U.S. TAXATION OF OID INCOME TO FOREIGN PERSONS AFTER THE 1984 TAX REFORM ACT

by Fred Feingold and Frank M. Cappuccio

Fred Feingold is a partner in the New York and Washington, D.C. law firm of Roberts & Holland. Frank M. Cappuccio is an associate in the firm.

In this article, the authors contend that new section 163(e)(3) does not achieve its objective of matching a related party's original issue discount (OID) deduction with the inclusion in income of a related foreign person's OID income. According to the authors, new section 163(e)(3) will allow a deduction for OID only when it is paid by a related party, while a related foreign person must include OID in income prior to such payment in any case in which OID is "effectively connected" with the conduct of a U.S. trade or business of a foreign person and when there is stated interest that is paid currently in addition to OID.

This article is reproduced here with permission.

Copyright, 1984 by Roberts & Holland

Considerable attention has been devoted in the press to certain of the very substantial changes made by the Tax Reform Act of 1984 (the "Act")[1] with respect to the taxation of discount income of U.S. persons.[2] As has been the case in the past, the direct tax[3] effect on foreign persons of discount income in general, and "original issue discount"[4] ("OID") income in particular, has apparently been given less than careful consideration by Congress.

Sections 128(a) and (b) of the Act attempt to do nothing more than expand the scope of the old OID rules, as they affected OID income not effectively connected with a U.S. trade or business,[5] to cover the wider scope of obligations made subject to the general OID rules (at least with respect to payments made 60 days after July 18, 1984 on obligations issued after March 31, 1972).[6] Depending on how one reads sections 128(a) and (b), these provisions may narrow the scope of the OID rules. Similarly, while the purpose of section 128(c) of the Act is to match the time of deduction of OID of a related person with the time of inclusion of OID income of a related foreign person, it will likely accomplish just the opposite. Section 128(c) will require, in many cases, that a foreign person include OID in income before a related person can obtain a deduction for the discount. It is unlikely that the rule adding new section 163(e)(3) to the Code effective with respect to payments made on or after September 16, 1984, on obligations issued after June 9, 1984, could have intended such harsh results. Yet as will be discussed below, if a mere matching was intended, could Congress have overlooked section 267 which already appears to accomplish that objective?

PRIOR LAW

Prior to the Act, section 871(a)(1)(C) subjected "non-effectively connected" OID income of a foreign person to tax when a stated interest payment was "received." The amount of OID income that was taxed was equal to the OID accrued on the obligation since the last payment of interest.[7] However, the total amount of tax withheld on

Tinkering with how OID is taxed to foreign persons appears to have caused a succession of Congresses to have been caught in their own complexity, enacting rules that almost, but not quite, accomplish the stated objective.

[1]Division A of the Deficit Reduction Act of 1984, P.L. 98-369.

[2]*See* IRC sections 1271-88, as added by the Act.

[3]The meaning of direct tax, as used here, is the tax imposed on the foreign person himself. This is to be contrasted with the tax imposed on shareholders of a foreign person on that foreign person's income under the provisions governing foreign personal holding companies, IRC sections 551-58, and those governing controlled foreign corporations, IRC sections 951-64. One aspect of the indirect tax effect on foreign persons under these provisions was dealt with by the Act in its addition of subsection (d) to IRC section 864. This subsection provides that the discount income earned on the purchase of a trade or service receivable from a related person is to be treated for certain purposes as if it were interest on a loan to the obligor under the receivable. Contrast this with the treatment of original issue discount ("OID") income under IRC sections 871(a) and 881, in which OID is treated in a subsection other than the subsection dealing with interest income.

[4]The term "OID" generally means the excess (if any) of the stated redemption price of an obligation at maturity over the issue price of such obligation. *See* IRC section 1273.

[5]IRC sections 871(a), 881. All further references to parallel provisions in sections 871(a) and 881 will refer only to section 871(a).

[6]*See* IRC section 871(g)(1); Act section 128(d)(1).

[7]IRC section 871(a)(1)(C)(iii), as it read prior to the Act.

both stated interest and OID income was not to exceed the amount of stated interest paid.[8] Market discount of a foreign person was generally not subject to tax unless effectively connected with the conduct of a U.S. trade or business. It was treated as income other than interest or OID income.[9]

It has never been made clear why only the OID accrued since the last payment of interest should be subject to tax at the time of the next interest payment rather than all previously untaxed, but accrued, OID. For example, because only OID accrued since the last payment of interest is taxed, it might be possible to pay substantial stated interest and to defer the taxation of much of the accrued OID by making a small stated interest payment at the time a large amount of OID had accrued, and, within a few months, a much larger interest payment at a time when very little OID had accrued since the last interest payment. Apparently, little accrued OID is taxed upon payment of a small amount of stated interest because of the limitation that the amount of tax withheld be no greater than the stated interest paid. Upon the next payment of interest, however, only a small amount of OID will have accrued since the last interest payment and, thus, only a small amount of OID will be taxed upon this payment.

If one assumes that OID income subject to section 871(a) is includable in a foreign person's income on a day-by-day basis...the current formulation of the taxability of OID on the retirement, sale or exchange of an obligation does not work.

Of course, the amount of untaxed, but accrued, OID would still be taxable at the time of retirement, sale or exchange of the obligation. This is accomplished by taxing the amount received on the disposition of the obligation to the extent the amount received by the foreign person would have been considered as ordinary income under section 1232(a)(2)(B) had such section applied.[10] This amount will equal at least the total OID multiplied by a fraction equaling the number of months the person held the obligation over the total number of months in the term of the obligation.[11] However, OID already taxed when stated interest is paid is not to be again taxed.[12] This formulation successfully taxes any previously untaxed, but accrued, OID income.

A problem that arose under prior law was the scope of old section 871(a)(1)(C). Literally read, old section 871(a)(1)(C), by its cross-reference to section 1232(a)(2)(B), suggests that only certain corporate and governmental obligations are covered. The proposed regulations, understandably, adopted a different view, treating all obligations issued after September 28, 1965 which have OID, as within the scope of section 871(a)(1)(C).

The Act clarifies what obligations will give rise to section 871(a)(1)(C) OID income. Section 871(g)(1) states that for purposes of sections 871 and 881, an OID obligation is any obligation (excluding short-term and tax-exempt obligations) having OID within the meaning of section 1273. Act section 128(d)(1) provides that the amendments to section 871 shall apply to payments made on or after September 16, 1984, with respect to obligations issued after March 31, 1972.

THE NEW LAW

The Act modifies the language of section 871(a)(1)(C) but does not attempt to change the method of taxation of OID income as set forth above.[13] One language change has, however, been made which, though it could not have been intended to be a substantive change, could result in an argument that a change was accomplished. Instead of taxing as-yet-untaxed, but accrued, OID on the retirement, sale or exchange of the obligation to the extent the amount received would have been considered ordinary income under section 1232(a)(2)(B), section 871(a)(1)(C)(i) now taxes the amount of *gain* upon retirement, sale or exchange which is not in excess of OID accruing while such obligation was held by the foreign person, to the extent such OID has not already been taxed. Whether this formulation of the rule will give the same result as that prior to the Act will depend on when OID income is includable in the income of foreign persons.

If one assumes that OID income subject to section 871(a) is includable in a foreign person's income on a day-by-day basis as provided by section 1272, the current formulation of the taxability of OID on the retirement, sale or exchange of an obligation does not work. If accrued OID has been included in gross income on a day-by-day basis under section 1272, then the foreign person's basis in the obligation has been increased by this same amount.[14] Ignoring price differences due to changed market conditions, the amount realized on the sale or exchange will be equal to this basis, resulting in no gain upon a sale or exchange of the obligation. This would allow any previously untaxed, but accrued, OID to escape taxation. Such is obviously not the result intended by Congress. Thus, we must examine when OID income is includable in a foreign person's income.

Section 1272(a)(1) generally provides that there shall be included in the gross income of the holder of any debt instrument having OID issued after July 1, 1982, an amount equal to the sum of the daily portions[15] of OID for each day during the taxable year in which such holder held the instrument. This rule applies whether or not the holder of the debt instrument is on a cash basis or an accrual method of accounting. Holders who are foreign persons are not excepted from its operation. Thus, barring an express or an implied exception elsewhere in the Code, foreign persons should include OID in their in-

[8] S. Rep. No. 92-437, 92d Cong., 1st Sess. 76 (1971).

[9] H.R. Rep. No. 98-432 (Part 2) ("House Report"), 98th Cong., 2d Sess. 1304 (1984); S. Rep. No. 98-169 ("Senate Report"), 98th Cong., 2d Sess. 347 (1984).

[10] IRC section 871(a)(1)(C)(ii), as it read prior to the Act.

[11] IRC section 1232(a)(2)(B), as it read prior to the Act.

[12] IRC section 1232(a)(2)(D), as it read prior to the Act.

[13] Nor does the Act generally affect the treatment of market discount income of foreign persons. *See* IRC sections 1276(a)(3), 1278(b)(1). *But cf.* IRC section 864(d).

[14] IRC section 1272(d)(2).

[15] Defined in IRC section 1272(a)(3).

come day-by-day as prescribed by section 1272, regardless of their method of accounting. For example, there appears to be no such exception for OID income effectively connected with the conduct of a U.S. trade or business. Thus, OID income which is effectively connected with the conduct of a trade or business in the U.S. should be includable as it accrues under the rules of section 1272.

Timing of Includability

Whether the timing of the includability of OID income not effectively connected with a U.S. trade or business is similarly controlled by section 1272 is not clear. Section 871(a)(1) provides that certain income is to be taxed at a 30 percent flat rate on the amount "received" by a foreign person. This has led to the assumption that with respect to these income items, foreign persons have been put on a type of cash method of accounting, whatever their normal method of accounting. Perhaps, section 871(a) imposes a kind of "deferred income method of accounting" similar to the method provided by the IRS for the reporting of blocked foreign income.[16] Nevertheless, there appears to be no clear authority on the question.[17] Even if section 871(a) puts foreign persons on a cash basis or hybrid method of accounting, it is unclear that the rule of section 1272 should be negated by the operation of section 871(a), as section 1272 and its predecessors[18] were intended to apply regardless of the debt holder's method of accounting.

It is clear, however, that Congress in making the changes to section 871 in the Act assumed that OID income falling within this section was not to be includable in the gross income of foreign persons until the tax is paid with respect to such income.[19] Both the Senate and the House stated: "[C]urrent inclusion of OID income of foreign investors might present practical enforcement problems. The committee believes that further study of current inclusion is in order."[20] However, it does not appear that Congress truly focused on this issue. In discussing the tax treatment of coupon stripping under present law, as background to the amendment to section 871, they cite a New York State Bar Report,[21] which very clearly assumes that OID falling under section 871(a) was currently includable in income. Nevertheless, Congress did not cite the discrepancy as to assumptions, nor did they discuss it. The New York State Bar Report was prepared and submitted to Treasury prior to the consideration and enactment of the Revenue Act of 1971, which adopted a number of the Report's recommendations as to the manner in which tax should be withheld on OID income.[22] Unfortunately, the legislative history of the Revenue Act of 1971 does not indicate what the then Congress considered to be the proper time for inclusion of OID income under section 871(a).[23]

If Congress thought that there was no current inclusion of OID income, then it must be asked why did Congress feel it necessary to enact new section 163(e)(3)? Section 163(e)(3) (added by section 128(c) of the Act) provides that if any debt instrument having OID is held by a related (within the meaning of section 267(b)) foreign person, any portion of such OID shall not be allowable as a deduction to the issuer *until paid.* As reason for enacting section 163(e)(3), Congress stated that there is no justification for the mismatching of deductions and income inclusion in the case of related party OID debt.[24] If there is no current inclusion of OID income under section 1272, then section 267 would appear to rectify any mismatching that might occur. So why section 163(e)(3)?

Whether the timing of the includability of OID income not effectively connected with a U.S. trade or business is. . .controlled by section 1272 is not clear.

Two reasons, neither one of which is entirely satisfactory, may be postulated as to why Congress should have thought section 267 insufficient to correct such mismatching. The first (and the most far-reaching in its effects) reason is that Congress thought section 267 did not apply to section 871(a) OID income because section 871(a) does not defer the inclusion of such income by imposition of a method of accounting, a necessary prerequisite for the application of section 267. As such reasoning would prevent the operation of section 267 upon any type of section 871(a) income (absent a deferral of income based upon the taxpayer's method of accounting), not many would be willing to assume that Congress did so reason.[25] In addition, such reasoning could lead to a conclusion that section 871 does not defer the time for inclusion of income at all, rather it merely defers the time for taxing such income. This conclusion, however, is directly contradictory to the apparent assumption of Congress that there is no current inclusion of OID income and would, in fact, require that a technical correction to section 871(a)(1)(C)(i) be made in order to allow that provision to have its intended effect.

[16] *See* Rev. Rul. 74-351, 1974-2 CB 144.

[17] *Cf.* I.T. 3020, XV-2 CB 106 (tax on all payments made on or after 7/2/36 to be withheld at rates then in effect, even though such payments were due and payable prior to 7/2/36), *declared obsolete* Rev. Rul. 68-100, 1968-1 CB 572; I.T. 1521 I-2 CB 197 (payment subject to withholding at the rate prevailing for the year in which paid), *declared obsolete* Rev. Rul. 69-45, 1969-1 CB 313; *Southern Pacific Co. v. Comm'r*, 21 B.T.A. 990 (1930) (withholding tax measured by the tax rate effective when payments made, not when interest coupons mature); *cf. also Caulk v. U.S.*, 53-2 U.S.T.C. Para. 9643 (D. Del. 1953) (withholding duty imposed at time of payment—cites above rulings and *Southern Pacific* approvingly).

[18] IRC section 1232A and, previous to section 1232A, section 1232(a)(3).

[19] *See* House Report, *supra* note 9, at 1331; Senate Report, *supra* note 9, at 376; *see also* H.R. Rep. No. 98-861 ("Conference Report"), 98th Cong., 2d Sess. 939 (1984).

[20] *See also* Prop. Reg. 1.871-7(c)(4)(v) (OID includable in income when taxed).

[21] "Taxation and Withholding for OID Realized by Nonresident Aliens and Foreign Corporations," 25 Tax Law. 201 (1972).

[22] *See id.* at 201 fn.*.

[23] *See* S. Rep. No. 92-437, 92d Cong., 1st Sess. 76 (1971); S. Rep. No. 92-553, 92d Cong., 1st Sess. 46-47 (1971).

[24] *See* Conference Report, *supra* note 19, at 939.

[25] *But see* H. Dale, "Withholding Tax on Payments to Foreign Persons," 36 Tax L. Rev. 49, 74 (1980) ("[T]his cash basis notion of taxation, imposed by [sections 871(a) and 881], is probably not a 'method of accounting' within the meaning of section 267(a)(2)(B) [now section 267(a)(2)(A)].").

A second reason for the enactment of section 163(e)(3) could lie in a belief that though section 267 applied, it was not tough enough. This may be illustrated as follows: A person related to a nonresident alien ("NRA") pays $30 in stated interest to the NRA under an OID obligation. At the time of payment, $150 of OID has accrued on the obligation since the last interest payment. Under section 871(a)(1)(C)(ii), $70 of the $150 of OID will be taxed at the time of payment. Thus, a total of $100 in income ($70 OID) is taxed to the NRA at the time of payment. The tax on this is $30—thus, the full $30 must be withheld from the NRA. The end result is that the NRA has been taxed on $100 of income and has received nothing.[26] So far this is the same result as under prior law. However, under section 267, the related person would be able to deduct $100, as this amount is includable in the NRA's gross income.[27] Under section 163(e)(3), the related person is only able to deduct $30, i.e., no more and no less than the stated interest that was "paid" to the NRA.[28] Thus, under section 163(e)(3), the related person's deduction is less than the amount of the NRA's income which is fully taxed by the U.S., a result which is difficult to justify on policy grounds.

If Congress thought that there was no current inclusion of OID income, then it must be asked why did Congress feel it necessary to enact new section 163(e)(3)?

Moreover, it may be noted that section 163(e)(3) applies not only to noneffectively connected OID income, but to effectively connected OID income, a case in which there clearly was no possibility of mismatching of deduction and income—although now section 163(e)(3) will often operate to create a mismatching in which OID income is taxed earlier than when the OID deduction will be allowed. There will also be mismatching created by the interaction of section 163(e)(3) with section 555 and regulation section 1.952-2(b)(1). The latter section and regulation provide, in general, that income of foreign personal holding companies and controlled foreign corporations are to be computed as if the foreign corporation were a domestic corporation. Thus, there would be a current inclusion of OID income by the corporation holding an OID obligation and there would be taxation of OID income under section 551 or 951 without an allowable deduction because the OID has presumably not been paid by the related issuer.

This second reason must be rejected; the stated reason for enactment of section 163(e)(3) was to match OID deductions with OID income and not to mismatch them. It mismatches OID deductions with OID income when the OID income is effectively connected with a U.S. trade or business and it mismatches when OID income is taxed upon the payment of stated interest. It may also mismatch when the foreign person sells the OID obligation prior to maturity, at which time that person is deemed to have received the previously untaxed, but accrued, OID and pays tax thereon. However, is such OID paid by the person who would deduct such OID at that time? If the answer to this question is in the affirmative, then section 267 already accomplishes the objective of section 163(e)(3). Given the multifarious problems posed by section 163(e)(3) and given that it was added in conference, very possibly in haste, there are strong indications that Congress was not truly aware of its wider ramifications.

Source of OID Income

The Act also added an explicit rule to determine the source of OID income. It states that the source of OID income shall be determined at the time of payment (or sale or exchange) as if such payment (or sale or exchange) involved the payment of interest.[29] The rule under prior law would appear to have been much the same.[30] However, it is explicitly provided that the rule given by the Act may be overridden by Treasury regulations. Congress was concerned that the general rule would not always produce the proper source of OID income. It gave as an example a 20-year zero-coupon bond issued to a foreign investor. For 19 of the 20 years the obligor is a U.S. resident. In the 20th year, the obligor becomes a non-U.S. resident. Under the general rule, the entire amount of OID income paid in the 20th year would be foreign-sourced. This is to be contrasted with a 20-year interest-bearing bond with all other facts remaining the same as above. For 19 years the interest payments would have been U.S.-sourced. Congress anticipated that in such a case, regulations could provide that the bulk of the income that arises from the OID on the zero-coupon bond is U.S.-source income.[31] For example, the regulations could allocate the relative amounts of OID to each source according to the relative amounts of time an obligor was or was not a U.S. resident. However, such a calculation would not give accurate results in cases where OID income is calculated on the basis of a constant interest rate, although such inaccuracy may be allowable for the sake of simplicity. Still other alternatives are possible. For example, the source of OID could be determined depending on the residence status of the obligor at the time the OID accrued.

Given the multifarious problems posed by section (e)(3). . .there are strong indications that Congress was not truly aware of its wider ramifications.

The regulation should also clarify what is meant by payment in the context of this source rule. One would hope that payment will mean the amount of income includable in the foreign person's income under section 871(a)(1)(C) and not the amount paid under section

[26] *See* Conference Report, *supra* note 19, at 939.

[27] *See* IRC section 267(a)(2).

[28] *See* Conference Report, *supra* note 19, at 939.

[29] IRC section 871(g)(3).

[30] *See* Reg. 1.861-2. Interest (including OID, Reg. section 1.861-2(a)(4)) is generally U.S.-sourced when the payor is a U.S. resident. Whether the payor is a U.S. resident is generally determined at the time of payment or within the same taxable year as the payment. Reg. 1.861-2(a).

[31] House Report, *supra* note 9, at 1332-33; Senate Report, *supra* note 9, at 377.

163(e)(3), if indeed different definitions apply for the two different provisions. This would appear to be the result intended by Congress and would avoid the questions inherent under section 163(e)(3) as to when OID is paid under that section. For example, in the case described above in which $30 was to be paid as stated interest, what is the amount of OID paid when the foreign person is taxed on $30 of stated interest and $70 of OID? It could be $0, $21 (70 percent of $30), or $70.[32] However, it is unclear which it is.

CONCLUSION

Tinkering with how OID is taxed to foreign persons appears to have caused a succession of Congresses to have been caught in their own complexity, enacting rules that almost, but not quite, accomplish the stated objective. The Act is no different in this respect from prior legislative attempts in this area.[33] With the aid of hindsight we can see that the possible technical deficiency in amended sections 871(a)(1)(C)(i) and 881(a)(3)(A) could be remedied by deleting the words "any gain not in excess of." Whether this would have occurred to us in the heat of a legislative session is perhaps another matter. Again, with the aid of hindsight, we think it obvious that section 163(e)(3) should be repealed. The mismatching feared by Congress has already been dealt with by section 267.

[32]The Conference Report, *supra* note 19, indicates that $70 of OID would not be considered paid for purposes of IRC section 163(e)(3).

[33]*See* S. Shajnfeld, "Original Issue Discount and the Foreign Investor—More Uncertainty About United States Treasury Bills," 36 Tax Law. 293 (1983) (exhaustive discussion of treatment of OID in context of taxation of foreign persons marks the complexities and uncertainties created by legislation up to and including the Tax Equity and Fiscal Responsibility Act of 1982).

TREASURY NEWS

TREASURY OFFICIALS TO VISIT EUROPE AND JAPAN TO DISCUSS TARGETED TREASURY ISSUES. *The Treasury issued the following news release on August 31, 1984:*

STATEMENT BY THE DEPARTMENT OF THE TREASURY

At the direction of Donald T. Regan, Secretary of the Treasury, senior Treasury officials will visit Japan and European financial centers during the week of September 10 to discuss the upcoming issue of Treasury securities targeted to foreign purchasers. Dr. Beryl Sprinkel, Under Secretary for Monetary Affairs, will lead a group to Japan, and Dr. David Mulford, Assistant Secretary for International Affairs, will lead a group to Europe. Both groups will discuss questions concerning the design of the securities, tender and delivery procedures, certification procedures and other matters.

Dr. Sprinkel will hold meetings in Tokyo from September 10 through September 12. Dr. Mulford will hold meetings in London on September 10 and 11, Zurich on September 12, Frankfurt on September 13 and Amsterdam on September 14. The meetings will be with financial institutions, including securities firms, and institutional investors in the various countries.

The full text of the Treasury news release has been placed in the September 10, 1984 Tax Notes Microfiche Data Base as Doc 84-6035.

MEETINGS AND SEMINARS

NATIONAL REAL ESTATE DEVELOPMENT CENTER WILL SPONSOR SEMINAR ON TAX-EXEMPT REAL ESTATE FINANCING. The National Real Estate Development Center (NRDC) will sponsor a two-day seminar on tax-exempt real estate financing on October 4-5 in San Francisco. Topics to be discussed include floating rate bond variations, the mechanics of the key credit-enchancement techniques, IDBs, alternative credit enchancement sources, recent innovations in floating rate IDBs for commercial and industrial projects, and interest-rate swaps to hedge risks on floating rate deals. The faculty for the seminar will be headed by William Henze, a partner at Jones, Day, Reavis & Pogue in Dallas. For further information, contact NRDC, 16th Floor, Suite 5, 4853 Cordell Avenue, Bethesda, MD 20814, or telephone (301) 657-8068.

GEORGETOWN UNIVERSITY TO SPONSOR A SEMINAR ON REAL ESTATE SYNDICATION. The Georgetown University Law Center Continuing Legal Education Division will sponsor a two-day seminar on real estate syndication on the following dates in the following cities: October 18-19, Washington, D.C.; December 5-6, New York. Topics to be discussed include the 1984 tax act, securities developments, real estate issues, original issue discount rules, tax shelter reporting provisions, IDB provisions, audit and penalty provisions, regulation D update, and government-regulated real estate. The seminar will be chaired by Stephen W. Porter and Joseph E. Resende, both of Washington, D.C. For further information, contact the Georgetown University Law Center/CLE Division, 25 E Street, N.W., Fourth Floor, Washington, D.C. 20001, or telephone (202) 624-8229.