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TAXATION OF
International trade
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The DRA's elimination of the "withholding" tax on portfolio interest

by FRED FEINGOLD and RICHARD G. FISHMAN

Interest on obligations issued to raise funds on the Eurodollar market will generally be exempt from the 30% tax on non-effectively-connected U.S.-source interest after the DRA. The authors examine the scope of the exemption, interaction with preexisting rules affecting taxation of foreign persons, and the impact of the backup withholding rules.

BEFORE THE ENACTMENT of the Deficit Reduction Act of 1984 (the "Act"),[1] the Code generally imposed a tax at the rate of 30% on interest from U.S. sources received by a nonresident alien individual or a foreign corporation, to the extent that such interest was not "effectively connected" with the conduct of a U.S. trade or business.[2] Act, Section 127 provides an exception from this tax with respect to "non-effectively connected" interest that (1) qualifies as "portfolio interest" and (2) is received after 7/18/84 on obligations issued after that date, in taxable years ending after that date. Act, Section 127 also amended the estate tax to provide that debt obligations giving rise to portfolio interest eligible for the exemption from the 30% tax are not treated as U.S. situs property. As a result, foreign holders of such obligations dying after 7/18/84 will not be subject to Federal estate tax with respect thereto.

Although the principal purpose of the portfolio interest exemption was to allow U.S. companies direct access to the Eurodollar market for the issuance of their interest-bearing obligations free of the 30% U.S. "withholding" tax,[3] it was not the only purpose. Thus, it came as no surprise that the statutory language[4] used in the portfolio interest exemption provision was broad enough to cover interest on obligations that were not of the type generally issued in Eurodollar financings. Notwithstanding the use of this language, the Treasury views the portfolio interest exemption to be limited essentially to interest on obligations of the type that are issued to raise funds on the Eurodollar market.

However one views its breadth, as a result of the new portfolio interest exemption, in principle it will no longer be necessary for a U.S. company to interpose a special-purpose international finance subsidiary, or "IFS" (usually but not always formed in the Netherlands Antilles), between itself and its ultimate foreign lenders as a means of obtaining an exemption from the 30% U.S. tax imposed on the receipt of the interest paid by the U.S. company. Moreover, under a rather extraordinary "transitional" provision applicable only to interest paid to an IFS that is a wholly-owned subsidiary of a U.S. company on debt issued before 6/22/84 and only if certain conditions were met, the IRS is precluded from raising the issue of whether the IFS is the beneficial recipient of the interest paid to it by its U.S. parent company.[5] Where applicable, the effect of this provision (discussed in more detail below) is to preclude the IRS from asserting that the U.S. company paying the interest was required to withhold the 30% tax it arguably would have been required to withhold if the IFS were to be treated as a conduit or agent (*i.e.*, not the beneficial recipient of the interest payment). Significantly, as more fully discussed below, the IRS has recently publicly announced that it will seek to impose liability for a "withholding" tax on interest payments that do not squarely fit under this special provision, unless, of course, the interest in question qualifies for the portfolio interest exemption.[6]

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Taxation of foreign persons

In order to better appreciate the significance of the changes, some background is in order. In general, nonresident alien individuals and foreign corporations (collectively referred to in this article as "foreign persons") are, apart from any tax treaty considerations, subject to Federal income tax only on two categories of income: The first category includes all income that is or is considered to be "effectively connected" with the conduct of a U.S. trade or business; such income is taxable to a foreign person generally at the same progressive tax rates that apply to U.S. persons, under Sections 871(b) and 882. The second category of income includes income from U.S. sources that is not effectively connected with a U.S. trade or business and that is of a fixed, determinable annual or periodical nature, expressly including interest (as well as dividends, royalties and compensation).[7] A foreign person is subject to the tax on this second category of income at a 30% rate applied to the gross amount of the income received (Sections 871(a)(1) and 881(a)). The 30% tax is generally (but not always) collected by withholding at the source (Sections 1441 and 1442) and therefore is often referred to as a "withholding tax" even though it is an income tax that, if not collected by withholding, is due from the recipient of the income. Income of a foreign person that does not fall within one of the above categories is not subject to U.S. income tax.

In certain cases, tax treaties to which the U.S. is a party modify the above rules. Thus, under virtually all U.S. tax treaties industrial and commercial profits of a U.S. trade or business of an enterprise of a treaty resident are exempt from U.S. income tax provided such profits are not attributable to a U.S. permanent establishment.[8] Tax treaties generally also reduce or eliminate the statutory 30% rate of tax on various items of income in the second category. The reduction in rates or exemption vary from treaty to treaty. Thus, while certain treaties provide an exemption from U.S. income tax for

interest income which is not attributable to a permanent establishment,[9] other tax treaties merely limit the rate of U.S. income tax that may be charged on such interest.[10]

Foreign persons who invest in the U.S. obviously wish to take advantage of the tax treaty with the greatest available benefits. Certain foreign persons need do little to qualify for such tax treaty benefits since they are resident in a country having an appropriate treaty provision. Other foreign persons are less fortunate. Where the stakes are significant enough, rather than forgo the best available treaty benefits, the less-fortunate foreign person is likely to attempt, in one manner or another, to take advantage of a more-favorable tax treaty a third country has with the U.S.

This generally is attempted by organizing an intermediate entity in a jurisdiction that has the appropriate treaty provision. Third-country residents have availed themselves of this technique, for example, in connection with the acquisition of U.S. real estate. The objective is to acquire U.S. real estate in a manner that allows for the financing of such acquisition to be made partly with "internal" debt giving rise to interest deductions available against the taxable income to be derived from the real estate, and at the same time avoid U.S. withholding taxes on such interest. Netherlands and Netherlands Antilles companies have been used for this purpose because Article XII of the respective treaties generally permits the payment of U.S.-source interest and dividends to a foreign person free of U.S. withholding tax.

In another, and in dollar terms much more significant, application of this technique, U.S. corporations have set up a treaty entity as an intermediary between the foreign person and the U.S. corporation. Virtually all "Eurodollar" financings of U.S. companies have in recent years been structured to take advantage of this technique. U.S. companies borrow on the Eurodollar market essentially because the interest rates are less there than they are in the U.S. To be able to borrow at these reduced rates, however, the U.S. borrower must ensure that the agreed interest rate will be payable free of any U.S. withholding tax (and that the holder of any such obligation will not be subject to U.S. estate tax with respect thereto). If the U.S. corporation borrowed directly for the purposes of using the funds in its U.S. operations,[11] a U.S. "withholding tax" would be due on the interest paid unless a holder of a Eurodollar obligation was entitled to a treaty exemption with respect to interest income. Given the nature of the instrument (usually issued in bearer form) and that many non-treaty residents were likely to acquire the Eurodollar bonds, a device had to be created that would allow for the issuance of these bonds that would be free of U.S. taxes.

The device created to accomplish the objective was the international finance subsidiary. Very generally, an IFS is usually but not always a wholly-owned subsidiary of a U.S. borrower organized under the laws of a jurisdiction such as the Netherlands Antilles that has a tax treaty with the U.S. that exempts from Federal income tax and withholding interest paid to corporations organized under the laws of such jurisdiction,[12] provided such corporation is the beneficial recipient of the interest income. Armed with an appropriate guarantee of the U.S. borrower and flush with capital contributed by the U.S. borrower, the IFS issues its bonds to foreign persons on the Eurodollar market. The IFS loans the proceeds of the borrowing to its U.S. parent. The U.S. parent claims a deduction for the interest due to the IFS, and the IFS claims an exemption from U.S. withholding tax on the interest payments. The basis for the latter claim is the treaty between the U.S. and the country of incorporation of the IFS. The IFS has two bases for not withholding U.S. tax on the interest payments it makes to the ultimate foreign purchasers of the IFS obligation. First, it can claim that such interest is not U.S.-source income under Section 861(a)(1)(A) and Reg. 1.861-2(a) because the IFS is not engaged in a U.S. trade or business. Second, it can claim the benefit of a provision such as Article XII of the Netherlands Antilles treaty, which under stated conditions exempts from U.S. tax (and withholding) interest paid to a foreign person. By acquiring the obligations of the IFS, the foreign person is not acquiring U.S. situs property and therefore is not subject to U.S. estate tax under Section 2104(c). Moreover, the IFS can even issue its bonds in bearer form, provided certain steps are taken.[13]

Initially, issues arose as to whether the techniques described above should be allowed as a matter of policy. For example, in connection with use of a Netherlands Antilles corporation by a resident of a third-party country, the IRS considered whether the benefits of the Netherlands Antilles treaty (particulary Article XII) should be granted where the ultimate shareholders were not residents of the Netherlands Antilles and concluded that the extension of the Netherlands treaty to the Netherlands Antilles contemplated that result.[14] Similarly, the IRS concluded early on, in connection with the interest

[1] P.L. 98-369, 7/18/84.

[2] Sections 871(a), 881, 1441 and 1442. The 30% statutory tax rate on payments of such interest was subject to reduction or elimination by an applicable U.S. tax treaty. See, *e.g.*, U.S.-Canada, Article XI. Interest income of a foreign person which is effectively connected with the conduct of a U.S. trade or business is subject to tax at the regular progressive rates of tax applied to net or taxable income. See Sections 871(b), 882.

[3] S. Rep't No. 98-169, 98th Cong., 2d Sess. 419-21 (1984).

[4] Sections 871(h), 881(c), 1441(c)(9) and 2105(b)(3).

[5] Act, Section 127(g)(3). See *Rev. Rul.* 69-501, 1969-2 CB 233; *Rev. Rul.* 69-377, 1969-2 CB 231; *Rev. Rul.* 70-645, 1970-2 CB 273; *Rev. Rul.* 73-110, 1973-1 CB 454.

[6] Significantly, Sections 871(h)(3) and 881(c)(3) provide that the portfolio interest exemption will not apply to (1) interest on debt of a corporation or partnership received by a 10% or more owner (determined, as provided in Sections 871(h)(3)(C) and 881(c)(3)(B), after application of broad ownership attribution rules), (2) interest on debt received by a "controlled foreign corporation" from a related person (within the meaning of Section 864(d)(4)) (Section 881(c)(3)(C)), or (3) in general, interest received by a bank (except in the case of interest paid on U.S. Government securities) (Section 881(c)(3)(A)).

[7] Non-effectively connected original issue discount of a foreign person is subject to tax under a special rule. See Sections 871(a)(1)(C), 871(g), 881(a)(3), 1441(b) and 1442(a). For a definition of OID, see Section 1273. However, except to the extent effectively connected with a U.S. trade or business, market discount realized by a foreign person is generally not subject to Federal income tax. See Sections 1276(a)(3) and 1278(b)(1); see also Reg. 1.1441-2(a)(3).

[8] See, *e.g.*, U.S.-Germany, Article III.

[9] See, *e.g.*, U.S.-U.K., Article 11; U.S.-Netherlands, Article VIII.

[10] See, *e.g.*, U.S.-Switzerland, Article VII (5%); U.S.-France, Article 10 (10%); U.S.-Canada, Article XI(2) (15%).

[11] U.S. borrowers deriving substantially all (that is, more than 80%) of their income from foreign sources were able to borrow directly without the interest paid on such borrowing being treated as U.S.-source interest subject to U.S. withholding tax. Section 861(a)(1)(B).

[12] See, *e.g.*, Article VIII, U.S.-Netherlands treaty as extended to the Netherlands Antilles. Generally, for a Netherlands Antilles company to qualify for this exemption, it cannot obtain the special rates of taxation in the Netherlands Antilles generally available to investment companies. See 1963 Protocol modifying and supplementing the extension to the Netherlands Antilles of the Convention between the United States and the Netherlands, Article I.

[13] Generally, an IFS can issue its bonds in bearer form after 1982 only if (1) steps are taken to ensure that such bonds would not be sold (or resold in connection with the original issue) to U.S. persons, (2) interest thereon is payable only outside the U.S. and its possessions and is not paid to a U.S. address, and (3) on the face of the bonds (and any detachable interest coupons) there is a statement that any U.S. person who holds the bonds will be subject to limitations under the U.S. income tax laws. See Section 163(f). See also Temp. Regs. 5f.163-1, 1.163-5(c)T. See Fishman, "Recent Procedural Changes to U.S. Tax Law," 31 *Canadian Tax J.* 108 (January-February 1983), at 114-117.

[14] *Rev. Rul.* 75-23, 1975-1 CB 290. See also *Ltr. Rul.* 7501171180A.

[15] See IRS Rulings cited *supra* note 5.

equalization tax (the "IET"), that, depending on the debt-equity ratio of the IFS and certain other facts, the IFS and not the U.S. parent would be regarded as the obligor with respect to the obligations held by the foreign person.[15] Although the Rulings issued under the IET were revoked in 1974[16] once the IET was phased out, numerous opinions of counsel, using an analysis similar to that found in these Rulings, have been issued that have allowed billions of dollars of financings to be accomplished through the Netherlands Antilles IFS route.

Recently, the U.S. has revisited the area using two different approaches. First, the U.S. has announced that it will insist not only that all new treaties to which the U.S. is a party limit benefits thereunder generally to residents of countries with which the U.S. has the treaty,[17] but in addition, it will seek to renegotiate all existing treaties in order to accomplish the policy objective of limiting treaty benefits.

Consistent with this general policy, the U.S. has sought to renegotiate its tax treaty with the Netherlands Antilles. The Netherlands Antilles, of course, had a considerable stake in the continuance of the *status quo* since a significant part of its revenue arose as a result of the ability of U.S. persons to use and benefit from the Netherlands Antilles IFS route. It, therefore, could not readily agree to a strict limitation of benefits provision that would negate the beneficial use of a Netherlands Antilles IFS owned entirely by a U.S. corporation. Notwithstanding that the Netherlands Antilles believed it could not readily agree, one might have thought that it had little with which to bargain. The Netherlands Antilles, with some justification, apparently believed otherwise, possibly because a termination of the Netherlands Antilles treaty could be a serious problem for large U.S. companies that had a considerable stake in the issue.[18] Perhaps to show serious intent, the U.S. gave notice of termination of a similar treaty with the British Virgin Islands.[19] The Netherlands Antilles apparently was not too impressed, and it had some justification, because very few U.S. companies had used the British Virgin Islands as the base for an IFS. All the while, there lurked in the background the possibility the U.S. would repeal the 30% tax on portfolio interest, making the Netherlands Antilles IFS route superfluous. Since this had been suggested on several previous occasions,[20] perhaps it was not taken too seriously.

Possibly unrelated to the first approach, a second approach developed. On audit, some IRS agents considered proposing a deficiency for the 30% withholding tax against U.S. borrowers who had used the Netherlands Antilles IFS route. This proposal was based on one or more theories, including that the IFS should be disregarded for tax purposes, either because it was a sham or a mere agent of the U.S. borrower or because the guarantee by the U.S. parent obligor evidenced that it, and not the IFS, was the obligor with respect to the financing. Under any of these theories, the treaty exemption would not be available since the U.S. obligor would be regarded as paying U.S.-source interest to a foreign person not entitled to the treaty exemption.[21]

Apparently as an outgrowth of the second approach and subsequent to the enactment of the portfolio interest exemption and the related extraordinary transitional provision, the IRS for the first time publicly announced, in *Rev. Ruls.* 84-152 and 84-153, IRB 1984-42, 8 and 9, its position to the effect that the 30% withholding tax was applicable on U.S.-source interest payments made to a Netherlands Antilles finance company in circumstances where the Netherlands Antilles finance company was obligated to pay interest on its obligations to persons not entitled to treaty benefits in an amount which represented a significant portion of the interest it received. In those circumstances, according to the IRS, interest received by the Antilles company has not been "derived" by it within the meaning of Article VIII of the U.S.-Netherlands treaty as applicable to the Netherlands Antilles because, in the IRS's view, the Antilles company does not exercise complete "dominion and control" over any amount it receives when it has an offsetting obligation to pay out a substantially similar sum.

Significantly, the Rulings would reach the result of requiring withholding even where (1) the Antilles finance company is adequately capitalized, (2) its debt is not guaranteed by a U.S. person, and (3) it earns a profit on its borrowing and lending activities which is a reasonable return on the equity it has invested. To this extent, the Rulings do not appear to be supportable by any authorities and certainly not the authority referred to in the Rulings.[22] Moreover, they are at odds with the IRS's previous pronouncements in this area which have formed the basis for the issuance of numerous opinions of counsel involving billions of dollars. At this writing, it is too early to tell whether the IRS position in the Rulings will prevail if tested in the courts.

It is against this background that the new exemption from portfolio interest can best be appreciated.

The statutory framework

The new provisions do not alter the general rules of taxation of foreign persons noted above. Thus, "portfolio interest" that is "effectively connected" with the conduct of a U.S. trade or business by a foreign person will continue to be subject to U.S. income tax along with all other effectively-connected income. Under the new rules, U.S.-source interest that is not effectively connected and is received by a foreign person either will be subject to tax at the 30% rate, at the reduced rate allowed by treaty or, if the portfolio interest exemption is applicable, will be exempt from tax. Thus, reduced rates of U.S. income tax accorded by an income tax treaty will continue to have significance to those foreign taxpayers who are receiving U.S.-source interest income that does not qualify as portfolio interest.

The new provisions do not expressly exclude from gross income portfolio interest that is exempt from tax under a tax treaty. Therefore, unless excluded for some other reason, portfolio interest exempt from tax under the new provision is, for example, included in gross income for purposes of applying, to the extent applicable, the controlled foreign corporation rules, the foreign personal holding company rules, the personal holding company tax and the accumulated earnings tax.[23]

Portfolio interest defined. The exemption applies only with respect to "portfolio interest." Sections 871(h)(2) and (3) and 881(c)(2) and (3) define this term broadly to include, with certain exceptions, all interest and original issue discount (OID) paid on any obligation (including U.S. Government obligations) which satisfies either of the following conditions:

1. With respect to interest paid on an obligation which is in "registered form,"[24] the U.S. person otherwise required to withhold tax on the interest must receive a statement to the effect that the beneficial owner is not a U.S. person. The statement may be issued by the beneficial owner of the obligation or a securities clearing organization, bank or other financial institution that holds securities in the ordinary course of its business (Section 871(h)(4)). If one month before the

payment of interest, however, the Treasury has published a statement to the effect that any statement from such person does not qualify, interest thereon will no longer qualify as portfolio interest.

2. With respect to interest paid on an obligation which is not in registered form (for example, in bearer form), the obligation must be "foreign targeted" (that is, if arrangements have been made that are reasonably designed to ensure that the obligation will be sold (or resold in connection with the original issue) only to non-U.S. persons),[25] interest on the obligation must be payable only outside the U.S. and its possessions, and except for certain obligations issued by qualifying banks, on the face of the obligation (and any detachable interest coupons) there must be a statement that any U.S. person who holds the obligation will be subject to limitations under the U.S. income tax laws.[26] Significantly, the IRS is given the discretion to require registration of any or all of these obligations without regard to whether these obligations are used frequently in avoiding U.S. taxes (Section 163(f)(2)(C)).

Under a literal reading of the statutory definition of portfolio interest, interest on the following obligations would seem to qualify as portfolio interest if the obligations are in registered form or are foreign-targeted and satisfy the other requirements (stated above). With respect to obligations not in registered form: (1) an obligation issued by an individual; (2) an obligation which is not of a type offered to the public; and (3) an obligation which has a maturity (at issue) of not more than one year. With respect to the latter two types of obligations, the obligations would include those issued by any borrower including a corporation.

Nevertheless, Temporary Regulations issued in question-and-answer form by the IRS on 8/17/84 expressly state, without citation of any supporting authority, that interest on the above obligations would not qualify as portfolio interest since none of the obligations are "registration-required obligations," as defined in Section 163(f)(2).[27] Under these Temporary Regulations, which relate to the conditions under which interest may qualify as portfolio interest and the application of information reporting and backup withholding to foreign holders of obligations, the interest on the above obligations would not qualify as portfolio interest even if the obligations were in registered form.

The Treasury's interpretation of the portfolio interest rules is surprising not only because it does not appear to be supported by the language of the Code or the Committee Reports but because it runs counter to the expressed statutory policy of the provisions dealing with registration-required obligations in Section 163(f)(2)(C). In furtherance of that policy (the prevention of tax evasion), these provisions permit the IRS to increase the class of obligations defined as registration-required obligations. Ironically, since, in the Treasury's view, interest qualifies as portfolio interest (and is exempt from the 30% withholding tax) only if it is paid on a registration-required obligation, any broadening of the class of obligations requiring registration also broadens the class of obligations the interest on which qualifies as portfolio interest and is exempt from the 30% withholding tax. At this time, it is not clear whether the Treasury's interpretation will prevail or will be modified, and close attention should be given to further developments in this area.

Although interest on U.S. Government obligations having a maturity of more than one year could qualify as portfolio interest even if the obligations were issued in bearer form (provided they were foreign targeted), the Treasury in connection with its issuance of the above Temporary Regulations announced that it will not issue bearer obligations, making U.S. Government obligations less attractive to foreign investors and therefore more expensive to the U.S.[28] This is somewhat ironic since it appears that one of the reasons for enactment of the legislation was to permit the U.S. to benefit from lower interest rates available on the Eurodollar market. With a little bit of creativity, however, entrepreneurs were soon repackaging registered U.S. Government obligations by issuing bearer securities backed by registered U.S. Government obligations. Were this to be permitted, the U.S. would have the worst of both worlds—higher interest costs without the perceived benefits of registration. So the Treasury announced that it would prohibit repackaging at least after the initial transactions then in process were com-

[16] *Rev. Rul.* 74-464, 1974-2 CB 47; *Rev. Rul.* 74-620, 1974-2 CB 380.

[17] See and compare 1981 Model Income Tax Convention, Article 16; Treasury Discussion Draft of Article 16 at CCH, *Tax Treaties*, ¶152A; U.S.-Australia, Article 16; Rosenbloom, "Tax Treaty Abuse: Policies and Issues," 15 *Law and Policy in Int'l Business* 763-831 (1983). This does not apply with respect to the recently ratified U.S. treaty with Canada except to the limited extent prescribed in Article XXIX(6) of that treaty.

[18] Generally, under the terms of a Eurodollar borrowing, bonds issued through an IFS may be prepaid if there is a significant change of circumstances such as, for example, termination of the treaty exempting the interest from withholding tax. Depending on interest rates at the time of any such termination in comparison to the stated interest rate of the bonds, U.S. obligors could have been adversely affected.

[19] Treas. Rel. R-859 (7/1/82).

[20] See, *e.g.*, Ways and Means Committee Print No. 3 of Tentative Draft of Title III, Changes in Treatment of Foreign Income, of Tax Reform Bill of 1974, Section 351; Section 1041 of H.R. 10612, Tax Reform Bill of 1975.

[21] See, *e.g.*, Section 269; *Aiken Industries, Inc.*, 56 TC 925 (1971), *acq.*; *Bass*, 50 TC 595 (1968); *Plantation Patterns, Inc.*, 462 F.2d 712 (CA-5, 1972), *cert. den.*

[22] *Aiken Industries, Inc., supra*, is cited in *Rev. Ruls.* 84-152 and 84-153, IRB 1984-42, 8 and 9, as authority for the position taken. That case, however, appears distinguishable on a number of different bases. First, in *Aiken* the finance company had no reasonable prospect of making any profit in the transaction; in the Rulings the finance company was entitled to earn a 1% spread between its interest income and expense. Second, in *Aiken*, it did not appear that the finance company had any significant capital; whereas in the Rulings it was assumed that the finance company was adequately capitalized. Third, unlike *Aiken*, in the Ruling the finance company initiated the loan rather than purchasing existing loans for equivalent notes. In one of the Rulings the finance company dealt with the public in offering its debt rather than dealing with related parties and otherwise appeared to act in the same manner as any third-party finance company might act.

[23] Inclusion in the income of a U.S. shareholder of a controlled foreign corporation or a foreign personal holding company is required in any event. See Section 555(a) and Reg. 1.952-2(a).

[24] Sections 871(h)(2)(B) and 881(c)(2)(B). For purposes of Sections 871(h) and 881(c), the term "registered form" has the same meaning given such term by Section 163(f). Temp. Reg. 5f.163-1(a) provides that such term is defined in Temp. Reg. 5f.103-1(c). The latter Regulation provides that an obligation is issued in registered form if "(i) The obligation is registered as to both principal and any stated interest and transfer of the obligation may be effected only by the surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder, or (ii) The right to the principal of, and stated interest on, the obligation may be transferred only through a book entry system . . . . " *Cf.* Sections 103(j)(3)(A), 163(f)(3) and 31 U.S.C.A. Section 3121(g)(3). Temp. Reg. 5f.103-1(c)(2) defines a book entry system as one in which the ownership of an interest in an obligation is required to be reflected in a book entry, whether or not physical securities are issued. This Regulation also states that "[a] book entry is a record of ownership that identifies the owner of an interest in the obligation."

[25] An example of an obligation for which there are such arrangements is an obligation which, in connection with its original issuance, is offered for sale or resale only outside the U.S. and its possessions, is delivered only outside the U.S. and its possessions, and need not be registered under the Securities Act of 1933 because such obligation is intended for distribution to persons who are not U.S. persons. Temp. Regs. 1.163-5(c)T(1)(i); 1.163-5(c)T(2)(i)(A).

[26] Sections 871(h)(2)(A) and 881(c)(2)(A). See also Section 163(f)(2)(B), Temp. Reg. 1.163-5(c)T(1). Under Temp. Reg. 1.163-5(c)T(1)(ii)(B), a "temporary global security" is excluded from the legend requirements. A temporary global security is defined therein to mean a security in bearer form which is held for the benefit of the purchasers of the obligation of the issuer and interests in which are exchangeable for securities in definitive registered or bearer form before its stated maturity.

[27] Temp. Regs. 35a.9999-5(a), Q&A-1; 35a.9999-5(b), Q&A-8.

[28] See TD 7965, IRB 1984-38, 6.

[29] Treas. Rel. R-2835 (9/1/84); Treas. Rel. R-2847 (9/7/84).

pleted.[29] In addition, it acknowledged that it was unlikely that the U.S. would be able to enforce this prohibition if the repackagers were foreign and not controlled by U.S. persons (an admission of a jurisdictional limitation generally outside the character of the U.S.).[30]

Creativity, however, is by no means the exclusive province of entrepreneurs. The U.S. has created a combination bearer-registered instrument—neither fish nor fowl, although smelling more like the former than the latter. This hybrid instrument is issued abroad in registered form to a foreign financial institution (for example, a foreign bank) or to a foreign office of a U.S. financial institution which, subject to certain restrictions, may purchase these obligations for the accounts of foreign persons. These institutions are not required to provide the U.S. with the identity of their customers but are required to certify at the time of purchase and prior to each annual interest payment date that the beneficial owner of the note is not a U.S. citizen or resident.[31] Whether the marketplace will treat these hybrid instruments as bearer or registered or something in between still remains to be seen, but the Treasury has indicated that it regards at least the first offering of these instruments to be a success.

Exclusions from portfolio interest

Payments to 10%-or-more owners. Portfolio interest does not include interest on an obligation issued to a 10%-or-more owner of the obligor.[32] For this purpose, a 10%-or-more owner means, in the case of a corporate obligor, any person who owns 10% or more of the total combined voting power of all classes of stock of such corporation entitled to vote. In the case of a partnership obligor, a 10%-or-more owner means any person who owns 10% or more of the capital or profits interest in such partnership.

A possible concern here is that a "look-through" rule will be applied with respect to an obligation issued by a partnership (that is, an obligation may, for this purpose, be considered "issued" by the partnership as well as the partners). In such event, for purposes of the 10%-or-more owner rule, each partner would be regarded as an issuer of his appropriate portion of the obligation.[33] Because the Code language does not appear either to establish or to permit a look-through rule, however, this interpretation appears unlikely. It also appears unlikely because a possible rationale of the 10% rule is to permit a party related to a less-than-10% partner to receive interest qualifying as portfolio interest from such partnership in order to avoid the complexities inherent in a look-through rule.[34] Since, as noted above, the Treasury maintains that interest on an obligation that is not a registration-required obligation does not qualify as a portfolio interest, it is possible that a look-through rule will be applied for the purpose of disqualifying as portfolio interest all or a portion of the interest paid on obligations issued by partnerships in which, for example, an individual is a partner.[35]

In any event, the statute itself indicates that the concept of 10%-or-more owner applies only to obligors that are corporations or partnerships and not to obligors that are natural persons or estates or trusts.[36] Although broad ownership attribution rules apply for purposes of determining whether one is a 10%-or-more owner of a corporate or partnership obligor (Section 871(h)(3)(C)), these rules do not convert an option to acquire an interest in property owned by a corporation or partnership to an ownership interest in the owning entity. Thus, an obligation issued, for example, by a corporate obligor that provides in one or a series of related documents that the creditor or its affiliate has an option to acquire property of the corporation securing the debt is not likely to be considered an ownership interest in the obligor.[37]

Since portfolio interest does not include interest paid on obligations issued to a 10%-or-more owner, loans made by, for example, a foreign parent company to its U.S. subsidiary will not be covered by the exemption. Of course, denial of the portfolio interest exemption will not affect entitlement to an exemption under an applicable treaty provision and accordingly Netherlands Antilles companies that hold U.S. real estate will continue to be able to pay U.S.-source interest to related foreign persons free of U.S. withholding tax so long as Article XII of the Netherlands Antilles treaty continues to be in effect. For those foreign persons who cannot take advantage of a treaty exemption or do not wish to rely on its availability, it will probably be difficult, although not entirely impossible, to get around the prohibition applicable in the case of a 10%-or-more owner. The Conference Report states: "The conferees understand that taxpayers may attempt to circumvent the foreign shareholder . . . rule . . . by entering into 'back to back' loans, wherein a foreign affiliate of a U.S. taxpayer . . . lends money to an unrelated foreign party that relends that money at discount to the U.S. taxpayer. *The conferees intend that the Internal Revenue Service, when appropriate, use means at its disposal to determine whether back to back loans exist.*" [Emphasis added.][38] Significantly, the quoted language does not say what the effect of a back-to-back loan will be, although the implication is fairly clear. The quoted language will probably be the genesis of Regulations that are likely to incorporate certain of the principles of *Aiken Industries, Inc.*, 56 TC 925 (1971), *acq.*

In *Aiken Industries*, the Tax Court held that an intermediary borrower and lender was to be viewed as a nominee or agent in the case of a back-to-back loan involving identical interest rates in which the intermediary had no economic stake. While the case has been cited by the IRS in connection with letter rulings issued in other areas,[39] it was, at least until the release of *Rev. Ruls.* 84-152 and 84-153, generally distinguished on the basis that in the particular case, the intermediary is not contractually bound to give up all the income it receives. On this basis, it has been the conventional wisdom that if there is an appropriate difference between the interest received and paid by the "intermediary," and if it has significant capital of its own at risk, the transaction will not be viewed as a back-to-back arrangement within the meaning of *Aiken Industries*. Indeed, numerous opinions of counsel issued in connection with an IFS were predicated on this distinction. Thus, it was thought that if the Regulations seek to apply a nominee concept merely because the intermediary has borrowed from a person related to the person to whom the funds are lent, they will be going beyond the general perception of current law. The language used in the legislative history does not appear to support such an expansive reading. To the contrary, the legislative history of the new rules relating to OID of a foreign person uses slightly different language, suggesting that nothing more than the common perception of current law is contemplated.[40]

Nevertheless, possibly as an attempt to head off entrepreneurs from taking advantage of the new rules, for example, in the same manner as has been considered in connection with the repackaging of Treasury obligations, the IRS in *Rev. Ruls.* 84-152 and 84-153 set forth its position on the application of the *Aiken Industries* test to this area. The IRS view is that merely obtaining a spread of, say, one percentage point on a loan will not by itself constitute

a business or economic purpose sufficient to establish that the IFS was more than a mere conduit for the passage of the U.S. company's interest payments to foreign shareholders. Unfortunately, the IRS does not say what would be sufficient. The courts have in other contexts told us that even a minimal "cash on cash" return on the equity invested may be sufficient.[41]

Two comments are in order. First, as has always been the case, to run the *Aiken Industries* gauntlet, it appears that the intermediary must run some risk. The Rulings, however, appear to significantly increase the risk the intermediary must run. Any effort to reduce this risk will put greater pressure on the nominee issue. Second, there are limits to what an intermediary will be able to do without becoming a bank. A bank generally is not entitled to the exemption from tax on portfolio interest, except in the case of interest on Government obligations.[42]

Special rules for controlled foreign corporations. Portfolio interest does not include interest on an obligation received by a controlled foreign corporation (CFC) from a related person.[43] Virtually every IFS will fit within the related CFC category and therefore an IFS will not be able to obtain the benefit of the new exemptions with respect to new debt; old debt does not qualify in any event. A special transitional rule (described below) is provided, however, that in many cases will resolve any "audit" issues arising under Eurodollar financings that were made through an IFS.

While the new exemption applies to a CFC that is not so related to the payor, other special rules are included to ensure that U.S. shareholders thereof do not take advantage of the new rule. Thus, portfolio interest received by a CFC will be includable under Section 951 without regard to the 10% *de minimis* rule of Section 954(b)(3)[44] even in the case where the CFC would have been exempt from such tax under an applicable tax treaty.[45] In addition, other exceptions in Section 881(c)(4)(A) to the application of Section 951 will not apply. While this provision has obvious revenue-raising implications, it will likely discourage CFCs from investing in obligations issued by U.S. borrowers. This appears to be contrary to the policy underlying the exception to the rules of Section 956(b)(2)(F) (relating to investment of earnings by a CFC in stock or obligations of certain domestic corporations) which is to encourage CFCs to invest in obligations issued by U.S. borrowers.[46]

Inadequate exchange of information. If the U.S. determines that the exchange of information between the U.S. and a foreign country is not sufficient to prevent evasion of U.S. tax by a U.S. person, the U.S. may publish a statement to that effect. In such case, the exemption from tax will not apply to interest paid after the publication to persons in that country on obligations issued after that date (Sections 871(h)(5) and 881(c)(5)).

Resolving IFS-related audits

Under a special "transitional" rule in Act, Section 127(g)(3), if an IFS was an "applicable CFC" that was in existence on or before 6/22/84, interest paid to it by its U.S. parent corporation on obligations issued before 6/22/84 will be treated as interest paid to a corporation resident in the country in which the CFC was incorporated.[47] A Senate floor statement indicates that this special rule also applies to "rollovers" of debt provided the total amount of U.S. relendings does not increase and the CFC does not acquire new funds.[48]

Under the transitional rule above, the IRS is, in effect, precluded from contesting the withholding tax issue at least so long as the treaty providing the exemption from withholding remains in effect. This rule applies only if the IFS met the "principles" of certain Rulings issued under the IET and since revoked.[49] It appears that the controlling principles relate to the debt-equity ratio (which cannot exceed 5 to 1) and the use of the capital of the IFS (which could be used to invest in short-term obligations or even deposited with a bank that has lent the money to the U.S. parent that the parent has contributed to the IFS provided such deposit was not held as collateral for that loan).

An "applicable CFC" is defined in Act, Sections 127(g)(3) and 121(b)(2)(D) as a CFC the principal purpose of which consisted of (1) the issuing of obligations in a manner reasonably designed to ensure their sale or resale to non-U.S. persons (and with respect to obligations issued after 1982, interest thereon is payable outside the U.S. and its possessions and the instrument contains a legend to the effect that any U.S. person who holds the obligation will be subject to limitations under the U.S. tax laws), (2) the holding of short-term obligations, and (3) lending the proceeds of such obligations to affiliates.

Significantly, the special transitional rule will continue to be of assistance with respect to a Netherlands Antilles IFS only so long as the tax convention between the U.S. and the Netherlands Antilles remains in effect in its present form. As has been noted earlier, the U.S. and the Netherlands Antilles have been negotiating a new treaty for several years. However, even if the treaty benefits were to be abrogated, the special transitional rule will still resolve withholding issues arising prior to the abrogation.

[30] BNA *Daily Tax Report* No. 177, G-5 (9/12/84).

[31] Treasury Documents on Sale of Targeted Registered Treasury Securities to Foreigners (9/11/84).

[32] Sections 871(h)(3) and 881(c)(3)(B). Moreover, withholding is required where the person required to deduct and withhold the tax knows, or has reason to know, that interest is not portfolio interest by reason of the 10%-or-more owner rule. Sections 1441(c)(9) and 1442(a).

[33] For this purpose, a partner's appropriate portion of an obligation could be determined by, *e.g.*, reference to the cash flow of the partnership (*i.e.*, who bears the cost of servicing the debt), or by analogy to Sections 465 or 752.

[34] *Cf.* Section 897(c)(4).

[35] See Temp. Regs. 35a.9999-5(a), Q&A-1; 35a.9999-5(b), Q&A-8.

[36] Although it is not clear, presumably the 10%-or-more owner rules will apply with respect to a grantor trust if the grantor is a corporation or a partnership. See generally Section 671 *et seq.*

[37] Depending on the terms of the option as well as the other terms of the transaction, a transaction will be treated as either an option (see *Estate of Franklin*, 64 TC 752 (1976), *aff'd* 544 F.2d 1045 (CA-9, 1976)), a loan (see *F.&R. Lazarus & Co.*, 308 U.S. 252 (1939); *Sun Oil Co.*, 562 F.2d 258 (CA-3, 1977), *cert. den.*), or as present ownership in the property (see, *e.g.*, *Frank Lyon Co.*, 435 U.S. 561 (1978)).

[38] H. Rep't No. 98-861, 98th Cong., 2d Sess. 937-38 (1984).

[39] See *Ltr. Ruls.* 8004139, 7931056 and 7406280930A. The IRS applied similar principles in a number of other rulings. See, *e.g.*, *Ltr. Ruls.* 8250028 and 8217104.

[40] H. Rep't No. 98-861, *supra* note 38, at 939-40. ("The conferees intend that the Internal Revenue Service, when appropriate, investigate the capitalization of foreign-owned U.S. corporations issuing OID debt to unrelated foreign parties to attempt to determine whether back to back loans exist.")

[41] For example, in *Frank Lyon Co.*, *supra* note 37, the return on the equity investment was 6%. In the case of an IFS that has a debt-equity ratio of 4 to 1, if funds are borrowed at 10% and relent at 11% and equity capital is invested at 11%, the return on the equity investment, before taxes and before operating expenses (which if the IRS is correct cannot be substantial since in the IRS view the IFS has no substance), would be 15%—not a bad return.

[42] Section 881(c)(3)(A). The term "bank" is not defined in this provision. But see Section 581. *Cf.* Regs. 1.864-4(c)(5)(i) and 1.954-2(d)(2)(ii).

[43] Section 881(c)(3)(C). For this purpose, a "related person" is defined in Section 864(d)(4) to mean (1) any person who is a related person within the meaning of Section 267(b), or (2) any U.S. shareholder (as defined in Section 951(b)) and any person who is a related person (within the meaning of Section 267(b)) to such a shareholder.

[44] Section 881(c)(4)(A)(i). The 10% *de minimis* rule of Section 954(b)(3) generally provides that if the foreign base company income of the CFC is less than 10% of gross income, no part of the gross income of the taxable year will be treated as foreign base company income and hence will not be includable in the gross income of the U.S. shareholders of the CFC.

At first blush, one would have thought that the repeal of the 30% withholding tax on portfolio interest eliminated any withholding tax concerns with respect to the issuance of obligations (including bearer obligations) the interest on which qualifies as portfolio interest. It turns out, however, that before the technical requirements of the backup withholding system were amended by Temporary Regulations, a payor, under certain conditions, would have been required to withhold a 20% tax on certain payments of interest and principal.[50]

Impact of backup withholding

The backup withholding system of Section 3406 applies only with respect to "reportable payments" made after 1983 to payees who have failed to comply with certain information reporting requirements (such as failing to furnish a correct taxpayer identification number). If such a failure arises, the payor is required to withhold a 20% tax from each reportable payment. A reportable payment includes payments of interest on, and the principal of, an obligation if such payments are required to be reported on an information return. Generally, payments of interest on, or principal of, an obligation to a corporation are not subject to such reporting requirements and are therefore generally exempt from backup withholding.[51]

Before the Act, interest subject to the 30% withholding tax was not a reportable payment and was not subject to backup withholding.[52] However, as a result of the Act, such interest is no longer subject to the 30% withholding tax and this exception is no longer applicable to payments of portfolio interest. As a result, in order to avoid backup withholding before the IRS issued the Temporary Regulations, a foreign holder (other than, in general, a corporation) generally was required to certify (on, for example, Form W-8) that he was a foreign person. Such certification is not a problem with respect to a registered obligation since the holder is identifiable by means of the registration system. However, such certification is contrary to the characteristic of anonymity inherent in bearer obligations.

In order to avoid this apparently unintended result, the IRS issued Temporary Regulations that contain an exemption from backup withholding for certain obligations issued in bearer form and certain foreign-targeted registered obligations. A foreign investor who owns or controls a foreign corporation may not find the changes made by the new Regulations particularly significant if either (1) the investor would have no problem certifying that he is a foreign person, or (2) he makes his investments through a foreign corporation. In the latter situation, either the corporation, as a corporation, will generally be exempt from backup withholding without having to provide any documentation,[53] or the foreign investor will have no problem disclosing that the foreign corporation (as opposed to its shareholders) is the owner of an obligation issued by a U.S. borrower. Presumably, such investors will simply acquire, or cause their foreign corporations to acquire, the obligations that represent the best investments, regardless of whether the obligations were in registered or bearer form or whether the obligations were issued on a U.S. market or, say, the Eurodollar market.

The following is a brief summary of the relevant provisions of the new Temporary Regulations. However, the technical details of these complex Regulations (as well as the applicable backup withholding rules) are beyond the scope of this article and should be carefully reviewed when planning transactions in this intricate area.

Generally, these new Temporary Regulations exempt from information reporting and backup withholding interest and principal payments made by U.S. issuers or their agents on obligations issued in bearer form the interest on which qualifies as portfolio interest if the issuer or its agent does not have actual knowledge that a payee is a U.S. person and the payment is made outside the U.S.[54] This exemption, however, does not extend to payments by a person acting in the capacity of a custodian, nominee or other agent of the payee with respect to an obligation if that person is otherwise required to report payments made to the payee. An example of the latter given by Temp Reg. 35a.9999-5(a), Q&A-2, is that of a foreign branch of a U.S. bank holding a bearer obligation on behalf of a customer. The branch is required to backup withhold on payments of portfolio interest unless the branch has documentary evidence[55] in its files that the customer either is not a U.S. person or is otherwise exempt.[56]

Similar rules are applicable with respect to foreign-targeted registered obligations except that, in general, the registered owner of the obligation, if it is outside the U.S. and a financial institution that holds the customers' securities in the ordinary course of its trade or business, must certify, with respect to each interest payment, that the beneficial owner is not a U.S. person. The identity of the beneficial owner, however, need not be given.[57] Finally, these Regulations confirm that with respect to foreign nontargeted registered obligations, backup withholding is generally imposed unless the foreign person certifies that he is a foreign person.[58] In any event, a foreign person who is not interested in preserving his anonymity can avoid backup withholding by certifying his foreign status to the issuer. ☆

[45] See, *e.g.*, U.S.-U.K., Article 11; U.S.-Netherlands, Article VIII.

[46] H. Rep't No. 94-658, 94th Cong., 1st Sess. 216 (1975); S. Rep't No. 94-938, 94th Cong., 2d Sess. 225-226 (1976).

[47] The special transition rule does not apply to obligations issued on or after 6/22/84 even though the Act did not take effect until 7/18/84. Issuers of, and investors in, obligations issued during the 6/22/84 and 7/18/84 "window period" may be adversely affected, on a retroactive basis, by *Rev. Ruls.* 84-152 and 84-153, *supra* note 22.

In recognition of this possibility, the IRS advised that issuers of, and investors in, obligations in process prior to 6/22/84 who believe they have a reasonable basis for relief from the operation of the Rulings for obligations issued during the window period should take advantage of existing procedures under Section 7805(b) to request relief promptly from the IRS. The IRS will grant such requests for relief expedited consideration. IR-84-110, 10/18/84. As previously noted, Eurodollar bonds generally contain call provisions if withholding taxes are applied to interest payments. Since interest rates have generally fallen since the window period, issuers may prefer to call the obligations than to seek this relief.

[48] 130 Cong. Rec. S8417 (daily ed., 6/27/84) (remarks of Senator Wallop).

[49] See *supra* note 5.

[50] See Section 3406 and Temp. Regs. 35a.9999-3, Q&A-34; 35a.9999-5. Temp. Regs. 35a.9999-5(a), Q&A-2, and 35a.9999-5(b), Q&A-11, eliminate information reporting requirements under Sections 6041 and 6049 (relating to reporting for payments of interest) with respect to portfolio interest. Moreover, the definition of portfolio interest is broad enough to cover interest which is effectively connected with the owner's U.S. trade or business as well as foreign-source interest income even though both effectively-connected and foreign-source income would not be subject to Chapter 3 withholding without regard to the portfolio interest exemption added by the Act. There does not appear to be any requirement to file Forms 1042 and 1042S with respect to portfolio interest exempt under the Act unless the interest is paid on a non-foreign-targeted obligation (which as previously discussed must be in registered form for interest thereon to qualify as portfolio interest). See Reg. 1.1461-2(c); Temp. Reg. 35a.9999-5(b), Q&A-9; Temp. Reg. 35a.9999-5(d), Q&A-19.

[51] See Regs. 1.6041-3(c); 1.6045-1(c)(3); 5f.6045-1(c)(3); 1.6049-4(c); Temp. Reg. 35a.9999-3, Q&A-13.

[52] See Reg. 1.6049-5(b)(1)(vi)(A).

[53] See Temp. Regs. 35a.9999-3, Q&A-13; 35a.9999-1, Q&A-22.

[54] See Temp. Reg. 35a.9999-5(a), Q&A-2, -7. See also Temp. Reg. 35a.9999-5(a), Q&A-3 through -6.

[55] For a discussion of the documentary evidence necessary to satisfy this requirement, see Temp. Reg. 35a.9999-3, Q&A-34.

[56] See, *e.g.*, Reg. 1.6049-4(c).

[57] See Temp. Reg. 35a.9999-5(b), Q&A-12 to -17.

[58] See Temp. Reg. 35a.9999-5(b), Q&A-9 through -11.