." STAFF OF JOINT COMM. ON TAX'N., 100TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 1035 (Comm. Print 1987) [hereinafter GENERAL EXPLANATION].

[19] I.R.C. § 1442(a) (1986). Section 1441(a) provides that "all persons . . . having the control,

1442(a) withholding is not required with items of income that are "effectively connected" with the conduct of a "trade or business" within the United States, as well as items that are included in the gross income of the foreign corporation under section 882(a).[20]

In general, if dividends were paid to a U.S. branch or a subsidiary of a U.S.-owned foreign corporation, section 245 provided a 100 percent deduction of the dividends received.[21] Since the recipients of these dividends were U.S. citizens, no second level withholding taxes were applied.

II. THE TAX REFORM ACT OF 1986

A. *The Branch Profits Tax*

Section 884 of the Internal Revenue Code imposes a branch profits tax at a flat rate of 30 percent on a foreign corporation's "dividend equivalent amount."[22] The "dividend equivalent amount" is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income "effectively connected" with a U.S. "trade or business." The dividend equivalent amount may be subjected to two adjustments.[23]

The first adjustment reduces the tax base (not below zero) to the extent the branch's earnings are reinvested in trade or business assets in the United States or a reduction of domestic trade or business liabilities.[24] The second adjustment increases the tax base to the extent prior reinvested earnings are considered remitted to the home office of the for-

receipt, custody, disposal, or payment of any of the items of income . . . [interest, dividends, rent, salaries, wages, provisions, annuities, compensations, renumerations, emoluments, or other fixed or determinable annual or periodical gains, profits and income, gains described in section 402(a)(2), 403(a)(2) or 631(b) or (c), amounts subject to tax under section 881(a)(3), and gains on transfers described in section 1235 made on or before October 4, 1966], (to the extent that any of such items constitutes gross income from sources within the United States), of any . . . foreign [corporation] . . . shall . . . deduct and withhold from such items a tax equal to 30 percent thereof."

20 I.R.C. § 1442(a) (1986). "No deduction or withholding . . . shall be required in the case of any item of income . . . which is . . . included in the gross income of the recipient under section 871(b)(2) for the taxable year." I.R.C. § 1441(c) (1986).

21 I.R.C. § 245(a) (1986). Under this provision the foreign corporation must be subject to taxation for an uninterrupted period of not less than 36 months ending with the close of the foreign corporation's taxable year in which the dividends are paid. The foreign corporation must be engaged in trade or business in the United States, and 50 percent or more of the corporation's entire gross income must be effectively connected with the conduct of trade or business in the United States.

22 I.R.C. § 884(a) (1986).

23 I.R.C. § 884(b) (1986). *See* GENERAL EXPLANATION, *supra* note 18, at 1039 and accompanying text, "[t]he branch profits tax applies to income treated as effectively connected by section 897. This is the case without regard to whether the corporation earning the income has made an election under section 897(i) to be treated as a U.S. corporation. Since the election under section 897(i) is effective only for purposes of sections 897, 1445, and 6039C, this election does not result in the corporation being treated as a U.S. corporation for branch profits tax purposes."

24 GENERAL EXPLANATION, *supra* note 18, at 1039. "This reduction is measured by the increase in the U.S. net equity of the branch: the difference between (1) the excess of the money and

eign corporation.[25] There are, however, exceptions to this provision for certain types of income that generally would be treated as "effectively connected" earnings and profits.[26]

If U.S. operations are conducted through a subsidiary of a foreign corporation, the resulting U.S. tax implications will not be altered by this new provision in the 1986 Tax Reform Act. On the other hand, if U.S. operations are simply an extension, or a branch of a foreign corporation, this new provision will impose an additional tax burden upon such operation. [27] Congress favors that a foreign corporation doing business in the United States through a branch generally be subject to the same substantive tax rules that apply to a foreign corporation operating in the United States through a U.S. subsidiary.[28]

"The branch profits tax was never intended to increase the U.S. tax liability of U.S. shareholders. It was designed to ensure that a shareholder level tax effectively would be collected from the foreign shareholders who, under prior law, had in many situations not been subject to U.S. tax."[29]

B. Impact on U.S.-owned Foreign Corporations

It has been suggested in other commentaries that Congress, through the enactment of the branch profits provision, has created an unintended adverse impact on U.S. stockholders of foreign corporations.[30] This unintended result of the branch profits tax occurs because U.S.-owned foreign corporations are subject to this provision, even in cases where the

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adjusted basis of the branch's assets over its liabilities at the end of the year, and (2) the excess of the money and adjusted basis of its assets over its liabilities at the end of the preceding year."

25 *Id.* "This adjustment is measured by the reduction in the U.S. net equity of the branch: the difference between (1) the excess of the money and adjusted basis of the branch's assets over its liabilities at the end of the preceding year, and (2) the excess of the money and adjusted basis of the branch's assets over its liabilities at the end of the year."

26 I.R.C. § 884(d)(2) (1986). These exceptions include gross income of a foreign corporation from the operation of a ship or aircraft, foreign trade income of a foreign subsidiary corporation, distributions to a foreign corporation, gains derived by the disposition of domestic real property, and income treated as "effectively connected" to a U.S. trade or business because of the election under section 953(C)(3)(C).

27 *See* I.R.C. § 884(a) (1986).

28 GENERAL EXPLANATION, *supra* note 18, at 1036. "Congress was concerned that these disparities arising under prior law provided an unintended advantage to U.S. branches of foreign corporations vis-a-vis their U.S. corporate competitors."

29 L. Terr, M. Richardson, and R. Safranek, Sutherland, Asbill Describes Branch Profits Tax Problem of Foreign Corporations with U.S. Shareholders, 87 T.N.T. 66-44 (1987) (Letters sent to I.R.S. International Tax Counsel) [hereinafter Branch Profits]. *See also infra* note 32.

30 L. O'Brien, O'Brien Suggests a Tax Credit Be Provided to U.S. Shareholders of U.S. Owned Foreign Corporations for Branch Profits Tax, 87 T.N.T. 167-39 (1987) (Letters sent to I.R.S. International Tax Counsel) [hereinafter Tax Credit]. *See* Branch Profits, *supra* note 29.

second level withholding tax is inapplicable.[31]

In order to eliminate the discrimination between the tax treatment of dividends received from domestic corporations and dividends received from foreign corporations engaged in a U.S. "trade or business," section 245 was drafted.[32] "The goal of 'symmetrical treatment' between domestic corporations and foreign corporations that operate in the United States was reaffirmed in the committee reports accompanying the branch profits tax."[33] As the previous example illustrates,[34] the branch profits tax frustrates the "goal of symmetrical treatment" in taxing "foreign corporations that operate in the United States like U.S. corporations that operate in the United States."[35]

These commentaries have proposed that the appropriate manner in which to eliminate this problem would be by providing a tax credit to U.S. stockholders of foreign corporations who receive a dividend from such corporations.[36] This corrective credit provision is to be modeled after the provision contained in the House Ways and Means Committee's

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31 *See* Branch Profits, *supra* note 29, and Tax Credit, *supra* note 30. The following example demonstrates the disparate impact of this provision. Under section 882, a U.S.-owned foreign corporation that has taxable income of $1000 will pay $340 in corporate tax (34 percent), and will also pay a branch profits tax of $198 (30 percent) on the remaining $660 of earnings and profits. The total domestic tax paid by the U.S.-owned foreign corporation is $538. If this corporation were a domestic owned corporation it would have to pay a total of $340 in U.S. tax. Therefore, the tax burden on potential distributions to United States stockholders of a foreign corporation is nearly 60 percent higher than that of a domestic corporation.

32 STAFF OF SENATE FINANCE COMMITTEE, S. REP. NO. 781, 82nd Cong., 1st Sess. 56 (1951).

33 Branch Profits, *supra* note 29. "In general, the United States seeks to tax foreign corporations that operate in the United States like U.S. corporations that operate in the United States. This goal of symmetrical treatment extends to dividends and interest payments. That is, the United States generally seeks to tax dividends and interest paid by foreign corporations most of whose operations are in the United States like dividends and interest paid by U.S. corporations that operate in the United States. If the recipient of the dividends or interest is a U.S. person, the United States imposes tax on the dividends or interest at the regular graduated rates. If the recipient of the dividends or interest is a foreign person, however, symmetry is more difficult to enforce [and the branch profits tax is therefore needed to ensure that there is a shareholder level tax on the foreign shareholder.]" *See also* S. REP. NO. 313, 99th Cong., 2d Sess. 400 (1986) and H. R. REP. NO. 426, 99th Cong., 1st Sess. 431 (1985).

34 *See* note 30 and accompanying text.

35 Branch Profits, *supra* note 29.

36 *See* Tax Credit, *supra* note 30 and Branch Profits, *supra* note 29. Below is an example of how the credit would be applied. Each domestic shareholder will receive a tax credit for their pro-rata share of the branch profits tax paid by the foreign corporation on its equivalent dividend. Using the facts in note 30 as background, assume further that domestic shareholder A owns 50 percent of the foreign corporation's stock and the remaining outstanding shares are owned by foreign shareholders. If the foreign corporation declares a $220 dividend, its earnings and profits will be reduced to $440. The branch profits tax will be $132 (30% x $440). Shareholder A will include $110 dividend in his gross income and consequently, pay income tax on that amount. Under the proposal, shareholder A would receive a tax credit of $16 for his pro-rata share of the branch profits tax paid on the equivalent dividend [(50% x $110/$440) x $132].

version of the Act.[37]

One might question whether this proposal is effective because the branch profits tax is paid at the corporate level, while the credit is given at the shareholder level. However, the writers have correctly viewed the branch profits tax as a shareholder level tax rather than a corporate level tax.

If the branch profits tax was viewed as a corporate level tax the foreign shareholders would benefit and the credit would frustrate the purpose behind the branch profits tax rather than correct the inequity created by it. This tax benefit arises because corporations do not pro-rate earnings and profits between domestic and foreign shareholders. Thus, a credit given at the corporate level will indirectly benefit all shareholders and not just domestic shareholders.

"The precept of horizontal equity states that recipients of income should not bear disparate income tax burdens simply because of the source of their income."[38] "Providing incentives for the making of economic choices that generate the *most desirable conditions in the economy* may be an aspect of fairness."[39] Under the assumption that this proposition is true, the previous illustration[40] demonstrates that section 884 will not create the "most desirable condition in the economy" in its attempt to eliminate the foreign branch's "unfair" tax advantage.

If a U.S.-owned foreign corporation attempts to reduce its tax base by increasing its U.S. net equity, the problem created by section 884 will be compounded.[41] From an economic standpoint, is society better off because this provision has eliminated the tax discrepancy between foreign corporations with U.S. operations and their U.S. competitors at the expense of domestic stockholders of such foreign corporations? In other words, it appears that this result-oriented provision, from a macro-economic perspective, has shifted a tax inequity from one taxable entity to another and in effect, has not removed this "thorn" from the U.S. tax system.

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[37] H.R. 3838, 99th Cong., 1st Sess., section 651 (1985) (proposed section 883(f) of the Code); *See* H.R. REP. NO. 426, 99th Cong., 1st Sess. 434-35 (1985).

[38] L. Gabinet & R. Coffey, *The Implications of the Economic Concept of Income for Corporation-Shareholder Income Tax Systems*, 27 CASE W. RES. L. REV. 895, 910 (1977). "Where the concept of horizontal equity finds its origin is difficult to say. It is not immediately obvious why it is 'unfair' to vary tax burdens according to income source."

[39] *Id.* (emphasis added).

[40] *See supra* note 31.

[41] Assume that the U.S.-owned foreign corporation from note 30 increased its domestic net equity by capitalizing $160 of its earnings and profits into U.S. assets. Accordingly, the tax base will be reduced to $500 and subject to $150 of branch profits tax. Due to this investment, the disparity in the tax burden between a foreign corporation and a domestic corporation has been reduced by nearly 15 percent. However, the remaining earnings and profits that may be distributed to the U.S. stockholders have been diminished by nearly 25 percent (from $462 to $350).

C. *Treaty Coordination*

In general, the branch profits tax will not be imposed upon a foreign corporation if it is a qualified resident of a foreign country and an income tax treaty between the United States and the foreign country exempts foreign corporations from the branch profits tax.[42] The Code defines a "qualified resident" as "any foreign corporation that is a resident of a foreign country unless (1) more than 50 percent (by value) of its stock is owned by individuals who are not residents of such foreign country and who are not U.S. citizens or resident aliens,"[43] or "(2) 50 percent or more of its income is used (directly or indirectly) to meet liabilities to persons who are not residents of such foreign country or the United States."[44]

Nevertheless, even if a foreign corporation violates one or both of these conditions, it will be treated as a qualified resident if either "(1) its stock is primarily and regularly traded on an established securities market in such foreign country,"[45] or "(2) such foreign corporation is wholly owned (either directly or indirectly) by another corporation organized in the country the stock of which is so traded."[46]

The interaction of section 884 and specific U.S. income tax treaties has been recently promulgated by the Service.[47] "The branch profits tax will not be imposed on a foreign corporation that is a qualified resident of any of the following countries:

Aruba**
Austria**
Belgium
People's Republic of China
Cyprus
Denmark*
Egypt*
Finland*
Germany**
Greece**
Hungary
Iceland
Ireland**
Italy
Jamaica
Japan
Korea*
Luxembourg**
Malta
Morocco
Netherlands
Netherlands Antilles**
Norway*
Pakistan**
Philippines*
Sweden*
Switzerland*
United Kingdom."[48]

Generally these treaties prohibit a second-tier dividend withholding tax and a branch tax.[49] The countries marked with an asterisk (*) have

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[42] I.R.C. § 884(e)(1)(A) (1986).

[43] I.R.C. § 884(e)(4)(A)(i) (1986).

[44] I.R.C. § 884(e)(4)(A)(ii) (1986).

[45] I.R.C. § 884(e)(4)(B)(i) (1986).

[46] I.R.C. § 884(e)(4)(B)(ii) (1986).

[47] I.R.S. Notice 87-9, 1987-35 I.R.B. 9.

[48] *Id.*

[49] Netherlands Income Tax Treaty, Apr. 29, 1948, CCH TAX TREATIES § 5816, 5829, P-H TAX TREATIES §§ 66,113, 66,123 (as extended to Aruba); Austria Income Tax Treaty, Oct. 25,

treaties that generally prohibit a branch tax but permit a second-tier dividend withholding tax.[50] Notwithstanding Sweden, Switzerland and the countries marked by a double asterisk (**), their treaties include a non-discrimination clause analogous to that in Article 24(3) of the 1981 Draft Model Treaty.[51] Those countries designated by the double asterisk have

1956, CCH TAX TREATIES §§ 517, 521, P-H TAX TREATIES §§ 16,114, 16,118; Belgium Income Tax Treaty, July 9, 1970, CCH TAX TREATIES §§ 588C, 590A, P-H TAX TREATIES §§ 17,040, 17,054; China Income Tax Treaty, Apr. 30, 1984, CCH TAX TREATIES §§ 1412, 1426, P-H TAX TREATIES §§ 72,109, 72,123; Cyprus Income Tax Treaty, Mar. 19, 1984, CCH TAX TREATIES §§ 2010, 2015, P-H TAX TREATIES §§ 29,107, 29,112; Germany Income Tax Treaty, July 22, 1954, CCH TAX TREATIES 3017, 3021, P-H TAX TREATIES §§ 39,114, 39,118; Greece Income Tax Treaty, Feb. 20, 1950, CCH TAX TREATIES §§ 3112, 3119, P-H TAX TREATIES 41,110, 41,117; Hungary Income Tax Treaty, Feb. 12, 1979, CCH TAX TREATIES 3612, 3624, P-H TAX TREATIES 45,109, 45,121; Iceland Income Tax Treaty, May 7, 1975, CCH TAX TREATIES 3710, 3715, P-H TAX TREATIES 46,107, 46,112; Ireland Income Tax Treaty, Sept. 13, 1949, CCH TAX TREATIES 4118, 4124, P-H TAX TREATIES 51,116, 51,122; Italy Income Tax Treaty, Apr. 17, 1984, CCH TAX TREATIES §§ 4331A, 4335, P-H TAX TREATIES 53,040, 53,054; Jamaica Income Tax Treaty, May 21, 1980, CCH TAX TREATIES §§ 4386J, 4386V, P-H TAX TREATIES 55,110, 55,122; Japan Income Tax Treaty, Mar. 21, 1980, CCH TAX TREATIES §§ 4393F, 4393G, P-H TAX TREATIES 54,036, 54,037; Luxembourg Income Tax Treaty, Dec. 18, 1962, CCH TAX TREATIES §§ 5313, 5323, P-H TAX TREATIES §§ 60,110, 60,120; Malta Income Tax Treaty, Mar. 21, 1980, CCH TAX TREATIES §§ 5413, 5428, P-H TAX TREATIES 61,110, 61,125; Morocco Income Tax Treaty, Aug. 1, 1977, CCH TAX TREATIES 5613, 5625, P-H TAX TREATIES 64,110, 64,122; Netherlands Income Tax Treaty, Apr. 29, 1948, CCH TAX TREATIES 5816, 5829, P-H TAX TREATIES §§ 66,108, 66,126; Netherlands Income Tax Treaty, Apr. 29, 1948, CCH TAX TREATIES §§ 5816, 5829, P-H TAX TREATIES §§ 66,113, 66,126 (as extended to Netherlands Antilles); Pakistan Income Tax Treaty, July 1, 1957, CCH TAX TREATIES §§ 6210, 6220, P-H TAX TREATIES §§ 70,107, 70,117; and United Kingdom Income Tax Treaty, Dec. 31, 1975, CCH TAX TREATIES §§ 8103J, 8103X, P-H TAX TREATIES 89,040, 89,054.

50 Blessing, *The Branch Tax*, 40 TAX LAW. 587, 662 nn. 195 & 197 (1987). Denmark Income Tax Treaty, May 6, 1948, 40 CCH TAX TREATIES § 2069, P-H TAX TREATIES 31,117; Denmark Income Tax Treaty, June 17, 1980, CCH TAX TREATIES §§ 2063, 2077, P-H TAX TREATIES §§ 31,040, 31,054 (not yet ratified) (articles 10.6, 24.3 provide for second-tier withholding tax only if more than 50 percent of share capital owned by non-Danish residents and company was formed, or availed of, to avoid such tax); Egypt Income Tax Treaty, Aug. 24, 1980, CCH TAX TREATIES §§ 8016, 8031, P-H TAX TREATIES §§ 34,111, 34,126; Finland Income Tax Treaty, Mar. 6, 1970, CCH TAX TREATIES §§ 2658, 2663, P-H TAX TREATIES § +s 37,037, 37,042; Korea Income Tax Treaty, June 4, 1976, CCH TAX TREATIES §§ 4810, 4815, P-H TAX TREATIES §§ 56,107, 56,112; Norway Income Tax Treaty, Dec. 3, 1971, CCH TAX TREATIES §§ 6061, 6078, P-H TAX TREATIES §§ 69,038, 69,055 (second-tier withholding tax only if 50 percent of the corporation's profits are attributable to U.S. permanent establishment); Philippines Income Tax Treaty, Oct. 1, 1976, CCH TAX TREATIES §§ 6614, 6627, P-H TAX TREATIES §§ 74,111, 74,124; Sweden Income Tax Treaty, Mar. 23, 1939, CCH TAX TREATIES § 7328, *amended by* § 7328A, P-H TAX TREATIES § 81,124, *amended by* § 81,143; and Switzerland Income Tax Treaty, May 24, 1951, CCH TAX TREATIES §§ 7417, 7421, P-H TAX TREATIES §§ 82,115, 82,119 (second-tier withholding tax only applicable to non-Swiss resident shareholders).

51 Blessing, *supra* note 50, at 587, 620 n.187. United States Draft Model Income Tax Treaty, June 16, 1981, CCH TAX TREATIES § 158, P-H TAX TREATIES § 1022. "The taxation of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities." Blessing, *supra* note 50, at 587, 614 n.144.

treaties which contain language prohibiting discrimination against a foreign corporation resident in the United States.[52]

The Senate Committee has refrained from advising full treaty overrides due to its "understanding that the Treasury Department will attempt to renegotiate outstanding treaties that prohibit the imposition of the [branch profits] tax."[53] "Thus, Congress apparently intended to forestall contrary future treaty provisions."[54]

The treaties in effect between the United States and the countries listed below permit the imposition of a branch profits tax.[55]

Australia*	Poland
Barbados	Romania
Canada*	Trinidad & Tobago*
France*	U.S.S.R.
New Zealand*	

The Service has taken the position that if a corporation is a qualified resident of one of these countries and is not treaty shopping, "the branch profits tax will be imposed at the rate applicable to dividends paid to it by a wholly owned subsidiary if a rate of tax on branch profits is not speci-

[52] Germany Income Tax Treaty, July 22, 1954, CCH TAX TREATIES § 3021, P-H TAX TREATIES § 39,118: "The citizens of one of the contracting States shall not, while resident in the other contracting State, be subject therein to other or more burdensome taxes than are the citizens of such other contracting State residing in its territory. The term "citizens" as used in this Article includes all juridical persons, partnerships and associations created or organized under the laws in force in the respective contracting States." Blessing, *supra* note 50, at 587, 623 n.198.

[53] S. REP. No. 313, 99th Cong., 2nd Sess., 402 (1986).

[54] Blessing, *supra* note 50, at 613.

[55] Australia Income Tax Treaty, Aug. 6, 1982, CCH TAX TREATIES § 402K, P-H TAX TREATIES § 15,040 (15 percent branch tax rate); Barbados Income Tax Treaty, Dec. 31, 1984, CCH TAX TREATIES § 579B, P-H TAX TREATIES § 20,124 (5 percent parent-subsidiary rate under CCH TAX TREATIES § 579M, P-H TAX TREATIES § 20,110); Canada Income Tax Treaty, Sept. 26, 1980, CCH TAX TREATIES § 1310, P-H TAX TREATIES § 22,040 (10 percent branch tax rate); France Income Tax Treaty, July 28, 1967, CCH TAX TREATIES §§ 2816, 2827, P-H TAX TREATIES §§ 38,043, 38,054 (10 percent branch tax rate); New Zealand Income Tax Treaty, July 23, 1982, CCH TAX TREATIES § 5902X, P-H TAX TREATIES § 67,053 (5 percent branch tax rate); Poland Income Tax Treaty, Oct. 8, 1974, CCH TAX TREATIES § 7024, P-H TAX TREATIES § 75,121 (5 percent parent-subsidiary rate under CCH TAX TREATIES § 7014, P-H TAX TREATIES § 75,111); Romania Income Tax Treaty, Dec. 4, 1973, CCH TAX TREATIES § 7276, P-H TAX TREATY § 77,122 (10 percent parent-subsidiary rate under CCH TAX TREATIES § 7264, P-H TAX TREATIES § 77,110); Trinadad & Tobago Income Tax Treaty, Jan. 9, 1970, CCH TAX TREATIES § 7614, P-H TAX TREATIES § 85,036 (10 percent branch tax rate); and The Soviet Union Income Tax Treaty, June 20, 1973, CCH TAX TREATIES § 8002L, P-H TAX TREATIES § 86,110 (no reduction). The nondiscrimination clauses of the treaties with Poland, Romania and the Soviet Union guarantee only the same treatment that a third country (nontreaty) resident would have. The other treaties expressly permit a branch tax. Blessing, *supra* note 50, at 587, 635 n.269.

fied in the treaty."[56] If treaty shopping is present section 884 governs and the 30 percent rate applies.[57] Notice 87-56 states that the branch profits tax of a foreign corporation that is a qualified resident of a country marked with an asterisk (*) "is computed by applying any limitations contained in the treaty with that country."[58]

The branch profits tax, because of its interrelationship with the U.S. network of income tax treaties, has received strong criticism. The most objectionable feature of the branch level tax is the unilateral limitation of benefits provisions without the agreement of the U.S. treaty partners. The new taxes on branch profits and branch level interest conflict with numerous treaties. For example, under modern treaties (e.g. Belgium, Italy, Japan, South Korea, and the United Kingdom) and older treaties (e.g. Austria, Ireland, Luxembourg, Netherlands, Netherland Antilles, Pakistan, Sweden and Switzerland), the nondiscrimination articles are worded so as to prevent application of the tax. The effect of the overriding anti-treaty shopping provisions is to increase U.S. taxes and increase the credit for U.S. taxes the treaty partner is obliged to give to its resident corporations (treaty shopping or otherwise). In effect, the United States is simply unilaterally appropriating taxing jurisdiction to itself from those treaty partners.[59]

The above criticism of section 884 is inaccurate and unduly harsh. The conclusion that the United States is "unilaterally appropriating taxing jurisdiction to itself" disregards the congressional policy behind the provision. The enactment of this provision arose because of Congress' concern with the disparities that were created under prior law which provided *"an unintended advantage* to U.S. branches of foreign corporations vis-a-vis their U.S. corporate competitors."[60] Furthermore, Congress specifically stated that it has no intention of overriding any existing U.S.

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[56] I.R.S. Notice 87-56, 1987-35 I.R.B. 9.

[57] I.R.C. § 884(e)(1) (1986).

[58] I.R.S. Notice 87-56, 1987-35 I.R.B. 9.

[59] Forry & Karlin, *1986 Act: Overrides, Conflicts, and Interactions with U.S. Income Tax Treaties*, 35 Tax Notes 793, 797 (1987).

[60] GENERAL EXPLANATION, *supra* note 18, at 1036 (emphasis added).

> Where a foreign corporation conducted its U.S. operations through a U.S. branch, the withholding taxes of prior law were designed to operate like the dividend and interest withholding taxes that would have applied had the U.S. operations been conducted through a separately incorporated U.S. subsidiary. However, under prior law, the withholding taxes applied only when a majority of the income of the foreign corporation was derived from its U.S. operations. Thus, a foreign corporation that derived a substantial amount of U.S. income but also operated extensively in other countries may not have been liable for the withholding taxes. Dividend and interest payments by U.S. corporations, on the other hand, were always subject to two levels of tax unless exempt by treaty or eligible for special code exemptions, such as that for portfolio interest.

Id.

tax treaties.[61] The branch profits tax simply represents an attempt by Congress to eliminate an unintended tax loop-hole in the Code, reinstating the original premise upon which our income tax treaties were founded. An assertion suggesting that the United States has taken affirmative measures that conflict with our treaty agreements misconstrues the interrelationship between U.S. tax treaties and this new provision.

III. Conclusion

The Tax Reform Act of 1986 has imposed a branch profits tax upon foreign corporations. The provision's overall purpose is to eliminate the tax advantage that foreign corporations operating in the United States held over their U.S. competitors. Unfortunately, this corrective measure has had a disparate tax impact upon the U.S. stockholders of foreign corporations. This unintended result, however, can be eliminated by providing a credit to U.S. stockholders of foreign corporations that are subject to the branch profits tax.

With respect to foreign corporations protected by U.S. tax treaties, the branch profits tax will not supersede any agreement the United States has that prohibits a branch profits tax unless such foreign corporation is engaged in treaty shopping. If a tax treaty does permit a branch profits tax, then it will be limited to the terms of the agreement. This policy is consistent with previous U.S. agreements and, accordingly, does not appropriate taxing jurisdiction from its treaty partners.

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[61] *Id.* at 1043.

> In general, the Act's branch profits tax and branch-level interest tax *do not apply* where their application would be inconsistent with an existing U.S. income treaty obligation. Congress understood that it is the Treasury Department's interpretation that if a corporation is organized in a country with which the United States has a treaty that contains a nondiscrimination article similar to the article contained in the United States 1981 Model Income Tax Treaty, such article prohibits the Act's branch profits tax.

Id. (emphasis added). *See also supra* note 47.

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