REPORT # 596

TAX SECTION

New York State Bar Association

Report on Temporary Branch Profits Tax Regulations

by the Committees on Financial Institutions and
U.S. Activities of Foreign Taxpayers

December 8, 1988

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December 8, 1988

Proposed Branch Profits Tax Regulations

Dear Larry:

I enclose our report on the temporary regulations concerning the 30% tax imposed by Section 894 on profits of U.S. branches of foreign corporations and related issues. The report was jointly prepared by the Committees on Financial Instruments and U.S. Activities of Foreign Taxpayers, and was written by John A. Corry, Kim Blanchard, Michael A. Costa, Marc Fuhrman, Peter A. Glicklich, L. Anthony Joseph, Edward Morgan, Kevin Rowe, Kenneth R. Silbergleit, Suzanne Sykora and John Weber. Helpful comments were made by William L. Burke, Richard O. Loengard, Jr., Donald Schapiro and Stephen L. Millman.

Although many of the comments in the report are of a largely technical nature, the report in a number of places expresses our concern that the temporary regulations have taken positions that are neither required nor supported by the statute and its legislative history. That is particularly the case in the tax treaty override area. Those positions unnecessarily restrict the ability of non-treaty shopping entities to qualify for treaty benefits. Indeed, certain requirements for establishing qualified treaty country resident status may be impossible to satisfy without obtaining a ruling from the Internal Revenue Service.

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The Tax Section of the New York State Bar Association is hopeful that this report will be useful to you in the process of preparing final regulations on this subject.

Sincerely,

Herbert L. Camp

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Enclosure

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Tax Report # 596

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Temporary Branch Profits Tax Regulations

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U.S. Activities of Foreign Taxpayers

December 8, 1988

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Temporary Branch Profits Tax Regulations

December 8, 1988

This report considers the temporary regulations* relating to the 30% tax on profits of U.S. branches of foreign corporations imposed by I.R.C. § 884 and to related issues.**

Prior to the publication of these regulations, the Tax Section prepared and filed two reports that made recommendations as to positions to be expressed in those regulations.*** A number of these suggestions, such as the type of treaty language that would prohibit imposition of the branch profits tax in the case of qualified treaty residents, are adopted in the regulations. We welcome their inclusion.

As the discussion of specific matters in this

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* Temporary Regulations §§ 1.884-OT through 1.884-5T, published on September 2, 1988.

** This report was jointly prepared by the Committees on Financial Institutions and U.S. Activities of Foreign Taxpayers, and was written by John A. Corry, Kim Blanchard, Michael A. Costa, Marc Fuhrman, Peter A. Glicklich, L. Anthony Joseph, Edward Morgan, Kevin Rowe, Kenneth R. Silbergleit, Suzanne Sykora and John Weber. Helpful comments were made by William L. Burke, Richard O. Loengard, Jr., Donald Schapiro and Stephen L. Millman.

*** Herein referred to as the Report and the Supplemental Report, the texts of which are set forth, respectively, in Tax Notes, Vol. 34, No. 6, p. 607 (February 9, 1987) and in Tax Notes, Vol. 37, No. 2, p. 191 (October 12, 1987).

report will indicate, however, we are concerned, particularly in the tax treaty override area, that the temporary regulations adopt positions that are neither required nor supported by the statute and its legislative history, and which very substantially and, we believe, unnecessarily limit the ability of non-treaty shopping entities to qualify for treaty benefits. Indeed, the qualified foreign resident stockholder documentation requirements contained in Sections 1.884-5T(b)(4), (5) and (6)* and the 100 person – 50 percent ownership requirement in Section 1.884-5T(d)(4)(ii), which are discussed in paragraphs 4(b) and (c) of this report, are so manifestly onerous and impractical as to result in the same intensity of criticism and ultimate damage to the credibility of the tax system that arose from early efforts in the FIRPTA area.

This is particularly disturbing since it appears to be totally at odds with the strongly expressed views of the Treasury Department at the time the branch profits tax was being considered by Congress that tax treaties generally should override branch tax legislation in cases of conflict. In a letter dated April 7, 1986 to then Senate Finance Committee Chairman Packwood, then Treasury Secretary Baker

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* Section references are to sections of the temporary regulations unless otherwise indicated.

stated that the provisions of the 1986 tax reform legislation that Congress was then considering that would override treaties would diminish the value of future treaty commitments from the United States, would complicate the process of revising existing treaties or negotiating new treaties and could offer foreign treaty partners an excuse to abrogate unilaterally the provisions of non-tax treaties (e.g., a treaty between the United States and the Netherlands regarding European missile testing). Thus, we fear that when our treaty partners understand the full implications of these provisions, it will become more difficult for the United States to negotiate meaningful treaty changes with them.

We also question the need for the length and complexity of the temporary regulations. As filed with the Office of the Federal Register, they consist of more than 165 double spaced pages. Assistant Secretary Chapoton is quoted in the September 14, 1988 BNA Daily Tax Report as expressing concern over the growing complexity of the internationally related provisions of our tax laws and suggested that this problem should be addressed through regulations and other forms of administrative guidance. We applaud his comments, but we respectfully suggest that this goal can be accomplished only if the regulations that interpret these provisions are themselves made as simple as possible, that

the time to do this is on an ongoing basis as regulations are proposed or announced and that this process should begin now rather than at some future date.*

In this report, as in our two earlier reports, we have been guided by what we believe to have been the primary Congressional purpose for enacting the branch profits tax, i.e., that then existing law, by not imposing any tax on transfers from U.S. branches of foreign corporations to their head offices, favored doing business in the United States through branches rather than through United States subsidiaries.** Therefore, the recommendations contained in this report are based on the premise that the regulations should reflect an even-handed approach between the two methods of doing business to the greatest possible extent.

Our specific comments follow the order in the proposed regulations of the subjects to which they relate.

1. Section 1.884-1T - Branch Profits Tax

(a) U.S. Assets -- General Rule

Section 1.884-1T(d)(1) provides that a “U.S. asset”

* In a similar vein, we note that the temporary regulations on the allocation and apportionment of interest expense and certain other expenses which were adopted September 9, 1988 as filed with the Office of the Federal Register contained 214 double spaced pages.

** H. Rep. 99-426, 99th Cong., 1st Sess., p. 432; S. Rep. 99-313, 99th Cong., 2d Sess., pp. 400-401.

is (a) property of a corporation that is described in Section 1.884-1T(d)(2) through (12) and (b) property "(other than that described in Section 1.884-1T(d)(2) through (12))" that is held on the determination date if all income from the use, and all gain from the disposition of the property on the determination date is effectively connected with the conduct of a trade or business in the U.S. (or would be effectively connected if the property were used or sold on that date). It is unclear whether the second prong of the general definition is intended to include an asset that is of a type that fits in one of the enumerated paragraphs of Section 1.884-1T(d) but does not meet all the conditions for inclusion as a U.S. asset there-under. For example, under Section 1.884-1T(d)(4), certain receivables are treated as U.S. assets in the same proportion that the amount of gross income represented by the receivables that is effectively connected with the conduct of a U.S. trade or business bears to the total amount of gross income represented by the receivable. It seems possible that this ratio would be less than 100% but that all the income from and all the gain from the disposition of the receivables would be effectively connected with the conduct of a U.S. trade or business and hence could fall into the second category of U.S. asset provided for in Section 1.884-1T(d)(ii). We believe that the proper interpretation of the regulation

should be that the parenthetical exception in the second category should instead be to "property of a type described in paragraphs (d)(2) through (12)" and hence would exclude a portion of the receivables in the preceding paragraph from treatment as U.S. assets. We suggest that the final regulations make this clear.

(b) Election to Treat Expansion Capital as a U.S. Asset

Section 1.884-1T(d)(11) provides a special election to treat as U.S. assets certain marketable securities that are not otherwise classified as U.S. assets. This election is available if the securities are held for the entire taxable year following the year for which the election is made, or, if disposed of during that taxable year, are replaced on the date of disposition by other marketable securities that are purchased on or before such date, or are received in exchange for the securities which have been disposed of. It is unclear why other marketable securities are the only permissible replacement property. We suggest that this language be revised so that a disposition of the securities in the year following the election which results in the taxpayer using the proceeds from the disposition in expanding its U.S. business operations will not prevent the marketable securities from being classified as U.S. assets.

Section 1.884-1T(d)(11)(ii) provides, in part, that

marketable securities that are held on the last business day of the following taxable year shall be treated as sold for their fair market value on that day, and that gain (but not loss) and accrued interest shall be taken into account in such following taxable year as income that is effectively connected with the conduct of a trade or business within the U.S. It is unclear why a loss is not permitted to be recognized under this constructive sale rule (cf. the mark to market rules of I.R.C. Section 1256(a)). The language of Section 1.884-1T(d)(11) allows marketable securities to be eligible for this election only if the fair market value of each such security on the date it is identified as a U.S. asset is not less than its adjusted basis on such date. Since a marketable security with a built-in loss is not eligible for the election, there appears to be no reason why a post-election decrease in value cannot be recognized as a loss under the constructive sale provision of Section 1.884-1T(d)(11)(ii).

(c) Acquisition of Assets for Tax Avoidance Purposes

Section 1.884-1T(d)(13)(iii) states that U.S. assets will not include money or property acquired or used by a foreign corporation if "one of the principal purposes" of the acquisition or use is to increase artificially the U.S. assets of the foreign corporation on the determination date.

The regulation states that this will be based upon a facts and circumstances test. The regulation provides that for a purpose to fall into this category, it must be "important" but need not be the "primary purpose".

The statute is silent on this issue, as I.R.C. § 884(c)(2)(A) merely confers broad regulatory powers on the Secretary. The Senate Finance Committee report (p. 404), however, states that the regulations may address "the potential abuse that may arise in the event a branch temporarily increases its assets at the end of its taxable year <u>merely</u> to reduce its branch profits tax base." (Emphasis added). Identical language appears in the Joint Committee Explanation of the 1986 Tax Reform Act at p. 1045 (the "1986 Act Bluebook").

While the word "merely" in the legislative history perhaps should not be taken literally,[*] we believe the legislative history clearly indicates that the purpose is to control real abuse and not to penalize situations where there are legitimate business reasons for increasing the U.S. assets. We believe, therefore, that the regulation's "one of the principal purposes" test is entirely too broad. We believe a more

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[*] Webster's New World Dictionary of the English Language, Second College Edition, defines "merely" as "no more than; and nothing else; only."

appropriate test would be the absence of any other substantial business reason, or at least one where "the principal purpose" for the asset increase was avoidance of the branch profits tax.

Similar considerations apply to the provisions in paragraph (e)(3) with respect to artificial decreases in U.S. liabilities.

(d) Effectively Connected Earnings and Profits -- Section 864(d)(7) Income

Section 1.884-1T(f) provides that the term "effectively connected earnings and profits" generally means earnings and profits determined under Section 312 that are attributable to income that is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States. There apparently is no exception for earnings and profits attributable to income that is treated as effectively connected with the conduct of a U.S. trade or business pursuant to Section 864(c)(7) (relating to property that ceases to be used or held for use in connection with a U.S. trade or business). However, Section 1.884- 1T(d)(13)(ii) would exclude certain Section 864(c)(7) property from the definition of U.S. asset. The result is that a taxpayer can dispose of an asset that is treated as giving rise to effectively connected earnings and profits, yet not be able to count that asset in its calculation of

U.S. assets, and therefore U.S. net equity. We believe that a more equitable result would be reached if an asset (and the proceeds of its disposition) were treated as a U.S. asset to the extent that it would create effectively connected income pursuant to I.R.C. Section 864(c)(7).

(e) <u>Effect of Branch Tax on Effectively Connected Earnings and Profits</u>

Section 1.884-1T(f)(1) provides that in determining the amount of a foreign corporation's effectively connected earnings and profits, no downward adjustment shall be made for the branch profits tax itself or the tax on excess interest. This provision with respect to the tax on excess interest is open to challenge. Although that tax is a substitute for a withholding tax that would be imposed if the excess interest had in fact been paid by the branch, the latter tax would normally be withheld from the interest payment, and its cost would normally not be borne by the payor of the interest. On the other hand, if a U.S. withholding agent fails to properly withhold and is subjected to a penalty equal to the amount of the withholding, that amount normally should be treated as a reduction in the payor's earnings and profits, perhaps as additional interest paid by it. We believe that since the tax on excess interest is borne by the U.S. branch over and above the cost allowed for the interest paid, it is a cost of doing business in the United States that should

reduce the branch's effectively connected earnings and profits for branch profits tax purposes.

2. Section 1.884-2T -- Special Rules for Termination or Incorporation of a U.S. Trade or Business or Liquidation or Reorganization of a Foreign Corporations or its Domestic Subsidiary.

(a) Discriminatory Effects

Section 1.884-2T provides special rules for terminations, incorporations, liquidations and reorganizations. Under certain circumstances, it can discriminate against foreign corporations conducting a branch business in the United States in favor of those doing business here through U.S. subsidiaries. Under these regulations, foreign branch operations can be subjected to a two-tier tax regime in situations where a foreign corporation operating through a U.S. subsidiary would not be.

The discrimination that can result under the temporary regulations could and should be eliminated by narrowing the scope of the regulations so as to focus more precisely upon potential abuses that can arise when the differences between the tax regime applicable to branch operations and that applicable to U.S. subsidiaries can be exploited by a branch. We note that I.R.S. Notice 86-17[*] in foreshadowing these provisions of the temporary

[*] I.R.B. 1986-52 (December 12, 1986).

regulations, merely stated that these regulations would provide "anti-abuse" rules, and did not adopt the view that such rules would be of general application. However, as noted more specifically throughout this report, the reach of the temporary regulations is far broader than that necessary to address potential abuses. Examples of the discriminatory effects that can be produced under the temporary regulations include the following:

(i) The prohibition against U.S. reinvestment by a related person during the three-year period following a complete termination unjustifiably discriminates against branch operations. Any reinvestment by a related corporation, whether or not in substantially the same business that was terminated, will trigger the branch tax on repatriated earnings. In contrast, if a U.S. subsidiary of a foreign corporation sells its U.S. assets and liquidates, the foreign parent will ordinarily not be subject to U.S. tax on the receipt of the liquidation proceeds. We suggest that traditional liquidation-reincorporation principles can and should be applied to distinguish between *bona fide* branch terminations and dividend-equivalent bailouts. Such principles would presumably prevent a foreign parent from obtaining its U.S. subsidiary's earnings as non-taxed capital gains through

the reincorporation of substantially all of the liquidated subsidiary's U.S. assets. The same rule should apply to branch terminations.

(ii) Under Section 1.884-2T(d), even a branch that transfers all of its U.S. assets to a U.S. subsidiary in a I.R.C. § 351 transaction will in many cases remain liable for the branch tax upon a sale of the subsidiary's stock that occurs many years after the transfer, unless the foreign transferor can meet the complete termination rules in that later year. The liability exposure arises even though the U.S. subsidiary must increase its earnings and profits by the amount of the accumulated branch profits, so that the result is essentially the same as if the operation had always been conducted in a subsidiary.[*] In contrast, if the foreign corporation had invested through a U.S. subsidiary at the outset, any undistributed earnings and profits would not be treated as a dividend on the sale of such subsidiary's stock.

(iii) Another example of the temporary regulations' discriminatory effect is found in the reorganization and liquidation provisions. As in the case of I.R.C. § 351

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[*] Because of the different rules for expense allocation for a branch, the cumulative tax consequences from a period of branch operation may differ, but any excess branch interest expense will, in principle, have been subjected to the branch level interest tax.

transfers, the basic approach to I.R.C. § 381(a) transactions is that the taint of a- foreign transferor's earnings and profits can rarely be purged. In drafting the reorganization rules of Section 1.884-2T(c), the Service did not have to be concerned — as it did in the Section 351 area -- that earnings and profits would not be inherited by the transferee, since such result is accomplished by existing Section 381. Given such an automatic result, we see no justification for a foreign corporation with a former U.S. branch having to remain presumptively liable for the branch tax after a domesticating Section 381(a) transaction.

(b) General Rules for Complete Termination of U.S. Trade or Business.

Section 1.884-2T(a) provides generally that a foreign corporation will not be subject to the branch profits tax in the year in which it completely terminates its U.S. trade or business. Failure to fully satisfy the requirements for the complete termination of the U.S. trade or business of a foreign corporation, as provided in Section 1.884-2T, results in application of the general provisions of the branch profits tax which, in most cases, will produce an increased dividend equivalent amount for the year of complete termination.

Section 1.884-2T(a)(2)(i)(A) provides rules for the complete termination of the U.S. trade or business of a

foreign corporation which is not completed within one taxable year. A foreign corporation is considered to have completely terminated its U.S. trade or business, if as of the close of the taxable year, it has no U.S. assets, or its shareholders have adopted an irrevocable resolution to liquidate the corporation and before the end of the succeeding taxable year the corporation has no U.S. assets. If the foreign corporation terminates its U.S. trade or business, but does not liquidate, the termination must be completed within one taxable year. The temporary regulations seem to provide some relief for non-liquidating terminations with a one-time election whereby the foreign corporation may designate an amount of marketable securities as U.S. assets for the taxable year of termination and the following year.* Section 1.884-2T(b).

The requirement that a liquidating foreign corporation with a U.S. trade or business adopt an "irrevocable resolution" to completely liquidate is troublesome because the temporary regulations do not define the term "irrevocable

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* The preamble to the temporary regulations states that this provision is designed for foreign corporations that have liquidated all their U.S. assets or retired them from use in a U.S. trade or business but that continue to hold cash or property with the expectation of continuing a U.S. trade or business in the future. Preamble to the Temporary Regulations under § 884, Reprinted in, BNA Daily Tax Report, August 30, 1988, L-4, L-5.

resolution".[*] Similarly, the requirement that the liquidating corporation dissolve is also undefined. If that rule means that the corporation must cease its existence under the laws under which it was organized, it appears to be at odds with the general rule that a liquidation for tax purposes does not require the dissolution of the liquidating corporation. See Treas. Reg. §1.332-2(c). Some explanation of this language should be provided.

The temporary regulations do not clearly address the practical problems associated with the termination of a U.S. trade or business by liquidating a foreign corporation. Section 1.884-2T(a)(2)(A) of the temporary regulations provides that before the close of the taxable year succeeding the year in which the irrevocable resolution to liquidate was adopted, all the U.S. assets of the liquidating foreign corporation must be "either distributed, used to pay off liabilities or cease to be U.S. assets". The phrase "used to pay off liabilities" is unclear. Does it mean that U.S. assets or money attributable thereto may not be retained in the U.S. to meet liabilities on indebtedness such as a bank loan that is not yet payable? U.S. creditors may

[*] Indeed, we question whether it is possible to irrevocably resolve to liquidate. As a matter of U.S. corporate law, the stockholders usually would be entitled to rescind such a resolution, at least prior to commencement of the liquidation process.

not accept the departure of assets beyond their immediate reach.

There is no analogous provision with respect to the termination of the U.S. trade or business of a non-liquidating foreign corporation. In that situation, the U.S. trade or business must be terminated within one taxable year. We believe that this requirement is too limiting. Although this requirement is probably reasonable in the case of a corporate liquidation (cf. I.R.C. § 332), it may be more difficult to accomplish when assets are being transferred within a single corporation. Liquidation is a legally recognized event whose procedures and ensuing consequences are spelled out under state law. Termination of a branch, on the other hand, involves no legal disposition of assets and hence the legal and tax determination of when it has occurred may be more difficult. In addition, the election to designate marketable securities as U.S. assets may not adequately address the practical difficulty of terminating a U.S. trade or business.

Arguably, assets of a foreign corporation retained in the U.S. to meet future liabilities arising from the terminated U.S. trade or business are not U.S. assets under Section 1.884-1T(d) because the foreign corporation has completely terminated its U.S. trade or business. This is unclear, however, and in light of the uncertain definition of a U.S. trade or business of

a foreign taxpayer, the final regulations should provide safe harbors for both liquidating and non-liquidating foreign corporations with respect to liabilities that become payable after the termination of a U.S. trade or business.

We therefore recommend that the final regulations not adopt any mandatory period within which a non-liquidating foreign corporation must complete the termination of its U.S. trade or business. Instead, the final regulations should deal with the problem similarly to what is now done in testing payments in protracted liquidation and perhaps provide a safe or at least a favorable presumption for termination completed within a reasonable time, such as 12 to 18 months, from the adoption of the "irrevocable resolution" to liquidate or to terminate the U.S. trade or business. We also recommend the adoption of a rule similar to Treas. Reg. §1.337-1 (promulgated under pre-1986 Tax Reform Act § 337) regarding the retention of assets by a liquidating corporation to meet potential liabilities arising after the 12-month liquidation period.

(c) Complete Termination in the Case of a Foreign Corporation with Deferred Income.

The provisions of the temporary regulations that address deferred payments covered by I.R.C. § 864(c)(6) apparently fail to achieve their intended result. We believe

that this is due to a mere drafting error. Section 1.884-2T(a)(2) requires, as a condition to a complete termination, that a foreign corporation have no effectively connected income other than income which is effectively connected income solely by reason of I.R.C. §§ 864(c)(6) or 864(c)(7) and, inter alia, that it retain no U.S. assets. Similarly, Section 1.884-2T(a)(4), which exempts deferred payments described in § 864(c)(6) from the branch profits tax, requires that the recipient of such payments have no U.S. assets. However, Section 1.884-1T(d)(7) defines U.S. asset to include any installment obligation described in I.R.C. § 453B, to the extent that such obligation, if satisfied in full, would produce effectively connected income. Section 1.884-1T(d)(7) thus addresses obligations giving rise to § 864(c)(6) income. We also note that Section 1.884- 1T(d)(13)(ii), which provides that an asset giving rise to effectively connected income solely as a result of § 864(c)(7) is not a U.S. asset, does not address the § 864(c)(6) issue. Since the exemption provided in Section 1.884-2T(a)(2) and (a)(4) do not purport to override this definitional test, the provisions as drafted appear to be nullities. Accordingly, we recommend that the final regulations provide that the retention of an installment obligation giving rise to income or gain described in I.R.C. § 864(c)(6) will not prevent the complete termination of a U.S. trade or business.

We recognize that allowing a branch to escape the branch profits tax without having to recognize currently the deferred income or gain on the I.R.C. § 864(c)(6) asset creates an assymmetry with the treatment of a subsidiary (where the deferred amount would now be taxed, at least in a Section 331 liquidation, as a result of the repeal of General Utilities). Congress appears to have stopped short of having a branch put in the same position as a subsidiary in every respect. Nevertheless, we believe that it may be appropriate to consider whether to condition the termination rules on the branch agreeing first to recognize any deferred income or gain on any I.R.C. § 864(c)(6) asset.

(d) Restrictions on Reinvestment in a U.S. Trade or Business.

Section 1.884-2T(a)(2)(i)(B) provides that a complete termination of the U.S. trade or business of a foreign corporation requires that:

> Neither the foreign corporation nor a related corporation uses, directly or indirectly, any of the U.S. assets of the terminated U.S. trade or business, or property attributable thereto or to effectively connected earnings and profits earned by the foreign corporation in the year of complete termination, in the conduct of a trade or business in the United States at any time during a period of three years from the close of the year of complete termination.

A “related corporation” for this purpose is defined as a corporation which owns 10 percent or more of the total value of the stock of the foreign corporation or a corporation 10 percent or more of the value of the stock of which is owned by the foreign corporation. Ownership for this purpose is determined as provided in I.R.C. § 871(h)(3)(C) using modified I.R.C. § 318 attribution rules. Section § 1.884- 2T(a)(2)(iv). In addition, Section 1.884- 2T(a)(2)(iii)(B) defines property attributable to the U.S. assets of a U.S. trade or business as:

> Property attributable to U.S. assets or to effectively connected earnings and profits earned by the foreign corporation in the year of complete termination shall mean money or other property into which any part or all of such assets or effectively connected earnings and profits are converted at any time before the expiration of the three-year period specified in paragraph (a)(2)(i)(B) of this section by way of sale, exchange, or other disposition, as well as any money or other property attributable to the sale by a shareholder of the foreign corporation of its interest in the foreign corporation (or a successor corporation) at any time after a date which is 12 months before the close of the year of complete termination (24 months in the case of a foreign corporation that makes an election under paragraph (b) of this section). Section 1.884-2T(a)(2)(iii)(B)

We are troubled by the potential reach of this rule. It appears that if a foreign corporation that terminates its U.S. trade or business and sells its U.S. assets at a gain, producing earnings and profits, and distributes a dividend or makes a liquidating distribution to a foreign corporation that is a related person under Section 1.884-2T(a)(2)(iv), the distributing corporation will be subject to branch profits tax for the year of complete termination if the distributee corporation invests "directly or indirectly" in a U.S. trade or business for the three year period beginning with the close of the taxable year of complete termination. Thus, the status of a foreign corporation's termination of its U.S. trade or business can be determined by the investment decisions of a corporation owning a mere 10 percent of the value of the foreign corporation.

We wonder what measures the Service will employ to enforce the rule. Section 1.884-2T(a)(2)(i)(D) requires that when a foreign corporation is terminating its U.S. trade or business, it agrees to extend the statute of limitations for assessment for the branch profits tax for the taxable year of such termination for six years following the close of the year of complete termination. Section 1.884-2T(a)(2)(ii) also provides:

> Such waiver shall contain such other terms with respect to assessment as may be considered appropriate by the Commissioner to assure the assessment and collection of the correct tax liability for each year for which the waiver is required.

Temp. Regs. § 1.884-2T(a)(2)(ii). It is a generally accepted principle that the enforcement of tax laws requires that the taxpayer have a jurisdictional nexus with the taxing state. As outlined above, a foreign corporation can easily fail the test for the complete termination of its U.S. trade or business as a result of events over which it has no effective control. Will the Internal Revenue Service require such a foreign corporation to maintain a jurisdictional nexus with the U.S. for some period of time following the year of complete termination? We believe that fuller inspection shows that the three year rule is not only draconian and probably unenforceable, but at best adds an additional level of complexity burdensome on both taxpayers and the Service.

The problems and implications of the restrictions on reinvestment of assets attributable to U.S. assets are fundamental enough that we believe a rule setting a fixed time period is administratively unwise and from a policy perspective is unjustified, indeed even contrary to the greater branch-subsidiary symmetry at the heart of the legislation. The liquidation-reincorporation and step transaction doctrine provide the Commissioner with ample authority to attack a purported

business termination that in fact represents a continuation of the business in another form. These rules would apply in determining whether a U.S. subsidiary of a foreign corporation has completely liquidated and they can be applied just as readily to a U.S. branch termination.

If a fixed time period is to have a role, we suggest that the role be reversed to be a safe harbor so that it can be applied where the necessary tracing can be accomplished without requiring the exercise in every case. For such a revised role, a different time period may also be appropriate.

If complete termination is disallowed, whether by reason of application of the usual liquidation-reincorporation type rule or a fixed time period rule, the regulations should allow a special election procedure to provide mitigation relief. The dividend equivalent amount for the year of complete termination should be reduced by an amount equal to the basis of the reinvested assets or property if the foreign corporation or the related corporation agrees to treat such amount as non-previously taxed accumulated effectively connected earnings and profits (or as accumulated earnings and profits in the case of a related corporation which is a U.S. corporation). For example, assume that foreign corporation C is owned equally by foreign

corporation A and foreign corporation B. Assume further that C has $5,000X of non-previously taxed accumulated effectively connected earnings and profits, that C completely liquidates under I.R.C. § 331 and that, pursuant to I.R.C. § 336, C recognizes $10,000X of effectively connected earnings and profits (after taxes) on the distribution of its appreciated assets in liquidation. Finally, assume that A or B makes a reinvestment that denies complete termination relief to C. No branch profits tax should be imposed on C if A and B each agrees to increase its non-previously taxed effectively connected earnings and profits by $7,500X.

(e) Carryover of Effectively Connected Earnings and Profits in a § 381 Transaction.

Section 1.884-2T(c) provides rules for the calculation of the dividend equivalent amounts of the transferor and the transferee when a foreign corporation transfers U.S. assets in a I.R.C. § 381(a) transaction. In general, the transferor's U.S. net equity will not be affected by the transfer of assets in the Section 381(a) transaction and the transferor's effectively connected earnings and profits, determined at the close of the taxable year in which the § 381(a) transaction occurs, will carry over to the transferee.

Apparently, one of the effects of this provision is to require the transferor to pay branch profits tax on its effectively connected earnings and profits (including, perhaps,

any earnings and profits generated in connection with the Section 381(a) transaction) unless it reinvests such amount in U.S. assets before the transfer. (Contrast this with Sections 1.884-2T(d)(3)(iii) and (4)(ii), which generally permit the transferee in an I.R.C. § 351 transaction to make the reinvestment.) We believe that the branch profits tax should not apply if the transferee in the Section 381(a) transaction makes the reinvestment before the end of its taxable year. This would be particularly appropriate in I.R.C. § 332 liquidations and in "F" reorganizations.

When non-previously taxed accumulated effectively connected earnings and profits are attributed to a domestic transferee as a result of a Section 381(a) transaction, the temporary regulations appear to provide that a portion of subsequent distributions by the transferee are to be treated as coming from such non-previously taxed accumulated effectively connected earnings and profits without regard to the transferee's subsequent earnings and profits history. Section 1.884-2T(c)(4)(iii). Although we recognize the potential for abuse in this area, we note, that in computing a corporation's accumulated earnings and profits it is well recognized that subsequent deficits in earnings and profits of a domestic transferee reduce or eliminate non-previously taxed accumulated effectively connected earnings profits.

Further, I.R.C. § 316(a) provides:

> Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits.

Neither § 884(g) nor its legislative history supports a regulation in conflict with that rule. Nor does it seem appropriate to impose the penalty of a different rule because the branch is transferred to a domestic corporation before the deficits arise.*

Section 1.884-2T(c)(4)(iii) provides that if a domestic corporation is treated as having received a distribution of non-previously taxed accumulated effectively connected earnings and profits in a Section 381(a) transaction, distributions of such amount by the domestic corporation to a foreign distributee will qualify for income tax treaty benefits only to the extent that a distribution from the transferor foreign corporation would have qualified for branch profits tax relief in the taxable year in which the Section 381(a) transaction occurs. The concern here is apparently that the domestic corporation would be used as a

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* It is clear that if subsequent deficits were incurred before the branch was transferred to a domestic corporation, the amount potentially subject to withholding would be reduced accordingly.

conduit, a situation the regulations should prohibit, but the regulations as drafted reach unnecessarily (and inappropriately) beyond the proper scope of concern.

Assume, for example, that a large U.S. corporation liquidates a foreign subsidiary that is subject to the branch profits tax because it carries on business in the United States. Assume further that the foreign corporation has only a small amount of non-previously taxed accumulated effectively connected earnings and profits that are not subject to such tax by reason of the liquidation. Assume finally that the U.S. corporation pays its regular quarterly dividend to stockholders, some of whom are residents of countries that have treaties with the United States that reduce the U.S. withholding tax rate from 30 percent to 15 percent. Under the temporary regulation as written, it would appear that in some unspecified manner a portion of these dividends will be ineligible for tax treaty relief. If this is not the intention of the regulation, it should be clarified. In any event, some sort of a _de_ _minimis_ rule or rule of reason should apply so that this non-treaty benefit eligibility provision would be invoked only in cases that at least presumptively involve conduit or conduit-like arrangements.

(f) _Third Party Action that May Affect Liability for Branch Profits Tax_.

The discriminatory effects of the rules restricting

reinvestment and partial disposition of branch interests transferred to domestic corporations have already been noted in Section 1(a) of these comments. But they are also objectionable, separate and apart from discrimination concerns.

Considerations of fairness, and perhaps also constitutionality, have generally insured that a taxpayer's ultimate liability for U.S. taxes will not be affected by the unilateral, voluntary and undisclosed actions of unrelated third parties. Unfortunately, the reinvestment and disposition provisions in the temporary regulations conflict with these considerations in a manner we believe unnecessary and unwise administratively. To take another example, under Section 1.884-2T(c)(6), where a branch undergoes a “Type C” reorganization into a domestic transferee and the transferee's parent sells stock of the transferee within three years after the reorganization, the branch will be fully liable for the branch tax as of the year of the reorganization. Suppose A, a foreign corporation, owns all of the stock of another foreign corporation, X, having U.S. branch operations. If X exchanges substantially all of its assets for a minority interest in domestic corporation Y in a Section 368/381(a) transaction, a subsequent sale of Y stock by an unrelated parent of Y could trigger a branch tax liability as to X. While well-advised taxpayers may be able to avoid the economic

hardship of these provisions through negotiation with unrelated purchasers, etc., such rules create an unjustifiable trap for the unwary. We believe these considerations provide further reasons for revising these aspects of the regulations as already suggested above.

(g) Section 351 Domesticating Branch Incorporations

Notice 86-17 generally exempted from the branch tax simple I.R.C. Section 351 transfers by foreign transferors to U.S. transferees, but left to regulations the extent to which the tax might apply to subsequent distributions by the transferee or to sales of stock of the transferee. Presumably, the potential abuse which such regulations were to address involves an end run of the complete termination rules (e.g., a Section 351 drop-down of less than all of a branch's U.S. businesses, followed by a prearranged sale of the transferee's stock or sale by the transferee of its assets).

Regrettably, even the simplest Section 351 transfer will qualify for relief under the temporary regulations only if (1) the domestic transferee makes a special election under Section 1.884-2T(d)(4) to inherit the transferor's earnings and profits accounts and (2) the transferor agrees under paragraph (d)(5)(i) to pay branch tax on most subsequent dispositions of the transferee's stock. Under the latter paragraph, even where no abuse is present, the transferor remains liable for the branch tax. The dividend equivalent amount in such a case is the lesser of the amount realized or the earnings and profits inherited by the transferee under paragraph (d)(4).

The apparent justification for this rule is unclear. If the rule is based upon a concern that earnings and profits are not normally inherited by a transferee in a Section 351 exchange, that concern is adequately addressed in Section 1.884-2T(d)(4). In any event, it seems inappropriate to discourage domestications of foreign branch operations by adoption of a rule that requires the foreign transferor to completely terminate its U.S. business as part of any sale of the transferee's stock.

We also suggest that in the event the transferor is required to treat as a dividend equivalent amount any portion of the earnings and profits transferred to the domestic transferee, such transferee's earnings and profits should be reduced by an equivalent amount. Absent such a rule, the temporary regulations under Section 1.884-2T(d) could in some cases result in a double counting of the transferor's earnings and profits.

(h) Transferor's Disposition of Stock or Securities of the Transferee in a Section 351 Transaction

Section 1.884-2T(d)(5)(i) requires the transferor of U.S. assets to a corporation in an I.R.C. §351 transaction

as defined in Section 1.884-2T(d)(1), to agree, in effect, to recognize a distribution subject to branch profits tax upon the disposition of less than all of the stock or securities of the transferee received in the transaction to the extent of the lessor of the amount realized or the amount of the non-previously taxed effectively connected earnings and profits assumed by the transferee, adjusted for any distributions by the transferee. This applies to all dispositions of stock or securities of the transferee except dispositions pursuant to transactions described in I.R.C. §332 or §368(a)(1)(F). Section 1.884-2T(d)(5)(ii) of the temporary regulations provides that dispositions described in any other non-recognition provision will be taxable under the above rule unless the Commissioner provides otherwise. We recommend that the final regulations should provide some indication of the standards that would permit the Commissioner to "provide otherwise."

3. Section 1.884-4T Branch-Level Interest Tax.

(a) Tax on Interest Paid -- General Rule.

I.R.C. § 884(f) as recently amended sets forth rules relating to the payment of interest which apply in the case of a foreign corporation having gross income treated as effectively connected with the conduct of a trade or business in the United States). I.R.C. § 884(f)(1)(A) treats interest

paid by such a trade or business as if it were paid by a domestic corporation. Section 1.884-4T(a)(1) extends the reach of I.R.C. § 884(f)(1)(A) by providing that a foreign corporation shall be treated as if it were engaged in trade or business in the United States if it owns any U.S. assets at any time during the taxable year. Accordingly, a foreign corporation that, for example, owns only raw land in the United States (or only an option to acquire such property)[*] could be subject to the rules of I.R.C. § 884(f)(1)(A) on any interest paid with respect to a liability secured by the land (or option) even if all of the foreign corporation's gross income for the taxable year is from sources outside the United States (none of which is effectively connected with the conduct of a U.S. trade or business). Since such a foreign corporation is not in fact engaged in trade or business in the United States, and has no effectively connected income, it is not entitled to any deductions under I.R.C. § 882 (even if a portion of its interest expense would otherwise be allocated to the U.S. under Treas. Reg. § 1.882-5). We believe that it is inappropriate to apply I.R.C. § 884(f)(1)(A) to such a foreign corporation.

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[*] Even the option would be treated as a U.S. asset under Section 1.884-1T(d)(5)(i).

(b) Tax on Excess Interest — General Rule.

Section 1.884-4T(a)(2), dealing with excess interest, provides in part that excess interest "shall not be exempt from tax under any subsection of I.R.C. § 881". This language is somewhat confusing. It is probably meant to (i) distinguish the treatment of excess interest from the treatment of interest paid by a U.S. trade or business, which can qualify for an exemption from withholding and substantive U.S. tax under a number of Code provisions (e.g., interest on deposits or portfolio interest) and (ii) override the clear implication in the Conference Committee Report* that excess interest might also qualify for such exemptions. Under this interpretation, presumably, the excess interest tax could apply even if, for example, all of the interest paid by the foreign corporation were paid to U.S. persons. If this is the intended meaning of the language in Section 1.884-4T(a)(2), the regulations should be clarified, and an example would be helpful.

While this result appears contrary to the intention of the Conference Committee, it appears to be a sensible resolution of the issue. Since excess interest is deemed to be an interest

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* See Conference Committee Report, pp. II-648 to II-649. The Conference Committee Report expressly suggests that the regulations may provide for excess interest to be treated as incurred on each type of external borrowing by the foreign corporation, such as bank deposits.

payment made by a hypothetical U.S. subsidiary to its foreign parent, the particular facts concerning the actual borrowings by the foreign corporation would not appear to be relevant. Moreover, developing and administering rules that take into account the actual borrowing of the foreign corporation may well be difficult. However, in light of the Conference Committee Report, we believe that at the very least the rules under these regulations should be liberal in permitting a foreign corporation to treat various borrowings as liabilities of its U.S. trade or business in order to avoid the excess interest tax where, for example, interest is paid to a U.S. person or otherwise would not be subject to U.S. withholding tax if paid by a U.S. corporation. In particular, we believe our comments below in subsection (c) (relating to interest paid by a U.S. trade or business) and in subsection (e) (with respect to the eighty-percent rule) should be adopted.*

(c) Interest Paid by a U.S. Trade or Business.

Section 1.884-4T(b)(1) defines interest paid by a U.S. trade or business. Under clause (A) of subparagraph (i)

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* In our earlier report in February, 1987, we recommended that, although the suggestion in the Conference Committee report could result in significant complications, it should be followed where the taxpayer provided sufficient proof, including access to its records by the Internal Revenue Service.

of that Section, interest paid by a foreign corporation with respect to a liability that is specifically identified as a liability of a U.S. trade or business of the foreign corporation on its books and records will generally be treated as interest paid by a U.S. trade or business if the interest is allowed as a deduction by reason of Treas. Reg. § 1.882-5(b)(3)(i). This reference is confusing. If it is meant to restrict this provision to foreign corporations that use the branch book/dollar pool method (as opposed to the separate currency pools method), the reason for such a limitation is not apparent. If it is meant to require that interest on the liability actually be allowed as a deduction, the requirement may never be satisfied since the interest deduction under I.R.C. § 882 does not relate to any specific liabilities, but rather is computed on a formula basis. This provision should be clarified.

Under clause (B) of subparagraph (i) of Section 1.884-4T(b)(1), interest paid with respect to a liability that is specifically identified as a liability of a U.S. trade or business of a foreign corporation on its books and records will generally be treated as interest paid by a U.S. trade or business if the liability is entered on such books and records within 60 days of the date the liability is incurred by the foreign corporation (unless the first interest payment is made before that 60th day). We believe that this generally is a useful rule,

particularly since a foreign corporation may not otherwise know how to apply Section 1.884-4T(b)(1)(A) to payments made during the course of its taxable year. However, since it is not clear what is necessary to comply with this rule, we believe that the rule should be clarified and, preferably, broadened. In particular, the regulations should (i) specify the procedures that will be considered adequate (e.g., making of a journal entry, or posting to a ledger) in order to assure a foreign corporation that it will be considered to have "entered" a liability in the required manner, (ii) provide how a foreign corporation may evidence the date on which such an entry ordinarily will be considered to have occurred, (iii) extend the 60-day period to at least 90 or, preferably 180, days and (4) either eliminate the "first interest payment" rule noted above or limit its application to cases where the first periodic payment of interest is made before the liability is "booked."*

Under subparagraph (iii) of Section 1.884-4T(b)(1), interest paid with respect to a liability is treated as

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* We note that the "first interest payment" rule as it presently appears would require a foreign corporation to determine whether certain fees paid to its lender at closing constitute interest for tax purposes.

interest paid by a U.S. trade or business if the liability is secured “predominantly” by property of the foreign corporation that is a U.S. asset (as defined in Section 1.884- 1T(d)), “unless such liability is secured by substantially all the property of the foreign corporation”. Under this standard read literally, if a foreign corporation has only one asset and that asset secures the liability in question, interest on the liability will not be treated as paid by a U.S. trade or business even if the asset is a U.S. asset. Similarly, under this rule, if a foreign corporation has several assets, all of which are U.S. assets, and all are pledged to secure the liability read literally, the interest will not be treated as paid by the corporation's U.S. trade or business.

We understand that the drafters of the temporary regulations intended the rule to serve two purposes. First, the rule was meant to ensure that the liability was secured primarily by U.S. assets rather than by foreign assets. Second, the rule was meant to ensure that a foreign corporation would not give a lender a security interest in property merely in order to come within this rule where the property was not of sufficient value to support the debt obligation. As suggested by the examples above, Section 1.884- 4T(b)(1)(ii) as drafted does not appear to accomplish these objectives. The regulations should be amended to

replace the rule in Section 1.884-4T(b)(1)(iii) with more specific rules which address these legitimate concerns more directly and which adopt objective numerical standards. For example, the final regulations might require that all the assets securing a particular liability have a combined value of at least 80% of the liability, and that of the assets securing the liability more than 50% (or some greater percentage) of their combined value must be represented by U.S. assets.

(d) Exceptions to Section 1.884-4T(b)(1).

Section 1.884-4T(b)(3) recharacterizes certain liabilities as liabilities that do not give rise to interest paid by a U.S. trade or business. Subparagraph (i) of that section concerns liabilities the interest on which is taken into account under the income tax laws of a foreign country as a reduction of income from sources within such country for certain purposes. We believe that where only a portion of the interest is so treated, only a portion of the liability should be recharacterized as a liability interest with respect to which will be treated as not giving rise to interest paid by a U.S. trade or business. Another recharacterization rule, in subparagraph (iii), is the converse of the "secured predominantly by U.S. assets" rule described in subsection (c) above. Our suggestions above apply here as well, generally substituting "non-U.S. assets" for "U.S. assets".

(e) Eighty-Percent Rule.

Section 1.884-4T(b)(5) increases the interest considered to be paid by a U.S. trade or business of a foreign corporation by the amount of the foreign corporation's excess interest where at least 80% of the foreign corporation's assets consist of U.S. assets. This rule, presumably intended to reduce the scope of the excess interest tax and increase the scope of the rule in I.R.C. § 884(f)(1)(A), is not authorized by the statute. Moreover, as indicated in subsection (b) above in our discussion of Section 1.884- 4T(a)(2), we believe that the regulations should be liberal in permitting a foreign corporation to treat certain liabilities as U.S. trade or business liabilities.[*] Accordingly, we believe that a foreign corporation which meets the 80% standard should be permitted to make an election to treat an amount equal to its excess interest as interest paid by its U.S. trade or business, but that such treatment should not be mandatory. At the very least, any

[*] Since it appears to be the position of the drafters that, despite the contrary implication of the Conference Committee Report, excess interest cannot qualify for statutory exemptions, the 80% rule may produce favorable, rather than unfavorable, results to foreign corporations where an exemption is available.

mandatory treatment should not be retroactive since this rule could not have been anticipated.

Moreover, the computation and collection of the portion of the foreign corporation's deductions for interest that is not paid by the U.S. trade or business but nonetheless is potentially subject to withholding may be difficult if not impossible. As noted above, the deduction for interest under I.R.C. § 882 does not relate to any specific items of interest, but rather is computed on a formula basis. Under these circumstances, a foreign corporation will have a very difficult time attempting to determine which of its interest payments would be made subject to withholding under the 80% rule but for, for example, the portfolio interest exemption. It is not clear how the foreign corporation could be assured that its interest payment qualified for that exemption (i.e., in the case of bearer debt, by satisfying the requirements of I.R.C. § 163(f)(2)(B) (see I.R.C. § 871(h)(2)(A)) and in the case of registered debt, by obtaining the required certificate of ownership from the holders). Similarly, where the portfolio interest exemption is clearly not available, the regulations provide no guidelines under which a foreign corporation can determine which interest is potentially subject to withholding (or exempt from withholding under a treaty) and which is not. We recommend that, at the very

least, the pro ration of liabilities rule of Section 1.884-4T(b)(5) be replaced with ordering rules similar to those set forth in Section 1.884-4T(b)(6)(including the provision of an election to the foreign corporation similar to that set forth in Section 1.884-4T(b)(6)(2)(ii)). Finally, we do not understand why, under the pro ration of liabilities rule, interest is treated as being paid first with respect to liabilities that are not specifically identified as U.S. liabilities on the foreign corporation's books and records.

(f) Interest Shortfall.

Section 1.884-4T(b)(6) deals with the converse of excess interest, i.e., where the interest paid by the U.S. trade or business exceeds the deductible interest (what one might call “interest shortfall”). The regulations deal with interest shortfall by treating a portion of the interest paid by the U.S. trade or business as not having been paid by the U.S. trade or business. This portion is not subject to U.S. withholding tax. This method of dealing with interest shortfall effectively gives lenders the possibility of reaping a windfall based upon the eventual composition of the foreign corporation's U.S. and foreign assets and liabilities. This method also requires complex rules for determining which lenders qualify for the reduction in withholding tax.

Since it is the foreign corporation, not its lenders, who bears the detriment with respect to excess interest, we believe that it would be more appropriate to give any benefit relating to interest shortfall to the foreign corporation rather than to its lenders. This also would avoid getting the foreign corporation's lenders involved in determining which lender qualifies for any refund.

One possibility is to permit the foreign corporation to obtain a "refund" of any U.S. withholding tax attributable to interest shortfall. This, however, would still require the foreign corporation to determine to which loans the interest shortfall related.

A simpler approach would be to permit interest shortfall from one year to be carried forward or back, without limitation, to offset excess interest from another year. For example, if a foreign corporation has a $2,000X interest shortfall in year 1 and $3,000X of excess interest in year 2, the excess interest otherwise subject to tax in year 2 should be reduced to $1,000X. Alternatively, if the foreign corporation has $3,000X of excess interest in year 1 and pays tax of $900X with respect to such excess interest, and the foreign corporation has a $2,000X interest shortfall in year 2, it should be entitled to carry back the interest shortfall to year 1 and obtain a $600X refund. Moreover, interest shortfall should be considered an item to which an acquiring or distributee corporation in an I.R.C. §381 transaction may succeed.

(g) Different Accrual and Payment Periods.

Section 1.884-4T(b)(7) generally deals with the problem of differences in the amount of interest paid and accrued by an accrual basis foreign corporation. This provision essentially permits a foreign corporation to elect to treat U.S. trade or business interest as having been paid on the earlier of the payment or accrual dates. We believe that this rule is inappropriate and fails to provide an appropriate rule to deal with the common situations where interest which generally accrues before it is paid is not paid until the taxable year after the taxable year in which it partly accrues.

Section 1.884-4T(b)(7)(i) provides that where a foreign corporation accrues interest expense that "would be interest paid" in a later year,[*] and if the appropriate election is in effect in both years, the interest will be treated as paid only once: in the year the interest accrues. This rule appears

[*] The regulations should expressly provide that the determination of whether an accrued interest expense "would be interest paid" in a later year should be made as if the interest were in fact paid in the year the interest accrued.

to require “withholding” under I.R.C. §§ 1441 and 1442 in the year of accrual, which may be difficult or impossible for the debtor to satisfy, since there is no payment actually being made that might fund the withholding obligation. In addition, such a system of withholding may require an automatic “gross up” because the debtor will be funding the lender's withholding tax. Moreover, distortions will result since the withholding tax status (as contrasted with the substantive tax status) of a debt obligation generally depends upon the identity of the holder of the obligation at the time the interest is paid, rather than at the time the interest accrues. See Rev. Rul. 85-193, 1985-2 C.B. 191.*

These problems would not arise under the approach included in our proposal in the Supplemental Report, which suggested that there be a reduction in the amount of excess interest on which the excess interest tax would otherwise be paid by the amount of accrued but unpaid interest, without altering the general rule that withholding applies at the time of payment. We strongly recommend that the final regulations so provide. In any event, in order to avoid possible traps for the unwary, we suggest that the rules of Section 1.884-4T(b)(7) (whether or not modified to reflect our recommendations) be made generally applicable rather than elective, but that taxpayers be permitted to elect out of these rules.

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* See also our comment on Section 1.884-4T(b)(8)(ii), in subsection (h), below.

Where interest is paid prior to the year in which it accrues, Section 1.884-4T(b)(7)(ii) permits the foreign corporate debtor to elect to reduce the amount of its excess interest in the later year by the amount of interest paid in the earlier year. (As in the case of the election under Section 1.884-4T(b)(7)(i), this election must be in effect for both years.) In order to avoid possible abuse by taxpayers, the regulations should clarify that the interest paid in the earlier year should not also reduce the amount of excess interest in such earlier year. (Consider, for example, a situation where the interest deduction under I.R.C. § 882 for the year exceeds the interest accrued that year by the U.S. trade or business but is less than the interest paid in such year by the U.S. trade or business.)

(h) Effect of Treaties on Interest Paid by U.S. Trade or Business.

Section 1.884-4T(b)(8) deals with the effect of treaties. Subparagraph (ii) of that section provides that a foreign corporation which receives interest paid by a U.S. trade or business of another foreign corporation shall be entitled to claim treaty benefits only if the recipient is a qualified resident of a foreign country that has an income tax treaty with the United States providing for such benefit and, in the case of interest paid in a taxable year beginning after December 31, 1988, with respect to an obligation having a maturity not exceeding one year, each foreign corporation that beneficially

owned the obligation prior to maturity was a qualified resident of a foreign country with which the United States had an appropriate income tax treaty. There is no statutory basis for this less-than-one-year-obligation rule. The rule appears to conflict with existing law (see Rev. Rul. 85-193, 1985-2 C.B. 191). Furthermore, we believe the rule to be unworkable in practice. Obligations of this sort frequently constitute non-interest bearing commercial paper that may change hands several times before maturity. The borrower, making payment at maturity, would normally have no way of knowing the identity or status (e.g., as a foreign corporation or as a “qualified resident”) of the persons who held the obligation while it was outstanding. Accordingly, we suggest that this rule be eliminated.

(i) Interest Paid by Partnerships.

The Section 1.884-4T branch level interest tax provisions do not treat all of a foreign corporation's distributive share of interest paid by a partnership engaged in trade or business in the U.S. as interest paid by a U.S.

trade or business of the foreign corporation in all cases. This is so despite the fact that I.R.C. § 861(a)(1) and Treas. Reg. §1.861-2(a)(2) treat such interest as U.S. source even to the extent it relates to liabilities attributable to non-U.S. business assets. (Section 861(a)(1) provides that interest on obligations of non-corporate residents of the United States is treated as income from sources within the United States, and Treas. Reg. Section 1.861-2(a)(2) defines "resident" of the United States for this purpose to include a domestic or foreign partnership which is engaged in a trade or business in the United States.)

We think that a foreign corporate partner's distributive share of any interest paid by such a "resident partnership" should be treated as interest paid by the partner's U.S. trade or business for all purposes of Section 1.884-4T. As discussed below, failure to do so raises the possibilities of (i) U.S. withholding tax and excess interest tax with respect to the same interest payments, (ii) more burdensome interest shortfall consequences where a foreign corporation incurs interest expense through a partnership than when the foreign corporation incurs the interest expense directly, and (iii) inadvertent treatment of a portion of a foreign corporation's directly incurred interest expense attributable to non-U.S. business liabilities as interest paid by the U.S. business where the foreign corporation is subject to the eighty-percent rule of Section 1.884-4T(b)(5).

Section 1.884-4T(c)(2) does provide that the amount of the foreign corporation's distributive share of interest paid by a partnership doing business in the United States shall reduce the amount of the foreign corporation's excess interest for the year. However, (i) no reduction is permitted on account of the foreign corporate partner's distributive share of interest expense attributable to a liability described in Section 1.884-4T(b)(3) or would be so described if entered on the partner's books (even though such amounts would be subject to U.S. withholding tax as discussed above) and (ii) any reduction under this provision cannot exceed the foreign corporation's excess interest for the year.

The preamble to the regulations states that the effect of this provision is that interest paid by a partnership is not subject to taxation both under I.R.C. §§ 871(a) or 881 and as excess interest. This clearly is not true. For example, assume that a foreign corporation's only asset is a 50% interest in a partnership having assets of $4,000X and liabilities of $900X. The assets and liabilities relate to a $2,000X foreign business asset secured by a $600X liability incurred in such business, and a $2,000X U.S. business asset secured by a $300X liability

incurred in such business. Both liabilities bear interest at 10%. Accordingly, the foreign corporation's distributive share of interest expense of the partnership is $45X, $30X of which relates to the foreign business liability and $15X of which relates to the U.S. business liability. Under the rules of Treas. Reg. § 1.882-5 and Temp. Reg. § 1.861-9T(e)(7), the foreign corporation's deductible interest for U.S. tax purposes is $22.5X ((1/2 times $2,000X) times (1/2 times $900X)/(l/2 times $4,000X) times 10%). Since the foreign corporation is not considered to have any interest paid by its U.S. business, its excess interest is also $22.5X. Section 1.884- 4T(c)(2), however, permits this excess interest to be reduced by the $15X of interest attributable to the U.S. business liability, leaving $7.5X of excess interest. This excess interest will be subject to excess interest tax despite the fact that, because the partnership is a U.S. resident, the entire $45X of interest paid by the partnership would also be subject to U.S. withholding tax if paid to foreign persons.

If the facts were the same as in the illustration above, except that the entire $900X of partnership liabilities are U.S. business liabilities, the foreign partner's deductible interest for U.S. tax purposes would still be limited to

$22.5X. As an initial matter, the foreign corporation would have. $22.5X of excess interest, but this amount would be reduced to zero, but not below zero, pursuant to Section 1.884-4T(c)(2). Accordingly, despite the fact that $22.5X of the $45X of interest paid with respect to the U.S. business would not be deductible in the U.S., any foreign lenders to the partnership would not obtain the benefits of reduced withholding with respect to interest short fall provided currently by the regulations pursuant to Section 1.884-4T(b)(6) (nor would the foreign corporate partner get the benefit of a carryover of interest shortfall under our recommendation in subsection (f) above), despite the fact that such reduced withholding (or carryover of interest shortfall benefits) would apply if the foreign corporation had held a 50% interest in the partnership's assets and liabilities directly.

As noted above, a portion of a foreign corporation's directly incurred interest expense attributable to non-U.S. business liabilities may be treated inadvertently as interest paid by the foreign corporation's U.S. business where the foreign corporation is a partner in a partnership and is subject to the 80% rule of Section 1.884-4T(b)(5). Under the 8 0% rule, the amount of interest paid by a U.S. trade or business of a foreign corporation is increased by the excess of the foreign

corporation's interest deduction over the interest paid by the U.S. trade or business. Since the foreign corporation's distributive share of interest paid by a partnership is included in its deductible interest but all of such income is not considered interest paid by its U.S. trade or business, a portion of the foreign corporation's interest expense attributable to foreign business liabilities will be treated as paid by the foreign corporation's U.S. trade or business and be potentially subject to U.S. withholding. For example, assume that a foreign corporation is a 50% partner in a partnership whose only asset is a $2,000X U.S. business asset subject to an $800X liability with interest payable at 10%. Assume that the foreign corporation also owns directly a $3,000X U.S. business asset subject to a $1,200X liability bearing interest at 10% and a $1,000X foreign business asset subject to a $400X liability bearing interest at 10%. $160X of the $200X interest expense borne by the foreign corporation would be deductible for U.S. tax purposes.[*] However, only $120X of interest initially would be considered to be paid by

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[*] $$\frac{(6.5 * \$2000X) + \$3{,}000) * ((.5 \text{ X } \$800X) + \$1{,}200X + 400X)}{(.5 * \$2000X) + \$3{,}000X + \$1{,}000X}$$

$$= \frac{\$4{,}000X * \$3{,}000X}{\$5{,}000} * 10\%$$

its U.S. trade or business for branch interest tax purposes. Pursuant to Section 1.884-4T(b)(5), however, the amount of interest paid by its U.S. trade or business ($120X) is increased by the excess of its interest deduction ($160X) over the interest paid by its U.S. trade or business ($120X), or $40X. Accordingly, the $40X of interest paid with respect to its foreign business liability will be treated as interest paid by a U.S. trade or business. If, as appears may be the case, the 80% rule is applied before the partnership interest, there will be no "excess interest" to which to apply the $4 0 interest attributable from the partnership. As a result all $200 in interest paid by the foreign corporation will be potentially subject to U.S. withholding tax even though the foreign corporation will not be getting a deduction on account of such interest for U.S. tax purposes'.

Despite the fact that the regulations do not generally treat a foreign corporate partner's distributive share of interest paid by a partnership as interest paid by a U.S. trade or business, subparagraph (iv) of Section 1.884-4T(b)(8) limits the relief that may be claimed under an income tax treaty with respect to a foreign corporate partner's distributive share of interest paid by a partnership. Since the regulations as a general matter choose not to look-through partnerships to

their foreign corporate partners, we believe it is inappropriate to require such a look- through only where it will result in greater U.S. tax. At the least, this rule should be limited to cases where the partnership is formed primarily for purposes of reducing U.S. tax. Moreover, if this rule or any variation is implemented, the regulations should establish procedures under which a foreign corporate partner should notify the partnership of its status as a foreign corporation and as a qualified resident of a treaty country.

Our recommendation that a foreign corporate partner's distributive share of any interest paid by a partnership engaged in business in the United States should be treated as interest paid by the partner's U.S. trade or business for all purposes of Section 1.884-4T follows from the treatment under I.R.C. § 861(a)(1) and Treas. Reg. § 1.861-2(a)(2) of all interest paid by such a “resident partnership” as U.S. source interest. If this general sourcing rule were modified, our recommendation would change accordingly. For example, the source of a foreign corporate partner's distributive share of interest paid by such a “resident partnership” could be determined under the rules of Section 1.884-4T (if a partnership so elects) as if the partnership were a foreign corporation.

(j) Tax on Excess Interest -- Effect of Treaties.

Section 1.884-4T(c)(3)(i) adopts the general rule suggested by the 1986 Act Bluebook,* namely, that in determining the rate of tax imposed on the excess interest of a foreign corporation which is a qualified resident of a country with which the United States has an income tax treaty, the appropriate treaty to look to is the one between the United States and the country of the foreign corporation's residence, rather than treaties between the United States and countries with respect to which the recipients of the interest are residents. Subparagraph (ii) of Section 1.884-4T(c)(3) provides that any provision in an income tax treaty that exempts or reduces the rate of tax on interest paid by a foreign corporation does not prevent imposition of the tax on excess interest or reduce its rate. In both our Report and our Supplemental Report we noted that most United States income tax treaties permit taxes only on "income" or "profits" that are effectively connected with a foreign corporation's United States permanent establishment and that, in computing these profits, deductions are to be allowed with respect to the permanent establishment. In our Supplemental Report we suggested that, since the tax on excess interest

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* p. 1042.

appears to take away from the permanent establishment a significant portion of the benefit of the deduction for interest that otherwise is provided, the tax on excess interest should not be imposed where the foreign corporate taxpayer is a qualified resident of a country that has an income tax treaty with the United States which contains such a provision. While subparagraph (ii) appears to have rejected this position, we question the validity of this aspect of the regulations.

The preamble to the regulations states that the effect of nondiscrimination provisions in tax treaties is under consideration in connection with the forthcoming Treasury Department study of the tax treaties program. We assume that the position we have taken, as described above, is also under consideration. In any event, we suggest that such issues are too important to be held in abeyance for much longer. If the Treasury Department does not expect to complete its study of the tax treaties program by the end of 1988, an announcement should be made concerning the current position of Treasury and the IRS on these issues. We continue to believe that there should be a treaty exemption from the tax on excess interest.

(k) Election to Reduce Excess Interest.

The Conference Committee added the rule providing

for a tax on excess interest, apparently as a proxy for the withholding tax that would be payable on deductible interest if it had been paid by a U.S. trade or business of the foreign corporation. If no tax were imposed, it might be argued that the benefit of the interest deduction reduced the amount of net income subject to U.S. tax without allowing the U.S. the opportunity to collect or withhold tax on amounts of interest paid most likely to foreign lenders. Assuming this to be the rationale for the tax on excess interest, we believe that a foreign corporation should be allowed to elect, on an annual basis, to reduce its otherwise allowable interest deductions determined under the rules of Treas. Reg. § 1.882-5 in order to avoid the tax on excess interest. Once the deduction is waived, there would be no reason to be concerned that the U.S. tax base is being eroded. An annual election is recommended because, with all the new rules applicable to, and new proposals that could affect the U.S. federal income tax liability of, foreign corporations, such corporations should be given the flexibility they need to make the election based upon their potentially changing circumstances.*

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* Consider, for example, the potential application to foreign corporations of the alternative minimum tax and the passive loss rules (for closely-held foreign corporations).

Of course, if such an election were permitted, other adjustments would also have to be made. In particular, any waived interest deductions should not reduce the foreign corporation's effectively connected earnings and profits for purposes of I.R.C. § 884(b). In addition, the amount of the foreign corporation's U.S. liabilities determined under Section 1.884-1T(e)(1) should be reduced by the amount of liabilities otherwise allocable to the United States under Treas. Reg. § 1.882-5 but with respect to which interest deductions have been waived. Moreover, in a subsequent year in which the foreign corporation has interest shortfall (whether the rule currently provided by Section 1.884-4T(b)(6) is in effect or our recommendations with respect to carryover of interest shortfall have been adopted), the foreign corporation should be permitted deductions for the interest shortfall to the extent of the amount of excess interest waived in the earlier year.

(1) Election by Treaty Residents to Reduce Excess Interest.

Even if it is determined that as a general rule it is not appropriate to permit foreign corporations to avoid the excess interest tax by electing to reduce their deductible interest expense, we strongly recommend that such an election be made available to any foreign corporation resident in a country whose treaty with the United States contains either a nondiscrimination provision or provisions relating to permanent establishments like those discussed in subsection (j), above.

4. Section 1.884-5T -- Effect of Tax Treaties

(a) Significance of Qualified Resident Status

The determination whether a corporation is a qualified resident of a country with which the United States has an income tax treaty is important for five reasons:

(i) Under I.R.C. § 884(e)(1) as recently amended* the branch profits tax will not apply to a corporation (or will apply at a reduced rate) if it is a qualified resident of a country whose treaty with the U.S. prohibits the tax (or permits it only at a reduced rate).

(ii) U.S. withholding taxes at the full 30% rate apply to U.S. source dividends which are either (a) paid by a foreign corporation to a payee which is not a qualified resident of the country whose treaty with the United States would otherwise reduce the rate of tax on the dividends, and (b) the foreign corporation is not a qualified resident of a country whose treaty with the United States would otherwise exempt (or reduce the rate of tax on) such dividends.

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* Technical and Miscellaneous Revenue Act of 1988, Section 1042(q)(2)

(iii) Payments of interest by the U.S. trade or business of a foreign corporation are treated as made by a U.S. corporation and thus are subject to 30 percent U.S. withholding tax unless either (a) the payee is a qualified resident of a country whose treaty with the United States would otherwise exempt (or reduce the rate of tax on) such interest, or (b) the payor is a qualified resident of such a country.

(iv) Under the temporary regulations a foreign corporate partner's share of interest paid by a partnership engaged in business in the United States would not be entitled (a) to an exemption of reduced rate of withholding tax under a U.S. treaty with the payee's country of residence unless the payee is a qualified resident of such country, or (b) to such benefits under the treaty with the foreign corporate partner's country of residence unless such partner is a qualified resident of that country.

The temporary regulations provide four alternative methods for determining whether a corporation is a qualified resident of a country.[*] We are concerned that the compliance requirements for those various tests appear so unrealistic

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[*] _See_, _in general_, Section 1.884-57T(a)

to implement in practice that they raise the specter of a repeat of- the criticism and damage to the credibility of the tax system that resulted from the early efforts to implement the FIRPTA provisions. We have a number of suggestions as to where such requirements can be eliminated, or modified so as to be more practical, while still dealing effectively with the apparent underlying concern.

(b) Stock Ownership/Base Erosion Test

Sections 1.884-5T(b) and (c) provide that a corporation is a qualified resident of a country if (i) at least 50 percent by value of its stock is owned by individual residents of the foreign corporation's country of residence (or by U.S. citizens or residents) during at least half of the number of days in the foreign corporation's taxable year, (ii) it obtains certain documentation sufficient to establish that such ownership test has been met, and (iii) less than 50 percent 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.

Section 1.884-1T(h)(2)(i) provides a special rule for a corporation which is a qualified resident for a given taxable year solely because it meets this stock ownership/base erosion test. Unless the corporation is a qualified resident for a 36-month period including such taxable year, it is denied the benefit of a treaty prohibiting or reducing the branch profits

tax with regard to the portion attributable to non-previously taxed accumulated effectively connected earnings and profits which were accumulated during prior taxable years in which the foreign corporation was not a qualified resident under any of the tests for qualified residence. A corporation which fails this 36-month test with respect to a given taxable year may seek a refund of branch profits tax for the year if it subsequently meets the 36-month test with respect to such year by the close of its second succeeding taxable year. Section 1.884-1T(h)(2)(ii).

In order to satisfy the base erosion test, a foreign corporation generally must establish that less than 50 percent of its income is used to meet liabilities to persons who are residents neither of the foreign corporation's treaty country nor of the United States ("disqualified persons"). The abuse at which the base erosion test is aimed does not exist where the recipient of the payment is taxable on its receipt in the same manner as a U.S. resident (i.e., where the income is effectively connected with the conduct of a U.S. trade or business). Accordingly, we recommend that a payment by a foreign corporation to a foreign person be considered a payment to a U.S. resident for purposes of the base erosion test if the foreign corporation obtains a Form 4224 from the foreign person which permits the foreign corporation not to withhold on payments to the foreign person.

We also suggest that payments of interest to foreign persons which qualify for the I.R.C. Section 871(h) or I.R.C. Section 881(c) (portfolio interest) exemption should not be treated as payments to disqualified persons. By definition, such payments are to unrelated parties and do not present an abusive situation.

In determining whether the stock ownership test has been met, our previous Report in February, 1987 on the basis of the legislative history of this provision, proposed that the burden of proof should be on the taxpayer. We respectfully suggest, however, that the requirements for documenting stock ownership contained in Section 1.884-5T(b)(3) and (4) are so onerous that in all but a few cases they will make the stock ownership/base erosion test virtually meaningless. The requirement in Section 1.884-5T(b)(4) that an individual stockholder identify himself may be reasonable, but to require, in addition as does Section 1.884-5T(b)(4)(ii), a certificate of residence signed by the authorities of the foreign country is impractical. We believe that most foreign countries, like the United States, do not generally enforce the tax law of another country. Moreover, Section 1.884-5T(b)(4)(ii)'s requirement that the certificate contain the official seal of the foreign government "if it generally affixes such a seal to official documents" raises the question as to what is "general" administrative practice in a foreign country and what is not. We suggest that this requirement goes far beyond the legislative intent in creating this test for qualified resident status and strongly recommend that it be deleted. Similarly, the intermediary ownership and verification statements required by Sections 1.8845T(b)(5) and (6) are so cumbersome it is unlikely they will be utilized to any significant extent.

(c) Publicly Traded Test

Section 1.884-5T(d) provides that a corporation will be treated as a qualified resident of a treaty country if (i) its stock is primarily and regularly traded on one or more established securities markets in that country, the United States or both, or (ii) it is wholly owned by a foreign corporation resident in the same foreign country or by a U.S. corporation and the stock of such parent is so traded.

The definition of "established securities market" contained in Section 1.884-5T(d)(2) is similar to the definition of the term for purposes of FIRPTA contained in Treas. Reg. § 1.897-1(m), which the Report suggested that the regulations should adopt. The temporary regulations, however, add the requirement that a foreign exchange not only be the principal exchange in the foreign country, but also that it have an annual value of shares traded exceeding $1 billion during each of the three calendar years immediately preceding the beginning of the taxable year. This requirement raises problems where a foreign country has multiple exchanges for which individual volume figures may not be readily available. For example, the 1987 annual report of the International Federation of Stock Exchanges (to which Section 1.884-5T(d)(1)(ii) refers) provides only aggregate figures for the German, Swiss and Italian exchanges. Accordingly, we recommend that the Treasury regularly publish lists of major exchanges which qualify as "established securities markets".

The practical utility of the “publicly traded” test for qualified resident status is significantly diminished by the limitation contained in Section 1.884-5T(d)(4)(ii) that a class of stock will not be treated as regularly traded if 100 or fewer persons own 50 percent or more of the outstanding shares of that class. For this purpose, persons treated as related within the meaning of I.R.C. § 267(b) will be treated as one person. We respectfully suggest that there is no way that a corporation with bearer shares can assure itself that it is not a closely held corporation under this definition.

Moreover, even a corporation with registered shares cannot do so without an inordinate amount of effort, assuming, as is likely to be the case, that a large number of its shares are held in “street name” so that it has no knowledge of either the actual owner of the shares or of the relationship, if any, between actual owners. Thus, in most cases, the 100 person rule makes qualification under the publicly traded test a practical impossibility. We strongly recommend that it be deleted.

Even if the 100 person rule is retained, we suggest that the regulations be amended to provide that shares of a corporation's stock as to which the stockholder satisfies the documentation requirements for establishing residence in the treaty country in which the foreign corporation is incorporated will be treated as a second class of stock and will not be taken into account in applying the 100 person rule to the remaining shares. For example, assume that a foreign corporation's common stock is widely held by a large number of persons and is actively traded on a securities exchange in the country of its

incorporation but that 40% of its shares are owned by three family groups each of which is treated as one person within the meaning of I.R.C. § 267(b) and as to all of whom residence in the foreign country has been substantiated by satisfactory documentary evidence. If these persons are included in applying the 100 person test, because there are other reasonably large holders as to whom such documentary evidence is unavailable, the test will not be satisfied. On the other hand, if the 100 shareholder test is applied only to the remaining 60% of the corporation's shares, that test will be satisfied. We propose that the regulations be amended to incorporate such a rule.

(d) Active Business Test

Under Section 1.884-5T(e) a corporation will be a qualified resident of a treaty country if it is a resident of such country, is engaged in the active conduct of a trade or business in such country, has a substantial presence in such country, and either (1) the activities that give rise to the income for which a treaty exemption or rate reduction is claimed constitute part of a U.S. trade or business in which the corporation is engaged and such U.S. trade or business is an integral part of its active trade or business in the treaty country, or (2) in the case of interest received by the corporation for which a treaty exemption or rate reduction is claimed, the interest is derived in connection with or is incidental to such an active trade or business in the treaty country.

Section 1.884-5T(e) makes a cross-reference to the regulations under I.R.C. § 367(a)(3) in order to define

active conduct of a trade or business in the case of corporations which do not qualify as banking, financing or credit institutions under the laws of the foreign country in which they are resident. The cross reference is not very helpful since Treas. Reg. § 1.367(a)-2T(b)(3) essentially provides a facts and circumstances test for whether a corporation is engaged in an active business, stating that "[in] general, a corporation actively conducts a trade or business only if the officers and employees of the corporation carry out substantial managerial and operational activities." Analogies which might provide a more detailed (and therefore useful) gloss on the concept of active business include I.R.C. §§ 355 and 954 and pre-TEFRA § 346 (partial liquidations), and accordingly we recommend that one or more of these be adopted.

A corporation has a "substantial presence" in its country of residence if "for the taxable year" the average of three ratios set forth in Section 1.884-5T(e)(3) exceeds 25 percent and each ratio is at least equal to 20 percent. The temporary regulations do not provide guidance as to when the separate ratios are to be computed. We recommend that it should be permissible to compute the asset ratio using an average of quarterly amounts, end of the year figures, or any other reasonable method.

A U.S. business is an "integral part" of an active foreign business of the corporation under Section 1.884-5T(e)(4) if "an active trade or business conducted by the foreign

corporation in both its country of residence and in the United States comprises, in principal part, complementary and mutually interdependent steps in the United States and its country of residence in the production and sale or lease of goods or in the provision of services." Section 1.884-5T(e)(4)(ii) establishes a presumption that a U.S. business is an "integral part" of an active business with respect to loans made to the public if the corporation is engaged in the active conduct of a banking or financial business and at least 50 percent of the principal amount of the foreign corporation's loans are to residents of the foreign corporation's country of residence. We have several problems with the presumption as proposed. First, we do not understand why these conditions bear on whether a foreign corporation's U.S. business is an "integral part" of its overall business. Second, the presumption as drafted is only available with regard to loans and covers no other banking or finance activities. If it is to be used, it should cover all banking and financial activities, both to give the corporation an objective assessment and to prevent the rule to be availed with only a limited amount of loan activity. Third, foreign banks may not be able to determine the residence (presumably, using U.S. tax concepts) of all customers to whom loans are made, especially if U.S. tax principles are to be used in determining residence.

If some additional quantitative determination is to be used, we believed that a better course would be to use factors that would reflect the locations from which the corporation is operating and that would also be determinable from the regular business records of the corporation. For example, most if not all corporations conducting a banking or financial business must report to various regulatory authorities with respect to the loans booked to their various branches. The presumption might be reformulated to speak in terms of more than 50% of the total amount of loans as of appropriate testing dates (quarterly, annually, etc.) being made by the branches in its country of residence as shown on the reports to regulators.

(e) Ruling Request

Due to the complexity and, in our opinion, onerous and impractical nature of the rules described above, in many cases a foreign corporation will be hard-pressed to determine whether it is or is not a qualified resident of a treaty jurisdiction. Section 1.884-5T(f) provides for a ruling procedure. However, in many circumstances the ruling may not be available on a timely enough basis to be useful to tax payers, especially those facing the question of whether withholding is required on a payment of interest. We recommend that the Service adopt an expedited and special process for issuing qualified resident rulings.