Branch Profits Tax[1]: Fictional Equivalent to Income Tax Withholding on Dividends Paid by a United States Subsidiary to a Foreign Corporation

1. In addition to the imposition of tax by section 882[2], thirty percent of the dividend equivalent amount is a second entity levy.

2. Dividend equivalent amount equals effectively connected earnings and profits adjusted for change in United States net equity.

3. Dividend equivalent amount increased by reduction in United States net equity; decreased by increase in United States net equity.

4. Change in United States net equity is the difference between the foreign corporation's United States net equity as of the close of the preceding taxable year compared to such quantity as of the close of the current taxable year.

5. Limitation of the increase in the dividend equivalent amount: Accumulated effectively connected earnings and profits for all the preceding taxable years beginning after December 31, 1986[3], over the aggregate dividend equivalent amounts determined for such preceding taxable years.

6. Treasury regulations determine the meanings of United States assets[4] and United States liabilities.[5]

7. "Effectively connected earnings and profits" is defined as (current) earnings and profits[6], without diminution by reason of any distributions made during the taxable year, which is effectively connected or so treated with the conduct of a trade or business[7] within the United States.

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[1] Definition of a tax update: Old law enacted by the Tax Reform Act of 1986 that practitioner retains a blurry rear view mirror image. The Tax Cuts and Jobs Act of 2017 does contain a modicum of tax reform even if its title might suggest otherwise particularly in the international arena contained within subchapter O.

[2] All citations are to the Internal Revenue Code unless otherwise indicated.

[3] Effective date of the Tax Reform Act of 1986 [P. L. 99-514 (October 22, 1986)]

[4] Treas. Reg. §1.884-1(d)(1 through 6, inclusive)

[5] Treas. Reg. §1.884-1(e)(1 through 5, inclusive)

[6] Bittker and Eustice have asserted that I.R.C. §312 does not define earnings and profits, but as a tax accountant if one provides me with a starting point (taxable income) followed by a plethora of additions and subtrahends, I think that the end result does indeed produce a satisfactory definition.

[7] The phrase "trade or business" is itself a technical tax term in search of a definition. When faced with a n inherently highly factual tax definition, perhaps Associate Justice Benjamin Cardozo provided a memorable definition:

> Here, indeed, as so often in other branches of the law, the decisive distinctions are those of degree and not of kind. One struggles in vain for any verbal formula that will supply a ready touchstone. The

8. As is quite common in this bailiwick of the tax law, bilateral treaties may provide statutory modifications by either eliminating or lowering the rate of the branch profits tax. But such treaty must be an income tax treaty and the foreign corporation must be a qualified resident of the foreign country. If the treaty fails to specify the rate reduction, the rate will equal the one provided for dividends paid by a domestic corporation to a corporation resident in such country, which wholly owns such domestic corporation.

9. If a foreign corporation is subject to the branch profits tax, no tax shall be imposed by the substantive "FDAPI"[8] sections of 871(a) for non-resident alien individuals or 881(a) for foreign corporations, or by the income tax withholding provisions of sections 1441 for non-resident alien individuals or 1442 for foreign corporations.

10. And now for a third tax imposed by subsection (f):

I.R.C. Sec. 884(f) Treatment of interest allocable to effectively connected income[9].

(1) In general.

In the case of a foreign corporation engaged in a trade or business in the United States (or having gross income treated as effectively connected with the conduct of a trade or business in the United States), for purposes of this subtitle—

(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 that the allocable interest 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.

To the extent provided in regulations, subparagraph (A) shall not apply to interest in excess of the amounts reasonably expected to be allocable interest.

(2) Allocable interest.

For purposes of this subsection, the term "allocable interest" means any interest which is allocable to income which is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States.

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standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle. [*Welch v. Helvering,* 290 U.S. 111, 115 (1933)]

[8] Fixed or determinable annual or periodic gains, profits and income, which are not effectively connected to a trade or business within the United States.

[9] The precise language of the subsection is provided to avoid any misinterpretations occasioned by any summary exposition of its well-crafted language.

11. Note that the entity level tax, the branch level interest tax, at the same 30 percent rate, subject of course to treaty modification, is imposed on the difference between the interest on allocable interest and the withholding tax on interest actually paid by the foreign corporation.

12. Subparagraph (f)(1)(A) treats any interest paid as coming from a domestic corporation so that under the source rules such interest would be subject to income tax withholding under section 1442.

13. The meaning of "allocable interest", that is, how one makes the precise numerical calculation is found in detailed regulations under section 882.[10] The computation is made on Schedule I with ten pages of instructions that essentially steer the income tax preparer through the three steps described in the treasury's regulations.[11]

14. Presumably this third entity level tax prevents an attempt to have an interest deduction wipe out or significantly reduce the branch profits.[12]

[10] **Treas. Reg. §1.882-5(paragraphs b, c, & d) [Determination of interest deduction] in three not so easy steps: 1. Determination of total value of U.S. assets for the taxable year. 2. Determination of total amount of U.S.-connected liabilities for the taxable year. 3. Determination of amount of interest expense allocable to ECI under the adjusted U.S. booked liabilities method.**

[11] **Similar to the legislative regulations of the consolidated income tax regulations, the tax lawyer is more receptive to the regulatory material if she possesses an accounting background.**

[12] **The hybrid territorial system, embraced in an attempt at tax reform for international taxation, may cause some practitioners to embrace the "old" law whose arcane provisions have at last been mastered. Change, of course, remains the one constant in our profession.**