SUMMARY OF INTERNATIONAL TAX LAW DEVELOPMENTS

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In the past year there have been many developments affecting the United States taxation of international transactions. The Taxpayer Relief Act of 1997 (the "Act") contained a significant number of foreign related provisions. In addition, new guidance was issued affecting the taxation of foreign trusts, withholding on payments to non-U.S. persons, cross-border securities lending transactions, foreign tax credits and the taxation of passive foreign investment companies. This memorandum highlights certain of the provisions of the Act and other international tax law developments that may be of interest to our clients with international operations. In addition, it provides a summary of some important developments in United States tax treaties during the past year.

TAXPAYER RELIEF ACT OF 1997

Provisions Affecting Foreign Tax Credits

Holding Period Requirement for Foreign Taxes Paid on Dividends

Under prior law, United States taxpayers owning stock in a foreign corporation could claim a foreign tax credit for taxes paid on a dividend from the foreign corporation regardless of the taxpayer's holding period for the stock.

The Act denies a taxpayer a foreign tax credit (including a "deemed paid" credit) with respect to a dividend from a foreign corporation or regulated investment company if (1) the taxpayer has not held the stock for a minimum period of 16 days (46 days with respect to preferred stock) during which the taxpayer is not protected from the risk of loss or (2) the taxpayer has an obligation to make payments related to the dividend with respect to positions in substantially similar or related property.

The amendment provides an exception for certain "qualified taxes" of active dealers in securities, although Treasury is given the authority to provide regulations which will restrict any abuses of this exception. The amendment does not affect the deductibility of foreign taxes. The provision is effective for dividends paid or accrued after September 5, 1997.

Change in Calculation of Foreign Tax Credit Limitation - "10/50" Companies

Under prior law, dividends received from *each* foreign corporation in which the taxpayer owned at least 10% of the stock (by vote) and that was not a controlled foreign corporation (so-called "10/50" companies) were subject to a separate foreign tax credit limitation. Congress recognized that this requirement caused significant record-keeping burdens and discouraged United States taxpayers from holding minority positions in foreign corporate joint ventures as the foreign tax credits from each venture were subject to separate limitations.

The Act provides that in the case of dividends from a 10/50 company paid out of earnings and profits accumulated in a taxable year beginning before January 1, 2003, a single foreign tax credit limitation generally applies to all such dividends from all 10/50 companies. The separate foreign tax credit limitations of prior law, however, continue to apply to dividends paid out of earnings and profits accumulated before January 1, 2003 received from each 10/50 company that qualifies as a passive foreign investment company ("PFIC"). A dividend from a 10/50 company paid out of earnings and profits accumulated in a taxable year beginning after December 31, 2002 will be treated as income in a foreign tax credit limitation category in proportion to the ratio of earnings and profits attributable to income in such category to the total earnings and profits. Both of these provisions are effective only for taxable years beginning after December 31, 2002.

Prior to the passage of the Act, the basket for dividends from 10/50 companies only excluded distributions from controlled foreign corporations ("CFCs") made out of earnings and profits for the periods during which it was a CFC and, except as provided in regulations, when the taxpayer was a 10 percent shareholder of the CFC ("10% U.S. Shareholder"). The Act eliminates the requirement that the earnings and profits be attributable to periods during which the taxpayer was a 10% Shareholder. This provision of the Act applies to distributions after August 5, 1997.

Extension of Indirect Foreign Tax Credit to 4th, 5th and 6th Tier CFCs

United States taxpayers who own at least 10 percent of the voting stock of a foreign corporation are treated as if they had paid a share of the foreign income taxes paid by the foreign corporation. This so-called "indirect foreign tax credit" is also available for taxes paid by certain second- or third- tier foreign corporations. Prior to the Act, however, no foreign tax credit was permitted for taxes paid by any foreign corporation below the third-tier. As a result, it was necessary to insure that no more than three tiers of foreign corporate entities existed if foreign tax credits were to be claimed.

Under the Act, the indirect foreign tax credit is extended to apply to taxes paid or incurred by certain fourth, fifth and sixth tier foreign corporations, but *only* if they are CFCs. The taxpayer claiming the credit must be a 10% U.S. Shareholder with respect to the foreign corporation, and the product of the percentage ownership of voting stock at each level below the U.S. corporation must equal at least 5%. The provision applies to taxes paid or incurred by CFCs during taxable years beginning after August 5, 1997. This is one of the many provisions of the Act specifically affecting CFCs - additional provisions are discussed below.

Provisions Affecting Controlled Foreign Corporations

Character of Gain on Sale of Stock in a Lower-Tier CFC

Prior to the changes made by the Act, if an upper-tier CFC sold stock of a lower-tier CFC, the gain generally was included in income by a U.S. shareholder as subpart F income, and for foreign tax credit purposes was treated as passive income from the sale of stock.

After the date of enactment, gain derived by a CFC from the sale or exchange of stock in a lower-tier CFC generally is treated as a dividend (which also constitutes subpart F income) rather than gain to the extent that the lower-tier CFC's earnings and profits attributable to the stock were accumulated during periods in which the upper-tier CFC owned at least 10 percent of the lower-tier CFC's stock. As a dividend, foreign taxes paid by the lower-tier CFC will be available as a credit and the foreign tax credit limitations will apply by reference to the nature of the income of the lower-tier CFC. Although designated as a dividend for certain purposes, it will not qualify for the exception from subpart F income for dividends received from a related corporation organized in the same country.

This provision applies to gain recognized on transactions occurring after August 5, 1997.

Basis Adjustments to Stock of Lower-Tier CFCs to Reflect Prior Subpart F Inclusions by 10% U.S. Shareholders

Under prior law, if a lower-tier CFC earned subpart F income that was included in the income of a 10% U.S. Shareholder, there was no provision to allow an adjustment of the basis of the upper-tier CFC's stock in the lower-tier CFC.

The Act provides that the United States Treasury Department may publish regulations providing that an upper-tier CFC's basis in the stock of a lower-tier CFC may be increased to reflect a 10% U.S. Shareholder's prior subpart F inclusions. A corresponding reduction in basis would occur upon an actual distribution to the upper-tier CFC. The provision applies for purposes of determining a U.S. shareholder's subpart F inclusions for taxable years of such shareholders beginning after December 31, 1997.

Subpart F Inclusions for Year of Acquisition

When a taxpayer acquires stock in a CFC, the taxpayer's subpart F income for the year generally is reduced by the amount of dividend distributions to other persons during the year. Under the Act, a "dividend distribution" would include any deemed dividend of the selling shareholder arising from the shareholder's disposition of the stock. The provision is effective for dispositions occurring after August 5, 1997.

Exclusion from Subpart F Income for Effectively Connected U.S. Source Income

Subpart F income does not include U.S. source income effectively connected with a CFC's trade or business in the U.S. provided the income is not exempt from tax, or subject to a reduced rate of tax, pursuant to a treaty. The Act clarifies that an exemption from, or reduction in the rate of, the branch profits tax does not affect the availability of the exclusion from subpart F income classification. The provision applies retroactively to taxable years beginning after December 31, 1986.

Inclusion of Income from Notional Principal Contracts and Stock Lending Transaction in Definition of "Foreign Personal Holding Company Income"

A 10% U.S. Shareholder of a CFC is subject to current taxation on certain income earned by the CFC, regardless of whether or not such income is distributed to the shareholder. One of the categories of income that is subject to current inclusion is foreign personal holding company income ("FPHCI").[1]

The Act adds two new categories of income to FPHCI - net income from notional principal contracts (other than income derived by dealers, and subject to a hedging exception), and payments in lieu of dividends made pursuant to certain securities lending transactions. The new categories are effective for taxable years beginning after August 5, 1997.

Presidential Veto of Exemption from "Foreign Personal Holding Company Income"

As initially enacted, the Act provided for a limited one year exclusion from FPHCI for income from the active conduct of an banking, financing, or similar business that was derived by a CFC that is predominantly engaged in the active conduct of such business. A similar exclusion was provided for certain income derived by CFCs that are "qualified insurance companies." The provision apparently would also have applied in determining a PFIC's passive income. President Clinton used the line-item veto authority on August 11, 1997, to veto this provision of the Act. Decisions on lawsuits which challenge the president's line-item veto are now pending in U.S. district court. In addition, new legislation has been introduced in Congress that would restore this provision with slight modifications.

Provisions Affecting Passive Foreign Investment Companies

Elimination of Overlap Between PFIC and CFC Rules

A PFIC is defined as any foreign corporation if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.

1. In addition, the definition of FPHCI is used to determine passive income for purposes of the PFIC rules discussed below.

A foreign corporation that is a CFC may also be a PFIC if it meets either of the tests described above. Under prior law, a 10% U.S. Shareholder of a CFC would be subject to both the current income inclusion rules of Subpart F (governing CFCs) and the PFIC provisions (which impose an interest charge on amounts distributed from the PFIC and gains on the disposition of the PFIC's stock, unless an election is made to include the PFIC's earnings in income currently).

The Act provides that, with respect to 10% U.S. Shareholders only, a corporation will not be considered a PFIC if the corporation is a CFC for periods after December 31, 1997. Shareholders of the corporation other than 10% U.S. Shareholders will remain subject to the PFIC rules.

Mark-to-Market Election for PFIC Shareholders

Prior to the Act, holders of stock in a PFIC were subject to either one of two alternative taxation regimes (both of which continue to apply after the Act). The "excess distribution" rules impose an interest charge on certain amounts distributed from the PFIC and on gains from the disposition of PFIC stock, and the Qualified Electing Fund ("QEF") rules require instead that an electing holder include its pro-rata share of a PFICs earnings in income currently.

The Act adds a third, mark-to-market, regime under which shareholders of a PFIC can make a mark-to-market election with respect to "marketable stock" and avoid the excess distribution PFIC regime. Amounts included in income pursuant to the election, as well as gain on the sale of the PFIC stock, are treated as ordinary income.

This election is only available for "marketable" stock. Currently, stock in foreign corporations generally will be considered marketable if it is regularly traded on a national securities exchange that is registered with the United States Securities and Exchange Commission (*e.g.*, the New York Stock Exchange, the American Stock Exchange) or on NASDAQ. The provision provides the United States Secretary of the Treasury with the authority to designate other exchanges in the future.

The provision is effective for taxable years of taxpayers beginning after December 31, 1997.

Modification to PFIC Asset Test

As discussed above, one of the tests for determining whether a foreign corporation is a PFIC for any given year is based on the percentage of its passive assets. Under the law prior to the enactment of the Act, this test was determined on the basis of fair market values for most foreign corporations, but a CFC was required to use the adjusted basis of its assets. Corporations that were not CFCs could elect to use adjusted basis in lieu of the fair market value of the assets.

The Act provides that if the stock of a foreign corporation is "publicly traded", the PFIC asset test is applied using fair market value rather than adjusted basis, even if such corporation is a CFC. Stock in a foreign corporation generally will be considered "publicly traded" if it is regularly traded in the same manner as "marketable" stock for purpose of the mark-to-market election discussed above. The provision provides the United States Secretary of the Treasury with the authority to designated other exchanges in the future.

The legislative history to the Act also provides that the total value of a publicly-traded foreign corporation's assets will generally be equal to the sum of the aggregate value of its outstanding stock plus its liabilities. The market capitalization approach to determining the total value of a corporation can help corporations with significant goodwill to avoid PFIC status.

The provision is applicable to taxable years of taxpayers beginning after December 31, 1997.

Provisions Affecting the Formation and Operation of International Joint Ventures and Other Transfers of Property for Foreign Entities

Repeal of Excise Tax on Transfers to Foreign Entities; Recognition of Gain On Certain Transfers

Prior to the Act, Code section 1491 provided for the imposition of an excise tax on transfers of property by a U.S. person to a foreign entity.

The Act repeals Code section 1491, but imposes significant reporting requirements on certain transfers of property to foreign partnerships. In addition, the Act provides for CFC-like reporting requirements in respect of "controlled foreign partnerships" and their 10 percent U.S. partners. The Act adds new Code section 684, which treats a transfer of property by a U.S. person to a foreign trust or estate as if the property were sold by the U.S. person for fair market value. The provision also gives the Treasury Department the authority to promulgate regulations that will provide gain recognition on the transfer of property by a U.S. person to a foreign corporation (in a transaction not otherwise described in Section 367) or partnership (where the gain would otherwise be transferred to a foreign partner).

The effective date of the provision is August 5, 1997.

Repeal of Filing Requirement for Foreign Partnerships with No U.S. Trade or Business

Under prior law, a foreign partnership with U.S. partners was required to file a U.S. income tax return even if it did not engage in a trade or business in the United States, although this provision was often ignored.

Under the Act, a foreign partnership generally is required to file a partnership return for a taxable year only if the partnership has U.S. source income or is engaged in a U.S. trade or business, although a return will still be advisable in many circumstances in order to claim certain deductions.

This provision is effective for taxable years beginning after August 5, 1997. Proposed regulations were recently issued which would reduce filing requirements for certain foreign partnerships with U.S. source income.

Foreign Partnerships vs. United States Partnerships

Under current law, a partnership generally is considered to be a United States partnership if it is created or organized in the United States or under the laws of the United States or any State. A foreign partnership is any partnership that is not a domestic partnership.

The Act provides the Secretary of Treasury with regulatory authority to provide other rules for determining when a partnership should be considered domestic or foreign. Such regulations will be prospective only and will not apply to reclassify pre-existing partnerships. Factors that may be relevant to this determination include the residence of the partners and the extent to which the partnership is engaged in business in the United States or earns U.S. source income. The regulations should also provide guidance regarding when a partnership is to be considered to be created or organized in or under the laws of the United States.

Provisions Affecting Treaty Benefits

Denial of Treaty Benefits for Payments to Hybrid Entities

The U.S. generally applied reductions in withholding tax rates to payments from U.S. sources made to partnerships based upon the treaty residence of the partners, even if the partnership was treated as a corporation under the internal laws of the partners' country of residence (i.e., was a "hybrid" entity). Under proposed regulations, however, the U.S. would allow treaty rates to apply only if the partnership was a flow-through entity under the treaty partner's rules.

Despite the fact that the regulations are proposed to become effective on January 1, 1998, the Act imposes similar rules 5 months earlier. Under the Act, a foreign person is entitled to a reduced rate of withholding under a treaty with a foreign country on an item of income derived by an entity that is treated as a partnership for U.S. purposes only if the foreign country treats the item as income of such person or imposes tax on an actual distribution of such item of income from the partnership to such person. This provision was aimed specifically at Canadian corporations financing their U.S. subsidiaries through U.S. limited liability companies.

The Act also gives the Treasury Department authority to prescribe regulations that deny treaty benefits with respect to payments received by, or attributable to, hybrid entities in other situations.

The provision is effective as of August 5, 1997.

Provision Affecting Offshore Funds and Others With Stocks and Securities Transactions in the United States

Repeal of Stock and Securities Safe Harbor Requirement that Principal Office be Outside of the United States

The Act eliminates the requirement that an entity that trades in stock and securities for its own account in the U.S. have its "principal office" outside of the U.S. in order to avoid being treated as engaged in a trade or business in the United States. Such an entity would therefore no longer have to satisfy the "10 commandments" in order to avoid being treated as engaged in a U.S. trade or business.

This provision is effective for taxable years beginning after December 31, 1997. Thus, offshore funds that trade solely in stock and securities will no longer be required to maintain a non-U.S. office simply to satisfy U.S. tax rules. Questions will continue to exist on the breadth of the trading in stock and securities exception (i.e., what activities other than mere stock and securities trading are protected).

Provisions of Interest to Individual Taxpayers

Simplification of Foreign Tax Credit Limitation for Individuals

Under prior law, all individual taxpayers claiming a foreign tax credit were required to file Form 1116 with their tax return computing foreign source income and calculating the foreign tax credit limitations in each category.

The Act provides that individuals with no more than $300 ($600 in the case of married persons filing jointly) of creditable foreign taxes, and no foreign source income other than passive income, may elect to credit these taxes without regard to the foreign tax credit limitation rules. Such taxpayers will not be required to file Form 1116, but will not be entitled to carryover any excess foreign taxes to or from a year to which the election applies.

This provision applies to taxable years beginning after December 31, 1997.

Increased Dollar Limitation for Exclusion of Foreign Earned Income

A U.S. Citizen living abroad may be eligible to exclude from his or her income for United States tax purposes certain foreign earned income and housing costs. The exclusion for foreign earned income generally applies to income earned from sources outside the United States as compensation for personal services actually rendered by the taxpayer. Currently, the maximum exclusion for foreign earned income for a taxable year is $70,000.

Under the Act, the $70,000 limitation on the exclusion for foreign earned income is increased to $80,000, in increments of $2,000 each year beginning in 1998. Beginning in 2008, the $80,000 limitation will be indexed for inflation.

Other Foreign Related Provisions of Interest

Restrict Like-Kind Exchanges Rules for Certain Personal Property

Under current rules, no gain or loss will be recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like-kind" that is to be held for productive use in a trade or business or for investment.

The Act provides that personal property predominately used within the United States and personal property predominately used outside the United States are not "like-kind" properties (thus adopting the rule applicable under current law to real estate). The provision is effective for exchanges after June 8, 1997, unless the exchange is pursuant to a binding contract in effect on such date and at all times thereafter.

PROPOSED REGULATIONS AFFECTING FOREIGN TRUSTS

The Small Business Act of 1996 modified the tax treatment of certain trusts. The legislation's primary effect is to eliminate grantor trust status for many foreign trusts, causing distributions from such trusts to United States beneficiaries to be subject to taxation in the United States. Proposed regulations were issued in June of 1997 generally implementing this legislation and providing special rules intended to prevent tax avoidance by United States beneficiaries on disguised distributions from foreign non-grantor trusts (the "Proposed Foreign Trust Regulations").

Under the Proposed Foreign Trust Regulations, distributions by a foreign trust intermediary are deemed paid directly by the trust to the United States beneficiary. In addition, if a United States donee receives a gift from a foreign corporation or partnership, the purported gift is treated as income to the donee unless another United States person treated this amount as a distribution from the partnership or corporation and a subsequent gift to the donee. Finally, the Proposed Foreign Trust Regulations further provide that if a United States beneficiary of a foreign trust directly or indirectly transfers property to the foreign grantor of the trust who would otherwise be treated as the trust's owner, then the United States beneficiary is treated as the owner of the trust to the extent of the value of the transfer.

FINAL REGULATIONS ON WITHHOLDING ON PAYMENTS TO NON-US PERSONS

Final regulations were issued in October of 1997 that provide extensive guidance regarding withholding on payments to non-U.S. persons. The regulations are generally effective for payments made after December 31, 1998. Following are highlights of some of the more important provisions of the rules.

The final regulations streamline the types of statements that must be provided by a non-U.S. person to claim a reduced rate of withholding. A new Form W-8 will be used in place of most of the certification forms currently used (*e.g.*, Form 1001, Form 4224). In addition, the requirement that a non-U.S. person provide a taxpayer identification number on such certification has been extended to certain transactions (*e.g.*, dividend on nonpublicly traded stock).

The final regulations eliminate the so-called "address rule" with respect to reduced rates of withholding on dividends paid to non-US persons under a tax treaty. Under current regulations, a non-US person is not required to provide any documentation in order to obtain the benefits of a reduced treaty rate of withholding on dividends. A withholding agent can rely on a non-US person's address of record in a treaty country to withhold at the treaty rate. Under the new regulations, non-US persons claiming a reduced rate of withholding on dividend payments generally must provide a beneficial owner withholding certificate (new Form W-8) to certify their residence in a country with which the U.S. has a tax treaty.

The new regulations provide guidance regarding payments to foreign intermediaries and provide a procedure whereby foreign intermediaries may enter into an agreement with the IRS and may thereafter certify as to the status of their customers or account holders for withholding purposes. This procedure will eliminate the need for such intermediaries to pass on certification information for all their customers to the U.S. payor.

The regulations provide new guidance on withholding on corporate distributions. A distributing corporation may calculate its withholding based on an estimate of its earnings and profits for the year. As long as such an estimate is reasonable, there will be no penalty for underwithholding.

FINAL REGULATIONS ON CROSS-BORDER SECURITIES LENDING TRANSACTIONS

Regulations were issued in October of 1997 that finalized rules regarding the sourcing of substitute payments made in cross-border securities lending transactions. Under the regulations, substitute payments will have the same source as the dividend or interest income for which they substitute. The regulations also provide that substitute payments will have the same character as the payments for which they substitute for withholding and treaty purposes. The regulations treat sale-repurchase transactions in the same way as securities lending transactions for purposes of the sourcing and characterization rules. Substitute payments on portfolio debt instruments will qualify for the portfolio interest exemption, provided the lender complies with documentation requirements and no exception from the exemption applies.

The regulations are applicable to payments made after November 13, 1997.

PROPOSED AND TEMPORARY REGULATIONS REGARDING PASSIVE FOREIGN INVESTMENT COMPANIES (PFICS)

Proposed and Temporary regulations were recently issued that include guidance for shareholders of a PFIC that elect to have the PFIC treated as a qualified electing fund (QEF), shareholders that are tax-exempt organizations, and the classification of certain bank assets in determining classification as a PFIC.

The regulations generally simplify the procedure for making a QEF election. An electing shareholder need only file Form 8621 for each PFIC on an annual basis and maintain records to support the information entered on that form. The filing of Shareholder Election Statements and PFIC Annual Information Statements is no longer required. In addition, the regulations provide a new procedure whereby retroactive QEF elections may be made under certain circumstances. The Temporary regulations specifically state that QEF elections cannot be made with respect to options to buy stock of a PFIC.

The regulations clarify that section 1291 and the proposed and temporary regulations apply to a tax-exempt organization only if a dividend from the PFIC would be taxable to the organization under subchapter F. This being the case, a tax-exempt organization is normally precluded from making a QEF election, and an election made by a pass-through entity through which the organization holds shares in a PFIC has no effect on the organization.

The regulations provide an exception from passive income classification for interbank deposits made in the ordinary course of a banking business. Such deposits are thereby considered with other deposits in determining whether a foreign corporation satisfies the deposit-taking requirement of the PFIC provisions.

NOTICE WITH RESPECT TO ABUSIVE TAX CREDIT TRANSACTIONS

On December 23, 1997, Notice 98-5 was issued announcing that Treasury and the IRS will issue regulations that will disallow the use of foreign tax credits in the case of certain “abusive” tax-motivated transactions that involve acquiring or generating foreign tax credits that can be used to shelter low-taxed foreign source income from residual U.S. tax. According to the notice, these transactions typically involve (i) the acquisition of an asset that generates an income stream subject to foreign withholding tax, or (2) effective duplication of tax benefits through the use of a structure designed to exploit inconsistencies between U.S. and foreign tax laws.

The notice provides five examples of arrangements that are within the scope of the notice, but does not provide specific guidance on many key aspects of the rules set forth. In particular, the notice provides that the regulations will disallow foreign tax credits in arrangements in which the reasonably expected economic profit is "insubstantial" compared to the value of the foreign tax credits expected to be obtained as a result of the arrangements, but provides no guidance as to what will constitute "insubstantial."

The regulations announced by the notice will be effective for foreign taxes paid or accrued on or after December 23, 1997. Note that with this effective date, taxpayers operating on the calendar year with foreign taxes that accrued on the last day of 1997 will be affected by the regulations.

NOTICE WITH RESPECT TO HYBRID ARRANGEMENTS UNDER SUBPART F

On January 16, 1998, Notice 98-11 was issued announcing that Treasury and the IRS plan to issue regulations which will restrict the use of certain "hybrid branches" to circumvent the purposes of subpart F. A hybrid branch is one that is viewed as part of the CFC under U.S. tax law principles, but a separate entity under the laws of the jurisdiction of the CFC.

According to the notice, these arrangements generally involve the use of deductible payments to reduce the taxable income of a CFC under foreign law and the corresponding creation in another entity of low-taxed passive income of the type to which subpart F was intended to apply. The Notice states that the recent check-the-box regulations have facilitated the creation of the hybrid branches used in these arrangements.

The notice provides two examples of hybrid arrangements which have been identified as "inconsistent with the policies and rules of subpart F". In both examples, a CFC is permitted an interest deduction for interest paid to a hybrid branch located in another jurisdiction and little or no tax is paid by the branch on the receipt of interest (because the branch is located in a low or no tax jurisdiction.) In the first example, the branch is owned by another CFC located in the same country as the payor. Because the branch is disregarded for U.S. tax purposes, the payment is deemed to be made from the payor to the CFC owner and the same country exception applies to remove the payment from the parameters of subpart F. In the second example, the payor itself owns the branch, so that for U.S. tax purposes the loan is ignored as a transaction that the CFC has entered into with itself. In both cases, the notice states that by disregarding the branch for U.S. tax purposes a CFC will have lowered its foreign tax on deferred income in a manner that is inconsistent with the policies and rules of subpart F.

The regulations announced by the notice will apply to all arrangements entered into on or after January 16, 1998. In addition, the regulations will apply to all payments and other transfers made or accrued after June 30, 1998 on arrangements that were entered into before January 16,

1998. The preamble to the regulations states that the United States Treasury Department and the Internal Revenue Service intend to address similar hybrid branch arrangements in the context of certain partnership and trust arrangements in the future.

TREATY UPDATES

Some important treaty developments this year that may be of interest are summarized below:

Africa

- An income tax treaty with South Africa entered into force on December 28, 1997 and applies to taxes withheld at source on amounts paid or credited on or after January 1, 1998.

Asia

- A protocol to the tax treaty between the United States and Indonesia entered into force and is effective for amounts paid or credited on or after February 1, 1997. Under the Protocol withholding rates on dividends (to shareholders owning at least 25% of the voting stock), interest and royalty payments are reduced from 15% to 10%.

- An income tax treaty with Thailand entered into force on December 15, 1997 and takes effect for taxes withheld at source on amounts paid or credited on or after June 1, 1998. This is the first income tax treaty between the United States and Thailand. Under the treaty, source-country withholding generally ranges from 10 to 15% on dividends, 10 to 15% on interest and 5 to 15% on royalties.

Europe

- A new income tax treaty with Austria enters into force on February 1, 1998 and applies to taxes withheld at source on payments made on or after April 1, 1998. The treaty replaces the existing treaty concluded in 1956.

- A new income tax treaty with Ireland entered into force on December 17, 1997 and takes effect for taxes withheld at source on amounts paid or credited on or after January 1, 1998. The treaty replaces the existing treaty concluded in 1949. Note that the new treaty contains a comprehensive limitation on benefits clause similar to the one included in many recent United States treaties.

- A new income tax treaty with Switzerland entered into force on December 19, 1997 and applies to taxes withheld at source on payments made on or after February 1, 1998. The treaty replaces the existing treaty concluded in 1951.

- An income tax treaty with Turkey entered into force on December 19, 1997 and applies to taxes withheld at source on payments made on or after January 1, 1998. This is the first income tax treaty between the United States and Turkey.

- The United States Senate approved the income tax treaty with Luxembourg on October 31, 1997. The United States will not exchange instruments of ratification with Luxembourg until they exchange instruments of ratification on a separate treaty which addresses mutual legal assistance in criminal matters.

North America

- A fourth protocol to the United States - Canada tax treaty entered into force on December 16, 1997. The protocol provides that Canada will not tax U.S. residents on capital gains on shares of U.S. corporations that are not resident in Canada even if they own Canadian real estate. Under Canadian domestic tax law, such gains would be subject to tax in Canada. The protocol also addresses social security benefits and provides that social security benefits will only be subject to tax in the country of residency of the recipient.

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This memorandum is intended as a summary of some of the United States tax developments that may be of interest to our clients with international operations. If you have any questions regarding the Act, the regulations, notices or any treaty developments, please do not hesitate to call John Creed (212-455-3485), Meredith Jones (212-455-2805), Karen Sakanashi in our Hong Kong office (011-852-2514-7655) or any other member of our tax department.

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