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Application of the Branch Profits Tax to Certain Foreign Corporations

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COMMENTS

Application of the Branch Profits Tax to Certain Foreign Corporations

The branch profits tax (BPT)[1] was enacted as part of the Tax Reform Act of 1986[2] in order to cure perceived inequities in the taxation of U.S. branches of foreign corporations as compared to that of U.S. subsidiaries of foreign corporations.[3] Although these taxes have their primary effect upon certain service-oriented foreign corporations operating in the United States, they also generally affect all foreign corporations with U.S. branches.[4]

The BPT is potentially applicable to any foreign corporations with branch operations in North Carolina;[5] some 229 foreign corporations have their U.S. headquarters in this state.[6] This Comment examines the nature of the BPT through a discussion of the bases for

[1] The branch profits tax (BPT), which imposes a 30% tax on the "dividend equivalent amount" of a U.S. branch of a foreign corporation, I.R.C. § 884(a) (1986), is only one of two branch level taxes enacted by the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986). The other branch tax is the branch level interest tax (BIT), which results in the imposition of a 30% tax on interest paid by a U.S. branch of a foreign corporation. I.R.C. § 884(f) (1986). *See also id.* §§ 871, 881 and *infra* note 19.

[2] Pub. L. No. 99-514, 100 Stat. 2085 (1986) [hereinafter The Tax Reform Act of 1986].

[3] S. REP. NO. 313, 99th Cong., 2d Sess. (1986) [hereinafter SENATE REPORT]. The Senate Report notes that prior to the inception of the BPT, nearly all foreign corporations were able to avoid liability for the second-level withholding tax. *See id.* at 401. *See also infra* notes 11-18 and accompanying text; Blessing, *The Branch Tax*, 40 TAX LAW. 587, 588-89 (1987); Sternlicht, *Inequality After the Branch Profits Tax*, 14 INT'L TAX J. 245, 245 (1988); Vito, *Integration of Branch Profits Tax with Existing Tax Treaty Provisions*, TAX ADVISOR, Sept. 1988, at 636.

[4] *See* Fisher & Rubinstein, *The Branch Level Taxes of the Tax Reform Act of 1986*, TAX ADVISOR, Sept. 1987, at 634.

[5] *See infra* notes 50-58 and accompanying text (discussing possible application of the BPT to foreign corporations doing business in North Carolina).

[6] KPMG PEAT MARWICK, SURVEY OF FOREIGN BASED COMPANIES WITH U.S. HEADQUARTERS IN NORTH CAROLINA 2 (1988) [hereinafter THE SURVEY]. This figure includes only those operations with U.S. headquarters in North Carolina. *Id.* There are other foreign corporations with branches or subsidiaries in North Carolina which are not the corporations' U.S. headquarters. *See* North Carolina Department of Commerce, Foreign-Owned Firms Operating in North Carolina (1987) [hereinafter Foreign-Owned Firms]. KPMG Peat Marwick estimates that its survey covers only 85% of foreign corporations with U.S. headquarters in North Carolina. THE SURVEY, *supra*, at 2.

its enactment[7] and the mechanics of its application.[8] The consequences of the tax are also examined, as is recent criticism regarding the impact of the BPT on international tax treaties.[9]

I. The Nature of the Branch Profits Tax

In enacting the BPT, Congress sought to create a situation in which it would be immaterial, in terms of tax treatment, whether a foreign corporation operated through a U.S. branch or a U.S. subsidiary.[10] An analysis of the state of the law in this area prior to the adoption of the Tax Reform Act of 1986 underscores the impact of the BPT on the manner in which a foreign corporation decides to do business in the United States.

A. Tax Treatment Prior to the Branch Profits Tax

In general, a U.S. corporation that pays dividends to a foreign shareholder not engaged in a trade or business within the United States must withhold thirty percent of the payment as a tax.[11] Some interest paid to foreign shareholders is also subject to a thirty percent withholding tax. Similarly, foreign corporations which have most of their operations in the United States and that pay dividends or interest (of the types taxable if paid by a U.S. corporation) to a foreign shareholder must withhold a portion of the payments.[12] This is often referred to as a second-level withholding tax. However, prior to the Tax Reform Act of 1986, dividends and interest paid by such a foreign corporation were generally not subject to the second-level withholding tax unless fifty percent or more of its gross income for a three-year period was "effectively connected" with a U.S. trade or business.[13] The original function of the second-level withholding tax was in part to treat dividends and interest payments by foreign corporations with U.S. operations like similar payments made by

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7 *See infra* notes 11-18 and accompanying text (discussing the history of the BPT).

8 *See infra* notes 19-34 and accompanying text (discussing the mechanics and limitations of the BPT).

9 *See infra* notes 35-49 and accompanying text (discussing the interaction between the BPT and international tax treaties).

10 H.R. CONF. REP. No. 841, 99th Cong., 2d Sess. II-647 (1986) [hereinafter CONFERENCE REPORT].

11 *See, e.g.*, I.R.C. §§ 871(a)(1)(A), 881(a)(1) (1954). *See also* SENATE REPORT, *supra* note 3, at 400.

12 SENATE REPORT, *supra* note 3, at 400.

13 I.R.C. §§ 861(a)(1)(C), 861(a)(1)(D), 861(a)(2)(B), 871(a)(1)(A),. 881(a)(1) (as these sections existed prior to the passage of the Tax Reform Act of 1986); see *infra* note 21 and accompanying text for the meaning of "effectively connected." Withholding in such a case would be imposed pro rata on that part of the dividend payments "effectively connected" with the U.S. trade or business. *See* Plutte, *Notice 87-56, The Interaction of Branch Profits Tax and Tax Treaties*, 17 TAX MGMT. INT'L J. 31, 31 (1988). Additionally, the second-level withholding tax applies only in absence of a contrary treaty provision. *See* Delta, *Branch Profits Tax Under the TRA 1986*, 16 TAX MGMT. INT'L J. 39, 39 (1987).

U.S. corporations.[14]

As a result of this system, foreign branches enjoyed more favorable tax treatment than did U.S. subsidiaries of foreign corporations.[15] If the foreign corporation which was distributing dividends kept its income which was "effectively connected" with a U.S. trade or business below the fifty percent threshold, it avoided the second-level withholding tax on the distributed dividends.[16] However, similar distributions from domestic subsidiaries of foreign corporations were subject to withholding.[17] Additionally, the Internal Revenue Service (IRS) had some problems enforcing these U.S. withholding requirements on foreign corporations.[18]

B. Mechanics of the Branch Profits Tax

The BPT, a tax on the profits deemed remitted by a U.S. branch of a foreign corporation to its head office, was enacted as a substitute for the second-level withholding tax on dividends.[19] Because impo-

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[14] SENATE REPORT, *supra* note 3, at 400.

[15] Fisher & Rubinstein, *supra* note 4, at 634.

[16] *Id. See also* Blessing, *supra* note 3, at 588-89 (discussing objections to prior law).

[17] Fisher & Rubinstein, *supra* note 4, at 634.

[18] *See* Sternlicht, *supra* note 3, at 245 ("it was difficult to enforce the payment of withholding taxes since the taxes were imposed on payments by foreign corporations to foreign persons (shareholders) who often had no contact with the United States.").

[19] I.R.C. § 884(a) (1986) (the BPT will not replace the second-level withholding tax on dividends if a U.S. tax treaty with a foreign country reduces the rate, or prohibits the BPT's imposition, unless there has been treaty shopping). The text of section 884(a) is as follows:

> (a) Imposition of tax. — In addition to the tax imposed by section 882 for any taxable year, there is hereby imposed on any foreign corporation a tax equal to 30 percent of the dividend equivalent amount for the taxable year.

Id.

The BIT (*see supra* note 1), enacted concurrently with the BPT, was meant to replace the second-level withholding tax on interest paid to foreign persons, I.R.C. § 884(f) (1986). Section 884(f) states:

> (f) Treatment of interest allocable to effectively connected income. —
>
> (1) In general. — In the case of a foreign corporation engaged in a trade or business in the United States, for purposes of sections 871, 881, 1441, and 1442 —
>
> (A) any interest paid by such trade or business in the United States shall be treated as if it were paid by a domestic corporation, and
>
> (B) to the extent the amount of interest allowable as a deduction under section 882 in computing the effectively connected taxable income of such foreign corporation exceeds the interest described in subparagraph (A), such foreign corporation shall be liable for tax under section 881(a) in the same manner as if such excess were interest paid to such foreign corporation by a wholly owned domestic corporation on the last day of such foreign corporation's taxable year. Rules similar to the rules of subsection (e)(3)(B) shall apply to interest described in the preceding sentence.
>
> (2) Effectively connected taxable income. — For purposes of this subsection, the term "effectively connected taxable income" means taxable income which is effectively connected (or treated as effectively connected) with the conduct of a trade or business within the United States.

Id. As with the BPT, the BIT's 30% rate can be overridden by an international tax treaty to the contrary. *See* Sternlicht, *supra* note 3, at 250-51 n.5.

sition of the BPT would not depend upon whether the foreign corporation's U.S. income exceeded an arbitrary threshold, Congress hoped the disparity between taxation of a U.S. branch and a U.S. subsidiary would be eliminated.[20]

Under section 882 of the Internal Revenue Code (IRC), a foreign corporation engaged in a U.S. trade or business must pay the corporate tax on income that is "effectively connected" with its U.S. trade or business in addition to paying a BPT.[21] The BPT is imposed at thirty percent of the corporation's "dividend equivalent amount" for the tax year;[22] the dividend equivalent amount is defined as the foreign corporation's "effectively connected earnings and profits," and is subject to two adjustments and a limitation on earnings and profits.[23] To the extent that the branch's income is re-

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[20] SENATE REPORT, *supra* note 3, at 401-02.

[21] I.R.C. § 882(a)(1) (1986). This section reads in part, "[a] foreign corporation that is engaged in a trade or business within the United States . . . [is] taxable as provided in section 11, . . . or 1201(a) on its taxable income which is effectively connected with the conduct of a trade or business." *Id.* The phrase "effectively connected" has a technical meaning within the Internal Revenue Code. There are three situations in which the taxable income of a foreign corporation will be considered "effectively connected" to its trade or business within the United States. I.R.C. § 864(c) (1986). First, an "asset-use test" or a "business-activities test" is applied to determine if such income is "effectively connected" if a foreign corporation derives fixed or determinable income or capital gains. *Id.*; Treas. Reg. § 1.864(c)(1)(i) (1986). If a foreign corporation has income derived from U.S. sources which is not fixed or determinable, the income is automatically considered "effectively connected." I.R.C. § 864(c)(3) (1986). Finally, certain types of foreign source income are considered "effectively connected"; for example: (1) rents, royalties or gains on sales of intangible property; (2) dividends or interest, or gain or loss from sales of stock or securities; and (3) income, gain or loss from the sale of goods or merchandise through a U.S. office. This income must be attributable to an office or other fixed place of business within the United States. *Id.* § 864(c)(4).

[22] *Id.* § 884(a).

[23] *Id.* §§ 884(b), 884(d)(2). Section 884(b) states:

> (b) Dividend equivalent amount. — For purposes of subsection (a), the term "dividend equivalent amount" means the foreign corporation's effectively connected earnings and profits for the taxable year adjusted as provided in this subsection:
>
> (1) Reduction for increase in U.S. net equity. —
>
> If —
>
> (A) the U.S. net equity of the foreign corporation as of the close of the taxable year, exceeds
>
> (B) the U.S. net equity of the foreign corporation as of the close of the preceding taxable year,
>
> the effectively connected earnings and profits for the taxable year shall be reduced (but not below zero) by the amount of such excess.
>
> (2) Increase for decrease in net equity. —
>
> (A) In general. — If —
>
> (i) the U.S. net equity of the foreign corporation as of the close of the preceding taxable year, exceeds
>
> (ii) the U.S. net equity of the foreign corporation as of the close of the taxable year, the effectively connected earnings and profits for the taxable year shall be increased by the amount of such excess.
>
> (B) Limitation. — The increase under subparagraph (A) for any taxable year shall not exceed the aggregate reductions under paragraph (1) for prior taxable years to the extent not previously taken into account under subparagraph (A).

invested in the United States, the dividend equivalent amount is reduced.[24] It is increased in any subsequent year to the extent those reinvested earnings are remitted to the home office of the foreign corporation.[25] Finally, the dividend equivalent amount is limited to current and accumulated earnings and profits attributable to the branch's "effectively connected" income.[26] This limitation is meant to ensure that the dividend equivalent amount "is reduced by Federal and foreign income taxes, by capital losses not allowed in computing taxable income, and by other adjustments that would affect the amount of earnings that could be repatriated as a dividend if the branch operated as a corporation."[27]

"Effectively connected earnings and profits" are earnings and profits, before reduction by any distributions, attributable to income that is "effectively connected" with a U.S. trade or business.[28] It is not necessary for a foreign corporation to have an office or other

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Id. See *infra* note 28 for the text of section 884(d)(2).

U.S. net equity is defined in section 884(c) as follows:

> (c) U.S. net equity. — For purposes of this section —
> (1) In general. — The term "U.S. net equity" means —
> (A) U.S. assets, reduced (including below zero) by
> (B) U.S. liabilities.

I.R.C. § 884(c)(1) (1986). U.S. assets and liabilities are defined as follows:

> (2) U.S. assets and U.S. liabilities. — For purposes of paragraph (1)—
> (A) U.S. assets. — The term "U.S. assets" means the money and aggregate adjusted basis of property of the foreign corporation treated as connected with the conduct of a trade or business in the United States under regulations prescribed by the Secretary. For purposes of the preceding sentence, the adjusted basis of any property shall be its adjusted basis for purposes of computing earnings and profits.
> (B) U.S. liabilities. — The term "U.S. liabilities" means the liabilities of the foreign corporation treated as connected with the conduct of a trade or business in the United States under regulations prescribed by the Secretary.

Id. § 884(c)(2)(A), (B).

[24] SENATE REPORT, *supra* note 3, at 403. "This reduction is measured by the increase in the money and adjusted basis of the branch's assets less its liabilities at the end of the year over the money and adjusted basis of its assets less its liabilities at the beginning of the year." *Id. See also supra* note 23 (citing the text of section 884(b)). The goal of the legislation is to measure earnings not reinvested in the U.S. branch; the dividend equivalent amount should approximate the withholding tax that would be imposed on the dividend payments of a U.S. subsidiary of a foreign corporation.

[25] SENATE REPORT, *supra* note 3, at 403. "This adjustment is measured by the amount by which the money and adjusted basis of the branch's assets less its liabilities at the beginning of the year exceeds the money and adjusted basis of the branch's assets less its liabilities at the end of the year." *Id. See also supra* note 23 (citing the text of section 884(b)).

[26] SENATE REPORT, *supra* note 3, at 403; I.R.C. §§ 884(b), 884(d)(2) (as cited in notes 23 and 28). See *supra* note 21 for the definition of "effectively connected" income.

[27] SENATE REPORT, *supra* note 3, at 403.

[28] *Id.* § 884(d)(1). See *supra* note 21 for the definition of "effectively connected" income. The text of section 884(d) is as follows:

> (d) Effectively connected earnings and profits. — For purposes of this section —
> (1) In general. — The term "effectively connected earnings and profits" means earnings and profits (without diminution by reason of any distributions made during the taxable year) which are attributable to income which is

fixed place of business in the United States in order to be subject to the BPT, as "effectively connected earnings and profits" also include income that is only treated as "effectively connected" under section 884(d).[29]

C. *Transactions to Which the BPT Does Not Apply*

In December 1986, the IRS issued an advance notice which advised that, under future regulations, certain transactions would not give rise to imposition of the BPT.[30] Specifically, the BPT will generally not be imposed on certain liquidations or reorganizations of a foreign corporation that conducted a U.S. business, on the complete termination of a foreign corporation's U.S. business, or on the incorporation of all of the U.S. business activities of a foreign corporation into a wholly owned U.S. subsidiary in a section 351 transfer.[31] These exemptions are meant to further the goal of parity between

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> effectively connected (or treated as effectively connected) with a trade or business within the United States.
>
> (2) Exception for certain income. — The term "effectively connected earnings and profits" shall not include any earnings and profits attributable to —
>
> (A) income not includible in gross income under paragraph (1) or (2) of section 883(a),
>
> (B) income treated as effectively connected with the conduct of a trade or business within the United States under section 921(d) or 926(b),
>
> (C) gain on the disposition of a United States real property interest described in section 897(c)(1)(A)(ii), or
>
> (D) income treated as effectively connected with the conduct of a trade or business within the United States under section 953(c)(3)(C).
>
> Property and liabilities of the foreign corporation treated as connected with such income under regulations prescribed by the Secretary shall not be taken into account in determining the U.S. assets or U.S. liabilities of the foreign corporation.

I.R.C. § 884(d) (1986).

29 Fisher & Rubinstein, *supra* note 4, at 635; I.R.C. § 884(d) (1986). For example, income treated as effectively connected includes certain gains taxable from the disposition of U.S. real property interests by foreign persons. Fisher & Rubinstein, *supra* note 4, at 635 (citing I.R.C. § 897 (1986)).

30 I.R.S. Notice 86-17, 1986-52 I.R.B. 19 [hereinafter Notice 86-17]. The notice provided that as to the "specific transactions described" therein, taxpayers could rely on the rules stated in the notice. *Id.* Section 884(g) of the BPT legislation was included in recognition of the need to consider that certain distributions should be exempt from the BPT. Joyce & Raedel, *IRS Notice Provides Guidance with Respect to Branch Profits Tax*, 16 TAX MGMT. INT'L J. 54, 55 (1987). The text of section 884(g) provides:

> (g) Regulations. — The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including regulations providing for appropriate adjustments in the determination of the dividend equivalent amount in connection with the distribution to shareholders or transfer to a controlled corporation of the taxpayer's U.S. assets and other adjustments in such determination as are necessary or appropriate to carry out the purposes of this section.

I.R.C. § 884(g) (1986). The Treasury has recently issued regulations in temporary and proposed form. 53 Fed. Reg. 34,045, 34,120 (1988).

31 Notice 86-17, *supra* note 30. *See also* Fisher & Rubinstein, *supra* note 4, at 638; I.R.C. § 351 (1954).

the taxation of U.S. corporations owned by foreign corporations and the taxation of U.S. branches of foreign corporations.[32]

Additionally, a foreign corporation might make a tax-free transfer of U.S. real estate to a wholly owned U.S. subsidiary; any gain on a subsequent sale of the subsidiary would not be subject to the BPT if the subsidiary were a domestic U.S. real property holding corporation.[33] However, in spite of the fact that Notice 86-17 states that the BPT will not apply to certain section 351 transfers, future regulations could impose the tax upon events, such as the sale of the subsidiary's stock, occurring after the transfer.[34]

II. Consequences of the Branch Profits Tax

Although Congress enacted the BPT in order to solve certain problems in the taxation of U.S. branches and subsidiaries, other problems developed as a result of the new tax concerning its interaction with international tax treaties.

A. Interaction between the BPT and International Tax Treaties

Section 884(e) of the IRC specifically provides for coordination between existing U.S. tax treaty obligations and the BPT.[35] Treaty protection from the BPT is allowed only if "treaty shopping" does not exist.[36] An exemption from the BPT, or a reduction in the amount of that tax, may be claimed by a foreign corporation based upon a U.S. treaty with its home country only if the foreign corporation is a "qualified resident" of its home country.[37] The corporation

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32 Fisher & Rubinstein, *supra* note 4, at 638. A set of reorganization and liquidation rules applicable to branches should be created in order to parallel the treatment of subsidiary operations. *Id.*

33 I.R.C. § 884(d)(2)(C) (1986).

34 Fisher & Rubinstein, *supra* note 4, at 658. *See also* Joyce & Raedel, *supra* note 30, at 57.

35 I.R.C. § 884(e) (1986). *See also* Plutte, *supra* note 13, at 32. Coordination of the BIT with existing treaty obligations is less clearly defined in the statute. *See* I.R.C. § 884 (1986). The relationship of treaty obligations to sections 871 and 881 would control in the case of the BIT. *See* Plutte, *supra* note 13, at 32 n.12.

36 *See* I.R.C. § 884(e) (1986). In general, a foreign corporation will not be said to be treaty shopping if it is a qualified resident of the country in question. *Id. See also* Blessing, *supra* note 3, at 613.

37 I.R.C. § 884(e)(1)(A) (1986). Section 884(e)(1) states:

> (e) Coordination with income tax treaties; etc. —
>
> (1) Limitation on treaty exemption. — No income tax treaty between the United States and a foreign country shall exempt any foreign corporation from the tax imposed by subsection (a) (or reduce the amount thereof) unless —
>
> (A) such foreign corporation is a qualified resident of such foreign country, or
>
> (B) such foreign corporation is not a qualified resident of such foreign country but such income tax treaty permits a withholding tax on dividends described in section 861(a)(2)(B) which are paid by such foreign corporation.

Id. § 884(e)(1).

will not qualify as a qualified resident of the foreign country in question if:

> 1. More than 50% of its stock value is owned by individuals who are not residents of the foreign country, U.S. citizens or resident aliens; or
> 2. 50% or more of the foreign corporation's income is used to pay liabilities of persons who are not residents of the treaty partner foreign country or the United States.[38]

There are also special rules granting qualified residency to publicly traded corporations and other corporations which specifically merit treaty protection, as determined by the Treasury.[39]

Once the question of qualified residency is determined, other rules govern the interaction of the BPT with existing treaty provisions. Generally, the BPT imposes a tax of thirty percent on the dividend equivalent amount; however:

> [1.] If an income tax treaty between the United States and the country in which the corporation is resident permits the branch profits tax, but reduces the rate, the lower treaty rate applies, unless the owners of the corporation are treaty shopping. . . . In treaty shopping cases, the 30 percent rate applies. [2.] If a treaty between the United States and the country in which the corporation is resident does not specifically provide for a branch profits tax, but otherwise permits such a tax, the treaty's direct investment dividend rate

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[38] *Id.* § 884(e)(4)(A). *See also* Plutte, *supra* note 13, at 32. Section 884 (e)(4)(A) states:

> (4) Qualified resident.— For purposes of this subsection —
>
> (A) In general. — Except as otherwise provided in this paragraph, the term "qualified resident" means, with respect to any foreign country, any foreign corporation which is a resident of such foreign country unless —
>
> (i) more than 50 percent (by value) of the stock of such foreign corporation is owned (within the meaning of section 883(c)(4)) by individuals who are not residents of such foreign country and who are not United States citizens or resident aliens, or
>
> (ii) 50 percent or more of its income is used (directly or indirectly) to meet liabilities to persons who are not residents of such foreign country or the United States.

I.R.C. § 884(e)(4)(A) (1986).

[39] I.R.C. § 884(e)(4)(B),(C). *See also* Vito, *supra* note 3, at 637. Section 884(e)(4)(B) states:

> (B) Special rule for publicly traded corporations. — A foreign corporation which is a resident of a foreign country shall be treated as a qualified resident of such foreign country if —
>
> (i) the stock of such corporation is primarily and regularly traded on an established securities market in such foreign country, or
>
> (ii) such corporation is wholly owned (either directly or indirectly) by another foreign corporation which is organized in such foreign country and the stock of which is so traded.

I.R.C. § 884(e)(4)(B) (1986). Section 884(e)(4)(C) states:

> (C) Secretarial authority. — The Secretary may, in his sole discretion, treat a foreign corporation as being a qualified resident of a foreign country if such corporation establishes to the satisfaction of the Secretary that such corporation meets such requirements as the Secretary may establish to ensure that individuals who are not residents of such foreign country do not use the treaty between such foreign country and the United States in a manner inconsistent with the purposes of this subsection.

Id. § 884(e)(4)(C).

> is applied to the branch base, unless the owners of the corporation are treaty shopping whereupon the [BPT] rate applies. . . . [3.] If a treaty between the United States and the country in which the corporation is resident permits a branch profits tax, but contains a different computation than the bill provides, or subjects the branch tax to restrictions not in the statute, the [BPT legislation] provides that the tax will be applied subject to the treaty's computation provisions and other restrictions, unless the owners of the corporation are treaty shopping whereupon the [BPT] provisions apply. . . . [4.] In the event a treaty with a particular foreign country does not allow a branch profits tax but does allow the [IRC's] second-level withholding tax on dividends, the [BPT legislation] provides that, to that extent, the present law second-level withholding tax is to apply. . . . [However, the] branch profits tax is imposed if the owners are treaty shopping. . . . [5.] In the event a treaty with the United States prohibits both a branch profits tax and any second-level dividend withholding tax generally, the . . . branch profits tax is imposed if the owners of the corporation are treaty shopping.[40]

Advance Notice 87-56 was issued by the IRS in order to clarify the

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[40] SENATE REPORT, *supra* note 3, at 403-04. These rules explain the mechanics of sections 884(e)(2) and (3). These sections provide as follows:

> (2) Treaty modifications. — If a foreign corporation is a qualified resident of a foreign country with which the United States has an income tax treaty —
>
> (A) the rate of tax under subsection (a) shall be the rate of tax specified in such treaty —
>
> (i) on branch profits if so specified, or
>
> (ii) if not so specified, on dividends paid by a domestic corporation to a corporation resident in such country which wholly owns such domestic corporation, and
>
> (B) any other limitations under such treaty on the tax imposed by subsection (a) shall apply.
>
> (3) Coordination with 2nd tier withholding tax. —
>
> (A) In general. — If a foreign corporation is not exempt for any taxable year from the tax imposed by subsection (a) by reason of a treaty, no tax shall be imposed by section 871(a), 881(a), 1441, or 1442 on any dividends paid by such corporation during the taxable year.
>
> (B) Limitation on certain treaty benefits. — No foreign corporation which is not a qualified resident of a foreign country shall be entitled to claim benefits under any income tax treaty between the United States and such foreign country with respect to dividends —
>
> (i) which are paid by such foreign corporation and with respect to which such foreign corporation is otherwise required to deduct and withhold tax under section 1441 or 1442, or
>
> (ii) which are received by such foreign corporation and are described in section 861(a)(2)(B).

I.R.C. §§ 884(e)(2), (3) (1986).

The following diagram illustrates the relationship between the qualified residency aspect of the BPT and existing treaty provisions:

relationship between the BPT and existing treaty provisions.[41] Section one of the notice lists twenty-eight countries whose tax treaties with the United States would prohibit the imposition of the BPT on qualified residents of the foreign country which is a party to the treaty.[42] Section two lists nine countries whose treaties with the United States allow imposition of the BPT on qualified residents of their countries; the treaties of five of these countries have provisions which would result in a special computation of the BPT different

If the corporation is a qualified resident	And under the treaty		Then the tax imposed is
	The BPT is	And the second level withholding tax is	
Yes	Allowed	Allowed	BPT
Yes	Allowed	Barred	BPT
Yes	Barred	Allowed	Second level withholding
Yes	Barred	Barred	None
No	Allowed	Allowed	BPT
No	Allowed	Barred	BPT
No	Barred	Barred	BPT
No	Barred	Allowed	Second level withholding

Vito, *supra* note 3, at 637.

[41] I.R.S. Notice 87-56, 1987-35 I.R.B. 9 [hereinafter Notice 87-56]. This notice applies to treaties in effect on August 31, 1987.

[42] *Id.* These countries are Aruba, Austria, Belgium, People's Republic of China, Cyprus, Denmark, Egypt, Finland, Federal Republic of Germany, Greece, Hungary, Iceland, Ireland, Italy, Jamaica, Japan, Korea, Luxembourg, Malta, Morocco, The Netherlands, Norway, Pakistan, Philippines, Sweden, Switzerland, and the United Kingdom. *Id. See also* Netherlands Income Tax Treaty, Apr. 29, 1948, CCH Tax Treaties §§ 5816, 5829, P-H Tax Treaties §§ 66,113, 66,123 (as extended to Aruba); Austria Income Tax Treaty, Oct. 25, 1956, CCH Tax Treaties §§ 517, 521, P-H Tax Treaties §§ 16,114, 16,118; Belgium Income Tax Treaty, July 9, 1970, CCH Tax Treaties §§ 588C, 590A, P-H Tax Treaties §§ 17,040, 17,054; China Income Tax Treaty, Apr. 30, 1984, CCH Tax Treaties §§ 1412, 1426, P-H Tax Treaties §§ 72,109, 72,123; Cyprus Income Tax Treaty, Mar. 19, 1984, CCH Tax Treaties §§ 2010, 2015, P-H Tax Treaties §§ 29,107, 29,112; Germany Income Tax Treaty, July 22, 1954, CCH Tax Treaties §§ 3017, 3021, P-H Tax Treaties §§ 39,114, 39,118; Greece Income Tax Treaty, Feb. 20, 1950, CCH Tax Treaties §§ 3112, 3119, P-H Tax Treaties §§ 41,110, 41,117; Hungary Income Tax Treaty, Feb. 12, 1979, CCH Tax Treaties §§ 3612, 3624, P-H Tax Treaties §§ 45,109, 45,121; Iceland Income Tax Treaty, May 7, 1975, CCH Tax Treaties §§ 3710, 3715, P-H Tax Treaties §§ 46,107, 46,112; Ireland Income Tax Treaty, Sept. 13, 1949, CCH Tax Treaties §§ 4118, 4124, P-H Tax Treaties §§ 51,116, 51,122; Italy Income Tax Treaty, Apr. 17, 1984, CCH Tax Treaties §§ 4331A, 4335, P-H Tax Treaties §§ 53,040, 53,054; Jamaica Income Tax Treaty, May 21, 1980, CCH Tax Treaties §§ 4386J, 4386V, P-H Tax Treaties §§ 55,110, 55,122; Japan Income Tax Treaty, Mar. 21, 1980, CCH Tax Treaties §§ 4393F, 4393G, P-H Tax Treaties §§ 54,036, 54,037; Luxembourg Income Tax Treaty, Dec. 18, 1962, CCH Tax Treaties §§ 5313, 5323, P-H Tax Treaties §§ 60,110, 60,120; Malta Income Tax Treaty, Mar. 21, 1980, CCH Tax Treaties §§ 5413, 5428, P-H Tax Treaties §§ 61,110, 61,125; Morocco Income Tax Treaty, Aug. 1, 1977, CCH Tax Treaties §§ 5313, 5625, P-H Tax Treaties §§ 64,110, 64,122; Netherlands Income Tax Treaty, Apr. 29, 1948, CCH Tax Treaties §§ 5816, 5829, P-H Tax Treaties §§ 66,108, 66,126; Pakistan Income Tax Treaty, July 1, 1957, CCH Tax Treaties §§ 6210, 6220, P-H Tax Treaties §§ 70,107, 70,117; and United Kingdom Income Tax Treaty, Dec. 31, 1975, CCH Tax Treaties §§ 8103J, 8103X, P-H Tax Treaties §§ 89,040, 89,054.

from that under IRC section 884(a).[43] Although this notice does not answer all questions regarding the relationship of the BPT and the branch level interest tax (BIT) to international tax treaties, it does provide basic rules regarding the effect of treaty limitations upon imposition of the branch taxes.[44]

B. *Criticism of the BPT's Impact on International Tax Treaties*

The BPT is to be imposed where it is not in conflict with an international tax treaty, and in treaty shopping situations notwithstanding any conflicting treaty provisions.[45] The effect of the tax, including the overriding antitreaty shopping provisions, is clearly to increase U.S. taxes; the branch tax was estimated to raise $110 million in the aggregate for the years 1987 through 1991.[46] The branch tax has been criticized as a means by which the United States is unilaterally appropriating taxing jurisdiction to itself from the treaty partners.[47] Nevertheless, Congress stated in enacting the BPT that it had no intention of overriding existing U.S. tax treaties.[48] It has been argued that the overriding antitreaty shopping provisions were a justifiable exception to imposition of contrary treaty tax rates based upon the purpose of the legislation to eliminate the tax advantage that foreign corporations operating in the United States held over their U.S. competitors.[49]

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[43] Notice 87-56, *supra* note 41. Tax treaties between the United States and the following countries allow the BPT to be imposed without modification to the IRC: Barbados, Poland, Romania, and the U.S.S.R. Under tax treaties with Australia, Canada, France, New Zealand, and Trinidad & Tobago, the BPT can be imposed but with certain limitations. *Id.* *See also* Australia Income Tax Treaty, Aug. 6, 1982, CCH TAX TREATIES § 402K, P-H TAX TREATIES § 15,040; Barbados Income Tax Treaty, Dec. 31, 1984, CCH TAX TREATIES § 579B, P-H TAX TREATIES § 20,124; Canada Income Tax Treaty, Sept. 26, 1980, CCH TAX TREATIES § 1310, P-H TAX TREATIES § 22,040; France Income Tax Treaty, July 28, 1967, CCH TAX TREATIES §§ 2816, 2827, P-H TAX TREATIES §§ 38,040, 38,054; New Zealand Income Tax Treaty, July 23, 1982, CCH TAX TREATIES § 5902X, P-H TAX TREATIES § 67,053; Poland Income Tax Treaty, Oct. 8, 1974, CCH TAX TREATIES § 7024, P-H TAX TREATIES § 75,121; Romania Income Tax Treaty, Dec. 4, 1973, CCH TAX TREATIES § 7276, P-H TAX TREATIES § 77,122; Trinidad & Tobago Income Tax Treaty, Jan. 9, 1970, CCH TAX TREATIES § 7614, P-H TAX TREATIES § 85,036; Soviet Union Income Tax Treaty, June 20, 1973, CCH TAX TREATIES § 8002L, P-H TAX TREATIES § 86,110; and Plutte, *supra* note 13, at 33, 37. A third section of the Notice discusses limitations on the imposition of the BIT under certain tax treaties. *See* Plutte, *supra* note 13, at 33.

[44] *See* Vito, *supra* note 3, at 640.

[45] I.R.C. § 884 (1986). *See also* SENATE REPORT, *supra* note 3, at 403-05.

[46] CONFERENCE REPORT, *supra* note 11, at 879.

[47] Note, *The Branch Profits Tax: An Analysis of Its Impact on Stockholders of U.S.-Owned Foreign Corporations and Its Interrelationship with the U.S. Network of Tax Treaties*, 20 CASE W. RES. J. INT'L L. 643, 653 (1988) (citing Forry & Karlin, *1986 Act: Overrides, Conflicts, and Interactions with U.S. Income Tax Treaties*, 35 TAX NOTES 793, 797 (1987)).

[48] SENATE REPORT, *supra* note 3, at 404.

[49] *See supra* notes 11-18 and accompanying text. "The branch profits tax simply represents an attempt by Congress to eliminate an unintended tax loophole in the Code, reinstating the original premise upon which our income tax treaties were founded." Note, *supra* note 47, at 654.

III. Conclusion: Potential Application of the BPT in North Carolina

The BPT predominantly affects foreign corporations operating banking/financial, insurance, and real estate activities in the United States, and generally all foreign corporations with U.S. branches.[50] In North Carolina, there are at least eight foreign corporations engaged in banking/financial, insurance, or real estate-related activities;[51] four of these have their U.S. headquarters in North Carolina.[52] Nevertheless, these corporations are all based in countries that have tax treaties with the United States which make the BPT inapplicable to that country's qualified residents.[53] Thus, assuming that these eight corporations are qualified residents of their countries of origin, the BPT will be inapplicable to them even if they are doing business as branches rather than as subsidiaries. Generally, if they are doing business as subsidiaries the BPT is not applicable to them.[54]

North Carolina has one foreign corporation doing business in the state which is based in a country whose tax treaty with the United States allows the BPT to be imposed without modification to the IRC.[55] If it is operating as a branch, it must be concerned with the mechanics of the BPT.[56] In addition, at least sixty-eight foreign corporations doing business in North Carolina are based in countries whose tax treaties with the United States allow the BPT to be imposed with certain limitations.[57] If any of these corporations are op-

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[50] Fisher & Rubinstein, *supra* note 4, at 634. In the case of foreign banks, a large number of them operate directly through branches for regulatory and other nontax reasons, although most operate in the United States through U.S. subsidiaries. Blessing, *supra* note 3, at 644. Banks that have operated through U.S. branches will potentially face an increased cost of doing business if they are organized in countries with which the United States does not have a tax treaty or in countries whose tax treaty with the United States permits a branch tax. *Id.*

[51] The eight corporations are Barclays American, British American, Commercial Union Insurance Company, First of Georgia/Peerless Insurance, Life Insurance Company of Georgia, North Hills, Royal Insurance, and SHB and Associates. Foreign-Owned Firms, *supra* note 6, at 55. Of these corporations, four are based in the United Kingdom (Barclays American, British American, Commercial Union Insurance Company, and Royal Insurance), three in the Netherlands (North Hills, First of Georgia/Peerless Insurance, and Life Insurance Company of Georgia), and one in the Federal Republic of Germany (SHB and Associates). *Id.* at 46-48.

[52] The Survey, *supra* note 6, at 17.

[53] *See supra* notes 42, 51 and accompanying text (discussing the U.S. tax treaties with the countries in question).

[54] In some cases, as a result of the treaty shopping restrictions, a subsidiary may be subject to the BPT. *See infra* note 57.

[55] This is Melex USA, a Polish corporation. Foreign-Owned Firms, *supra* note 6, at 55. *See also supra* note 43 and accompanying text (discussing Poland's tax treaty with the United States).

[56] This is also true if the corporation was treaty shopping. *See infra* note 57.

[57] These corporations, their countries of origin and their types of operation are Belt Concepts of America, Dixie Yeast, Protector Safety (Australian manufacturing corporations); Rental Tool, Southcoal, T.N.T. Pilot (Australian sales/service corporations); Abitibi-Price, Aeronca, Alcan Aluminum, Alcan North/Roofing & Siding, Alcan-Sumitomo

erating as branches or are engaging in treaty shopping,[58] they should consult the U.S. tax treaty with their home country in order to evaluate the degree to which the BPT is applicable to them.

Congress' primary goal in enacting the branch level taxes is to achieve greater parity in the taxation of profits and the payment of interest by U.S. branches of foreign corporations as compared to the tax treatment of U.S. subsidiaries; the legislation is consistent with the purposes behind the United States' international tax treaties.[59] Regardless of the rationality of the BPT, however, the cumulative effect of the new tax may be to discourage direct operations by foreign corporations in the United States.[60]

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Electric, American Ornamental, Atlantic Forest Products, Big "O" Filter, Butler Polymet, Cascades Industries, Casson and Crane/Division of Huron Tech, Cortina Fabrics, Cuddy Farms, Fast Food Merchandisers, GENPAK, Genwove U.S., Hardee's, Huron Tech, Ilco Unican, Inco Alloys International, Indusmin, Linn-Corriher, Midland Machine, Moldex International, Northern Telecom, Polydrain, Porritts and Spencer U.S.A., Tandem Mills, Varco-Pruden Buildings (Canadian manufacturing corporations); Boise Cascade, General Woods and Veneers, Interforest, Kinder-Care Learning Centers, LaQue Center for Corrosion Technology, Moore Business Forms, Morbern U.S.A., Omnitex Division of Omnitrade, Pic 'N Pay Stores (Canadian sales/service corporations); Absorba, Alcatel N.A., Allibert, Aplis, Baikowski International, Certain-Teed, Isomat, Synthron, Texasgulf, Unilog, Valdese Textiles (French manufacturing corporations); Absorba Factory Outlet, A.L. Welding Co., Asseline America, Dillon Supply Co., Dinac Corp., Etri, French Countryside, Joucomatic Controls, Liquid Air Co., Ober-Stenerson Sales, Rhone-Poulenc Ag Co., Texwood, and Thomson CGR Medical (French sales/service corporations). Foreign-Owned Firms, *supra* note 6, at 46-48. *See also supra* note 43 and accompanying text (discussing these countries' tax treaties with the United States).

In addition to real estate, banking/financial and insurance-oriented corporations, another class of activity which might increase a corporation's chances of being subject to the BPT is that of "sales subsidiaries." Blessing, *supra* note 3, at 646. Such a subsidiary may be subject to the branch tax as a result of the treaty-shopping restrictions and may have branch tax liability even though it may rely on the treaty, without regard to statutory treaty-shopping rules, to exempt it from the underlying corporate tax. *Id.*

58 *See supra* note 54, 57 and accompanying text (discussing possible application of the BPT to a subsidiary that is treaty shopping).

59 *See supra* note 49 and accompanying text.

60 *See* Blessing, *supra* note 3, at 647.

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