INTERNATIONAL FINANCINGS: REPEAL OF THE 30-PERCENT TAX IN THE CASE OF PORTFOLIO INTEREST RECEIVED BY FOREIGNERS*

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A. Introduction

1. On July 18, 1984, with the enactment of the Tax Reform Act of 1984 (the "1984 Act"), the traditional Netherlands Antilles international finance subsidiary was eclipsed as the primary means of accessing the Eurodollar market; henceforth, it appeared that American corporations, the United States Government, and, putatively, even individuals and other entities resident here could offer their respective obligations directly into this market free of the imposition of withholding or estate taxes or disclosure requirements upon ultimate beneficial holders receiving "portfolio interest" on such obligations. Subsequent developments have shown that some of these initial conclusions were not to obtain.

2. Section 127 of the 1984 Act, which embodied the final version of the legislation which repealed the 30-percent withholding tax on certain specified interest payments discussed *infra*, departed in several important respects from the parallel provisions of the Senate Bill (and was not presaged by the House Bill).

a. Although the 30-percent withholding tax would have been phased out over a four year period under the Senate bill, Section 127 of the 1984 Act eliminated the tax immediately with respect to obligations issued after July 18, 1984.

b. Conversely, the Senate Bill would have applied both to outstanding Eurodollar issues as well as the assumption of such debts by U.S. corporations from their affiliates or other entities.

c. Although the 1984 Act did not eliminate withholding tax on pre-effective date issues, it contained amnesty provisions for existing finance subsidiary debt (discussed _infra_) which recently have been applied in several technical advice memoranda.

d. A selected Bibliography of articles written both before and after the 1984 Act appears in the Appendix to this outline. The legislative background to the 1984 Act is addressed generally in items 16, 17, and 19 therein.

B. Prior Law

1. The United States would impose a flat 30-percent tax on the gross amount of U.S. source interest, dividends, rents, royalties, or similar types of investment income

received by a nonresident alien individual or foreign corporation if such income were not effectively connected with the taxpayer's U.S. trade or business. I.R.C. §§ 871(a), 881(a).

a. This tax generally is referred to as a withholding tax, since it is collected by means of withholding by the payor. I.R.C. §§ 1441, 1442. In most cases, the foreign recipient files no U.S. income tax return. Reg. §§ 1.6012-1(b)(2), 1.6012-2(g)(2).

b. If the interest, dividend, or other similar income is effectively connected with the taxpayer's U.S. trade or business, that income is not subject to the flat 30-percent withholding tax but instead is taxed at the ordinary graduated rates. I.R.C. §§ 871(b), 882(a)(1).

c. Various U.S. income tax treaties provide either for an exemption or for a reduced rate of tax for U.S. source interest paid to foreign persons covered by these treaties. Article VIII of the U.S. income tax treaty with the Netherlands (as extended to the Netherlands Antilles) generally exempts from withholding tax U.S. source interest paid to Netherlands Antilles persons.

2. Historically, U.S. corporations would issue bonds not subject to U.S. withholding tax through the use of international finance subsidiaries, almost all of which were incorporated in the Netherlands Antilles. Such international finance subsidiaries would reloan the proceeds of Eurodollar bond offerings to their U.S. parent corporations or their affiliates. See generally item 34 in the Bibliography.

   a. Under this arrangement, the U.S. parent would receive the cash proceeds of the bond issue but pay the interest to the Antilles finance subsidiary rather than directly to the foreign bondholders.

      i. To avoid the U.S. withholding tax, the U.S. parent would then claim the benefits of the tax treaty between the United States and the Netherlands, as extended to the Netherlands Antilles.

      ii. Pursuant to Article VIII of the treaty, the interest payments made by the U.S. parent to the Antilles finance subsidiary would be exempt from the U.S. withholding tax.

      iii. The interest payments received by the Antilles finance subsidiary would be subject to local taxation in the Netherlands Antilles but

only after the allowance of a deduction for the interest payments to the foreign bondholders.

iv. The interest payments by the Antilles subsidiary to the foreign bondholders are not subject to tax by the Antilles.

v. Because the Antilles finance subsidiary would have no income effectively connected with a trade or business within the United States, under sections 861(a)(1)(C) and 862(a)(1) the finance subsidiary would pay foreign source interest to the bondholders that would not be subject to the 30-percent withholding tax. (Such interest would be exempt from U.S. withholding tax irrespective of its source under Article XII of the treaty.)

b. Consequently, no tax is withheld, by either the United States or the Netherlands Antilles, on the interest paid by the U.S. parent to its Antilles finance subsidiary nor on the interest paid by the Antilles finance subsidiary to the foreign bondholders.

3. Eurobond offerings by finance subsidiaries have involved difficult U.S. tax issues in the absence of a favorable IRS ruling.

   a. One risk has been that the bonds might be treated as, in substance, debt of the parent rather than the subsidiary and that withholding thus would be required.

      i. A finance subsidiary has only limited activities and lacks any substantial business purpose other than the avoidance of U.S. withholding tax. Compare, e.g., Aiken Industries, Inc. v. Commissioner, 56 T.C. 925 (1971), acq. 1972-2 C.B. 1, and Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir.), cert. denied, 406 U.S. 1076 (1972), with Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), and Bass v. Commissioner, 50 T.C. 595 (1968).

      ii. This risk was significantly augmented after the enactment of the 1984 Act with the issuance of Rev. Rul. 84-152, 1984-2 C.B. 381, and Rev. Rul. 84-153, 1984-2 C.B. 383, during October 1984, holding that interest paid by U.S. subsidiaries of Swiss and U.S. parent corporations, respectively, to a Netherlands Antilles subsidiary of

the parent corporation on certain obligations was not exempt under Article VIII.

iii. Although ostensibly dating back to 1979 and the preparation of G.C.M 37940 (declassified January 30, 1985), it was not until alternative avenues became available to access the Eurodollar market that the IRS announced a complete about-face from prior practices. See generally Bibliography items 7, 8, and 9.

iv. The validity and scope of the legal theory adopted in both rulings -- that the respective Netherlands Antilles finance subsidiaries were mere conduits lacking sufficient "dominion and control" over interest payments potentially subject to the 30-percent withholding tax -- have not been well established by earlier precedents. Moreover, it is particularly difficult to reconcile Rev. Rul. 84-153, which involved the specific Netherlands Antilles finance subsidiary structure, with Rev. Rul. 75-23, 1975-1 C.B. 290, and Rev. Rul. 79-65, 1979-1 C.B. 458, neither of which has been revoked in the aftermath of the 1984

rulings. Other possibly inconsistent rulings include: Rev. Rul. 65-16, 1965-1 C.B. 626; Rev. Rul. 72-514, 1972-2 C.B. 440; Rev. Rul. 75-118, 1975-1 C.B. 390; Rev. Rul. 76-192, 1976-1 C.B. 205; Rev. Rul. 78-118, 1978-1 C.B. 219; Rev. Rul. 79-251, 1979-2 C.B. 271; Rev. Rul. 80-4, 1980-1 C.B. 169; and Rev. Rul. 80-362, 1980-2 C.B. 208.

b. Despite IRS refusal since 1974 to issue rulings involving Antilles finance subsidiaries, many bond issues had been issued prior to the 1984 Act on the basis of opinions of counsel.

i. In recent years, however, IRS field agents have challenged certain arrangements involving Antilles finance subsidiaries.

ii. In enacting the statutory repeal of _post_-July 18, 1984 obligations, Section 127(g)(3) of the 1984 Act contained amnesty provisions applicable to obligations issued _before_ June 22, 1984 which satisfy the principles set forth in Rev. Rul. 69-501, 1969-2 C.B. 233; Rev. Rul. 69-377, 1969-2 C.B. 231; Rev. Rul. 70-645, 1970-2 C.B. 273; and Rev. Rul. 73-110, 1973-1 C.B. 454. _See_, _e.g._, TAM 8530002 (April 16,

1985); TAM 8527010 (March 22, 1985).

iii. Congress made clear that no inference was to be drawn from the enactment of Section 127 of the 1984 Act regarding the proper resolution of other tax issues. H.R. Rep. No. 98-861 (Conference Report), 98th Cong., 2d Sess. 938 (1984).

iv. The repeal for post-July 18, 1984 obligations together with amnesty provisions for pre-June 22, 1984 obligations created a window of uncertainty for obligations issued in the interim, such as the July 1, 1984 offering considered in Rev. Rul. 84-153. Accordingly, in a news release issued shortly after the ruling taxpayers were invited to seek relief from the retroactive application of Rev. Rul. 84-153 under the procedures of section 7805(b). _See_ PLRs 8520055, 8520061, 8520062, 8520092, 8520093, 8520094, and 8520095, issued on February 19 and 20, 1985, granting section 7805(b) relief.

v. Section 110(d)(2) of the Technical Corrections Bill of 1985 (H.R. 1800) would expand the amnesty

provision to apply to interest paid to an applicable CFC by a qualified <u>foreign</u> affiliate and to apply to all foreign finance affiliates regardless of their stock ownership, subject, in the case where the finance affiliate is not a CFC, to a reduction in the income tax deduction of the affiliated U.S. borrower to reflect the spread between the interest rate paid by the payor to the foreign-owned finance affiliate and the interest rate paid by the finance affiliate to the unrelated lenders of the borrowed funds.

c. Typically, the U.S. parent and the finance subsidiary have agreed to indemnify the foreign bondholders against all U.S. withholding taxes should the IRS successfully attack the claimed exemption from the U.S. withholding tax or should U.S. tax law or the tax treaty with the Netherlands Antilles be changed to eliminate the exemption.

d. Also, the Eurobonds typically provide that if U.S. withholding tax is imposed, the bonds are immediately callable.

e. The United States and the Netherlands Antilles have been renegotiating the existing tax treaty over the last five years. Despite some optimistic reports during late 1983 and early 1984, no satisfactory resolution of these negotiations appears likely soon.

C. <u>Reasons for Change</u>

1. Congress believed that the 30-percent withholding tax on interest paid to foreign corporations and nonresident alien individuals on debt obligations by a U.S. borrower generally should be repealed to allow U.S. corporations the type of direct access to the Eurobond market that had existed from 1972 through mid-1974, a vestige of which is reflected in section 861(a)(1)(g). See Bibliography items 32 and 33.

   a. Section 127 of the 1984 Act was the culmination of more than a decade of earlier legislative proposals, all of which had been supported by the incumbent administration but each of which had failed on the floor despite favorable action by the Senate Finance or House Ways and Means Committees.

   b. The scope of the prior proposals varied from repeal of the 30-percent withholding tax in the case of both dividend and interest payments, to repeal solely

in the case of interest payments, to repeal only in the case of targeted interest.

c. As reported in the Fall 1984 _Statistics of Income Bulletin_ issued shortly after the enactment of the 1984 Act, during 1982 U.S. withholding taxes on all classes of income subject to withholding amounted to $619 million; tax on interest payments represented only 20 percent of all withholding taxes collected even though interest income comprised 48 percent of all income subject to withholding. In contrast, dividend income represented 43 percent of all income and accounted for 71 percent of all tax.

2. In Congress' view, the practice by U.S. corporations of issuing Eurobonds through finance subsidiaries located in the Netherlands Antilles, rather than directly from the United States, was neither economical nor indicative of sound tax policy. It imposed additional cost burdens on the issuing corporations, since the cost of Eurobond borrowing probably would have been lower if the Eurobonds had been issued directly from the United States.

D. Explanation of Changes

1. New sections 871(h)(1) and 881(c)(1) repeal the 30-percent withholding tax on "portfolio interest" paid by U.S. borrowers to non-resident alien individuals and foreign corporations, respectively.

   a. The new term of art, "portfolio interest," is defined in sections 871(h)(2) and 881(c)(2).

   b. The mechanism employed by Congress was a direct repeal of tax i.e., "no tax shall be imposed . . . ," in contrast to the source change approach applicable in the case of bank deposit interest (I.R.C. §§ 861(a)(1)(A), 861(c)) or the exclusion from gross income which obtains to certain shipping, air craft, and other income (I.R.C. § 883).

   c. Other relevant tax aspects of portfolio interest, such as its source and character as fixed or determinable annual or periodical income, were preserved by the 1984 Act.

      i. Although sections 871 and 881 impose a tax on interest income only where such income is from U.S. sources, nothing in sections 871(h) or 881(c) expressly limits the

definition of portfolio interest to U.S. source interest.

ii. Indeed, a special rule applicable to CFCs which is set forth in section 881(c)(4)(A)(v) (discussed _infra_) refers to the related party interest rule of section 954(c)(4)(A). Since the latter provision ordinarily relates to foreign source interest, an implication arises that portfolio interest could include foreign source interest.

iii. This point would be clarified by Section 110(d)(1) of the Technical Corrections Bill of 1985 (H.R. 1800), the purpose of which is to ensure that interest received by CFCs is denied the benefit of otherwise applicable subpart F exceptions (discussed _infra_ at (D)(4)(a)(i) through (v)) only where the interest would have been subject to the 30-percent tax prior to the 1984 Act.

2. The statute treats differently two different types of debt obligations: debt obligations _not_ in "registered form" (I.R.C. §§ 871(h)(2)(A), 881(c)(2)(A)); and debt obligations in "registered form" (I.R.C. §§ 871(h)(2)(B), 881(c)(2)(B)).

a. The first type of debt instrument is governed by sections 871(h)(2)(A) and 881(c)(2)(A), which apply to interest paid on an obligation that is (I) not in registered form ("bearer debt"), and that is (II) described in section 163(f)(2)(B).

   i. The effect of the latter requirement is that bearer debt must satisy three requirements enacted by TEFRA in 1982 in conjunction with back-up withholding on domestic payments of dividend and interest income:

      A. Arrangements must be made to ensure that the obligation will be sold (or resold in connection with its original issue) only to non-U.S. persons.

      B. The interest must be payable only outside the United States and its possessions.

      C. On the face of the obligation, there must be a statement that any U.S person who holds it will be subject to limitations under the U.S. income tax laws.

ii. Failure to comply with these TEFRA rules results in a number of sanctions applicable to both the issuer and the holder. Under such circumstances:

A. Section 163(f) disallows an interest deduction otherwise allowable to the issuer under section 163(a).

B. Section 312(m) provides that the issuer shall not reduce its earnings and profits in respect of interest paid on the obligation.

C. Section 4701 imposes an excise tax on the issuer (equal to one percent of the principal amount of the obligation multiplied by the number of years to maturity).

D. Section 165(j) disallows a deduction for any loss sustained by the holder.

E. Section 1287(a) denies capital gain treatment otherwise available to the holder.

F. Section 103(j) denies tax-exempt treatment otherwise available to the holder.

b. The second type of debt instrument is governed by sections 871(h)(2)(B) and 881(c)(2)(B), which apply to interest paid on an obligation that is (I) in registered form, provided that (II) the U.S. payor has received a statement that the beneficial owner is not a U.S. person ("registered debt").

i. The statute indicates that the statement must be made either by the beneficial owner (I.R.C. § 871(h)(4)(A)) or by a securities clearing organization, a bank, or other financial institution that holds customers' securities in the ordinary course of its trade or business (I.R.C. § 871(h)(4)(B)).

ii. Under the operative statutory language (I.R.C. §§ 871(h)(2)(B), 881(c)(2)(B)), the statement need not identify the owner but must simply state that the owner is not a U.S. person.

iii. Temporary regulations provide separate rules governing two different types of non-U.S. person

statements, in effect creating two different types of registered debt.

A. One type of statement is provided to the withholding agent either by the beneficial owner -- signed under penalties of perjury and certifying that such owner is not a U.S. person and providing the owner's name and address -- or by a securities clearing organization, a bank, or other financial institution that holds customers' securities in the ordinary course of its trade or business -- signed under penalties of perjury by an authorized representative stating that such institution has received the foregoing non-U.S. owner certification from the beneficial owner (or that it has received a parallel certification from another financial institution). Temp. Reg. section 35a.9999-5(b)(Q-9) (T.D. 7967).

B. A second type of statement which does not require a penalties of perjury certification or name and

address disclosure regarding the beneficial owner is provided for registered debt that is "targeted" to foreign markets, in accordance with procedures similar to those applicable to bearer debt (Temp. Reg. § 35a.9999-5(b)(Q-13) (T.D. 7967)), in respect of interest that is paid only outside the United States. Temp. Reg. section 35a.9999-5(b)(Q-12) and (Q-14) (T.D. 8046). For the most part, this statement is available for use in respect of interest paid to financial institutions described in I.R.C. § 871(h)(4)(B) (or members of a clearing organization which are beneficial owners of the targeted registered debt) that hold such foreign targeted registered debt on behalf of customers who are non-U.S. persons. Recent amendments to Temp. Reg. section 35a.9999-5(b)(Q-10), (Q-12), (Q-14), and (Q-15) (T.D. 8046) revise a number of the detailed rules applicable to non-U.S. person statements in the case of

foreign targeted registered debt.

C. Such statements will be ineffective if, at least one month before an interest payment, the Secretary of the Treasury has published a determination that any statement from such person (or any class including such person) does not meet the statutory requirements. I.R.C. § 871(h)(4); Temp. Reg. section 35a.9999-5(b)(Q-15) (T.D. 8046).

iii. Section 110(d)(3) of the Technical Corrections Bill of 1985 (H.R. 1800) would clarify that the beneficial owner of a registered obligation, the interest on which otherwise is eligible for repeal of 30-percent withholding, may claim a refund of any tax withheld where the requisite non-U.S person statement is provided only <u>after</u> one or more interest payments have been made (subject to the normal statute of limitations for refund claims; I.R.C. § 6511).

c. Temporary regulations have added a number of additional limitations on the

kinds of bearer and registered debt qualifying for the repeal of withholding tax, several of which are not obvious from the express language of the statute.

i. The most controversial limitation appears in Temp. Reg. section 35a.9999-5(a)(Q-1) (T.D. 7967). It construes the definition of portfolio interest, in the case of bearer debt, to apply only to a "a registration required obligation" within the meaning of section 163(f)(2)(A) (but for the fact that such obligation is described in section 163(f)(2)(B)).

ii. A parallel limitation applicable to registered debt appears in Temp. Reg. section 35a.9999-5(b)(Q-8) (T.D. 7967).

iii. The effect of these interpretations is that interest paid on an obligation, whether it is bearer debt or registered debt, that is issued by a natural person, issued with a maturity of not more than one year, or of a type not offered to the public cannot qualify as portfolio interest.

iv. The reference to section 163(f)(2)(B) in the definition of bearer debt (I.R.C. § 871(h)(2)(A)(ii)) does implicate, albeit weakly, the operative provisions of section 163(f)(2)(A)(iv). However, this opaque basis for invoking the registration required obligation provisions of TEFRA lacks any parallel in the definition of registered debt.

v. As indicated in the testimony of J. Roger Mentz, Deputy Assistant Secretary (Tax Policy), before the Senate Finance Committee (a copy of the relevant portions of which appears in the Appendix to this outline at pp. A-1 and A-2), the Treasury Department presently is proposing "technical corrections" to the 1984 Act in order to clarify that only interest paid on an obligation issued pursuant to a public offering would qualify as "portfolio interest."

A. The stated rationale for such a limitation is two-fold: that it was Congress' intent in enacting Section 127 of the 1984 Act to permit direct access to the Eurobond market, which consists only of

publicly offered obligations which trade in an active secondary market and which does not include trade indebtedness or privately placed obligations; and that unilateral repeal of the 30-percent tax on interest paid, e.g., on private placements or trade indebtedness is not consistent with the practices of other taxing jurisdictions and thus would undermine U.S. tax treaty negotiations.

B. Though not reflected in the Deputy Assistant Secretary's testimony, another apparent rationale is Treasury's desire to accommodate the preference of some members of Congress to narrowly circumscribe the types of obligations eligible for the 30-percent withholding tax repeal in an effort to limit their availability to tax-evasion minded U.S. persons.

vi. Another controversial limitation appears in Temp. Reg. section 35a.9999-5(c)(Q-18)(T.D. 7967). Unlike the antecedent regulations promulgated under TEFRA, which

permitted the issuance of registered debt that could be converted into bearer debt for foreign purchasers, the portfolio interest regulations prohibit the issuance of registered debt which may be converted into bearer debt for the stated reason that such conversion would have created a substantial market for bearer paper that would be more readily available to U.S. persons. The regulations permit conversion only in the opposite case of bearer debt conversions into registered debt.

vii. In a news release in September 1984 (T.D. News Rel. R-2835) (September 7, 1984), former Treasury Secretary Regan indicated that, notwithstanding section 163(f)(2)(B), the following U.S. government backed securities prospectively would be ineligible for issuance to foreign persons in bearer form: (i) pass-through or participation certificates backed by U.S. Government securities; (ii) interests in fixed investment or grantor trusts or custodial arrangements funded with U.S. Government securities; (iii) debt obligations collateralized with U.S. Government securities; (iv) securities backed by

securities, the interest or principal of which is U.S. Government guaranteed; and (v) other similar instruments or interests.

viii. A more recent development is Temp. Reg. section 35a.9999-5(d)(Q-20) (T.D.8046), effective for payments made on or after September 20, 1985. It construes the definition of portfolio interest in the case of mortgage pass-through or participation certificates (i.e., instruments which evidence an interest in a pool of mortgage loans which, under subpart E of Subchapter J of the Code, is treated as a trust of which the grantor is the owner) to include certificates issued after July 18, 1984, provided that the underlying obligations (generally those of individual borrowers) held by the fund or trust to which the pass-through certificate relates are issued after July 18, 1984.

3. In addition to the exclusions and limitations arising under the temporary regulations, the repeal also does not apply to certain interest which is excluded from the definition of portfolio interest by the statute itself.

a. Section 871(h)(3) indicates that the repeal does not apply to interest received by "a 10-percent shareholder," which term means --

i. In the case of an obligation issued by a corporation, any person who owns, directly or indirectly, 10-percent or more of the total combined voting power of all classes of stock entitled to vote. I.R.C. § 871(h)(3)(B)(i). _Cf_. I.R.C. §951(b).

ii. In the case of an obligation issued by a partnership, any person who owns, directly or indirectly, 10 percent or more of the capital or profits interest in the partnership. I.R.C. § 871(h)(3)(B)(ii).

iii. In determining stock ownership, the attribution rules of section 318 apply, subject to certain exceptions. I.R.C. § 871(h)(3)(C). (_Note_: as indicated _infra_, separate attribution rules apply for other purposes pursuant to I.R.C. §§ 881(c)(3)(C) and 864(d)(4).)

b. Section 881(c)(3)(A) indicates that the repeal does not apply to interest received by a (foreign corporate) bank on an extension of credit made pursuant to

a loan agreement entered into in the ordinary course of its trade or business, except in the case of interest paid on an obligation of the United States. (In view of the failure of section 871(h) to contain a parallel restriction, it would appear that this limitation would not obtain to a bank organized as a partnership, nor to an individual.)

c. Congress noted that the two foregoing restrictions might be circumvented by back-to-back loans and directed the IRS to "use means at its disposal" to determine the existence of such loans. H.R. Rep. No. 98-861 (Conference Report), 98th Cong., 2d Sess. 937-38 (1984). What "means" are available?

d. Section 881(c)(3)(C) provides that the repeal does not apply to interest received by a CFC from a related person (within the meaning of new section 864(d)(4)). The latter provision incorporates the section 267(b) attribution rules.

4. Portfolio interest paid to a CFC by a person other than a related person is subject to special rules pursuant to section 881(c)(4).

   a. Such interest paid to a CFC is includible in the gross income of its U.S.

shareholders under subpart F without regard to the following exceptions otherwise applicable under the subpart F rules.

i. Section 954(b)(3)(A), providing an exception where foreign base company income is less than 10 percent of total income.

ii. Section 954(b)(4), providing an exception in the case of corporations not formed or availed of to avoid tax.

iii. Section 954(c)(3)(B), providing an exception for certain income derived in the active conduct of a trade or business.

iv. Section 954(c)(3)(C), providing an exception for certain income derived by an insurance company.

v. Section 954(c)(4), providing exceptions for certain income received from related persons (as may be clarified by Section 110(d)(1) of H.R. 1800, noted *supra*).

b. The conferees intended generally that such interest would retain its U.S. source under section 904(g) upon its

inclusion as subpart F income. See I.R.C. 904(g)(1)(A)(i); H.R. Rep. No. 98-861 (Conference Report), 98th Cong., 2d Sess. 937 (1984).

5. No U.S. estate tax will apply to nonresident alien individuals, dying after the date of enactment, in the case of obligations the interest income of which, if received by the decedent at the time of his or her death, would be exempt from the 30-percent tax. Whether or not a statement under section 871(h)(4) is filed, such obligations are not deemed property within the United States. I.R.C. 2105(b)(3).

6. Sections 871(h)(5) and 881(c)(5) provide that if the Secretary of the Treasury determines that the United States is not receiving adequate information from a foreign country to prevent U.S. income tax evasion by U.S. persons, then the Secretary may publish a statement that interest payments addressed to, or for the account of, persons in that country will no longer be exempt from the 30-percent tax. The statement is prospective only and will remain in effect until the Secretary terminates it. Cf. I.R.C. §§ 927(e)(3) (FSCs), 274(h)(6) (foreign conventions).

7. Sections 1441(c)(9) and 1442(a) were amended by the 1984 Act to provide that a duty to deduct and withhold tax at the 30-percent

rate under sections 1441 and 1442 will no longer arise in the case of portfolio interest (which complies with the requirements of the temporary regulations) unless the person otherwise subject to the duty knows, or has reason to know, that the interest is excluded from the definition of portfolio interest under sections 871(h)(3) or 881(c)(3).

a. As discussed <u>supra</u> (at (D)(3)(a), (b), and (d)), this could arise where the recipient (i) is a related CFC; (ii) has a direct ownership interest in the U.S. payor; or (iii) is a bank and the interest is received on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of the bank's business.

b. <u>Compare</u> sections 1445(b)(7)(A)(i) and 1445(d)(1) (B)(ii) on other duties of care of withholding agents (stated in terms of "actual knowledge" standards).

E. Comments

1. Because no assumptions are authorized, foreign investors are not able to claim the benefits of the new law for obligations issued prior to enactment, and thus existing structures and strategies must continue to be utilized notwithstanding Rev. Rul. 84-152 and Rev. Rul. 84-153.

    a. Also, the new law applies only to portfolio interest income and does not exempt from U.S. tax payments of dividends, rents, or royalties from U.S. sources.

    b. For new investments in qualifying portfolio debt obligations, however, borrowers should now consider that investors will be making such investments directly and, at a minimum, be aware of the additional risks and costs of such borrowings through pre-existing structures which they may have used to avoid the U.S. withholding tax.

2. Foreign investors will not be able to invest directly in entities in which they own a 10 percent or greater interest and still qualify for the repeal treatment.

3. For the numerous other cases where sections 871(h) and 881(c) do not apply, what can be

done in light of Rev. Rul. 84-152 and Rev. Rul. 84-153?

4. Temporary regulations issued since the enactment of Section 127 have not resolved many problems blocking simple and direct access to the Eurodollar market and have been influenced to a considerable degree by TEFRA compliance mechanisms.

5. What impact will all of the foregoing developments have on the Antilles treaty, which does not contain the type of compliance safeguards incorporated by the temporary regulations, and the future course of those treaty negotiations?

As of September 12, 1985 H.P. Dale

For Release Upon Delivery
Expected at 9:30 a.m. E.D.T.
June 5, 1985

STATEMENT OF
J. ROGER MENTZ
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

* * * *

Interest Paid to Foreign Persons

The Treasury Department proposes additional provisions for the portion of the bill relating to the 30 percent withholding tax on U.S. source interest paid to foreign persons. The Tax Reform Act generally repealed this tax with respect to interest on portfolio obligations issued after July 18, 1984.

The most significant proposal would provide that only interest paid on an obligation issued pursuant to a public offering would qualify as "portfolio interest" eligible for repeal of the 30 percent tax. The legislation would be drafted to ensure that interest on debt that is in substance publicly offered and traded abroad would enjoy the exemption.

It has been suggested that this proposal does not constitute a technical correction. If this is determined to be correct, we nevertheless regard the proposal as good tax policy and would support its inclusion in another legislative vehicle if that were considered more appropriate.

The Treasury Department believes that the purpose of the repeal legislation was to provide direct access to the Eurobond market for U.S. borrowers. When Congress in effect repealed the withholding tax for several years beginning in 1971, it limited the exemption to interest on underwritten public issues of debt obligations in the Eurobond market. This market consists of publicly offered obligations which trade in an active secondary market. It does not include trade indebtedness and privately placed obligations, which generally are exempted by treaty provision.

The Treasury Department opposes unilateral repeal of the 30 percent tax on interest paid, for example, on trade indebtedness and obligations issued in private placements for two reasons. First, the policy basis for unilateral repeal with respect to publicly offered obligations does not apply to such obligations. Publicly offered obligations trade in an active secondary market. That is, the original holder of a publicly offered obligation may sell it to another person who lives in another country, who in turn may sell it to a third person who lives in yet a third country. Any or all of these countries may have a tax treaty with the United States which eliminates the U.S. withholding tax. There is no way, however, for the issuer of the obligation to ensure that it will be held by only residents of treaty countries who will not be taxed on the interest. The only way to ensure that foreign persons will not be taxed on publicly offered obligations, and that these obligations will be able to trade freely in the Eurobond market, is to eliminate the tax by statute.

This rationale simply does not apply to obligations placed with a few private holders or to trade indebtedness. If U.S. issuers of such obligations wish holders of their debt obligations to avoid the U.S. withholding tax, such issuers can feasibly target the obligations to residents of treaty countries. In this context, we believe it inappropriate as a matter of tax policy to exempt income from tax unilaterally, in the absence of overriding policy reasons. This is particularly true in the current fiscal environment.

The second reason we oppose repeal of the 30 percent tax on interest paid on trade indebtedness and privately placed obligations is that other countries generally have not repealed their interest withholding taxes on such obligations. Exemption for such obligations should be negotiated through tax treaties, whereby reciprocal treatment can be obtained for U.S. sellers of goods and U.S. persons wishing to undertake private borrowings.

In addition to the foregoing proposal, Treasury would suggest some minor clarifications relating to the effective date of repeal and certifications required for registered obligations. We would be pleased to discuss these issues with Committee staff.

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