Federal Income Taxation of U.S. Branches of Foreign Corporations: Separate Entity or Separate Rules?

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Federal Income Taxation of U.S. Branches of Foreign Corporations: Separate Entity or Separate Rules?

FRED B. BROWN*

I. INTRODUCTION

The level of international business transactions has grown enormously in the last few decades. U.S. companies have expanded their overseas operations, and with the recent availability of new markets in Eastern Europe, the former Soviet Union and China, further expansion is inevitable. The rise of international business activities has been even more dramatic on the inbound side, that is, by foreign companies operating in the United States. As American preferences for foreign goods have increased significantly, foreign-controlled U.S. businesses have grown and may continue to grow in number.1

This international business explosion has magnified the problems associated with the U.S. taxation of international entities. The current provisions dealing with international transactions were enacted in a piecemeal fashion over a period of 50 years when the tax revenues derived from such transactions were relatively insubstantial.2 Commentators have criticized the resulting U.S. system as outmoded,3

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1 See Staff of Joint Comm. on Tax’n, 101st Cong., 2d Sess., Background and Issues Relating to the Taxation of Foreign Income in the United States 2 (Comm. Print 1990) (stating that foreign investment in the United States has tripled since 1980).


flawed in reflecting economic income, duplicative, overly complex, not tailored towards international approaches and, on the whole, somewhat irrational.

These criticisms are particularly relevant for the current system used to tax foreign-controlled U.S. businesses. U.S. business activities of foreign persons generally are conducted either through a U.S. subsidiary or a U.S. branch of a foreign corporation. There are, however, vast differences in the U.S. tax treatment of these two forms. Indeed, the Code and regulations provide two entirely different regimes for the taxation of such business operations.

Briefly, a U.S. subsidiary of a foreign corporation is taxed as any other domestic corporation, that is, as a separate taxable entity apart from its foreign parent. Thus, a U.S. subsidiary generally determines its taxable income by including income items that it receives or accrues and deducting expense items that it pays or incurs. In determining a U.S. subsidiary's taxable income, transactions between the subsidiary and its foreign parent are recognized for tax purposes. Given the lack of an arm's length relationship between the parties, however, the Code provides the Service and the courts with mechanisms to adjust subsidiary-parent transactions in order to prevent tax manipulation. One such mechanism is § 482 and the regulations thereunder, which allow the Service to allocate income and deduc-

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6 John Turro, Treasury Works Against the Clock on Transfer Pricing Regulations, 57 Tax Notes 1621, 1622 (Dec. 21, 1992) (reporting statements by then Treasury International Tax Counsel James R. Mogle describing the current international tax rules as "unreasonably complex to the point that very few companies can comply with the rules anymore").

7 See generally Stanford G. Ross, National Versus International Approaches to Cross-Border Tax Issues, 54 Tax Notes 589 (Feb. 3, 1992) [hereinafter Approaches] (pointing out the need for more international as opposed to national approaches to cross border tax issues).

8 See ALI International Project, note 4, at 16 (noting that the unifying theme of the recommendations dealing with the taxation of foreign persons is an "attempt at rationalization").

tions among related taxpayers in order to clearly reflect income, based generally on amounts charged in comparable transactions between unrelated parties. Another is debt/equity classification, which is used to determine whether a purported debt instrument is actually debt or equity in an economic sense. Furthermore, dividend and interest payments by the U.S. subsidiary to the foreign parent and other recipients are generally subject to an additional U.S. tax.\textsuperscript{10}

In stark contrast, a U.S. branch of a foreign corporation is not treated as a separate taxable entity, and thus transactions involving the U.S. branch, including those with other branches of the foreign corporation, generally are not recognized for tax purposes. Instead, the Code and regulations employ a set of special rules that allocate and apportion to the U.S. branch a portion of the foreign corporation's worldwide income in order to determine the net income subject to U.S. tax.\textsuperscript{11} Generally either all or none of the gross income from a particular transaction is allocated to the U.S. branch, often based on the level of U.S. branch participation in the transaction. Deductions generally are apportioned to the U.S. branch under complex regulatory formulae, which typically use factors not tailored to the specific facts relating to a particular U.S. branch.\textsuperscript{12} Furthermore, to approximate the taxes on dividend and interest payments made by U.S. subsidiaries, a complicated set of rules impute (and tax) dividend and interest payments from the U.S. branch to foreign branches of the foreign corporation.\textsuperscript{13}

The special rules used for taxing U.S. branch activities are problematic in a number of respects. First, they often fail to accurately reflect the income produced by U.S. branch activities. For example, the income allocation rules subject either all or none of the net income from a transaction to U.S. tax in situations where the U.S. branch acts in conjunction with another branch of the foreign corporation in generating income. Interest deductions are apportioned to the U.S. branch under a formulary approach that is similarly distortive, in that it uses fixed factors and aggregate data from many transactions and thus results in nothing more than an approximation of the actual interest expense associated with U.S. branch activities.

In addition, because the system for measuring the taxable income of U.S. branches is rather unique, it may differ substantially from methods employed by other countries to assign income to U.S. activities.

\textsuperscript{10} IRC §§ 871(a), 881(a).
\textsuperscript{11} IRC §§ 864(c), 882(c)(1).  
\textsuperscript{12} Reg. § 1.882-4, -5.  
\textsuperscript{13} IRC § 884.
Consequently, a foreign corporation faces a serious risk that a portion of its income will be taxed by two countries.

Perhaps even more important, the special rules for taxing U.S. branches appear to result in excessive administrative burdens. Although they avoid the difficult fact-specific inquiries necessitated by the transfer pricing rules\(^\text{14}\) used with U.S. subsidiaries, they often require the use of a foreign corporation's worldwide data, which may be extremely troublesome. Furthermore, the existence of special rules for U.S. branches means that the Service must administer, and taxpayers must attempt to master, an additional set of complex provisions.

The end result of a separate entity method for U.S. subsidiaries and different rules for U.S. branches is unwarranted variation in tax treatment based on the form of business used by a foreign corporation. The amount of taxable income under these two methods can be significantly different. For example, unlike the "all or nothing" net income results that may occur where a U.S. and foreign branch participate in a single transaction, a similarly situated U.S. subsidiary is taxed on a portion of the net income determined under arm's length principles.\(^\text{15}\) Likewise, U.S. branches and U.S. subsidiaries face varying degrees of double taxation risk: In contrast to the uniqueness of the rules used by the United States for U.S. branches, the separate entity method used for U.S. subsidiaries is consistent with the methods adopted by most developed nations for assigning income to subsidiaries. Furthermore, the two methods result in substantially different administrative requirements, as U.S. branches must use several categories of worldwide data, while U.S. subsidiaries need to determine and support appropriate intercompany charges based on arm's length principles. Finally, the rules that impute (and tax) dividend and interest payments from a U.S. branch to foreign branches of a foreign corporation often fail to produce results that are similar to the taxes imposed on a U.S. subsidiary's payments of dividends and interest.

This Article proposes the adoption of the separate entity method for U.S. branches of foreign corporations\(^\text{16}\) so long as this method continues to be used for U.S. subsidiaries. For readers desiring a more in-depth examination of the current regimes for taxing U.S. subsidiaries

\(^{14}\) See notes 22-38 and accompanying text for an explanation of the transfer pricing rules.

\(^{15}\) IRC § 482.

\(^{16}\) The use of the separate entity method for U.S. branches is not a completely novel idea. Several foreign corporations have maintained that income tax treaties entitle them to use this method for computing the interest deductions attributable to their U.S. branches. For a further discussion of this point, see note 147. Moreover, as indicated by the position of the Organization for Economic Cooperation and Development, many foreign countries employ a separate entity method in taxing branch operations. See notes 301-06 and accompanying text.
and U.S. branches, Section II discusses these rules at greater length. Section III sets forth in detail the proposal for the use of the separate entity in taxing U.S. branches. Section IV supports this proposal by examining four fundamental policies relevant to international taxation: accurate reflection of income, administrability and simplification, harmonization of international tax systems and neutral application of the tax laws to different forms of conducting business. Section V suggests that the use of the separate entity method for U.S. branches may further improve international tax laws by serving as a laboratory for applying this method to foreign branches of U.S. corporations. Section VI discusses the future of the separate entity arm's length method for U.S. subsidiaries and its effect on the proposal for U.S. branches. Section VII summarizes and concludes the Article.

II. CURRENT LAW

Currently, vast differences exist in the tax treatment of a foreign corporate-controlled U.S. business depending on the form in which that business is conducted. Specifically, the tax law provides what are, in effect, two entirely different regimes for the taxation of such business operations: one for U.S. operations conducted through a U.S. subsidiary of a foreign corporation and another for U.S. operations conducted through a U.S. branch of a foreign corporation. Set forth below is a summary of these two regimes.

A. Operations Through a U.S. Subsidiary

1. General Rules For Taxable Income Determination

Where a foreign corporation conducts its U.S. business through a U.S. subsidiary, the U.S. subsidiary is taxed like any other domestic corporation, that is, as a separate taxable entity. Thus, a U.S. subsidiary determines its taxable income by including income items\(^{17}\) that it receives or accrues\(^ {18}\) and deducting expense items\(^ {19}\) that it pays or incurs.\(^ {20}\)

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\(^{17}\) Section 61 provides the general definition of gross income. Sections 101 to 136 set forth items statutorily excluded from gross income.

\(^{18}\) Depending on a U.S. subsidiary's method of accounting (either cash or accrual), either the receipt or accrual of income generally generates inclusions. Reg. § 1.451-1(a). A U.S. subsidiary's ability to use the cash method, however, is limited by § 448, which generally prevents subchapter C corporations from using the cash method.

\(^{19}\) Section 162 provides a general business expense deduction. Various other Code provisions allow for specific deductions. E.g., IRC § 163 (interest expense), § 168 (depreciation).

\(^{20}\) Similarly, either the payment or incurrence of expenses generally results in deductions, depending on a U.S. subsidiary's accounting method.
2. Intercompany Transactions and Safeguards Ensuring Economic Substance

In accordance with generally treating each corporate legal entity as a separate taxpayer, transactions between the U.S. subsidiary and its foreign parent corporation are recognized for tax purposes. Because the foreign corporation owns the U.S. subsidiary, there is, however, a lack of an arm's length relationship between the parties. That is, the amounts charged in dealings between the subsidiary and parent should have little economic consequence, given that the same persons (the shareholders of the foreign corporation) in effect own both corporations. Yet, without any restrictions, these intercompany transactions could have significant U.S. tax effects, by reducing the taxable income of a U.S. subsidiary and thereby reducing the related party's income subject to U.S. tax. Consequently, to prevent manipulation and ensure that the form of related party transactions corresponds to their economic substance, the Service and the courts have mechanisms to scrutinize and adjust transactions such as those between a U.S. subsidiary and its foreign parent. These features are examined below in some detail.

a. Section 482

One such mechanism is § 482, which gives the Service the authority to allocate income and deductions among related taxpayers, such as a U.S. subsidiary and its foreign parent, in order to reflect the true taxable income of the parties. The regulations under § 482 implement the statute by generally requiring related parties to charge the same amounts in their dealings as would unrelated parties dealing at arm's length.

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A U.S. subsidiary, like any other U.S. person, is subject to U.S. tax on its worldwide income. To alleviate double taxation, § 901 allows the U.S. subsidiary (and generally any other U.S. persons such as U.S. corporations, citizens and resident aliens) a credit for foreign income taxes, subject to limits. In general, under § 904, the foreign tax credit cannot exceed the U.S. tax on the taxpayer's foreign source income. For a brief discussion of the rules for determining the source of income, see note 40.

21 See Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943). Certain affiliated corporations can elect to be treated as essentially a single taxpayer by filing a consolidated return. IRC §§ 1502-1504 and the regulations thereunder. A foreign corporation, however, is excluded from joining in the filing of a consolidated return with affiliated U.S. corporations. IRC § 1504(b)(3). Section 1504(d) does allow a wholly domestically-owned foreign corporation that is organized in a contiguous foreign country to elect to be treated as a U.S. corporation for tax purposes.

22 Cf. Reg. § 1.482-1(a). Of course, transactions between the U.S. subsidiary and unrelated taxpayers also are recognized.

23 See also Reg. § 1.482-1(a)(1).

24 Reg. § 1.482-1(b), (c).
The § 482 regulations have separate rules for several specific situations: loans, performance of services, use of tangible property, use or transfer of intangible property and sale of tangible property. In each situation, the regulations authorize the Service to allocate income and deductions among related parties to reflect arm's length charges. In general, an arm's length charge is the amount that would have been charged in comparable transactions between unrelated parties. Nonetheless, in certain limited cases, the regulations allow for the use of other methods in determining appropriate charges: safe harbor interest rates for loans where the lender is not in the business of making loans, the use of costs for services where the services rendered are not an integral part of the business activity of either the provider or the recipient, and the use of costs for subleases of tangible property where the sublessor and sublessee are not engaged regularly in the business of renting such property.

Furthermore, recently adopted regulations under § 482 give taxpayers flexibility in determining transfer prices based on comparability for transfers of tangible and intangible property. Specifically, for transfers of tangible property, § 1.482-3 of the regulations allows tax-
payers to use one of the following several alternatives, based on the method that produces the most accurate results under the particular facts and circumstances: (1) the prices charged in uncontrolled sales involving sufficiently similar property and facts and circumstances, (2) resale prices less the gross profit earned by comparable distributors in uncontrolled transactions, (3) costs plus the gross profit earned by comparable manufacturers in uncontrolled transactions, (4) prices based on the "profit level indicators" of similar parties in uncontrolled transactions (comparable profits method), (5) profit splits, and (6) unspecified methods.

For transfers of intangible property, the regulations similarly permit taxpayers to use the best of the following methods under the particular facts: (1) prices charged for intangibles in uncontrolled transactions that involve similar products or processes within the same general industry or market and similar profit potential, (2) the comparable profits method, (3) profit splits, and (4) unspecified methods.

Several important new measures should improve the administration of § 482. First, the Service has instituted an advanced pricing agreement procedure, whereby taxpayers, the Service and foreign tax authorities enter into agreements providing for determinations of transfer prices for several future years. In addition, recently revised § 6038A should allow the Service greater access to foreign documents relating to transfer pricing. Furthermore, arbitration has begun to be recognized as an alternative to litigation in resolving transfer pricing disputes. Finally, recently enacted § 6662(e) imposes a penalty for

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32 Reg. § 1.482-6 sets forth two specific profit split methods: the comparable profit split rule and the residual profit split rule. Reg. § 1.482-6(c)(1).

33 Reg. § 1.482-3, -5. Except for the comparable profits method, the transfer pricing methods for tangible property prescribed by the regulations are essentially the same as those under the previous regulations. The main difference between the current and previous regulations is the priority accorded the various methods; unlike the previous regulations, which provided a hierarchy with respect to methods, the current regulations generally allow for the use of the best method under the particular facts and circumstances. Compare Reg. § 1.482-2A(e) with Reg. § 1.482-3.

34 Reg. § 1.482-4(c)(2)(ii). In addition to the above requirements, the regulations list several specific factors that are considered in evaluating the comparability of the circumstances of the controlled and uncontrolled transactions.

35 Reg. § 1.482-4.


37 See IRS Announces Transfer Pricing Arbitration Agreement, 54 Tax Notes 1335 (Mar. 16, 1992) (announcing that Apple will subject a transfer pricing dispute to arbitration); Barbara N. McLennan, Responses to Section 482 Litigation: Advance Pricing Agreements or Arbitration?, 54 Tax Notes 431 (Jan. 27, 1992) (exploring ways of dealing with transfer pricing, including arbitration).
certain violations of the § 482 transfer pricing rules.\textsuperscript{38}

\subsection*{b. Debt-Equity Classification}

Another mechanism employed by the Service and the courts to ensure that related party transactions bear economic substance is debt-equity classification. Under this classification process, purported loans from a foreign parent to its U.S. subsidiary are evaluated in order to prevent the U.S. subsidiary from receiving debt treatment (and interest deductions) for advances that resemble equity in a substantive sense.

Although § 385 addresses debt-equity classification, the statute merely authorizes Treasury to promulgate regulations, and, after nearly 25 years, there are no final or currently proposed regulations, nor is there an active regulation project. Consequently, the courts have been primarily responsible for crafting the debt-equity classification standards. While uniform standards do not exist, the courts typically analyze purported loans under a facts and circumstances approach that focuses on several factors including the borrowing corporation's debt/equity ratio, the form of the purported debt obligation and whether there have been timely payments of purported principal and interest.\textsuperscript{39}

\section*{3. Dividend and Interest Payments}

Payments of dividends by a U.S. subsidiary to its foreign parent generally are subject to U.S. tax. Because such dividends are paid by a domestic corporation, they usually are treated as U.S. source income.\textsuperscript{40} Consequently, the foreign parent generally is subject to a

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{38} Section 6662(e) generally subjects underpayments to the 20\% penalty imposed by § 6662(a) where either (1) the price claimed on any return is at least 200\% or at most 50\% of the correct § 482 price or (2) the net § 482 income adjustment for the taxable year exceeds the lesser of $5 million or 10\% of the taxpayer's gross receipts (excluding certain adjustments relating to price determinations).
\item \textsuperscript{40} IRC § 861(a)(2)(A). Excepted from U.S. source treatment are dividends paid by a domestic corporation that has elected to receive a special possession tax credit under § 936. IRC § 861(a)(2)(A).
\end{itemize}
\end{footnotesize}
30% tax on the dividends, as well as interest and other fixed or determinable annual or periodical income received from U.S. sources. This tax is collected through withholding from the dividend payments.

Similarly, payments of interest by a U.S. subsidiary to its foreign parent and other recipients generally are subject to U.S. tax. Because such interest is paid by a U.S. corporation, it generally is treated as U.S. source income. As a consequence, the foreign parent and other foreign recipients of interest paid by a U.S. subsidiary generally are taxed. This tax on interest payments is subject, however, to two rather significant exceptions. First, it does not apply to payments of portfolio interest, which generally is interest on obligations held by persons who are less than 10% shareholders of the debtor corporation, provided certain notice and registration requirements are met. In addition, the tax does not apply to interest paid on deposits with banks, savings institutions or insurance companies. As with dividends, the tax on interest is collected through withholding. Where the recipient of the interest payments is a U.S. corporation, U.S. citizen or resident alien, the interest is taxed pursuant to the regular provisions applicable to U.S. persons.

See IRC § 904. In essence then, the source rules reflect the United States' asserted right to exercise primary taxing jurisdiction over income that has some nexus with the United States. In general, this nexus is considered to exist, and income thereby is treated as U.S. source, where the income is derived from either (1) activities carried on in the United States or (2) property or capital utilized in the United States. See ALI International Project, note 4, at 19.

IRC § 881(a). The tax does not apply to at least 80% of any dividend paid by a U.S. corporation if at least 80% of the U.S. corporation's gross income for the three-year period ending immediately before the year of the dividend is active foreign business income. IRC §§ 881(d), 871(i)(2), 861(c)(1). Furthermore, tax treaties may apply to reduce the tax rate below 30%. See, e.g., Income Tax Convention, Aug. 6, 1982, U.S.-Aust., art. 10, Tax Treaties (CCH) ¶ 503.21 [hereinafter Australian Treaty].

IRC § 1442.

IRC § 861(a)(1). Excepted from U.S. source treatment is (1) interest paid by a U.S. corporation where at least 80% of its gross income for the prior three years is active foreign business income and (2) interest paid on deposits with a foreign branch of a domestic corporation engaged in either a banking or savings and loan business. IRC § 861(a)(1), (e)(1).

IRC §§ 871(a)(1), 881(a)(1).

IRC §§ 871(h), 881(c).

IRC §§ 871(i), 881(d). Furthermore, tax treaties may reduce or eliminate the tax under either §§ 871(a) or 881(a). See, e.g., Australian Treaty, note 41, art. 11, at ¶ 503.23.

IRC §§ 1441-1442.

IRC §§ 1, 11, 61.
B. Operations Through a U.S. Branch

Where a foreign corporation conducts its U.S. operations through a U.S. branch, the Code employs a set of special rules that allocate and apportion to the U.S. branch a portion of the foreign corporation's worldwide income and expense to determine the net income subject to U.S. tax. Under these rules, the U.S. branch is not viewed as a separate taxable entity, and thus transactions between the U.S. branch and other branches of the foreign corporation are not recognized for tax purposes.

A foreign corporation with a U.S. branch (referred to by the Code as "engaged in trade or business within the United States") is subject to U.S. tax on its "taxable income which is effectively connected" with its U.S. business. Thus, effectively connected taxable income is the base on which such a foreign corporation is taxed. Effectively connected taxable income is equal to effectively connected gross income reduced by the deductions that are apportioned and allocated to such gross income.

1. Effectively Connected Income Rules

Section 864(c) sets forth the rules that determine the gross income effectively connected to a foreign corporation's U.S. business. As

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49 IRC § 882(a); see ALI International Project, note 4, at 15 n.12 (noting that the business of a corporation that is carried on outside the corporation's home country is referred to colloquially as a "branch"). "Trade or business within the United States" is defined primarily by case law under a facts and circumstances test that requires that active, regular, income producing activities be performed in the United States. See, e.g., Continental Trading, Inc. v. Commissioner, 265 F.2d 40 (9th Cir. 1959), cert. denied, 361 U.S. 827 (1959); United States v. Balanovski, 236 F.2d 298 (2d Cir. 1956), cert. denied, 352 U.S. 968 (1957); Pasquel v. Commissioner, 12 T.C.M. (CCH) 1431 (1953). In addition, § 864(b) provides that certain activities relating to the performance of services and trading in securities and commodities will, or will not, be considered a U.S. trade or business of a foreign corporation, as the case may be.

50 Such taxable income is subject to the graduated tax rates prescribed in § 11. IRC § 882(a)(1). The type of taxation provided in § 882(a), that is, gross income less deductions subject to graduated rates, is referred to as net basis taxation. In contrast, the type of taxation provided in §§ 871(a) and 881(a), that is, gross income subject to flat rates, is referred to as gross basis taxation.

51 IRC § 882(a)(2), (c)(1)(A). Similar to a foreign corporation's operations through a U.S. subsidiary, a foreign corporation with a U.S. branch can receive a foreign tax credit, although it is somewhat more limited. Specifically, § 906 allows such a foreign corporation a foreign tax credit against U.S. taxes on effectively connected income, but generally only to the extent that foreign income taxes are imposed on either (1) foreign source effectively connected income or (2) U.S. source effectively connected income by countries other than the foreign corporation's country of incorporation or domicile. Furthermore, the § 904 limitations also apply so that the foreign tax credit under § 906 generally cannot exceed the U.S. tax on the foreign corporation's foreign source effectively connected income.

52 For a detailed discussion of these rules, see Harvey P. Dale, Effectively Connected Income, 42 Tax L. Rev. 689 (1987).
their name implies, these rules generally require that there be some connection to the foreign corporation's U.S. business activities for the income in question to be treated as effectively connected. Before the enactment of these rules, no such U.S. business connection was required; instead, a foreign corporation with a U.S. business was subject to net basis taxation on all of its U.S. source income, under what was referred to as the "force of attraction" rule.

The effectively connected rules essentially are divided into three parts. In general, there are different rules depending on the source and type (passive or active) of the income involved. For the most part, however, these rules focus on the level of U.S. branch participation in allocating gross income to U.S. activities.

The first part of these rules deals with U.S. source income consisting of dividends, interest, royalties and other fixed or determinable annual income or periodical income (often referred to as FDAP items), along with gain from the sale or exchange of capital assets. These items of income have their effectively connected status determined under three tests set forth in the regulations: the business activities test, the asset use test and the special banking rules.

The business activities test ordinarily applies in determining the status of passive-type income that "arises directly from the active conduct" of a foreign corporation's U.S. business. Under this test, such income is effectively connected where the activities of the foreign corporation's U.S. business "were a material factor in the realization of the income." Furthermore, due regard, but not controlling effect, is given to whether or not the income or the underlying asset is booked through separate accounts maintained by the foreign corporation's U.S. business.

In contrast, the asset use test ordinarily applies to determine the status of passive-type income where the U.S. business activities of the foreign corporation "do not give rise directly to the realization of the

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54 See note 50.
55 See H.R. Rep. No. 1450, 89th Cong., 2nd Sess. 14 (1966), reprinted in 1966-2 C.B. 965, 976. Under this prior regime, all U.S. source income was considered to be attributable to U.S. business activities, regardless of any actual connection. Thus, U.S. source income was said to be "attracted" to the U.S. business. See Dale, note 52, at 690.
57 Reg. § 1.864-4(c).
58 Reg. § 1.864-4(c)(3)(i). For example, dividends or interest derived by a dealer in stocks or securities are considered to arise directly from the active conduct of a foreign corporation's U.S. business and therefore are governed by the business activities test. Reg. § 1.864-4(c)(3)(i)(a).
59 Reg. § 1.864-4(c)(1)(i)(b).
60 Reg. § 1.864-4(c)(4).
income.” Under this test, such income is effectively connected where the asset giving rise to the income is either (1) “held for the principal purpose of promoting the present conduct of” the foreign corporation’s U.S. business, (2) “acquired and held in the ordinary course of” the foreign corporation’s U.S. business, or (3) “[o]therwise held in a direct relationship to the” foreign corporation’s U.S. business. In addition, even under the asset use test, any U.S. branch activities that materially contribute to the realization of the income are taken into account. Furthermore, as in the business activities test, due regard is given to where items are booked.

Finally, special rules apply to foreign corporations engaged in a U.S. banking business. These rules determine whether dividends, interest or gain or loss from the disposition of stocks or securities are effectively connected to such a business. Such items generally are effectively connected where the U.S. branch “actively and materially participated in soliciting, negotiating, or performing other activities required to arrange the acquisition of the stock or security.”

The second part of the effectively connected rules pertains to U.S. source income other than FDAP and capital gains. These items are treated as effectively connected to a foreign corporation’s U.S. business regardless of whether there is an actual connection of the item to the U.S. business operations. Thus, to this limited extent, the force of attraction rule continues.

Finally, the third part of the effectively connected rules governs the status of foreign source income. Only certain types of foreign source income are even considered for effectively connected treatment. Except for certain rents, royalties, dividends, interest and income from sales of inventory and similar property, foreign source income is not treated as effectively connected. These excepted items are effec-

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61 Reg. § 1.864-4(c)(2)(i). For example, interest income earned on securities that are held to meet the operating expenses of a foreign corporation’s U.S. manufacturing branch is not considered to arise directly from the U.S. business activities and therefore is subject to the asset use test. Reg. § 1.864-4(c)(2)(i).
62 Reg. § 1.864-4(c)(2)(ii)(a)-(c).
63 Reg. § 1.864-4(c)(2)(iii)(b)(3).
64 Reg. § 1.864-4(c)(5).
65 Reg. § 1.864-4(c)(5)(iii)(a). The regulation further provides that “[t]he U.S. office need not have been the only active participant in arranging the acquisition of the stock or security.” Reg. § 1.864-4(c)(5)(iii)(a). Notwithstanding meeting the participation standard, the income from most stocks and a portion of investment securities are not effectively connected. See Reg. § 1.864-4(c)(5)(iii)(b).
66 IRC § 864(c)(3).
67 Because this rule only applies to income other than FDAP and capital gains, it primarily applies to sales of inventory and similar property. See Bittker & Lokken, note 56, ¶ 66.3.3, at 66-45; cf. Reg. § 1.864-4(b)(Ex. 3).
68 IRC § 864(c)(4). Further requirements are set forth in the statute limiting the types of rents, royalties, dividends and interest that will be considered for effectively connected
tively connected only if the U.S. branch is a "material factor in the production" of the income item. 69

2. **Apportionment and Allocation of Deductions to Effectively Connected Income**

Section 882(c)(1)(A) authorizes Treasury to issue regulations that apportion and allocate deductions to a foreign corporation's effectively connected income. The regulations are divided into two categories: (1) those for determining the interest expense deduction and (2) those for determining all other expense deductions. 70

The interest expense deduction is determined under a complex formula. In general, the regulation apportions interest expense to a foreign corporation's U.S. business activities largely based on the relative amount of the foreign corporation's worldwide assets held by its U.S. branch. 71 This approach is based on the view that money is fungible and that therefore the use of borrowed funds in one branch of a foreign corporation frees up and allows for the use of funds in other branches. 72

The regulation provides a three-step process for the determination of the interest deduction apportioned to a foreign corporation's effectively connected income. First, the average total value of all assets that generate effectively connected income ("U.S. assets") is determined for the particular taxable year. 73 Second, the amount of the foreign corporation's worldwide liabilities connected to its U.S. business ("U.S.-connected liabilities") for the particular year is determined by multiplying the amount of U.S. assets by either (1) the

69 IRC § 864(c)(4), (c)(5)(B). More specifically, the statute requires that a foreign corporation's U.S. "office or other fixed place of business" meet this participation standard. IRC § 864(c)(4)(B). The statute and the regulations go on to define U.S. office with detailed rules provided for agent activity. IRC § 864(c)(5)(A); Reg. § 1.864-7. The regulations also contain a detailed description of the material factor test with respect to specific categories of income. Reg. § 1.864-6. Finally, the statute provides special rules for insurance income and income of controlled foreign corporations. IRC § 864(c)(4)(C)-(D).

70 Reg. § 1.882-4(b)(1).

71 Reg. § 1.882-5.


73 In particular, the regulation includes assets that "generate, have generated, or could reasonably have been or be expected to generate" effectively connected income, gain or loss. Reg. § 1.882-5(b)(1). For purpose of the regulations, assets can be valued on the basis of either their adjusted basis or fair market value. Reg. § 1.882-5(a)(2). Furthermore, for purposes of computing assets, liabilities and interest expense under the regulations, interbranch transactions are disregarded. Reg. § 1.882-5(a)(5).
foreign corporation's actual worldwide liabilities-to-asset ratio or (2) a fixed ratio intended to approximate the actual ratio. The actual ratio is determined for the particular year by dividing the foreign corporation's average total amount of worldwide liabilities by its average total amount of worldwide assets. The fixed ratio is 95% for a U.S. banking or similar business and 50% for any other U.S. business.

Under the third step, an interest rate is imputed to the U.S.-connected liabilities and a resulting interest deduction determined pursuant to either the branch book-dollar pool method or the separate currency pools method.

Under the branch book-dollar pool method, emphasis is placed on the interest rate for liabilities shown on the books of the foreign corporation's U.S. business. In particular, if the amount of U.S.-connected liabilities does not exceed the average total amount of U.S. book liabilities for the particular taxable year, the interest expense deduction is equal to U.S.-connected liabilities multiplied by the average interest rate on U.S. book liabilities for the particular year ("U.S.-connected interest rate"). On the other hand, if U.S.-connected liabilities exceed U.S. book liabilities, the interest expense deduction is equal to the sum of (1) U.S. book interest expense and (2) excess U.S.-connected liabilities multiplied by the average interest rate on U.S. dollar liabilities for the particular taxable year booked at non-U.S. branches of the foreign corporation ("non-U.S.-connected interest rate").

Under the separate currency pools method, the focus is on the worldwide interest rates for the currencies in which the U.S. branch has borrowings. Specifically, for each currency reflected in U.S.-book liabilities, a separate interest deduction is computed that equals the product of (1) the ratio of U.S.-connected liabilities to U.S.-book liabilities, (2) the average amount of U.S.-book liabilities denominated in the particular currency and (3) the foreign corporation's average worldwide interest rate for that particular currency for the particular year.

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74 Reg. § 1.882-5(b)(2). A foreign corporation is given an election to use either ratio, which must be made on the corporation's return for the first taxable year subject to the regulations and cannot be changed without Service consent. Reg. § 1.882-5(b) (flush language).
75 Reg. § 1.882-5(b)(2)(ii).
76 Reg. § 1.882-5(b)(2)(i).
77 Reg. § 1.882-5(b)(3). As with the choice of ratios, a foreign corporation generally has a one-time election to use either method. Reg. § 1.882-5(b)(3).
79 Reg. § 1.882-5(b)(3)(i)(B). Where information regarding the non-U.S.-connected interest rate cannot reasonably be obtained, approximate rates, such as London interbank offered rates (LIBOR) for U.S. dollar deposits, may be used. Furthermore, where only a de minimis amount of U.S. dollar liabilities are booked at non-U.S. branches, the U.S.-connected rate is used for all U.S.-connected liabilities. Reg. § 1.882-5(b)(3)(i)(B).
The foreign corporation's interest deduction is equal to the sum of the separate computations for each currency involved. In 1992, Treasury issued a proposed regulation that makes several significant changes to the interest expense determination. First, the fixed worldwide liability-to-asset ratio for banks has been lowered to 93%. In addition, for banks electing to use the actual ratio, a ratio in excess of 96% is not permitted, even if it can be substantiated. Finally, the third step of the calculation is revised so as to effectively eliminate the separate currency pools method and modify the branch book-dollar pool method. The proposed regulation calls for the use of a rate dependent on LIBOR for U.S. dollar demand deposits, instead of the foreign corporation's non-U.S. connected interest rate, where U.S.-connected liabilities exceed U.S.-book liabilities.

The deduction for expenses other than interest is determined under an approach that involves both specific allocation and formulary apportionment. In general, the regulations assign expense deductions to U.S. branch activities based on the factual connection of the expenses to these activities.

In particular, where an expense factually is related solely to effectively connected income, the expense is specifically allocated to such income, and therefore a foreign corporation is allowed a deduction for the item. A deduction is considered factually related to a particular "class of gross income . . . if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived." 

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80 Reg. § 1.882-5(b)(3)(ii). Generally speaking, with respect to currencies for which a relatively small amount of liabilities are shown on the U.S. books, a foreign corporation may elect to use the U.S. dollar worldwide interest rate in the above computation.
82 Prop. Reg. § 1.882-5(c)(3).
84 Prop. Reg. § 1.882-5(d).
85 Prop. Reg. § 1.882-5(d)(4)(ii). Specifically, banks must use a rate equal to 90% of the average U.S. dollar deposit LIBOR for the taxable year, and nonbanks must use 110% of this rate.
86 The proposed regulation also makes other changes including conforming the definition of U.S. assets to that contained in the regulations under the branch profits tax provision, Prop. Reg. § 1.882-5(b)(1)(ii)(A)(1), and providing a detailed definition of U.S.-book liabilities (referred to in the proposed regulations as "booked liabilities"), which may require that U.S. branch personnel perform certain activities with respect to the liabilities. Prop. Reg. § 1.882-5(d)(2).
87 Reg. § 1.861-8; Temp. Reg. § 1.861-8T. The method for allocating and apportioning deductions prescribed in Reg. § 1.861-8 also is used for assigning deductions to U.S. and foreign source income for purposes of determining the foreign tax credit limitations under § 904. Reg. § 1.861-8(a)(1).
88 Reg. § 1.861-8(b)(1); Temp. Reg. § 1.861-8T(c)(1).
89 Reg. § 1.861-8(b)(2). The regulations provide further illumination on the factual relationship test for specific items such as legal and accounting fees, income taxes, losses on the
On the other hand, where a deduction is factually related to a class of gross income that consists of both effectively connected and non-effectively connected income, the deduction must be apportioned between these two types of income. In general, the regulation requires that apportionment be accomplished in a way that "reflects to a reasonably close extent the factual relationship between the deduction" and the effectively and non-effectively connected income. To this end, the regulation gives examples of apportionment factors that may be used: units sold, gross receipts, costs of goods sold, profit contribution, expenses incurred, assets used, salaries paid, space utilized, time spent and gross income. For example, in the case of a deduction factually related to income that includes both effectively and non-effectively connected income, the deduction may be apportioned to effectively connected income based on the relative amount of such gross income, provided this method reasonably reflects the factual relationship between the deduction and the effectively connected income.

3. Branch Profits Tax

A foreign corporation with a U.S. business is also subject to the branch profits tax: actually two separate taxing mechanisms, the branch profits tax and the so-called excess interest tax.

The branch profits tax was enacted in 1986 "[t]o achieve greater parity between the remittance of [a foreign corporation's U.S.] branch profits and the distribution of [a U.S.] subsidiary's earnings." As mentioned earlier, where a foreign corporation conducts a U.S. business through a U.S. subsidiary, distributions of earnings by the subsidiary generally are subject to a 30% tax. The branch profits tax attempts to bring about similar treatment where a foreign corporation conducts its U.S. business in branch form by imposing a second level of tax on earnings remitted by the U.S. branch.
Unlike the workings of a dividend tax, however, the branch profits tax does not measure and tax actual remittances made by the U.S. branch. Congress apparently felt it would not be feasible to do so, given that a U.S. branch does not have legally separate assets and activities. Instead, the branch profits tax indirectly measures remittances as the yearly earnings of the U.S. branch that are not reinvested in the U.S. branch. In addition, prior year's earnings not yet subject to the branch profits tax are considered to be remitted to the extent that investment in the U.S. branch decreases.

Specifically, § 884(a) imposes on a foreign corporation a tax equal to 30% of the dividend equivalent amount, that is, the earnings deemed to be remitted. The dividend equivalent amount is defined as effectively connected earnings and profits for the year, reduced by any increase in U.S. net equity (U.S. assets less U.S. liabilities) during the year. Where, however, there is an annual decrease in U.S. net equity, the amount of this reduction is included in the dividend equivalent amount to the extent that the aggregate effectively connected E&P for prior years (beginning in 1987 or thereafter) exceeds the aggregate dividend equivalent amount for those years. The regulations provide special rules for such events as a termination of the

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effectively connected. It had been observed that the effectively connected gross income of foreign corporations almost never reached this threshold, and thus this tax rarely, if ever, was imposed. See H.R. Rep. No. 841, note 94, at II-648.

97 See Bittker & Lokken, note 56, ¶ 66.5.2, at 66-92.
98 The 30% tax is subject to treaty modifications. IRC § 884(e)(2).
99 Effectively connected E&P is determined in a manner similar to the E&P of domestic corporations, except that effectively connected taxable income is used in place of taxable income. IRC § 884(d); Reg. § 1.884-1(f)(1); cf. IRC § 312.
100 IRC § 884(b)(1), (c)(1). U.S. assets and liabilities are defined in the statute and in greater detail in the regulations. IRC § 884(c)(2); Reg. § 1.884-1(d)-(e). The regulations define U.S. assets as generally those assets that produce effectively connected income, and thus the focus is on the factual connection of the assets to the U.S. branch's business. Reg. § 1.884-1(d)(1). With respect to liabilities, however, the regulations eschew a factual connection approach and instead define U.S. liabilities as essentially the liabilities attributed to the U.S. branch for purposes of the Reg. § 1.882-5 interest expense calculation. Reg. § 1.884-1(e)(1).

It would appear that based on the terms of the statute, Treasury had support for defining liabilities under an approach that focuses on the factual relationship of the liabilities to the U.S. branch's business, such as treating U.S. liabilities as those that are booked at the U.S. branch. Specifically, § 884(c)(2)(C) provides that the regulations defining U.S. assets and U.S. liabilities "shall be consistent with the allocation of deductions under section 882(c)(1)," which is the provision authorizing the promulgation of regulations to allocate and apportion deductions to effectively connected income. As discussed previously, the regulations assigning deductions to effectively connected income use two different approaches: a factual relationship-formulary apportionment approach for noninterest deductions and a formulary apportionment approach for interest deductions. Thus, a factual relationship approach for determining U.S. liabilities would appear to be somewhat consistent with one of the methods used in allocating deductions to effectively connected income.

101 IRC § 884(b)(2).
U.S. business, as well as incorporation, reorganizations and liquidations involving the U.S. business.102

Similar to the branch profits tax, the so-called excess interest tax was enacted in 1986 to achieve a greater parity between the payments of interest by a foreign corporation with U.S. branch operations and those made by a foreign corporation with U.S. subsidiary operations.103 As noted above, where a foreign corporation conducts a U.S. business through a U.S. subsidiary, interest payments to foreign persons generally are subject to a 30% tax,104 and interest payments to U.S. persons are includable in the income of those persons.105 Additionally, a U.S. subsidiary should receive interest deductions only for amounts ultimately paid.106 Consequently, all interest for which a U.S. subsidiary receives a deduction generally is subject to U.S. tax in the hands of the recipient.

Before the enactment of the excess interest tax, it was possible for a foreign corporation with U.S. branch operations to receive an interest expense deduction that exceeded the interest paid by the foreign corporation that was treated as U.S. source and thereby potentially subject to U.S. taxation to foreign recipients.107 While this is still true today,108 the excess interest tax steps in and taxes the foreign corporation on the excess of its deductible interest expense over the U.S. source interest that it pays; consequently, similar to the treatment of a U.S. subsidiary's operations, all interest payments made by the foreign corporation that give rise to a deduction generally are subject to U.S. tax.109

In particular, any interest paid by a foreign corporation's U.S. busi-

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102 Temp. Reg. § 1.884-2T.
104 IRC §§ 871(a)(1)(A), 881(a)(1).
105 IRC § 61; see notes 43-48 and accompanying text.
106 See IRC § 163(a). Even though an accrual basis U.S. subsidiary would receive a deduction when the liability to pay interest accrues, any amounts that are not ultimately paid would have to be added back into income under the tax benefit rule, effectively negating the previous deduction. See Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370 (1983).
107 Before the 1986 Act, interest paid by a foreign corporation was U.S. source only when either (1) the foreign corporation's gross income over the prior three years consisted of at least 50% effectively connected income (and then only to the extent of its effectively connected income percentage) or (2) the interest was paid or credited by a U.S. banking branch of a foreign corporation. IRC § 861(a)(1)(B), (C) (before amendment in 1986). Thus, the U.S. source determination was not tied to the amount of deductible interest expense under Reg. § 1.882-5.
108 Currently, interest paid by a foreign corporation's U.S. trade or business is treated as U.S. source. IRC §§ 884(f)(1)(A), 861(a)(1).
ness is treated as if it were interest paid by a U.S. corporation. The regulations define interest paid by the U.S. business as follows: for nonbanks, it is generally the interest paid on U.S. branch book liabilities and for banks, it is generally the interest paid on liabilities treated as U.S. branch liabilities under bank regulatory rules and the interest paid on certain foreign branch liabilities with respect to which U.S. personnel performed substantially all material duties. See Reg. § 1.884-4(b)(1)-(2).

Additionally, the Code provides that any excess of deductible interest under § 1.882-5 of the regulations over interest paid by the foreign corporation's U.S. business is treated as paid to the foreign corporation by a wholly-owned U.S. subsidiary. As a consequence, the foreign corporation is subject to U.S. tax on this constructively received interest. The regulations provide exceptions to the excess interest tax as well as methods of reducing the amount of excess interest. These features are examined later.

III. The Separate Entity Method Proposal

A. In General

This Section proposes that, in lieu of the current treatment, a U.S. branch should be treated as a separate taxable entity for U.S. tax purposes, provided that the separate entity method continues to be used for U.S. subsidiaries. As a consequence, the rules currently applicable to a foreign corporation's U.S. operations through a U.S. subsidiary would be applicable to U.S. branch operations as well.

Like a U.S. subsidiary, a U.S. branch would determine its taxable income under the separate entity method by including income that it receives or accrues and deducting expenses that it pays or incurs. In doing so, transactions between the U.S. branch and foreign branches of the foreign corporation would be recognized to the same extent as transactions with third parties. Thus, an important change would be the recognition of interbranch transactions.

As with a U.S. subsidiary and its foreign parent, however, there would not be an arm's length relationship between the U.S. branch and foreign branches of the foreign corporation. Consequently, it

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110 IRC § 884(f)(1)(A). The regulations define interest paid by the U.S. business as follows: for nonbanks, it is generally the interest paid on U.S. branch book liabilities and for banks, it is generally the interest paid on liabilities treated as U.S. branch liabilities under bank regulatory rules and the interest paid on certain foreign branch liabilities with respect to which U.S. personnel performed substantially all material duties. See Reg. § 1.884-4(b)(1)-(2).

111 See note 43 and accompanying text.

112 IRC § 884(f)(1)(B).

113 IRC § 884(a); see text following note 43. The interest treated as paid by a U.S. corporation would be U.S. source under § 861(a)(1). See note 43 and accompanying text. Treaties may reduce or eliminate this tax on excess interest. IRC § 884(e)(3).

114 See notes 340-42 and accompanying text.

115 Section VI of this Article recommends an alternative tax treatment if the separate entity method is discontinued for U.S. subsidiaries.

116 This alternative formulation is due to a branch's choice to use either the cash or accrual methods of tax accounting, as limited by § 448.
would be necessary to use the transfer pricing rules of § 482 to allocate income and deductions among the U.S. branch and foreign branches in accordance with arm's length principles. Similarly, purported borrowing transactions between the U.S. branch and foreign branches would need to be scrutinized under debt-equity classification standards to determine whether such transactions involve debt in an economic sense.

Finally, as is the case with dividends paid by a U.S. subsidiary, earnings remittances made by the U.S. branch to foreign branches of the foreign corporation would be treated as U.S. source dividends, taxable to the foreign corporation under § 881(a). Likewise, interest payments made by the U.S. branch, including those made to foreign branches of the foreign corporation, would be treated as U.S. source interest and thereby generally subject to tax under §§ 871(a) or 881(a) to foreign recipients.

B. Mechanical Details

Separate entity treatment for U.S. branches could be accomplished by amending the Code to provide that for purposes of the Code, a foreign corporation's "trade or business within the United States" (the terms used to describe a U.S. branch) shall be treated as a U.S. corporation that is wholly-owned by the foreign corporation. This would permit repeal of the statutory provisions and regulations comprising the current regime for operations through U.S. branches, that is, §§ 864(c), 882 and 884. As a consequence, all of the rules providing separate entity treatment for U.S. corporations would govern the taxation of U.S. branches as well. Thus, as a constructive U.S. corporation, a U.S. branch would determine its taxable income separately pursuant to the normal statutory provisions applicable to U.S. corporations (such as §§ 61, 162 and 163), be subject to § 482 and debt-equity classification standards, and have its payments of dividends and interest treated as from U.S. sources (pursuant to § 861(a)) and

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117 Cf. Ernst & Young, Tax Implications of Cross-Border Trading by International Banks, 51 Tax Notes 765, 779 (May 13, 1991) (noting that separate entity treatment would require the Service to ensure that interbranch transactions reflect arm's length principles).

118 Treaties may reduce the 30% tax under § 881(a). See note 41.

119 As noted earlier, exemptions are provided for portfolio and deposit interest. See notes 45-46 and accompanying text. In addition, treaties may reduce or eliminate the 30% tax under §§ 871(a) or 881(a). See note 46.

120 IRC § 882(a)(1). See note 49 and accompanying text.

121 Such an amendment could be made to § 7701(a), which provides definitions.

122 Dividends would be distributions by the U.S. branch to foreign branches of the foreign corporation (its deemed shareholder) that are out of the U.S. branch's E&P. See IRC §§ 301(c), 316(a).
thereby generally taxable to foreign recipients (including foreign branches of the foreign corporation) under §§ 871(a) or 881(a). 123

Unlike an actual U.S. subsidiary, a U.S. branch treated as a U.S. corporation would not have a legal existence separate from that of the foreign corporation. Thus, a branch will not have legally separate bank accounts, assets, employees or contracts with customers. Without such separate elements, it might be difficult for the Service to verify the income and deductions claimed by the U.S. branch, especially when interbranch transactions are involved.

To avoid abuse, I propose that a U.S. branch be required to maintain separate bank accounts designated in the name of the U.S. branch. In addition, employees and assets of the U.S. branch should be specifically designated as such, pursuant to a mandatory identification procedure. Additionally, I propose that all documents relating to U.S. branch activities, such as contracts with customers, receipts and the like be designated similarly as documents of the U.S. branch. Finally, a U.S. branch would maintain separate books of account, an implicit requirement under several current provisions. 124 Penalties would be imposed where a U.S. branch fails to comply with these designation and recordkeeping requirements. 125

It should be emphasized that the U.S. branch’s books of account and designated bank accounts would serve merely as a starting point in the Service’s determination of the U.S. branch’s taxable income. As in the case of an actual U.S. corporation, the U.S. branch’s books, along with payments made into its bank accounts for goods, services and the like, and payments made from these accounts for expenses (including interbranch payments made to and from these accounts),

123 As a constructive U.S. corporation, a U.S. branch also would be allowed a foreign tax credit under § 901, rather than under § 906, absent any limitations on the extent to which a U.S. branch is treated as a U.S. corporation. I recommend, however, that § 901 not be used and that § 906 be retained in modified form. If § 901 were used, a U.S. branch as a constructive U.S. corporation would receive a credit, subject to limitations, for income taxes imposed on it by foreign countries. Because other countries currently do not separately impose their income taxes on a U.S. branch, it would be necessary to have some mechanism within § 901 to determine the portion of a foreign corporation’s foreign income taxes imposed on U.S. branch income. Consequently, § 906, which contains such a mechanism, essentially should be retained. See note 51. Nonetheless, § 906 should be modified to refer to a U.S. branch’s taxable income as opposed to effectively connected income, in light of the separate entity proposal.

124 See, e.g., Reg. § 1.882-5, which uses U.S. book liabilities and interest expense in the interest deduction determination. Separate accounts for branches commonly are used for businesses, in order for corporations to know the profitability of their several branches. OECD Committee on Fiscal Affairs, Commentaries on the Articles of the Model Convention (Sept. 1992), at C(7)-5 [hereinafter Commentaries].

125 The penalties probably should be a fixed dollar amount for each violation, that is, similar to the penalties that apply for a failure to file an information return. Cf. IRC §§ 6721-6724.
would be used by the U.S. branch and the Service in the determination of the branch's income tax liability. As is also the case with an actual U.S. corporation, the Service would not be bound by the branch's books and bank account transactions. Instead, the Service would have the ability under § 482 to allocate gross income and deductions between the U.S. branch and other branches of the foreign corporation so as to reflect the income economically earned by the activities of the U.S. branch.\textsuperscript{126} In allocating income and deductions based on U.S. branch activities, the designation of employees, assets and transactional documents as belonging to the U.S. branch would be useful, although not dispositive. Consequently, for both an actual U.S. corporation and a U.S. branch treated as a U.S. corporation, the activities performed by the entity ultimately should determine its income tax liability.\textsuperscript{127}

\textbf{C. Treatment of Investment Income}

The treatment of investment income, such as dividends and interest, deserves further discussion. Under the terms of the proposal, passive income with no connection to the business of the U.S. branch nevertheless could be included in the taxable income of the U.S. branch. This would result from the designation requirement under which the U.S. branch is free to designate assets as "owned" by itself. For example, the U.S. branch would have the freedom to designate particular stocks or securities as owned by the U.S. branch, and any income on the stocks or securities so designated generally would be included in

\textsuperscript{126} This is generally the approach recommended by the OECD for determining the profits attributed to a branch, that is, starting with the separate accounts of the branch and making adjustments as are necessary to reflect the facts. See Commentaries, note 124, at C(7)-6 to C(7)-7. Similarly, the ALI, in recommending a tracing method for determining a U.S. branch's expense deductions, proposes that the fact that an expense was incurred and booked at the U.S. branch "should be given some presumptive weight in attributing" the expense to U.S. operations; however, the Service always would have the opportunity to establish that such expenses, in fact, did not relate to U.S. operations. See ALI International Project, note 4, at 118-19.

\textsuperscript{127} Although this Article does not dwell on this point, it would seem sensible to apply the separate entity method to those somewhat rare instances where a U.S. business is conducted by a nonresident alien. This could be accomplished by treating such a nonresident alien as a constructive resident alien solely with respect to the U.S. business operations. This treatment would have the advantage of allowing the full repeal of § 864(c), as this provision applies to nonresident aliens as well as foreign corporations. See generally Section IV.B.3, dealing with administrative benefits arising from the use of the separate entity method for U.S. branches. In addition, the use of the separate entity method for a nonresident alien's U.S. business operations should more accurately reflect the income arising from these operations. See generally Section IV.A.3, discussing the separate entity method's advantages in reflecting income.
the U.S. branch’s taxable income. Consequently, a U.S. branch, in effect, would be able to elect to include investment income in either the U.S. branch’s taxable income or in the income taxable to the foreign corporation under § 881(a).

This ability to subject investment income to U.S. net basis taxation electively is contrary to current law. When viewed in connection with the separate entity proposal as a whole, however, it does not appear to implicate the concerns that gave rise to current limitations regarding the effectively connected status of investment income.

The restrictions currently set forth in § 864(c)(2) and the regulations thereunder on the effectively connected status of passive income appear to be due to two concerns. First, Congress wanted to ensure that in most cases U.S. source dividends would be fully subject to U.S. tax. In the situation where U.S. source dividends are effectively connected, there is a corresponding dividends-received deduction

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128 The ability on the part of the Service to use § 482 to allocate such investment income would appear to be very limited. This is because the U.S. branch would be treated for tax purposes as engaging in the activity that economically generated the income, that is, owning the stock or securities. If work were performed by another branch of the foreign corporation to arrange the acquisition of the stock or securities (for example, a loan made by a foreign branch of a foreign banking corporation), the Service should be able to use § 482 to allocate a portion of the income to the other branch, presumably as fees for the performance of services.

129 A U.S. branch, however, would not possess an effective election to completely exclude from U.S. net basis taxation passive income that arises from branch business activities. For example, assume a U.S. branch of a foreign bank performs all the work necessary to arrange a loan, but the security evidencing the loan is held by a foreign branch. Although the interest received from the borrower at the accounts of the foreign branch should not be included in the income of the U.S. branch, this transaction should result in at least some income to the U.S. branch and possibly additional consequences to the foreign branch. First, there should be income under § 482 to the U.S. branch for the services it performed for the foreign branch with respect to the loan. In addition, if there was an agreement between the branches calling for the foreign branch to return the funds supplied by the U.S. branch in the transaction, there should be interest income imputed to the U.S. branch on this interbranch loan. If, however, there was no such agreement, the effective transfer of the funds to the foreign branch should be viewed as a distribution by the U.S. branch; to the extent of the U.S. branch’s E&P, the distribution would be treated as a dividend taxable to the foreign corporation under § 881.

130 See Section II.B.1. Of course, all aspects of the separate entity proposal are contrary to the current regime applicable to U.S. branches. Except for this rule for investment income, however, the remainder of the proposal can be viewed as a different method of achieving what current law does—subjecting only the business income of the U.S. branch to net basis taxation when earned and to a second tax when remitted. The investment income rule is more of a substantive change in that it would allow a U.S. branch a choice as to whether to subject investment income to net basis taxation.

131 These limitations are reflected for the most part in the asset use test contained in the regulations. Under this test, passive-type income that is not a direct result of a foreign corporation’s U.S. business activities will be effectively connected only where the investment assets bear some relationship to the business, say by providing a needed source of working capital. See notes 61-63 and accompanying text.

under § 243. At the time the effectively connected rules were enacted, § 243 generally provided for an 85% deduction. Consequently, at that time no more than 15% of the amount of such a dividend would be subject to U.S. net basis taxation. Furthermore, there likely would be no U.S. tax on the U.S. source dividends when these amounts ultimately are distributed to the shareholders of the foreign corporation, in light of the applicable source rules adopted in the 1966 Act. In order to prevent this result, Congress limited the ability to effectively connect U.S. source dividends so that such dividends instead would be fully taxable under § 881(a).

Congress also was concerned that, in the absence of some limitation on the effectively connected status of passive income, U.S. tax considerations would have a disruptive effect on the decision of a foreign corporation to invest or engage in business in the United States. It had come to the attention of Congress that the force of attraction rule deterred foreign corporations with U.S. branches from investing in the United States, because such investment income would be subject to U.S. tax at graduated rates without any applicable treaty reduction. Similarly, under the force of attraction rule, foreign corporations with investment income were deterred from establishing a U.S. branch. Moreover, Congress felt that it was inequitable and illogical for there to be such a substantial difference in the tax treatment of investment income based on the presence or absence of an unrelated U.S. business.

An election to subject nonbusiness income to net basis taxation, in the context of the separate entity proposal, does not appear to implicate these concerns. First, because remittances of earnings by the U.S.

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133 Currently, § 243 generally provides for a 70% deduction.
134 This percentage could even be lower where expenses such as interest were allocated to and deductible against the dividend income.
135 Congress amended § 861(a)(2)(B) to provide that a dividend paid by a foreign corporation would be U.S. source income (and therefore taxable to foreign shareholders) only where at least 50% of the foreign corporation's gross income for the three-year period prior to the declaration of the dividend consists of effectively connected income, and then, only in an amount equal to the percentage of effectively connected income. Pub. L. No. 89-809, § 102(b), 80 Stat. 1539, 1543 (1966). Consequently, any dividends paid by the foreign corporation likely would be foreign source income and therefore, not taxable to the recipients. Before this amendment, the rule was the same except that the percentage test focused on the foreign corporation's U.S. source income as opposed to effectively connected income.
136 This rule is subject to any applicable treaty reductions.
138 See note 55 and accompanying text.
140 Id.
branch would be taxable to the foreign corporation under § 881(a), U.S. source dividends subject to net basis taxation (and a corresponding dividends-received deduction) effectively would be fully subject to U.S. tax when ultimately distributed by the U.S. branch to foreign branches of the foreign corporation. Second, foreign corporations should not be deterred from making investments or establishing a U.S. branch because they always can choose to have the investments held by foreign branches and thereby be taxable on the investment income under § 881(a), subject to treaty reductions. Finally and importantly, it does not appear to be inequitable or illogical to allow such an election, given the fact that a foreign corporation operating through a U.S. subsidiary effectively can elect to have investment income subject to U.S. net basis taxation by having investments held by its U.S. subsidiary.141

IV. Fundamental Tax Policies Supporting Separate Entity Method for U.S. Branches

It appears that Congress has not fully articulated any policy justification for using the current regime applicable to U.S. branches of foreign corporations as opposed to the separate entity method. The congressional reports accompanying the 1966 legislation enacting the effectively connected income rules are devoid of any such discussion.142 Similarly, the congressional hearings on the earlier act adopting the force of attraction rule do not appear to address a separate entity alternative.143

Most likely, the current treatment for U.S. branches is an outgrowth of the general principle that each legal entity is considered a single taxpayer and that transactions between elements of a single taxpayer have no tax significance.144 Thus, the current regime, which allocates

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141 Nevertheless, as in the case of operations through a U.S. subsidiary, there would appear to be some limits on the ability of a U.S. branch to hold investment assets, in light of the accumulated earnings tax and personal holding company tax that would be applicable to U.S. branches under the separate entity proposal. See IRC §§ 531-537, 541, 547.


144 Cf. ALI International Project, note 4, at 15 n.12 (noting that when a corporation incorporated in one country carries on business through a branch in another country, "only a singletaxpaying entity is involved"); H. David Rosenbloom, The Source of Interest Payments Made by Nonresidents, 30 Wayne L. Rev. 1023, 1035-36 (1984) [hereinafter Interest
and apportions segments of a foreign corporation’s total income in order to determine the income subject to U.S. net basis taxation, is apparently a logical consequence of this single taxpayer principle. To a lesser extent, and after the fact, administrative concerns with a separate entity method have been voiced by commentators and possibly implied by Congress.\textsuperscript{145} For the most part, however, a separate entity method alternative to the current regime used for taxing U.S. branches has not been seriously considered by either Congress\textsuperscript{146} or commentators.\textsuperscript{147}

Payments\textsuperscript{[14]} (pointing out that a treaty-based separate entity method for U.S. branches is difficult to mesh with U.S. tax law, in that a payment from a foreign corporation’s U.S. branch to its home office is no more deductible “than a ‘payment’ by an operating department of a corporation to the administrative department”).

\textsuperscript{145} See notes 219-20 and accompanying text.

\textsuperscript{146} Interestingly, the House once passed legislation that would have allowed foreign branches of U.S. corporations to be treated as separate taxable entities. In enacting the 1954 Code, the House passed a provision that would have permitted a U.S. corporation to elect to defer the tax on income allocable to its foreign branch until the income was withdrawn from the branch. The purpose of this provision was to provide parity in the tax treatment of foreign branches and foreign subsidiaries of U.S. corporations. To determine the income allocable to the foreign branch, the branch was to be viewed as a separate and distinct entity apart from the U.S. corporation, and thus transactions between the foreign branch and other parts of the U.S. corporation were to be recognized for tax purposes, subject to possible § 482 adjustments. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 76 app. at 259-65 (1954). The Senate Finance Committee, however, did not include this provision in the Senate Bill because it felt that a related rate differential provision for foreign income passed by the House presented uncertainties and difficult problems. See S. Rep. No. 1622, 83d Cong., 2d Sess. 105 (1954), reprinted in 2 U.S. Revenue Acts, 1954 Legislative Histories & Congressional Documents. When the bill went to the Conference Committee, the House receded on both the deferral and rate differential provisions. H.R. Rep. No. 2543, 83d Cong., 2d Sess. 68-69 (Conf. Rep. 1954), reprinted in 2 U.S. Revenue Acts, 1954 Legislative Histories & Congressional Documents. Of course, several years later Congress took a different course in achieving a degree of parity between foreign branch and subsidiary operations when it enacted subpart F, which restricts the deferral of U.S. tax on income earned through certain foreign subsidiaries. See IRC §§ 951-964.

\textsuperscript{147} See ALI International Project, note 4, at 121 (stating, without elaboration, that the separate entity method “should not govern the basic relationship between branch and head office” because “[a]t bottom there seems to be an irreconcilable difference between a branch and a subsidiary”); cf. Ross, note 2, at 284 (noting that at least until the 1966 Act, the taxation of foreign persons had been given less scrutiny than other areas). Recently, a few commentators have requested that consideration should be given to using a separate entity method for U.S. branches. See John A. Corry, NYSBA Reports on Foreign Interest Expense Regs., 92 Tax Notes Int'l 39-31 (Sept. 23, 1992) (noting that it would be productive to give the separate entity method further consideration); Jack Wilson, Ernst & Young Comments On Foreign Banking Issues, 92 Tax Notes Int'l 64-3 (Nov. 4, 1992) (noting that serious consideration should be given to treating a U.S. branch as a separate entity for U.S. tax purposes). In addition, a few other commentators have recommended a limited use of the separate entity method for U.S. branches. See Stephen M. Brecher, John N. Bush & Ronald B. Hadley, Peat Marwick Clients Comment on Global Trading of Financial Products and Potential Regulations, 91 Tax Notes Int'l 22-19 (May 29, 1991) (recognizing that U.S. branches be treated as separate entities for purposes of taxing the trading of financial products); Alfred C. Groff & James F. Hoch, Selected Issues in U.S. Taxation of U.S. Branches of Foreign Banks, 1988 U. Ill. L. Rev. 343, 369 (noting that a possible alter-
As a consequence, the application of the single taxpayer principle to the taxation of U.S. branches, and in particular the separate entity alternative, has not been subject to a rigorous policy analysis. Set forth below is such an analysis, focusing on four fundamental policy concerns in the taxation of international business operations: accurate reflection of income, tax administration and simplicity, harmonizing different countries’ tax laws and neutrally taxing different forms of conducting businesses.148

A. Accurate Reflection of Income

1. Overview

The general rule regarding jurisdiction to tax, which the United States follows, is to tax a person based either on that person’s domicile149 or source of income.150 Accordingly, the United States taxes the worldwide income of a person who is domiciled in the United States151 (that is, a U.S. corporation).152 Alternatively, with respect to a person with a foreign domicile (such as, a foreign corporation), the

native to the current U.S. tax treatment of U.S. branches of foreign banks would be to allow foreign banks to elect to treat their U.S. branches as separate entities; cf. Rosenbloom, The “Separate Entity” Issue: Some Observations, unpublished paper presented at the George Washington University/Internal Revenue Service 5th Institute on Current Issues in International Taxation, 1992 [hereinafter Separate Entity] (examining the need for treating a U.S. branch as a separate entity, especially in connection with the taxation of swap and currency transactions).

Nonetheless, the Service has been forced to consider whether income tax treaties require the use of the separate entity method for determining a foreign corporation’s interest deduction. Several foreign corporations have claimed that pursuant to treaties they are entitled to use the separate entity method, rather than Reg. § 1.882-5 (or its predecessor), in computing interest deductions attributable to their U.S. branches. In three separate revenue rulings, the Service concluded that its regulatory method is consistent with the language of the applicable treaties. Rev. Rul. 89-115, 1989-2 C.B. 130 (U.K. treaty); Rev. Rul. 85-7, 1985-1 C.B. 188 (Japan treaty); Rev. Rul. 78-423, 1978-2 C.B. 194 (Japan treaty), superseded by Rev. Rul. 85-7, 1985-1 C.B. 188. The controversy may not be over, however, as these taxpayers may well litigate the matter. Cf. Rosenbloom, Interest Payments, note 144, at 1035. Furthermore, as indicated by the position of the Organization for Economic Corporation and Development, there is a great deal of international support for using a separate entity method for branches. See notes 301-06 and accompanying text.

Of course, there are nontax legal differences between conducting a business through a U.S. subsidiary and a U.S. branch. However, legal differences alone do not justify different treatment, as indicated by the similar rules used to tax partnerships and S corporations. Instead, the appropriate treatment for taxing U.S. branches should be determined based on fundamental tax policies.

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149 The term domicile as used here includes residence, in the case of an individual, and place of incorporation, in the case of a corporation. See ALI International Project, note 4, at 6.

150 See id.

151 See Bittker & Lokken, note 56, ¶ 65.1, at 65-2. In addition, the United States (unlike most countries) taxes individuals on the basis of U.S. citizenship. See ALI International Project, note 4, at 6.
United States strives to tax only income that has its source in the United States.\textsuperscript{153}

In particular, with respect to a foreign corporation with a U.S. branch and no investment income from the United States, the theoretical goal should be to include in the U.S. tax base only that income from U.S. business activities.\textsuperscript{154} Implicit within this concept of activity-based jurisdiction is that the taxing mechanism of a jurisdiction should attempt to measure accurately the economic income produced by the activities within that jurisdiction.\textsuperscript{155} Thus, a fundamental policy concern in the taxation of U.S. branches of foreign corporations should be to reflect the economic income arising from the branch's activities accurately.\textsuperscript{156}

As explained below, the current system used for taxing the U.S. branch operations of a foreign corporation does not reflect the branch's income accurately. In contrast, the separate entity method, with its greater focus on the specific facts of each transaction in allocating income, would appear to measure the income actually produced by the branch's activities more accurately.

2. Failure of Current Regime

The current U.S. tax system governing the taxation of U.S. branches can be characterized as basically a combination of formulary apportionment and threshold allocation rules. The formulary apportion-

\textsuperscript{152} The United States fully or partially cedes such tax jurisdiction through its foreign tax credit system. IRC §§ 901-905. Other developed countries typically do the same via their own foreign tax credit or exemption systems.

\textsuperscript{153} IRC §§ 871, 881, 882. The term "source" is used here in the generic context to include all income derived from U.S. business operations, even though technically its source may be foreign for purposes of determining foreign tax credit limitations. See ALI International Project, note 4, at 7.

\textsuperscript{154} Cf. ALI International Project, note 4, at 7, 19 (noting that the United States' exercise of source jurisdiction should be limited to income that has an appropriate nexus to U.S. economic activities, and that income from business activities should be sourced to where the business is carried on).

\textsuperscript{155} See Reka P. Hoff, Income Taxation of Foreign Direct Investment in Arizona by Foreign Manufacturing and Merchandising Enterprises: Analysis of the Data and the Federal and State Rules, 28 Ariz. L. Rev. 407 (1986) (pointing out that a goal of income taxation is to measure real earning capacity attributable to activities carried on in a taxing jurisdiction); cf. ALI International Project, note 4, at 21-24, 31-34 (recommending new source rules for sales of inventory property that generally provide for a more refined approach in attributing income to sales and manufacturing activities).

\textsuperscript{156} In this regard, several fairly recent tax provisions demonstrate Congress' desire to reflect economic income accurately in other contexts with respect to the income's timing and elements. For example, the imputed interest rules in §§ 1272-1275 generally require that implicit interest in deferred payment transactions be included and deducted as it economically accrues. Similarly, for certain leasing transactions, § 467 mandates the reporting of rent and interest as they economically accrue.
ment rules generally consist of the regulations under § 1.861-8 and § 1.882-5 for determining the amount of deductions allowed in computing effectively connected income. The threshold allocation rules are the provisions used for determining the amount of effectively connected gross income.

a. Formulary Methods for Apportioning Deductions

By their very nature, rules that apportion income or deductions on the basis of generally applicable formulas result in nothing more than an approximation of the actual economic income in any given situation. 157 This is because such formulas typically use fixed apportionment factors and aggregate data from many transactions. Application of the factors to aggregate data from many transactions assumes that the relative relevance of the factors to the production of income (or the incurrence of expenses) remains constant for each transaction. Given the likelihood that this assumption is incorrect, the formulas may not produce results that are reflective of the actual transactions in all or any cases. Moreover, additional distortion arises from the fact that the fixed factors are not tailored to the specific facts of particular situations, 158 that is, situations involving various industries, different businesses within a particular industry and different economic environments. 159 Criticisms of this nature have been leveled against the unitary method of apportionment employed by several states to tax the state business operations of multinational corporate enterprises. 160 Furthermore, for similar reasons, Treasury officials have continued to oppose the use of the unitary method for federal income tax purposes. 161

157 In this regard, the OECD generally opposes the use of formulary methods to apportion profits between affiliated corporations on the grounds that such methods are all somewhat arbitrary. See Committee on Fiscal Affairs, Organization for Economic Co-operation and Development, Transfer Pricing and Multinational Enterprises 14 (1979); see also Rosenbloom, Interest Payments, note 144, at 1044 (noting that formulas by their very nature “are intended to achieve a proper result in the average case, not every case”).

158 Cf. John S. Nolan, United States Taxation of Foreign Investment in the United States, 8 Am. J. Tax Pol’y 291, 297 (1990) (arguing that the so-called earnings stripping provision contained in § 163(j), which in effect applies a formulary approach to determine a high debt-equity ratio and excessive interest payments, is flawed in that it fails to take into account the individual facts and circumstances of a particular situation).

159 See Hoff, note 155, at 440.

160 See Ernst & Young, note 117, at 785.

161 See Dale W. Wickham & Charles J. Kerester, New Directions Needed for Solution of the International Transfer Pricing Tax Puzzle: Internationally Agreed Rules or Tax Warfare?, 56 Tax Notes 339, 343 (July 20, 1992); cf. ALI International Project, note 4, at 5 (pointing out that there never has been a serious proposal to use any unitary method for federal income tax purposes and that the possibility of its use seems remote).
The formulary methods used to apportion deductions to a foreign corporation's effectively connected income are subject to the same types of problems. The method for determining interest deductions contained in § 1.882-5 of the regulations is based on the concept that money is fungible and that therefore the use of loan proceeds in one branch of a foreign corporation frees up and allows for the use of funds in other branches. Consequently, borrowings and the resulting interest expense are apportioned to the U.S. branch largely based on the relative amount of worldwide assets within the U.S. branch.

While the premise on which the fungibility approach is based, that is, that borrowings allow for the use of funds in all branches of a foreign corporation in proportion to the relative amount of branch assets, is no doubt correct for many transactions, it is not correct for numerous others. Thus, the fungibility approach may not reflect the facts. Based on these considerations, the New York State Bar Association, in reporting on the first proposed interest apportionment regulations, recommended that the fungibility approach be elective only, with the default option being a tracing approach that takes into account the facts of individual transactions.

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163 Id. at 355-58.

164 See N.Y. St. Bar Ass'n Tax Section, Proposals for Improvement of Rules for Allocation of Deductions Between Foreign and U.S. Source Income: A Report on Section 1.861-8 of the Proposed Regulations, 29 Tax L. Rev. 597, 645 (1973) [hereinafter NYSBA Report]. In this regard, the NYSBA Report sets forth several examples illustrating the fungibility approach's failure to reflect facts in particular cases accurately. One such example begins with a U.S. corporation having only U.S. activities and $10 million of outstanding indebtedness incurred for the purposes of these activities. The corporation then acquires all of the stock of a foreign corporation with funds obtained through the issuance of additional shares of its own stock. The example points out that the $10 million of previously outstanding indebtedness neither bears a factual relationship to the acquired subsidiary nor frees up funds for use in the subsidiary's business. Yet, the fungibility approach would attribute a portion of the pre-existing borrowings to the stock investment in the foreign subsidiary and thus fail to reflect the factual connection of the interest expense to the activities of the U.S. corporation. Id. at 653. The report provides another example that can be paraphrased to pertain to a foreign corporation with a U.S. branch. A foreign corporation's home office borrows funds and then reinvests these funds in bonds issued by a third party. This borrowing does not free up any funds for use in the U.S. branch, and thus assigning a portion of this interest expense to U.S. branch activities would not reflect the underlying facts. Id.


166 NYSBA Report, note 164, at 659-60. The NYSBA Report also notes that the fungibility approach of the proposed § 1.861 regulations would conflict with the allocations required under §§ 57(b), 163(d) and 265(2), as they stood in 1973. Id.

The ALI project also recommends a tracing approach for taxpayers in general, but does carve out an exception for financial institutions for whom some sort of formulary approach is warranted. ALI International Project, note 4, at 122-25. The ALI makes these recom-
Another distortion caused by § 1.882-5 of the regulations relates to the fact that one factor used in the apportionment formula, the rate of interest, is not comparable across different economic environments. As originally promulgated, the rules apportioning interest deductions to effectively connected income did so by reference to borrowings in various currencies and consequently had the effect of averaging the interest rates on the worldwide, multicurrency borrowings of a foreign corporation. Thus, the regulation disregarded the fact that interest rates on borrowings in a particular currency are affected by expectations concerning that currency's future appreciation or depreciation and therefore could vary from currency to currency. In time, Treasury recognized that, as a result of this aspect, the regulation poorly reflected the actual cost of the mainly U.S. dollar borrowings incurred to fund the U.S. branch. To remedy this problem, Treasury issued § 1.882-5 of the regulations in 1980, which as discussed above, attempts to use the interest rates for the particular currencies involved in the U.S. branch borrowings in apportioning interest deductions to effectively connected income.

Unfortunately, while the current regulations take into account average worldwide interest rates for individual currencies, distortions continue to result. These distortions seem to be due in part to the fact that using average worldwide interest rates for dollar borrowings fails

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167 Cf. note 159 and accompanying text.
169 See Ruchelman & Orlin, note 162, at 355. This problem appears to be somewhat unique for foreign corporations, given the fact that they, unlike U.S. corporations, typically tend to borrow large amounts in currencies other than the dollar. See Staff of the Joint Comm. on Tax'n, 98th Cong., 2d Sess., Tax Reform Proposals: Taxation of Foreign Income and Foreign Taxpayers 135 (Comm. Print. 1985) [hereinafter Tax Reform].
170 Tax Reform, note 169, at 135 (discussing the reasons for the special rules used to apportion the interest expense of foreign corporations).
171 See notes 77-86 and accompanying text.
172 As two commentators noted at the time, the revised regulations reflected "a significant step into the realm of economic reality." Ruchelman & Orlin, note 162, at 359.
to accurately reflect the interest rate for the dollar borrowings used to fund U.S. branches. As a result of this and other perceived problems, Treasury issued proposed amendments to § 1.882-5 of the regulations in 1992 that substantially revised the regulation. As noted earlier, one of the changes requires that, to the extent that U.S.-connected liabilities do not exceed U.S.-book liabilities, the actual interest rate on U.S.-book liabilities is to be used to compute the interest deduction; to the extent that U.S.-connected liabilities exceed U.S. book liabilities, a rate dependent on LIBOR is to be used.174

Although the proposed changes to § 1.882-5 of the regulations are a commendable attempt to achieve results better reflecting the actual cost of funding U.S. branches, distortions are still possible. They eliminate the use of average worldwide rates for individual currencies and mandate a greater focus on the actual interest rates incurred to fund the U.S. branch. Nevertheless, in the situation where the U.S. branch's attributable liabilities exceed its booked liabilities and inter-branch borrowings by the U.S. branch are in effect presumed, the regulation still would not seek to determine a market interest rate for these borrowings based upon the particular facts of the situation. Instead, they use the somewhat arbitrary LIBOR-dependent rate that potentially could result in a failure to properly reflect the actual cost of funding the U.S. operations.175

The rules for apportioning deductions other than interest, contained in § 1.861-8 of the regulations, similarly may produce results that do not reflect the actual expenses incurred with respect to U.S. branch activities. Although Reg. § 1.861-8 allows deductions for expenses that are solely related to activities producing effectively connected income, apportionment is mandated where expenses are incurred at foreign branches that relate to both effectively connected and non-effectively connected income.176 Such apportionment can be based on a wide range of factors and therefore is much more flexible and fact specific than the method prescribed in § 1.882-5 of the regulations. Furthermore, the regulation does not explicitly require that aggregate deductions be so apportioned; that is, it seems permissible to apportion each separate deduction on a basis that is reasonable in light of

175 See Public Comments on Proposed Regulations, 57 Tax Notes 468, 470-73 (Oct. 26, 1992) (reporting comments pointing out that the use of this LIBOR-based rate will fail to reflect U.S. branches' actual borrowing costs). Furthermore, this rate distortion is in addition to other distortions caused by the regulations' general failure to take into account the particular facts of individual transactions in apportioning liabilities and interest expenses to U.S. operations. See notes 164-66 and accompanying text.
176 Similarly, apportionment is mandated in the less likely case where expenses are incurred at the U.S. branch that relate to both categories of income.
the factual relationship of the deduction to effectively connected income. Nevertheless, the regulation apparently also allows several deductible items to be apportioned on the basis of a single factor.\textsuperscript{177} Consequently, the regulation may be subject to the problems alluded to earlier by producing results that differ from the facts of individual transactions.\textsuperscript{178} Perhaps even more important, by focusing on only the costs incurred at foreign branches in connection with the production of effectively and noneffectively connected income, the regulation in effect assigns none of the total net profit realized by the foreign corporation to the foreign branches—a result that typically does not accord with the manner in which the income is economically earned.

\textbf{b. Distortions from the Rules for Assigning Income}

Unlike the apportionment rules contained in §§ 1.882-5 and 1.861-8 of the regulations, which at least attempt to divide expenses between the U.S. branch and foreign branches, the rules for determining effectively connected income, set forth in § 864 and the regulations thereunder, often do not even endeavor to make such a division. Instead, these rules generally assign either all or none of the income from a given transaction to the U.S. branch largely based on the level of participation by the branch’s personnel,\textsuperscript{179} and thus generally can be described as a threshold allocation approach. Where the U.S. branch and one or more foreign branches of a foreign corporation have participated in a particular transaction, these rules result in the allocation of an amount of income to the U.S. branch that deviates from the economic income attributable to branch activities.\textsuperscript{180}

While always having had the potential for distortions, the problems brought on by the effectively connected rules have been exacerbated in the last several years due to increased cross-border financial activi-

\textsuperscript{177} The author is aware of one situation where the Service permitted a taxpayer to apportion all expenses (salaries, depreciation, supplies and the like) relating to a given activity based on the relative amounts of effectively and noneffectively connected gross income from that activity.

\textsuperscript{178} The ALI report also recommends an approach for deductions other than interest that generally eschews apportionment in favor of stressing the factual connection between the expenses incurred and the U.S. branch operations. ALI International Project, note 4, at 116-18. While the preference for factual connection is based mainly on administrative concerns, the ALI apparently does not view formulary apportionment as clearly superior to factual connection as far as reflecting the actual expenses attributable to U.S. branch operations. In this regard, the report notes that while formulary apportionment possibly offers a conceptually purer result in some cases, it (along with a factual connection approach) also offers taxpayers latitude to minimize U.S. tax.

\textsuperscript{179} See Ernst & Young, note 117, at 776; Plambeck, note 3, at 1154; notes 56-69 and accompanying text.

\textsuperscript{180} See Ernst & Young, note 117, at 776; Plambeck, note 3, at 1154.
ties of foreign banks and financial institutions. With the advent of
global trading, it is not unusual for two or more branches of a financial
institution to be involved in a single transaction.181

For example, in the situation where a multibranch transaction is
conducted by a foreign corporate bank, the operative test for effec­
tively connected treatment should likely be the active and material
participation standard of § 1.864-4(c)(5) of the regulations.182 Conse­
quently, if activities are performed at the U.S. branch with respect to
such a transaction that constitute active and material participation, all
of the gross income from the transaction would be effectively con­
nected. Furthermore, the U.S. branch would not be allowed any de­
ductions against effectively connected income for any interbranch
payments made to non-U.S. branches for the activities performed at
those branches, since interbranch transactions generally are disre­
garded for U.S. tax purposes.183 Although the bank should be al­
lowed deductions against effectively connected income for any costs
incurred at the foreign branches with respect to the transaction,184 the
result would be that all of the net income from the transaction would
be subject to U.S. tax. From an economic standpoint, however, some
of the net income is probably due to activities performed at the for­
egn branches. Similarly, if the U.S. branch's participation was below
the “active and material” threshold, then none of the income would
be subject to U.S. tax,185 though some must be attributable to U.S.
branch activities in an economic sense.

The problem may be even more pronounced in the case of interest
rate swaps and currency swaps. For example, assume that a foreign
corporation functions as a financial intermediary, for a fee, between
two third parties desiring to swap interest rates. This is accomplished
by having the U.S. branch enter into an interest rate swap with a third
party and a foreign branch enter into an offsetting (with a spread)
interest rate swap with the other third party. Except for the spread
(the fee received), the foreign corporation is perfectly hedged. In or­
der to prevent cash flow problems in funding their respective obliga­
tions under the swaps, the U.S. and foreign branches enter into an
offsetting interest rate swap with each other. Thus, except for all or a

181 See generally Ernst & Young, note 117, at 767-71; Plambeck, note 3, at 1145-49.
182 See notes 64-65 and accompanying text. If the transactions involve notional principal
contracts (such as interest rate swaps), both the material factor standard (contained in
the business activities test) and the asset use test may apply instead. See note 186. Where
nonbanks engage in financial activities, the material factor standard and the asset use test
should be used.
184 Reg. § 1.861-8; notes 87-92 and accompanying text.
185 This assumes that the income would not be subject to gross basis taxation under
§ 881 because it is either foreign source, or is excluded by way of a statute or treaty.
portion of the spread, the two branches each have hedged their positions.

Economically, each branch earns a portion of the fee received by the foreign corporation for the activities performed in bringing together the two swapping third parties. The tax results, however, may be far different. If, for a given year, the U.S. branch-third party swap produces a net loss, this loss should be deductible for U.S. tax purposes under the material factor standard set forth in the business activities test.\(^\text{186}\) And because the net income from the offsetting interbranch swap is disregarded\(^\text{187}\) for U.S. tax purposes, the foreign corporation should show a net loss from the swap for the year.\(^\text{188}\) Consequently, even though the U.S. branch economically has earned a portion of the fee from these “swap” financial services, it likely would be treated as having a loss for U.S. tax purposes.\(^\text{189}\)

\(^{186}\) Reg. § 1.863-7(b)(3) provides that the effectively connected status of interest rate swap income is determined “under principles similar to those set forth in § 1.864-4(c).” The cited regulation contains the business activities test, the asset use test and the special banking rules. See notes 56-65 and accompanying text. The special banking rules are applicable only to certain stock or securities and therefore do not seem appropriate for swaps. Consequently, it appears that swap net income or loss for all foreign corporations should be effectively connected if it satisfies either the business activities test or the asset use test. Cf. Ltr. Rul. 9348015 (Aug. 31, 1993); Ernst & Young, note 117, at 777 (concluding that the single most appropriate test for swap income is the business activities test, which focuses on whether the activities of the U.S. branch were a material factor in the realization of the income).

\(^{187}\) Reg. § 1.863-7(a)(1). Similarly, the net gain on the foreign branch third party swap likely would not be included in the U.S. branch’s effectively connected income, in light of the U.S. branch’s lack of relationship to this swap. Cf. Rosenbloom, Separate Entity, note 147, at 16-17.

\(^{188}\) Cf. Rosenbloom, Separate Entity, note 147, at 16-17; Ernst & Young, note 117, at 779 (pointing out that a U.S. branch’s disposition of a depreciated third party swap position should generate a deductible loss, whereas the termination of an appreciated, offsetting interbranch swap would not give use to includible income); Plambeck, note 3, at 1154 (noting the problems created by failing to take into account interbranch swaps).

\(^{189}\) Similar distortions would occur with respect to currency swaps, since their effectively connected status also should be determined principally under the material factor test and by ignoring interbranch swaps. See Reg. § 1.988-4(e).

Arguably, there may be less of a problem in the situation where the U.S. branch third party swap produces a net gain for the year. Although the U.S. branch will not be allowed to deduct the net loss on the offsetting interbranch swap, it may be able to deduct the net loss on the foreign branch third party swap. This is because such net loss may be viewed as factually related to the production of the effectively connected net gain on the U.S. swap, and therefore possibly deductible under Reg. § 1.861-8. If not currently deductible under this regulation, the Service would appear to have the authority under § 882(c)(1)(A) to address this in regulations. See Rosenbloom, Separate Entity, note 147, at 16-17. This approach, however, would result in all of the foreign corporation’s spread on the swaps (that is, the fee from financial services) being subject to U.S. tax—a result that deviates from the economics of the transaction. On the other hand, where the U.S. branch third party swap produces a net loss (as in the text example), the Service may lack the regulatory authority to pull in the net income from the offsetting swap, in light of the statutory effectively connected rules. See id.
Another distortion created by the effectively connected income rules is due to the vestiges of the force of attraction rule, coupled with somewhat arbitrary source rules. As noted earlier, one category of income, namely U.S. source income other than FDAP, is effectively connected to a foreign corporation's U.S. business without any necessary connection to U.S. business activities. Furthermore, the remnants of the title passage rule for the sourcing of income from inventory sales do not require any substantive U.S. connection for U.S. sourcing. Consequently, it is entirely possible that income from a transaction can be effectively connected when it arises solely from activities performed outside the United States.

The Regulation illustrates how the remaining force of attraction rule can cause income to be effectively connected in a situation where it is clear that the income bears no economic relation to the activities of the U.S. branch. In an example, a foreign corporation conducts a U.S. business through a branch office in the United States that sells electronic equipment. The home office of the corporation also is engaged in the business of purchasing and selling wine. The U.S. branch is not involved to any degree in the wine business. Notwithstanding, the example concludes that sales of wine made by the home office directly to U.S. customers (without routing the transactions through the U.S. branch) give rise to effectively connected income where the income from such sales is U.S. source (which would be the case if title passes in the United States).

Finally, although there is one situation where the effectively connected income rules (through application of the source rules) divide

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190 IRC § 864(c)(3); see notes 66-67 and accompanying text.
191 Although § 865(e)(2), added by the Tax Reform Act of 1986, provides that income from the sale of personal property by a foreign corporation is U.S. source where the income is attributable to the U.S. branch of the foreign corporation, the wording of the paragraph, along with § 865(b), indicates that the title passage rule of § 861(a)(6) continues to control where the income is not so attributable.
192 Thus, not only do these particular rules result in an "all or nothing" threshold allocation, they do so in situations where there may be no connection to U.S. business activities. The ALI report recommended the elimination of the title passage rule in favor of an approach focusing on the place of a certain level of sales activity that generated the income in question (a threshold allocation rule). ALI International Project, note 4, at 21-23. As a result, § 864(c)(3) implicitly would require a factual connection to U.S. business activities, because the income referred to in this section would be U.S. source only where that is the case. Id. at 79 n.136. While the ALI's recommendation to effectively remove the remains of the force of attraction rule is commendable, its decision to retain a threshold allocation ("all or nothing") rule would continue to lead to distortions.
193 Reg. § 1.864-4(b)(Ex. 3). The income, however, may not be subject to U.S. tax where there is an applicable treaty limiting the taxable profits to those which are "attributable to the permanent establishment." Rev. Rul. 81-78, 1981-1 C.B. 694 (ruling that Article 8(1) of the U.S.-Poland Income Tax Convention overrides the application of the residual "force of attraction" principle of § 864(c)(3)).
the income generated from a transaction between U.S. and foreign branches, the method of division is often a somewhat arbitrary income apportionment resulting in a near 50-50 split of taxable income. Section 863(b)(2) and the regulations thereunder provide source rules (and through the application of § 864(c)(3), effectively connected rules) for income generated by the production of property in one country and its sale in another country—for example, production at a foreign corporation's U.S. branch and sale at its non-U.S. branch. The regulations provide that where the taxpayer has an independent factory price for the property, that price governs the income split between the U.S. and non-foreign branches. Where an independent factory price does not exist, the taxable income from the production and sale of property generally is apportioned in the following manner: one half of the entire taxable income is apportioned to the country of sale (the foreign country in this situation) and the remaining one half of the entire taxable income is apportioned to the two branches in accordance with the relative amount of branch assets. In the typical case where the amount of assets of the foreign sales branch is small compared to that of the U.S. manufacturing branch, the effect of these rules is that slightly less than 50% of the taxable income from the manufacture and sale will be effectively connected where there is no independent factory price. Consequently, although the rules divide the income from a transaction, it is entirely possible that the method of division will not reflect the economic income generated at each of the two branches.

3. Advantages of Separate Entity Method

In contrast to the current U.S. method used to determine the taxable income of U.S. branch operations, the separate entity method generally would focus on the specific facts of each transaction to allocate income based on economic activities. This method should result in a

194 Reg. § 1.863-3(b)(2)(Ex. 1). See Notice 89-10, 1989-1 C.B. 631. Typically, an independent factory price would exist where the manufacturer regularly sells to wholly independent distributors. Without such sales, the taxpayer must show to the satisfaction of the Service that an independent factory price can be established, and the Service cannot do so if the taxpayer chooses not to establish an independent factory price. See id.

195 Reg. § 1.863-3T(b)(2)(Ex. 2). This apportionment formula actually is applicable only to gross income. The regulation provides, however, that where the formula applies, deductions relating to the manufacturing and sales activities are apportioned ratably to the U.S. and foreign portions of the gross income. Reg. § 1.863-3T(b)(2)(Ex. 2(ii)). Consequently, the formula in effect applies to the taxable income generated by these activities.

196 Under § 864(c)(4)(B)(iii), the foreign source portion of the income should not be effectively connected.

197 The result would likely be an overallocation to foreign source and therefore non-effectively connected income. See ALI International Project, note 4, at 32.
more accurate reflection of income than the application of the formu-
lary apportionment/threshold allocation approaches currently in use.

In particular, the problems created by § 1.882-5 of the regulations in
the determination of a branch’s interest expense deductions would not
be present under the separate entity method. While the regulation
attributes a portion of all of a foreign corporation’s worldwide bor-
rowings to the U.S. branch operations, the separate entity method
would take into account only the actual borrowings made by the
branch from third parties and other branches of the foreign corpora-
tion. Although the separate entity method generally would pay heed
to the specific facts of individual transactions, of course, it would not
always respect the labels affixed to transactions by the parties in inter-
branch dealings. To ensure that their labels comport with economic
reality, purported lending transactions between foreign branches and
the U.S. branch, like those between related incorporated entities,
would be scrutinized under debt-equity classification standards. As a
result, the separate entity method should not result in a failure to re-
fect the facts of particular transactions, a criticism leveled against the
fungibility approach.198

Furthermore, the separate entity method generally would take into
account the actual interest rate charged to the U.S. branch for each
borrowing transaction, including interbranch borrowings. And, as
with all transactions between related parties, the Service would em-
ploy § 482 and its transfer pricing principles to ensure that the interest
rates charged in interbranch borrowings adhere to an arm’s length
standard. Consequently, the distortions from the use of average inter-
est rates or interest rate indices, which are possible under § 1.882-5 of
the regulations, should not occur under the separate entity method.199

For similar reasons, the use of the separate entity method should
improve upon regulation § 1.861-8’s treatment of expenses other than
interest that are incurred with respect to U.S. branch activities. Under
the separate entity method, the U.S. branch would receive expense
deductions for payments made to third parties and arm’s length pay-
ments made (or deemed to be made) to foreign branches of the for-
eign corporation. Thus, no longer would aggregate data from many
transactions along with other factors be used to apportion those ex-

198 See notes 164-66 and accompanying text.
199 See Carr, note 173 (claiming that the distortions caused by Reg. § 1.882-5’s use of
average interest rates would be overcome under the separate entity method).
pense transactions or impute them under § 482.200 Furthermore, these arm’s length interbranch payments (actual or deemed) may include a profit element.201 Thus, this approach should better reflect the economic income attributable to U.S. branch activities.

The use of the separate entity method to determine expense deductions for U.S. branch operations is similar, but not identical, to the tracing approaches recommended by the New York State Bar Association and the ALI.202 Under both approaches, the facts of individual transactions are taken into account and payments made in the United States for U.S. activities would be deductible by the U.S. branch. A difference between the approaches relates to the charge recognized or imputed in interbranch transactions. Under a tracing approach, when costs are incurred outside the United States for the U.S. branch, interbranch transactions are effectively imputed at a charge equal to the cost of the expenses. In contrast, under the separate entity approach, which would call for application of transfer pricing principles, the recognized or imputed charge for interbranch expense transactions may include a profit element. Thus, the separate entity method would result in a better reflection of income than the tracing approach, as a portion of the total net profit would be allocated to the economic activities responsible for such.

On the income side, the use of the separate entity method would avoid the distortions arising from the effectively connected rules, which have the potential for “all or nothing” income results. Instead of assigning either all or none of the income from a transaction with multibranch involvement generally on the basis of a certain level of participation by U.S. personnel, the separate entity method would attempt to divide income according to the occurrence of economic activity, through the recognition of interbranch transactions. Under the separate entity method and the concomitant use of transfer pricing rules, where the U.S. branch and one or more foreign branches participate in a transaction, an arm’s length charge would be recognized (or imputed) for the products or services provided in the interbranch transactions. Thus, the income from a transaction could be divided among the contributing branches in a manner better comporting with

200 In the less typical case where payments are made out of U.S. branch accounts for expenses relating to both U.S. and foreign activities, arm’s length payments for expense transactions would be deemed to have been made from the foreign branch to the U.S. branch, resulting in additional gross income to the U.S. branch.

201 Cf. notes 27-30 and accompanying text.

202 See note 166 and accompanying text.
economic reality.\textsuperscript{203}

Similarly, the application of the separate entity method should eliminate the gross distortions that occur under the current rules with respect to swap transactions. Through the recognition of interbranch swaps, along with imputed charges for the swap facilitation services performed either by or for the U.S. branch, the U.S. tax base would reflect the income economically earned by the U.S. branch on the swaps.

The use of the separate entity method also would rid the tax system of the anomalies created by the remnants of the force of attraction rule in conjunction with the arbitrary source rule for inventory sales. Because a U.S. branch under the separate entity method would include only the income attributable to the branch's activities,\textsuperscript{204} sales with no connection to U.S. branch activities would not generate income subject to U.S. tax.

Finally, the adoption of the separate entity method would improve upon the method now in use for dividing income between the U.S. and foreign branches from the manufacture and sale of property.\textsuperscript{205} Instead of using a near 50-50 apportionment in situations where an independent factory price does not exist, an arm's length division of the income between the branches would be sought in all cases. In fact, the ALI report recommended that the current sourcing rule be replaced by an approach using § 482 transfer pricing principles to divide the income among the branches.\textsuperscript{206} Although generally advocating threshold allocation approaches to source (and effectively connect) income, the ALI report recommended a separate entity approach in this context because it felt that without such a refined method, severe distortions would result.\textsuperscript{207}

The arm's length pricing approach has been criticized in that it allegedly fails to accurately reflect the synergistic effect of integrated operations.\textsuperscript{208} This criticism is based on the view that related multina-

\textsuperscript{203} See Ernst & Young, note 117, at 776 (stating that apportioning profits on the basis of economic activity provides a more equitable result to both taxpayers and taxing jurisdictions than current law's "all or nothing" approach).

\textsuperscript{204} Under the proposed rules, income earned by U.S. branch activities would be received through the branch's designated accounts. To the extent that such income is not received in the designated accounts, or income not earned by branch activities was so received, there would be imputed arm's length interbranch payments.

\textsuperscript{205} See Reg. § 1.863-3T(b)(2).

\textsuperscript{206} ALI International Project, note 4, at 29-34.

\textsuperscript{207} Id. at 33-34. The report also noted that administrative difficulties in establishing arm's length charges would be greater in other contexts as well. Id. at 24. Administrative concerns are discussed more fully in Section IV.B.

\textsuperscript{208} Stanley L. Langbein, The Unitary Method and the Myth of Arm's Length, 30 Tax Notes 625, 654-69 (Feb. 17, 1986); Plambeck, note 3, at 1152; Wickham & Kerester, note 161, at 345-47.
tional companies often function as an economic unit, quite unlike unrelated parties.209 As a consequence, there typically may be a lack of comparable arm’s length transactions between unrelated parties. Furthermore, commentators have alleged that other pricing methods, such as costs plus appropriate markups, similarly fail to reflect the profits of an integrated business enterprise accurately.210 While a strict application of arm’s length pricing approaches may prove unsatisfactory in this regard, there are other alternatives sanctioned by the arm’s length standard—namely, the use of individualized formulary apportionment methods to divide the profits from business activities among the participants.211 Consequently, in a situation where an arm’s length pricing method would improperly reflect the income generated by integrated business operations, an individualized apportionment formula could be used, that is, a formula based on the particular facts and circumstances of each case as opposed to uniform factors that may turn out to be arbitrary.212

Furthermore, some commentators have denounced the arm’s length approach as unenforceable, and claim that an unacceptable number of taxpayers fail to comply with the transfer pricing rules. If so, although the separate entity arm’s length method may have the most potential for accurately reflecting income, its potential may not be realized due to taxpayer manipulation. These compliance problems appear to be solvable, however. Moreover, the current rules for U.S. branches also may have serious enforcement problems, as they rely on a foreign corporation’s worldwide data, which are difficult to verify, and use vague, fact-intensive participation standards that can lead to taxpayer manipulation.213 Finally, at the very least, the use of the separate entity

210 See, e.g., Langbein, note 208, at 654-69.
211 See ALI International Project, note 4, at 33; John Turro, IRS Inks Two Pricing Agreements in Derivative Products Area, 55 Tax Notes 725 (May 11, 1992) (discussing advanced pricing agreements entered into by financial institutions reflecting individualized formulary apportionment); note 32 and accompanying text (referring to profit split methods); see also Langbein, note 208, at 671-73.
212 See Ernst & Young, note 117, at 782, 783, 785. In this regard, advanced pricing agreements possibly could provide a workable means of implementing both transfer pricing and individualized formulary approaches. See notes 259-66 and accompanying text. Even generalized formulary apportionment approaches have been advocated to overcome the perceived failings of the arm’s length pricing method in reflecting income of integrated business operations. Wickham & Kerester, note 161, at 360. It would appear, however, that no matter how economically substantive the apportionment factors are in such a generalized approach, any method that applies the same formula to different industries or even different businesses within the same industry could result in distortions. But see Langbein, note 208, at 673 (noting the debate of general versus case-by-case apportionment and viewing general apportionment, possibly differing by industry, as more desirable).
213 These matters are discussed more fully in Section IV.B.
method should lead to an improvement in that it attempts to divide profits among participating branches, whereas the current rules often make no such attempt.

In sum, treating the U.S. branch of a foreign corporation as a separate taxable entity should result in a more accurate reflection of the branch's net income for U.S. tax purposes. Interbranch transactions would be recognized (or imputed), subject to arm's length principles, giving foreign corporations and the Service the flexibility to divide a corporation's profits between its branches on the basis of its particular facts and circumstances—whether through the determination of transfer prices or formulation and application of an individualized apportionment formula. Consequently, the economics of a particular foreign corporation's business would be respected, resulting in a more accurate reflection of U.S. branch income.

B. Tax Administration and Simplification

A major tax policy consideration in recent years has been simplification. The increasing sophistication of U.S. tax laws has triggered consternation over the unwieldiness of the system. As a result, tax reform simplification bills are proposed annually, and in general, the subject has dominated current tax literature.

Using the separate entity method for U.S. branches would help to simplify the U.S. tax law. To begin with, there apparently are no greater concerns with the use of the separate entity method for U.S. branches than there currently are with U.S. subsidiaries. Nevertheless, the use of the separate entity method for U.S. branches would have certain disadvantages compared to the current regime—namely, the need to resort to fact-specific mechanisms aimed at ensuring that related party transactions have economic substance. Several administrative advantages, however, appear to outweigh these negative features, the most important of which is that the use of the separate entity method for U.S. branches would result in one regime for the taxation of U.S. operations of foreign corporations.

214 See Ernst & Young, note 117, at 781.
217 Wilson, note 147 (noting, without much discussion, that use of the separate entity method for U.S. branches would simplify this area of tax law).
1. Separate Entity Method for U.S. Branches as Compared to U.S. Subsidiaries

There has been very little reported discussion on the part of Congress and commentators concerning the reasons why the separate entity method is appropriate for U.S. subsidiaries, but not for U.S. branches. The limited comment suggests that there are two administrative concerns in using the separate entity method for U.S. branches. First, a U.S. branch’s lack of legally separate assets and activities would hinder the ability to measure directly the flow of funds to and from the branch; and second, generally respecting a branch’s separate accounts could lead to taxpayer manipulation, given that there would not be any nontax constraints (such as financial accounting) on where to book items.

Despite these assertions, use of the separate entity method for U.S. branches should not result in any additional problems as compared to its use for U.S. subsidiaries. The separate entity method proposal calls for the use of separately kept books, accounts, assets, employees and documents. Consequently, these administrative requirements should alleviate concerns over a U.S. branch’s lack of legally separate assets and activities.

Moreover, the feasibility of using such separately kept books, accounts and assets, in the absence of legally separate items and accounting requirements, is demonstrated by their use for tax purposes in several other contexts. For example, the amount of liabilities and interest shown on the books of the U.S. branch are used in apportioning a foreign corporation’s interest deduction to effectively connected

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218 See notes 142-47 and accompanying text.
219 This concern may have caused Congress to adopt an indirect system of measuring branch remittances in enacting the branch profits tax. Bittker & Lokken, note 56, ¶ 66.52, at 66-92.
220 See Nolan, note 158, at 316 (objecting to the ALI’s recommended tracing approach for the determination of a U.S. branch’s expenses); see also Rosenbloom, Interest Payments, note 144, at 1041 (noting that use of a tracing approach in lieu of a fungibility approach for determining a U.S. branch’s interest deduction would lead to taxpayer manipulation).

A substantial number of the foreign corporations with U.S. branches, however, are either banks or insurance companies and thus are subject to nontax regulatory reporting requirements regarding assets and liabilities. See note 9. Consequently, for a significant portion of the foreign corporations with U.S. branches, there is nontax legal significance as to where items are booked, and therefore, the risk of taxpayer manipulation is reduced. Cf. Prop. Reg. § 1.882-5(d)(2)(ii)(B)-(C) (liabilities of banks and insurance companies that are reported to U.S. regulators ordinarily are properly reflected on the U.S. branch books and thus taken into account in determining the branch interest expense deduction); Brecher et al., note 147 (noting that separate entity treatment may be particularly appropriate for foreign banks and insurance companies whose U.S. branches are subject to U.S. regulatory requirements).

221 See notes 124-25 and accompanying text.
income.\(^{222}\) Similarly, the amount of interest paid on U.S. branch book liabilities is used to determine the U.S. source interest paid by the foreign corporation and the excess interest tax liability.\(^{223}\) Additionally, under the effectively connected income rules, whether or not items are booked at the U.S. branch is given consideration, although not controlling effect.\(^{224}\) Furthermore, under certain circumstances, a taxpayer may obtain from the Service permission to use its books and records in allocating to U.S. and foreign sources the income derived from the sale of property manufactured within (without) the U.S. and sold without (within) the U.S.\(^{225}\)

Indeed, in a slightly different context, Congress apparently has recognized that there is no greater risk of taxpayer manipulation in treating a branch as a separate taxable entity as there is in so treating a subsidiary. Specifically, for purposes of determining the tax consequences of transactions conducted in foreign currencies, § 989(a) and the regulations thereunder provide that a branch (as well as a corporation) can be considered a separate Qualified Business Unit ("QBU").\(^{226}\) As long as a separate set of books and records are maintained, business activities conducted in branch form are treated as a QBU.\(^{227}\) It appears that Congress recognizes, at least for this purpose, that treating a branch as a separate entity is administratively feasible.\(^{228}\)

Thus, there would appear to be no greater concerns of taxpayer manipulation in using the separate entity method for U.S. branches as

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\(^{222}\) See notes 78-86 and accompanying text.

\(^{223}\) See notes 110-14 and accompanying text.

\(^{224}\) See note 60 and accompanying text.

\(^{225}\) See Reg. § 1.863-3(b)(2)(Ex. 3). In particular, the taxpayer would have to show that (1) its books and records better reflect the sourcing of income than either the independent factory price or formulary apportionment methods and (2) such books are regularly employed in good faith and without considerations of tax liability. See notes 194-96 and accompanying text for a discussion of the other methods of allocating such income to U.S. and foreign sources.

\(^{226}\) Reg. § 1.989(a)-1(b).

\(^{227}\) Reg. § 1.989(a)-1(b)-(d). The effect of separate QBU status for a foreign branch of a U.S. corporation is as follows: Income from transactions that are conducted in the particular foreign currency applicable to the QBU (its "functional currency") is determined in foreign currency amounts and then translated into U.S. dollar amounts based on a yearly average of applicable exchange rates. IRC § 987; Reg. § 1.985-1(a), (c). Furthermore, transfers of assets, functional currency and liabilities between QBUs result in the recognition of currency gain or loss. Prop. Reg. § 1.987-2. On the other hand, if separate QBU status were not given to such a foreign branch, the income from each foreign currency transaction would be translated into a U.S. dollar amount based on the applicable exchange rate in effect on the day of the transaction. IRC § 988.

\(^{228}\) Admittedly, these foreign currency provisions apply separate entity treatment only for limited purposes. It would appear to be a small extension from treating a branch as a separate entity for foreign currency translation and gain-loss purposes to treating it as separate entity for all tax purposes. See Rosenbloom, Separate Entity, note 147, at 12.
compared to U.S. subsidiaries. There is, however, a risk of abuse with regard to related-party transactions in both the branch and subsidiary setting, which necessitates the use of mechanisms requiring that such transactions have economic substance. The administrative difficulties occasioned by these mechanisms are examined below.

2. Administrative Disadvantages of Separate Entity Method

a. Debt-Equity Classification

The primary disadvantages in using the separate entity method stem from the need to use two fact-specific and somewhat vague standards to allocate income and deductions in order to ensure that interbranch transactions comport with economic reality. The separate entity method would apply debt-equity classification principles to purported loans from a foreign corporation's foreign branches to its U.S. branch, in the same way that advances between a foreign parent and its domestic subsidiary are scrutinized. Under this approach, each advance from a foreign branch to a U.S. branch would be evaluated under the classification standards in order to prevent taxpayers from receiving debt treatment (and interest deductions against the U.S. tax base) for advances resembling equity in an economic sense. Consequently, unlike § 1.882-5 of the regulations, which calls for a single determination of a corporation's interest expense deduction based on the aggregate data from many transactions, the separate entity method could require several determinations, one for each purported interbranch loan, to compute the interest deduction for a given taxable year.

To add to the administrative burden, the debt-equity classification standards are far from clear. Congress has spoken on the subject only to authorize Treasury to promulgate regulations. And, Treasury's attempts at exercising this regulatory authority have proven largely unsuccessful, with proposed regulations on the subject never finalized.

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229 Under the separate entity method, debt-equity classification would be merely the first step in computing the allowable interest deduction. That is, after a given advance is determined to represent debt, it still must be determined whether the interest rate charged reflects an arm's length rate. See note 117 and accompanying text.

230 In this connection, the New York State Bar Association, in commenting on the proposed interest apportionment regulations under Prop. Reg. § 1.861-8, indicated that the fungibility approach might be preferable to some taxpayers over a facts and circumstances tracing approach in that the former would be easy to apply and less likely to result in audit disputes. For these administrative reasons, the New York State Bar Association's report recommended that the fungibility approach be elective, even though the report generally favored a facts and circumstances approach because of its advantages in reflecting income. NYSBA Report, note 164, at 652, 660.

231 IRC § 385.
and ultimately withdrawn.\textsuperscript{232} As a result, it has been mainly the courts that have established the principles of debt-equity classification. Because the inquiry is a question of fact that requires the weighing of factors, the factors employed by the courts are hardly uniform, and it is difficult to ascertain the relative weight, if any, given to the various factors in any particular case, the court decisions have been described in such extreme terms as a "jungle" and a "vipers tangle."\textsuperscript{233}

Nevertheless, the classification standards formulated by the courts are not completely unworkable and certain factors do predominate. These key factors\textsuperscript{234} include a corporation’s debt-equity ratio,\textsuperscript{235} whether or not debt is held by shareholders in proportion to their stockholdings,\textsuperscript{236} the form of the obligation,\textsuperscript{237} the corporation’s ability to make payments of purported principal and interest,\textsuperscript{238} whether there have been timely payments of purported principal and interest\textsuperscript{239} and whether shareholder-held debt is subordinated to the claims of independent creditors.\textsuperscript{240} Furthermore, the § 385 proposed regulations, even though withdrawn, apparently provide objective guidance for taxpayers. Specifically, some practitioners believe that debt meeting the requirements of a safe harbor contained in these regulations will not be challenged by the Service.\textsuperscript{241} It seems clear, however, that this area could benefit from a renewed attempt by Treasury (or Congress) to establish more concrete and uniform guidelines.\textsuperscript{242}

\textsuperscript{232} See Prop. Reg. §§ 1.385-1 to -6 (withdrawn 1983); Bittker & Eustice, note 39, ¶ 4.02[8], at 4-16 to 4-18.
\textsuperscript{234} See generally Bittker & Eustice, note 39, ¶ 4.04, at 4-31.
\textsuperscript{235} There are, however, some differences among the courts on how this ratio is to be computed, that is, whether market value or book value should be used in valuing assets (market generally is used) and whether or not debt includes outside debt or is limited to shareholder debt (outside debt generally is included). See id. Furthermore, there is vast disagreement as to what is an excessive ratio. Bradshaw v. United States, 683 F.2d 365, 374 (Ct. Cl. 1982) (50 to 1 being held as not fatal); Schnitzer v. Commissioner, 13 T.C. 43 (1949) (three to one being held as excessive), aff’d, 183 F.2d 70 (9th Cir. 1950), cert. denied, 340 U.S. 911 (1951). In this regard, some courts have applied different standards for different industries. See Lind et al., note 233, at 128. Nonetheless, a ratio of 3 to 1 or less generally is viewed as not excessive. See Bittker & Eustice, note 39, ¶ 4.04[3], at 4-35.
\textsuperscript{236} See Bittker & Eustice, note 39, ¶ 4.04[2], at 4-33.
\textsuperscript{237} See Lind et al., note 233, at 127. In the context of shareholder-held debt, instruments whose form bears some equity characteristics (such as the payment of interest contingent on earnings) seem especially susceptible to reclassification. See id.
\textsuperscript{238} Bradshaw, 683 F.2d at 374.
\textsuperscript{239} See Lind et al., note 233, at 128.
\textsuperscript{240} See id. at 129.
\textsuperscript{241} The safe harbor provided that debt would not be reclassified where the corporation’s total debt-equity ratio did not exceed 10 to 1 and the corporation’s shareholder-held debt-equity ratio did not exceed 3 to 1. Prop. Reg. § 1.385-6(f)(3) (withdrawn 1983).
\textsuperscript{242} Congressional tax writing committees have reiterated that Treasury is authorized, but not required, to issue regulations on debt-equity classification. H.R. Rep. No. 247, 101st.
b. Transfer Pricing Rules

The use of the separate entity method also would call for the application of the § 482 transfer pricing rules, and consequently, would involve their administrative difficulties. Accordingly, similar to debt-equity classification, each transaction between the U.S. branch and other branches of a foreign corporation potentially would have to be scrutinized to determine whether the transaction conformed to arm’s length pricing principles. Thus, with respect to a U.S. branch’s expense deductions, the separate entity method would require a separate determination for each interbranch expense transaction, whereas current law allows for a single determination of each type of expense deduction (such as interest) based on aggregate data from many transactions. With regard to a U.S. branch’s gross income inclusions, however, both the separate entity method and current law, with its threshold allocation rules, require a separate determination for each transaction. The threshold allocation rules, however, do not involve the additional complexity of having to determine an appropriate interbranch transfer price, as these rules generally allocate either all or none of the income from a given transaction to the U.S. branch.

The separate transactions feature of the transfer pricing rules seems to pose minor administrative difficulties when compared to another source of problems: the difficulty in determining an arm’s length price. The § 482 regulations generally require related parties to charge the same amounts in their dealings as would unrelated parties operating under the same or similar circumstances. As a consequence, the search for comparables often dominates transfer pricing inquiries.

As noted by the Joint Committee, a recurrent problem with the § 482 regulations is “the absence of comparable arm’s length transactions between unrelated parties.” The Joint Committee points out that a “fundamental problem is the fact that the relationship between

Cong., 1st Sess. 1235-36 (1989). In addition, these committees have instructed Treasury to increase the number of published rulings on debt-equity classification so as to provide more guidance to taxpayers. Id.

243 See note 117 and accompanying text.
244 See Section II.B.2.
245 See Section II.B.1.
246 See id.
247 See Reg. § 1.482-1(a)(1) (“Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer”), (b)(1); notes 24-27.
248 Nevertheless, as noted earlier, the § 482 regulations also allow for the use of other methods in certain circumstances, which include using costs, safe harbors, costs plus a gross profit markup, resale, price minus a markup and profit splits. See notes 28-35 and accompanying text.
249 1986 Bluebook, note 31, at 1014.
related parties is different from that of unrelated parties," in that "multinational companies operate as an economic unit, and not 'as if' they were unrelated to their foreign subsidiaries." Thus, the search for comparable arm's length transactions, administratively difficult in itself, seems further complicated by their possible absence.

Additionally, in implementing the standard, the documentation burdens can be severe. The documentation required for each transaction between related parties appears to be a small portion of the overall burden. The most onerous aspect apparently is the production by taxpayers and verification by the Service of vast amounts of data relating to purported comparable transactions.

Other criticism goes to the case-by-case approach necessitated by the inherently fact-specific arm's length standard. Some claim that the case-by-case approach places great strain on the Service and courts, and leads to inconsistent, and thus inequitable results among taxpayers.

An end result of these problems with the arm’s length standard may be a lack of compliance. Given the fact-specific inquiry, elusive and possibly nonexistent standards and burdensome documentation requirements, an unacceptable number of taxpayers may not comply with the law, either intentionally or not. This asserted lack of compliance has been blamed for large revenue losses and the undertaxation of foreign controlled businesses. In fact, the enforcement

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250 Id.
252 See Wickham & Kerester, note 161, at 346. Recently adopted regulations under § 482 use a new method, the comparable profits method, as an alternative method in determining transfer prices. Reg. § 1.482-5. This concept first appeared in proposed regulations under § 482. Prop. Reg. § 1.482-2(f) (the comparable profits interval ("CPI")), although with considerably more emphasis placed on it. Commentators leveled an extraordinary amount of criticism against this proposal, with a great deal of it focusing on the enormous data necessary to construct a CPI and the fact that a taxpayer may need to know the future in order to do so. See Public Comments on Proposed Regulations, 56 Tax Notes 1001, 1002-07 (Aug. 24, 1992); see also John Turro, Witnesses Criticize "Other" CPI at Hearing on Transfer Pricing Regs, 56 Tax Notes 1244, 1245 (Sept. 7, 1992).
253 See Wickham & Kerester, note 161, at 356.
254 Id.
255 Id. In light of these criticisms, Wickham and Kerester recommend a generalized geographic sourcing approach for allocating income among related parties. Id. at 360.
256 See Hubbard, Transfer Pricing, note 251, at 547.
257 See John Turro, Treasury Blasted Over Alleged Transfer Pricing Shenanigans, 55 Tax Notes 150 (Apr. 13, 1992) [hereinafter Shenanigans] (describing House hearings on whether transfer pricing abuses have led to undertaxation of foreign controlled business); U.S. Seen Abolishing Arm's Length Standard Unless Section 482 Enforcement Improves, Daily Tax Rep. (BNA), June 12, 1992, at G1. But cf. Nolan, note 158, at 292 (pointing out that low amounts of taxable income reported by U.S. affiliates of foreign parents have not been qualitatively analyzed).
problems have been viewed as so severe that proposals have been
made either to abandon or substantially modify the current transfer
pricing system. 258

Despite these problems, recent measures instituted by the Service
and Congress should render § 482 more workable and enforceable.
Experience with these measures over the next several years should
reveal the degree of their effectiveness. In particular, the advanced
pricing agreement ("APA") procedure should add a measure of cer­
tainty for taxpayers and eliminate some enforcement difficulties.259
Under this procedure, taxpayers, the Service and foreign governments
agree to a determination of transfer prices for several future years. 260
Taxpayers are given firm guidance as to appropriate transfer prices,
and the Service's enforcement task should be reduced to confirming
that the taxpayers adhere to the agreement in reporting their income.

As with any new procedure, certain problems need to be
addressed.261 Some practitioners claim that the APA procedure is time
consuming and expensive to both taxpayers and the Service.262 In
fact, as APAs have gained in popularity, there is concern that the Ser­
vice may have reached its capacity to handle APA requests.263

These problems, however, seem capable of solution. First, the lim­
ited experience with APAs reveals that a second APA by the same
taxpayer is less expensive and easier to accomplish than the first.264
More importantly, through experience, the Service should be able to
formulate several pattern APAs for specific industries,265 thereby
greatly expediting the APA process. The Service may simply have to
devote more resources to the APA process to solve the purported lack
of manpower; given that widespread use of APAs should reduce the
number of personnel needed for auditing and litigation, greater re-

258 See Daily Tax Report, note 257 (reporting statement of assistant counsel to House
Ways & Means Oversight Committee that unless enforcement improves, the arm's length
standard may be dropped). Cf. Foreign Income Tax Rationalization and Simplification Act
of 1992, H.R. 5270, 102d Cong., 2nd Sess., § 304 (legislation proposing a taxable income
floor on U.S. subsidiaries of foreign corporations). For further discussion of this issue, see
notes 357-71 and accompanying text.

259 See McLennan, note 37 (exploring ways of dealing with transfer pricing, including
APAs).


261 See Wickham & Kerester, note 161, at 353-54 (generally criticizing APA procedure).

262 Id. at 354.

263 See Catherine Hubbard, Advance Pricing Agreements Gaining Popularity, IRS
Claims, 56 Tax Notes 1530 (Sept. 21, 1992) (reporting statements by Charles Triplett, IRS
deputy associate chief counsel (international)).

264 See John Turro, Transfer Pricing: Apple Computer Readies for APA Replay, 56 Tax
Notes 694 (Aug. 10, 1992) (noting that second APA for Apple was easier, less expensive).

265 Cf. Flambeck, note 3, at 1156 (noting that advanced pricing agreements dealing with
the global trading of financial products may lead to general principles that can be incorpo­
rated into treaties or domestic legislation).
sources for the APA process may not necessarily mean an increase in overall Service staffing.

Perhaps computer technology could be used in formulating APAs, as well as in verifying taxpayer compliance with these agreements. The vast data processing capabilities of computers may be used to assemble data for purposes of determining comparables. In this connection, the Service is studying whether databases can be compiled that contain information on third-party comparables.266 Similarly, data processing capabilities may be of aid in developing economic models that could form the basis for individualized apportionment formulas. In addition, through computerized return filing and Service computer programs reflecting APA transfer pricing methodologies, the Service may be able to verify compliance with APAs without resorting to costly and time consuming audits.

Another measure that should facilitate the administration of § 482 is § 6038A, which should give the Service greater access to foreign documents relating to transfer pricing and thus should alleviate some of the enforcement difficulties.267 In addition, § 6662(e), which imposes a penalty for certain violations of the transfer pricing rules, should result in increased taxpayer compliance.268

Finally, arbitration has begun to be recognized as an alternative to litigation in resolving transfer pricing disputes.269 Arbitration appears to offer several advantages over litigation, as the process is flexible270 and should be less costly and time consuming. Furthermore, although arbitration, unlike litigation, cannot result in written opinions that provide guidance in deciding future cases, the fact-specific nature of transfer pricing cases often renders court opinions of little value in

266 See Kathleen Matthews, International Conference Focuses on Competent Authority Process, APAs, 57 Tax Notes 1623, 1624 (Dec. 21, 1992).

267 See Turro, Shenanigans, note 257, at 151 (reporting that Service personnel urge Congress that new measures, including § 6038A, be given time to work prior to initiating new rules to deal with the transfer pricing problem). Regarding the constitutionality of § 6038A, see Nicola W. Palmieri, Section 6038A Violates the Constitution and International Law, 54 Tax Notes 1017 (Feb. 24, 1992). Other efforts aimed at improving enforcement include the House's approval of Treasury's practice of hiring outside counsel to litigate transfer pricing cases. See Rita L. Zeidner, House Approves IRS Funding Bill, Okays Use of Outside Attorneys, 56 Tax Notes 7, 8 (July 6, 1992) (noting also House Report's statements calling for increased Service efforts against U.S. subsidiaries of foreign parents).

268 See note 38 and accompanying text.

269 See Robert Manning, IRS News, 54 Tax Notes 1335 (Mar. 16, 1992) (announcing that Apple will subject a transfer pricing dispute to arbitration); McClellan, note 37 (exploring ways of dealing with transfer pricing, including arbitration).

270 See Kenneth B. Clark, Ronald B. Schrottenboer & William A. Fenwick, A Different Approach to Resolving Section 482 Disputes, 55 Tax Notes 1813 (June 29, 1992) (noting use of "baseball"-type arbitration in Apple proceedings).
dealing with subsequent cases. Consequently, transfer pricing disputes seem particularly suitable to being resolved by arbitration.

3. Administrative Advantages in Using the Separate Entity Method
   a. No Need For Worldwide Data

The use of the separate entity method for U.S. branches should result in several administrative advantages that appear to outweigh the disadvantages discussed above. One advantage is that the use of the separate entity method would obviate the current need for worldwide data. Under existing law, the apportionment methods of § 1.882-5 and § 1.861-8 of the regulations may require taxpayers to produce, and IRS examiners to verify, several categories of worldwide data in the determination of a U.S. branch's expense deductions. With use of the separate entity method, there would be a need only for a foreign corporation's data that relates to transactions involving the U.S. branch.

In particular, under § 1.882-5 of the regulations, worldwide interest rates currently are used in the determination of a foreign corporation's interest expense deduction. In addition, worldwide asset and liability data are needed in order to compute a foreign corporation's actual worldwide liability-to-asset ratio, which can be used in the interest deduction computation. Not only does the computation of an actual worldwide ratio require such voluminous worldwide data, it also necessitates that such data be translated, that is, foreign accounting entries must be characterized as assets and liabilities for U.S. tax purposes. Because the foreign accounting methods used in keeping books and records for non-U.S. branches often differ from U.S. methods, this task can be quite onerous.

Similarly, under § 1.861-8 of the regulations, several groupings of worldwide data may be required in order to determine a foreign corporation's deductions for expenses other than interest. Under this...
regulation, it may be necessary to produce and verify worldwide data for various types of expenses, along with worldwide data for one or more factors of apportionment (such as gross receipts).\textsuperscript{275}

Furthermore, the need to examine worldwide data of a foreign corporation raises concerns of interference with a foreign government's jurisdiction over such matters. When worldwide data is required, the Service must scrutinize documents relating to transactions that took place between the foreign corporation and another foreign person. In contrast, under the separate entity approach, the Service must examine only documents and transactions with a U.S. connection. For these reasons, governments are hesitant to replace the arm's length approach applicable to subsidiaries with a formulary method of apportioning income.\textsuperscript{276}

Due to these concerns of administrative feasibility, the ALI report recommended a tracing approach over a formulary apportionment approach as its general rule for allocating deductions to the activities of a U.S. branch.\textsuperscript{277} The ALI report noted that a formulary approach in apportioning deductions must take into account a foreign corporation's worldwide activities and that this places substantial administrative burdens on foreign corporations in providing worldwide data and on the Service in verifying such data.\textsuperscript{278} Consequently, the ALI opted for an approach focusing on the factual connection of expenses to the U.S. branch to place more emphasis on U.S. information.\textsuperscript{279}

\textbf{b. Avoidance of Difficulties Regarding the Status of Investment Income}

The use of the separate entity method also would avoid the difficulties caused under the effectively connected income rules with respect to the status of investment income. As previously discussed,\textsuperscript{280} Reg. § 1.864-4(c) contains several tests\textsuperscript{281} governing the effectively connected status of passive-type income such as dividends, interest and royalties. In particular, the asset use test provides rather vague stan-

\textsuperscript{275} See notes 87-92 and accompanying text. There is an additional need for worldwide data in implementing the excess interest tax. Specifically, it may be necessary to determine a foreign bank's worldwide percentage of deposit liabilities for purposes of applying an exemption to the excess interest tax. See notes 341-42 and accompanying text.

\textsuperscript{276} See Hubbard, Transfer Pricing, note 251, at 547.

\textsuperscript{277} See ALI International Project, note 4, at 117.

\textsuperscript{278} Id.

\textsuperscript{279} Id. Similar concerns may have led Treasury to consider at length a tracing approach for interest deductions before eventually adopting a fungibility approach. Cf. Rosenbloom, note 144, at 1028.

\textsuperscript{280} See notes 56-65 and accompanying text.

\textsuperscript{281} These tests are the business activities test, the asset use test and the special banking rules.
dards for determining the effectively connected status of passive income not arising directly from U.S. branch activities. This nebulous standard has engendered a considerable number of disputes between taxpayers and the Service.\textsuperscript{282} Under the separate entity proposal, this test would be replaced by a system that would effectively allow foreign corporations to elect to treat investment assets as either subject to U.S. net basis taxation or not, depending on whether the foreign corporation has chosen to include the assets in its U.S. holdings.\textsuperscript{283}

c. \textit{Elimination of Disputes Caused by All or Nothing Income Rules}

The use of the separate entity method also should eliminate the high stakes taxpayer-Service disputes caused by the all or nothing threshold allocation income rules. Several of the current rules governing the effectively connected status of income items treat either all or none of the income as effectively connected based on the level of U.S. branch participation.\textsuperscript{284} Because of the extreme effects of effectively connected status, taxpayers have an incentive to take aggressive positions in claiming items as either non-effectively or effectively connected.\textsuperscript{285} This can lead to increased burdens on the audit process in detecting such return positions and undertaxation to the extent that incorrect positions go undetected. Furthermore, even where Service auditors adjust items based on effectively connected status, it often behooves taxpayers to continue to press their claims in the Service appeals process, thus resulting in protracted administrative proceedings that ultimately may result in litigation.\textsuperscript{286} These same tax stakes may cause the Service to take aggressive positions on audits, thereby further increasing the likelihood of expensive and time-consuming administrative and judicial proceedings.

In contrast, under the separate entity method, there should be less tax dollar pressure placed on individual item determinations. Rather than subjecting all or none of the income from a transaction with multiple branch involvement to U.S. net basis taxation, the separate entity method would employ transfer pricing principles so that only a portion of the total income from such a transaction would be taxable by the United States. Because the tax stakes are lower with respect to

\textsuperscript{282} See, e.g., Ltr. Rul. 8940005 (May 15, 1989).

\textsuperscript{283} See notes 128-29 and accompanying text. Such an election would produce results consistent with the policies underlying the 1966 Foreign Investors Tax Act. See notes 130-41 and accompanying text.

\textsuperscript{284} See notes 179-93 and accompanying text.

\textsuperscript{285} Under certain situations, effectively connected status can be advantageous to taxpayers, such as by increasing the interest expense deduction under Reg. § 1.882-5 due to a greater amount of U.S. assets. See Ltr. Rul. 8940005 (May 15, 1989).

\textsuperscript{286} The author is aware of a situation of this type.
individual item determinations, both the taxpayers and the Service should have less incentive to take aggressive positions and maintain them through administrative and judicial proceedings.287

d. Single Method for Determining Income and Deductions

The separate entity method also has administrative advantages over the current regime in that it provides a single method for determining income and deductions. Current law's threshold allocation approach for income and formulary apportionment approach for deductions present their own peculiar issues. As a consequence, taxpayers (and their advisors) are required to master two sets of rules, doubling their compliance burden. Treasury and the Service likewise have a more onerous task as they are called upon to administer, through their regulation and ruling functions, two sets of rules; this bifurcated regime has the potential for an increased burden on the courts as well.288 The separate entity method would avoid these added complexities by providing one basic method for determining both income and deductions, supplemented by rules aimed at ensuring that the form of the transactions follows their economic substance, that is, debt-equity classification standards and § 482 transfer pricing principles.289

The Service recently has moved in the direction of applying general principles to facts and circumstances, rather than following a detailed and complex mechanical approach.290 This approach has been praised as a healthy move towards simplicity and common sense in regulation drafting, pressure for which came from high level Treasury and Service officials as well as the field.291 The separate entity method, which

287 See Richard L. Kaplan, Federal Taxation of International Transactions 51 (1988) (noting more Service-taxpayer contentiousness with all or nothing approaches like the title passage rule); cf. ALI, Discussion Draft of a Study of Definitional Problems in Capital Gains Taxation 332-33 (1960) (pointing out that a bifurcated tax treatment of gain from the sale of assets converted from capital assets to ordinary income assets should facilitate the settlement of controversies; consequently, even though the mechanics of dual treatment would be more complicated than under current law, overall, the administration of the law should be simplified). But see Langbein, note 208, at 655-66 (arguing that disputes engendered by the transfer pricing regime may not be due to transfer pricing per se but how it has been implemented in the regulations through the use of single component method rules, such as costs plus markups).

288 Similar comments relating to the burdens on the tax system caused by additional rules are made in a more elaborate fashion later in this section. See notes 292-94 and accompanying text.

289 Of course, the rules defining income and deductions differ from one another. Compare IRC § 61 with IRC § 163. These differences exist, however, whether the separate entity method or the current regime is in force.

290 See, e.g., Reg. § 1.469-4(c)(2).

applies arm’s length principles to the facts of individual transactions to determine the taxable income of a U.S. branch, in place of the current myriad of mechanical rules, is a move in the same direction.

e. One Tax Regime for U.S. Subsidiaries and Branches

Numerous administrative benefits would flow from the use of a single regime for taxing foreign corporate controlled U.S. businesses, whether conducted as a separate U.S. corporation or a branch of a foreign corporation. First and most important, there would be less of an administrative burden on Treasury and the Service. The repeal and deletion of the special provisions dealing only with the taxation of U.S. branches would mean that the government need no longer amend the Code, write and/or amend regulations or issue rulings in these areas. Consequently, the government’s tax officials would have more time to devote to other areas, such as transfer pricing and debt-equity classification. An increased focus on these issues should result in rules for foreign corporate controlled U.S. businesses that are better thought out, more comprehensive and issued in a more timely manner. Given that a major cause of complexity in the tax system is legal uncertainty, there should be an improvement in the tax regime for foreign corporate controlled U.S. businesses, because a single system would pose fewer issues for Treasury and the Service. Similarly, the use of a single regime might result in less of a burden for the courts, since there would be fewer issues to decide. Furthermore, use of the separate entity method for both U.S. subsidiaries and U.S. branches would allow for a greater focus by the congressional tax-writing committees on this method.

Finally, a single regime should produce substantial benefits for taxpayers as they (and their tax advisers) would no longer need to take into account disparate tax considerations in deciding what form to use in structuring a U.S. business venture. Furthermore, a single regime with less legal uncertainty should lower the cost of compliance by reducing the need to resort to expert tax advisors.

292 Cf. Wickham & Kerester, note 161, at 350 (recommending a single set of source rules for allocating profits for both branches and subsidiaries, in order to eliminate the added complexity occasioned by current law’s dual treatment).


294 Although it appears that the courts rarely have dealt with issues pertaining to the taxation of U.S. branches, that could change given that several of the key provisions, such as Reg. § 1.882-5 and § 884, were introduced only in the 1980's.
C. Harmonizing Different Countries' Tax Laws

Harmonizing the income tax systems of different countries is an ever increasing concern in the formulation of sound tax policy. Where the methods of determining income vary among countries, double taxation is a possible result. That is, even if two countries provide for foreign tax credit or exemption systems, a taxpayer with income derived from both countries can be taxed on the same income twice where the countries view different amounts of income as properly allocable to each country. While treaties often provide for competent authority proceedings to address discrepancies among the methods used by countries to allocate income, treaties do not always exist, and furthermore, the competent authority process generally is quite protracted. Consequently, more effort should be placed on making income tax systems compatible.

The current U.S. regime used for U.S. branches appears to be unique and therefore at odds with the systems used by most other developed countries. Those that are a part of the Organization of Economic Cooperation and Development ("OECD") appear to recognize interbranch transactions to some degree. This general approach is reflected in the OECD's Model Income Tax Treaty. Article 7 provides that the business profits of an enterprise of one country (such as a foreign corporation), which carries on business in another

295 See Ulysses S. Crockett & James B. Ashwell, Federal Taxation of Nonresident Aliens and Foreign Corporations, 13 Duq. L. Rev. 37, 51 (1974) (contending that uniform tax treatment among countries should be a goal); Daniel J. Frisch, The Economics of Tax Policy: Some Old and New Approaches, 47 Tax Notes 581 (Apr. 30, 1990) (recommending that tax policy for international transactions focus on harmonizing the tax systems of different countries); Nolan, note 158, at 295, 298 (encouraging the meshing of international tax systems and arguing that instead of earnings stripping provision, United States should have sought an international solution to the problem on a uniform basis); Ross, Approaches, note 7 (pointing out the need for more international approaches (as opposed to national approaches) to cross border tax issues); Wickham & Kerester, note 161, at 360-61 (recommending that an international approach be used to achieve geographic source rules based on apportionment factors having economic significance).

296 See Ernst & Young, note 117, at 778.

297 Such can be provided either pursuant to internal laws or bilateral treaties.


299 Matthews, note 266, at 1623-24 (noting that the competent authority process is very lengthy and discussing efforts to streamline the process).

300 See Plambeck, note 3, at 1155-56 (suggesting the need for a coordinated approach among countries in allocating global trading income in order to reduce the risk of double taxation). See also Public Comments on Proposed Regulations, 57 Tax Notes 468, 473 (Oct. 26, 1992) (claiming that bilateral or multilateral agreement is necessary in measuring U.S. branch interest expense, given that both the current and proposed methods pose risks of double taxation); Comments on Proposed Regulations, 57 Tax Notes 184, 185 (Oct. 12, 1992) (contending that Prop. Reg. § 1.882-5 should be reviewed in light of Treasury's goals of compatibility with appropriate international norms).
country (such as a U.S. branch), is only subject to tax by the other country (such as the United States) to the extent of the profits that are attributable to the permanent establishment. The article goes on to provide that the profits attributable to the permanent establishment are those "which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."\textsuperscript{301} The official commentary to the OECD Model Treaty indicates that this article authorizes the use of a separate entity method in determining the taxable income of a branch of a foreign corporation located in another country.\textsuperscript{302} The commentary provides that in so computing a branch's taxable income, interbranch expense transactions are generally, but not always, to be taken into account.\textsuperscript{303}

\textsuperscript{301} 1992 OECD Model Income Tax Treaty, art. 7(2), Tax Treaties (CCH) ¶ 191.


Paragraph 4 of Article 7 does allow the use of profit apportionment methods to determine the income of a branch where it has been customary in a country to use this method. The commentaries to this article, however, make it clear that the use of profit apportionment methods is generally not as appropriate as the separate entity method and that the apportionment method should be used only in the exceptional cases where its use has been customary in the past. Commentaries, supra, at C(7)-12 to C(7)-13.

\textsuperscript{303} In particular, the OECD commentaries carve out interbranch interest and royalty payments as exceptions to the general rule recognizing interbranch expense transactions. Commentaries, note 124, at C(7)-8 to C(7)-9. However, the 1992 Commentary, along with a 1984 OECD Commentary, provides that for banks, interbranch interest payments are to be recognized. See id.; 1984 OECD Report, note 302, at 56-58. The United States and Japan, however, dissent from this majority position of the OECD member countries, which recognizes intrabank interest payments. Id. at 58.

The OECD commentary also provides that there should be no attributed profit element where one branch of foreign corporation performs ancillary services for another branch. The Commentary adopts this treatment based on considerations of practical administration. See Commentaries, note 124, at C(7)-9 to C(7)-10. For example, if the home office of a foreign corporation advertises on behalf of one of its branches, the branch should receive a deduction only for the expenses the home office incurred; no additional deduction should be allowed for any notional commission earned by the home office on performing these services. Id. Under this approach, it is therefore possible that the taxable profit attributable to a branch would differ from the profit economically earned. Nonetheless, the Commentary appears to limit this approach to the performance of ancillary services; consequently, it would not seem applicable to the situation where two or more branches participate in a single transaction. Accordingly, the OECD does not appear to sanction the "all or nothing" net profit results that occur under the effectively connected rules where two branches so participate.

Several income tax treaties entered into by the United States use language similar to, and are apparently patterned after, Article 7 of the OECD model treaty. See, e.g., U.K. Treaty, note 298, art. 7, at ¶ 10,903.15. As noted earlier, several foreign corporations have relied on these articles in claiming the right to use a separate entity method, as opposed to Reg. § 1.882-5, in computing their interest expense deduction connected to effectively connected income. The Service has rejected these claims. See note 147.
Although most developed countries apparently take into account interbranch transactions in some capacity in allocating income,\(^{304}\) they do not appear to use a complete separate entity method for the tax treatment of branches.\(^{305}\) In general, there seems to be a good deal of divergence in the methods used by countries to attribute income to branches.\(^{306}\) Importantly, however, it is doubtful that any other country uses the specific combination of apportionment and threshold allocation approaches used by the United States.\(^{307}\)

\(^{304}\) Ernst & Young, note 117, at 778 (noting that many foreign countries, including the United Kingdom, Switzerland and Australia, recognize interbranch transactions). In fact, in the new treaty with Mexico, the United States itself has acquiesced to the use of a separate entity method for the interest expense determination of a U.S. bank's Mexican branch. The treaty provides that a permanent establishment is not entitled to a deduction for interest paid to other branches on interbranch loans to the permanent establishment, “except in the case of a banking enterprise.” Income Tax Convention, Sept. 18, 1992, U.S.-Mex., art. 7(3), Tax Treaties (CCH) ¶ 5903.08. While this could be interpreted as overriding the application of Reg. § 1.882-5 to a U.S. branch, both the Treasury Technical Explanation to the Treaty and the Report of the Senate Foreign Relations Committee clarify that this clause was not so intended. See Treasury Dep't, Technical Explanation of the Convention and Protocol Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 18, 1992, reprinted in Tax Treaties (CCH) ¶ 5943; Income Tax Convention with Mexico, with Protocol, Exec. Rep. No. 20, 103d Cong., 1st Sess. 55 (1993). Instead, the clause was inserted to allow Mexico to consider interbranch transactions between a U.S. bank's Mexican branch and other branches in order to determine the Mexican branch's deductible interest expense for Mexican tax purposes, given that Mexico does not currently have a mechanism analogous to Reg. § 1.882-5.

\(^{305}\) See ALI International Project, note 4, at 121 (noting that “[e]ven in jurisdictions that have put considerable stress on the ‘separate’ entity nature of branch operations, intra-entity transactions do not generally generate tax consequences”); Ernst & Young, note 117, at 778; Jörg-Dietrich Kramer, Branch Taxation—German Federal Finance Academy Seminar Explores International Taxation of Branches, (pts. 1 & 2), 2 Tax Notes Int'l 683 (July 1990), 2 Tax Notes Int'l 812 (Aug. 1990), 90 TNI 34-11, 90 TNI 37-11, available in LEXIS, Fedtax Library, TNI File (discussing the German tax administration's and courts' normal preference for the use of a separate entity method for determining the profits of foreign and domestic branches and noting its application with respect to interbranch sales of goods and business assets as well as interbranch services and pointing out, however, that interbranch loans and licenses are not recognized for tax purposes).

\(^{306}\) See ALI International Project, note 4, at 120, 121 (pointing out that some countries do not allow a branch deductions for costs incurred outside their taxing jurisdiction and noting differences in the emphasis placed by countries on the “separate entity” nature of branch operations); Ernst & Young, note 117, at 778 n.79 (noting that even within one country, Australia, there seems to be differences in taxing branches); Kramer, note 305, 816 (pt. 2) (indicating that because there is even less agreement regarding the allocation of income to branches than with regard to subsidiaries, the potential for double taxation is particularly high).

\(^{307}\) In particular, because a substantial number of the foreign corporations that have U.S. branches are banks, the fact that the U.S. rules regarding a bank’s interest expense differ from those of many other developed countries is quite significant. Cf. Rosenbloom, Separate Entity, note 147, at 3-4 (pointing out that the U.S. treatment for a banking branch's interest expense is in conflict with that of many other developed countries and that this is likely to complicate the prevention of double taxation).
Accordingly, use of the separate entity method for U.S. branches at least would put the U.S. tax system more in line with the tax systems of other developed nations. Even more important, adoption and promotion of the separate entity method by the United States could result in other countries using this method, thereby harmonizing the world’s tax systems with respect to branch taxation. Such a role for the United States would not be unusual; the United States had moderate success in convincing other countries to adopt its arm’s length method for allocations among separate legal entities.

The separate entity method for branches appears particularly suitable for such worldwide adoption for a number of reasons. First, as noted above, it is similar to the methods currently used by most developed countries in allocating income to branches for it takes into account interbranch transactions. In addition, the separate entity arm’s length approach is the same method generally used worldwide for allocating income to subsidiary operations. Finally and most important, the separate entity method appears to be the only method realistically susceptible to worldwide adoption, as it would be difficult for governments to agree on either uniform apportionment factors or objective profit measures, which likely would be necessary with other methods. Consequently, the use of the separate entity method for the taxation of U.S. branches, along with the promotion thereof, may lead to its worldwide adoption and the resulting harmonization of this area of international taxation.

Cf. Nolan, note 158, at 306, 324 (suggesting that the United States should continue to exert leadership in meshing the differing tax systems of countries in order to minimize double taxation); Wickham & Kerester, note 161, at 361-62 (recommending that the United States take the lead in a harmonized international approach in sourcing income).

See Langbein, note 208, at 642-54 (pointing out that the U.S.’s export campaign of its novel arm’s length method contained in the § 482 regulations was successful among tax administrators and in producing general agreements as to principles; however, this campaign produced little significant change in the legislation, regulations or administrative practices of other countries); see also Lee A. Sheppard, Talking Sense About Transfer Pricing, 55 Tax Notes 1312, 1313 (June 8, 1992) (noting that the United States persuaded other nations to use the arm’s length method).

See Notice 88-123, 1988-2 C.B. 458, 475 (stating that the separate entity arm’s length standard for legal entities is accepted internationally).

See Ernst & Young, note 117, at 785 (noting that a formulary apportionment approach to cross border trading profits could lead to double taxation given that different countries may have their own view of the formula); Hubbard, Transfer Pricing, note 251, at 546 (statements by former Treasury official pointing out that because it would be difficult for countries to agree on a single apportionment formula, implementing formulary apportionment for subsidiaries on an international level would be problematic); Plambeck, note 3, at 1156 (pointing out that a principal difficulty in using a formulary approach to apportion global trading profits would be countries reaching agreements as to apportionment factors); cf. Sheppard, note 309, at 1312 (noting that it would be politically difficult to convince other nations to use a formulary apportionment approach for subsidiaries in place of the arm’s length method).
D. Tax Neutrality

The use of the separate entity method for taxing U.S. branches of foreign corporations would advance the principle of tax neutrality, under which tax consequences should not vary with respect to different forms of conducting business activities. The adoption of the separate entity method for U.S. branches would substantially eliminate the disparities in the taxation of U.S. branches and U.S. subsidiaries of foreign corporations by subjecting both forms of conducting a U.S. business to the same treatment. 312

1. Neutrality in Form of Conducting Business

A growing view among tax policymakers and commentators is that the tax system should be neutral in its treatment of different forms of conducting business. 313 This view is grounded in the belief that business, rather than tax, considerations should dictate the form of business operations, lest inefficiencies result. 314 While U.S. tax law traditionally has treated incorporated and unincorporated entities quite differently, that is, a double tax regime for the former but not the latter, inroads in this distinction have been (and may continue to be) made. For example, the Code allows most closely held corporations to be taxed under a pass-through regime similar to the rules applicable to partnerships. 315 Furthermore, there continues to be interest in corporate integration. The latest Treasury study of the subject included among its initial alternative integration recommendations, a proposal calling for the taxation of all businesses, whether incorporated or not, under one regime calling for a single level of tax. 316 As noted in this study, the U.S. adoption of an integrated regime for corporations and their shareholders would put the U.S. tax system in line with the tax laws of several other industrialized

312 See Wilson, note 147 (noting that the most simplistic way of achieving parity between the taxation of U.S. branches and U.S. subsidiaries would be to use the separate entity method for branches). Of course, adopting the separate entity method for U.S. branches will only bring about tax neutrality for purposes of U.S. tax law. Foreign countries still may accord different tax treatment based on whether the foreign corporation conducts its U.S. operations through a branch or subsidiary.

313 See, e.g., Wickham & Kerester, note 161, at 348-49.

314 Plambeck, note 3, at 1155.

315 See IRC §§ 1361-1379.

nations.317

With respect to the U.S. operations of a foreign corporation conducted in either branch or subsidiary form, an even stronger argument can be made for identical treatment than can be made for incorporated and unincorporated entities. Whether conducted in a branch or subsidiary, both forms are conducted through a corporation. That is, the only difference between U.S. branch and subsidiary operations of a foreign corporation is that the former is conducted through a foreign corporation and the latter is conducted in a U.S. corporation. Thus, even if a distinction in the taxation of incorporated and unincorporated entities is warranted, such a distinction does not support dissimilar treatment for branches and subsidiaries.

Indeed, Congress specifically has indicated its desire to further the goal of tax neutrality in the taxation of branches and subsidiaries of foreign corporations. In enacting the branch profits tax,318 Congress imposed taxes on a U.S. branch's deemed payments of dividends and interest for the stated purpose of reducing the disparity in tax treatment of U.S. branches and U.S. subsidiaries: "[A] foreign corporation doing business in the United States generally should be subject to the same substantive tax rules that apply to a foreign corporation operating in the United States through a U.S. subsidiary."319 Commentators also have expressed dissatisfaction with the current differences in tax-

317 Integration Study, note 316, at 2. In several other areas, tax reform has eliminated tax distinctions resulting solely from the form of transactions. For example, § 902 allows certain U.S. corporations a credit for foreign taxes paid by their foreign subsidiaries, in order to roughly equalize the tax treatment between operations through foreign subsidiaries and those through foreign branches. See Bittker & Lokken, note 56, ¶ 69.8.1, at 69-89. In addition, § 338 allows a corporate purchaser of another corporation to elect to treat the transaction as an asset acquisition for tax purposes.

318 See Section II.B.3.

319 1986 Bluebook, note 31, at 1036; see also Notice 89-80, 1989-2 C.B. 394, 397 (noting that the purpose of the excess interest tax "is to treat the interest expense of a foreign corporation doing business through a U.S. branch in approximately the same manner as the interest expense of a wholly-owned domestic subsidiary of a foreign corporation"). As discussed above, the enactment of the branch profits tax provides indirect support for using the separate entity method for U.S. branches. The branch profits tax indicates Congress's desire to have neutral tax treatment of U.S. branch and U.S. subsidiary operations, and such tax neutrality could be realized through the adoption of the separate entity method for U.S. branches. Some commentators go beyond this assertion and see the enactment of the branch profits tax as direct support for the use of the separate entity method. Ernst & Young, note 117, at 779 (arguing branch profits tax represents a de facto separate entity approach); Angela Yu & Philip L. Tretiak, Tax Planning Ideas Under the Branch-Level Tax Regime, 13 Int'l Tax J. 327, 335 (1987) (stating branch profits tax supports recognizing a U.S. branch as a separate entity for interest deduction purposes). While the branch profits tax seeks to achieve results that are similar to those under the separate entity method, it eschews the very essence of this method, that is, the general recognition of interbranch transactions, in favor of a generalized formulary approach.

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ing branches and subsidiaries, both on the inbound\textsuperscript{320} and outbound\textsuperscript{321} sides.

2. \textit{Significant Differences Exist In the Tax Treatment of U.S. Branches and U.S. Subsidiaries}

Unfortunately, the branch profits tax has done little to bring about equal treatment in the taxation of U.S. branches and U.S. subsidiaries of foreign corporations,\textsuperscript{322} and thus significant differences in the two regimes remain. First, the branch profits tax has no effect on the rules governing the regular income tax liability of U.S. branches, and considerable differences exist between these rules and the ones applying to U.S. subsidiaries.\textsuperscript{323} Second, in many cases, the branch profits tax itself fails to produce results that are similar to the taxes imposed on dividend and interest payments where a U.S. subsidiary is used.

The amount of taxable income under these two regimes can be vastly different.\textsuperscript{324} In addition, the two regimes result in varying administrative requirements for U.S. branches and U.S. subsidiaries,\textsuperscript{325} which also face varying degrees of double taxation risk.\textsuperscript{326} Furthermore, a foreign corporation's U.S. subsidiary is permitted to file a consolidated return with lower-tier U.S. subsidiaries, whereas a foreign corporation's U.S. branch is not permitted to do so.\textsuperscript{327}

\textsuperscript{320} See Wickham & Kerester, note 161, at 348 (noting unjustified difference in the tax treatment of branches and subsidiaries); cf. Hoff, note 155, at 448-50 (advocating amendment of Arizona tax law so that water's edge principle of apportionment applies to both U.S. branches and U.S. subsidiaries of foreign corporations); Plambeck, note 3, at 1155 (noting that with respect to global trading, economic efficiency dictates that taxes be applied neutrally regardless of whether operations are in subsidiary or branch form).

\textsuperscript{321} See NYSBA Report, note 164, at 617-18 (report on proposed Reg. § 1.861-8 points out that the regulation's treatment of a U.S. parent's supervisory expenses relating to its foreign subsidiary produces a disparity in treatment between operating a foreign business in a foreign subsidiary or foreign branch; report also notes that U.S. treaty policy is to achieve neutrality for U.S. taxpayer operations conducted in foreign subsidiaries and foreign branches).

\textsuperscript{322} See Groff & Hoch, note 147, at 369.

\textsuperscript{323} See generally Thomas H. Olson, Tax Considerations in Structuring Foreign Investment in the United States, 1983 B.Y.U. L. Rev. 713, 741-53 (noting differences in the U.S. tax treatment of a Canadian foreign corporation acting in U.S. branch and U.S. subsidiary form). In fact, opponents of the branch profits tax argued that it was inappropriate to treat U.S. branches like U.S. subsidiaries for one purpose, the taxes on dividends and interest, and not for other purposes, such as the allocation of interest expense and transactions between the U.S. and foreign branches. See Tax Reform, note 169, at 139.

\textsuperscript{324} See Section IV.A.

\textsuperscript{325} See Section IV.B.

\textsuperscript{326} See notes 301-10 and accompanying text.

\textsuperscript{327} IRC § 1504(b)(3). The apparent reason for not allowing U.S. branches to consolidate is that U.S. branches and U.S. subsidiaries currently are subject to different tax rules that would be incompatible on a consolidated basis. Some support for this can be found in § 1504(d), which generally allows a wholly-owned foreign subsidiary organized under the
Even the branch profits and excess interest taxes result in treatment for U.S. branches that can vary considerably from the treatment accorded similarly situated U.S. subsidiaries. Rather than track actual remittances of earnings by the U.S. branch, the branch profits tax attempts to measure such remittances indirectly through the application of a formula. There are obvious differences in the mechanics used for U.S. subsidiaries and U.S. branches in exacting a tax on remittances of U.S. earnings, with a separate transactions approach used for subsidiaries and a formulary approach used for branches. Despite different mechanics, however, neutrality would not be offended if similar treatment nonetheless was achieved. The different mechanics do result in substantive differences, though, at least under the manner in which Treasury has chosen to exercise its regulation-making authority.

By defining U.S. liabilities as those attributable to the U.S. under § 1.882-5 of the rule creates the possibility that a foreign corporation could be subject to the branch profits tax even if all its U.S. earnings are reinvested in U.S. branch assets. Thus, unlike a similarly situated U.S. subsidiary, a second level of tax may be imposed where no U.S. earnings are actually remitted by the U.S. branch.

An example illustrates the foregoing proposition. FC (a foreign corporate bank) has $100 of U.S. earnings for a particular year, and reinvests all of the earnings in the assets of the U.S. branch. Aside

laws of Mexico or Canada to file a consolidated return with its parent group, provided it elects to be treated as a U.S. corporation for purposes of the Code. Use of the separate entity method for U.S. branches and subsidiaries would remove the apparent obstacle in the way of allowing a U.S. branch to file a consolidated return with its foreign corporation's U.S. subsidiaries.

An additional difference exists between the treatment of U.S. branches and U.S. subsidiaries with respect to the determination of the interest expense deduction: namely, the tax consequences are less predictable for branches. See Incoming Treasury Letters, 56 Tax Notes 19, 20 (July 6, 1992) (paper submitted by Institute of International Bankers noting the unpredictability of Reg. § 1.882-5, among other problems). A branch, unlike a subsidiary, usually is not in a position to know the deductible interest expense and after-tax profit at the time of a transaction. In this regard, commentators on the previously proposed regulations under § 482 argued that the regulations' adoption of an approach that takes into account future data would result in less predictability of tax consequences. See David A. DiMuzio, An Open Letter to Corporate Tax Directors, 55 Tax Notes 127, 129 (Apr. 6, 1992).

It should be noted, however, that the separate transactions arm's length approach used for U.S. subsidiaries also has been criticized for a lack of predictability. Commentators have pointed out that because of Service-taxpayer disputes over proper transfer prices, businesses find it difficult to forecast after-tax returns. See Wickham & Kerester, note 161, at 351. It would appear, though, that unlike the interest predictability problems associated with formulary methods, the problems occasioned by transfer pricing can be solved by adopting measures that provide taxpayers with more certainty that their transfer prices would not be challenged. In this connection, the advanced pricing agreement procedure along with additional Service guidance in the area should be helpful in providing a higher degree of certainty. See notes 259-66, 293 and accompanying text.

328 See notes 97-101 and accompanying text.
from this $100 increase, there are no other changes in the amount of U.S. assets. FC determines its interest expense deduction under Reg. § 1.882-5 by using the 95% fixed liabilities-to-assets ratio. Based on these facts, the foreign corporation would have a deemed earnings remittance (dividend equivalent amount) of $95, which is equal to its U.S. earnings for the year ($100) reduced by its increase in U.S. net equity ($5). The increase in U.S. net equity is only $5, even though U.S. assets have increased by $100, because under § 1.882-5 of the regulations these additional assets generate $95 of attributable liabilities (95% of $100). Consequently, FC has deemed earnings remittances of $95 although none of its U.S. earnings have actually been remitted.329

In issuing temporary regulations under the branch profits tax, Treasury articulated an apparent justification for this result: It is appropriate to “define U.S. liabilities as liabilities that produce deductions that reduce effectively connected earnings and profits.”330 Apparently, Treasury is of the view that defining U.S. liabilities by reference to attributable liabilities under § 1.882-5 of the regulations is consistent with the goal of similarly taxing U.S. branches and U.S. subsidiaries, in that in both situations, U.S. earnings are subject to a second tax when they will no longer generate income subject to U.S. tax. That is, in the previous example, because of the $95 of additional liabilities and interest expense thereon, only $5 of the $100 of U.S. earnings can be viewed as continuing to generate income that will be subject to U.S. tax; consequently, $95 can be viewed as not continuing to generate such income and will be deemed to be remitted. If a U.S. subsidiary with $100 of earnings had actually made a $95 earnings remittance to its foreign parent, there similarly would have been only $5 of earnings that would continue to generate income subject to U.S. tax. Thus, according to Treasury, there is similar treatment for U.S. branches and U.S. subsidiaries when the amount subject to the second tax is compared to the U.S. earnings that will continue to generate U.S. taxable income.

While there is some merit in Treasury's apparent claim of similar treatment, Treasury did overlook an important difference. Unlike a U.S. subsidiary, a U.S. branch may not have a choice in the timing of the second level of tax. A U.S. subsidiary that wants to avoid a current second tax on its earnings can forgo distributing the earnings to its foreign parent. As the previous example illustrates, a U.S. branch lacks this same degree of control over the imposition of the second tax.

329 See Groff & Hoch, note 147, at 363-64.

The final regulations provide some relief from this automatic imposition of the branch profits tax, although it may not always be available. Specifically, § 1.884-1(e)(3) of the regulations gives foreign corporations an election to reduce liabilities for both the U.S. liability determination under the branch profits tax and the interest expense calculation under § 1.882-5 of the regulations. Liabilities may be reduced, however, only to the extent that attributable liabilities exceed the liabilities shown on the books of the U.S. branch. Thus, under the facts of the previous example, the foreign corporation could elect to reduce its additional U.S. liabilities from $95 to zero, so that the amount of the deemed earnings remittance would be zero, that is, $100 (U.S. earnings) − $100 ($100 (increase in U.S. assets) − zero (increase in U.S. liabilities)), provided that its attributable liabilities exceed its U.S. book liabilities by $95. Consequently, a U.S. branch, unlike a U.S. subsidiary, can control the timing of the second level of tax on its U.S. earnings only when it is a net borrower from other branches of the foreign corporation.

The excess interest tax also fails to treat U.S. branches and U.S. subsidiaries in a similar fashion. As noted earlier, the excess interest tax was enacted to impose U.S. tax on any interest payments for which the U.S. branch is allowed a deduction under § 1.882-5 of the regulations. Congress believed that this was needed in order to similarly treat interest relating to U.S. branch operations and that of U.S. subsidiary operations, since all interest payments that give rise to a deduction for a U.S. subsidiary are generally includable in income by the recipients.

The excess interest tax attempts to accomplish this goal by treating interest paid by a foreign corporation's U.S. trade or business as if it were interest paid by a U.S. corporation. Pursuant to the source rules, such interest is treated as U.S. source income to the recipients. Additionally, the statute provides that any excess of deductible interest under § 1.882-5 of the regulations over interest paid by the

331 The temporary regulations provided no relief from the automatic imposition of the branch profits tax. Temp. Reg. § 1.884-1T.
333 The excess of attributable liabilities over U.S. book liabilities is either due to U.S. branch borrowings from the other branches of the foreign corporation or advances effectively treated as borrowings for tax purposes. See notes 174-75 and accompanying text.
334 Cf. Aaron A. Rubenstein & Angela W.Y. Yu, The Benefits and Burdens of the Final Branch Level Taxes Regulations, Int'l Tax J., Spring 1994, at 58, 60 (noting that relief from the uncontrollable nature of the branch profits tax is available in part, concluding that the control over the timing of the second level of tax that exists for U.S. subsidiaries is lost for U.S. branches).
335 See note 109 and accompanying text.
336 IRC § 884(f)(1)(A).
337 IRC § 861(a)(1).
foreign corporation's U.S. trade or business is treated as paid to the foreign corporation by a wholly owned U.S. subsidiary. The foreign corporation generally is then subject to a 30% U.S. tax on this deemed paid interest. Consequently, the full amount of the interest deduction is generally taxable, either to the recipients or the foreign corporation.

Congress, however, was mindful of the fact that if the "excess interest" had actually been received by the foreign corporation from a U.S. subsidiary, the interest may have been exempt from tax pursuant to a specific exemption. In this regard, the Conference Report to the 1986 Act indicates that the regulations may treat the excess interest as incurred on each type of external borrowing by the foreign corporation, based on the relative amounts of such external borrowings, for purposes of characterizing the excess interest for § 881 exemptions. It is noteworthy that while the legislative history apparently calls for a look-through approach, the statute treats the excess interest as paid to the foreign corporation from a hypothetical U.S. subsidiary and thus could be viewed as sanctioning a characterization test based on the types of borrowings by the U.S. branch from other branches. Presumably seizing upon the look-through approach language in the legislative history, the final regulations provide that for foreign banks a portion of the excess interest shall be treated as deposit interest and therefore exempt from tax, with such portion being the greater of (1) the foreign corporation's percentage of its total liabilities that are deposits or (2) 85%.

By focusing on the external borrowings of a foreign bank for purposes of characterizing excess interest, rather than on the nature of interbranch borrowings by the U.S. branch, the excess interest tax

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338 IRC § 884(d)(1)(B).
339 IRC § 881(a).
340 For example, §§ 881(d) and 871(i) provide that interest on banking deposits is exempt from the § 881(a) tax.
341 See H.R. Rep. No. 841, note 94, at 649. The Conference Report also provides that the regulations possibly could characterize excess interest on the basis of legally recognized interbranch loans. The report then goes on to say that the regulations should guard against taxpayers' attempts to reduce their excess interest liability by artificially structuring such loans in a manner different than their external liabilities. Id. As one commentator has pointed out, the Conference Report seems to sanction the recognition of interbranch liabilities only when a look-through approach would not yield a worse result for the taxpayer. See Peter H. Blessing, The Branch Tax, 40 Tax Law. 587, 634 (1987).
342 Reg. § 1.884-4(a)(2)(iii). Foreign corporations other than banks may specifically identify foreign booked liabilities as liabilities of a U.S. trade or business to thereby reduce the amount of excess interest; however, the reduction in excess interest pursuant to the specific identification of liabilities cannot exceed 85% of the amount of excess interest that otherwise would exist. Reg. § 1.884-4(b)(1)(ii). Apparently, the specific identification procedure was adopted to effectuate a look-through characterization approach for the § 881 exemption for portfolio interest.
treats U.S. branches differently than similarly situated U.S. subsidiaries are treated. For example, assume that a foreign bank conducts a U.S. banking business in branch form. Deposit liabilities constitute 90% of the foreign bank's external liabilities. The foreign bank's U.S. branch has substantial borrowings from the foreign bank's home office, which are all designated as deposit liabilities. Because of the assets received by the U.S. branch through the interbranch borrowings, § 1.882-5 of the regulations produces an interest expense deduction that exceeds the interest paid by the U.S. branch, thereby resulting in excess interest. Pursuant to the look-through rule, 90% of the excess interest is treated as deposit interest and therefore exempt from tax. Consequently, the foreign bank is subject to tax under § 881(a) on 10% of its excess interest. If, however, the same U.S. banking business were conducted as a U.S. subsidiary, the foreign bank would have no § 881(a) tax liability, as all the interest paid to it by its U.S. banking subsidiary would have been deposit interest exempt from tax. Thus, the excess interest tax, despite its lofty goal of equalizing the taxation of branch and subsidiary operations, fails to treat U.S. branches and U.S. subsidiaries in a similar manner.

V. LABORATORY FOR USING THE SEPARATE ENTITY METHOD FOR FOREIGN BRANCHES OF U.S. CORPORATIONS

Adoption of the separate entity method for U.S. branches of foreign corporations could further improve U.S. international tax laws by serving as a laboratory for the possible use of this method for foreign branches of U.S. corporations.

Currently, U.S. tax law applicable to a U.S. corporation's foreign operations similarly consists of a dual regime. To explain in very brief and general fashion, where a U.S. corporation conducts a foreign business through a foreign subsidiary corporation, the income of the foreign subsidiary generally is not subject to U.S. tax until it is distributed to its U.S. parent. The foreign subsidiary is respected as a separate legal entity and transactions that it has with its U.S. parent (and other persons) are taken into account subject to § 482 adjustments.

In contrast, where a foreign business is conducted through a foreign branch of a U.S. corporation, the income derived from the foreign business is subject to U.S. tax. To alleviate double taxation, the

343 See note 341.
345 A major exception to this general rule is subpart F, IRC §§ 951-964.
346 In general, a U.S. corporation is subject to U.S. tax on its worldwide income. See Bittker & Lokken, note 56, ¶ 65.1, at 65-2.
United States allows a credit for income taxes paid or accrued to foreign countries, subject to limitations. In very general terms, under the foreign tax credit limitations, the credit cannot exceed the U.S. tax on the income derived from the foreign business, as determined under U.S. tax law. Thus, in the case where the U.S. corporation's foreign taxes exceed this limitation, the foreign tax credit will be equal to the U.S. tax on the income derived from the foreign business; consequently, in this situation foreign business income is effectively exempt from U.S. tax. For this purpose, the income of the foreign business is determined under the source rules contained in the Code and regulations.

Several of the policy concerns discussed in this Article also would support use of the separate entity method for foreign branch operations of U.S. corporations. A single method for the tax treatment of U.S. corporate controlled foreign businesses would advance the policies of simplification and neutrality. Furthermore, because some of the sourcing rules use threshold allocation and formulary apportionment approaches, a separate entity method for a foreign branch may well achieve a more accurate reflection of the branch's income. Moreover, using the separate entity method for foreign branches would make the U.S. tax system more compatible with the tax systems of many other developed countries and therefore reduce the risk of double taxation.

347 IRC §§ 901, 904.
348 IRC § 904(a). In addition, there are separate limitations for various categories of income. IRC § 904(d).
349 This currently is often the case as U.S. tax rates generally are lower than foreign rates.
350 See generally IRC §§ 861-865, and the regulations thereunder. Where a U.S. corporation conducts a foreign business through a foreign subsidiary, the separate entity method is used to determine the income of the foreign business that is exempt from U.S. tax. On the other hand, where a foreign business is conducted through a U.S. corporation's foreign branch, the source rules are used to determine the foreign business income that is effectively exempt from U.S. tax. Therefore, different methods currently are used to determine the exempt foreign business income depending on the form used to operate the foreign business.
351 Cf. Wickham & Kerester, note 161, at 350 (recommending a single set of source rules for allocating profits for both branches and subsidiaries in order to eliminate the added complexity occasioned by current law's dual treatment of the issue).
352 See, e.g., IRC § 861(a)(6); Reg. § 1.861-7(c) (title passage rule).
353 See, e.g., Temp. Reg. § 1.863-3T(b)(2)(Ex. 2); notes 194-97 and accompanying text.
354 Cf. notes 301-07 and accompanying text. Indeed, if the United States is able to convince other developed countries to adopt the separate entity method for branches, as previously suggested, see notes 308-09 and accompanying text, a failure to use the separate entity method for foreign branches of U.S. corporations would be quite anomalous.
355 Cf. Ernst & Young, note 117, at 779 (pointing out that a foreign country's recognition of interbranch transactions, coupled with the failure of the United States to do so, could result in double taxation to U.S. incorporated international banks).
Although recognition of interbranch transactions does not appear to be any more problematic than the recognition of intercompany transactions, this method is largely untested as far as the United States is concerned. Therefore, rather than initially use the separate entity method for both inbound and outbound branch operations, it appears to be more sensible to use it first on a more limited basis, that is, for U.S. branches of foreign corporations. Successful use on the inbound side could lead to its possible use on the outbound side and further improvement of U.S. international tax laws.

VI. THE FUTURE OF THE ARM'S LENGTH APPROACH AND ITS EFFECT ON THE PROPOSAL FOR U.S. BRANCHES

In the last several years, the arm's length method of allocating income among related parties has come under severe attack. Among the criticism leveled against the § 482 approach is a lack of compliance by taxpayers, which has been blamed for the general undertaxation of foreign controlled businesses. Indeed, the perceived enforcement problems are so great that the arm's length approach may be abandoned unless compliance improves. Congress previously has considered legislation that would have imposed a taxable income floor on U.S. subsidiaries of foreign corporations based in part on industry wide profits. Although the proposal was not enacted and was subject to the charge that it abandoned the arm's length standard, similar future legislative proposals are likely. Furthermore, as Congress continues to address the taxation of foreign-controlled U.S. corporations, proposals may be made to apportion the worldwide income of affiliated corporations to U.S. subsidiaries based on generalized formulas.

356 See Section IV.B.1.
357 Other criticisms of the arm’s length approach include the difficulty of finding comparable transactions between unrelated parties, the possible nonexistence of such comparables and documentation burdens. See notes 247-58 and accompanying text.
358 See notes 256-57 and accompanying text.
359 See note 258 and accompanying text.
360 Foreign Income Tax Rationalization and Simplification Act of 1992, H.R. 5270, 102d Cong., 2nd Sess. § 304. The legislation also provided that a foreign corporation with a U.S. business would be subject to these rules if the foreign corporation had a substantial amount of transactions with related foreign persons. Id.
363 Indeed, in 1994 Congress passed a joint resolution containing nonbinding language recommending that Treasury use a formulary approach under § 482 for those cases in
On the other hand, various government officials and commentators continue to support the use of arm's length allocation principles. Supporters point out that politically it would be difficult for the United States to replace the arm's length standard, given that the United States promoted international acceptance of this standard. Others claim that methods such as the income floor proposal would violate treaty nondiscrimination provisions and could lead to retaliatory legislation by foreign countries. In addition, supporters suggest that formulary apportionment would result in greater interference with the affairs of foreign countries because there would be a need for the worldwide data of related corporations, as opposed to data relating only to transactions involving U.S. business operations. Perhaps even more important, formulary apportionment would be likely to result in an increased risk of double taxation, as it would be difficult for various governments to agree on uniform apportionment factors. Consequently, proponents argue that instead of abandoning the arm's length standard, several new administrative measures, such as advance pricing agreements and § 6038A, should be given an opportunity to work.

which the current transfer pricing rules are inadequate. H. Con. Res. 218 § 38. In addition, during 1994, bills were introduced in the House and Senate that similarly include a non-binding recommendation for Treasury to use a formulary approach in cases where the current § 482 rules fail to work. The Foreign Tax Compliance Act of 1994, H.R. 4860, 103d Cong., 2d Sess. (1994); S. 2342, 103d Cong., 2d Sess. (1994); see Barbara Kirchheimer, Crackdown on Multinationals Seen as Major Revenue Source, 64 Tax Notes 700 (Aug. 8, 1994). The bill was not enacted and was opposed by the business community in the United States and abroad, as well as by OECD members. See Dorgan Will Try To Delay Vote On Treaties If Treasury Opposes Formula Method, Daily Tax Rep. (BNA) Sept. 30, 1994, at G-4. Yet, this legislative action is a clear signal that the dispute over using formulary apportionment continues. See J. Dwight Evans, With Barclays and Colgate Settled, Worldwide Formulary Reporting Goes Federal, 65 Tax Notes 241, 243 (Oct. 10, 1994).

364 See Hubbard, Transfer Pricing, note 251 (reprinting statements of former Service official Rom Watson); cf. Nolan, note 158, at 292 (noting that United States sponsored the arm's length approach as the proper international rule for all countries).

365 See ABA Comments, note 361, at 43-44, 49-50; Joanna Richardson, Gains From Foreign Tax Bill Not Worth Losses, Witnesses Charge, 56 Tax Notes 397, 399 (July 27, 1992) (reporting statements by Fred Goldberg, Ass't Treas. Sec. (Tax Policy), who termed the proposal “fatally flawed”). Similarly, the comparable profit method, which was given great weight in the proposed § 482 regulations but substantially deemphasized in the final regulations has been criticized as deviating from the arm's length standard. See John Turro, 46th IFA Congress Blasts Comparable Profit Method in Proposed U.S. Transfer-Pricing Regulations, 5 Tax Notes Int'l 867, 868 (Oct. 26, 1992) (reporting adoption by IFA of resolution reaffirming commitment to arm's length principle and rejecting comparable profit method).

366 See note 276 and accompanying text.

367 See note 311 and accompanying text.

368 See Richardson, note 362, at 399. For a discussion of these new measures, see notes 259-70 and accompanying text. Indications are that the Clinton administration currently is opposed to abandoning the arm's length standard. See J. Andrew Hoerner, The Clinton Tax Package: Traces of Robin Hood?, 57 Tax Notes 441, 444 (Oct. 26, 1992) (statements
Finally, as previously discussed, the arm's length approach would appear to have advantages over generalized formulary apportionment approaches in reflecting the economic income produced by an entity's activities. In this regard, the arm's length approach likewise should have advantages over methods such as the proposed income floor, as the § 482 method focuses on comparable unrelated party transactions in allocating income rather than on transactions relating to an entire industry.

Although the arm's length method no doubt has problems, on the whole, it appears to be the best of the possible approaches. Nevertheless, its future may be in doubt. Given that the arguments in support of using the separate entity arm's length method for U.S. branches, as well as its political viability, are substantially based on the use of this method for U.S. subsidiaries, it is reasonable to apply any new method for U.S. subsidiaries to U.S. branches as well. Initially, it should be recognized that if the arm’s length method is abandoned for U.S. subsidiaries, it would be unrealistic to think that Congress would allow its use for U.S. branches. Thus, the choice of treatment for U.S. branches likely would be either the current regime used for U.S. branches or any new method used for U.S. subsidiaries. There is more support for the latter choice.

First, tax administration concerns would support the use of one method for both forms of conducting a foreign corporate controlled U.S. business. In addition, the use of any new method for U.S. branches along with U.S. subsidiaries would adhere to the policy of neutrally applying the tax laws to different forms of conducting business. However, unless a substantial number of other countries also use this new method to determine the taxable income of U.S. branches for their foreign tax credit and exemption systems, there

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370 Cf. ABA Comments, note 361, at 41-42.

371 Cf. Eric J. Coffill & Prentiss Wilson, Jr., Federal Formulary Apportionment as an Alternative to Arm's Length Pricing: From the Frying Pan Into the Fire?, 59 Tax Notes 1103, 1116-17 (May 24, 1993) (concluding that while the arm's length method has problems, formulary apportionment is not a viable alternative until many difficult and complex questions are addressed adequately).

372 See notes 292-94 and accompanying text.

373 See notes 313-21 and accompanying text.
could be a serious risk of double taxation with U.S. use of this method for U.S. branches.\textsuperscript{374} Nevertheless, the current regime also poses such a risk,\textsuperscript{375} and therefore this harmonization of tax laws policy would not likely support either available choice. Similarly, while any new method might have flaws in accurately reflecting income (assuming it is either a generalized formulary apportionment method or transfer pricing approach using industrywide standards for comparability), it may well be no more inaccurate than the current regime.\textsuperscript{376} Consequently, on the whole, the policies appear to support the use of the new method for U.S. branches rather than the current regime, as two of the policies support the new method while the other two appear to support neither method.

The separate entity arm's length method for subsidiaries currently is under review. The results over the next several years from the use of new compliance measures will likely be critical to the future of the arm's length approach. Thus, it is not likely that Congress would extend the separate entity method to branches before there is some positive experience with these compliance measures. Therefore, political reality dictates that any implementation of the separate entity method for U.S. branches be delayed until this review is completed and the continued use of this approach for U.S. subsidiaries is more firmly established. If, on the other hand, the separate entity arm's length method ultimately is discarded for U.S. subsidiaries and some new method employed instead, this new method also should be used for U.S. branches.

VII. Conclusion

Foreign corporations' U.S. business operations through U.S. subsidiaries and U.S. branches have one essential difference: the legal form used for conducting these operations. Although this difference effectively can be eliminated for tax purposes by requiring U.S. branches to designate accounts, assets and employees as belonging to itself, the United States currently employs two completely different regimes for taxing these two forms of conducting a foreign-controlled U.S. business.

These two taxing regimes result in numerous differences in the tax treatment accorded U.S. subsidiaries and U.S. branches. Concerns of tax neutrality and simplification support using one method for both U.S. subsidiaries and U.S. branches.

\textsuperscript{374} Cf. notes 296-97 and accompanying text.
\textsuperscript{375} Cf. notes 301-07 and accompanying text.
\textsuperscript{376} Cf. notes 162-97 and accompanying text.
Of the two methods currently used, the separate entity method used for U.S. subsidiary operations is preferable. It reflects income more accurately than the current regime used for U.S. branches, which has serious flaws. The separate entity method also should result in a lower risk of double taxation, as it is more consistent with the methods generally employed by developed countries with respect to branches and may be the only method suitable for harmonizing the differing approaches currently used. Although the separate entity method will necessitate the difficult fact specific inquiries required under the transfer pricing rules, its use also obviates the troublesome need for a foreign corporation's worldwide data. For similar reasons, the separate entity method appears to be better than other possible approaches, such as generalized formulary apportionment or income floors based on industry-wide levels of profitability. On the whole, the policies of accurately reflecting income, harmonizing tax systems and administrability support the use of the separate entity method for U.S. subsidiaries and U.S. branches.

The best short-term solution for the problems confronted in taxing foreign-controlled U.S. businesses may well be the use of the separate entity method along with individual income allocation agreements between taxpayers and all affected governments. Such agreements could set forth either transfer prices based on comparables or individualized apportionment formulas based on the specific factual circumstances of the taxpayer involved. With these agreements, allocations would reflect the income economically generated, and avoid double taxation. To aid in the formulation and use of these agreements, it may be possible to use the enormous data processing capabilities of computer technology. These individual agreements may eventually lead to harmonized legislation among countries that would contain various income allocation rules for different types of business.377

This Article recommends that the separate entity method be used for U.S. branches of foreign corporations, provided its use continues for U.S. subsidiaries. Adoption of the separate entity method, however, should be delayed for the next several years pending the ongoing review of this approach for U.S. subsidiaries. In the alternative, any new method employed for U.S. subsidiaries should be used for U.S. branches as well.

Over the years, the law has evolved from the force of attraction rule, which subjected a foreign corporation's income to net basis taxation regardless of any actual connection to its U.S. business, to the effectively connected rules, which at least usually require such a connection. As one commentator noted shortly after the effectively con-

377 Cf. note 265.
nected rules were enacted, these rules should be viewed as merely the first step in reforming the tax treatment of U.S. branches. The use of the separate entity method would complete this evolutionary process.

378 See Ross, Developments, note 2, at 366.